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Corporate Governance and Control

Finance Working Paper N°. 02/2002

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* This survey has the same title and most of the content of our earlier survey article which appeared in the Handbook of the Economics of Finance, edited by G.M. Constantinides, M. Harris and R. Stulz, 2003 Elsevier B.V. Substantive new material is confined to section 8.

Abstract

Corporate governance is concerned with the resolution of collective action problems among dispersed investors and the reconciliation of conflicts of interest between various corporate claimholders. In this survey we review the theoretical and empirical research on the main mechanisms of corporate control, discuss the main legal and regulatory institutions in different countries, and examine the comparative corporate governance literature. A fundamental dilemma of corporate governance emerges from this overview: regulation of large shareholder intervention may provide better protection to small shareholders; but such regulations may increase managerial discretion and scope for abuse.

Keywords: Corporate governance, ownership, takeovers, block holders, boards

JEL Classifications: G32, G34

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1. Introduction

At the most basic level a corporate governance problem arises whenever an outside investor wishes to exercise control differently from the manager in charge of the firm. Dispersed ownership magnifies the problem by giving rise to conflicts of interest between the various corporate claimholders and by creating a collective action problem among investors.[1]

Most research on corporate governance has been concerned with the resolution of this collective action problem. Five alternative mechanisms may mitigate it: i) partial concentration of ownership and control in the hands of one or a few large investors; ii) hostile takeovers and proxy voting contests, which concentrate ownership and/or voting power temporarily when needed; iii) delegation and concentration of control in the board of directors; iv) alignment of managerial interests with investors through executive compensation contracts; and v) clearly defined fiduciary duties for CEOs together with class-action suits that either block corporate decisions that go against investors' interests, or seek compensation for past actions that have harmed their interests.

In this survey we review the theoretical and empirical research on these five main mechanisms and discuss the main legal and regulatory institutions of corporate governance in different countries. We discuss how different classes of investors and their constituencies can or ought to participate in corporate governance. We also review the comparative corporate governance literature.[2]

The favored mechanism for resolving collective action problems among shareholders in most countries appears to be partial ownership and control concentration in the hands of large shareholders.[3] Two important costs of this form of governance have been emphasized: i) the potential collusion of large shareholders with management against smaller investors; and ii) the reduced liquidity of secondary markets. In an attempt to boost stock market liquidity and limit the potential abuse of minority shareholders some countries' corporate law drastically curbs the power of large shareholders.[4] These countries rely on the board of directors as the main mechanism for co-ordinating shareholder actions. But boards are widely perceived to be ineffective.[5] Thus, while minority shareholders get better protection in these countries, managers may also have greater discretion.

In a nutshell, the fundamental issue concerning governance by shareholders today seems to be how to regulate large or active shareholders so as to obtain the right balance between managerial discretion and small shareholder protection. Before exploring in greater detail the different facets of this issue and the five basic mechanisms described above, it is instructive to begin with a brief overview of historical origins and early writings on the subject.

[1] See Zingales (1998) for a similar definition.
[2] We do not cover the extensive strategy and management literature; see Pettigrew, Thomas and Whittington (2002) for an overview, in particular Davis and Useem (2002).
[3] See ECGN (1997), La Porta et al. (1999), Claessens et al. (2000) and Barca and Becht (2001) for evidence on control concentration in different countries.
[4] Black (1990) provides a detailed description of the various legal and regulatory limits on the exercise of power by large shareholders in the USA. Wymeersch (2003) discusses legal impediments to large shareholder actions outside the USA.
[5] Gilson and Kraakman (1991) provide analysis and an agenda for board reform in the USA against the background of a declining market for corporate control and scattered institutional investor votes.

2. Historical origins: a brief sketch

The term "corporate governance" derives from an analogy between the government of cities, nations or states and the governance of corporations.[6] The early corporate finance textbooks saw "representative government" [Mead (1928, p. 31)] as an important advantage of the corporation over partnerships but there has been and still is little agreement on how representative corporate governance really is, or whom it should represent.

2.1. How representative is corporate government?

The institutional arrangements surrounding corporate elections and the role and fiduciary duties of the board have been the central themes in the corporate governance literature from its inception. The dilemma of how to balance limits on managerial discretion and small investor protection is ever present. Should one limit the power of corporate plutocrats (large shareholders or voting trusts) or should one tolerate concentrated voting power as a way of limiting managerial discretion?

The concern of early writers of corporate charters was the establishment of "corporate suffrage", where each member (shareholder) had one vote [Dunlavy (1998)]. The aim was to establish "democracy" by eliminating special privileges of some members and by limiting the number of votes each shareholder could cast, irrespective of the number of shares held.[7] However, just as "corporate democracy" was being established it was already being transformed into "plutocracy" by moving towards "one-share–one-vote" and thus allowing for concentrated ownership and control [Dunlavy (1998)].[8]

In the USA this was followed by two distinct systems of "corporate feudalism": first, to the voting trusts[9] and holding companies[10] [Cushing (1915), Mead (1903), Liefmann (1909, 1920] originating in the "Gilded Age" [Twain and Warner (1873)][11] and later to the managerial

[6] The analogy between corporate and political voting was explicit in early corporate charters and writings, dating back to the revolutionary origins of the American corporation and the first railway corporations in Germany [Dunlavy (1998)]. The precise term "corporate governance" itself seems to have been used first by [Richard Eells (1960, p. 108)], to denote "the structure and functioning of the corporate polity".

[7] Frequently voting scales were used to achieve this aim. For example, under the voting scale imposed by a Virginia law of 1836 shareholders of manufacturing corporations cast "one vote for each share up to 15, one vote for every five shares from 15 to 100, and one vote for each increment of 20 shares above 100 shares" [Dunlavy (1998, p. 18)].

[8] Voting right restrictions survived until very recently in Germany [Franks and Mayer (2001)]. They are still in use in Denmark, France, Spain and other European countries [Becht and Mayer (2001)].

[9] Under a typical voting trust agreement shareholders transfer their shares to a trust and receive certificates in return. The certificate holders elect a group of trustees who vote the deposited shares. Voting trusts were an improvement over pooling agreements and designed to restrict product market competition. They offered two principal advantages: putting the stock of several companies into the voting trust ensured that the trustees had permanent control over the management of the various operating companies, allowing them to enforce a common policy on output and prices; the certificates issued by the voting trust could be widely placed and traded on a stock exchange.

[10] Holding companies have the purpose of owning and voting shares in other companies. After the passage of the Sherman Antitrust Act in 1890 many of the voting trusts converted themselves into New Jersey registered holding companies ("industrial combinations") that were identical in function, but escaped the initial round of antitrust legislation, for example the Sugar Trust in 1891 [Mead (1903, p. 44)] and Rockefeller's Standard Oil in 1892 [Mead (1903, p. 35)].

[11] The "captains of industry" of this era, also referred to as the "Robber Barons" [Josephson (1934), DeLong (1998)], were the target of an early anti-trust movement that culminated in the election of Woodrow Wilson as

corporation.[12] The "captains of industry" in the trusts and hierarchical groups controlled the majority of votes in vast corporate empires with relatively small(er) amounts of capital, allowing them to exert product market power and leaving ample room for self-dealing.[13] In contrast, the later managerial corporations were controlled mainly by professional managers and most of their shareholders were too small and numerous to have a say. In these firms control was effectively separated from ownership. [14]

Today corporate feudalism of the managerial variety in the USA and the "captain of industry" kind elsewhere is challenged by calls for more "shareholder democracy", a global movement that finds its roots with the "corporate Jacksonians" of the 1960s in the USA.[15]

As an alternative to shareholder activism some commentators in the 1960s proposed for the first time that hostile takeovers might be a more effective way of disciplining management. Thus, Rostow (1959, p. 47) argued, "the raider persuades the stockholders for once to act as if they really were stockholders, in the black-letter sense of the term, each with the voice of partial ownership and a partial owner's responsibility for the election of directors". Similarly, Manne (1964, p. 1445) wrote, "vote selling [. . .] negatives many of the criticisms often levelled at the public corporation". As we shall see, the abstract "market for corporate control" has remained a central theme in the corporate governance literature.

2.2. Whom should corporate government represent?

The debate on whether management should run the corporation solely in the interests of shareholders or whether it should take account of other constituencies is almost as old as the first writings on corporate governance. Berle (1931) held the view that corporate powers are powers in trust for shareholders and nobody else.[16] But, Dodd (1932, p. 1162) argued that:

USA President in 1912. Standard Oil was broken up even before (in 1911) under the Sherman Act of 1890 and converted from a corporation that was tightly controlled by the Rockefeller clan to a managerial corporation. Trust finance disappeared from the early corporate finance textbooks [for example Mead (1912) vs. Mead (1928)]. In 1929 Rockefeller Jr. (14.9%) ousted the scandal ridden Chairman of Standard Oil of Indiana, who enjoyed the full support of his board, only by small margin, an example that was widely used for illustrating how much the balance of power had swung from the "Robber Barons" to management [Berle and Means (1932, pp. 82–83), cited in Galbraith (1967)], another type of feudal lord.

[12] For Berle and Means (1930): "[the] "publicly owned" stock corporation in America . . . constitutes an institution analogous to the feudal system in the Middle Ages".

[13] They also laid the foundations for some of theWorld's finest arts collections, philanthropic foundations and university endowments.

[14] This "separation of ownership and control" triggered a huge public and academic debate of "the corporate problem"; see, for example, the Berle and Means symposia in the Columbia Law Review (1964) and the Journal of Law and Economics (1983). Before Means (1931a,b) and Berle and Means (1930, 1932) the point was argued in Lippmann (1914), Veblen (1923), Carver (1925), Ripley (1927) and Wormser (1931); see Hessen (1983).

[15] Non-Americans often consider shareholder activism as a free-market movement and associated calls for more small shareholder power as a part of the conservative agenda. They are puzzled when they learn that shareholder activism today has its roots in part of the anti-Vietnam War, anti-apartheid and anti-tobacco movements and has close links with the unions. In terms of government (of corporations) there is no contradiction. The "corporate Jacksonians", as a prominent critic called them [Manning (1958, p. 1489)], are named after the 7th President of the USA (1829–37) who introduced universal male suffrage and organised the Democratic Party that has historically represented minorities, labour and progressive reformers (Encyclopaedia Britannica: Jackson, Andrew; Democratic Party).

[16] Consequently "all powers granted to a corporation or to the management of a corporation, or to any group within the corporation, whether derived from statute or charter or both, are necessarily and at all times exercisable only for the ratable benefit of all the shareholders as their interest appears", Berle(1931).

"[business] is private property only in the qualified sense, and society may properly demand that it be carried on in such a way as to safeguard the interests of those who deal with it either as employees or consumers even if the proprietary rights of its owners are thereby curtailed". Berle (1932) disagreed on the grounds that responsibility to multiple parties would exacerbate the separation of ownership and control and make management even less accountable to shareholders. [17]

There is nowadays a voluminous literature on corporate governance. On many key issues our understanding has improved enormously since the 1930s. Remarkably though, some of the main issues over which the early writers have been debating remain central today.

3. Why corporate governance is currently such a prominent issue

Why has corporate governance become such a prominent topic in the past two decades or so and not before? We have identified, in no particular order, the following reasons: i) the world-wide wave of privatization of the past two decades; ii) pension fund reform and the growth of private savings; iii) the takeover wave of the 1980s; iv) deregulation and the integration of capital markets; v) the 1998 East Asia crisis, which has put the spotlight on corporate governance in emerging markets; vi) a series of recent USA scandals and corporate failures that built up but did not surface during the bull market
of the late 1990s.

3.1. The world-wide privatization wave

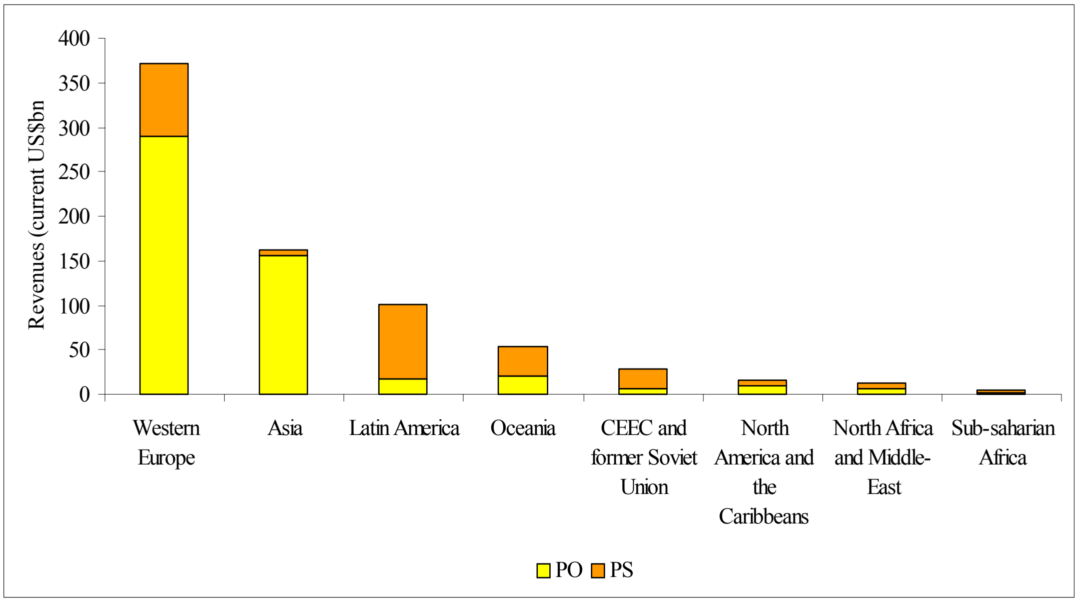
Privatization has been an important phenomenon in Latin America, Western Europe, Asia and (obviously) the former Soviet block, but not in the USA where state ownership of enterprises has always been very small (see Figure 1). On average, since 1990 OECD privatization programmes have generated proceeds equivalent to 2.7% of total GDP, and in some cases up to 27% of country GDP. The privatization wave started in the UK, which was responsible for 58% of OECD and 90% of European Community privatization proceeds in 1991. Since 1995 Australia, Italy, France, Japan and Spain alone have generated 60% of total privatization revenues.

Inevitably, the privatization wave has raized the issue of how the newly privatized corporations should be owned and controlled. In some countries, most notably the UK, part of the agenda behind the massive privatization program was to attempt to recreate a form of "shareholder democracy" [18] [see Biais and Perotti (2002)]. In other countries great care was given to ensure the transfer of control to large shareholders. The issues surrounding the choice of privatization method rekindled interest in governance issues; indeed Shinn (2001) finds that the state's new role as a public shareholder in privatized corporations has been an important source of impetus for changes in corporate governance practices worldwide. In general, privatizations have boosted the role of stock markets as most OECD sales have been conducted via public offerings, and this has also focused attention on the protection of small shareholders.

[17] He seems to have changed his mind some twenty years later as he wrote that he was "squarely in favour of Professor Dodd's contention"[Berle (1954)]. For a comprehensive account of the Berle–Dodd dialogue see Weiner (1964) and for additional papers arguing both points of view Mason (1959). Galbraith (1967) in his influential The New Industrial State took Dodd's position.

[18] A state-owned and -controlled company is indirectly owned by the citizens via the state, which has a say in the affairs of the company. In a "shareholder democracy" each citizen holds a small share in the widely held company, having a direct interest and – theoretically – say in the affairs of the company.

