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The Elephant in the Room: Benchmarking Behavior of Corporate Governance

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ABSTRACT: *The recent failures of corporate governance can be attributed to individual choices and systemic, organizational failures. One cause appears to be the inability of corporate governance members and regulators to create and enforce regulations and rules that address both individual and systemic or organizational shortcomings. However, corporate governance rules and regulations should not hinder the necessary economic actions that drive corporations' successes. This paper evaluates previous empirical evidence on the "engagement" or norms of the system of corporate governance and values demonstrated by individuals in the system. We further analyze German, Japanese and U.S. governance models in an attempt to integrate this model of corporate governance. We also evaluate the previous literature on implementation of values and norms in corporate governance with a recommendation on integrating specific behaviors in the corporate governance system to enhance trust between shareholders, stakeholders, and the society at large.*

Keywords: Corporate Governance, Economic Personalism, Integrated Social Contract Theory

In the wake of corporate failures from Enron to Lehman Brothers, corporate governance has become a prominent issue on the political and business landscape. Lawmakers in the United States reacted to corporate failures with the passing of the Sarbanes-Oxley Act of 2002, which represents the most drastic corporate reform legislation since the Great Depression (Bazerman, et. al., 2002). This sweeping legislation brought to light the workings of and interactions of the critical corporate governance groups of management, the board and shareholders. Of course, public company managers have fiduciary duties towards their shareholders; however, some Chief Executive Officers (CEO's) have suggested that excessive regulation and overly strict auditing procedures may impede the ability of companies to grow effectively (Lawrence et. al., 2004). It appears that the lack of benchmark values by individuals and the lack of norms adopted with the corporate governance system contributed to corporate failures (cite).

The questions then become what benchmark values and what system norms. A key element to "what benchmarks and norms" is the framework or paradigm adopted by individuals and the organization. The paradigm also must address the relationship between individual behavior and the system. Individual behavior manifests itself through the individuals who are members of the critical groups of the corporate governance system: management, the board and shareholders. The system guides the interaction between the critical groups. The need for an evaluation of the benchmarks and norms of corporate governance system may be due the current norm of managerial autonomy (Pazzaglia, 2010). Pazzaglia (2010) contends that this autonomy leads to opportunistic behavior. Therefore, the current corporate governance systems often results in a focus on the short-term, encourages a disengaged board of directors and distances shareholders.

A corporate governance system that integrates both individual benchmarks with system norms is needed. For individual benchmarks we look to economic personalism. Economic personalism focuses on the human person in the economic system emphasizing the values of individual responsibility (O'Boyle, 1998; Fontrodona & Sison, 2006). Each transaction in which the individual engages should enhance the individual as a total human person. This benchmark value sees corporate governance as individuals who act freely with self imposed limits, self interestedly but with regard for others and who recognize that humans have worth and dignity beyond measure of monetary gains and losses (O'Boyle, 2001). For the norms of the corporate governance system, we adopt integrated social contract theory which defines the economic activity of an enterprise in terms of duties and rights to the society in which the enterprise operates. Adoption of this simple paradigm by corporate managers would dismiss the need for excessive regulation and long lists of rules on the corporate code of conduct. In this paper, we explain further this "Engagement" framework which ideally focuses on increasing firm performance through individual members' of the corporate governance system adoption of economic personalism philosophy and the adoption of norms consistent with the integrated social contract paradigm for the corporate governance process among individuals and groups.

System of Corporate Governance

Lawrence et. al (2004) define stakeholders in a corporate governance system as eight interconnecting parties: shareholders, board of directors, executive management, employees, suppliers, environment, community and customers. The importance of corporate governance lies in the fiduciary duty of executive management to stockholders, society, customers and employees. Good corporate governance fundamentally ensures a management team that is openly accountable to the board and a board that, in turn, is accountable to shareholders and that all are accountable to the society at large. Success is dependent on trust and personal integrity of the parties involved, and trust and integrity are demonstrated by providing information transparency and open communication channels.

Corporate governance is a system of principles and rules established on behalf of all stakeholders, employees, shareholders/creditors, consumers, and society, that hold public companies accountable (Dion, 2005). Accountability simply means to call for responsibility of both the rewards and consequences of its actions. Further, we argue that accountability need not be controlled by regulation or law, but also by benchmarks instilled in the individual and norms adopted in the corporate governance system. Once this paradigm becomes an integral part of personal decision maker and the corporate system, corporations are accountable.

Fukuyama (1995) contends that trust is an important lubricant of any well-meaning social system. Trust is required to maintain any type of market stability and market viability. Thus, trust is also one of the outcomes of accountable corporate governance. Success is also defined here as maximizing societal and stakeholder value rather than the misconstrued notion of maximizing shareholder wealth. Value can be broadly defined to include not only profit making but making society better, providing a good product, and employing and enhancing good citizens. This definition of success and value is supported by Lorsch (2008), who argues that maximizing shareholder return is required only upon the breakup of the corporation or upon a change of control.

Economics Personalism, Personal Integrity and Corporate Governance

Economic personalism, insists that the community to which the corporation must be accountable includes all with a stake in the corporation (O'Boyle, 1998). The logic of this view focuses on all who invested in time, effort, skills and talent in the corporation's development, and include not only management, the board and the shareholders, but customers, employees, consultants, and society at large. All have a stake because the corporation would not be a viable enterprise without all their effort, and both the corporation and the stakeholder depend on each for a secure and long-term relationship (O'Boyle, 1998).

