POSITIVE CORPORATE GOVERNANCE

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1. INTRODUCTION

There is a growing perception that company directors and executives are self-interested actors, using their positions to pursue their own ends rather than focusing on pursuing what is best for the company and its stakeholders. Aiding this perception is recent news of the record 25-year jail sentence handed down to former World.Com boss Bernard Ebbers for his part in the fraud which caused the $11 billion collapse of that company,[1] and reports of overly-exuberant compensation arrangements at Fannie Mae, in which large rewards were provided to company executives even if the company failed or their own performance was substandard.[2] Indeed, according to Harvard professor Robert C. Clark in a recently-released paper, the media frenzy following the collapse of Enron and a host of other corporate scandals, resulted in a "social facilitation" (a term derived from social psychology) of the idea that the bursting of the corporate bubble was due to bad corporate behaviour, rather than normal economic forces.[3]

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[1] *See* Mirko Bagaric & James McConvill, *Give The Corporate Crooks A Break*, LAWYERS WEEKLY (Austl.) (Aug. 19, 2005).

[2] Lucian Bebchuk & Jesse Fried, *Executive Compensation at Fannie Mae: A Case Study of Perverse Incentives, Non-Performance Pay, and Camouflage*, John M. Olin Ctr. For L., Econ. & Bus., Discussion Paper No. 505 (2005), *available at* http://www.law.harvard.edu/programs/olin_center/.

[3] *See* Robert C. Clark, *Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act: A Morality Tale to Policymakers Too*, John M. Olin Ctr. for L., Econ. & Bus., Discussion Paper No. 525 (2005), *available at* http://www.law.harvard.edu/programs/olin_center/. Clark believes that because of this, "major legal reform to stop corporate fraud was [seen as a] needed response. *Id.* at 2.

The growing distrust of, and scepticism towards, company executives and directors across the developed world has resulted in an panoply of new corporate governance requirements enshrined in legislation (in particular, the Sarbanes-Oxley Act in the U.S.) or through other regulatory mechanisms (eg.., the NYSE rules and the requirements of corporate governance ratings agencies).[4] The assumption underlying

[4] The most significant changes made by the *Public Company Accounting Reform and Investor Protection Act 2002* ("Sarbanes-Oxley Act") included:

1. prohibiting registered public accounting firms from performing specified non-audit services contemporaneously with a mandatory audit, with firms only allowed to perform such services if they are approved by the client's audit committee, or the fees for non-audit services amount to no more than 5% of total revenues paid to the auditor by the company.
2. requiring that the lead audit partner and the review partner for each audit client be replaced every five years.
3. prohibiting a registered public accounting firm from performing statutorily mandated audit services for a company if the audit client's senior management officials had been employed by the audit firm and participated in the client's audit during the one-year period proceeding the audit initiation date.
4. requiring that a company's audit committee have the responsibility for the appointment, compensation and oversight of a registered public accounting firm, which is required to perform the audit. Members of the audit committee must be members of the board of directors of the company, and be independent.
5. the establishment of a Public Company Accounting Oversight Board with the following mandate:
    a. overseeing the audit of public companies that are subject to the securities laws;
    b. establishing audit reporting standards and rules; and
    c. investigating, inspecting, and enforcing compliance relating to registered public accounting firms, associated persons, and the obligations and liabilities of accountants.

15 U.S.C. §§ 78j-1(g), (j), (l), (m), 7211

As to the New York Stock Exchange Rules on corporate governance, which were approved by the SEC in November 2003 (with amendments made in 2004), see NYSE, 2004 LISTED COMPANY MANUAL 303A (2004), *available at* http://www.nyse.com. The main corporate governance rules introduced by the NYSE were that:

- Listed companies must have a majority of independent directors and 'independence' is defined in detail.
- To empower non-management directors to serve as a more effective check on management, the non-management directors of each listed company must meet at regularly scheduled executive sessions without management.
- Listed companies must have a nominating/corporate governance committee composed entirely of independent directors.
- Listed companies must have a compensation committee, with a minimum of 3 members, composed entirely of independent directors (as defined in section303A.02).
- Each listed company must have an internal audit function.
- Listed companies must adopt and disclose corporate governance guidelines
- Listed companies must adopt and disclose a code of business conduct and ethics for directors, officers and employees, and promptly disclose any waivers of the code for directors or executive officers.
- Listed foreign private issuers must disclose any significant ways in which their corporate governance practices differ from those followed by domestic companies under NYSE listing standards.
- Each listed company CEO must certify to the NYSE each year that he or she is not aware of any violation by the company of NYSE corporate governance listing standards, qualifying the certification to the extent necessary.

such initiatives is that top-down external regulatory mechanisms are needed to "encourage" those in positions of power to put the interests of the company above their own when wearing their corporate hat. Without such regulation, shirking and rent-seeking is inevitable, or so the argument goes.

A counter-argument that has been circling for some time in the press and academic resources is that such "quack"[5] regulatory initiatives are undesirable, and at least an over-reaction. The main effect of the initiatives, which are targeting the small group of "bad eggs," is to punish the much larger group of "good eggs" in the boardroom and managerial offices who perform successfully; have the company's best interests at heart; and want to get on with growing the company and providing returns to stakeholders, rather than having to resort to box-ticking.

Implied in this argument is that the great majority of company directors and executives are decent citizens with commendable virtues and objectives, rather than being untrustworthy, grubby animals with their snouts in the trough. Further, regulating—through external legislation and "soft law" initiatives—to achieve good corporate governance initiatives is inefficient and unnecessary, because the same objective can—and indeed is—being achieved inside the corporation through fostering a successful corporate culture which aligns itself with contemporary corporate governance objectives.

