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Director conduct in the context of legal and cultural frameworks of corporate governance

Dr Maureen Bickley
Graduate School of Business, Curtin University of Technology, Perth Campus, Western Australia
Email: bickleym@gsb.curtin.edu.au

Professor Margaret Nowak
Graduate School of Business, Curtin University of Technology, Perth Campus, Western Australia
Email: nowakm@gsb.curtin.edu.au

Contact Author: Dr M Bickley, Graduate School of Business, Curtin University
83 Murray Street Perth WA 6000
Phone 9266 3563

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Abstract:

In recent years there has been considerable discussion of and some movement towards, harmonisation of governance structures and processes between the EU and North America in particular. Multilateral organisations such as the World Bank together with the expansion of the EU in 2004 have provided added impetus for a broader focus on harmonisation. At the same time, emanating from the USA, the requirement to conform to Sarbanes Oxley has exerted unilateral pressure on individual corporations world-wide.
The authors argue, however that a 'one size fits all' approach to governance is not consistent with the different cultural values, frameworks and legal systems which are

the various national contexts of governance. These differences are consistent with alternate paradigms concerning the motivation and behaviours of directors. It is further argued that these differences are relevant to discussion of corporate sustainability.
The authors note that the theoretical models, agency theory, and stewardship theory, are each consistent with alternative accountability approaches and thus different approaches to director motivation.
A qualitative study of Austrian company directors is used to investigate whether the recent development of a more open economy coupled with the global capital market is generating a convergent model of director conduct. It was apparent that a stakeholder approach , where stewardship theory best explains the processes to mediate director conduct, continues to best describe the Austrian way. This contrasts with "theory in use" in Anglo/US practice which conforms to the tenets of Agency Theory. We conclude with a discussion of the implications for sustainability management.

Key words: agency theory, corporate social responsibility, comparative governance, director conduct, ethics, stewardship theory, stakeholders.

Behind Descriptions of market reforms, …and the convolutions of the Dow, I gradually made out the pieces of a grand narrative about the inner meaning of human history, why things had gone wrong and how to put them right. Theologians call these myths of origin, legends of the fall and doctrines of sin and redemption.

(Cox 1999)

Introduction:

In April 1999 the OECD issued its' "Principles of Corporate Governance", developed by its Ad-Hoc Task Force on Corporate Governance. While these are specifically a "set of non-binding principles," they are presented in the words of the preamble, as "a common basis that OECD Member countries consider essential for the development of good governance practice."(OECD Principles of Corporate Governance 1999, p.2). These principles bring a multinational perspective to the principles and practices of corporate governance which had previously resided within individual state historical, legal, social and cultural contexts. In doing so this document focuses on shareholder interests and rights. While a number of OECD member states specifically recognise stakeholder rights in corporate law and regulation, this document considers stakeholder aspects of governance to be treated elsewhere and not within the document on the Principles of Corporate Governance. A recent report for the European Commission (2002) also tended to downplay the issue of divergence in governance grounding, structures and processes and seeks to foster convergence. At the same time, a doubling in the past decade of foreign corporations listed in the USA has increased the reach of the United States Securities and Exchange Commission (SEC). Recent high profile cases which have involved the SEC include Parmalat and Royal Dutch Shell Group (Schroeder, 2004, p.14).

As Europe grapples with governance "harmonisation" issues, these competing paradigms, grounded in different legal and cultural traditions have been debated (for example, Becht 1999, and in Van den Berghe and De Ridder, 1999 and Maeijer and

Geens1990 as well as the forums provided by the European Commission 'High Level Group of Company Law Experts 2002).

Whilst more open securities markets are encouraging a convergence which is, in effect, pressure to accept the Anglo/USA paradigm giving primacy to the shareholder, some European nations hold on to the importance of divergence (co- existence of European tradition). The Draft Fifth Directive which was under active discussion in the 1990s, and which included a range of proposals to increase shareholder rights, was completely abandoned at the end of the decade (Becht 1999, p.1081) while governments continued to develop interpretations of corporations law consistent with their governance traditions. As an example newly introduced German law regulating takeovers provided that the takeover code specifically protects the interests of employees and continues to make hostile takeovers more difficult (McCathie, 2000).