Economic personalism assumes that the individual economic decision maker acts by producing, distributing, exchanging, consuming, saving, investing and innovating; and these actions, in turn, change him/her as a human being (O'Boyle, 1998). Virtuous behavior accumulates personalistic capital by investing in good habits (Becker, 1996) such as personal integrity. S/he understands that s/he is not an autonomous economic actor but a person integrated into a system of economic interdependence (O'Boyle, 2001). Further, research finds that personal values do affect business decisions such as investment decisions (Pasewark and Riley, 2010). The corporate stakeholders trust or rely on the integrity (Random House, 2001) of the individual decision makers to act to benefit all stakeholders and society, as they are dependent on the corporation and the corporation on them.

One of the principles of economics personalism is subsidiarity where higher units of society should not undertake functions that are better handled by lower units of society (O'Boyle, 1998). Subsidiarity helps limit the abuse of highly centralized decision helping to lower the risk of large-scale and society-pervasive mistakes. The concept of subsidiarity reduces the likelihood of centralized bad decisions resulting in firms that are "too big to fail" or require government bail outs. Research has shown, however, that concentration of ownership may resolve conflict among stakeholders in a corporation. However, it may also trample on minority interests (Becht, et. al, 2005) In the corporate governance system, adoption of economic personalism as a value system would have managers, board members and shareholders understand their dependence on all stakeholders and spread decision-making to the units where it is best handled - all through transparency.

Additional principles of economic personalism include equivalence where buyer and seller or worker and employee have two duties. They must exchange things of equal value and impose equal duties (O'Boyle, 1998). An economy functions best when it maximizes personalistic capital verses economic capital and a corporate system of governance is one that promotes personalistic capital while making a profit necessary for the continuation of the enterprise (O'Boyle, 1998).

Social Contract Theory and Integrated Social Contract Theory

The social contract model of organizations, as explained by Donaldson (1989), views all productive organizations such as corporations as engaged in an implied contract with society. Therefore, reciprocal obligations exist on the part of the corporation and the society. The social contract model recognizes the importance of the corporation which activities provide increases in productivity through combined, rather than individual, effort of corporation and society, enhancing the benefits of both the producers of products (Brink, 2010) and services as well as the consumers.

Donaldson (1989) further explains that the social contract model differs from the shareholder model and the stakeholder model in that managers and the board not only owe a duty to the shareholders or even stakeholders but the managers have supplementary business responsibilities to the society. The norms and laws of society generate these additional responsibilities. The stakeholder and shareholder models address much of what is in the social contract model; however, these models have difficulty distinguishing between the duties to shareholders and stakeholders and supplementary business responsibilities. Thus, the responsibilities of the manager under these models are confused when conflict occurs between various stakeholders (Donaldson, 1989).

Corporate governance under the social contract model includes many claims on the corporation - not only the explicit contracts between shareholder, board and management but implicit claims from all stakeholders and society. For example, Brink (2010) confirms that the corporation has implicit claims due to employees. There are responsibilities that include moral obligations as well as legal obligations generated from the society in which the corporation resides (Donaldson, 1989). This responsibility generates the ability for parties to trust the organization.

Further, Donaldson (1989) list three conditions under which a corporation should operate in a capitalist society. First, productive organizations should enhance the **long-term** welfare of employees and consumers in any society in which the organization operates. Second, productive organizations should minimize the drawbacks associated with their operations. And third, productive organizations should refrain from violating minimum standards of justice and of human rights in any society in which they operate. Wettstein (2010) extends this condition to an obligation to protect the standards. Therefore, all parts of the corporate governance system are obligated to honor the conditions of operations under its social contract. By operating under these conditions, the corporation has voluntarily accepted this obligation, and trust is the reliance by stakeholders/society that this duty includes protecting their rights and interests (Greenwood and Van Buren, 2010).

Donaldson furthers the social contract theory to what he and Dunfee (1994, 1999) call the integrated social contract theory. In their research, they address the "ought" of social contract theory with the "is" of the corporate environment (Donaldson& Dunfee, 1994). They contend that individual decision makers possess "bounded moral rationality" meaning they can or do not always know what is right because the business context may be enormously complex. Further, the business context is generally created by common business practices and culture can have an impact (McCarthy and Puffer, 2009). As such, a system that keeps in check "bounded moral rationality" can help evaluate decisions within the corporate environment and, in fact, can be stipulated (Donaldson & Dunfee, 1994). Therefore, we can define the system of norms and rules to assist the individual in making decisions that are right.

Sacconi (2006) extends integrated social contract theory to incorporate corporate social responsibility by attempting to define the benchmarks needed to assess management and board behavior. He does this by defining Corporate Social Responsibility "as a model of extended corporate governance whereby those who run a firm (entrepreneurs, directors and managers) have responsibilities that range from fulfillment of their fiduciary duties towards the owners to fulfillment of analogous fiduciary duties towards all the firm's stakeholders." Sacconi proposes that conflicts among stakeholders should be resolved via a bargaining mechanism. Benchmarks are sought through agreement among stakeholders. The benchmarks include trust and self- regulation (Sacconi, 2007) which we define as part of personal integrity.

