Democracy and the Evolution of Corporate Governance

Pierre-Yves Gomez* and Harry Korine

Under what conditions do stakeholders consent to a regime of corporate governance? We propose that consent by the governed in corporate governance cannot be satisfactorily explained without reference to the collective value of procedural fairness that underlies markets. Drawing on the social psychology of justice and the political economy of social choice, we highlight the critical role played by democratic procedures in achieving consent by the governed in modern society. This line of reasoning leads us to suggest that the evolution of corporate governance, too, can be understood in terms of Tocqueville's well-known hypothesis that democracy eventually prevails in all spheres of organised activity. Examining the historical record of institutional reform in France, Germany, the United Kingdom and the United States, we find that corporate governance has indeed evolved to make increasing use of democratic procedures. Viewed over the long-term of two centuries of capitalist development, corporate governance is seen to have successively incorporated enfranchisement, separation of powers and representation. In conclusion, we consider the implications of basing the study of corporate governance on the question of stakeholder consent and the practice of corporate governance on the procedures of democracy.

Keywords: Political economics, evolution, corporate governance, democracy, activism

Introduction

Under what conditions do stakeholders consent to a regime of corporate governance? The dominant orientation in research on corporate governance, agency theory, is built on the premise that corporate profit satisfies individual preferences and thereby ensures general consent. While agency theory relies purely on the market in resolving the question of consent, influential scholars in contemporary political economy stress that social choice depends upon collective values (cf. Harsanyi, 1955; Sen, 1970; Rawls, 1971; Etzioni, 1990). In this view, markets still constitute the ultimate selection mechanism for (corporate) governance forms, but the collective values of society create the context within which markets operate and choices are made.

Corporate governance can be understood as a set of contracts that defines the relationships among the three principal actors in the corporation: the *sovereign*,[1] who in the vast majority of modern legal systems is the shareowner; the *governed*, namely all stakeholders, including owners of shares; and the *governing*, who direct and/or control the corporation. Analogously based on the voluntary contractual triad of sovereign, governed and governing, and equally embedded in a society of natural law, corporate governance shares with modern political governance a common root in consent by the governed.

Consistent with the perspective articulated in the political economy of social choice, we propose that consent by the governed in corporate governance cannot be satisfactorily explained without reference to the collective value of procedural fairness that underlies markets. Drawing on the social psychology of justice (Thibaut and Walker, 1975; Soltan, 1987; Lind and Tyler, 1988; Tyler, 1990) and the poli-

*Address for correspondence: IFGE/EM Lyon, BP 174, 69132 Ecully Cedex, France. Tel: +33 4 78 33 79 61; Fax +33 4 78 33 79 27; E-mail: Gomez@em-lyon.com

tical economy of social choice (Rawls, 1971; Sen, 1989; Mackie, 2003), we highlight the critical role played by the procedures of democracy in achieving consent by the governed in modern society. This line of reasoning leads us to suggest that the evolution of corporate governance, too, can be understood in terms of Tocqueville's well-known hypothesis that democracy eventually prevails in all spheres of organised activity (Part 1). Examining the historical record of institutional reform in France, Germany, the United Kingdom and the United States, we find that corporate governance has indeed evolved to make increasing use of democratic procedures. Viewed over the long-term of two centuries of capitalist development, corporate governance is seen to have slowly and successively incorporated the fundamental democratic procedures of enfranchisement, separation of powers and representation (Part 2). In conclusion, we consider the implications of basing the study of corporate governance on the question of stakeholder consent and the practice of corporate governance on the procedures of democracy.

Part 1. Consent by the governed, collective values and corporate governance

The question of consent in the agency theoretical treatment of corporate governance

Most economic research in corporate governance occurs within agency theory (cf. Aguilera and Jackson, 2003), and a large proportion of sociological and political research in corporate governance positions itself in reference to and indeed against agency theory (cf. Roe, 1991; Davis and Thompson, 1994). Agency theoretic research in corporate governance is a specific application of a broader theory of the firm built around information economics (Jensen and Meckling, 1976; Fama, 1980; Holmstrom and Tirole, 1989) and property rights (Alchian and Demsetz, 1972; Alessi, 1983). By the general hypothesis that individuals are self-interested and can be opportunistic, efficiency in controlling information and reducing transaction costs is posited as the selection mechanism that determines both the forms of organisation and the forms of corporate governance (Jensen and Meckling, 1976; Jensen 2001). Corporate governance forms in place then represent a successful, market-rational adaptation of corporate institutions (Fama and Jensen, 1983a, 1983b). The same criterion which applies to managerial decisions – profit-maximising efficiency – also applies to the choice of corporate governance forms (Hayek, 1960). This view of governance posits that the search for profit renders the diverging individual interests of the governed compatible; the social choice of consent is based upon the stakeholders' acceptance of profit maximisation as the rationally legitimate framework of their behaviours (cf. Weber, 1947 [1922]).