It is argued here that there may be important issues at stake in respect of questions of sustainability and corporate social responsibility which convergence could overrun. In particular we argue that the property rights and enterprise based approach of the major European tradition may embody important elements required to assure a culture of social responsibility and sustainability.

This paper considers alternate paradigms and competing theories concerning the motivation and behaviour of directors. It looks at how difference in the specification of property rights within corporate law impacts on director motivation and corporate accountability. It concludes with a case study based on Austrian data. Austrian directors' views focussing on director conduct and board dynamics demonstrate that, despite tensions arising from EU integration and globalisation, an "Austrian Way" continues to hold sway. It is firmly based in the social, legal and cultural context and a stakeholder approach. It is further argued that such an approach may be more compatible with a culture of sustainability than one sustained by the view that, for corporations, the property rights of the shareholder (as financial owner) are dominant.

Legal traditions and the corporate law

Nowak and Bickley (2004) point out that the differences in legal traditions underlined by Berglöf (1997) which underpin the European as compared to the Anglo/US patterns of corporate law are the basis for differences in the mechanisms for corporate monitoring and accountability.

The system typical of traditions based in common law (eg. Australia, Canada, USA, UK) is based on a nexus of contracts with the focus of the law being the analysis of contracts between the various capital providers (Berglöf, 1997, p.105). Corporate law is specific about the obligations and accountability of the corporation to the shareholder group as owners and confers on that group specific powers such as voting at the annual general meeting. Nowak and Bickley (2004) argue that within this tradition the only property rights which are closely specified in corporate law are the property rights of the shareholder as 'owner'/ finance provider.

In contrast, the traditions of the European or Continental legal systems (Berglöf, 1997) result in a corporate law tradition which is based on multiple property rights and provides specifically for corporate accountability to multiple stakeholders. In a number of cases (e.g. Germany, Austria) specific voice is given to one group of

stakeholders, viz. employees who have the right to representation on the Supervisory Board.

Governance Theory and political/legal traditions

Whilst we recognise that country specific variations are to be found, our focus in the discussion below is on the general features or characteristics of each tradition.

The Anglo/USA paradigm aligns with the political tradition of economic liberalism (Benn and Dunphy, 2004). It identifies 'economic man'- individualist, opportunistic and self serving. The underlying principles of behaviour are modelled by Agency Theory. In the agency relationship the principal (shareholder or owner) engages an agent "to perform some service on their behalf which involves delegating *some decision making authority* on their behalf" (Jensen and Meckling, 1976, p.308 emphasis added). It has come to mean the shareholder as principal, delegates the *power to maximise return* on financial capital.

Underlying the analysis of behaviour in Agency Theory is the assumption that rational individuals act always in their own self-interest. Thus "goal conflict is inherent when individuals with differing preferences engage in co-operative effort" (Bird and Wiersema, 1996, p.151) as they are required to do in organisations. Governance systems are required to "align goals" of the principals/owners or shareholders and the agents/management (Jensen and Meckling, 1976). A range of internal accountability and incentive mechanisms under the authority of the board of directors (the focus of governance activities) seek to ensure the agents – management - ***do*** operate in the shareholder's interest and not in their own. This model also places emphasis on market place contestability for control through its facilitation of shareholder exit and takeovers.

It has been argued that this is a far narrower view than originally conceived in this tradition. Clarkson (1994) argues for recognition that the context of the firm is society. He proposes we view the firm from a systems perspective, with each firm a system of stakeholders within the host society system. The host society provides the infrastructure for the firm's operations. The firm's purpose, he argues, is to convert the 'stakes' into goods and services, thus creating wealth for stakeholders. (Clarkson, 1994).