Managing the Corporate Governance System and Enhancing Trust

Trust is a fundamental aspect of the moral treatment of stakeholders (Greenwood and Van Buren, 2010). Donaldson and Dunfee (1994) would call trust in a business context an authentic norm grounded in the society at large. Carlton and Lad (1995) note that social contracting is the process by which trust is created and sustained in on-going contractual relationships. Working under the model of corporate governance that individuals act under the values of economics personalism and that the system of a corporation's governance is bound by its social contract, we look at the relationships between key groups in the corporate governance system – managers, the board, and shareholders. The relationships provide the governance mechanisms that can enhance trust in an organization (Verhezen, 2010). The value system of economics personalism and the maintenance of the social contract require the establishment and maintenance of societal and individual trust.

William W. George, former CEO of Medtronic, (Spaulding et al, 2006) notes that governance starts and ends with the board of directors. The board, he believes, has an overarching responsibility to preserve and build the enterprise (Spaulding et al, 2006). Instead of maximizing short-term shareholder value, which may have a detrimental effect on the organization's long-term viability, the board should move to an enterprise doctrine of long-term, contribution to society promoted under social contract theory. Furthermore, the board committees must instill trust among individuals and groups in the corporate governance system and must instill trust among parties in the society. This is true because if the leaders of the corporation are perceived as trustworthy then trust increases throughout the organization and with society (Caldwell, et. al, 2010). That trust can only be maintained through independence of various parts of the corporate governance system. Impartiality or independence has been defined as a "hypernorm" under integrated social contract theory (Sama and Shoaf, 2005). The hypenorms refer to fundamental principles that have enjoyed broad consensus over time and across cultures (Sama and Shoaf, 2005). Independence creates trust as group and individual motivations are not compromised by conflicting interests. Therefore, board committees, particularly audit and compensation, must be independent from the organization's individuals who are responsible for profits (Lorsch and Simpson, 2009).

Management generally is responsible for profits, and likewise, should be independent from the board and shareholders in order to maintain the trust. Kaufman et. al. (2004) suggest that the positions of chairman of the board and Chief Executive Officer (top manager) be held by two different individuals in order to maintain independence in the corporate governance system. Similarly, Estanislao and Norton (2010) suggest that the chairman of the audit committee should be independent of management. These conditions on the governance system of the corporation facilitate trust due to the independence among parties.

In addition to independence of individuals and groups in the corporate governance instilling trust, independence of information between groups and among individuals is essential in promoting trust. The relationship between top management and board of directors and between the board and shareholders in corporation has always been a precarious one. The reason according to Kanter (2010) is poor access and deficient information as a result of the dependence of the board on management to provide them with appropriate information.

Further, trust is assured through voice as well as independence. For Pound (1995), trust would be increase in the relationship between the board, management and shareholders if the transition to a “governed” environment occurs. By “governed” he means a corporation where managers, shareholders and the board all have a voice and the result of that voice must be reported. Taylor and Curtis (2010) note that voice, in their example of whistle blowing among public accounting auditors, is an important form of corporate governance. To ensure that a voice occurs for all, a record of individual directors’ votes on key corporate resolutions in proxy statements must be made available to all stakeholders and society at large (Kaufman et al, 2004).

For Nadler (2004), the board having a voice relates to board type. He suggests three board types. The first type of board is the passive board whose main objective is to ratify management decisions. The second type of board is the operating board whose main responsibilities include making key decisions which management then implements. And the third type of board is the engaged board, which actively assists the chief executive in his decision-making. A key concept Nadler introduces with his three board types is the relationship between active participation and active reaction. Voice here is not merely having a say, but a say in the implementation and review of results. When boards become less involved, as was the case at Enron and WorldCom, their main role is to react to adverse situations rather than engaged participation to prevent such situations. Thus, the centerpiece of corporate governance from Nadler’s postulation is the need to engage the board in active participation in policy making, execution and assessment of activities. Again, the engaged board leads to trust through independence and voice.

Siciliano (2002) disagrees with the engagement of all parties in all activities of the corporation suggesting that a more focused role for the board is needed in terms of its control functions and strategy implementation. However, Lorsch and Carter (2004) articulate a more engaged corporate governance structure of the board known as the “empowered board” contending that an empowered board consists mainly of directors from outside the company (independent from management), that the board is small enough to be a cohesive group, that members range in expertise, that they communicates freely with and without management (voice), and that the directors receive independent information (independence) about the company’s financial and product performance (Lorsch and Carter, 2004). Therefore, the implication for the board is to not micromanage top management, but rather to fully engage in policy making, policy execution and accountability for results on behalf of the shareholders, stakeholders and society at large.

The “empowered board” as asserted by Lorsch and Carter (2004) resembles Nadler’s (2004) third type of board. The “enlightened board” by Brink (2010) recognizes the responsibility to employee stakeholders, but the “engaged board,” recognizes that the board to be an active participant in the corporate activities while recognizing that the ultimate responsibility of any board is accountability to society. O’Higgins (2010) notes that there are engaged firms that have at their heart’s the long-term sustainability of the company. “An engaged firm attempts to safeguard itself into the future by creating a self-perpetuating virtuous cycle that is good for all stakeholders, including owners, enabling it to serve two purposes simultaneously.”
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Additionally, transparency is a key element to an engaged board system**.** Transparency has also been defined as a hypernorm or a fundamental principle under integrated social contract theory (Sama and Shoaf, 2005). As Louis Brandeis and Norman Hapgood said in their 1914 treatise Other People’s Money, and How the Bankers use it, “Sunlight is said to be the best of disinfectants…. Disclosure is needed and to be effective….. knowledge of the exact facts must be communicated to the investor.” (Kaufman et al, 2004). Further, perceived transparency by a corporation has been found to enhance stakeholders’ willingness to collaborate with the organization (Vaccaro and Echeverri, 2010).