Figure 1. Privatisation Revenues by Region 1977-97



Source : Bortolotti, Fantini and Siniscalco (2000)
Note : PO – Public Offerings; PS – Private Sales

3.2. Pension funds and active investors

The growth in defined contribution pension plans has channeled an increasing fraction of household savings through mutual and pension funds and has created a constituency of investors that is large and powerful enough to be able to influence corporate governance. Table 1 illustrates how the share of financial assets controlled by institutional investors has steadily grown over the 1990s in OECD countries. It also highlights the disproportionately large institutional holdings in small countries with large financial centres, like Switzerland, the Netherlands and Luxembourg. Institutional investors in the USA alone command slightly more than 50% of the total assets under management and 59.7% of total equity investment in the OECD, rising to 60.1% and 76.3%, respectively, when UK institutions are added. A significant proportion is held by pension funds (for USA and UK based funds, 35.1% and 40.1% of total assets, respectively). These funds are playing an increasingly active role in global corporate governance. In the USA ERISA[19] regulations oblige pension funds to cast the votes in their portfolio responsibly.

This has led to the emergence of a service industry that makes voting recommendations and exercises votes for clients. The largest providers now offer global services. Japanese institutional investors command 13.7% of total institutional investor assets in the OECD but just 8.3% of the equities. These investors are becoming more demanding and they are one of the forces behind the rapid transformation of the Japanese corporate governance system. As a percentage of GDP, the holdings of Italian and German institutional investors are small (39.9% and 49.9% in 1996) and well below the OECD average of 83.8%. The ongoing

[19] ERISA stands for the Employee Retirement Income Security Act of 1974.

reform of the pension systems in both countries and changing savings patterns, however, are likely to change this picture in the near future. [20]

Table 1. Financial Assets of Institutional Investors in OECD Countries

	Value Assets Billion U.S.$		Asset growth	% Total OECD Assets	Assets as % GDP		% Pension Funds	% Insurance Companies	% Invest. Companies	% of Assets in Equity	% OECD Equity
	1990	1996	1990-96	1996	1990	1996	1996	1996	1996	1996	1996
Australia	145.6	331.1	127.4	1.3	49.3	83.8	36.3	46.0	14.1	52	1.9
Austria	38.8	90.1	132.2	0.3	24.3	39.4	3.0	53.3	43.7	8	0.1
Belgium	87.0	169.1	94.4	0.7	44.4	63	6.5	49.0	41.0	23	0.4
Canada	332.8	560.5	68.4	2.2	58.1	94.6	43.0	31.4	25.7	9	0.6
Czech Republic	-	(1994) 7.3	-	-	-	-	-	-	-		< 0.1
Denmark	74.2	123.5	66.4	0.5	55.6	67.1	25.2	67.2	7.6	31	0.4
Finland	44.7	71.2	59.3	0.3	33.2	57	-	24.6	3.4	23	0.2
France	655.7	1,278.1	94.9	4.9	54.8	83.1		55.2	44.8	26	3.7
Germany	599.0	1,167.9	95.0	4.5	36.5	49.9	5.5	59.2	35.3	14	1.8
Greece	5.4	35.1	550.0	0.1	6.5	28.5	41.6	12.3	46.2	6	< 0.1
Hungary	-	2.6	-	< 0.1		5.7	-	65.4	26.9	6	< 0.1
Iceland	2.9	5.8	100.0	< 0.1	45.7	78.7	79.3	12.1	8.6	6	< 0.1
Italy	146.6	484.6	230.6	1.9	13.4	39.9	8.1	30.1	26.6	12	0.6
Japan	2,427.9	3,563.6	46.8	13.7	81.7	77.6	-	48.9	12.6	21	8.3
Korea	121.9	277.8	127.9	1.1	48	57.3	4.9	43.4	51.7	12	0.4
Luxembourg	95.9	392.1	308.9	1.5	926.8	2139.1	0.8	-	99.2		< 0.1
Mexico	23.1	14.9	-35.5	0.1	8.8	4.5		32.9	67.1	17	< 0.1
Netherlands	378.3	671.2	77.4	2.6	133.4	169.1	55.2	33.5	9.9	28	2.1
New Zealand	-	24.9	-	0.1	-	38.1	-	31.7	17.3	37	0.1
Norway	41.5	68.6	65.3	0.3	36	43.4	14.9	70.1	15.0	20	0.2
Poland	-	2.7	-	< 0.1	-	2	-	81.5	18.5	23	< 0.1
Portugal	6.2	37.5	504.8	0.1	9	34.4	26.4	27.2	45.1	9	< 0.1
Spain	78.9	264.5	235.2	1.0	16	45.4	4.5	41.0	54.5	6	0.2
Sweden	196.8	302.9	53.9	1.2	85.7	120.3	2.0	47.3	19.8	40	1.4
Switzerland	271.7	449.8	65.6	1.7	119	77.3	49.3	40.2	10.5	24	1.2
Turkey	0.9	2.3	155.6	< 0.1	0.6	1.3	-	47.8	52.2	8	< 0.1
U.K.	1,116.8	2,226.9	99.4	8.6	114.5	193.1	40.1	45.9	14.0	67	16.6
U.S.	6,875.7	13,382.1	94.6	51.5	123.8	181.1	35.6	22.6	25.2	40	59.7
Total OECD	15,758.3	26,001.4									
Mean OECD			94.6		49.3	83.8	26.3	33.6	24.9	22	

Source : OECD (2000), *Institutional Investors Statistical Yearbook 1998,* Tables S.1., S.2., S.3., S.4., S.6., S.11 and own calculations.

3.3. Mergers and takeovers

The hostile takeover wave in the USA in the 1980s and in Europe in the 1990s, together with the recent merger wave, has also fuelled the public debate on corporate governance. The successful $199 billion cross-border hostile bid of Vodafone for Mannesmann in 2000 was the largest ever to take place in Europe. The recent hostile takeovers in Italy (Olivetti for Telecom Italia; Generali for INA) and in France (BNPParibas; Elf Aquitaine for Total Fina) have spectacularly shaken up the sleepy corporate world of continental Europe. Interestingly, these deals involve newly privatized giants. It is also remarkable that they have not been opposed by the social

[20] One note of caution. The figures for Luxemburg and Switzerland illustrate that figures are compiled on the basis of the geographical location of the fund managers, not the origin of the funds under management. Judging from the GDP figures, it is very likely that a substantial proportion of the funds administered in the UK, the USA, Switzerland and the Netherlands belong to citizens of other countries. For governance the location of the fund managers matters. They make the investment decisions and have the power to vote the equity in their portfolios and the sheer size of the numbers suggests that fund governance is a topic in its own right.

democratic administrations in place at the time. Understandably, these high profile cases have moved takeover regulation of domestic and cross-border deals in the European Union to the top of the political agenda.

3.4. Deregulation and capital market integration

Corporate governance rules have been promoted in part as a way of protecting and encouraging foreign investment in Eastern Europe, Asia and other emerging markets. The greater integration of world capital markets (in particular in the European Union following the introduction of the Euro) and the growth in equity capital throughout the 1990s have also been a significant factor in rekindling interest in corporate governance issues. Increasingly fast growing corporations in Europe have been raising capital from different sources by cross listing on multiple exchanges [Pagano, Röell and Zechner (2002)]. In the process they have had to contend more with USA and UK pension funds. This has inevitably contributed to the spread of an 'equity culture' outside the USA and UK.

3.5. The 1998 Russia/East Asia/Brazil crisis

The East Asia crisis has highlighted the flimsy protections investors in emerging markets have and put the spotlight on the weak corporate governance practices in these markets. The crisis has also led to a reassessment of the Asian model of industrial organisation and finance around highly centralized and hierarchical industrial groups controlled by management and large investors. There has been a similar reassessment of mass insider privatization and its concomitant weak protection of small investors in Russia and other transition economies.

The crisis has led international policy makers to conclude that macro-management is not sufficient to prevent crises and their contagion in an integrated global economy. Thus, in South Korea, the International Monetary Fund has imposed detailed structural conditions that go far beyond the usual Fund policy. It is no coincidence that corporate governance reform in Russia, Asia and Brazil has been a top priority for the OECD, the World Bank and institutional investor activists.

3.6. Scandals and failures at major USA corporations

As we are writing, a series of scandals and corporate failures is surfacing in the United States, a market where the other factors we highlighted played a less important role.[21] Many of these cases concern accounting irregularities that enabled firms to vastly overstate their earnings. Such scandals often emerge during economic downturns: as John Kenneth Galbraith once remarked, recessions catch what the auditors miss.

[21] Recent failures include undetected off-balance sheet loans to a controlling family (Adelphia) combined with alleged self-dealing by CEOs and other company employees (Computer Associates, Dynegy, Enron, Global Crossing, Qwest, Tyco), deliberate misleading of investors (Kmart, Lucent Technologies, WorldCom), insider trading (ImClone Systems) and/or fraud (Rite Aid) ("Accounting Scandals Spread Across Wall Street", Financial Times, 26 June 2002).

4. Conceptual framework

4.1. Agency and contracting

At a general level corporate governance can be described as a problem involving an agent – the CEO of the corporation – and multiple principals – the shareholders, creditors, suppliers, clients, employees, and other parties with whom the CEO engages in business on behalf of the corporation. Boards and external auditors act as intermediaries or representatives of these different constituencies. This view dates back to at least Jensen and Meckling (1976), who describe a firm in abstract terms as "a nexus of contracting relationships". Using more modern language the corporate governance problem can also be described as a "common agency problem", that is an agency problem involving one agent (the CEO) and multiple principals (shareholders, creditors, employees, clients [see Bernheim and Whinston (1985, 1986a,b)]. [22]

Corporate governance rules can be seen as the outcome of the contracting process between the various principals or constituencies and the CEO. Thus, the central issue in corporate governance is to understand what the outcome of this contracting process is likely to be, and how corporate governance deviates in practice from the efficient contracting benchmark.

4.2. Ex-ante and ex-post efficiency

Economists determine efficiency by two closely related criteria. The first is ex-ante efficiency: a corporate charter is ex-ante efficient if it generates the highest possible joint payoff for all the parties involved, shareholders, creditors, employees, clients, tax authorities, and other third parties that may be affected by the corporation's actions. The second criterion is Pareto efficiency: a corporate charter is Pareto efficient if no other charter exists that all parties prefer. The two criteria are closely related when the parties can undertake compensating transfers among themselves: a Pareto efficient charter is also a surplus maximizing charter when the parties can make unrestricted side transfers. As closely related as these two notions are it is still important to distinguish between them, since in practice side transfers are often constrained by wealth or borrowing constraints.

4.3. Shareholder value

An efficiency criterion that is often advocated in finance and legal writings on corporate governance is "shareholder value", or the stock market valuation of the corporation. An important basic question is how this notion is related to Pareto efficiency or surplus maximization. Is maximization of shareholder value synonymous with either or both notions of efficiency?

One influential view on this question [articulated by Jensen and Meckling (1976)] is the following. If a) the firm is viewed as a nexus of complete contracts with creditors, employees, clients, suppliers, third and other relevant parties, b) only contracts with shareholders are open-

[22] A slightly different, sometimes broader perspective, is to describe corporate governance as a multiprincipal–multi-agent problem, where both managers and employees are seen as agents for multiple classes of investors. The labelling of employees as 'agent' or 'principal' is not just a matter of definition. If they are defined as 'principal' they are implicitly seen as participants in corporate governance. When and how employees should participate in corporate governance is a delicate and politically sensitive question. We discuss this issue at length in Section 5.6 below. For now, we shall simply take the view that employees are partly 'principal' when they have made firm specific investments, which require protection.

ended; that is, only shareholders have a claim on residual returns after all other contractual obligations have been met, and c) there are no agency problems, then maximization of (residual) shareholder value is tantamount to economic efficiency. Under this scenario, corporate governance rules should be designed to protect and promote the interests of shareholders exclusively.[23]

As Jensen and Meckling point out, however, managerial agency problems produce inefficiencies when CEOs act only in the interest of shareholders. There may be excess risk-taking when the firm is highly levered, or, as Myers (1977) has shown, debt overhang may induce underinvestment. Either form of investment inefficiency can be mitigated if managers do not exclusively pursue shareholder value maximization.

4.4. Incomplete contracts and multiple constituencies

Contracts engaging the corporation with parties other than shareholders are generally incomplete, so that there is no guarantee that corporate governance rules designed to maximize shareholder value are efficient. To guarantee efficiency it is then necessary to take into account explicitly the interests of other constituencies besides shareholders. Whether to take into account other constituencies, and how, is a central issue in corporate governance. Some commentators have argued that shareholder value maximization is the relevant objective even if contracts with other constituencies are incomplete. Others maintain that board representation should extend beyond shareholders and include other constituencies. There are major differences across countries on this issue, with at one extreme UK and USA rules designed mainly to promote shareholder value, and at the other German rules designed to balance the interests of shareholders and employees.

One line of argument in favor of shareholder value maximization in a world of incomplete contracts, first articulated by Oliver Williamson (1984, 1985b), is that shareholders are relatively less well protected than other constituencies. He argues that most workers are not locked into a firm specific relation and can quit at reasonably low cost. Similarly, creditors can get greater protection by taking collateral or by shortening the maturity of the debt. Shareholders, on the other hand, have an openended contract without specific protection. They need protection the most. Therefore, corporate governance rules should primarily be designed to protect shareholders' interests.

In addition, Hansmann (1996) has argued that one advantage of involving only one constituency in corporate governance is that both corporate decision-making costs and managerial discretion will be reduced. Although Hansmann argues in favor of a governance system by a single constituency he allows for the possibility that other constituencies besides shareholders may control the firm. In some situations a labormanaged firm, a customer co-operative, or possibly a supplier co-operative may be a more efficient corporate governance arrangement. In his view, determining which constituency should govern the firm comes down to identifying which has the lowest decision making costs and which has the greatest need of protection.

An obvious question raized by Williamson's argument is that if it is possible to get better protection by signing debt contracts, why not encourage all investors in the firm to take out debt

[23] Jensen and Meckling's argument updates an older observation formally articulated by Arrow and Debreu [see Debreu (1959)], that in a competitive economy with complete markets the objective of the firm – unanimously espoused by all claimholders – is profit (or value) maximization.

contracts. Why worry about protecting shareholders when investors can find better protection by writing a debt contract? Jensen (1986, 1989) has been a leading advocate of this position, arguing that the best way to resolve the agency problem between the CEO and investors is to have the firm take on as much debt as possible. This would limit managerial discretion by minimizing the "free cash-flow" available to managers and, thus, would provide the best possible protection to investors.

The main difficulty with Jensen's logic is that highly levered firms may incur substantial costs of financial distress. They may face direct bankruptcy costs or indirect costs in the form of debt-overhang [see Myers (1977) or Hart and Moore (1995) and Hennessy and Levy (2002)]. To reduce the risk of financial distress it may be desirable to have the firm rely partly on equity financing. And to reduce the cost of equity capital it is clearly desirable to provide protections to shareholders through suitably designed corporate governance rules.

Arguably it is in the interest of corporations and their CEOs to design efficient corporate governance rules, since this would minimize their cost of capital, labor and other inputs. It would also maximize the value of their products or services to their clients. Firms may want to acquire a reputation for treating shareholders or creditors well, as Kreps (1990) and Diamond (1989) have suggested. [24] If reputation building is effective then mandatory regulatory intervention seems unnecessary.

