Reasonably good corporate governance

Donald Nordberg

Developmental paper for BAM track on Corporate Governance, 2014

Abstract: Attempts to determine what constitutes “good” corporate governance have become mired in the quicksand of the ethical conflict between duty and utility, virtue and rights, as well as the fight over for *whose good* the organization exists. This paper takes a different tack. Drawing upon evidence from the efforts to build and develop the UK code of corporate governance, it argues that the nature of “good” is intractable, but that in the practical world a philosophically pragmatic approach applies, exemplified in the preference for a comply-or-explain approach rather than more formal modes of regulation. Using Toulmin’s (2001) of advocacy the reasonable, in opposition to the rational, it argues that “reasonably good” governance is the best that can be expected, given the contingent nature of organizational life and strategies and the uncertain and potentially fungible benefits of various mechanisms of corporate governance.

Keywords: Corporate governance, ethics, reasonableness, rationality, Toulmin

Once upon a time …

The story of corporate governance is often told as a fable of good and evil: the good journalists at Mirror Group Newspapers and the evil Robert Maxwell who stole their pensions to prop up his failing business empire, the good shareholders of Enron defrauded by the omnipotent and "unfettered" CEO, or the poor fisherman in the Gulf of Mexico deprived of their livelihoods by the greedy oilmen (and a few oil women) at BP, Halliburton and the rest. For most boards of directors, most of the time, the story is a more mundane one: forms to fill in, boxes to tick, time to be wasted in compliance that might be better spent strategizing or negotiating access to value and scarce resources. No wonder corporate governance has given itself a bad name.

Evidence of the bad name is often more anecdotal than empirically verifiable: That corporate governance is a good is politically incorrect to deny. But in private conversations, corporate directors complain:

> A non-executive director of one of the world's largest corporations, who chairs its remuneration committee, meets an old acquaintance from earlier in their business careers. "What are you doing now?" the non-exec asks. "I'm working in corporate governance," his former colleague replies. "If I had my gun now I would shoot," the non-exec says and walks away.
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> Or of the chairman of a major financial services firm who meets a complete stranger at a social event, someone who also expresses an interest in corporate governance. The next sentence could not be printed in a family academic journal, both for its diction and lest the slander it voiced became libel.

These tales suggest that corporate governance is something these directors take very seriously. They care about their companies and resent the intrusions by what they see as do-gooding outsiders trying to impose ways of thinking and standards of action on others, when those others are responsible, in a legal sense, for the decisions to be made. Yet directors like these are also responsible, in a moral sense, for cases of malfeasance we have seen at all too many corporations. Those excesses have led, over several decades, to a movement to identify good or even best practice in corporate governance, reinforced by mechanisms, structures and procedures. Scholars have then attempted to discover a formula for good board performance by assessing the correlation of one or several mechanisms of governance, with one or another measure of performance. Such efforts seem to yield ambiguous results, even if we could agree that the selected measures were the ones that somehow mattered.

This paper takes a different approach. It argues that good governance is elusive, contingent upon too many factors that cannot be controlled, that is, factors the directors could not reasonably control, however rational their thought processes were. This argument recalls – and in its detail is based upon – the distinction in Toulmin (2001) between what's reasonable and what's rational. It is analogous to but not the same as the bounded rationality in the work of Simon (1955, 1959, 1978). Toulmin argues that epistemological and ontological limits to certainty make the rational, as we have come to understand it in modern thought, impossible. The limits of human intelligence alone do not create the problem, but rather the complexity of the problem itself.

If the problems of governing a corporation or another type of organization are inherently complex and intractable, then efforts to control them – to construct mechanism of governance – must falter when they encounter the law of requisite variety (Ashby, 1958, 1968/2011). The best we can reasonably expect of a director and board is that they are reasonable, recognize the contingency of their situation, and be – in the philosophic sense – pragmatic in their decisions (Rorty, 1989). That involves trading off one set of norms for another, when the one no longer seems to suit the circumstances and the other holds out hope of something better.

Let us first consider the thinking of Toulmin (1992, 2001, 2003) on rationality and reasonableness, as well as the notion of contingency in Rorty (1989). We will then explore the landscape of corporate governance, paying particular attention to the UK, where the code of conduct promulgated in 1992 became a model for much of the world (Aguilera & Cuervo-Cazurra, 2009). We will look at the conflicting aims and logics that actors bring to the field and that contest for the attention that will shape future social practice (Ocasio, 2011).

Next we rummage through the garbage can of prescriptions, whose apparent ineffectiveness have made the crisis in corporate governance a recurrent one (MacAvoy & Millstein, 2003) looking for contingencies where some methods might work some of the time. To give an empirical turn to the analysis, let us then consider that principle of corporate governance called "comply or explain", a principle much admired and reviled as it developed in UK corporate governance. Through doing so, the paper will demonstrate how corporate governance came to embody the contingency, irony and solidarity of Rorty and institutionalize a logic grounded in Toulmin's type of reason.