Moreover, an engaged or empowered board is an effective monitor of the corporation’s activities. Monitoring is also an effective way of establishing trust in addition to independence, voice and transparency. This notion is supported by Jensen and Meckling (1976) who note that the importance of monitoring by the board of management to make corporate activities effective.
Further, Jensen and Meckling (1976) posit that independence; transparency and monitoring through voice, information disclosure, and board engagement increase trust among the parties in the corporate governance system and with society. An actively engaged board monitoring management on behalf of shareholders, stakeholders and society provides for corporate activities that are effective. Further,

independence of board members and management members enhance trust in the system (Jensen and Meckling, 1976). Monitoring, transparency, voice and independence address the important elements needed for the engaged board. Let us now discuss a key characteristic of individual members of the board.

Board Member Selection and Personal Integrity

Kaufman et al (2004) emphasize the importance of directors having the right mindset. Under economics personalism, the right mindset would include a value system of personal integrity which includes the value of subsidiarity where a decision is greatly weighted by information from those most affected by the outcome of the decision and the value of equivalence where equal value and equal duties occurs in all exchanges. Under social contract theory, personal integrity promotes trust in the corporation with society by encompassing independence, transparency, monitoring and voice. Therefore, it is essential that selecting the right people to form the board of directors is vital to the effectiveness of the board. Kaufman et al (2004) further state, "(Corporate Governance) reform efforts unduly emphasize several narrow aspects of board composition." The Sarbanes-Oxley Act, for example, prescribes a heavy dose of independent directors. Trust under Sarbanes-Oxley, therefore, is established through a system promoting independence. Under Brink's (2010) enlightened board, board composition should include employees. However, it is not just the job a person holds that makes him /her a good board member but his/her person integrity, and personal integrity includes many aspects including independence of mind, business credibility and high moral character (Kaufman et al, 2004).

Monitoring as well as independence is an essential aspect of personal integrity. Personal integrity is demonstrated when a person knows his/her limitations and monitors his/her actions and decisions based upon his/her competence. Nadler (2004) notes that certain competencies and skill sets are required of all directors, such as industry expertise, financial expertise, nonconformist mindset, confidence, and teamwork. A person with personal integrity would not allow him/herself serve on a board unless s/he had the appropriate skill set. Enron is an example of a board that was comprised of board directors who were of professions (politician, college professor, medical doctor) that did not prepare them for the skill set needed to properly run an energy company (Guardian, 2002). Similarly, Fannie Mae and Freddie Mac also show monitoring by politically skill people is not necessarily the right skill set for governance of a mortgage company (Fannie Mae, 2011). Nadler (2004) further indicates that in order to foster constant individual improvement to ensure continued personal integrity, there must be mechanisms in place such as annual constructive self-assessments to define the board member's role in the corporate governance system.

Contingency theory states that there is no best way to organize a corporate governance system; however, context and structure must fit together (Drazin and Van de Ven, 1985). It is for this reason that, as stated above, an engaged board is most effective (Nadler, 2004). An engaged board is transparent while promoting personal integrity. Thus, a structure must limit every board to no more than three insiders of Chief Executive Officer, Chief Financial Officer and Senior Vice President of Human Resources. These three positions on the board help provide access to information for the other board members. Therefore, a board member who provides access to all information to other board members shows personal integrity through transparency.

Economic personalism requires individual Board members to practice subsidiarity and equivalence. Equivalence implies equal duties and value in all exchanges. A restriction on directors from serving on more than two boards and a ban on stock sales by directors for the duration of their terms promote equal duties and value in all exchanges that the director engages in rather than receiving preference in transactions that others do not receive. Time limits on board appointment further promote equivalence by limiting long relationships from clouding decision judgments.

Subsidiarity is promoted by not centralizing all decisions and keeping the place of the decision at the level of the organization where the parties are most affected. For example, if the board has a requirement that every board appoint a lead director who can convene the board without the CEO this allows decentralizing decision making when needed. A requirement that independent outsiders are assigned to the audit, compensation, and nominating committees further enhances protection for those stakeholders most affected by the corporate decision.

While serving on a board, the board member must exercise his/her voice. This is an essential aspect of the personal integrity of the board member. Speaking to a decision and providing expertise helps the corporation operate more efficiently and effectively. Furthermore, voice promotes discussion and adds to transparency to the decision making process.

It is pertinent, therefore, to question whether it is possible to create a structure that will operate efficiently and fairly, despite the fact that there is a separation of ownership and control (Monks, 2004). Due to this separation of ownership and control, it is essential that the board consist of individuals with personal integrity demonstrating equivalence and subsidiarity, exercising voice and monitoring with independence and transparency.

Rules of Engagement or the Process of the "Engaged" Board

The "engaged" board monitors management through personal integrity, transparency, independence and voice. See diagram 1 for an illustration of the "engaged" board model. However, how does the board know the wishes of shareholders and stakeholders? How can we practically improve shareholder and stakeholder (society) involvement in order to govern corporations effectively?