Agency theoretic research in corporate governance has been subject to multiple criticisms – of its ideological foundations (Ellerman, 1992; Engelen, 2002), of the importance it accords to ownership (Blair, 1995; Donaldson and Preston, 1995), of the realism of its assumptions (Canella and Monroe, 1997; Davis and Greve, 1997), and of its neglect of political and social contexts (Pound, 1989; Whitley, 1999; Roe, 1994, 2000). In many of the critiques, agency theoretic research is reproached for being too narrowly economic and not taking the points of view of other social sciences into account (Fligstein, 1990; Turnbull, 1997). Reversing the common thread of these critiques, we argue that corporate governance research based upon agency theory is not too narrowly economic, but, rather, represents only a narrow slice of economic theory on questions of social choice.

The importance of collective values in the economics of social choice

The process whereby free individuals with different preference functions reach collective choices has for a long time been an important subject of study in economics (see Mandeville's Fable of the Bees [1714] for a very early discussion and Arrow (1951), March (1978) for overviews). From the Paradox of Condorcet to the research of Arrow (1951), economists have recognised that socially acceptable order does not emerge spontaneously from individual choices. Running across the intellectual spectrum from the strict individualism of Gary Becker (Becker and Murphy, 2001) to the social welfarism of Amartya Sen (1970, 1989, 1997), economists share a profound interest in understanding how collective decisions emerge. In Sen's words, the aim of social choice theory is to find a "rational basis for making such aggregative judgments as 'the society prefers this to that,' or 'the society should choose this over that,' or 'this is socially right'" (1989, p. 349). The common thread in the study of social choice is the importance of collective values in enabling decisions for society while maintaining individual freedom. Thus, whether collective values are described as ex ante "ethical preferences" (Harsanyi, 1975, 1978, 1982) or as ex post "principles of justice" (Rawls, 1971), they constitute a *necessary* set of conditions for collective decisions and mitigate the anarchical tendency of social systems (Arrow, 1951). Collective values ensure that institutions are compatible with individual freedom and support the constitution of modern (economic) society (Charkham and Simpson, 1999; Arrow, 1974; Rawls, 1971; Sen, 1970).[2]

Collective values, procedural fairness and consent by the governed

Surprisingly, research in corporate governance has to date paid only limited attention to the findings of the economics of social choice. Emphasis has been placed on the study of the efficiency of corporate governance forms, to the detriment of careful inquiry on the collective values that underlie markets and enable the social choice of consent by the governed. What are these collective values? In the social psychology of justice, consent by free individuals is seen to require agreement on the essential elements of what makes a particular form of governance fair and just (cf. Thibaut and Walker, 1975; Soltan, 1987; Tyler, 1990). The perceived fairness of any system depends on both procedural and distributive considerations, in other words, procedures and outcomes. Since fair procedures ensure a fair distribution of outcomes over the long term, regardless of initial position, traditions as diverse as social psychology, economic philosophy and legal studies (i.e. Thibaut and Walker, 1975; Rawls, 1971; Lind and Tyler, 1988) accord prime importance to the fairness of procedures in the achievement of consent (Dahl, 1971). Perhaps just as importantly from the point of view of identifying collective values, a large body of empirical research demonstrates that procedural fairness concerns are widely shared, both across contexts and across cultures (Lind *et al.*, 1978; Leung and Lind, 1986). We therefore propose that procedural fairness can also provide a basis for understanding consent by the governed in corporate governance research.

Procedural fairness and the procedures of democracy

A fair process of governance (1) preserves individual freedom of behaviour and (2) makes possible the promotion of individual choices. Procedural fairness thus implies equal treatment and protects voice. Although the meanings given to procedural fairness in law, social psychology and other applications differ in their nuances (cf. Greenberg, 1986; Lind and Tyler, 1988), equal treatment and voice are consistently seen as the fundamental building blocks. In the context of modern governance, it is the procedures of democracy that ensure the maintenance of equal treatment and the protection of voice (i.e. Mackie, 2003). On the definition of the procedures of democracy, if not on their merit or effectiveness, there is a strong consensus in the literature of political science. Authors as far apart in time and space as early thinkers Rousseau, Madison and Tocqueville, on the one hand, and contemporary theorists such as Dahl (1956), Gastil (1986) and Mackie (2003), on the other hand, agree that the procedures of democracy cover enfranchisement, separation of powers and representation with (public) debate.

> *Enfranchisement*: in accordance with the Enlightenment's philosophy of equal treatment and individual freedom (Locke), the law is the same for every citizen, and every citizen has the freedom to act independently, within the limits set by private property rights.
>
> *Separation of powers*: again in the tradition established by the Enlightenment (Montesquieu), a separation obtains between the powers of direction (the executive) and control (the legislature and the judiciary) to prevent the abuses of autocracy and to ensure the protection of individual freedom.
>
> *Representation with public debate*: in a system where sovereignty is delegated to representatives, in contrast to authoritarian regimes built on secrecy and information monopoly, democracy welcomes differences of opinion, and the expression of differences reinforces consent to decisions made by strengthening individual freedom.