I have certainly been a supporter of this view, and have taken this argument a step further by utilising research and ideas that have been percolating outside corporate law and governance.[6] Rather than focusing on the bad eggs and obsessing over the slight chance that things will go wrong in the corporation (which has certainly characterised mainstream commentary as well as regulatory initiatives in recent times) I believe it is time for commentators, legislators and regulators to embrace what I term "positive corporate governance", and start from the base point that the overwhelming majority of company executives are inherently decent people, who desire (like we all do) to be happy, and do good. If corporate governance changed its orientation to focus upon and work to develop and the positive virtues of those involved in the corporation, I strongly believe that not only would there be less need for externally-imposed rules which place a burden on corporations (as corporate culture would naturally align itself with the principles and objectives of the contemporary corporate governance movement), but the corporation would also be more capable of aligning the interests of shareholders and other stakeholders—which is again a major objective in contemporary corporate governance.[7]

The concept of "positive corporate governance" draws largely upon literature in the positive psychology movement developed recently by University of Pennsylvania psychology professor Martin Seligman—both in terms of what it is trying to achieve,

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- Each listed company CEO must promptly notify the NYSE in writing after any executive officer of the listed company becomes aware of any material non-compliance with any applicable provisions of this Section 303A.

See also JEAN J DU PLESSIS, JAMES MCCONVILL & MIRKO BAGARIC, PRINCIPLES OF CONTEMPORARY CORPORATE GOVERNANCE Ch. 12 (2005).

[5] Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005). According to Professor Romano, there is no justification for prescriptive rules (with the principal focus of the paper being on the federal *Sarbanes-Oxley Act*) mandating corporate governance practices.

[6] James McConvill, *Reflections on the Regulation of Contemporary Corporate Governance* (forthcoming, 2006).

[7] *See* James McConvill, *Directors' Duties to Stakeholders: A Reform Proposal Based on Three False Assumptions*, 15 AUSTL. J. CORP. L. 88 (2005).

and also in terms of how individuals are perceived and the faith placed in individuals to develop. Accordingly, before providing an account of "positive corporate governance," I begin with an explanation of "positive psychology."

2. THE POSITIVE PSYCHOLOGY MOVEMENT

Positive psychology recognises positive human strengths and virtues (so-called "signature strengths"), rather than focusing on negative human traits. In his book *Authentic Happiness*, Martin Seligman explains the underlying rationale for positive psychology:

> For the last half century, psychology has been consumed with a single topic only - mental illness - and has done fairly well with it. … But this progress has come at a cost. Relieving the states that make life miserable, it seems, has made building the states that make life worth living less of a priority. But people want more than just to correct their weaknesses. They want lives imbued with meaning, and not just to fidget until they die.[8]

Another exploration of the rationale underlying positive psychology comes from another Seligman contribution:

> The message of the positive psychology movement is to remind our field that it has been deformed. Psychology is not just the study of disease, weakness and damage; it also is the study of strength and virtue. Treatment is not just fixing what it is wrong; it also is building what is right. Psychology is not just about illness or health; it also is about work, education, insight, love, growth and play. And in this quest for what is best, positive psychology does not rely on wishful thinking, self-deception, or hand waving; instead, it tries to adapt what is best in the scientific method to the unique problems that human behaviour presents in all its complexity.[9]

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[8] MARTIN SELIGMAN, AUTHENTIC HAPPINESS 1 (2002). Seligman provides an even more succinct explanation in saying positive psychology "seeks to cultivate human strengths, rather than focus on human weaknesses." Martin Seligman, Paul R. Verkuil & Terry H. Kang, *Why Lawyers are Unhappy*, 23 CARDOZO L. REV. 33, 35 (2001). *See also* Martin Seligman & Mihaly Csikzentmihalyi, *Positive Psychology: An Introduction*, 55 AMERICAN PSYCHOLOGIST 5, 13 (2000):

> The prevailing social sciences tend to view the authentic forces governing human behavior to be self-interest, aggressiveness, territoriality, class conflict, and the like. Such a science, even at its best, is by necessity incomplete. Even if utopianly successful, it would then have to proceed to ask how humanity can achieve what is best in life.

On the nature and utility of positive psychology, see HANDBOOK OF POSITIVE PSYCHOLOGY (C.R. Snyder & Shane J. Lopez eds., 2002); the March 22, 2005 edition of THE JOURNAL OF POSITIVE BEHAVIOR INTERVENTIONS (Spring 2005); and FLOURISHING: POSITIVE PSYCHOLOGY AND THE LIFE WELL-LIVED (Corey L.M. Keyes & Jonathan Haidt eds., 2002).

[9] *See* Martin Seligman, *Positive Psychology, Positive Prevention, and Positive Therapy*, *in* HANDBOOK OF POSITIVE PSYCHOLOGY 4 (C.R Snyder & Shane J. Lopez eds., 2002). In this piece, Seligman notes that it is important to recognise that positive psychology does not ignore the duty of psychologists to "both heal what is weak and nurture what is strong", but believes that recognising and promoting positive strengths and virtues is the key to real, long-lasting happiness. On this point, see also Mark F. Lezenweger, *Authentic Happiness*, 161(5) AMERICAN JOURNAL OF PSYCHIATRY 936 (2004) (book

Importantly, Seligman envisages that the approach underpinning positive psychology could be extended to the social sciences more generally, that is 'positive social science'.

> How has it happened that the social sciences view the human strengths and virtues - altruism, courage, honesty, duty, joy, health, responsibility and good character - as derivative, defensive or downright illusions, while weaknesses and negative motivations … are viewed as authentic.
>
> My vision is that social science will finally see beyond the remedial and escape from the muckraking that has claimed it, that social science will become a positive force for understanding and promoting the highest qualities of civil and personal life.[10]

As noted in *Character Strengths and Virtues: A Handbook and Classification* (2004) (by Christopher Peterson and Martin Seligman), positive psychology has the effect of reclaiming the *study of character* as a legitimate topic of psychological inquiry and informed societal discourse. As discussed below, this re-emphasis on studying character is important and provides a useful basis for a similar enlightened approach in corporate governance. The focus in corporate governance—at least recently—has been on control and compliance, emphasising the negatives and weaknesses in human beings, which need to be addressed by external incentives (executive pay being the most common, or negative sanctions).[11] But if we were to also focus on character in corporate governance, appreciating and promoting the view that positive character is something that is important to the corporation and can be fostered in the managers of the corporation; that positive character is inherent and can be utilised and developed in a corporate setting, and that the importance of character can be taught, then it could be considered that there is less need for control, with implications in terms of the manner of corporate regulation.