Reason, rationality and contingency

Particularly in the wake of near-meltdown of the financial system in 2008, various commentators have blamed the crisis in corporate governance on excessive faith in the rationality of efficient markets (Fama, 1970) and of managers to account for risk. Evidence of this is in the popularity of the Black Swan conception of Nassim Nicholas Taleb (2007), which seemed in hindsight to have predicted the turmoil. Fama's original thinking of market efficiency in the late 1950s assumed that rational investors would, through the wisdom of markets, collectively find the right price for assets, provided all relevant information was freely and uniformly available.

At the same time, however, doubts about rationality were emerging elsewhere in the literatures of economics and epistemology. Herbert Simon wrote of rationality as being bounded by our ability to compute the values at stake (Simon, 1955, 1959), creating a new field of behavioural economics. This period, too, saw doubts about rationality emerge in a rather different setting. The philosopher Stephen Toulmin published the book *The Uses of Argument* in 1958 (republished 2003), which discussed the importance of field-dependent variables in logic, suggesting a limit not just to the ability of people to determine what's rational, but also to find a single rationality at all. This thinking contributed to the sense of an inherent non-rationality arising in physics since Einstein and Heisenberg, and evident in the sociology that came to be called post-modernism.

In his book *Cosmopolis*, Toulmin (1992) traced excessive faith in rationality to Descartes and the resulting narrow conception of scientific inquiry that followed in the tradition he helped to establish. Returning to these themes in *Return to Reason* (Toulmin, 2001), he argued that the best we could expect in an uncertain and contingent world was that people acted reasonably. It resonated with the contingency associated with the pragmatists Thomas Dewey and William James and central to the work of Richard Rorty (1989).

Reasonableness, in Toulmin's terms, is "the possibility of living, as in pre-modern times, without any absolute necessities or certainties" (2001, p. 1). Rationality, linked philosophically to positivism and certainty, falters at the hurdle of describing what happens in practice. Under reasonableness, analytic philosophy of the 1930 to 1950s has retreated, and moral problems (he uses the example of medical practice) "are being handled less by strictly theoretical analysis than on a 'case-by-case' basis" (Toulmin, 2001, p. 167). In the face of complexity, of the sort of complexity that defies calculation, multiple answers may apply to the same situation, and what's best is impossible to determine.

These ideas resonate with the themes of corporate governance, as we shall see. For corporate governance itself lacks clear definition, and actors from various disciplines take very different stances not only as to what is the right answer but even as to what is the right question.

Corporate governance as a landscape

Corporate governance scholars sometimes describe their subject as a field, but it isn't, not in a conventional way. Metaphorically, fields have boundaries – limits where they abut other fields or paths – with dividing lines that define their shape and delineate ownership. In sociology, fields have members who share a common language, making communication possible, and common understanding, making communication sometimes unnecessary. That is, they have norms, rules of the game, creating institutional arrangements with their own logics that members understand even when they might not articulate them (Fligstein & McAdam, 2012).

A field that isn't

Corporate governance isn't like that. The organizational field of corporations overlaps the field of institutional investors (some of which are themselves corporations). Their advisers inhabit other fields, the professions of law and accountancy prominent among them. These fields arise in different broad social domains, what Puxty and colleagues (1987) call organizing principles, or what Friedland and Alford (1991) and Thornton (2004) call institutional orders, where deeply held beliefs are rooted: principal among are the belief in efficiency of markets, or the natural justice of families; the immanent power of religion, the hierarchy of the corporation, or the bureaucracy of the state.

In corporate governance the state is an important actor, setting out the legal basis for corporations and the regulatory regimes they follow. But as we will see, there are reasons to believe it is a weakened actor, and was a particularly weak one as UK corporate governance became codified. Actors from other fields, arising in other orders, play a prominent role, too. Corporations in Thornton's view warrant an order of their own. Institutional investors populate the field of capital markets with a power than overwhelm the mere "savers" who co-habit it. Advisers, whether in law, accountancy or management consulting, sit in fields governed by professional logics, with their adherence to a body of knowledge that nominally takes precedence over the merely commercial. There are many other actors, less powerful, in other fields, too. Corporate governance looks different to different actors, depending on where they stand.

In increasingly global investment markets, even the geographic boundaries of fields have become blurred, and as that happens questions arise about who rules apply, which can throw the legitimacy of the rules themselves into doubt. Indeed, that globalization of markets diminished the power of the state, reducing the constraints on corporations as well as markets.