It is important to note that what we call the procedures of democracy are not seen as a system of moral values but rather as a *technique of governance*, or what Foucault called a "political technology" (1980, pp. 440–452). The procedures of democracy are techniques that ensure the fairness of the decision-making process.

Tocqueville's democracy hypothesis[3]

If consent by the governed can be achieved through the procedures of democracy, the question to be asked of the evolution of modern governance is to what extent different spheres of organised activity, including corporations, have incorporated these procedures over time. The temporal relationship between governance and democracy was described most memorably (if not uniquely) in Tocqueville's well-known democracy hypothesis.

Much like Kant's famous peace hypothesis (cf. Hess and Orphanides, 2001), Tocqueville's democracy hypothesis has stood as a long-term reference for scholarly inquiry (cf. Marshall, 1987 [1949]; Rueschmeyer *et al.*, 1993).

To Tocqueville, all of history can be read as the slow, but inexorable struggle of the collective values underlying democracy, namely the values of fairness and equality of condition, to assert themselves. It is Tocqueville's central hypothesis that democracy constitutes the sole model of acceptable governance in modern society and will eventually prevail in all spheres of organised activity.

> *When one runs through the pages of our [European] history, one finds so to speak no great event in seven hundred years that has not turned to the profit of equality (DA, Introduction, p. 5). In whichever direction we cast a glance we perceive the same revolution continuing in all the Christian universe. Everywhere the various incidents in the lives of peoples are seen to turn to the profit of democracy (DA, Introduction, p. 6). . . . The gradual development of equality of conditions is, therefore, a providential fact and it has all the principal characteristics of one: it is universal, enduring, each day escapes human power; all events, like all men serve its development (DA, Introduction, p. 6). To wish to stop democracy would then appear to be to struggle against God itself and it would only remain for nations to accommodate themselves to the social state that Providence imposes on them. (DA, Introduction, p. 7). It appears to me beyond doubt that sooner or later we shall arrive, like the Americans, at an almost complete equality (DA, Introduction, p. 12).*

Faithful to the traditions of the Enlightenment and analogous to Foucault (1980), Tocqueville views democratic governance as a technique for institutionalising the practices of power and supporting consent: democracy "draws a formidable circle around thought" (DA I, 2, 7, p. 244). It is important to note that Tocqueville's hypothesis is not presented as a moral judgement, but as an analytic result (cf. DA, Introduction, p. 12). Accordingly, we also find in Tocqueville the same three basic procedures of democracy identified by classical and modern writers – enfranchisement, separation of powers and representation.

> *Enfranchisement: Then with none differing from those like him, no one will be able to exercise a tyrannical power; men will be perfectly free because they will all be entirely equal and they will be perfectly equal because they will be free. This is the ideal toward which democratic people tend (DA II, 2, 1, p. 479). Each one, having a particular good to defend, recognizes the right of property in principle (DA I, 2, 6, pp. 227–228).*

> *Separation of powers: The right of direct the official presumes the right to discharge him if he does not follow the orders that one transmits to him, or to raise him in grade if he zealously fulfills all his duties [. . .] One should indeed be careful, for an elective power that is not to be subject to a judicial power sooner or later escapes from all control or is destroyed (DA I, 1, 5, pp. 69–70).*

> *Representation: In America, the people name those who made the law and those who execute it; they themselves form a jury that punishes infractions of the law. Not only are institutions democratic in their principle, but also in all their developments; thus the people name their representatives directly and generally choose them every year in order to keep them more completely under their dependence (DA II, 1, 1, p. 165).*

Tocqueville's hypothesis in historical perspective

Tocqueville's hypothesis did not meet with unanimous approval, particularly in the 19th and early 20th centuries. Reactionaries regularly denied the inevitability of democracy and appealed for new authoritarian forms (Schmitt, 1988 [1927]). The resistance of the old order was often countered by ideologues who believed that democracy could not be truly achieved by history and the will of God (cf. DA, Introduction, p. 7) alone and sought to impose a popular democracy by revolution. As a result of these struggles, the world has seen ups and downs of democracy, corruptions of democratic governance and at least temporary reversals of it.

However, over the long term, the empirical validity of Tocqueville's hypothesis is difficult to refute. Marshall's seminal essay (1987 [1949]) showed that equal treatment and its corollary, democratic decision-making, had become the main reference points: first in civic life from the end of the 18th century onwards, with the principle of equality before the law; then in political life from the first third of the 19th century, with the principle of one person/one vote; and, finally, in social life from the first half of the 20th century, with the principle of equal social rights. Since Marshall's corroboration of Tocqueville's hypothesis some 100 years after the publication of "Democracy in America", democratic decision-making has continued its expansion, spreading into many other areas of social life, as pushed by an "iron law of democratization". In terms of political governance, Gastil's benchmark surveys (1986, 1996) show that the proportion of what he calls "free" (democratically governed) countries has increased significantly in recent years, reaching a very high level (1996: 40 per cent free; 72 per cent partially free). Indeed, although scholars may not agree on the nature, the salience or the desirability of democratic values, the spread of the *procedures* of democracy in the political and social spheres is generally seen as critical to the development of capitalism as a whole (Schumpeter, 1987 [1942]; Rueschmeyer, 1993). In our time, democratic procedures – enfranchisement, separation of powers and representation – have come to represent the ultimate standard for judging the acceptability of the exercise of authority and power in most spheres of organised activity (Huntington, 1991).