3. WHAT IS "POSITIVE CORPORATE GOVERNANCE"?

While positive corporate governance is not just positive psychology inside a corporate setting but with a different label, it draws heavily on thinking and practices in relation to positive psychology (in particular the use of education in recognising and promoting the "signature strengths" which contribute to happiness, and the development of "infrastructure" to emphasise human virtues and strengths).

Positive corporate governance represents a movement that views the behaviour and motivations of corporate participants (particularly executives) in a positive light (and is thus a significant departure from the "anti-management" approach which presently maintain support in law faculties and management schools), to recognise their personal strengths and virtues, and to promote the tangible implications that this

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review)—the positive psychology movement is a "supplement to negative psychology, not a substitute." (quoting SELIGMAN, *supra* note 8, at 289.)

[10] *See* Martin Seligman, *Positive Social Science*, 29 APA MONITOR 4 (Apr. 1998).

[11] *See* LUCIAN BEBCHUK AND JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004); Stephen Bainbridge, *Executive Compensation: Who Decides?*, 83 TEX. L. REV. 1615 (2005) (reviewing LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004)).

positive perspective has for corporate governance (in particular the regulation of internal governance arrangements and the performance of companies).

This mode of governance, by adopting a positive view of executives and their role in the corporation, is a useful umbrella term to unify under the one label emerging literature on real human behaviour (behaviouralism), trust and altruism, as well as happiness studies and stewardship theory—which has had relatively little impact in legal and corporate governance literature.[12] These areas of study all question reject the mainstream views of agency theorists regarding the strict motivating factor for corporate executives of wealth maximization, and the approach to regulating corporate governance based on assumptions about the behaviour and motivations of corporate executives. This is far from revolutionary, but requires a concerted effort—particularly as (discussed by Daniel Nettle in *Happiness: The Science Behind Your Smile* (2005)), there are evolutionary reasons why negative thoughts tend to have a more powerful force with human beings than positive thoughts.

Positive corporate governance recognises the dominance of the corporation in modern society and places enormous faith in the corporation as a facilitator of positive outcomes in society (strong employment, sustainable environment, healthy relationships on a professional and personal level). It does this by emphasising and promoting the positive traits in corporate participants, how these traits can be materialised through the corporation (as well as how these traits can be brought to the corporation), and the important implications of this positive emphasis on the corporation and its performance and sustainability. This provides positive corporate governance with a solid normative grounding.[13]

In this respect, it could be said that there are various close parallels between positive corporate governance and "virtue ethics", first advocated by Aristotle in *The Nicomachean Ethics*, and which have since been applied in contemporary management literature and thinking to infuse management with moral accountability and autonomy. Virtue ethics is fundamentally concerned with the character or attributes of a person that allow that person to "best" perform their role (as director, executive or otherwise). There is a focus on character and how it can be enhanced, rather than emphasising the utility of rules. Education is considered to have an important role to play in this systematic development.[14]

Because of the concentration on human weaknesses inside the corporation rather than recognising and fostering strengths, what we have seen in recent years is a change in the dynamics of regulation in relation to corporate governance - from adherence to internal 'norms' to the emergence of external regulatory mechanisms (i.e., formal legal rules) designed to perform a reward or punishment function in an effort to control the behaviour of managers. Under this approach, the corporation, and the individuals within the corporation, cannot be trusted to regulate their own internal arrangements without some external oversight and imposition of external rules.

But the important question is "what would happen if we were to change our perception of top executives in the corporation?" Rather than devoting our energy to

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[12] For a review of this literature, see JAMES MCCONVILL, THE FALSE PROMISE OF PAY FOR PERFORMANCE: EMBRACING A POSITIVE MODEL OF THE COMPANY EXECUTIVE Ch 5 & 6 (2005).

[13] On the importance of developing a normative theory of the corporation for contemporary corporate governance, *see* Stephen M. Bainbridge, *Competing Concepts of the Corporation (a.k.a. Criteria? Just Say No)*, (UCLA School of Law, Law- Econ Research Paper, No 05-01, Jan. 10, 2005), *available at* http://www.ssrn.com.

[14] *See*, for example, IAN E. THOMPSON AND BRYAN A. HOWIESON, ETHICS 92 (1997); Barbara Mescher & Bryan Howieson, *Beyond Compliance: Promoting Ethical Conduct by Directors and Corporations*, 1 THE CORP. GOVERNANCE L. REV. 93 (2005).

endeavouring to control their weaknesses, what if we instead devote our energy to recognising and promoting their positive traits—what positive psychologists refer to as "signature strengths"?

This simple change in perception and approach, one which has already commenced through recent work of some leading scholars but until now has not had a unifying label, raises some important—indeed fundamental questions. Many perceived inevitabilities in corporate governance may indeed become no longer inevitable. For example, if we are to emphasise and promote an alternative, "positive" perspective of the motivations and behaviour of executives, what are the implications in terms of the framework of corporate governance (regarding the operation of the board, meetings, the role of auditors, executive compensation, shareholder participation, etc.)? What would and should be the nature of regulation of corporate governance—could and should we rely more on "positive norms" that develop inside the corporation? Another, and broader, issue is the impact of this change of perception about the motivations and behaviour of executives in terms of our understanding of the corporation.

If we accept that the rational self-interested model (*homo economicus*) does not paint a complete picture of the typical corporate executive, and that the typical executive would not be drawn to a short-term, profit-orientated view of the corporation, what would be the implications? It may be said, intuitively, that if we are to emphasise and promote a positive model of the company executive, with importance placed on positive relationships between corporate participants and stakeholders and the genuine fulfilment of what is in the best interests of the corporation, we would naturally witness a change in attitude and approach directed towards the long-term best interests of the corporation. Sustainability rather than selfish pursuit would come to be appreciated as the overriding company objective.

Accordingly, positive corporate governance is not just "pie in the sky" stuff (or a push for a "smiley faced world"[15]). Rather, it has potentially significant implications in terms of the efficiency of corporate governance regulation (through the development and application of 'positive norms'), the relationship between the corporations and its stakeholders, and the long-term sustainability of the company's growth.

Some specific implications of embracing a positive model of the company executive are explored in more detail below.

