Corporate Governance of Non-Listed Companies: The Way Forward

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1. A New Corporate Governance Debate

At the end of the 20th century, the corporate governance movement captured the imagination of policymakers, lawmakers, and company executives worldwide. Skeptics might have argued that it all started as merely a fashion trend among corporate law professors who were inspired by Berle and Means' book on the Modern Corporation and Private Property (1933). In the modern corporation, characterized by the separation of ownership and control, the shareholders have lost their direct influence and involvement in the firm. As a consequence, managers and insider control groups are encouraged to pursue their own personal goals without taking the interests of the shareholders, other stakeholders, and society into account. Scholars have written extensively on the managerial agency problem, and have recommended the introduction of both market mechanisms and legal strategies that mitigate opportunism and shirking in listed companies.

The finance-ridden scandals in the United States and Europe further brought attention to the importance of governance and provided new momentum for introducing important legal and regulatory reforms. Certainly the scandals were not only instrumental in moving corporate governance up the policy-making agenda, but also in making corporate governance an integral part of the day-to-day decision-making process of public firms. Corporate governance is currently a major political issue, attracting considerable attention from policymakers, lawmakers, company executives, shareholders, banks and other investors, the media, and legal and financial professionals. To be sure, managerial abuses have been around for as long as minority investors poured their money into risky ventures (such as the Dutch East India Company) and, as always, policymakers and lawmakers have attempted to mitigate the underlying governance failures and errors. However, some argue that the current corporate governance movement has tended to overreact by creating too many rules and attempt to overprotect shareholders and other stakeholders. Unchecked, this trend could jeopardize entrepreneurship and longer term economic growth. This prompts questions about the 'one-size-fits-all' mentality of policymakers, lawmakers and gatekeeper institutions and the success of ready-made strategies that can be detrimental to the operation and development of non-listed companies.

There are, however, four developments that could usher in a new movement towards corporate governance initiatives focused on non-listed companies. First, the 'one-size-fits-all' and regulatory mentality of policymakers arguably led to some undesired spill-over effects to non-listed companies. In this respect, separate corporate governance projects could mitigate these effects and the ambiguities related to these issues. Second, since firms cannot afford to ignore the rewards of joint venturing any longer, it is important that business parties, both large and smaller enterprises, be made aware of the benefits of improved and stronger corporate governance structures for these joint operations. The refocusing of corporate governance on typical problems in these non-listed companies could help promote the economic performance

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of countries. Third, it is widely acknowledged that family-owned businesses and start-ups are the backbone of a country's economy. The typical life cycle of family-owned firms, however, indicates that where the first generation establishes the business, the second generation develops it and the third generation destroys it. Only companies with strong and professional governance structures are able to survive beyond the third generation. It is submitted that education and training of family-owned firms is of utmost importance to assure the steady and healthy growth of these businesses, while ensuring the continued participation of family members. Finally, it is only to be expected that non-listed firms, which rely heavily on bank finance and venture capital, would be required to have a professional governance structure in place. Separate corporate governance discussions could well contribute to the awareness creation regarding the beneficial effects of such measures.

2. The Corporate Governance Framework of Non-Listed Companies

Why then have policymakers repeatedly chosen to provide governance structures for non-listed companies that are derived mainly from the framework designed for the public corporation? Three theories can explain the pattern of legal reform measures in this area. First, there are those who argue that the predominance of a particular legal structure tends to thwart the evolution of the law rather than enhancing its development. It is no surprise that this view, which argues that standardization of governance measures confers increasing returns to business parties, helps to explain the persistence and continuous use of the dominant business form, namely the corporate form, even if not ideally suited to some firms. A second theory, which builds on the economic theory of legislation, assumes that legal rules are demanded and supplied in much the same way as other products. Typically, interest groups will seek to influence key policymakers and legislators to supply legal products in order to satisfy the outstanding demand for these changes. We expect the effectiveness of lobby groups corresponds not only to their size, organization and ability, but also to the height of the barriers they face when intervening to realize gains for the parties they represent. Third, those governments with sufficient resources may choose to ignore existing interest group pressures and instead officials may be encouraged to undertake innovations themselves. Besides traditional governance measures, policymakers sometimes look to develop a variety of reforms to support their indigenous industries to successfully compete in this new environment.