If democratic procedures are essential for consent by the governed in modern society, and if these procedures are extending to *all* spheres of organised life, then the question of their relevance to the evolution of corporate governance merits examination.[4] Should Tocqueville's hypothesis hold true, we ought to be able to observe, over time, the incorporation of democratic procedures as points of reference for evaluating the fairness of corporate governance forms. The following section reconsiders the evolution of corporate governance over the last two centuries in light of Tocqueville's hypothesis.

Part 2. Reconsidering the evolution of corporate governance

Based on the seminal summary of Berle and Means (1932) and extensions made by institutionalists and agency theorists, scholars describe the evolution of corporate governance in terms of changes in the relationship between ownership and control (Chandler 1962, 1977; Galbraith, 1967; Fligstein, 1990). One speaks of three major periods, each with its own model of reference for corporate governance, a model that comes to be accepted as standard for the times and is generally adopted, whether a company is large, or small, listed, or unlisted (Frentrop, 2003). The first period is typified by the dominance of the founding family and stretches from the Industrial Revolution to the 1920s; the second period is marked by the rise of the professional manager and prevails from the 1920s to the 1970s; and the third period, with its origins in the 1970s, is characterised by increasing accountability to society. These three periods are presented as distinct stages in the history of the corporation, each with its own model of reference for corporate governance. By examining the historical record in the four largest Western economies, France, Germany, the United Kingdom and the United States, we will show that each period can be interpreted as a further step in the deployment of the procedures of democracy in corporate governance. Although far from exhaustive, this sample of four countries has the benefit of theoretical variety (cf. Yin, 1984). Corporate governance research situates the United Kingdom and the United States at one end of a market-society continuum and Germany at the other, with France located somewhere in between, depending on the institutions under study (cf. La Porta *et al.*, 1999). If Tocqueville's hypothesis can be validated in such diverse contexts, then our proposition's claim to generality is significantly strengthened.

Familial governance and economic enfranchisement

The primary distinction between pre-capitalist and capitalist forms is private ownership of the means of production (North, 1973; Furubotn and Pejovich, 1974). The birth of the new economic order involves two steps: first, the establishment of property rights for industry; and, subsequently, the removal of the requirement of public authorisation for incorporation. The French *Code du Commerce* (1808), the American legislation on *General Incorporation* (1811 for New York) and the English *Joint Stock Company Regulation and Registration Act* (1844), represent the first step in a fundamental reshaping of the notion of economic sovereignty. These acts of legislation open the right to the ownership of a business corporation to any individual who can afford it, independently of social status, class or heredity and establish that each owner of property has equal rights before the law.

However, until the second part of the 19th century, the incorporation of the limited liability company is subject to public authorisation and therefore remains highly restrictive in practice. The removal of the requirement of public authorisation for incorporation takes place over a 20-year period commencing around 1860 (United Kingdom 1856; France 1867; Germany 1870; but also, Spain 1869; Belgium 1873, Hungary 1875 and Italy 1882). This latter development in property rights represents what has been called the "Magna Carta" of emerging shareowner power (Ripert, 1951, p. 63): individuals are definitively emancipated from the public authority, and shareowners acquire full sovereignty over the corporation. This is indeed a revolution. Individuals may now freely create, buy and sell shares of ownership in a corporation. We can say that corporate governance in the 19th century puts in place the first defining element of democratic procedure – economic enfranchisement.

However, that is not to say that the corporation of the 19th and early 20th centuries is governed by the procedures of democracy – equal rights to ownership only establish economic enfranchisement. If we trace the beginnings of capitalism as we know it today to the Industrial Revolution, the most striking characteristic from a corporate governance point of view is the lengthy dominance of the founding family. Apart from very few exceptions, and across nations, the family firm represented the model of reference for corporate governance throughout the 19th and the early 20th centuries (cf. Bourguignon and Levy-Leboyer, 1998; Kaeble, 1990; Coffee, 2001). Since the family both owns and manages the assets of the corporation, there is no separation of powers in the corporation. And since decisions are made in secret family council, there is no representation of stakeholders outside the family and no public debate. Indeed, the new entrepreneurs who more often than not are commoners benefiting from the new legal order, appear to recreate the institutions of the old regime, constituting veritable dynasties of industry: the Dupont de Nemours in the US, the Siemens or the Haniel in Germany, the De Wendel or the Boussac in France, and the Courtaulds in the United Kingdom, to name just a few of the most prominent business families.