4. Positive Corporate Governance and Regulation

Positive corporate governance has important implications for the regulation of corporate governance. This is because the "agency problem" is the underlying and ultimate justifying force for external regulation of corporate governance.[16]

In their text *Understanding Company Law*, Lipton and Herzberg make it quite clear that regulation of corporate governance is based entirely on the presumption that directors and managers of modern public corporations need to be kept accountable:

> Corporate governance best practice seeks to provide the mechanisms which align the interests of management with those of shareholders. The development of increased interest in corporate governance reflects

[15] Erica Goode, *Seeing Pessimism's Place in a Smiley-Faced World*, N.Y. TIMES, Aug. 15, 2000, at F7.
[16] *See* BEBCHUK & FRIED, *supra* note 11.

> higher expectations by the public and investment community that greater efforts be made by listed public companies to develop structures and procedures so as to ensure management is effective and acts in the interests of shareholders and adopts appropriate standards of corporate behaviour.[17]

Similarly, in their article, *Toward a Management Theory of Management*, Davis, Schoorman, and Donaldson discuss how "governance structures", along with executive compensation, are the two mechanisms which "protect shareholder interests, minimize agency costs and ensure agent-principal interest alignment."[18]

The authors continue:

> Controlling governance mechanisms are prescribed, because agency theorists assume that agent-principal interests may diverge and that given the opportunity the agent *will* maximize his or her individual utility at the expense of the principal's utility. . . . the model of the agent remains as inherently opportunistic, in that there is an ever-present possibility of opportunism, unless it is curbed through controls.[19]

This view on the significance of the agency problem to corporate regulation is commonly attributed to F.H. Easterbrook and D.R. Fischel's classic treatise on the law and economics of corporate law, *The Economic Structure of Corporate Law.* It was argued by Easterbrook and Fischel in this work that corporate law (at least in the United States) is designed to limit agency costs by providing a menu of default rules that parties can alter by contract if they so choose.[20]

If we are to embrace a positive model of the company executive, what would be the implications for corporate regulation? Existing rules—indeed the entire formal regulation of corporate governance arrangements—would need to be re-examined. If we can be confident that executives are naturally inclined to pursue what is best for the company, and doing so is an incentive in itself, external regulation can be dispensed with (at least to a significant extent).

But what about the rare number of executives who are purely self-interested and motivated by money? Isn't traditional, external regulation—in the form of corporate law rules—needed to control these individuals? Not necessarily. Traditionally it has been assumed that all those in senior management are self-interested, putting their own interests before the corporation's interest (agency theory). Under this traditional account, individuals would be less likely to challenge illegal or inappropriate actions of others within the corporation unless it interfered with their own interests. But under positive corporate governance, there is less need for formal regulation as other (usually more senior) individuals within the corporation will condemn and challenge actions that are contrary to the interests of the corporation or its stakeholders. Market forces will also be at work—positive individuals will wish to work with other positive individuals, and may take action against individuals who are attempting to put their own interests above the best interests of the corporation. Contracts may not be

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[17] *See* PHILLIP LIPTON & ABE HERZBERG, UNDERSTANDING COMPANY LAW 295 (11th ed. 2003).
[18] *See* James H. Davis, F. David Schoorman & Lex Donaldson, *Towards a Stewardship Theory of Management*, 22 ACAD. OF MGMT. REV. 20, 22 (1997).
[19] *Id.* at 23.
[20] *See* F.H. EASTERBROOK & D.R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 14-15 (1991).

renewed, promotions may not be granted, and so on. Applying a cost/benefit analysis, this may convince detractors that it is in their overall best interests to act positively, and promote positive strengths and virtues.

This line of reasoning for why formal regulation may not be necessary under a schema of positive corporate governance, notwithstanding the presence of "bad eggs" within the corporation, has close parallels with the concept of "socially mediated deterrence" which has received some attention in recent academic commentary. Michael Wenzel[21] has recently referred to research by Williams and Hawkins[22] that distinguishes between three general processes through which legal sanctions can inhibit crimes. These are the processes of "mere deterrence", "normative validation", and "socially mediated deterrence", the third being where "legal sanctions are 'costly' due to others' reaction to one's conviction, arrest, or legal punishment."[23] Wenzel goes on to explain in relation to this third effect of legal sanction, that "People are, in their attempts to attain esteem, attachment, and even material goals, dependent on others. If others reacted negatively to one's conviction of a crime, they could stigmatise the offender and end their relationship to, or cooperation with, the offender."[24]

A good grounding in regulatory studies is important to understand the implications of positive corporate governance for regulation. It needs to be appreciated that the State is not the only source of regulation, and that regulation extends beyond formal "rule-based" mechanisms.

In their contribution on *Regulation* to the *Oxford Handbook of Legal Studies*, Christine Parker and John Braithwaite contend that much regulation is in fact accomplished without recourse to rules. It is also organised by economic incentives to steer business behaviour, by moral suasion, by shaming and even by architecture.[25] Similarly, Parker and Braithwaite define regulation broadly:

> For scholars of regulation, the core area of study is "regulation" in the sense of 'the intentional activity of attempting to control, order or influence the behaviour of others'. This definition is broad in the sense that 'regulation' is not limited to targeted rules that are enforced and monitored, nor is it limited to state intervention in the economy and/or civil society. . . .
>
> *It incorporates three basic requirements for a regulatory regime: the setting of standards; processes for monitoring compliance with the standards; and mechanisms for enforcing the standards. . . .*
>
> The most influential theories of regulation involve some conception of private or public intent to shape the flow of events.[26]

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[21] Michael Wenzel, *The Social Side of Sanctions: Personal and Social Norms as Moderators of Deterrence*, 28 L. & HUM. BEHAV. 547 (2004).
[22] *See* K.R. Williams & R. Hawkins, *Perceptual Research on General Deterrence: A Critical Review*, 20 L. & SOC'Y REV. 545 (1986).
[23] Wenzel, *supra* note 21, at 550,
[24] *Id.*
[25] *See* Christine Parker & John Braithwaite*, Regulation, in* OXFORD HANDBOOK OF LEGAL STUDIES 119-45 (Peter Cane & Mark Tushnet eds., 2005).
[26] Christine Parker ET AL., *Introduction*, *in* REGULATING LAW 2-3 (Christine Parker ET AL. eds., 2004) (emphasis added).