Let's call corporate governance something else, then, a landscape. A picture of it includes a number of fields. Their definition can be pretty difficult to distinguish unless to move to a different vantage point, but doing so presents a different picture, a different landscape, similar and recognizable but not the same. Some of the common understandings may prove, therefore, to be common misunderstandings, where actors use the same words to mean something different, and where meanings may be translated to fit with the actors' individual meaning systems (Czarniawska & Joerges, 1996), leading to differing interpretations that may remain without articulation, because in this non-field we still, almost, understand.

In an oft-cited paragraph, the Cadbury Commission called corporate governance "the system by which companies are directed and controlled". The next sentence added: "Boards of directors are responsible for the governance of their companies" (Cadbury, 1992, Section 2.5). This seemingly uncontroversial statement was the subject of controversy during the drafting. This passage was rendered rather differently in the draft text published in May 1992. It described corporate governance as "the system by which companies are run" adding: "At the centre of the system is the board of directors whose actions are subject to laws, regulations and the shareholder in the general meeting" (CAD-02229[1]). In the draft, the board was not in charge, merely at the centre of a complete web of governance arrangements.

Under pressure from the many, often hostile voices from corporations responding to the draft (Nordberg, 2012; Spira & Slinn, 2013), the text was changed and the board became preeminent. But the language remained that of a "system", with interacting components. In the view of the landscape framed by the Cadbury Code, the institutional orders of the state and the market were present, but as the code became institutionalized the order of the corporation was the dominant object in view.

Logics in the landscape

The various fields in the landscape of corporate governance each come with their own sets of rituals and routines, and the institutions they constitute have their own logics. In the institutional logics perspective (Thornton, Ocasio, & Lounsbury, 2012), social action is governed through the interplay of logics in an inter-institutional system, as institutions from different orders contest for attention. While there are several logics at work in this landscape, three are particularly important and feature prominently in the debate over the code: corporations, investors and professional advisers.

Corporations and their boards might be expected to be guided by logics that give primacy to the manager at the top of the internal hierarchy. This is a logic of managerialism in Lok (2010), which in its beneficial manifestation has links to stewardship theory (Davis, Schoorman, & Donaldson, 1997). But managerialism is also associated self-serving managers, whose neglect of shareholder interests provided the springboard for corporate governance reform in the US and the rise of shareholder activism in the 1970s and 1980s (Pearlstein, 2014).

Those changes in thinking involved an assumption of shareholder primacy, in evidence in the recipes of agency theory to align managerial pay with shareholder returns (Jensen & Meckling, 1976). The assumption here is that shareholders operate on a different logic, emphasizing the primacy of market determination. Following the precepts of the efficient market hypothesis (Fama, 1970), control of corporations involves the use of ever greater transparency and disclosure.

[1] CAD- numbers refers to the document identification at the Cadbury Archive in the library of the Judge Business School at the University of Cambridge.

Professional advisers to both corporations and investment firms include the lawyers and accountants who gain their special place in corporate affairs and capital markets by virtue of their specialist knowledge and adherence to professional norms. These logics presume that such norms take precedence over mere commercial benefit. But the recurrent crisis in corporate governance has been traced, at least in part, to the failure of these professionals to give sufficient primacy to the norms. The accounting profession, for example, faced a competing logic from the commercial imperatives of running large organizations themselves (Hinings, Brown, & Greenwood, 1991; Suddaby, Gendron, & Lam, 2009; Thornton, Jones, & Kury, 2005).

These logics may bring different understandings to bear on the specific recipes of the new proto-institution that embraces all three fields. A managerial logic might value the advice and counsel of non-executives, that is, the service role of directors, over the control function, and the decisive power of a unified leader implied by embodying the chairman and CEO in one person. A market-logic might favour a controlling board, with strong supervisory powers (though not at the cost of financial performance) and certainly a separation of chairman and CEO. A professional logic would look for standards to be applied, albeit with discretion, the type of discretion implied in the principle of comply-or-explain. It might also advocate a clear evidence-base for the decision. As we shall see, the evidence is somewhat less than clear.

Direction for development

The balance of this paper will involve a detailed analysis of the debate that led to formulation in Cadbury of explanation as a means of compliance, and how that comply-or-explain rule was debated again in 2003 and then again in 2009-10. These were the versions of the UK code of corporate governance that underwent consultative scrutiny in the wake of fresh crises of legitimacy. It then set this debate in the context of the notions of reasonableness and rationality in Toulmin and Rorty's contingency and solidarity, suggesting that in "comply-or-explain" the corporate governance world has stumbled its way through contingency into reasonableness.

For developmental purposes, BAM participants might offer other insights, either in examples of similar practices in other domains or in the philosophical underpinnings sketched here.

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