In a pattern that we will see repeats itself through the different periods of capitalism, the establishment and practice of democratic procedures in corporate governance *temporally lags* the practice in political governance. Whereas the major upheavals of the late 18th century lead to the political institutionalisation of enfranchisement, separation of powers and representation in much of 19th century America and Europe, business adopts a form of governance that is much closer to aristocracy, with a concentration of power and a lack of representation and public debate. As lucidly noted by Tocqueville at the very beginning of this new era,

> *Thus, as a mass of the nation turns to democracy, the particular class occupied with industry becomes more aristocratic. Men show themselves more and more alike in the one, and more and more different in the other, and the inequality increases in the small society as it decreases in the great. Thus, when one goes back to the source, it seems that one sees aristocracy issue by a natural effort from within the very heart of democracy. (DA, II, 3, 20, p. 532)*

Managerial governance and the separation of powers

Towards the end of the 19th century already in some industries and ever more widely after World War I, familial governance starts to reach its limits. Firms are becoming bigger and more complex, requiring greater financial resources to continue growth than single families can provide and broader managerial skills than possessed by the typical owner/manager and his offspring. Great corporations grow out of once small family businesses and need professional management to deal with the new challenges of size, product diversity and modern manufacturing, even in those cases in which ownership remains in family hands.

These developments are now very well documented, with substantial research to show by when the large-scale transition to managerial governance is accomplished in the different countries under consideration: the late 1920s in the United States and in France (Levy-Leboyer, 1985), somewhat earlier in Germany (Stahl, 1973) and only after World War II in the United Kingdom (Florence, 1961; Hannah, 1976). In many, if not all cases, familial governance cannot cope with the changed economic conditions of the 20th century and managerial governance arises to take its place (cf. Berle and Means, 1932; Chandler, 1962, 1977).[5]

With the takeover of the professional manager in the early 20th century, corporate governance integrates the separation of powers, the second defining element of democratic procedure. Under managerial governance, ownership and control are separated, with owners providing capital and leaving managers to control the business of the firm (Veblen, 1921; Berle and Means, 1932; Burnham, 1941). The limited liability corporation becomes the dominant legal form in all Western economies, and a series of laws are enacted to more strictly define and circumscribe corporate institutions (Bourguignon and Levy-Leboyer, 1998; Cheffins, 2002; Frentrop, 2003).

In the era of managerial governance, laws are passed and codes are written that favour the separation of ownership and managerial control: for example, securities laws concerning the obligation of disclosure in the US, 1933 and 1934; company laws making a board of directors compulsory in France, 1940 and 1943; and laws establishing the two-tier board in Germany, 1947 and 1957. With this type of legislation in place, corporate governance takes on many of the practices of political democracy. Thus, the most general structure for a publicly held company includes an annual shareholder's *meeting* that *votes* on major corporate issues, an *elected* board of directors that oversees professional management, and, in some jurisdictions like Germany, owner and worker *representatives* on the board (Roe *et al.*, 1993). Most significantly, the power of the board to hire and fire managers is supposed to put in place a *counterweight* to managerial authority (cf. on the US, David and Soref, 1981; Mizruchi, 1983; on Germany, Joly, 1996).

These historical changes notwithstanding, one cannot describe the adoption of the procedures of democracy in corporate governance as a straightforward process (cf. Kaufman and Zacharias, 1992). In effect, the managerial revolution leads to the replacement of the old capitalist aristocracy by a new capitalist technocracy (Stanworth and Giddens, 1974). Although in theory *independent* of management, in practice, the corporate board is often controlled by a "managerial technocracy" (Galbraith, 1967; Bourdieu, 1998). Shareowners and other stakeholders are typically excluded from the board in favour of managers from other companies (Jensen and Meckling, 1973; Monks and Minow, 1995).

Popular governance and representation

Demonstrated economic efficiency notwithstanding, managerial governance begins to meet resistance. The great business challenges of the last decades of the 20th century – technology, deregulation and globalisation – reveal the limitations of a system that put too much control in the hands of managers. On the one hand, centralisation of managerial authority proves inefficient in far-flung multinational corporations that need to be able to act swiftly in global markets (Bartlett and Ghoshal, 1989; Korine and Gomez, 2002). On the other hand, the withdrawal of the state from large swathes of activity and the concentration of economic weight in a few, very large, corporations, raises new questions about corporate social responsibility in decision making (Wartick and Cochran, 1985; Freeman, 1986; McGuire *et al.*, 1988).[6] The manager is called upon to both decentralise authority inside the corporation and respond to a broader set of demands from stakeholders outside the corporation. These developments go to the heart of the definition of the manager's job and undermine the technocratic claim to authority and specialised expertise (Useem, 1984).

At the same time as the professional manager is grappling with major challenges, the nature of ownership is also undergoing a fundamental shift. With the increase of equity-based retirement financing, with the development of employee stock plans, and with the privatisation of numerous large enterprises around the world, the number of individuals who own shares has grown approximately tenfold to 250 million over the last 20 years (to 2002). This increase is not limited to the United States (85 million), but extends also to such non-traditional homes of individual share ownership as Germany (18 million), and France (6 million, of which 2 million are shareholding employees). Share-owning individuals in such large numbers signify a new force in corporate governance, a force we call mass ownership and wish to differentiate from dispersed ownership as described by Berle and Means and assumed by many agency theorists (cf. Fama and Jensen, 1983a).