Regulation within the corporation is very important; indeed internal governance has historically provided a reference point for the shape and content of external regulation. This is recognised in the recent commentary on "corporate law and norms," in terms of the effectiveness of "norms" in regulating corporations and corporate participants. Richard Posner defines a "norm" as:

> [A] rule that is neither promulgated by an official source, such as a court or a legislature, nor enforced by the threat of legal sanctions, yet is regularly complied with.[27]

Norms, by establishing standards of behaviour from the ground up inside the corporation, can be just as effective and all-encompassing as external rules imposed from institutions outside of the corporation.[28] Why then do we assume that external arrangements are more effective than arrangements which develop naturally within the corporation?

At a Symposium on Norms and Corporate Law, held at the University of Pennsylvania Law School in 2000, Professors Edward B. Rock and Michael L. Wachter had the following to say about "norms" in the context of corporate law (and by implication, the regulation of corporate governance):

> Norms are an essential element of human conduct. We have always known that they guide behavior and that they are important in this role. They represent those behavioral rules and standards that are primarily, if not exclusively, enforced by the parties themselves. But until recently, writing about legal rules and standards was of much greater interest to the legal academy.
>
> . . . .
>
> Thinking about the role of norms in a corporate setting is critical for several reasons. Inside the corporation second-party relationships reign, but the relationships are importantly, indeed primarily, noncontractual. For example, behavioural rules and standards for corporate actors are provided by corporate culture and are essentially norm-based. Much of what goes on in the corporate boardroom varies among companies and follows corporate-specific practice….
>
> With great latitude, corporations can still follow their own norms and still do it "right".[29]

Positive corporate governance needs to have as its objective influencing and promoting a change in corporate culture, a change which recognises and promotes the development of "positive norms." Indeed, as I have written elsewhere:

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[27] R A Posner, *Social Norms and the Law: An Economics Approach*, 87 AM. ECON. REV. 365, 365 (1997).

[28] In THE OPEN CORPORATION (2003), Christine Parker suggests that "the open corporation" may be a more effective means of regulating than the traditional command and control method (at 8). According to Parker, there is a need to foster self-regulation through programs designed to 'internalize responsibility' (at 32). This is an alternative to external regulation (backed up by punishment).

[29] Edward B. Rock & Michael L. Wachter, *Norms & Corporate Law: Introduction*, 149 U. PA. L. REV. 1607, 1607-08 (2001).

> In the specific context of corporate governance regulation, the percolation of norms inside the corporation is important. If we can identify a systematic body of norms operating inside the corporation (which past inquiries from leading organisations and eminent individuals have demonstrated to be quite possible), and also between the corporation and its stakeholders, backed by nonlegal sanctions, then in areas where norms are operating effectively it can be argued that formal rules are not necessary. Applying a simple cost/benefit analysis, why introduce formal regulation in relation to a particular matter, whether it be board structures, executive compensation, the responsibilities of auditors or whatever else, with the attendant cost and time that is associated with compliance, if substantially the same, or indeed the same, outcome can be achieved through enabling norms of best practice to operate independently?[30]

Michael Wenzel has recently also dismissed the implications of formal regulation in a particular area (here, it was tax) and the development and shape of norms. Wenzel investigated personal and social norms (both internalized and externally attributed prescriptions) of Australian citizens regarding tax evasion with respect to their role in the deterrence process. This was to understand the limitations and force of the existing regulatory approach. The general finding was that by way of externally imposed rules and regulations, personal and social norms were found to moderate the effects of deterrence on tax evasion. Personal, internalised norms of tax honesty were found to be negatively related to tax evasion. When internalised, norms reduce the effects of deterrence. However, when norms are considered external, they boost deterrence effects—which give "social meaning" to formal sanctions. Wenzel comments that:

> …deterrence and norms can be considered as interdependent or interacting processes, where ethics and internalized norms basically render deterrence superfluous. Deterrence, with the implied rational weighting of costs and benefits of different behavioral options, should only be relevant where people's ethics do not discard non-compliance as one such option altogether. That is, deterrence would only be relevant and effective for taxpayers who do not have strong ethical objections against tax evasion. In contrast, taxpayers who have internalized norms against tax evasion would be unaffected by deterrence variables.
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> …
>
> … it would emerge that ethics and norms are not only more potent means to achieve compliance with the law than deterrence is, but in fact also delimit the relevance of deterrence.[31]

It is useful to focus on the specific area of executive compensation as an example of how embracing positive corporate governance could have this effect on regulation. If we are to accept that aligning executive pay with company performance is not the most effective method of setting executive compensation because the underlying agency theory rationale for this approach defies reality, then less regulation in this area would seem a natural result. There would be no need for the complex and

[30] James McConvill, *Of Stewards, Surfboards and Homo Sapiens: Reflections on the Regulation of Contemporary Corporate Governance* (2005) (forthcoming).
[31] Wenzel, *supra* note 21, at 549.

burdensome rules requiring disclosure of particular aspects of executive compensation packages and the link with company performance, because remuneration would be separated from performance. The level and structure of executive compensation would instead be controlled through the operation and influence of "positive norms" inside the corporation.

Improved and enhanced disclosure of remuneration has traditionally been the reason for regulating in this area of corporate governance.[32] For example, in an article published in 1992, Professor Ian Ramsay wrote that:

> There are a number of reasons why it is appropriate to focus upon improved disclosure as a means of reform. First, disclosure is important to the efficient operation of market forces. [O]ne possible reason why remuneration may not be related to company performance is that managers are inadequately disciplined by market forces. In part, this may be because of informational deficiencies in these markets. A second reason why it is appropriate to focus upon improved disclosure is that disclosure assists in monitoring by shareholders. . . . [T]he greater the variety of ways managers can be compensated, the more difficult and expensive it is for shareholders to monitor the use of these varied and frequent plans and measure their effectiveness. Disclosure of the terms of remuneration plans is therefore essential.[33]

But an emphasis on disclosing the link between executive pay and corporate performance loses its relevance if we appreciate that the link between pay and performance is at best questionable. Given that the very reason for external regulation of executive compensation in the form of express disclosure requirements is to improve the link between pay and performance, once this link is no longer supported, there is really no need for regulation of executive remuneration outside of the corporation. This is particularly the case when the need for disclosure has traditionally been based on a mistrust of directors and executives to defray from self-dealing.