4.5. Why do we need regulation?

A natural question to ask then is why regulations imposing particular governance rules (required by stock exchanges, legislatures, courts or supervisory authorities) are necessary.[25] If it is in the interest of firms to provide adequate protection to shareholders, why mandate rules, which may be counterproductive? Even with the best intentions regulators may not have all the information available to design efficient rules. [26] Worse still, regulators can be captured by a given constituency and impose rules favoring one group over another.

There are at least two reasons for regulatory intervention. The main argument in support of mandatory rules is that even if the founder of the firm or the shareholders can design and implement any corporate charter they like, they will tend to write inefficient rules since they cannot feasibly involve all the parties concerned in a comprehensive bargain. By pursuing their interests over those of parties missing from the bargaining table they are likely to write inefficient rules. For example, the founder of the firm or shareholders will want to put in place anti-takeover defenses in an attempt to improve the terms of takeovers and they will thereby tend to

[24] Interestingly, although reputation building is an obvious way to establish investor protection, this type of strategy has been somewhat under-emphasized in the corporate governance literature. In particular, there appears to be no systematic empirical study on reputation building, even if there are many examples of large corporations that attempt to build a reputation by committing to regular dividend payments, disclosing information, and communicating with analysts (see however Carleton, Nelson and Weisbach (1998) for evidence on voluntary communications between large USA corporations and institutional investors). For a recent survey of the disclosure literature, including voluntary disclosure by management, see Healy and Palepu (2001).

[25] Compliance with corporate governance "codes" is mostly voluntary.

[26] On the other hand, if the identification and formulation of efficient corporate governance rules is a costly process it makes sense to rely on courts and corporate law to formulate default rules, which corporations could adopt or opt out of [see Ayres and Gertner (1989)].

limit hostile takeover activity excessively. [27] Alternatively, shareholders may favor takeovers that increase the value of their shares even if they involve greater losses for unprotected creditors or employees. [28]

Another argument in support of mandatory rules is that, even if firms initially have the right incentives to design efficient rules, they may want to break or alter them later. A problem then arises when firms do not have the power to commit not to change (or break) the rules down the road. When shareholders are dispersed and do not take an active interest in the firm it is possible, indeed straightforward, for management to change the rules to their advantage *ex post*. Dispersed shareholders, with small interests in the corporation, are unlikely to incur the large monitoring costs that are sometimes required to keep management at bay. They are more likely to make management their proxy, or to abstain. [29] Similarly, firms may not be able to build credible reputations for treating shareholders well if dispersed shareholders do not take an active interest in the firm and if important decisions such as mergers or replacements of CEOs are infrequent. Shareholder protection may then require some form of concentrated ownership or a regulatory intervention to overcome the collective action problem among dispersed shareholders.

4.6. Dispersed ownership

Since dispersed ownership is such an important source of corporate governance problems it is important to inquire what causes dispersion in the first place. There are at least three reasons why share ownership may be dispersed in reality. First, and perhaps most importantly, individual investors' wealth may be small relative to the size of some investments. Second, even if a shareholder can take a large stake in a firm, he may want to diversify risk by investing less. A related third reason is investors' concern for liquidity: a large stake may be harder to sell in the secondary market.[30] For these reasons it is not realistic or desirable to expect to resolve the collective action problem among dispersed shareholders by simply getting rid of dispersion.

4.7. Summary and conclusion

In sum, mandatory governance rules (as required by stock exchanges, legislatures, courts or supervisory authorities) are necessary for two main reasons: first, to overcome the collective action problem resulting from the dispersion among shareholders, and second, to ensure that the interests of all relevant constituencies are represented. Indeed, other constituencies besides shareholders face the same basic collective action problem. Corporate bondholders are also dispersed and their collective action problems are only imperfectly resolved through trust agreements or consortia or in bankruptcy courts. In large corporations employees and clients may face similar collective action problems, which again are imperfectly resolved by unions or consumer protection organizations.

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[27] We shall return to this observation, articulated in Grossman and Hart (1980) and Scharfstein (1988), at greater length in Section 5.

[28] Shleifer and Summers (1988) discuss several hostile takeover cases where the value for target and bidding shareholders came apparently at the expense of employees and creditors.

[29] Alternatively, limiting managerial discretion ex ante and making it harder to change the rules by introducing supermajority requirements into the corporate charter would introduce similar types of inefficiency as with debt.

[30] A fourth reason for the observed dispersion in shareholdings may be securities regulation designed to protect minority shareholders, which raises the cost of holding large blocks. This regulatory bias in USA corporate law has been highlighted by Black (1990), Roe (1990, 1991, 1994) and Bhide (1993).

Most of the finance and corporate law literature on corporate governance focuses only on collective action problems of shareholders. Accordingly, we will emphasize those problems in this survey. As the literature on representation of other constituencies is much less developed we shall only touch on this issue in Sections 5 to 7.

We distinguish five main ways to mitigate shareholders' collective action problems:

1) Election of a board of directors representing shareholders' interests, to which the CEO is accountable.

2) When the need arises, a takeover or proxy fight launched by a corporate raider who temporarily concentrates voting power (and/or ownership) in his hands to resolve a crisis, reach an important decision or remove an inefficient manager.

3) Active and continuous monitoring by a large blockholder, who could be a wealthy investor or a financial intermediary, such as a bank, a holding company or a pension fund.

4) Alignment of managerial interests with investors through executive compensation contracts.

5) Clearly defined fiduciary duties for CEOs and the threat of class-action suits that either block corporate decisions that go against investors' interests, or seek compensation for past actions that have harmed their interests.

As we shall explain, a potential difficulty with the first three approaches is the old problem of who monitors the monitor and the risk of collusion between management (the agent) and the delegated monitor (director, raider, blockholder). If dispersed shareholders have no incentive to supervise management and take an active interest in the management of the corporation why should directors – who generally have equally small stakes – have much better incentives to oversee management? The same point applies to pension fund managers. Even if they are required to vote, why should they spend the resources to make informed decisions when the main beneficiaries of those decisions are their own principals, the dispersed investors in the pension fund? Finally, it might appear that corporate raiders, who concentrate ownership directly in their hands, are not susceptible to this delegated monitoring problem. This is only partially true since the raiders themselves have to raise funds to finance the takeover. Typically, firms that are taken over through a hostile bid end up being substantially more highly levered. They may have resolved the shareholder collective action problem, but at the cost of significantly increasing the expected cost of financial distress.

Enforcement of fiduciary duties through the courts has its own shortcomings. First, management can shield itself against shareholder suits by taking out appropriate insurance contracts at the expense of shareholders.[31] Second, the "business judgement" rule (and similar provisions in other countries) severely limits shareholders' ability to prevail in court.[32] Finally,

[31] Most large USA corporations have taken out director and officer liability (D&O) insurance policies [see Danielson and Karpoff (1998)]. See Guti´errez (2000, 2003) for an analysis of fiduciary duties, liability and D&O insurance.

[32] The "directors' business judgement cannot be attacked unless their judgement was arrived at in a negligent manner, or was tainted by fraud, conflict of interest, or illegality" [Clark (1986, p. 124)]. The business judgement rule gives little protection to directors for breaches of form (e.g., for directors who fail to attend meetings or read documents) but can extend to conflict of interest situations, provided that a self-interested decision is approved by disinterested directors [Clark (1986, pp. 123, 138)].

plaintiffs' attorneys do not always have the right incentives to monitor management. Managers and investment bankers often complain that contingency fee awards (which are typically a percentage of damages awarded in the event that the plaintiff prevails) can encourage them to engage in frivolous suits, a problem that is likely to be exacerbated by the widespread use of director and officer (D&O) liability insurance. This is most likely to be the case in the USA. In other countries fee awards (which mainly reflect costs incurred) tend to increase the risk of lawsuits for small shareholders and the absence of D&O insurance makes it harder to recover damages. [33]

5. Models

5.1. Takeover models

One of the most radical and spectacular mechanisms for disciplining and replacing managers is a hostile takeover. This mechanism is highly disruptive and costly. Even in the USA and the UK it is relatively rarely used. In most other countries it is almost nonexistent. Yet, hostile takeovers have received a great deal of attention from academic researchers. In a hostile takeover the raider makes an offer to buy all or a fraction of outstanding shares at a stated tender price. The takeover is successful if the raider gains more than 50% of the voting shares and thereby obtains effective control of the company. With more than 50% of the voting shares, in due course he will be able to gain majority representation on the board and thus be able to appoint the CEO.

Much research has been devoted to the mechanics of the takeover process, the analysis of potentially complex strategies for the raider and individual shareholders, and to the question of ex-post efficiency of the outcome. Much less research has been concerned with the ex-ante efficiency of hostile takeovers: the extent to which takeovers are an effective disciplining device on managers.

On this latter issue, the formal analysis by Scharfstein (1988) stands out. Building on the insights of Grossman and Hart (1980), he considers the ex-ante financial contracting problem between a financier and a manager. This contract specifies a state contingent compensation scheme for the manager to induce optimal effort provision. In addition the contract allows for ex-post takeovers, which can be efficiency enhancing if either the raider has information about the state of nature not available to the financier or if the raider is a better manager. In other words, takeovers are useful both because they reduce the informational monopoly of the incumbent manager about the state of the firm and because they allow for the replacement of inefficient managers. The important observation made by Scharfstein is that even if the firm can commit to an ex-ante optimal contract, this contract is generally inefficient. The reason is that the financier and manager partly design the contract to try and extract the efficiency rents of future raiders. Like a non-discriminating monopolist, they will design the contract so as to "price" the acquisition above the efficient competitive price. As a result, the contract will induce too few hostile takeovers on average.

Scharfstein's observation provides an important justification for regulatory intervention limiting anti-takeover defenses, such as super-majority amendments,[34] staggered boards,[35] fair price

[33] See Fischel and Bradley (1986), Romano (1991) and Kraakman, Park and Shavell (1994) for an analysis of distortions of litigation incentives in shareholder suits.
[34] These amendments raise the majority rule above 50% in the event of a hostile takeover.

amendments (ruling out two-tier tender offers),[36] and poison pills [37] (see Section 7.1.4 for a more detailed discussion). These defenses are seen by many to be against shareholders' interests and to be put in place by managers of companies with weak corporate governance structures [see, for example, Gilson (1981) and Easterbrook and Fischel (1981)]. Others, however, see them as an important weapon enabling the target firm to extract better terms from a raider [see Baron (1983), Macey and McChesney (1985), Shleifer and Vishny (1986), Hirshleifer and Titman (1990), Hirshleifer and Thakor (1994), Hirshleifer (1995)]. Even if one takes the latter perspective, however, Scharfstein's argument suggests that some of these defenses should be regulated or banned.

A much larger literature exists on the issue of ex-post efficiency of hostile takeovers. The first formal model of a tender offer game is due to Grossman and Hart (1980). They consider the following basic game. A raider can raise the value per share from $v = 0$ under current management to $v = 1$. He needs 50% of the voting shares and makes a conditional tender offer of p per share.[38] Share ownership is completely dispersed; indeed to simplify the analysis they consider an idealized situation with an infinite number of shareholders. It is not difficult to see that a dominant strategy for each shareholder is to tender if $p = 1$ and to hold on to their shares if $p<1$. Therefore, the lowest price at which the raider is able to take over the firm is $p = 1$, the post-takeover value per share. In other words, the raider has to give up all the value he can generate to existing shareholders. If he incurs costs in making the offer or in undertaking the management changes that produce the higher value per share he may well be discouraged from attempting a takeover. In other words, there may be too few takeover attempts ex-post.

Grossman and Hart (1980) suggest several ways of improving the efficiency of the hostile takeover mechanism. All involve some dilution of minority shareholder rights. Consistent with their proposals for example is the idea that raiders be allowed to "squeeze (freeze) out" minority shareholders that have not tendered their shares,[39] or to allow raiders to build up a larger "toehold" before they are required to disclose their stake. [40]

Following the publication of the Grossman and Hart article a large literature has developed analyzing different variants of the takeover game, with non-atomistic share ownership [e.g.,

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[35] Staggered boards are a common defence designed to postpone the time at which the raider can gain full control of the board after a takeover. With only a fraction y of the board renewable every x years, the raider would have to wait up to x/2y years before gaining over 50% of the seats.

[36] Two-tier offers specify a higher price for the first n shares tendered than for the remaining ones. They tend to induce shareholders to tender and, hence, facilitate the takeover. Such offers are generally illegal in the USA, but when they are not companies can ban them by writing an amendment into the corporate charter.

[37] Most poison pills give the right to management to issue more voting shares at a low price to existing shareholders in the event that one shareholder owns more than a fraction x of outstanding shares. Such clauses, when enforced, make it virtually impossible for a takeover to succeed. When such a defence is in place the raider has to oust the incumbent board in a proxy fight and remove the pill. When the pill is combined with defenses that limit the raider's ability to fight a proxy fight – for example a staggered board – the raider effectively has to bribe the incumbent board.

[38] A conditional offer is one that binds only if the raider gains control by having more than a specified percentage of the shares tendered.

[39] A squeeze or freeze out forces minority shareholders to sell their shares to the raider at (or below) the tender offer price. When the raider has this right it is no longer a dominant strategy to hold on to one's shares when p < 1.

[40] A toehold is the stake owned by the raider before he makes a tender offer. In the USA a shareholder owning more than 5% of outstanding shares must disclose his stake to the SEC. The raider can always make a profit on his toehold by taking over the firm. Thus, the larger his toehold the more likely he is to make a takeover attempt [see Shleifer and Vishny (1986) and Kyle and Vila (1991)].

Kovenock (1984), Bagnoli and Lipman (1988), Holmstrom and Nalebuff (1992)], with multiple bidders [e.g., Fishman (1988), Burkart (1995), Bulow, Huang and Klemperer (1999)], with multiple rounds of bidding [Dewatripont (1993)], with arbitrageurs [e.g., Cornelli and Li (2002)], asymmetric information [e.g., Hirshleifer and Titman (1990), Yilmaz (2000)], etc. Much of this literature has found Grossman and Hart's result that most of the gains of a takeover go to target shareholders (because of "free riding" by small shareholders) to be non-robust when there is only one bidder. With either non-atomistic shareholders or asymmetric information their extreme "free-riding" result breaks down. In contrast, empirical studies have found again and again that on average all the gains from hostile takeovers go to target shareholders [see Jensen and Ruback (1983) for a survey of the early literature]. While this is consistent with Grossman and Hart's result, other explanations have been suggested, such as (potential) competition by multiple bidders, or raiders' hubris leading to over-eagerness to close the deal [Roll (1986)].

More generally, the theoretical literature following Grossman and Hart (1980) is concerned more with explaining bidding patterns and equilibrium bids given existing regulations than with determining which regulatory rules are efficient. A survey of most of this literature can be found in Hirshleifer (1995). For an extensive discussion of empirical research on takeovers see also the survey by Burkart (1999).

Formal analyses of optimal takeover regulation have focused on four issues:1) whether deviations from a "one-share–one vote" rule result in inefficient takeover outcomes; 2) whether raiders should be required to buy out minority shareholders; 3) whether takeovers may result in the partial expropriation of other inadequately protected claims on the corporation, and if so, whether some anti-takeover amendments may be justified as basic protections against expropriation; and 4) whether proxy contests should be favored over tender offers.