These three views on the implication of legal reform give insights into the variations of corporate governance frameworks across countries, from the introduction of hybrid business forms to the emergence of codes of conduct for non-listed companies. In order to understand the variations, we look at the specific legal and contractual components of the corporate governance framework and focus on domestic debates to explain the domination of specific arrangements. We introduce a common approach for discussing a variety of corporate governance issues for non-listed firms. The common approach, which explains the three-way interaction among controlling shareholders, minority shareholders and management, employs a three pillars framework that consists of company law, contractual arrangements and optional guidelines (McCahery and Vermeulen 2008).

One of the key pillars, of course, is company law which could be viewed as the most important source of corporate governance techniques in the context of non-listed companies. The company law systems across jurisdictions contain rules on management control and disclosure and transparency, which are designed to enable shareholders to employ legal techniques that secure accurate and timely information on the financial affairs and performance of the company. In general, company law also provides for basic techniques that protect minority shareholders' interests through participation rights and legal restrictions on managers'

power to act in response to directions given by controlling shareholders. More effective lock-in rules, moreover, should ensure both continued investment and minority protection. Fiduciary duties, for instance, should play an important role in preventing non pro rata distributions. The open-ended duty of loyalty arguably provides a safety mechanism to protect investors against the abusive tactics of controlling shareholders. In this view, courts and other conflict resolution bodies are crucial to fill the gaps in the corporate governance framework ex post.

However, the ex post gap filling function of courts arguably resolves some issue only to raise others. In many cases, judicial intervention leads to costly and time-consuming procedures without making their outcome any more predictable. It is therefore not surprising that business parties often prefer to bargain for contractual provisions that deal with possible dissension and deadlocks ex ante. Examples from the area of family businesses and joint ventures portrayed a range of contractual arrangements through which business parties could be encouraged to resolve their differences and conflicts before resorting to the more costly and uncertain judicial process. Policymakers and lawmakers appear to have picked up on this by either modernizing their company laws or introducing contractual entities that combine the best of traditional corporation and partnership forms. Indeed, pass-through taxation and the freedom to contractually establish the rights and obligations within the organizational structure economize on transaction costs such as drafting, information and enforcement costs. The flexible provisions give business parties the opportunity not only to contract around the company law default rules, but also permitting them to contract into additional protective measures that reflect their preferences.

Yet even when company law rules are sufficiently flexible to enable business parties to contract into the desired organizational structure, transaction costs and information asymmetries may prevent the emergence of effective and optimal governance solutions. While there could be a great appeal to the utilization of existing corporate governance mechanisms (designed for listed companies) to address, among other thing, the ownership and control structures, the composition and operation of the board of management, transparency requirements, accessing outside capital, and strategies for succession planning and conflict resolution, this article advocates the introduction of a separate approach to the creation of corporate governance guidelines. It is important, particularly in view of the need for more professionally managed non-listed businesses, to produce measures that are sufficiently attractive and coherent from a cost-benefit perspective to persuade non-listed companies to opt into a well-tailored framework of legal mechanisms and norms.

Thus, an optional set of recommendations could not only play a pivotal role in the awareness creation of the importance of good corporate governance practices, but also contain provisions about the benefits of educating and training board members and shareholders to become competent and reliable players in non-listed companies. Despite the prospective benefits of these guidelines, empirical research is needed to confirm the anticipated productivity effects for non-listed companies overall. In this regard, an important starting point for such work would be to analyze the implementation of the recent recommendations introduced by standard-setting institutions, such as the Belgian Buysse committee and the European Venture Capital Association. Clearly, non-listed companies that operate under a well-designed and effective governance structure are likely to perform better and consequently will be more attractive to external investors. All in all, the flexibility and informality of company law and the introduction of optional guidelines have proved beneficial in the European venture capital industry. Yet as is always the case government regulation, such as restrictions on foreign direct investment and rules governing public offerings, may influence the structure of ownership in non-listed companies. Surely the real amount of regulation needed for non-listed firms is a crucial issue that should not be ignored in the corporate governance discussions around the world. In this

respect, we would suggest three important directions for the future which lie in the relationship between the firm and the government.