5. POSITIVE CORPORATE GOVERNANCE AND OUR UNDERSTANDING OF THE CORPORATION

Positive corporate governance also impacts on our conception or theory of the corporation. There is an emerging field of literature in corporate governance and financial economics about the role and objectives of the modern corporation. The concept of wealth maximisation is changing from focusing on short-term profits for shareholders to long-term sustainable growth with the company's stakeholders having

[32] The classic statement in support of enhanced disclosure is "sunlight is the best disinfectant" by Justice Louis D Brandeis. *See* LOUIS D BRANDEIS, OTHER PEOPLE'S MONEY 72 (1933). On the importance of disclosure as a concern for regulation, see Jennifer Hill, *What Reward Have Ye? Disclosure of Director and Executive Remuneration in Australia*, 14 COMPANY & SEC. L. J. 232, 233 (1996). *See* more recently, Jennifer Hill, *Regulatory Responses to Global Corporate Scandals*, WIS. INT'L L. J. (forthcoming, 2005). *See* in particular 237-38, where Professor Hill outlines some mainly economic-based reasons why "adequate" disclosure of director and executive remuneration is important.

[33] *See* Ian M. Ramsay, *Directors and Officers' Remuneration: The Role of the Law*, J. BUS. L. 351, 371 (1992).

an important role to play. Simon Deakin refers to the latter, emerging view as the "enlightened stakeholder theory" of the corporation.[34]

Deakin argues that the shareholder primacy norm is not as deeply rooted in corporate governance as assumed. Shareholder attitudes are emerging beyond traditional assumptions, therefore naturally implying that the attitude and stewardship of directors and managers can and should move in this direction as well.

> Because it is essentially a cultural rather than legal point of reference, shareholder primacy is less strongly institutionalised than might be supposed.
>
> . . . .
>
> [S]hareholder primacy is undergoing an internal transformation, via a notion of corporate responsibility in which shareholder activism becomes the means by which society holds corporate management to account.[35]

Deakin attributes to this "emerging transformation" to the implications of "universal ownership."

> [T]he institutionalisation of share ownership which has occurred in the USA and UK since the 1940s has created a new category of "universal owners" with strong incentives to become actively involved in the affairs of individual companies. This is because pension funds, in particular, tend to have holdings in a broad cross section of the listed company sector. . . . *This increasingly means that they have interests in the economy as a whole.* . . . As a result, these shareholders do not benefit from short-term gains achieved through the operation of the market for corporate control. . . .
>
> Universal owners are also likely to have an extended time horizon for assessing corporate performance. The more they are required by prudent investment standards to diversify their holdings across the market as a whole, the more they become locked in both to the market and to the individual firms in which they hold stakes. Being subject to lock-in makes them more likely to engage with management on a long-term basis to improve performance, and less likely to respond to managerial failure by selling their stakes in the companies concerned. In addition, universal ownership provides pension funds with incentives to monitor the degree to which firms produce externalities in terms of social and environmental costs which fall on third parties or the wider communities. The logic of universal ownership is that shareholders will in the final analysis, bear the costs of externalities which cannot easily be absorbed by third parties or which produce dislocative effects upon society or the economy.
>
> . . . .
>
> What we are witnessing is the content of the shareholder value norm, so that it comes to represent the idea that shareholders exercise their powers

[34] *See* Simon Deakin, *The Coming Transformation of Shareholder Value*, 13 CORP. GOVERNANCE: AN INT'L REV. 11 (2005).
[35] *Id.* at 16.

> not as the representatives of the market, but as agents of society as a whole. *The corporate governance of the future will be centrally concerned with how this idea is worked out in practice.*[36]

Embracing positive corporate governance, with an emphasis placed on facilitating and promoting positive motivation and behaviour of executives, rather than seeking to control executives and emphasising short-term profit maximisation, will certainly assist with this emerging transformation.

6. Positive Corporate Governance and Education

For positive corporate governance to be as effective and significant as envisaged, the positive model of the executive needs to be broadly acknowledged and accepted. In other words, a positive corporate culture needs to develop which nurtures positive norms as an effective substitute for external regulation. This will be difficult as many commentators and regulators will consider much of the argument underlying positive corporate governance as being not only counterintuitive, but pure fantasy.

Both formal education inside institutions and the corporation and informal education through reading commentaries and observance of norms inside the corporation will be important. In the context of discussing the importance of appreciating the relevance of ethics in contemporary corporate governance and teaching how these ethics can be applied in the modern corporation by corporate participants, Barbara Mescher and Bryan Howieson noted recently that:

> Corporate governance can be enhanced if all staff, not only directors, receive training in these core skills and if these skills are adopted throughout an organization as part of its everyday systems and operations, thus reflecting a cycle of continuous improvement.[37]

Education is the key to positive corporate governance in terms of promoting the virtues of adhering to a professional ideal and the rewards which flow on from this, as opposed to emphasising the need for external incentives and sanctions to influence certain outcomes. These qualities, rather than money and status, must become the Holy Grail for corporate governance regulation. This is indeed possible.

Professor Layard sums up the virtues of "positive education" nicely:

> In most of us there is a deep positive force which can be liberated if we can overcome our negative thoughts. To develop this inner strength of character should be a major goal of education.[38]
>
> . . . .
>
> We need better education, including, for want of a better word, moral education. . . .[T]he basic aim should be the sense of an overall purpose wider than one self.[39]

Looking at what can be achieved through positive education in a corporate setting, Layard comments that:

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[36] *Id.* (emphasis added).
[37] Mescher & Howieson, *supra* note 14, at 93.
[38] RICHARD LAYARD, HAPPINESS: LESSONS FROM A NEW SCIENCE 230 (2005).
[39] *Id.* at 234.

> Respect is certainly given to status, but it is given to many other qualities as well. Thus a different way to deal with the status race is to increase the respect that is given to other things.[40]

Useful also in this regard is the comment of Handelsman, Knapp and Gottlieb:

> Self-reflection and self-care are integral parts of positive ethics; if they were reinforced in training, continuing education, professional associations, and regulatory agencies, they could improve not only our lives but also the lives of those we serve and the society in which we live.[41]

In their book, *Management Redeemed*, Hilmer and Donaldson also emphasise the importance of education to the future of management, as a positive-oriented profession. According to Hilmer and Donaldson, education of managers and future managers is not enough, it is also important to educate the public about the positive virtues of management and the positive traits of managers.