By contrast with the shareholder centric Anglo/US model, the European tradition has often given specific voice, both legislatively and in practice to a wider group defined in legislation as stakeholders. Maeijer and Geens(1990) term this the institutional view of companies and argue that in this tradition the interests of the company do not only or primarily correspond to the interests of the shareholders.. This tradition of company as institution and 'enterprise' is deeply rooted in the German/ Austrian systems and the Netherlands but, they argue is also important in "Civil Code " countries such as France, Spain (Maeijer & Geens, 1990 p5.). This may, as in Austria and Germany, include specific board representation of employees. This approach aligns with a political tradition which Benn and Dunphy (2004) term social democracy which has a focus on the protection of the collective interests of citizens.

The European model specifies the two tiered board system, a management board (internal) and a supervisory board (external). In this tradition management is responsible to conduct the affairs of the corporation with specific recognition of their responsibilities to multiple stakeholders. Senior management comprise the Management Board. Management is not represented on the Supervisory Board. This board, which usually includes employee, union or works council representatives (under codetermination legislation, Maeijer & Geens,1990) and in some cases government instrumentality representatives, is responsible to hire and fire management and to monitor in the interests of stakeholders. It is interesting to note that corporations in this tradition have in the past made little use of market related executive incentive pay schemes while the market for corporate control is very blunted both by corporate structures and lower levels of share market penetration (Becht, 1999).

The behavioural principles underlying this model align with Stewardship Theory. Stewardship theory depicts organisational participants as potentially collectivists, pro-organisation and trustworthy (Davis et al., 1997). It proposes that the interests of stakeholders and management may be able to be aligned through empowerment and trust rather than through monitoring and control. In such a setting, performance pay may be more broadly specified to reflect performance in spheres other than shareholder value.

Albert (1993) argues that a stakeholder model includes the processes to challenge its own sustainability. He contrasts this with "company" in capitalism as epitomised by the Anglo/USA model. "Things have come a long way since the word 'company' meant, as its etymology suggests, a community of interest, a mutually beneficial partnership of employers, employees and investors. Gone is the *esprit de corps* implicit in incorporation; companies are now mere cash flow machines, subject to the whims of finance and exposed to the crudest elements of stock market speculation" Albert (1993, p. 75).

Sustainability and property rights.

The assumption of optimisation of resource use claimed for the competitive markets is based on completely specified property rights. Where property rights are incomplete (for example in water) the market seems unable to achieve this optimisation. We have argued (Nowak and Bickley, 2004) that one of the problems for stakeholders who contribute value to corporate activities, (communities, employees and the natural environment), is that their property rights are legally underspecified and lacking in recognition in Anglo/US corporate regulation. The problem of underspecified property rights for the environment has long been recognised by economists but Steadman, Albright & Dunn (1996) have suggested that community property rights, stemming from the provision of social capital and infrastructure, are also inadequately specified.
Corporate law specifies the rights of shareholders and the obligations of the corporate board and management in the protection of shareholder interests. This emphasis on shareholder interests results in primacy to these interests in rhetoric and in practice in the Anglo/US paradigm.

Stakeholder theory, however, proposes a broader set of accountabilities exists (Donaldson & Preston, 1995, Freeman,1999, Jones, 1994,1995 and Turnbull, 1997). As noted above Albert (1993) argues that 'company' originally was, "a community of interest, a mutually beneficial partnership of employers, employees and investors." These broader accountabilities implicitly recognise the property rights of participants other than shareholders/owners. The issue for stakeholder theory is then posed as how to manage what may at times be conflicting interests.

In the Anglo/US paradigm the interests of employees customers, suppliers, and the environment are not given voice in corporate law and thus, where protected, this is done through separate legal intervention such as employment law. This separation has the effect of bringing protection of such stakeholders, for example employee property rights, into the adversarial legal system. Turnbull (1995) proposes new institutional protections for stakeholders such as independently appointed stakeholder councils to advise non-affiliated independent directors on corporate boards.