Becht, et. al. (2005) see conflicts among shareholders, stakeholders and society as a collective action problem on corporate governance and focus on five mechanisms to mitigate the problem. Three of the mechanisms to mitigate the problem involve board action: the delegation and concentration of control in the board, the clear definition of fiduciary duties for CEOs, and the alignment of managerial interests with investors through executive compensation. The other two mechanisms address mitigation through concentration of ownership by shareholder. We, however, address the conflict resolution through personal integrity, transparency, independence, monitoring and voice in the corporate governance system. This is consistent with Donaldson and Dunfee (1994) who state in their Integrated Social Contract Theory that conflicts in norms should be resolved through a priority scheme in favor of what society sees as important and then what subgroups or subsystems may see as right. Thus, the values of independence, voice, transparency and monitoring with personal integrity are societal values applied to the subsystem of corporate governance.

Shareholder Involvement

Emmons (2003) outlines some key solutions to shareholder involvement:
1. Institutional shareholders of public companies should see themselves as owners rather than investors (This would promote monitoring.)
2. Shareholders should not be involved in the day-to-day affairs of the operations of a company (This would allow for an independent vision.)
3. Shareholders should evaluate the performance of the directors regularly (Again, monitoring the board promotes trust.)
4. In evaluating the performance of directors, shareholders should become better informed (More information sharing leads to trust through transparency.)
5. Shareholders should recognize and respect that the goal of governance is to ensure the ongoing prosperity of the company. (Economic personalism recognizes that the long-term viability of the organization is beneficial to all to contribute to the organization.)

These suggestions promote trust of the corporation through independence, transparency and monitoring practiced not only by the board but by shareholders as well. Voice through shareholder activism also promotes trust. Sjostrom (2010) notes that shareholders can be norm entrepreneurs persuading others to adopt new standards of appropriateness. Shareholders, she further contends, are change agents for corporate responsibilities. Since institutional investors hold a substantial amount of American public stock (Binay, 2005), their involvement is essential to changing corporate governance behavior. There is a fundamental distinction between shareholders who view the company, as would an owner and shareholder as opposed to as an investor and shareholder. An owner generally has greater sensitivity for long-term prospects. It is also important to acknowledge that not all institutional shareholders have the same objective. Therefore, the shareholders who invest long-term would view certain strategic initiatives, such as a hasty sell-off of assets or a hostile takeover, detrimental to long-term health. Meanwhile, the short-term institutional investor is most certainly focused on short-term prospects such as quarterly results. This represents a significant dilemma in corporations where the "shareholder owners" and "shareholder investors" do not share the same goals.

The establishment of real "ownership" of equity in America's corporations may be impossible because shareholders, stakeholders and society have an interest in the equity of the corporation (Lorsch and Simpson, 2009). The questions become: Who should act as long-term owners? Should institutional investors act as true long-term owners, and if they cannot, then to whom and for what should directors be accountable? Becht, et. al. (2005) find that the resolution of the conflicts of interests among investors is difficult and varies across countries. Further, they note that "regulation of large shareholder intervention may provide better protection to small shareholders but such regulations may increase managerial discretion and scope for abuse." Therefore, shareholders involvement should focus on substantive matters. David, et. al. (2007) find that corporation may be less responsible socially in cases where there is shareholder activism because resources are diverted to merely appease shareholders politically. They suggest shareholders focus on changes that review managerially discretion.

Stakeholder Involvement

Who acts for the long-term benefit of the corporation? Lorsch and Simpson (2009) suggest that large institutional investors have a significant voice in the corporate governance system but may not act as true owners because their primary fiduciary responsibility is to their own investors and beneficiaries not their fellow shareholders or other stakeholders. Other diffuse shareholders generally do not have the same significant voice. Therefore, to create true ownership in the corporation which leads to focusing on its long-term benefit, a fundamental shift in the personal integrity and social contract practices of major institutional investors, other shareholders and other stakeholders must occur. O'Higgins (2010) writes "in Engaged firms, the power of stakeholders is not ignored, but normative obligations – duties of fairness toward legitimate stakeholders, consent, stakeholders as ends in themselves – prevent subverting the rights of a group of legitimate stakeholders in favor of another more powerful but less legitimate one, unless it had longer-term beneficial consequences for the less powerful group with normative claims." However, this presumes that stakeholders make their wishes known.

It is difficult to monitor top management and guide them to act in the best interests of all. Handy (2002), argues that executives no longer run their companies for the benefit of consumers and shareholders but for their own personal ambition and financial gain. Major reform in the laws and regulations that affect all shareholder (particularly institutional shareholders), stakeholder and societal participation in the corporate governance process is needed (Lorsch and Clark, 2008). Further, Brink (2010) contends that employees should have more of a voice in corporate governance due to their specific relationship and need for the corporation's long-term welfare. The reform to the system must focus on long-term survival and prosperity through transparency, independence, voice and monitoring. The reform must aim at individual participants in the system promoting personal integrity rather that personal ambition. This type of reform will restore trust needed in the corporate governance system.

Comparing Corporate Governance Frameworks: An International Perspective

Jackson and Apostolakou (2010) note that corporate social responsibility model can be used to enhance value and reputation of the corporation. They also state that it can be seen as a form of governance of economic behavior. With regard to stakeholder involvement, countries with liberal free market economies exhibit more corporate social responsibility than those with more coordinated markets. We argue that the "engaged" model of corporate governance, similar to corporate social responsibility model, may be the most effective model to govern U.S. corporations.