Hilmer and Donaldson argue that the future of management depends on it being perceived as a profession.[42] Traditionally, management has not been given a "professional" tag alongside doctors and lawyers, but if we appreciate that corporate management is a profession, this should have a positive impact in terms of the way we perceive managers. Hilmer and Donaldson make this point very clear and provide their view on how professionalism can be truly realised:

> The lofty ideals of professional management are rarely discussed in management education, and if covered tend to be quickly dismissed with the words "It's a value judgment" or "Interesting question but let's get back to the numbers." We would encourage that more attention be paid to the goals of management and to its constructive and detrimental impact on society. These questions can be woven into courses that deal with more practical problems, such as introducing a new product, evaluating investments, or managing people.[43]

Hilmer and Donaldson suggest that there may be a close relationship between our perception of managers and the level of external regulation that needs to be imposed on the corporation:

> [P]ublic perception is now quite negative, as evidenced by the popularity of management bashing in the media and by the vast increase in proposals for more regulation and even personally instructive disclosure.

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[40] *Id.* at 156.

[41] Mitchell M Handelsman et al., *Positive Ethics*, in HANDBOOK OF POSITIVE PSYCHOLOGY 731, 742 (C R Snyder and Shane J Lopez, eds., 2002).

[42] *See* also the debate in the new edited work, RESTORING TRUST IN AMERICAN BUSINESS (Jay W. Lorsch et al. eds., 2005), as to whether there is/should be a "re-imaging" of company directors as professionals, and the company director as a profession. See the essays by Rakesh Khurana, Nitin Nohna & Daniel Pennice, *Management as a Profession*, at 43; Martin Lipton, *The Professionalization of Corporate Directors*, 71; and and Jay W. Lorsch, *Comment: Should Directors Be Professionals?*, 79.

[43] FREDERICK G. HILMER & LEX DONALDSON, MANAGEMENT REDEEMED: DEBUNKING THE FADS THAT UNDERMINE CORPORATE PERFORMANCE 188 (1996).

> Consequently, we believe that there is a need now to begin to improve the public's understanding to redeem the idea of management as a valuable contributor to society. This is a job that can be done by management schools' improving their curricula … and by managers and their representative associations' becoming more effective public advocates.[44]

Hilmer and Donaldson go on to suggest how education can be approached to foster positive corporate governance:

> Managers should network to combat unjustified criticism by external parties, such as the media, and should collaborate to resist unwarranted intervention by external parties, such as regulators or short-term investors. Managers should insist that their professional associations take an active part in advancing the cause of management. This includes running seminars countering the myth that all managers are corrupt, foolish, or lazy by illustrating the realities and complexities of managing, not the glib simplifications.[45]

This positive-oriented education can be achieved through conventional educational courses at universities and colleges, through special training programs (either external or internal) for directors and executives about positive virtues, and more informally through the natural cultivation and refinement of norms, word-of-mouth and the way in which the press report business news.

There is a precedent of positive psychology thinking being embedded into conventional educational environments with a view to "capacity building" (that is, building the capacity of students and observers to be happy). In December 2002, *The Philadelphia Inquirer* reported that, with a $2.8 million, four-year US Department of Education grant, Strath Haven High School in Delaware Country, Philadelphia, the school partnered with Professor Martin Seligman and a team from Swarthmore College to research whether infusing the study of positive character traits in the curriculum will help students academically and emotionally.[46] It was envisaged that if the trial worked, the program could become a national model to be promoted through a Department of Education clearinghouse.

Beginning in 2003, the program involves a group of ninth-grade language arts classes adding instruction in six "key character areas" identified by Martin Seligman and his colleagues. These are: wisdom and knowledge; courage; love; justice; temperance (forgiveness, humility and self-control), and transcendence (gratitude and hope).

Layard also looks at the potential of a re-orientation of education in the specific context of executive compensation. Layard raises a number of difficulties with the pay for performance pay-setting methodology from a happiness perspective, and suggests some solutions in terms of public policy and education.[47]

Layard ultimately contends that the direction in relation to motivating current executives and training/educating future executives has been misguided. Layard

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[44] *Id.* at 190-91.
[45] *Id.* at 191.
[46] Susan Snyder, *Making Character the Subject of Study*, PHILA. INQUIRER, Dec. 10, 2002, at A01 Local.
[47] LAYARD, *supra* note 38, at 157-60.

believes that education, both formal and informal, rather than more burdensome regulation stemming from complex external incentives and the emphasis on disclosure, is what is needed to make the role of executive, and executive compensation, more effective. Layard states that:

> [I]t seems that governments over the last twenty years have made serious errors in their approach … They have stressed ever more the need to reward individual performance, *rather than providing proper pay for each grade and stressing the importance of the job and of professional norms and professional competence*.[48]

Layard goes on to discuss what he sees as the virtues of a change in approach to management education, one which naturally engenders trustworthiness and respect within the corporation. According to Layard, a change in approach is warranted—one that promotes the virtue of adhering to professional ethics. Layard argues:

> [C]ontinuous reoptimisation is not the best route to happiness; you are more likely to be happy if you settle for what is "good enough" than if you feel you must always have the most.[49]

Settling at what is "good enough" is an important thing to remember when approaching executive compensation. A refocusing of executive recruitment and the relationship between company and the executive, with an emphasis on the job and the virtues of the job, rather than one's level of pay and matching performance with pay, is what is needed. What needs to be emphasised more clearly is that executive compensation is no more than a means to an end, rather than an end in itself.

7. Positive Corporate Governance, Happiness and Social Capital

For both the stakeholders of the company, and society in general, fostering and promoting trust and respect in the corporation by providing a positive model of the executive, rather than engendering lack of trust and respect in the corporation by using pay as a means of control, should also be happiness-enhancing. Empirical studies in the emerging science of happiness again show that, on the whole, individuals are happier in countries where people are considered to be genuinely trustworthy.[50]

Trustworthiness is best demonstrated by adhering to a standard of conduct, or behaving in a genuinely altruistic manner, with an absence of formal sanction guiding such conduct or behaviour. Trustworthiness comes from natural behaviour, as opposed to behaviour performed due to the threat of formal legal sanction. In relation to company executives, their trustworthiness is more likely to be demonstrated by showing that they can adhere to an admirable standard of conduct/behaviour without being pressured by formal legal rules.