If mass ownership led merely to a further dilution of shareholdings, its consequences for managerial governance in the publicly held company would be negligible. However, mass ownership and pension reform have given birth to a new class of institutional shareholders that is sufficiently well organised and intrinsically motivated to take its concerns to management (Gilbert, 1956; Pound, 1988, 1989; Monks and Minow, 1995; Monks, 1998).[7] Laws enacted in the United States since the 1970s to protect the individual's pension fund savings require institutional investors to actively monitor and vote their holdings (i.e. Erisa 1974, Avon Letter 1986). As a consequence, engaged institutional investors have fought to gain more information from and rights over management – sometimes even engaging in a public debate that has engulfed the courts, the legislatures and the press (cf. Davis and Thompson, 1994; Brancato, 1996). Engaged investment reached a first peak in the United States with the 1980s battle over corporate control. The movement has since spread to Europe where individual pension funds such as Hermes in the United Kingdom and shareholder rights organisations such as the Institutional Shareholders Committee in the United Kingdom, ADAM in France or Association of Critical Shareholders (Dachverband der Kritischen Aktionärinnen und Aktionäre) in Germany have played, amongst others, a major role in its expansion.

In general, the form taken by engaged investment and the influence it yields depend on the possibilities inherent in pension law and shareholder rights. Studies have shown that although institutional investor engagement is increasing, its effect on corporate conduct and performance is not straightforward (for an overview, see Romano, 2002). The practice of offering proposals to the general assembly has no significant effect (Del Guercio and Hawkins, 1999; Gillan and Starks, 2000); by contrast, engagement has a positive effect when institutional investors use non proxy techniques such as threats to sell and direct negotiations with executives (Smith, 1996; Wahal, 1996). Further studies based on data from the 1990s until today should show that the impact of investor engagement is increasing, as indicated by the number and public reach of recently contested cases (i.e. Eurotunnel, 2003, in France and the UK; Mannesmann, 2004 in Germany; and Disney, 2004, in the United States).

However, shareowners are not the only actors in the emerging popular governance. Stakeholders as diverse as unions, churches, NGOs and multilateral institutions such as the United Nations Organisation are becoming actively involved in the governance of corporations and their views are of concern to both publicly owned and privately held businesses. In many cases, these stakeholders are re-occupying the space abandoned by national governments in the successive waves of trade liberalisation and industry deregulation that characterised the half-century following World War II (O'Sullivan, 2001). Non-shareowner stakeholders draw the legitimacy to speak out on corporate affairs from a variety of sources: moral, political and also professional. Whether shareowner or not, activist stakeholders share two characteristics: (a) they are vitally interested in the future of corporations and (b) they are large enough in number and well organised enough to seek representation in corporate deliberations.

As the visionary Peter Drucker foresaw many years ago (1976), managerial governance faces a crisis: how can managers whose very jobs are being redefined pretend to understand and act for the interests of many thousands of increasingly well organised shareowners and other stakeholders? A view maintained by many in the 1990s suggested that the creation of shareholder value (managing for a higher share price) could reconcile the interests of *all* the different stakeholders of the corporation (Jensen, 2001). The problem with this view is that shareowners as diverse in character as employees, pension funds, responsible funds (10 per cent of the US market) and hedge funds can have radically different opinions on *how* shareholder value ought to be created (Goodstein and Boeker, 1991; Sherman *et al.*, 1998). Mass ownership and stakeholder activism imply a diversity of expectations regarding the performance of the corporation, and managers need to address the different concerns of stakeholder groups to gain and maintain the consent that could be taken for granted in the heyday of managerial governance.

Over the last 30 years, then, we can observe a struggle for the right of representation and public debate in corporate governance. Characterised by mass ownership and growing stakeholder activism in all four of the countries under consideration in this study, capitalism today makes much more open and intensive use of debates and contests than it did in the past (Romano, 2002; Turnbull, 2002), and differences of opinion are subject to increasing media attention.

Recent actions to raise the number and enlarge the role of independent directors (Higgs Report, UK, 2003; Bouton Report, France, 1999), to require funds to declare how they vote in shareholders' meetings (SEC, 2002; Loi de modernisation, France, 2003) and to make the responsibilities of the executive versus shareholders and third parties explicit (Sarbanes-Oxley, US, 2002), all go in the direction of opening the institutions of corporate governance to the representation of different stakeholder interests and to debate, especially in cases where major strategic decisions are being contemplated. Executives are put under pressure by shareholders, analysts and journalists to explain their actions (reports, road shows and interviews), not only in the United States, but also in France, Germany and the United Kingdom. If executives and members of the board make significant errors of judgement, they are today increasingly likely to be questioned and, if they cannot prove that their choices were based on clear information and open debate of different points of view, to be removed from office. In this questioning of executives and members of the board, the extent to which decision-making procedures that guarantee a separation of powers and an open, representative contest of ideas have been respected often carries as much, if not more weight than the outcome of the decision itself.