2.1 Company Law Restrictions on Foreign Direct Investment

In the context of foreign direct investment (FDI), countries over the years have with increasing frequency sought to liberalize their foreign direct investment rules and the array of restrictions that affect the flow of capital across border. We can clearly observe the changes that are taking place in the areas of foreign ownership and foreign participation. Still the evidence suggests that many countries, like China, Thailand, and surprisingly Canada, are found to have highly restrictive measures to protect their domestic industries, primarily in the services sectors including transportation, electricity, financial services and insurance. In particular, the rules on management and the composition of the board of directors add another layer to the regulatory costs for foreign investors. For instance, should a foreign investor undertake to establish a subsidiary in a country with restrictive measures on foreign direct investment, we typically see at work the implementation of draconian restrictions (i.e., mandatory screening and approval by the government of the foreign direct investor, restriction of ownership, etc) that effectively undermine all efforts to attract FDI.

This is an important issue for emerging market economies that have been found to create legislation that promotes FDI, but were unable to ensure implementation and effective enforcement of such measures. Naturally, this situation creates complications for foreign firms that are, regardless of circumstances, obliged to employ directors and carry out their operations according to standards set by their investors. If, for example, a parent company is required to appoint one or more local directors to the board of its subsidiary, it should be expected, given the incentives, that protective measures be in place to oversee the performance of these directors. Equally important, governments continue to use ownership restrictions that makes it difficult for investors to maximize their returns on investment.

There are alternatives to this situation. Consider the free trade agreements (FTA) that are entered into by investor countries to liberalize the restrictions on investment and trade. While the potential for this approach is high, empirical work that has already been conducted indicates that there are numerous restrictions that continue to hamper investment across the board (Urata and Sasuya 2007). In addition, there is another strand of empirical work conducted under similar lines which asks how the corporate governance framework in emerging markets can be influenced by the entry of foreign firms (Loungani and Razin 2001). Since the emerging markets with their relatively small number of listed companies have a particular interest in seeking to understand the corporate governance challenges for non-listed companies, we clearly need more empirical research to show the most effective measures to increase transparency and control and to facilitate the conditions for effective business contracting while limiting corruption.

2.2 The Development of an Equity-Oriented Market

Smaller firms are sometime foreclosed from raising capital from banking institutions because they are unable to commit collateral and have a limited track record of success. The implementation of the Basel II Accord is likely to reduce further the availability of funds for small and medium-sized enterprises (SMEs). At the same time, we expect more closely held firms, like family-controlled companies, to access the public capital markets for their financing needs, particularly as Europe moves towards the adoption of an equity-oriented system.

It is noteworthy that the introduction of the New Markets in Europe were launched already in the late 1990s. They were conceived to facilitate the financing of innovative companies with low capitalizations and high growth potentials that would ordinarily have been excluded earlier. As with the United States-based NASDAQ, the alternative markets adopted a combination of stricter disclosure rules and less stringent entry requirements (regarding size, age and minimum profitability requirements) than companies on first-tier markets. Lower regulatory barriers and ideal market conditions together led to the development of a very active IPO market in Europe until 2001, when a wide-ranging market shake-up occurred leading to the rapid consolidation of this market segment. Ultimately, the Alternative Investment Market (AIM) emerged as the market leader due largely to having succeeded in diversifying the mix of companies seeking a listing, and ensuring effective disclosure for investors.

Throughout the recent period, AIM consolidated its position as the market leader in listings based primarily on admission rules that are not very stringent for firms with low market capitalization. As such, AIM functions as an alternative to the private equity market for many classes of companies. We clearly see that AIM has succeeded in attracting US firms which have attempted to flee the higher regulatory costs introduced in the wake of the Enron scandal. AIM serves as a model for other jurisdictions, such as Brazil, in developing a platform for facilitating alternative sources of financing for SMEs and family firms. Still, we believe it would be worthwhile to carry out a more systematic exploration of the implications of establishing AIM-style exchanges that can be seen as substitutes for private equity financing. That said, it is also necessary to explore whether the AIM model is likely to emerge as the dominant approach for public listings or will the tighter regulated NASDAQ prove superior in the longer run.