From 1926 to 1986 one of the requirements for a new listing on the New York Stock Exchange was that companies issue a single class of voting stock [Seligman (1986)]. [41] That is, companies could only issue shares with the same number (effectively one) of votes each. Does this regulation induce efficient corporate control contests? The analysis of Grossman and Hart (1988) and Harris and Raviv (1988a,b) suggests that the answer is a qualified "yes". They point out that under a "one-share–one-vote" rule inefficient raiders must pay the highest possible price to acquire control. In other words, they face the greatest deterrent to taking over a firm under this rule. In addition, they point out that a simple majority rule is most likely to achieve efficiency by treating incumbent management and the raider symmetrically.

Deviations from "one-share–one-vote" may, however, allow initial shareholders to extract a greater share of the efficiency gain of the raider in a value-increasing takeover. Indeed, Harris and Raviv (1988a), Zingales (1995) and Gromb (1993) show that maximum extraction of the raider's efficiency rent can be obtained by issuing two extreme classes of shares, votes-only shares and non-voting shares. Under such a share ownership structure the raider only purchases votes-only shares. He can easily gain control, but all the benefits he brings go to the non-voting shareholders. Under their share allocation scheme all non-voting shareholders have no choice but to "free-ride" and thus appropriate most of the gains from the takeover.

[41] A well-known exception to this listing rule was the Ford Motor Company, listed with a dual class stock capitalization in 1956, allowing the Ford family to exert 40% of the voting rights with 5.1% of the capital [Seligman (1986)].

Another potential benefit of deviations from "one-share–one-vote" is that they may induce more listings by firms whose owners value retaining control of the company. Family-owned firms are often reluctant to go public if they risk losing control in the process. These firms might go public if they could retain control through a dual-class share structure. As Hart (1988) argues, deviations from one-share–one-vote would benefit both the firm and the exchange in this case. They are also unlikely to hurt minority shareholders, as they presumably price in the lack of control rights attached to their shares at the IPO stage.

Burkart, Gromb and Panunzi (1998) extend this analysis by introducing a posttakeover agency problem. Such a problem arises when the raider does not own 100% of the shares ex post, and is potentially worse, the lower the raider's post-takeover stake. They show that in such a model initial shareholders extract the raider's whole efficiency rent under a "one-share–one-vote" rule. As a result, some costly takeovers may be deterred. To reduce this inefficiency they argue that some deviations from "one-share–one-vote" may be desirable.

The analysis of mandatory bid rules is similar to that of deviations from "one-share–one-vote". By forcing a raider to acquire all outstanding shares, such a rule maximizes the price an inefficient raider must pay to acquire control. On the other hand, such a rule may also discourage some value increasing takeovers [see Bergstrom, Hogfeldt and Molin (1997)].

In an influential article Shleifer and Summers (1988) have argued that some takeovers may be undesirable if they result in a "breach of trust" between management and employees. If employees (or clients, creditors and suppliers) anticipate that informal relations with current management may be broken by a new managerial team that has taken over the firm they may be reluctant to invest in such relations and to acquire firm specific human capital. They argue that some anti-takeover protections may be justified at least for firms where specific (human and physical) capital is important. A small formal literature has developed around this theme [see e.g., Knoeber (1986), Schnitzer (1995), Chemla (1998)]. One lesson emerging from this research is that efficiency depends critically on which type of anti-takeover protection is put in place. For example, Schnitzer (1995) shows that only a specific combination of a poison pill with a golden parachute would provide adequate protection for the manager's (or employees') specific investments. The main difficulty from a regulatory perspective, however, is that protection of specific human capital is just too easy an excuse to justify managerial entrenchment. Little or no work to date has been devoted to the question of identifying which actions or investments constitute "entrenchment behavior" and which do not. It is therefore impossible to say conclusively whether current regulations permitting anti-takeover amendments, which both facilitate managerial entrenchment and provide protections supporting informal agreements, are beneficial overall.

Another justification for poison pills that has recently been proposed by Bebchuk and Hart (2001) is that poison pills make it impossible to remove an incumbent manager through a hostile takeover unless the tender offer is accompanied by a proxy fight over the redemption of the poison pill. [42] In other words, Bebchuk and Hart argue that the presence of a poison pill requires

[42] Bebchuk and Hart's conclusions rest critically on their view of why straight proxy fights are likely to be ineffective in practice in removing incumbent management. Alternative reasons have been given why proxy fights have so often failed, which would lead to different conclusions. For example, it has often been argued that management has an unfair advantage in campaigning for shareholder votes as they have access to shareholder lists as well as the company coffers (for example, Hewlett-Packard spent over $100 mn to convince shareholders to approve its merger with Compaq). In addition they can pressure institutional investors to vote for them (in the case of Hewlett-Packard, it was alleged that the prospect of future corporate finance business

a mechanism for removing incumbent managers that combines both a tender offer and a proxy contest. In their model such a mechanism dominates both straight proxy contests and straight tender offers. The reason why straight proxy contests are dominated is that shareholders tend to be (rationally) skeptical of challengers. Challengers may be worse than incumbents and only seek control to gain access to large private benefits of control. A tender offer accompanying a proxy fight mollifies shareholder skepticism by demonstrating that the challenger is ready to "put his money where his mouth is". In general terms, the reason why straight tender offers are dominated is that a tender offer puts the decision in the hands of the marginal shareholder while majority voting effectively puts the control decision in the hands of the average shareholder (or median voter). The average shareholder always votes in favor of a value increasing control change, while the marginal shareholder in a tender offer only decides to tender if she is better off tendering than holding on to her shares assuming that the takeover will succeed. Such behavior can result in excessive free-riding and inefficient control allocations.

5.2. Blockholder models

An alternative approach to mitigating the collective action problem of shareholders is to have a semi-concentrated ownership structure with at least one large shareholder, who has an interest in monitoring management and the power to implement management changes. Although this solution is less common in the USA and UK – because of regulatory restrictions on blockholder actions – some form of concentration of ownership or control is the dominant form of corporate governance arrangement in continental Europe and other OECD countries.

The first formal analyses of corporate governance with large shareholders point to the benefits of large shareholders in facilitating takeovers [see Grossman and Hart (1980) and Shleifer and Vishny (1986)]. A related theme is the classic tradeoff underlying the standard agency problem with moral hazard: the tradeoff between optimal risk diversification, which is obtained under a fully dispersed ownership structure, and optimal monitoring incentives, which require concentrated ownership. Thus, Leland and Pyle (1977) have shown that it may be in the interest of a risk-averse entrepreneur going public to retain a large stake in the firm as a signal of quality, or as a commitment to manage the firm well. Later, Admati, Pfleiderer and Zechner (1994) and Huddart (1993) have considered the monitoring incentives of a large risk-averse shareholder. They show that in equilibrium the large shareholder has too small a stake and under-invests in monitoring, because the large shareholder prefers to diversify his holdings somewhat even if this reduces his incentives to monitor. They also point out that ownership structures with one large block may be unstable if the blockholder can gradually erode his stake by selling small quantities of shares in the secondary market. The main regulating implication of these analyses is that corporate governance might be improved if blockholders could be subsidized to hold larger

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was implicitly used to entice Deutsche Bank to vote for the merger). If it is the case that institutional and other affiliated shareholders are likely to vote for the incumbent for these reasons then it is imperative to ban poison pills to make way for a possible hostile takeover as Shleifer and Vishny (1986), Harris and Raviv (1988a), Gilson (2000, 2002) and Gilson and Schwartz (2001) have argued among others. Lipton and Rowe (2002) take yet another perspective. They question the premise in most formal analyses of takeovers that financial markets are efficient. They point to the recent bubble and crash on NASDAQ and other financial markets as evidence that stock valuations are as likely to reflect fundamental value as not. They argue that when stock valuations deviate in this way from fundamental value they can no longer be taken as a reliable guide for the efficient allocation of control or for that matter as a reliable mechanism to discipline management. In such inefficient financial markets poison pills are necessary to protect management from the vagaries of the market and from opportunistic bids. They maintain that this is the doctrine underlying Delaware law on takeover defenses.

blocks. Indeed, the main problem in these models is to give greater incentives to monitor to the blockholder.[43]

A related set of models further pursues the issue of monitoring incentives of firms with liquid secondary markets. An influential view generally attributed to Hirschman (1970) is that when monitors can easily 'exit' the firm they tend not to exercise their 'voice'. In other words, blockholders cannot be relied upon to monitor management actively if they have the option to sell their stake instead.[44] Indeed, some commentators [most notably Mayer (1988), Black (1990), Coffee (1991), Roe (1994) and Bhide (1993)] have argued that it is precisely the highly liquid nature of USA secondary markets that makes it difficult to provide incentives to large shareholders to monitor management.

This issue has been analyzed by Kahn and Winton (1998) and Maug (1998) among others. Kahn and Winton show how market liquidity can undermine large shareholders' incentives to monitor by giving them incentives to trade on private information rather than intervene. They argue, however, that incentives to speculate may be small for blue-chip companies, where the large shareholder is unlikely to have a significant informational advantage over other market participants. Similarly, Maug points out that in liquid markets it is also easier to build a block. This gives large shareholders an added incentive to invest in information gathering.

To summarize, this literature emphasizes the idea that if the limited size of a block is mainly due to the large shareholder's desire to diversify risk then under-monitoring by the large shareholder is generally to be expected.

An entirely different perspective is that the large investor may want to limit his stake to ensure minimum secondary market liquidity. This is the perspective taken by Holmstrom and Tirole (1993). They argue that share prices in the secondary market provide valuable information about the firm's performance. To obtain accurate valuations, however, the secondary market must be sufficiently liquid. Indeed, liquidity raises speculators' return to acquiring information and thus improves the informativeness of the secondary market price. The more informative stock price can then be included in compensation packages to provide better incentives to managers. According to this view it is the market that does the monitoring and the large shareholder may only be necessary to act on the information produced by the market. [45]

In other words, there may be a natural complementarity between speculation in secondary markets and monitoring by large shareholders. This idea is pursued further in Faure-Grimaud and Gromb (2004) and Aghion, Bolton and Tirole (2004). These models show how large shareholders' monitoring costs can be reduced through better pricing of shares in the secondary market. The basic idea is that more accurate pricing provides not only greater liquidity to the large shareholder, but also enhances his incentives to monitor by reflecting the added value of his monitoring activities in the stock price. The latter paper also determines the optimal degree of liquidity of the large shareholder's stake to maximize his incentives to monitor. This theory

[43] Demsetz (1986) points out that insider trading makes it easier for a shareholder to build a toehold and thus facilitates monitoring.
[44] The idea that blockholders would rather sell their stake in mismanaged firms than try to fix the management problem is known as the "Wall Street rule" [see Black (1990)].
[45] Strictly speaking, in their model the large shareholder is only there by default, because in selling to the secondary market he has to accept a discount reflecting the information-related trading costs that investors anticipate incurring. Thus, the large shareholder can achieve the desired amount of information acquisition in the market by adjusting the size of his stake.

finds its most natural application for corporate governance in start-ups financed with venture capital. It is well known that venture capitalists not only invest large stakes in individual start-ups but also participate in running the firm before it goes public. Typical venture capital contracts can be seen as incentive contracts aimed in part at regulating the venture capitalist's exit options so as to provide the best incentives for monitoring.[46][47]

Just as with takeovers, there are obvious benefits from large shareholder monitoring but there may also be costs. We pointed out earlier that hostile takeovers might be undesirable if their main purpose is to expropriate employees or minority shareholders. Similarly, large shareholder monitoring can be too much of a good thing. If the large shareholder uses his power to hold up employees or managers, the latter may be discouraged from making costly firm specific investments. This point has been emphasized in a number of theoretical studies, most notably in Aghion and Tirole (1997), Burkart, Gromb and Panunzi (1997), and Pagano and Röell (1998). Thus, another reason for limiting a large shareholder's stake may be to prevent overmonitoring and ex-post opportunism. As privately held firms tend to have concentrated ownership structures they are more prone to over-monitoring. Pagano and Röell argue that one important motive for going public is that the manager may want to free himself from an overbearing owner or venture capitalist. [48]

It is only a short step from over-monitoring to downright expropriation, self-dealing or collusion with management at the expense of minority shareholders. Indeed, an important concern of many commentators is the conflict of interest among shareholders inherent in blockholder ownership structures. This conflict is exacerbated when in addition there is separation between voting rights and cash-flow rights, as is common in continental Europe. Many commentators have argued that such an arrangement is particularly vulnerable to self-dealing by the controlling shareholder [see e.g. Zingales (1994), Bianco et al. (1997), Burkart, Gromb and Panunzi (1997), La Porta et al. (1998), Wolfenzon (1999), Bebchuk (1999), Bebchuk, Kraakman and Trianis (2000)]. [49] Most of these commentators go as far as arguing that existing blockholder structures

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[46] See Bartlett (1994), Gompers and Lerner (1999), Levin (1995) and Kaplan and Strömberg (2003) for discussions of contractual provisions governing the venture capitalist's 'exit'. See also Berglöf (1994) and Hellman (1998) for models of corporate governance of venture capital financed firms.

[47] Another form of complementarity is considered in a recent paper by Chidambaran and John (1998). They argue that large shareholder monitoring can be facilitated by managerial cooperation. However, to achieve such cooperation managers must be given an equity stake in the firm. With sufficient equity participation, the authors show that managers have an incentive to disclose information that brings market valuations closer to fundamental values of the business. They argue that this explains why greater institutional holdings are associated with larger stock option awards but lower compensation levels for CEOs [see Hartzell and Starks (2003)].

[48] Most of the theoretical literature on large shareholders only considers ownership structures where all but one shareholder are small. Zwiebel (1995) is a recent exception. He considers ownership structures where there may be more than one large shareholder and also allows for alliances among small blockholders. In such a setting he shows that one of the roles of a large blockholding is to fend off alliances of smaller blockholders that might compete for control [see also Gomes and Novaes (2000) and Bloch and Hege (2000) for two other recent formal analyses of ownership structures with multiple large shareholders]. An entirely different perspective on the role of large outside shareholders is given in Muller and Warneryd (2001) who argue that outside owners can reduce inefficient rent seeking of insiders and managers by inducing them to join forces to fight the outsider's own rent seeking activities. This story fits well the situation of many second-generation family-owned firms, who decide to open up their ownership to outsiders in an attempt to stop feuding among family members.

[49] Most commentators point to self-dealing and "private benefits" of control of the large shareholder. Perhaps equally worrying, however, is collusion between management and the blockholder. This aspect of the problem has not received much attention. For two noteworthy exceptions see Tirole (1986) and Burkart and Panunzi (2005).

in continental Europe are in fact likely to be inefficient and that USA-style regulations restricting blockholder rights should be phased in.

The analyses of Aghion and Tirole (1997), Burkart, Gromb and Panunzi (1997), and Pagano and Röell (1998), however, suggest that if there is a risk of over-monitoring or self-dealing it is often possible to design the corporate ownership structure or charter to limit the power of the blockholder. But Bebchuk (1999) and Bebchuk and Roe (1999) retort that although it is theoretically possible to design corporate charters that restrain self-dealing, in practice the Coase theorem is likely to break down and therefore regulations limiting blockholder rights are called for. Bebchuk (1999) develops a model where dispersed ownership is unstable when large shareholders can obtain rents through self-dealing since there is always an incentive to grab and protect control rents. If a large shareholder does not grab the control rents then management will. Bebchuk's extreme conclusion, however, is based on the assumption that a self-dealing manager cannot be disciplined by a takeover threat. [50] His general conclusion – that if selfdealing is possible under a lax corporate law it will inevitably lead to concentrated ownership – is a particular version of the general argument outlined in the introduction that under dispersed ownership management may not be able to commit to an ex-ante efficient corporate governance rule. Bebchuk and Roe (1999) make a complementary point, arguing that inefficiencies can persist if there is a collective action problem in introducing better corporate governance arrangements.