Nowak and Bickley (2003) however, found that within the EU, Austria provides an example of where accountability to stakeholders is internalised to the organisation through corporate law rather than externally mediated either through the adversarial legal system or through additional institutional arrangements as proposed by Turnbull.

We have been able to explore the perceptions of Austrian Board members in the research reported below. We argue that this example of the European enterprise based model with its recognition of stakeholder rights, is more able to encompass the range of societal sustaining property rights than one where corporate law and corporate rhetoric give primacy to recognition of the property rights of the capital provider. In doing so within the corporate governance system, it reduces the need for regulatory intervention in the case of market failure to protect property rights, while developing a culture more conducive to corporate sustainability.

Perceptions of Austrian Corporate Governance

The study of the perceptions of Austrian directors provides interesting perspectives on the European tradition during a period of economic change which is not well represented in English-language journals.

The Austrian corporate scene at the beginning of 21st Century could be described as a mixed private/public system. The private part comprised a high proportion of family owned or dominated firms. Many of these were moving to widen their shareholdings to increase access to capital and assist expansion in the climate of opportunities offered by an expanding European Union (EU). The earlier structure of dominating and complex public ownership of firms (involving city and provincial as well as central government) had been diluted with partial privatisation in the 1990's. A holding company, ÖIAG, was established to manage the remaining central government holdings at "arms length".

Doralt (1999) investigated the impact of these changes on Austrian companies and in particular the arrival of US and UK institutional investors as shareholders. He concluded that institutional investors had an impact on managerial attitudes and

behaviour; this could be interpreted as convergence and he noted that companies "could only afford to ignore some key demands (*of institutions*), by responding to others". It was in this climate of pressure for change that in depth interviews with company directors/senior executives of 15 Austrian listed companies along with 5 executives of large private unlisted companies, were conducted in late 1999.

Austrian corporate law epitomises the European tradition described above. It lays down the two-board system, a Supe rvisory board and a Management board, and sets out the representation of employees on the Supervisory board at one third of membership. It specifies that the company is responsible to act in the interests of stakeholders, not just shareholders.

In the qualitative study of Austrian directors' perceptions about corporate governance Nowak and Bickley (2003) did conclude that there were pressures to increase emphasis on shareholder value emanating from the opening up of the capital market. One director who had long experience on a number of boards stated " *…wouldn't say it changed but has evolved."* As another Director observed "*…[we] know their jargon, language, their fashions and affairs and everything…"*. However the stakeholder approach remained the pervasive model and director conduct and accountability was mediated by processes consistent with stewardship theory. What emerged from the analysis of director interviews was a strong sense that Austrian companies were tuned to stakeholder power. Director reflections from the study are provided below as evidence of this approach.

"The management board runs the company under its own responsibility in the interests of the shareholders, the employees and the public. This is the law. It's Paragraph 70 of our company law..."
"The company law defines the stakeholder approach…"
"There is a basic rule in Austrian Company Law and has been originally in German law which defines for the law the stakeholder approach…… So, but the differences are not as sharp as they are often described in literature,…… but there is a very strong feeling that [holding company name] must behave as a steward "
"…our attitude is not pure shareholder value but[rather that] shareholders are happy and will stay…"

Employee stakeholders as board participants

Directors and executives in general expressed a positive approach to employees as participants in the decision processes of the supervisory board.

"Shopstewards would know the firm is totally dependent on reasonable profit …would be now quite willing to criticise something that is detrimental //…boards have representatives of unions, shopstewards and others, get them into the boat…"

"I think that Austrian companies compare quite well with their participation of workers on the board because whatever has to be decided, then the employees and the unions also have to follow. They can't agree to cost cutting and then say the opposite in practice. So basically, I think this one third participation, I think they have already, they were very good and very positive"

"Yes, they have seats in the supervisory board. I enjoy very much to have these people on top in this hierarchy because they are growing enormously. They hear all the troubles and all the interesting decisions ……in the old days he had only one point to do. He wanted to increase his salary and the income of the workers, nothing else. So if the company goes bankrupt or not he does not more or less care. He wants more income. Now it is a really big responsibility and those labour union people who are in the supervisory board, they are changed completely. You have now a partner who really knows that decisions are so important and what a decision may bring your company, the way your company's going will be changed if the wrong decision is taken. If the right decision is taken at the end of the day this leads to jobs which leads to income for the people, this leads to employment or unemployment"

One director did suggest that having unions on the Supervisory board reduced the frankness of discussion at board level but this was not the general view.