To gain insight into how corporate governance can be structured, we explore the frameworks of Japan and Germany, both of which represent more coordinated markets with regard to stakeholder participation. We choose these two countries because they each represent different paradigms in board composition and equity ownership compared to each other and to the U.S. in corporate governance. Further, their different legal systems have had an effect on the corporate governance structures. Denis and McConnell (2003) review the research on corporate governance systems around the world. Japan and Germany have been studied extensively for their corporate governance differences from the U.S. Denis and McConnell (2003) find that individual governance mechanisms such as board composition (Kaplan and Minton, 1994; Wymeersch, 1998) and equity ownership (Prowse, 1992) differ among the three countries and differing legal systems have an effect on the different corporate governance structures (Shleifer and Vishny, 1997). It is important to note that there may be some commonalities among the three nation's corporate governance as well. Shleifer and Vishny (1997) assert that good corporate governance systems are rooted in an appropriate combination of legal protection of investors and some form of concentrated ownership. We explore the best aspects of each corporate governance systems under the paradigm of the "engaged board" driven by personalism economics and social contract theory and demonstrated by independence, transparency, monitoring, voice and personal integrity so as to build trust with all shareholders, stakeholders and society.

Germany's system of corporate governance structure separates management and supervisory functions into two distinct bodies: the Management (Executive) Board and the Supervisory Board. Since governance in Germany includes employee participation, the Supervisory Board includes employee members. The German Stock Corporation Act also provides for the General Shareholders' Meeting at which members of the Supervisory Board are elected and actions of both boards are ratified (SAP Global, 2011; Rosen, 2007). The Supervisory Board represents the financial and other partners who provide a voice for stakeholders and the society and who appoint and monitor the Management (Executive) Board. The Supervisory Board is independent from management. The Management board represents shareholders and is much more like the conventional board of directors in the United States. These two boards meet quarterly. The Supervisory Board provides active engaged platform with shared information for transparency for all stakeholders to exert some control over the decision-making process

(Lawrence, et. al., 2004). This structure promotes transparency, independence, monitoring and voice as well as personal integrity for all board members.

Despite the Commercial Code changes in Japan that now permit firms to opt for a U.S. styled "company with committees" governance system, most firms are keeping the present system where the CEO selects internal executives to sit on the board and statutory auditors serve to monitor the board (McCarty and Toda, 2005). In Japanese companies, boards generally consist of 20 to 25 directors (although the size of the board is falling (McCarty and Toda, 2005)). Virtually all Japanese directors are inside managing directors chosen from the ranks of top management itself (Lorsch and Clark, 2008), which on its face may appear to promote a corporate governance system that lacks independence. The lack of qualified outside directors is cited by Japanese companies as the reason for the lack of outside directors (McCarty and Toda, 2005). A system of inter-corporation relationships (termed keiretsu), however, exists in which there is an affiliation of related companies whose interests are aligned partly with the corporation through long-term supply contracts, inter-company personnel transfers, and reciprocal equity ownership (Lawrence, et. al., 2004). This is essentially an added layer of accountability since the counter-corporation can be a supplier, equity owner, and competitor simultaneously. This creates interest in seeing the counter-corporation succeed. As such, the prominent feature of Japanese corporate governance is the tendency for corporations to focus on long-term commercial relationships as opposed to the U.S. corporate focus on quarterly results. There is transparency through mutual ownership, independence through competition and monitoring. personal integrity and voice exercise through long-term relationships.

An additional characteristic affecting corporate governance in both Germany and Japan is that banks own equity stakes in public corporations (Ross, 1999). This encourages corporations to finance their operations with bank debt rather than equity, thus enabling the banks to exert power in the form of influence on management. It can be argued, however, that private bank debt may lead to less transparency and less independence.

Currently, the United States has certain laws affecting corporate governance. U.S. laws tend to focus board responsibilities by attempting to reduce inefficiencies from moral hazard and adverse selection, both of which are forms of asymmetric information. Sarbanes-Oxley Act of 2002 requires audit committee members to be independent from the company, thus ensuring that financial information is not manipulated. Further, non management directors must meet regularly without management. A system of communication with directors must be established. A code of ethics must be established for principle managers. Information must be made available on compensation. As result of U.S. law corporate governance regulations require some independence, some transparency, and some monitoring. The code of ethics requires no benchmarks such as personal integrity and voice exercise is not specifically required. Effective structures are needed to ensure that CEO's are making decisions that are in the best interests of the owners and stakeholders of the firm and society at large. This is the primary reason for having a board of directors, who are required to ensure that the right decisions are being made through voice, transparency, independence and monitoring and with personal integrity.

Case Study: Berkshire Hathaway

Berkshire Hathaway is a large U. S. holding company with approximately 52 lines of business with major emphasis in the insurance and reinsurance industries (Berkshire Hathaway, 2010b). Berkshire Hathaway has substantial funds available for investment, and the company uses these funds to purchase shares in industrial based companies like Coca-Cola and American Express (CNBC.com, 2011) in order to maximize long-term shareholder value. However, Berkshire's investment approach is not necessarily the company's most striking attribute. Berkshire's approach to corporate governance and investor relations is equally unique.

Berkshire Hathaway encourages its shareholders to be actively engaged in the affairs of the company and to invest long-term. Berkshire's Chairman, Warren Buffet said in his letters to the shareholders:

"Although our form is corporate, our attitude is partnership. Charlie Munger and I think of our shareholders as owner-partners, and of ourselves as managing partners…Charlie and I hope that you do not think of yourself as merely owning a piece of paper whose price wiggles around daily and that is candidate for sale when some economic or political event makes you nervous. We hope you instead visualize yourself as a part owner of a business that you expect to stay with indefinitely, much as you might if you owned a farm or apartment house in partnership with members of your family" (Berkshire Hathaway, 2009).