So far we have discussed the costs and benefits of takeovers and large shareholder monitoring, respectively. But what are the relative advantages of each approach? One comparative analysis of this question is proposed by Bolton and von Thadden (1998a,b). They argue that one potential benefit of blockholder structures is that monitoring will take place on an ongoing basis. In contrast, a system with dispersed shareholders can provide monitoring and intervention only in crisis situations (if at all), through a hostile takeover. The benefit of dispersed ownership, on the other hand is enhanced liquidity in secondary markets. They show that depending on the value of monitoring, the need for intervention and the demand for liquidity either system can dominate the other. The comparison between the two systems obviously also depends on the regulatory structure in place. If, as Black (1990) has forcefully argued, regulations substantially increase the costs of holding blocks[51] (as is the case in both the USA and the UK) then a system with dispersed shareholders relying on hostile takeovers might be best. On the other hand, if regulations which mainly increase the costs of hostile takeovers but do not otherwise substantially restrict blockholder rights (as in continental Europe) are in place then a system based on blockholder monitoring may arise.

Another comparative analysis is proposed by John and Kedia (2000). They draw the distinction between 'self-binding' mechanisms (like bank or large shareholder monitoring) and 'intervention'

[50] The issue of competition for control rents between a large shareholder and the CEO is analysed in Burkart and Panunzi (2005). They argue that access to control rents has positive incentive effects on the CEO. It also has positive effects on the blockholder's incentive to monitor. However, competition for these rents between the CEO and the blockholder may undermine the incentives of either party.

[51] Among USA rules discouraging shareholder action are disclosure requirements, prohibitions on insider trading and short-swing trading, rules imposing liability on 'controlling shareholders', limits on institutional shareholdings in a single company and fiduciary duty rules; a detailed account is given by Black (1990). One of the most striking restrictions is the rule governing shareholder proposals (Rule 14a-8): a shareholder "can offer only one proposal per year, . . . must submit the proposal . . . 5 months before the next annual meeting . . . A proposal cannot relate to ordinary business operations or the election of directors . . . and not conflict with a manager proposal" [Black (1990, p. 541)].

mechanisms (like hostile takeovers). They let underlying conditions vary according to two parameters: the costs of bank monitoring and the effectiveness of hostile takeovers. Depending on the values of these parameters the optimal governance mechanism is either: i) concentrated ownership (when bank monitoring is costly and takeovers are not a threat); ii) bank monitoring (when monitoring costs are low and takeovers are ineffective); or iii) dispersed ownership and hostile takeovers (when anti-takeover defenses are low and monitoring is costly). One implication of their analysis is that corporate governance in Europe and Japan may not converge to USA practice simply by introducing the same takeover regulations. If banks are able to maintain a comparative advantage in monitoring these countries may continue to see a predominance of bank monitoring. [52]

5.3. Delegated monitoring and large creditors

One increasingly important issue relating to large shareholders or investor monitoring concerns the role of institutional shareholder activism by pension funds and other financial intermediaries. Pension funds, mutual funds and insurance companies (and banks outside the USA) often buy large stakes in corporations and could take an active role in monitoring management. Generally, however, because of regulatory constraints or lack of incentives they tend to be passive [see Black (1990), Coffee (1991), Black and Coffee (1994)]. One advantage of greater activism by large institutional investors is that fund managers are less likely to engage in self-dealing and can therefore be seen as almost ideal monitors of management. But a major problem with institutional monitoring is that fund managers themselves have no direct financial stake in the companies they invest in and therefore have no direct or adequate incentives for monitoring. [53]

The issue of institutional investor incentives to monitor has been analyzed mainly in the context of bank monitoring. The first formal analysis of the issue of who monitors the monitor (in the context of bank finance) is due to Diamond (1984). He shows that, as a means of avoiding duplication of monitoring by small investors, delegated monitoring by a banker may be efficient.[54] He resolves the issue of 'who monitors the monitor' and the potential duplication of monitoring costs for depositors, by showing that if the bank is sufficiently well diversified then it can almost perfectly guarantee a fixed return to its depositors. As a result of this (almost safe) debt-like contract that the bank offers to its depositors, the latter do not need to monitor the bank's management continuously.[55] They only need to inspect the bank's books when it is in financial distress, an event that is extremely unlikely when the bank is well diversified. As Calomiris and Kahn (1991) and Diamond and Rajan (2001) have emphasized more recently, however, preservation of the banker's incentives to monitor also requires a careful specification of deposit contracts. In particular, banks' incentives are preserved in their model only if there is no deposit insurance and the first-come first-served feature of bank deposit contracts is

[52] Yet another comparative analysis is given in Ayres and Cramton (1994). They emphasise two benefits of large shareholder structures. First, better monitoring and second less myopic market pressure to perform or fend off a hostile takeover [see also Narayanan (1985), Shleifer and Vishny (1989), and Stein (1988, 1989) for a formal analysis of myopic behaviour induced by hostile takeovers]. It is debatable, however, whether less market pressure is truly a benefit [see Romano (1998) for a discussion of this point].

[53] As Romano (2001) has argued and as the empirical evidence to date suggests [see Karpoff (1998)], USA institutional activism can be ineffective or misplaced.

[54] More generally, banks are not just delegated monitors but also delegated renegotiators; that is they offer a lending relationship; see Bolton and Freixas (2000) and Petersen and Rajan (1994).

[55] See also Krasa and Villamil (1992) and Hellwig (2000a) for generalizations of Diamond's result.

maintained. In other words, bankers' incentives to monitor are preserved only if banks are disciplined by the threat of a bank run by depositors. [56]

One implication of these latter models is that under a regime of deposit insurance banks will not adequately monitor firms and will engage in reckless lending. The greater incidence of banking crises in the past 20 years is sometimes cited as corroborating evidence for this perspective. Whether the origin of these crises is to be found in deposit insurance and inadequate bank governance is a debated issue. Other commentators argue that the recent banking crises are just as (or more) likely to have resulted from exchange rate crises and/or a speculative bubble. Many commentators put little faith in depositors' abilities (let alone incentives) to monitor banks and see bank regulators as better placed to monitor banks in the interest of depositors [see Dewatripont and Tirole (1994)]. Consistent with this perspective is the idea that deposit insurance creates adequate incentives for bank regulators to monitor banks, as it makes them residual claimants on banks' losses. However, these incentives can be outweighed by a lack of commitment to close down insolvent banks and by regulatory forbearance. It is often argued that bank bailouts and the expectation of future bailouts create a 'moral hazard' problem in the allocation of credit (see Chapter 8 in this Volume by Gorton and Winton for an extended survey of these issues). [57]

To summarize, the theoretical literature on bank monitoring shows that delegated monitoring by banks or other financial intermediaries can be an efficient form of corporate governance. It offers one way of resolving collective action problems among multiple investors. However, the effectiveness of bank monitoring depends on bank managers' incentives to monitor. These incentives, in turn, are driven by bank regulation. The existing evidence on bank regulation and banking crises suggests that bank regulation can at least be designed to work when the entire banking system is healthy, but it is often seen to fail when there is a system-wide crisis [see Gorton and Winton (1998)]. Thus, the effectiveness of bank monitoring can vary with the aggregate state of the banking industry. This can explain the perception that Japanese banks have played a broadly positive role in the 1970s and 1980s, while in the 1990s they appear to have been more concerned with covering up loan losses than with effectively monitoring the corporations they lend to.

5.4. Board models

The third alternative for solving the collective action problem among dispersed shareholders is monitoring of the CEO by a board of directors. Most corporate charters require that shareholders elect a board of directors, whose mission is to select the CEO, monitor management, and vote on important decisions such as mergers and acquisitions, changes in remuneration of the CEO, changes in the firm's capital structure like stock repurchases or new debt issues, etc. In spirit most charters are meant to operate like a 'shareholder democracy', with the CEO as the executive branch of government and the board as the legislative branch. But, as

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[56] Pension fund managers' incentives to monitor are not backed with a similar disciplining threat. Despite mandatory requirements for activism (at least in the USA) pension fund managers do not appear to have strong incentives to monitor managers [see Black (1990) for a discussion of USA regulations governing pension funds' monitoring activities and their effects].

[57] The moral hazard problem is exacerbated by bank managers' incentives to hide loan losses as Mitchell (2000) and Aghion, Bolton and Fries (1999) have pointed out. A related problem, which may also exacerbate moral hazard, is banks' inability to commit ex ante to terminate inefficient projects [see Dewatripont and Maskin (1995)]. On the other hand, as senior (secured) debtholders banks also have a bias towards liquidation of distressed lenders [see Zender (1991) and Dewatripont and Tirole (1994)].

many commentators have argued, in firms with dispersed share ownership the board is more of a 'rubberstamp assembly' than a truly independent legislature checking and balancing the power of the CEO. One important reason why boards are often 'captured' by management is that CEOs have considerable influence over the choice of directors. CEOs also have superior information. Even when boards have achieved independence from management they are often not as effective as they could be because directors prefer to play a less confrontational 'advisory' role than a more critical monitoring role. Finally, directors generally only have a very limited financial stake in the corporation.

Most regulatory efforts have concentrated on the issue of independence of the board. In an attempt to reduce the CEO's influence over the board many countries have introduced requirements that a minimum fraction of the board be composed of socalled 'independent' directors.[58] The rationale behind these regulations is that if directors are not otherwise dependent on the CEO they are more likely to defend shareholders' interests. It is not difficult to find flaws in this logic. For one thing, directors who are unrelated to the firm may lack the knowledge or information to be effective monitors. For another, independent directors are still dependent on the CEO for reappointment. Perhaps the biggest flaw in this perspective is that it does not apply well to concentrated ownership structures. When a large controlling shareholder is in place what may be called for is not only independence from the CEO, but also independence from the controlling shareholder. In corporations with concentrated ownership independent directors must protect the interests of minority shareholders against both the CEO's and the blockholder's actions.

Many commentators view these regulations with much scepticism. To date, most research on boards and the impact of independent directors is empirical, and the findings concerning the effects of independent directors are mixed. Some evidence supporting the hypothesis that independent directors improve board performance is available, such as the higher likelihood that an independent board will dismiss the CEO following poor performance [Weisbach (1988)], or the positive stock price reaction to news of the appointment of an outside director [Rosenstein and Wyatt (1990)]. But other evidence suggests that there is no significant relation between firm performance and board composition [e.g., Hermalin and Weisbach (1991), Byrd and Hickman (1992); Mehran (1995); see Romano (1996), John and Senbet (1998), Hermalin and Weisbach (2003) for surveys of the empirical literature on boards].

In contrast to the large empirical literature on the composition of boards, formal analysis of the role of boards of directors and how they should be regulated is almost non-existent. An important contribution in this area is by Hermalin and Weisbach (1998). They consider a model where the firm's performance together with monitoring by the board reveals information over time about the ability of the CEO. The extent of monitoring by the board is a function of the board's 'independence' as measured by directors' financial incentives as well as their distaste for confronting management. Board independence is thus an endogenous variable. Board appointments in their model are determined through negotiations between the existing board and the CEO. The latter's bargaining power derives entirely from his perceived superior ability relative to alternative managers that might be available. Thus, as the firm does better the CEO's power grows and the independence of the board tends to diminish. As a result CEOs tend to be less closely monitored the longer they have been on the job. Their model highlights an important

[58] A director is defined as 'independent' if he or she is not otherwise employed by the corporation, is not engaged in business with the corporation, and is not a family member. Even if the director is a personal friend of the CEO, (s)he will be considered independent if (s)he meets the above criteria.

insight: the gradual erosion of the effectiveness of boards over time. It suggests that regulatory responses should be targeted more directly at the selection process of directors and their financial incentives to monitor management.

The model by Hermalin and Weisbach is an important first step in analyzing how directors get selected and how their incentives to monitor management are linked to the selection process. Other formal analyses of boards do not explicitly model the selection process of directors. Warther (1998) allows for the dismissal of minority directors who oppose management, but newly selected members are assumed to act in the interest of shareholders. [59] Since directors prefer to stay on the board than be dismissed, his model predicts that directors will be reluctant to vote against management unless the evidence of mismanagement is so strong that they can be confident enough that a majority against management will form. His model thus predicts that boards are active only in crisis situations. One implication of his analysis is that limiting dismissal and/or introducing fixed term limits tends to improve the vigilance of the board.

Raheja (2002) does not model the selection process of directors either. He takes the proportion of independent directors as a control variable. A critical assumption in his model is that independent directors are not as well informed as the CEO and inside directors. He considers two types of board decisions: project choice and CEO succession. Competition for succession is used to induce insiders to reveal the private information they share about project characteristics. Raheja derives the board composition and size that best elicits insider information and shows how it may vary with underlying firm characteristics.

Hirshleifer and Thakor (1994) consider the interaction between inside monitoring by boards and external monitoring by corporate raiders. Takeover threats have a disciplining effect on both management and boards. They show that sometimes even boards acting in the interest of shareholders may attempt to block a hostile takeover.[60]

Adams (2001) focuses on the conflict between the monitoring and advisory functions of the board: the board's monitoring role can restrict its ability to extract information from management that is needed for its advisory role. Thus the model gives insight into the possible benefits of instituting a dual board system, as in Germany.

In sum, the formal literature on boards is surprisingly thin given the importance of the board of directors in policy debates. This literature mainly highlights the complexity of the issues. There is also surprisingly little common ground between the models. Clearly, much remains to be explored. The literature has mainly focused on issues relating to board composition and the selection of directors. Equally important, however, are issues relating to the functioning of the board and how board meetings can be structured to ensure more effective monitoring of management. This seems to be a particularly fruitful area for future research.

5.5. Executive compensation models

Besides monitoring and control of CEO actions another way of improving shareholder protection is to structure the CEO's rewards so as to align his objectives with those of shareholders. This is what executive compensation is supposed to achieve.

[59] See also Noe and Rebello (1996) for a similar model of the functioning of boards.
[60] See also Maug (1997) for an analysis of the relative strengths and weaknesses of board supervision, takeovers and leverage in disciplining management.

Most compensation packages in publicly traded firms comprise a basic salary component, a bonus related to short run performance (e.g., accounting profits), and a stock participation plan (most of the time in the form of stock options). The package also includes various other benefits, such as pension rights and severance pay (often described as "golden parachutes").

Executive compensation in the USA has skyrocketed in the past decade, in part as a result of the unexpectedly strong bull market, and in part because of the process of determining compensation packages for CEOs. In most USA corporations a compensation committee of the board is responsible for setting executive pay. These committees generally rely on 'market standards' for determining the level and structure of pay. [61] This process tends to result in an upward creep in pay standards. USA corporations set by far the highest levels of CEO compensation in the world. Although USA executives were already the highest paid executives in the world by a wide margin at the beginning of the past decade – even correcting for firm size – the gap in CEO pay has continued to widen significantly over the past decade – largely due to the growing importance of stock options in executive compensation packages [see Murphy (1999) for an extensive survey of empirical and theoretical work on executive compensation and Hallock and Murphy (1999) for a reader].

There has always been the concern that although stock options may improve CEOs' incentives to raise share value they are also a simple and direct way for CEOs to enrich themselves and expropriate shareholders. Indeed, practitioners see a grant of an unusually large compensation package as a signal of poor corporate governance [Minow (2000)].