Layard discusses in detail the importance of trust as a factor contributing to happiness. In his book, Layard refers to the "World Values Survey", which compared levels of happiness in fifty countries in up to four different years. According to the

[48] *Id.* at 160 (emphasis added).
[49] *Id.* at 227.
[50] *Id.* at 64.

Survey, there are reportedly six factors which explain 80% of the variation in happiness. The factors are:

3. divorce rate;
4. unemployment rate;
5. *** level of trust;
6. membership in non-religious organisations;
7. quality of government;
8. fraction believing in faith.[51]

According to the World Values Survey carried out four times since 1981, there was a 1.5 point fall on the scale of happiness (from 10 to 100) as a result of the percentage of persons answering "yes" to the question "In general, people can be trusted", falling by 50 percentage points over this time.[52]

Trust is thus integral to the overall happiness of our society. According to sociology professor Robert Putnam and others, the quality of the community—what Putnam called "social capital"—is considered to be closely associated with the general impression in the community about whether people can be trusted.

In a recent book, Putnam identifies a "growing social-capital deficit" in the United States, the causes and consequences of this deficit, and attempts to provide an explanation for why Americans are increasingly telling pollsters that they wish they lived in a more civil, more trustworthy, more collectively caring community.[53] Putnam's book emphasises that there is a withering of the bonds of communities, and that this has led to very real costs in terms of individual and collective well-being.[54]

Not only does building social capital enhance the overall well-being of our society, but also provides for an effective and natural substitute to externally-imposed legal rules. Social capital provides for the trust, and cooperation and outcomes flowing from trust, which external rules are precisely trying to achieve. Put simply, cooperation replaces conformance. Cooperation breeds trust, conformance is merely paperwork.

According to law academic Jason Mazzone:

> [Under] social capital theory, transactions between and among individuals occur more readily when the individuals are embedded in

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[51] *Id.*

[52] On page 69 of his book, Professor Layard states:

> Researchers have dropped wallets in the street in different countries, wallets that included the name and address of the owner. They then counted the proportion of dropped wallets that were returned to the owner the highest was in Scandinavia. These proportions were then compared with how the citizens of the country replied about trust [and particularly the percentage/proportion who say "Yes, most people can be trusted".] It turned out that the two were closely related: so when we ask about trust, we do learn something about whether people can actually be trusted. [my interpolation].

[53] ROBERT PUTNAM, BOWLING ALONE: THE COLLAPSE AND REVIVAL OF AMERICAN COMMUNITY (2001).

[54] As to how a higher level of overall trust in the community builds social capital, *see* D. HALPERN, SOCIAL CAPITAL (2004). On the nature and benefits of trust, *see also* S. Knack, *Trust, Associational Life and Economic Performance*, in THE CONTRIBUTION OF HUMAN AND SOCIAL CAPITAL TO SUSTAINED ECONOMIC GROWTH AND WELL-BEING (J. Helliwell and A. Bonikowska eds., 2001). *See* also JOHN FIELD, SOCIAL CAPITAL (2003) – "social capital" is a way of conceptualizing the intangible resources of community, shared values and trust upon which we draw in daily life.

> strong social networks and they can draw upon the norms and trust that result from social ties.[55]

Mazzone believes that

> social networks serve as a kind of capital that can solve collective action dilemmas by *furnishing sufficient guarantees of trust and by tempering self-interested behaviour*. Groups that are able to draw upon strong social ties and other forms of social capital can therefore reap the benefits of cooperation in collective action settings and enjoy increased productivity as a result more readily than groups in which social relationships are too weak to overcome suspicion and self-dealing.[56]

Biologist Paul Martin makes a similar point about the benefits that flow from fostering a relationship built on trust and cooperation in *Making Happy People* (2005). Martin goes further and points to studies and commentary in evolutionary biology that as human beings we are *naturally inclined* to be trusting creatures:

> Biological theory, backed by empirical evidence, strongly implies that we are predisposed to trust each other. . . . Natural selection has equipped us with brains that suit us for living in social groups. One way in which we are adapted for group living is to be predisposed to trust each other, up to a point, so that we can cooperate with them and reap the considerable benefits that cooperation brings. . . .Evolutionary biologists refer to this phenomenon as reciprocal altruism, and it is observed in many other social species including apes, monkeys and birds.[57]

Accordingly, a system of regulation built on, and which promotes, suspicion and mistrust of others (which much of contemporary corporate governance does, most strongly highlighted in the pay for performance regime), taking away or limiting the natural role of trust, is an unnatural mechanism, and we should instead allow nature to work its course.

These studies on trust are not limited to non-commercial contexts. Martin points to evidence that trust is just as relevant and important in commercial settings. Martin states that:

> Carefully controlled psychological experiments have established that, contrary to what simple economic theory predicts, real people actually do trust others and want to cooperate with them - *even in situations that are explicitly concerned with money*.[58]

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[55] Jason Mazzone, *The Social Capital Argument Against Federalism*, 6 DEAKIN LAW REVIEW 200, 204-5 (2001).
[56] *Id.* at 208 (emphasis added).
[57] PAUL MARTIN, MAKING HAPPY PEOPLE: THE NATURE OF HAPPINESS AND ITS ORIGINS IN CHILDHOOD 81 (2005).
[58] *Id.* at 82 (emphasis added).

8. CONCLUSION

If we accept that for the overwhelming majority of corporate executives, happiness comes not from money per se, but rather one's relative position because of the income/wealth one has, this natural competitive instinct should be directed towards being utilised (with the help of education both in and outside of the corporation) to promote more productive endeavours. Conventional methodologies such as "pay for performance" should not be relied on to achieve these same objectives. A company executive's relative position, and hence happiness, can be just as successfully fostered through being able to proclaim "my company is better and more respected than yours," than "my executive options are bigger than yours."

Such a change in emphasis is likely to attract a person to the position of executive in a company for the long-term, and with a real genuine interest in what he or she is doing. This is best for both the executive and the corporation.