Furthermore, Berkshire's low level of stock turnover indicates that the company's leadership has been successful in convincing stockholders to think of themselves as owners (Berkshire Hathaway, 2009). This success is due to Berkshire's leadership through its excellent two-way communication. The company actively communicates relevant information to shareholders in plain English so that shareholders really understand what is going on in the company. This element of transparency in the corporate governance system at Berkshire through communication is highlighted in a leadership that encourages questions from its shareholders. It is based on cross communication that encourages shareholder involvement, which represents a significant part of Berkshire's approach to corporate governance.

Monitoring through ownership is another success of the Berkshire Hathaway corporate governance system:

"In line with Berkshire's owner-orientation, most of our directors have a major portion of their net worth invested in the company. We eat our own cooking. Charlie's family has 90% or more of its net worth in Berkshire shares; my wife, Susie, and I have more than 99%... Charlie and I cannot promise you results. But we can guarantee that your financial fortunes will move in lockstep with ours for whatever period of time you elect to be our partner. We have no interest in large salaries or options or other means of gaining an "edge" over you. We want to make money only when our partners do and in exactly the same proportion. Moreover, when I do something dumb, I want you to be able to derive some solace from the fact that my financial suffering is proportional to yours." (Berkshire Hathaway, 2009).

In addition to the elements of independence and monitoring in its governance system, Berkshire Hathaway lives the values and characteristics of engaged corporate governance (Pound 1995) through the qualifications of its directors. One of the key board members' qualifications includes competence (defined above as part of personal integrity) in finance and industry sufficient to allow the board to add value to the decision-making process. "In choosing directors, the Company (Berkshire Hathaway) seeks individuals who have very high integrity, business savvy, shareholder orientation and a genuine interest in the Company"(Berkshire Hathaway, 2010b).

Further, Berkshire Hathaway's corporate governance system includes procedures that foster open debate (voice), self evaluation by the Governance, Compensation and Nominating Committee (transparency), and full and free access to officers and employees without preapproval (monitoring). Additionally, directors' fees are nominal and immediate (independence) (Berkshire Hathaway, 2010b). By aligning their personal assets to company profits, the company's leadership shows personal integrity through its adherence to a Code of Business Conduct and Ethics looking out for the best long-term interests of shareholders (Berkshire Hathaway, 2010a). Berkshire Hathaway has a determination to relentlessly adhere to fundamental principles of doing what is right and focusing on the long-term survival of the company regardless of the whims of the marketplace.

Proposed Corporate Governance Behaviors that Emulate Economic Personalism and the Social Contract Model through the New Rules of Engagement

Individual Responsibilities

Individual members of management: The most important individual member of management is the Chief Executive Officer (CEO). S/He is responsible for defining a compelling vision for the company, developing a strategy with insights from the board for reaching that vision, and leading management and employees in executing the strategy (Lawrence, et. al., 2004). The CEO must value personal integrity and competence. S/He must realize that all stakeholders have time, effort, skill and talent invested in the corporation. S/He must understand that all are economically interdependent. His/Her behavior must reflect this personal integrity and competence by:

1. Creating a culture high on moral/ethical core values of doing right, fairness, integrity, honesty, justice and hard work.
2. Rewarding doers who live company values
3. Leading by example by becoming the moral compass of the organization
4. Encouraging dissent among senior managers and implementing a system that discourages groupthink and cronyism.
5. Encouraging criticism of decisions and aligning personal interests to that of others, particularly the organization.
6. Listening, coaching and setting direction for the elevation of long-term people and business performance.
7. Encouraging decision-making at lower levels of the corporation to encourage subsidiarity and limiting abuse of highly centralized decision making.
8. Encouraging exchange of things of equal value and imposing equal duties.

Individual Members of the Board: The individual members of the board must also value personal integrity and competence. The Board of Directors provides direction and oversees the conduct of the top management. Instilling trust into the corporate governance system through the members' own personal integrity and competence is important to long-term corporate survival and good performance. Therefore, each member's behavior must reflect his/her personal integrity and competence by:

1. Selecting the Chief Executive Officer, not necessarily merely a visionary, but one who is very willing to serve.
2. Working with the CEO and other members of the executive team in planning, formulating and monitoring strategic execution.
3. Evaluating the CEO's performance and the company's business performance as it relates to meeting goals.
4. Dismissing the CEO for poor performance, misdeeds, and lack of long-term focus. One of the greatest flaws of many of today's leaders is their avoidance of the tough calls. Wisdom demonstrated by personal integrity is doing the right thing.
5. Monitoring financial and legal compliance as determined by regulators and ethical compliance as determined by stakeholders and society.
6. Maintaining transparency of actions and transactions of the firm.
7. Maintaining independence of decision making from management yet understanding interdependence of the economic system of the stakeholders and society.

Stakeholders and Society

We argue that the system of corporate governance would not function well unless shareholders take responsibility as owners and actively engage with not only board members and management as they affect the strategic direction of the enterprise but all stakeholders and society. Shareholders must exercise personal integrity and competence by taking responsible action towards the corporation's governance. In the German model discussed above, shareholders who are well informed as to the voting records of the director candidates control the nomination and election process of board members (Ross, 1999). Shareholders must insist on accurate and real time information to facilitate the oversight function over the board. Financial institutions such as banks, pension funds, insurance companies, mutual funds, and money managers and other stakeholders in society must unite to voice concerns to the board and to insist on transparency, independence, effective monitoring and personal integrity.