Despite this frequently voiced concern, however, there has been no attempt to analyze the determination of executive pay along the lines of Hermalin and Weisbach (1998), by explicitly modelling the bargaining process between the CEO, the remuneration committee and the Board, as well as the process of selection of committee and board members. Instead, most existing formal analyses have relied on the general theory of contracting under moral hazard of Mirrlees (1976, 1999), Holmstrom (1979) and Grossman and Hart (1983) to draw general conclusions about the structure of executive pay, such as the trade-off between risk-sharing and incentives and the desirability of basing compensation on all performance measures that are informative about the CEO's actions.

The agency model of Holmstrom and Tirole (1993), which introduces stock trading in a secondary market, can rationalize the three main components of executive compensation packages (salary, profit related bonus, and stock participation), but that does not mean that in practice executive compensation consultants base the design of compensation contracts on fine considerations such as the relative informativeness of different performance measures. On the contrary, all existing evidence suggests that these are not the main considerations for determining the structure of the pay package [see again the extensive survey by Murphy (1999)].

Another complicating factor is that CEOs are driven by both implicit and explicit incentives. They are concerned about performance not only because their pay is linked to performance but also because their future career opportunities are affected. The formal analysis of Gibbons and

[61] Compensation committees often rely on the advice of outside experts who make recommendations based on observed average pay, the going rate for the latest hires, and/or their estimate of the pay expected by potential candidates.

Murphy (1992) allows for both types of incentives. [62] It suggests that explicit incentives should be rising with age and tenure, as the longer the CEO has been on the job the lower are his implicit incentives.

Finally, much of the agency theory that justifies executive compensation schemes unrealistically assumes that earnings and stock prices cannot be manipulated. This is a major weakness of the theory as brought to light in recent accounting scandals involving Enron, Global Crossing, WorldCom and others. To quote corporate governance expert Nell Minow: "Options are very motivational. We just have to be a little more thoughtful about what it is we're asking them to motivate". [63]

All in all, while the extensive literature on agency theory provides a useful framework for analyzing optimal incentive contracts it is generally too far removed from the specifics of executive compensation. Moreover, the important link between executive compensation and corporate governance, as well as the process of determination of executive pay remain open problems to be explored at a formal level.

5.6. Multi-constituency models

The formal literature on boards and executive compensation takes the view that the board exclusively represents the interests of shareholders. In practice, however, this is not always the case. When a firm has a long-term relation with a bank it is not uncommon that a bank representative sits on the board [see Bacon and Brown (1975)]. Similarly, it is not unusual for CEOs of firms in related businesses to sit on the board. In some countries, most notably Germany, firms are even required to have representatives of employees on the board. The extent to which boards should be mandated to have representatives of other constituencies besides shareholders is a hotly debated issue. In the European Union in particular the issue of board representation of employees is a major stumbling block for the adoption of the European Company Statute (ECS). [64]

As important as this issue is there is only a small formal literature on the subject. What is worse, this literature mostly considers highly stylized models of multiple constituencies. Perhaps the biggest gap is the absence of a model that considers the functioning of a board with representatives of multiple constituencies. Existing models mainly focus on the issue of when and whether it is desirable for the firm to share control among multiple constituencies. These models are too stylized to address the issue of board representation.

5.6.1. Sharing control with creditors

A number of studies have considered the question of dividing control between managers, shareholders and creditors and how different control allocations affect future liquidation or restructuring decisions. A critical factor in these studies is whether share ownership is concentrated or not.

[62] See also Holmstrom and Ricart i Costa (1986) and Zwiebel (1995) for an analysis of managerial compensation with implicit incentives. These papers focus on the issue of how career concerns can distort managers' incentives to invest efficiently. In particular they can induce a form of conservatism in the choice of investment projects.
[63] New York Times, 17 February 2002.
[64] Either the ECS would allow German companies to opt out of mandatory codetermination or it would impose mandatory codetermination on all companies adopting the ECS.

Aghion and Bolton (1992) consider a situation where ownership is concentrated and argue that family-owned firms want to limit control by outside investors because they value the option of being able to pursue actions in the future which may not be profit maximizing. They may value family control so much that they may want to turn down acquisition bids even if they are worth more than the net present value of the current business. Or, they may prefer to keep the business small and under family control even if it is more profitable to expand the business. In some situations, however, they may have no choice but to relinquish some if not all control to the outside investor if they want to secure capital at reasonable cost. Aghion and Bolton show that under some conditions the efficient contractual arrangement is to have a state-contingent control allocation, as under debt financing or under standard venture capital arrangements.[65] Although their model only considers a situation of bilateral contracting with incomplete contracts it captures some basic elements of a multi-constituency situation and provides a rationale for extending control to other constituencies than shareholders.

Another rationale for dividing control with creditors (or more generally fixed claim holders) is given in Zender (1991), Diamond (1991, 1993), Dewatripont and Tirole (1994), Berglöf and von Thadden (1994), Aoki (1990) and Aoki et al. (1994). All these studies propose that the threat of termination (or liquidation) if performance is poor may be an effective incentive scheme for management. But, in order to credibly commit to liquidate the firm if performance is poor, control must be transferred to fixed claimholders. As these investors get a disproportionate share of the liquidation value and only a fraction of the potential continuation value, they are more inclined to liquidate the firm than shareholders, who as the most junior claimholders often prefer to 'gamble for resurrection'. The commitment to liquidate is all the stronger the more dispersed debt is, as that makes debt restructuring in the event of financial distress more difficult [see Hart and Moore (1995), Dewatripont and Maskin (1995), Bolton and Scharfstein (1996)].

Interestingly, Berkovitch and Israel (1996) have argued that when it comes to replacing managers, shareholders may be more inclined to be tough than creditors. The reason why a large shareholder is more likely to fire a poorly performing manager is that the shareholder effectively exercises a valuable option when replacing the manager, while the creditor does not. Sometimes the large shareholder may be too eager to replace management, in which case it may be desirable to let creditors have veto rights over management replacement decisions (or to have them sit on the board).

Another way of limiting shareholders' power to dismiss management is, of course, to have a diffuse ownership structure. This is the situation considered by Chang (1992). In his model the firm can only rely on creditors to dismiss management, since share ownership is dispersed. Chang shows that creditors are more likely to dismiss a poorly performing manager the higher the firm's leverage. Since a large shareholder would tend to dismiss poorly performing managers too easily, Chang shows that there is an efficient level of leverage, implementing a particular division of control rights.

[65] The analysis of venture capital contracts in terms of contingent control allocations has been pursued and extended by Berglöf (1994), Hellman (1998) and Neher (1999). More recently, Kaplan and Strömberg (2003) have provided a detailed analysis of control allocation in 100 venture capital contracts. Their analysis highlights the prevalence of contingent control allocations in venture capital contracts.

5.6.2. Sharing control with employees

Models of corporate governance showing that some form of shared control between creditors and shareholders may be optimal can sometimes also be reinterpreted as models of shared control between employees and the providers of capital. This is the case of Chang's model, where the role of employee representatives on the board can be justified as a way of dampening shareholders' excessive urge to dismiss employees.

But for a systematic analysis of shared governance arrangements one has to turn to the general theory of property rights recently formulated by Grossman, Hart and Moore [see Grossman and Hart (1986), Hart and Moore (1990), Hart (1995)]. The central issue in their theory is the so-called 'holdup' problem,[66] which refers to the potential ex-post expropriation of unprotected returns from *ex ante* (specific)[67] human capital investment. Much of the property-rights theory is concerned with the protection of physical capital [as in Grossman and Hart (1986)], but it also deals with human capital investments. An extreme example of 'holdup' problem for human capital investments is the case of a researcher or inventor, who cannot specify terms of trade for his invention before its creation. Once his machine or product is invented, however, the inventor can only extract a fraction of the total value of the invention to his clients (assuming there is limited competition among clients). What is worse, the ex-post terms of trade will not take into account the research and development costs, which are 'sunk' at the time of negotiation. The terms of trade the inventor will be able to negotiate, however, will be greater if he owns the assets that are required to produce the invention, or if he sits on the board of directors of the client company.

As this example highlights, a general prediction of the theory of property rights is that some form of shared control with employees is efficient, whenever employees (like the inventor) make valuable firm-specific human-capital investments.[68]

Building on this property-rights theory, Roberts and Van den Steen (2000) and Bolton and Xu (2001) provide a related justification for employee representation on the board to Chang's. They consider firms in professional service or R&D intensive industries, where firm-specific human capital investment by employees adds significant value. As in Hart and Moore (1990), say, an important issue in these firms is how to protect employees against the risk of ex-post expropriation or hold-up by management or the providers of financial capital. More concretely, the issue is how to guarantee sufficient job security to induce employees to invest in the firm. Indeed, as with any provider of capital (financial or human), employees will tend to under-invest in firm-specific human capital if they do not have adequate protection against ex-post hold ups

[66] See Goldberg (1976) and Klein, Crawford and Alchian (1978) for an early informal definition and discussion of the holdup concept. See also Williamson (1971, 1975, 1979, 1985a) for a discussion of the closely related concept of opportunism.
[67] It is only when investment is specific to a relation, or a task, that concerns of ex-post expropriation arise. If investment is of a general purpose, then competition ex-post for the investment provides adequate protection to the investor.
[68] The property-rights theory also provides a useful analytical framework to assess the costs and benefits of privatization of state-owned firms. Thus, Hart, Shleifer and Vishny (1997) have argued that privatized firms have a better incentive to minimize costs, but the systematic pursuit of profits may also lead to the provision of poorer quality service. They apply their analysis to the case of privatization of prisons. Perhaps a more apt application might have been to the privatization of railways in the UK and the Netherlands, where quality of service has visibly deteriorated following privatization. Schmidt (1996) and Shapiro and Willig (1990) emphasize a different trade-off. They argue that under state ownership the government has better information about the firm's management (that is the benefit), but the government

and expropriation threats. They show that in firms where (firm-specific) human capital is valuable it may be in the interest of the providers of capital to share control with employees, although generally the providers of financial capital will relinquish less control to employees than is efficient. Indeed, the providers of financial capital are concerned as much with extracting the highest possible share of profits as with inducing the highest possible creation of profits through human capital investments. [69]

Sharing control with employees can be achieved by letting employees participate in share ownership of the company, by giving them board representation, or by strengthening their bargaining power through, say, increased unionization. An important remark made by Holmstrom (1999) and echoed by Roberts and Van den Steen (2000) is that when employees cannot participate in corporate decision-making a likely response may be unionization and/or strikes. There are many examples in corporate history where this form of employee protection has proved to be highly inefficient, often resulting in extremely costly conflict resolutions.

Thus, in practice an important effect of employee representation on boards may be that employees' human capital investments are better protected and that shareholders' excessive urge to dismiss employees is dampened. Interestingly, there appears to be some empirical evidence of this effect of employee representation in the study of co-determination in German corporations by Gorton and Schmid (2000a). However, their study also suggests that shareholders in Germany do not passively accept board representation by employees. In an effort to counteract employees' influence they tend to encourage the firm to be more highly levered [as Perotti and Spier (1993) have explained, creditors are likely to be tougher in liquidation decisions than shareholders]. Also, in some cases, shareholder representatives have gone as far as holding informal meetings on their own to avoid disclosing sensitive information or discussing delicate decisions with representatives of employees.

Bolton (1995) looks at yet another angle. He argues that state ownership is actually a form of governance with extreme dispersion of ownership (all the citizens are owners). This structure tends to exacerbate problems of self-dealing. These problems, however, are not always best dealt with through privatization, which may also involve shareholder dispersion. Pointing to the example of Chinese Township and Village enterprises, Bolton argues instead that state ownership at the community level may be another way of mitigating the inefficiencies of state-owned firms.

An extreme result highlighted by Roberts and Van den Steen (2000) is that it may even be efficient to have employee-dominated boards when only human capital investment matters. Examples of such governance structures are not uncommon in practice, especially in the professional services industry. Most accounting, consulting or law partnerships effectively have employee-dominated boards. Another example is universities, where academics not only have full job security (when they have tenure) but also substantial control rights. [70]

[69] Again, see Aghion and Bolton (1987) for a formal elaboration of this point.

[70] Bolton and Xu (2001) extend this analysis by considering how internal and external competition among employees can provide alternative or complementary protections to employee control [see also Zingales (1998) for a discussion of corporate governance as a mechanism to mitigate ex-post hold-up problems, and Rajan and Zingales (2000) for an analysis of when a shareholder-controlled firm wants to create internal competition among employees as an incentive scheme].

Hansmann (1996) and Hart and Moore (1996, 1998) are concerned with another aspect of governance by employees. They ask when it is best to have 'inside' ownership and control in the form of an employee cooperative or partnership, or when 'outside' ownership in the form of a limited liability company is better. A central prediction of the property rights theory is that ownership and control rights should be given to the parties that make ex-ante specific investments. In other words, it should be given mainly to 'insiders'. Yet, as Hansmann and Hart and Moore observe, the dominant form of governance structure is 'outside' ownership. Hansmann resolves this apparent paradox by arguing that often shareholders are the most homogenous constituency in a firm and therefore are generally the best placed group to minimize decision-making costs. He also accepts Williamson's argument that shareholders are the constituency in most need of protection due to the open-ended nature of their contracts. Hart and Moore (1996, 1998) also focus on distortions in decision-making that can arise in a member cooperative, where members have very diverse interests.[71] They compare these distortions to those that can arise under outside ownership. However, they only consider outside ownership by a single large shareholder and assume away all the governance issues related to dispersed ownership. Like Aghion and Tirole (1997), Burkart, Gromb and Panunzi (1997), and Pagano and Röell (1998), they argue that a large shareholder will introduce distortions in his attempt to extract a larger share of the firm's value. At the margin he will do this even at the expense of greater value creation. The central observations of their analysis are that employee cooperatives are relatively worse governance structures the more heterogeneous employees are as a group, and outside ownership is relatively better the more the firm faces competition limiting the outside owner's ability to extract rents. They apply their analytical framework to explain why greater worldwide financial integration, which has resulted in increased competition among stock exchanges, has led to a move towards the incorporation of exchanges.

To summarize, the property rights theory of Grossman, Hart and Moore provides one basic rationale for sharing corporate control with employees and for employee representation on the board: protection of employees' firm-specific investments. But there may be others, like potentially better monitoring of management by employees. Indeed, the latter are likely to be better informed than shareholders about the management's actions, and they may be in a better position to monitor the management of, say, company pension plans. As persuasive as these reasons may be, however, it does not follow that rules mandating employee representation on the board, as in Germany, are necessarily desirable. As we have argued above, such rules can only be justified by appealing to a contractual failure of some kind. As we have already mentioned, one important potential source of contractual failure under sequential contracting, may arise when the providers of capital and the entrepreneur design the corporate charter partly as a means of extracting future potential rents from employees [see Aghion and Bolton (1987), Scharfstein (1988)]. Another possible failure, as Aghion and Bolton (1987), Aghion and Hermalin (1990), Spier (1992) and Freeman and Lazear (1995) have argued, may be due to the firm's founders' concern that allowing for employee representation may send a bad signal to potential investors.