Regulation

With this sense of stakeholder power and power sharing, government intervention as the referee was less evident.

"Theoretically, very, very strict regulation of responsibility, so theoretically we, I think all of us [supervisory board] could be sued for something. [That] is practically not done, and even in some dubious cases, it is not done because the sums involved are so huge, that it absolutely makes no sense."

The securities market role in providing market discipline and control in the Anglo/US model is less evident in Austria. In discussing new takeover law in Austria one director sought to differentiate it as having an Austrian flavour *"…amount of fairness which brings equal treatment of shareholders, not the UK/US [model where it is] necessary to have pressure on the management.*" Another director likened takeovers to the mini skirt:
"*We don't need it* (takeover law*) and it's sort of foreign to us.…"*

Implications for Director Conduct

Relationships between the management board and supervisory board in this different corporate governance climate were characterised by trust and good information flows which in turn enabled fast decision-making when required. Although most supervisory boards meet infrequently – 4 to 8 meetings each year – most had executive decision-making processes characterised by regular and often informal communication processes.

"We have a small working committee within this board …consists only of three people. This is the President, the Chairman and his Deputy Chairman, both coming from the two main shareholders plus the head of our Reps [union] council. These people are available day and night if I like it and this gives us the opportunity of very hard decision making // we are not around for approval or just clipping some papers. We are informing these three people in advance of the projects. Sometimes a project never becomes reality but they are informed, so we are prepared but if we need a

decision we get it very, very quickly because they're informed and they are only three people and they trust us"
"There is a good and positive contact to the Chairman and Vice Chairman of the Board. He does not mingle in day-to-day business but there is very good communication. There is mutual trust"
"The Austrian system of co-operation is opposed to the US/UK fad of gaining dominant position... "

Within Supervisory Boards the board dynamics were characterised by consensus seeking, compromise and a broader sense of self-control. Consensus seeking leading to compromise or agreement were key concepts seen as deep-rooted national characteristics evidenced by the Post WW2 grand coalition government structures (see Nowak and Bickley, 2003). The Chairperson's role was to achieve this consensus through compromise and to ensure board processes, including robust discussion, reflected this objective.

" I insist that in difficult situations and important situations that [our] compromise is written down immediately, that it is copied and that each member gets his copy and then we have the final voting on that and "Have you all read it? Is that our common compromised opinion? Yes. OK. Then we vote""
"No, no, no. We don't have cumulative voting. And this is very important to understand. You find consensus and that then is the decision of the management board."
"But it is impossible that you are a member of <u>both</u> boards because you cannot control yourself"
"If you have a spectrum and put on one extreme some US board cultures which can be controversial ... and on the other extreme the Japanese who decide everything beforehand .... We are somewhere in the middle. We try to communicate well enough so that I know no great surprises but there is discussion. There's lively discussion. We have a Japanese board member. He's always surprised. He is quite flabbergasted by the frankness of the discussions, especially between employee representatives and ourselves. It's somewhere in between -it is not argumentative and controversial but it is also, it's a lively sort of community structure. "

One chairperson's conclusion of the requirements of best practice was- *"to have a certain minimum number of meetings, to have good minutes, to have good reporting, to have good discussion, to have a chance for good preparation"*. Whilst this list might appear in many countries, in Austria it is underpinned with trust and communication – directors and managers maintain an internal sense of ethical orderliness.