The Relationships in the Corporate Governance System

Management and the Board

The relationship of the CEO and top management to the Board is a relationship that requires trust. The CEO has the responsibility of articulating the vision, but policymaking, particularly strategy formulation, must be a joint effort. Transparency in information sharing, communication and business results is a must for a successful relationship. The Board's trust in the relationship must be enhanced by monitoring but as a partner. However, the partnership members should have personal integrity and remain independent in their thinking and action.

How management is compensated is an important element in the management–board relationship. In many U.S. Corporation, there is no internal process to evaluate CEO performance (Drucker, 1995). From 1990 to 2001, the share of equity-based compensation in total CEO compensation, meaning how much is coming from options and other forms of equity, grew from 8 to 66 percent (Clark, 2003). Generally, this occurred due to the belief that aligning management with owners through company ownership would result in better stewardship of the shareholders' investment (Jensen and Meckling, 1976). However, it appears that in practice this type of compensation incentivizes managers to increase short-term profits in order to increase a current paycheck.

CEOs were granted packages that ensured executives receive above average pay in spite of financial performance rather than align executive pay and benefits to profitability (Lorsch, 1995). Stock options were not expensed immediately. As this changes (See Berkshire Hathaway case described above), board compensation committees may be less likely to use this compensation method. The CEO may then be paid in restricted stock with the consequence of losing his/her compensation if *long-term* performance is not met. This should better instill trust through voice exercised by the board that is setting compensation that results in transparency of currently expensed compensation, independence of compensation levels determined by long term performance measures and monitoring CEO performance through restricted stock compensation.

In addition to compensation of management, the determination of who composes management is just as important in the board-management relationship. The board generally has a nominating committee composed of members of the Board should have sole responsibility to appoint the CEO and the Chief Financial Officer (CFO) (Lawrence, et. al., 2009; Berkshire Hathaway, 2010b). Characteristics of successful CEOs have been found to include the capacity to execute, the ability for hiring and assigning the right people to the right positions, intellectual curiosity and the capacity for self reflection, the ability to confront and deal with reality, personal integrity, the capacity to build connections with people, decisiveness in decision making, being unafraid of Wall street, the strength to deal with complexity and finally a servant's heart (Lorsch, 1989). Boards must use their voice to hire candidates with these qualities, independently, transparently and monitoring the process of selection.

The Board, Shareholders, Stakeholders and Society

The Board must have the long-term perspective of the company as its primary focus in the corporate governance system. The shareholders, stakeholders and society at large needs to trust that the long-term survival of the company is paramount before they will invest their time, effort, skills and talent into the enterprise. To ensure accountability to this long-term perspective, shareholder resolutions (that pass by a majority of the shares) must be binding. Rajagopalan and Zhag (2009) argue that shareholders should seek each other out and work in concert on issues on which they share common ground. When boards and managers believe there is a real chance that shareholders will push back on the director slate or block an initiative, their behavior and decision-making process may change.

To ensure that resolutions are, in fact, followed and accountable to shareholders, stakeholders and society, independent, transparent information must be available. The audit committee is the board's vehicle for monitoring financial reporting and must ensure correct accounting and full disclosure by the organization. Personal integrity and competence are important characteristics for the chairman of the audit committee. A certified public accountant (C.P.A) provides the competence and under the U.S. C.P.A code of ethics personal integrity as well. Further, s/he provides the status, experience and leadership to insist on full and complete discussions on all business transactions and investments. The audit committee must be fully independent so as to be able to work with independent auditors appointed by management. Audit firm, not just the partners currently assigned to the company account as required by the SEC (Security Exchange Commission), should be rotated every few years to prevent long-term ties between management and the firm of auditors, but more importantly, so as to ensure a "fresh look'' by a new firm. The audit committee should also review all analyst and press reports about the organization's accounting and financial disclosures on a consistent basis. Finally, the all-important role of the audit committee is forensic –the need to dig behind the journal entries (Lorsch, 1989).

Conclusion

This paper proposes the "engaged board" as the model of corporate governance in American firms. This model hopes to address the recent failures in governance due to individual choices and behaviors and systemic and organizational failures by integrating the two perspectives of economic personalism and (integrated) social contract theory. These two perspectives provide guidance for the individual behavior and the governance system relationships. The long-term viability of the corporation is paramount to all stakeholders and the society at large.

Economic personalism addresses individual shortcomings by providing a value system of personal integrity and responsibility for behavior and choices to the three critical groups of the corporate governance system, the board, management and shareholders, as well as other stakeholders and society at large. Individuals must value the principles of subsidiarity and equivalence. Competence by the members of system is also deemed a part of personal integrity.

The social contract model must guide the system of relationships in corporate governance. Again, the focus must be on long-term prosperity of the corporation. Trust must be established and enhanced among the three critical groups and those groups with other stakeholders through exercising voice, independence, transparency, and monitoring. Behaviors by all parties should be specific to establishing the trust. Selection process of members of the system must seek individuals who value these principles.

The international examples provided here along with the specific example of Berkshire Hathaway help to understand the best practices in corporate governance today. Regulation can only do so much to prevent corporate failure. The attitude and values of the members of the corporate governance system can define the appropriate vision for the long term future of the company making it an "engaged" viable member of the society in which it resides.

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Appendix

Diagram 1 The "Engaged Board" Model