But, even if contractual failures exist, they must be weighed against other potential inefficiencies that may arise as a result of multi-constituency representation on the board, such as shareholder responses to weaken employee influence, greater board passivity or less disclosure of valuable but divisive information by management. One argument against multiple constituencies that is

[71] It has often been highlighted that an important source of conflict in member cooperatives is the conflict between old and young members. The former want to milk past investments, while the younger members want to invest more in the firm [see Mitchell (1990)].

sometimes voiced is that when the firm's management is required to trade off the interests of different constituencies one important 'side effect' is that management gains too much discretion. When the stock tanks management can always claim that it was acting in the interest of employees [see, for example, Macey (1992), Tirole (2001), Hart (1995), Jensen (2002)]. This argument is particularly relevant when defining the CEO's fiduciary duties (or 'mission'). If these duties are too broadly defined to include the interests of multiple constituencies they are in danger of becoming toothless. The current narrow definition of fiduciary duties in the USA is already balanced by the 'business judgement rule', which makes it difficult for plaintiffs to prevail. If one were to add a 'protection of other constituencies rule' it is likely that winning a suit would be even harder.

However, note that as relevant as this argument is when applied to the definition of the fiduciary duties of the CEO, it is less so when applied to board representation. Having representatives of creditors, employees or related firms on the board does not *per se* increase the manager's discretion. The manager is still monitored by the board and will still have to deal with the majority of directors that control the board, just as in any democracy the power of the executive branch of government is held in check by the majority in control of the legislature, no matter how diverse the representation of the legislature is. Unfortunately, a systematic analysis of these issues remains to be done, as there are no formal models of the functioning of boards with representation of multiple constituencies. Nor are there comparative empirical studies analyzing the differences in managerial accountability and discretion in Germany and other countries.

Finally, as the introduction of mandatory employee representation has both efficiency and distributive effects there must be a sufficiently strong political constituency supporting such rules. Although the link between politics and corporate governance regulation is clearly relevant there has been virtually no formal modelling of this link. A recent exception is Pagano and Volpin (2005a) who derive the degree of investor protection endogenously from a political equilibrium between 'rentier', management and employees.[72] They show that depending on the relative political power of these constituencies, different laws on shareholder protection will be enacted. Thus, if the employee constituency is large and powerful as, say in Italy, then laws will be less protective of shareholder interests.[73]

6. Comparative perspectives and debates

Sections 4 and 5 illustrate the core issues of corporate governance: how to decide who should participate in corporate governance, how to solve the collective action problem of supervising management, how to regulate takeovers and the actions of large investors, how boards should be structured, how managers' fiduciary duties should be defined, what are appropriate legal actions against managerial abuses, all these issues have no unique simple answer. Corporations have multiple constituencies and there are multiple and interlocking tradeoffs. Different solutions may be needed depending on the type of activity to be financed. Human capital-intensive projects may require different governance arrangements than capital-intensive projects;[74] projects with

[72] A second paper by Pagano and Volpin (2005b) shifts the focus to the internal politics of the firm, arguing that there is a natural alliance between management and employees in staving off hostile bids.

[73] As we discuss below, there has been substantially more systematic historical analysis of the link between politics and corporate governance, most notably by Roe (1994), who argues that weak minority shareholder protection is the expected outcome in social democracies.

[74] See, for example, Allen and Gale (2000), Maher and Andersson (2000), Rajan and Zingales (2000) and Roberts and Van den Steen (2000) for discussions of how corporate governance may vary with underlying business characteristics.

long implementation periods may require different solutions than projects with short horizons.[75] It is not possible to conclude on the basis of economic analysis alone that there is a unique set of optimal rules that are universally applicable to all corporations and economies, just as there is no single political constitution that is universally best for all nations.

The practical reality of corporate governance is one of great diversity across countries and corporations. An alternative line of research that complements the formal analyses described in the previous section exploits the great diversity of corporate governance rules across countries and firms, attempting to uncover statistical relations between corporate governance practice and performance or to gain insights from a comparative institutional analysis. A whole sub-field of research has developed comparing the strengths and weaknesses of corporate governance rules in different countries. In this section we review the main comparative perspectives on governance systems proposed in the literature.[76]

6.1. Comparative systems

Broadly speaking and at the risk of oversimplifying, two systems of corporate governance have been pitted against each other: the Anglo-American market-based system and the long-term large investor models of, say, Germany and Japan. Which of these systems has been most favored by commentators has varied over time as a function of the relative success of each country's underlying economy, with two broad phases: the 1980s – when the Japanese and German long-term investor corporate governance perspective were seen as strengths relative to the Anglo-American marketbased short-termist perspective – and the 1990s – when greater minority shareholder protections and the greater reliance on equity financing in the Anglo-American systems were seen as major advantages. [77]

Japanese and German corporate governance looked good in the 1980s when Japan and Germany were growing faster than the USA. In contrast, in the late 1990s, following nearly a decade of economic recession in Japan, a decade of costly postunification economic adjustments in Germany, and an unprecedented economic and stock market boom in the USA, the American corporate governance model has been hailed as the model for all to follow [see Hansmann and Kraakman (2001)]. As we are writing sentiment is turning again in light of the stock market

[75] See Maher and Andersson (2000) and Carlin and Mayer (2003) for a discussion of corporate governance responses in firms with different investment horizons.

[76] For recent surveys of the comparative corporate governance literature see Roe (1996), Bratton and McCahery (1999) and Allen and Gale (2000); see also the collections edited by Hopt et al. (1998), McCahery et al. (2002) and Hopt and Wymeersch (2003).

[77] The comparative classifications proposed in the literature broadly fit this (over)simplification. Commentators have distinguished between "bank oriented" and "market oriented" systems [e.g., Berglöf (1990)] and "insider" versus "outsider" systems [e.g., Franks and Mayer (1995)]. These distinctions are based on a range of characteristics of governance and financial systems, such as the importance of longterm bank lending relations, share ownership concentration, stock market capitalization and regulatory restrictions on shareholder power. More recently, commentators such as La Porta et al. (1998) attempt no such distinction and introduce a single ranking of countries' corporate governance systems according to the extent of minority shareholder protections as measured by an "anti-director rights index" based on six elements of corporate law. As we shall see, all attempts at objectively classifying country corporate governance systems have been criticized for overemphasizing, leaving out or misunderstanding elements of each country's system. Thus, for example, the declining importance of the market for corporate control in the USA has generally been overlooked, as well as the lower anti-director rights in Delaware [see Kraakman et al. (2004)]. Similarly, bank influence in Germany has often been exaggerated [see Edwards and Fischer (1994), Hellwig (2000b)], or the importance of stock markets in Japan [La Porta et al. (2000b)].

excesses on Nasdaq and the *Neuer Markt,* which have resulted in massive overinvestment in the technology sector, leading to some of the largest bankruptcies in corporate history, often accompanied by corporate governance scandals. [78]

Critics of USA governance in the 1980s have argued that Germany and Japan had a lower cost of capital because corporations maintained close relationships with banks and other long-term debt and equity holders. As a result Japan had a low cost of equity, [79] Germany a low cost of bank debt and both could avoid the equity premium by sustaining high levels of leverage [see e.g., Fukao (1995)]. Despite a convergence of the real cost of debt and equity during the 1980s [McCauley and Zimmer (1994)], they have enjoyed a lower cost of capital than the USA and the UK. As a result, Japanese corporations had higher investment rates than their USA counterparts [Prowse (1990)]. Interestingly, a revisionist perspective gained prominence in the early 1990s according to which the low cost of capital in Japan was a sign of excesses leading to overinvestment [Kang and Stulz (2000)].

Following the stock market crash of 1990, Japan lost its relatively low cost of equity capital, while the USA gradually gained a lower cost of equity capital as the unprecedented bull market gained steam. This lower cost of equity capital in the USA has been seen by many commentators as resulting from superior minority shareholder protections [see e.g., La Porta et al. (1998)], and was often the stated reason why foreign firms increasingly chose to issue shares on Nasdaq and other USA exchanges and why the *Neuer Markt* was booming [see Coffee (2002), La Porta et al. (2000b)]. Similarly the Asian crisis has been attributed to poor investor protections (see Johnson (2000) and Claessens, Djankov, Fan and Lang (2002); and Shinn and Gourevitch (2002) for the implications for USA policy to promote better governance worldwide). Exchanges that adopted NASDAQ-style IPO strategies and investor protections, like the *Neuer Market* in Germany, have witnessed a similar boom (and bust) cycle. With the benefit of hindsight, however, it appears that the low cost of equity capital on these exchanges during the late 1990s had more to do with the technology bubble than with minority shareholder protection, just as the low cost of capital in Japan in the late 1980s had more to do with the real estate bubble than with Japanese corporate governance.

Another aspect of Japanese corporate governance that has been praised in the 1980s is the long-run nature of relationships between the multiple constituencies in the corporation, which made greater involvement by employees and suppliers possible. It has been argued that this greater participation by employees and suppliers has facilitated the introduction of 'just in time' or 'lean production' methods in Japanese manufacturing firms [see Womack et al. (1991)]. The benefits of these long-term relations have been contrasted with the costs of potential 'breaches of trust' following hostile takeovers in the USA [Shleifer and Summers (1988)]. [80]

One of the main criticisms of Anglo-American market-based corporate governance has been that managers tend to be obsessed with quarterly performance measures and have an excessively short-termist perspective. Thus, Narayanan (1985), Shleifer and Vishny (1989), Porter (1992a,b) and Stein (1988, 1989), among others, have argued that USA managers are myopically 'short-

[78] Enron is the landmark case, but there have been many smaller cases on Neuer Markt that have these characteristics.
[79] The cost of equity was significantly lower in Japan in the 1980s. This advantage has of course disappeared following the stock market crash.
[80] As 'lean production' methods have successfully been implemented in the USA, however, it has become clear that these methods do not depend fundamentally on the implementation of Japanese-style corporate governance [Sabel (1996)].

termist' and pay too much attention to potential takeover threats. Porter, in particular, contrasts USA corporate governance with the governance in German and Japanese corporations, where the long-term involvement of investors, especially banks, allowed managers to invest for the long run while, at the same time, monitoring their performance. Japanese *keiretsu* have also been praised for their superior ability to resolve financial distress or achieve corporate diversification [see e.g., Aoki (1990), Hoshi, Kashyap and Scharfstein (1990)]. This view has also been backed by critics in the USA, who have argued that populist political pressures at the beginning of the last century have led to the introduction of financial regulations which excessively limit effective monitoring by USA financial institutions and other large investors, leading these authors to call for larger and more active owners [see Roe (1990, 1991, 1994), Black (1990)]. [81]

In the 1990s the positive sides of Anglo-American corporate governance have gradually gained greater prominence. Hostile takeovers were no longer criticized for bringing about short-termist behavior. They were instead hailed as an effective way to break up inefficient conglomerates [Shleifer and Vishny (1997b)].[82] Most commentators praising the Anglo-American model of corporate governance single out hostile takeovers as a key feature of this model. Yet, starting in the early 1990s the market for corporate control in the USA has essentially collapsed.[83] Indeed, following the wave of anti-takeover laws and charter amendments introduced at the end of the 1980s, most USA corporations are now extremely well protected against hostile takeovers. [84] Their control is generally no longer contestable.[85] In contrast, in the UK the City Code prevents post-bid action that might frustrate the bid and few companies have put in place pre-bid defenses, thus making the UK the only OECD country with an active and open market for corporate control. [86]

[81] Interestingly, even the former chairman of the Securities and Exchange Commission argued against 'over-regulation' and 'short-termism' [Grundfest (1993)] and for "investors' ability to monitor corporate performance and to control assets that they ultimately own", an ability that the USA regulatory systems has "subordinated to the interests of other constituencies, most notable corporate management" [Grundfest (1990, pp. 89–90)]. The call for more active (and larger) owners is also typical of USA shareholder activists [see Monks and Minow (2001)].

[82] See Chapter 2 in this Handbook for a survey of the conglomerate literature.

[83] See Comment and Schwert (1995) for the early 1990s and Bebchuk, Coates and Subramanian (2002) for 1996–2000.

[84] See Danielson and Karpoff (1998) for a detailed analysis of takeover defences in the USA. Grundfest (1993) observed: "The takeover wars are over. Management won [. . .] As a result, corporate America is now governed by directors who are largely impervious to capital market electoral challenges".

[85] The introduction of the anti-takeover laws has also shifted perceptions on state corporate law competition. This competition is not depicted as a "race to the bottom" anymore as in Cary (1974) or Bebchuk (1992). Instead Romano (1993) has argued in her influential book, The Genius of American Law, that competition between states in the production of corporate law leads to better laws. She goes as far as recommending the extension of such competition to securities regulation [Romano (1998)]. On the other hand, Bebchuk and Ferrell (1999, 2001) have argued that it is hard to justify the race to pass anti-takeover laws as a race to the top. Supporting their view, Kamar (1998) has pointed out that network effects can create regulatory monopolies and that limited state competition may therefore be consistent with the existence of inferior standards that are hard to remove. He goes on to argue that the break up of the monopoly of the SEC over securities regulation could lead to convergence to the standards of the dominant producer of corporate law, Delaware.

[86] In the UK institutional investors have larger holdings and regulation allows them to jointly force companies to dismantle their pre-bid defenses. For example, in the mid-1970s Lloyds Bank wanted to cap votes at 500 votes per shareholder, which would have left the largest twenty shareholders commanding 16% of the voting rights with 0.01% each. Institutional investors threatened to boycott Lloyd's issues and the plan was dropped [Black and Coffee (1994)]. In 2001 institutional investors "encouraged" British Telecom to rescind a 15% ownership and voting power ceiling, a powerful pre-bid defence dating back to BT's privatization.

An influential recent classification of corporate governance systems has been provided by La Porta et al. (1997, 1998). The authors show that indices designed to capture the degree of investor protection in different countries correlate very strongly with a classification of legal systems based on the notion of "legal origin" [inspired by David and Brierley (1985)]. [87] In a series of papers the authors go on to show that legal origin correlates with the size of stock markets,[88] ownership concentration, the level of dividend payments,[89] corporate valuation and other measures of the financial system across a large cross-section of countries [La Porta et al. (1997, 1999, 2000a, 2002)].[90] Other authors have applied the legal origin view to issues like cross-border mergers and the home bias. [91] Stulz and Williamson (2003) add language and religion (culture) as possible explanatory variables.

In the same vein the regulatory constraints in the USA that hamper intervention by large shareholders, previously criticized for giving too much discretion to management [e.g., by Roe (1990, 1991, 1994), Black (1990), Grundfest (1990)], have been painted in a positive light as providing valuable protections to minority shareholders against expropriation or self-dealing by large shareholders, reversing the causality of the argument [see La Porta et al. (2000b), Bebchuk (1999, 2000)]. [92] In a recent reply, Roe (2002) argues that this argument is misconceived because it is based on a misunderstanding of corporate law. Law imposes very few limits on managerial discretion and agency costs, particularly in the United States, suggesting that the correlation between classifications of corporate law and ownership concentration is spurious or captures the influence of missing variables, for example the degree of product market competition. More damagingly, recent historical evidence shows that investor protection in the United Kingdom was not very strong before World War II [Cheffins (2002)], but ownership has already dispersed very quickly [Franks, Mayer and Rossi (2005)].

Recently, some commentators have gone as far as predicting a world-wide convergence of corporate governance practice to the USA model [see e.g., Hansmann and Kraakman (2001)]. [93]

[87] The La Porta et al. (1997, 1998) indices do not cover securities regulation and have been widely criticized, both conceptually and because the numbers are wrong for certain countries. Of course the direct correlation between "legal origin" and other variables is not affected by such criticism. Pistor (2000) broadens and improves the basic index design for a cross-section of transition countries. She shows that improvements in the index levels were larger in countries that implemented voucher privatizations (opted for ownership dispersion), concluding that corporate finance drives changes in the index levels, not legal origin.