2.3 The Going Private Decision and The Listing of Private Equity Firms

Despite the extra costs of complying with the tougher corporate governance regulations, the corporate form arguably remains the dominant form of structuring a business. In most western jurisdictions, the majority of firms are organized under the provisions of the corporate statute. Such statutes confer substantial learning and network effects to its users, including statutory provisions and case law. These effects, which come from the use of the corporate form, for instance, explain why most of the parties that originally opted into this form have an incentive to continue to use this regime. Factors that arguably add to the value of the corporation include avoidance of formulation errors, ease in drafting the articles of association, availability of case law on the interpretation of the statute, and the familiarity to business participants. As we have seen, the consequence of network and learning effects is the continuous use of the dominant business form, even if it is not ideally suited to some types of firms. Indeed, the recent corporate governance reforms are of course no impediment to ending the dominance of the corporate form. On the one hand, the listed firms have no other choice but to comply with the new regulations or to explain why they take a different route. Other firms may even be attracted to apply these tougher corporate governance rules voluntarily. They use the compliance with rigorous corporate governance principles as a marketing tool to demonstrate to potential investors their trustworthiness and transparent status.

On the other hand, however, a large number of publicly held firms view the corporate governance reforms as too cumbersome and costly. They look to escape the application of corporate governance regulations by delisting their shares from the stock exchange. In addition, firms that are planning an IPO may very well reconsider their intention.

From these firms' perspective, the exorbitantly high compliance costs (lawyers fees, director's liability, hiring independent directors or supervisors) exceed the network and learning benefits of the corporate form. They are not persuaded that the new regulations will be effective

in promoting better corporate governance and may even lead to unintended results. They are of the opinion that the corporate governance reforms have gone too far. As we have seen, the new developments may even hamper entrepreneurship. In this view, the costs of complying with the new rules and standards only exhaust the firm's resources. The only winners are the accountants and other company advisors, and the firm's competitors to which the extensive transparency requirements are a welcome opportunity to adjust their business policies.

Given the rising regulatory burden, a large number of firms have chosen to de-list. Some have even been taken private by large private equity firms, such as Carlyle, Blackstone, and Kohlberg, Kravis Roberts. It is perhaps an irony that a number of the leading private equity firms have taken a radical step to go public through listings on the New York Stock Exchange, London Stock Exchange and the Euronext respectively. There will be surely those commentators who argue that these new style offerings may lead to a different type of firm. To see this, the private equity firms taken public have employed, for example, a limited partnership structure in which the public investors own units. In this construction, investors are deprived of the normal complement of rights, such as fiduciary duties and voting powers that accompany the corporate form. While the decision-making authority rests solely with the general partners in these constructions, investors enjoy few privileges as a consequence of contracting into this arrangement. Clearly this trend raises a number of important policy questions. First, can we identify the consequence of the trade-off investors make between the package of rights that they typically receive when purchasing shares in a public corporation and the normal distributions and incentive structure that characterize the private equity based partnership structure used in this industry? Second, do we need a separate governance structure that offers investors in these limited partnerships a direct right to influence the decision-making procedure in portfolio companies. It has become apparent that the private equity partnership has chosen to continue to operate as much as possible as a non-listed company to avoid excessive state and federal regulation that now threatens the public corporation. If this trend were to succeed, it could very well become a blueprint for a new type of firm.

3. Where We Stand

In the end, the central reason for analyzing the corporate governance of non-listed companies is that this subject should begin to play a pivotal role in policy discussions around the world. If we recall the dominant position of the public corporation in mainstream discussions on corporate governance, we understand why non-listed companies receive less attention than their public counterparts. But there is no excuse for neglecting the needs of closely held companies. In this short article, we have encouraged an analytical approach and future orientation to corporate governance, notably by bringing into proper focus the realm of the non-listed company, as a legitimate and important perspective for policymakers and lawmakers to think about when undertaking legislative reforms.

References

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