"There is mutual trust... the trust is very big, we trust in what we make and so we don't act all disorderly"

This stakeholder based governance system placed employee, social and environmental accountability alongside accountability to shareholders. *"I can't imagine non complying management decisions…"* one director commented in respect of the environment. *"Public concern translates into management concern"* another remarked.

The Austrian stakeholder model, which fits well with the Austrian historical and social environment, illustrates the case for not accepting the 'one size fits all' approach.

Moving from Amoral to Moral

As identified earlier in this paper agency theory and the supporting philosophical framework of economic liberalism treats companies as amoral instruments of commerce, charged with the single responsibility to maximise investor value. In this model the question of ethics is outside the arena of companies responsibilities although compliance with legal requirements becomes a focus of companies in the quest for maximum profitability. However, increasingly companies are viewed as having responsibilities for their impacts on others. In corporate surveys (see Paine, 2003, p.119 for an analysis of Asian Business, Fortune, Financial Times and other surveys), company performance is defined by multiple criteria including their appeal to investors, employees, customers and communities. Publicity about the impact of companies on ‘others’ has been felt in many major corporations. Where Nike had argued that supplier labour conditions were “not their business” in the early 90’s, rapid loss of shareholder value led to them taking a very different stance on working conditions among suppliers by 1998. Shell experienced similar community backlash over its involvement with the brutal Nigerian regime. James Hardie seems likely to reap a similar backlash from governments and unions in Australia.

Shareholder and activist voices have forced more companies to adopt a voluntary quasi-stakeholder approach as ‘good for business’. The debate on triple-bottom-line reporting is evidence of this move. Paine (2003) argues that the broadening domains of accountability can bee seen on two fronts: accountability for whom and accountability for what as represented in the diagram below.

INSERT FIG 1 here

She argues that managers and directors find this broadened accountability hard to accept because it adds significantly to the range of issues that demand their attention. Furthermore, accepting wider impacts on ‘others’, moves them from an amoral instrument role to the moral actor role. The increasing attachment of person characteristics for companies can be seen in legal developments where corporate manslaughter has been recorded and directors given custodial sentences for breaching their duty of care (Slapper, 2003).

Concluding Comments:

What are the conclusions for corporate sustainability? As Bird and Wiersema point out, “economic views of organisations tend to ignore concepts such as norms, trust or tradition” (1996, p.153). There is a groundswell of comment from corporate players in Australia about the onerous nature of regulation. Nevertheless if our argument is supported, the Anglo/US model logically leads to the need for an enforceable and structured regulatory environment which provides the benchmarks for monitoring and accountable reporting. This provides the ‘external’ enforcement processes required because while property rights of the investor are contractually complete (and subject to continued strengthening) the important social and environmental property rights for

sustainability are incomplete and not able to be contractually specified in this tight way. Primacy to the shareholder, which is the hallmark of this system, means that the argument for sustainability is seen to depend on the ‘good for business ’ approach or to require specific government regulation.

In contrast the stakeholder approach produces, via the legal recognition of a range of property rights (even though not fully specified), an ‘internal’ frame of reference, relying on stewardship, judgement and trust. This alternative provides the opportunity for a less regulated and less adversarial system that considers a range of stakeholders including employees and the community. The Austrian case study demonstrates this alternative despite the pressure now exerted for conformance with the Anglo/US model. With the stakeholder approach the focus switches to choosing management who will act responsibly as stewards for these multiple interests. This requirement for gaining consensus among multiple interests provides internal control requiring an underlying climate of trust. Managers and directors are then charged with accepting the complexity of these multiple claims as moral actors. We argue this provides a more sustainable corporate and social future. Carroll, quoted in Vinten (2001), points out that this dictates that managers assess stakeholder interests - legal, moral and ownership rights; this is a process with which Austrian management is well versed by virtue of its commitment to stakeholders. It is a path along which South Africa (King Report 2002) has signalled a commitment to travel. Australia has the choice of defaulting to the Anglo/US model or choosing, as have the Austrians, to recognise those unique elements of our national culture which we wish to see played out in our boardrooms.

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