Democracy and corporate governance: an overview

In summary, we can say that the evolution of corporate governance models with reference to Tocqueville's democracy hypothesis in the four countries under study has been accomplished in stages, with each new stage integrating one more of the three defining elements of democratic procedure and reinforcing what was established in the previous stage (see Table 1 and accompanying explanatory footnote). The diachronic lens of analysis we have adopted demonstrates a link between

Table 1: The evolution of corporate governance and the procedures of democracy[8]

	19th century–1920s	1920s–1970s	1970s–21st century
Model of reference for corporate governance	Familial	Managerial	Popular
Economic enfranchisement	*Implementation*. Creation of rights to ownership independent of social standing	*Reinforcement*. Strengthened by law and corporate practice. Public general meetings become standard	*Reinforcement*. Strengthened by new rules on the right to vote; protection of minority interests
Separation of ownership/control	No	*Implementation*. Generalisation of the limited liability form, with boards and disclosure requirements	*Reinforcement.* Increasing board supervision over managers
Representation with public debate	No	No	*Implementation.* Mass ownership; stakeholder activism

the evolution of corporate governance and the application of democratic procedures. This is consistent with Tocqueville's hypothesis. A long-term view suggests that the need to achieve consent by the governed has served to orient not only political and social governance, but also corporate governance.

Conclusion

Corporate governance depends upon consent by the governed. If one contends with political economy that consent depends upon collective values centred upon fairness, then one cannot assume with agency theory that profit is a *sufficient* condition for consent by the governed (although it is a *necessary* condition). Consistent with modern research evidence that fair decision procedures underlie acceptable governance in modern society, Tocqueville hypothesised that democracy would become the model form of governance for all spheres of organised activity. We have built on Tocqueville's hypothesis, demonstrating that corporate governance forms appear to evolve in relation to the procedures of democracy and are accepted (or contested) by the governed in reference to these procedures. Our review of how laws and practices have developed over the last two centuries in the four largest Western economies shows that corporate governance has come to incorporate economic enfranchisement, separation of powers and representation. In this sense, the procedures of democracy can be said to constitute the deep structure (Gomez and Jones, 2000) of modern corporate governance.

Considering the procedures of democracy as points of reference in the long-term evolution of corporate governance forms opens new avenues for understanding differences and convergences among countries. From our conclusions, we can draw the contours of a research programme in corporate governance that articulates a comparative perspective around the procedures of democracy. By comparing corporate governance forms first within countries, then across countries, and finally in practice along the dimensions of enfranchisement, separation of powers and representation, it will be possible to elaborate on Tocqueville's hypothesis and identify the boundary conditions of our approach. Three specific research directions are suggested.

Research direction 1: Diachronic analysis, country by country. Implicit in our argument is the proposition that corporate governance co-evolves with political democracy. This is a hypothesis that can be tested and further developed by means of country-specific study. Indeed, it is necessary to tackle the question country by country, taking into account not only the passing of formal laws and directives concerning corporate governance (Roe, 1991; Albert, 1993), but also the actual practice of corporate governance in general meetings and board rooms. It will be particularly interesting to compare the different categories of ownership (entrepreneur, family, state, public, investment, etc.) with reference to the same social environment. The procedures of democracy are likely to play out quite differently in the different categories, thus shedding light on alternative meanings and differential rates of adoption over time.

Research direction 2: Synchronic analysis, across countries. Our development of Tocqueville's hypothesis suggests a way of reconciling different points of view on the critical question of convergence of corporate governance forms across countries (Bratton and McCahery, 2002; Guillén, 2000; Boyer, 1996). In our view, convergence is a reality, because modern societies all implicitly (or explicitly) build on the procedures of democracy as the model for fair governance. Functional convergence (Coffee, 1999) may have its proximate cause in the imitation of fund-raising practices (Davis and Marquis, 2002), but we would look for its underlying drivers in the spread of democracy accompanying the globalisation of capitalism. Conversely, profound, persistent differences in corporate governance between countries (i.e. Laporta *et al.*, 1999) may not merely be the result of contingent path dependencies (Licht, 2000), but might be traced to country-specific differences in the relationship between political democracy and the adoption of democratic procedures in corporate governance.

Research direction 3: Study of current corporate governance reforms. The larger part of policy-oriented discussion takes the extant form of institutions as given and revolves around designing structural improvements. If such discussion were embedded in a broader historical appreciation of the adoption of democratic procedures, advisors and policymakers alike might revise their approach. The composition and functioning of the corporate board, for example, could not be reduced to questions of expertise and (committee) independence. Rather, the role of the board, and with its role, also composition and functioning, would need to be examined in light of the board's responsibility to the governed. The more pressure for democracy exerted by the governed at a particular moment in time, the more representative the board likely needs to be. In general, if corporate governance were understood to evolve in the long term with reference to the procedures of democracy, then advisors and policy-makers might be more likely to offer choices and corporations more likely to adopt solutions that have the robustness to stand the test of time.

Research conducted along the three directions suggested here takes the procedures of democracy as the basis of comparing different forms of corporate governance. Our research plan complements the traditional comparison by economic performance, explicitly incorporating the country-specific collective values necessary for consent by the governed. Reference to the procedures of democracy also grounds the study of corporate governance in a long-term, historical perspective. In building the basis for objective comparison along the dimensions of space and time, we are proposing a return to the methodology that Tocqueville used to such powerful effect.

> *It appears to me beyond doubt that sooner or later we shall arrive, like Americans, at an almost complete equality of conditions. I do not conclude from this that we are destined one day necessarily to draw the political consequences the Americans have drawn from a similar social state. I am very far from believing that they have found the only form of government that democracy can give itself; but it is enough that in the two countries the generative cause of laws and mores be the same, for us to have an immense interest of knowing what has produced in each of them. (DA intro. 12)*

Notes

1. The shareowner's claim to sovereignty has been called into question in socialist (Ellerman, 1992) and stakeholder (Turnbull, 1997) critiques. In capitalistic economies, the owner of capital is granted property rights and sovereignty over the corporation by definition. We do not discuss the merits of this definition, but take it as a starting point for this paper.
2. The very fact that economists have deep divergences over what forms the basis of collective (ethical) values, human nature (Hayek, 1960) or community (Etzioni, 2003) underlines the salience of this discussion in economics.
3. All citations are taken from the Mansfield and Winthrop edition (2000) of *Democracy in America*, The University of Chicago Press, Chicago. DA stands for Democracy in America, followed by the book in Roman numerals, the part, the chapter and the page number.
4. It is common to argue that the business corporation cannot be governed by the techniques of democracy. The distinctive character of the corporation in this view is based on two premises: first, that the corporation, unlike other institutions of society, is exclusively profit oriented and that stakeholders (i.e. shareholders) in the corporation, unlike citizens, participate by choice and are always free to exit. This view ignores that the profit-oriented corporation exists only within the

limits of the collective values accepted by individuals. Moreover, it underestimates both the possibility of exit in civic society (i.e. emigration) and the importance of voice in all types of governance (Hirshman, 1970), including corporate governance.

5. It is important to distinguish between form of ownership and governance model. Evidence from France and Germany (cf. Bourguignon and Levy-Leboyer, 1988; Berghahn, 1985) shows that the managerial model (strong management; uninvolved ownership) also obtains under conditions of concentrated shareholdings. In France and Germany, the most typical case has been that of large (block) holdings that do not exert their influence, either because the individual firm is only one of many in a bank or insurance company's vast portfolio, or because the owners have no competence or interest in the management of the companies they hold (e.g. state-owned companies).
6. It is worth noting that national governments have played a central role in shaping the institutions of managerial governance, as shown by Roe (1994) and Coffee (2001) for the case of the Anglo-Saxon economies, Gomez (2002) for the French, and Berghahn (1985) for the German. As the nation state has come under pressure from globalisation, so have the institutions of managerial governance that the nation state helped create.
7. The engaged (institutional) investor is typically not a large block holder and differs from the large block holder traditionally seen in Germany and France in several important ways: (1) is not associated with management; (2) is not represented on the board; and (3) has no commercial relations with the corporation. These differences allow the engaged investor to take a more independent view, but imply greater difficulty in making its voice heard.
8. In interpreting the table, it is important to remember the distinction between governance model and ownership form. Over the last 200 years, multiple ownership forms (family, partnership, cooperative, government, listed, etc.) have co-existed and will undoubtedly continue to do so in the future. In fact, family-owned firms far outnumber all the other forms put together. However, the model of reference for corporate governance for all these different ownership forms has changed over time. Thus, for example, the family-owned firm of today is not governed in the same way as it was in the 19th century. Instead, corporate governance in the family-owned firm of the 21st century is likely to integrate separation of ownership and (non-family) professional management, a board of directors including non-family members, a significant amount of disclosure, and an explicit policy for responsiveness to stakeholders.

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Pierre-Yves Gomez is a full professor of Strategic Management at EM Lyon (France). He is director of the French Corporate Governance Institute. His research focuses on micro-economic and political foundations of management science. He has been conducting research on new micro-economic models on collective utility functions and their application to strategy and organization. He is currently working on the links between corporate governance and strategy. He has published several books in French and English including *Trust, Firm and Society* (1997) and *The Leap to Globalization* (2002) and articles on economics and strategy.

Harry Korine is a Teaching Fellow in Strategic and International Management at the London Business School and a Senior Research Fellow at the French Corporate Governance Institute. His academic research and investment management practice bridge the fields of corporate governance and strategic management. Together with Pierre-Yves Gomez, he is currently working on a new book "A General Theory of Corporate Governance", scheduled for publication in 2006 by Cambridge University Press.