[88] Rajan and Zingales (2003) show that the correlation of legal origin and the size of stock markets did not hold at the beginning of the century.

[89] On corporate governance and payout policies see Chapter 7 in this Handbook.

[90] La Porta et al. (2000b) provide a summary of this view.

[91] The "legal origin" view's prediction that bidders from common law countries increase the value of civil law targets, because the post-bid entity has (value-enhancing) common law level investor protection is supported by recent studies of cross-border mergers [Bris and Cabolis (2002), Rossi and Volpin (2004)]. At the same time, recent acquisitions by U.S. (common law) firms were generally poor, producing very large losses in bidder value [Moeller, Schlingemann and Stulz (2004, 2005)]. Dahlquist, Pinkowitz, Stulz and Williamson (2003) relate investor protection to the size of free float in different countries and the "home bias".

[92] This reversal of causality is particularly important in the context of emerging markets because it provides and alternative "ex-post" rationalisation of the voucher privatization experiment in the Czech Republic.

[93] Hansmann and Kraakman (2001) call the U.S. model the "standard shareholder-oriented model". In the shareholder model "ultimate control over the corporation should be in the hands of the shareholder class; [. . .] managers [. . .] should be charged with the obligation to manage the corporation in the interests of its shareholders; [. . .] other corporate constituencies, such as creditors, employees, suppliers, and customers should have their interests protected by contractual and regulatory means rather than through participation in corporate governance; [. . .] non-controlling shareholders should receive strong protection from exploitation at the hands of controlling shareholders; [. . .] the principal measure of the interests of the public corporation's

In a variant of this view, world-wide competition to attract corporate headquarters and investment is seen like the corporate law competition between USA states portrayed by Romano (1993). Such competition is predicted to eventually bring about a single standard resembling the current law in Delaware or, at least, securities regulation standards as set by the USA SEC [see Coffee (1999)]. [94]

Although few advocates of the Anglo-American model look back at the 1980s and the perceived strengths of the Japanese and German models at the time, there have been some attempts to reconcile these contradictions. Thus, some commentators have argued that poison pill amendments and other anti-takeover devices are actually an improvement because they eliminate partial bids "of a coercive character" [Hansmann and Kraakman (2001)]. Others have also argued that the market for corporate control in the USA is more active than elsewhere, suggesting that U.S. anti-takeover rules are less effective than anti-takeover measures elsewhere [La Porta et al. (1999)]. Finally, Holmstrom and Kaplan (2001) have argued that the hostile takeovers and leveraged buyouts of the 1980s are no longer needed as USA governance "has reinvented itself, and the rest of the world seems to be following the same path". [95]

As we write, dissatisfaction with U.S. corporate governance is on the rise again. There is little doubt that the Enron collapse, the largest corporate bankruptcy in USA history to date, was caused by corporate governance problems. Yet Enron had all the characteristics of an exemplary "Anglo-American" corporation. As stock prices are falling executive remuneration (compensation) at U.S. corporations looks increasingly out of line with corporate reality. At the same time the global corporate governance reform movement is pressing ahead, but not necessarily by imitating the U.S. model. [96] The most visible manifestations are corporate governance codes that have been adopted in most markets, except the USA.[97]

6.2. Views expressed in corporate governance principles and codes

Following the publication of the Cadbury Report and Recommendations (1992) in the UK, there has been a proliferation of proposals by various committees and interest groups on corporate governance principles and codes.[98] These policy documents have been issued by institutional

shareholders is the market value of their shares in their firm". They contrast this "standard model" with the "manager-oriented model", the "labour-oriented model", the "state-oriented model" and the "stakeholder model".

[94] In Europe, The Netherlands now seems to be taking on Delaware's role. Andenas, Hopt and Wymeersch (2003) survey the legal mobility of companies within the European Union.

[95] Holmstrom and Kaplan (2001) emphasize that the lucrative stock option plans of the 1990s have replaced the disciplinary role of hostile takeovers and debt (see Section 7.5). They also stress the role of activist boards and investors (op. cit., p. 140).

[96] Indeed, on takeover regulation many countries are explicitly rejecting the USA model adopting mandatory bid rules and not the Delaware rules. At the same time pension funds are lobbying corporations to take into account the interests of multiple constituencies, under the banner of "corporate social responsibility".

[97] There are indications that, as a result of the Enron collapse, the USA too will join in this global development originating from other shores.

[98] The Cadbury Report and Recommendations (1992) is the benchmark for corporate governance codes. Cadbury also set the agenda on issues and provided an example of "soft regulation" the business community in other countries was quick to endorse and emulate, for example the "comply or explain" principle of enforcement via moral suasion and implicit contracts. However, Cadbury did not invent the governance wheel. The subject was already receiving attention in Commonwealth countries like Hong Kong (1989) and Australia (1991). Internationally, the OECD (1999) "Principles of Corporate Governance" have been the main catalyst for the development of further codes and a driver of law reform (see www.oecd.org). The OECD Principles were a direct response to the Asia/Russia/Brazil crisis (see Section 3.5).

investors and their advisors, companies, stock exchanges, securities markets regulators, international organizations and lawmakers.[99] We briefly take stock of these views here and contrast them with the general economic principles discussed in the models section (Section 5) as well as the available empirical evidence (Section 7). [100]

Codes provide recommendations on a variety of issues such as executive compensation, the role of auditors, the role of non-shareholder constituencies and their relation with the company, disclosure, shareholder voting and capital structure, the role of large shareholders and anti-takeover devices. But a quick reading of these codes quickly reveals their dominant focus on boards and board-related issues. [101] Topics covered by codes include: board membership criteria, separation of the role of chairman of the board and CEO, board size, the frequency of board meetings, the proportion of inside versus outside (and independent) directors, the appointment of former executives as directors, age and other term limits, evaluation of board performance, the existence, number and structure of board committees, meeting length and agenda, and assignment and rotation of members. [102] Interestingly, many of the most prominent concerns articulated in codes are not echoed or supported in current in 2002. The European Association of Securities Dealers was first to issue European Principles and Recommendations (2000), followed by Euroshareholders (2000). From the investor side, there have been statements from France (AFG-ASFFI 1998), Ireland (IAIM 1992), Germany (DSW 1998), the UK (PIRC 1993, 1996, 1999; Hermes 1999). In Asia, guidelines have been written for Japan (1998) and Korea (1999), in addition to the Commonwealth countries already mentioned. In Latin America, Brazil (1999), Mexico (1999) and Peru (2002) have their own guidelines. Undoubtedly, other countries are sure to follow. In the USA, there is no "Code" as such but corporations have been issuing corporate governance statements [e.g. General Motors' guidelines (1994), the National Association of Corporate Directors (NACD 1996) and the Business Roundtable (BRT 1997)]. Pension funds also issue their own corporate governance principles, policies, positions and voting guidelines (TIAA-CREF 1997; AFL-CIO 1997; CalPERS 1998; CII 1998, revised 1999). The American Bar Association published a "Directors Guidebook" (1994). The American Law Institute (1994) adopted and promulgated its "Principles of Corporate Governance" in 1992. Although not binding in nature, these principles are widely cited in USA case law. empirical

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In the UK, Cadbury was followed by the Greenbury Committee (1995), the Hampel Committee (1998) and the "Combined Code". Other Commonwealth countries followed suit: Canada [Dey Committee (1994)], South Africa [King Committee (1994)], Thailand [Stock Exchange of Thailand (SET) (1998)], India [Confederation of Indian Industry (1998)], Singapore [Stock Exchange of Singapore (1998)], Malaysia [High Level Finance Committee on Corporate Governance (1999)] and the Commonwealth Association (1999). In Continental Europe, corporate governance principles, recommendations and "codes of best practice" are also numerous. France has seen two Viénot Reports (1995, updated in 1999), the Netherlands the Peters Report (1997), Spain the Olivencia Report (1998) and Belgium the Cardon Report (1998). Greece, Italy and Portugal followed in 1999, Finland and Germany in 2000, Denmark in 2001, and Austria

[99] The codes have triggered an avalanche of corporate governance statements from companies often leading to the creation of new jobs, job titles ("Head of Corporate Governance"), competence centres and task-forces within companies. From the investors' side, countries and companies are starting to be ranked and rated according to corporate governance benchmarks. The proposals tabled at shareholder meetings are scrutinised and compared "best practice".

[100] Not all policy documents mentioned here are included in the list of references. An extensive list, full text copies and international comparisons [in particular Gregory (2000, 2001a,b, 2002)] can be found on the codes pages of the European Corporate Governance Institute (www.ecgi.org).

[101] Gregory (2001a) compares 33 codes from 13 member states of the European Union and two pan-European codes to the OECD Principles. All the international and 28 national codes provide a board job-description and all the codes cover at least one board-related issue. In contrast, only about 15 national codes cover anti-takeover devices. A similar picture emerges from comparisons of codes from outside the EU [Gregory (2000, 2001b)].

[102] Again, see Gregory (2000, 2001a,b) for an extensive listing and comparisons.

research, as we will discuss in Section 7. The striking schism between firmly held beliefs of business people and academic research calls for an explanation. For instance, why do independent directors feature so prominently in codes but appear to add so little in event studies and regressions? Equally, why do institutional investors attach so much importance to the separation of the roles of chairman of the board and CEO, while the empirical evidence suggests that this separation hardly matters?

6.3. Other views

Some commentators of comparative corporate governance systems attempt to go beyond a simple comparison of one system to another. Thus, although Black (1990, 1998) criticizes USA corporate governance rules for excessively raising the costs of large shareholder intervention, he is also critical of other countries' corporate governance standards. He argues that all countries fall short of what he would like USA governance to look like [Black (2000a)].[103] Taking a radically different and far more optimistic perspective Easterbrook (1997) has argued that no global standards of corporate governance are needed because "international differences in corporate governance are attributable more to differences in markets than to differences in law" [see also Easterbrook and Fischel (1991)]. Since markets are unlikely to converge, neither will the law. Although some fine-tuning might be required locally, market forces will automatically create the regulatory underpinnings national systems need.

7. Empirical evidence and practice

The empirical literature on corporate governance is so extensive that it is a daunting task to provide a comprehensive survey in a single article. Fortunately, a number of surveys of specific issues have appeared recently.[104] We shall to a large extent rely on these surveys and only cover the salient points in this section. In the introduction we have defined five different approaches to resolving collective action problems among dispersed shareholders: (i) hostile takeovers; (ii) large investors; (iii) boards of directors; (iv) CEO incentive schemes; and (v) fiduciary duties and shareholder suits. Each of these approaches has been examined extensively and recent surveys have appeared on takeovers [Burkart (1999)],[105] the role of boards [Romano (1996), Hermalin and Weisbach (2003)], shareholder activism [Black (1998), Gillan and Starks (1998), Karpoff (1998), Romano (2001)], CEO compensation [Core, Guay and Larcker (2003), Bebchuk, Fried and Walker (2002), Gugler (2001), Perry and Zenner (2000), Loewenstein (2000), Abowd and Kaplan (1999), Murphy (1999)] and large shareholders [Short (1994), Gugler (2001), [106] Holderness (2003)]. Not even these surveys cover everything. In particular, research on the role of large investors is not fully surveyed – partly because research in this area has been rapidly evolving in recent years. The literature on fiduciary duties and shareholder suits is very limited.

7.1. Takeovers

Hostile takeovers are a powerful governance mechanism because they offer the possibility of bypassing the management to take permanent control of the company, by concentrating voting

[103] See Avilov et al. (1999), Black et al. (1996) and Black (2000b) in the context of emerging markets.
[104] An earlier general survey taking an agency perspective is Shleifer and Vishny (1997a).
[105] Andrade, Mitchell and Stafford (2001) survey the stylised facts on takeovers and mergers in the USA, 1973–1998.
[106] Gugler (2001) surveys the English-language literature and draws on national experts to survey the local language literatures in Austria, Belgium, Germany, France, Italy, Japan, The Netherlands, Spain and Turkey.

and cash-flow rights. [107] Corporate governance codes endorse hostile takeovers and the voting guidelines issued by investor groups come out very strongly against anti-takeover devices and for the mandatory disclosure of price sensitive information and toeholds. [108] Paradoxically disclosure and insider trading laws may actually make hostile takeovers harder, as Grossman and Hart (1983) have noted. Indeed, the market for corporate control should work better in regulatory environments with low shareholder protection and lax disclosure standards, so bidder incentives are not eroded by the free-riding problem. On the other hand, low shareholder protection can also give rise to excessive takeover activity by empire builders. Anti-takeover protections reduce the threat of hostile takeovers but both theory and empirical evidence suggest that they also strengthen the bargaining position of the target for the benefit of target shareholders. Finally, it is important to keep in mind that hostile takeovers are difficult to finance even in the most liquid capital markets. Despite their alleged importance, hostile takeovers are isolated instances and their study has been largely confined to the USA and the UK.

7.1.1. Incidence of hostile takeovers

Takeovers are well publicized, but in sheer numbers they are relatively rare events. Even at the peak of the USA takeover wave in the 1980s, takeover rates (the number of bids as a percentage of the number of listed companies) rarely exceeded 1.5% and declined steeply afterwards [Comment and Schwert (1995)]. [109] Hostile takeovers, the events that are of interest here, are even more elusive. Under standard definitions, even at their pre-1990 peak hostile bids never represented more than 30% of all USA deals [Schwert (2000)].[110] Between 1990 and 1998 only 4% of all USA deals were hostile at some stage and hostile bidders acquired 2.6% of the targets [Andrade, Mitchell and Stafford (2001)]. [111] The paucity of hostile deals is also evident outside the USA; however, there is an unusually high amount of hostile activity in Europe in 1999 (Table 2).

If hostile takeovers are a disciplining device for management they should predominantly affect poorly performing firms. This prediction is not borne out by the available empirical evidence. Successful USA takeover targets are smaller than other companies, but otherwise they do not differ significantly from their peers [Comment and Schwert (1995)].[112] The targets of hostile bids

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[107] In the USA control changes often require board approval. In countries like the UK the bidder bypasses the management and the board; the change of control decision is the sovereign right of the target shareholders.

[108] For example, the OECD (1999) Principle I.E states that the "markets for corporate control should be allowed to function in an efficient and transparent manner". The Euro-Shareholder Guidelines (2000) state that "anti-takeover defences or other measures which restrict the influence of shareholders should be avoided" (Recommendation 3) and that "companies should immediately disclose information which can influence the share price, as well as information about those shareholders who pass (upwards or downwards) 5% thresholds" (Recommendation 5).

[109] The causes of such cycles in takeover activity are many, and their relative importance is an open issue. The 1980s USA takeover boom has been attributed to, inter alia, the 1986 Tax Reform Act and to the 1978 Bankruptcy Act; see Kaplan (1994b) for a discussion of the latter point.

[110] Other characteristics of USA hostile deals are that they are more likely to involve cash offers and multiple bidders. Also, hostile bids are less likely to succeed than uncontested bids [Schwert (2000)].

[111] For 1973–79 8.4% of all deals were hostile at some stage, between 1980–89 14.3%; hostile acquisitions were 4.1% and 7.1%, respectively [Andrade, Mitchell and Stafford (2001)]. The full merger sample covers 4300 completed deals on the CRSP tapes, covering all USA firms on the NYSE, AMEX and Nasdaq between 1973–1998.

[112] Comment and Schwert (1995) estimate the probability of a successful takeover as a function of antitakeover devices, abnormal returns, sales growth, the ration of net-liquid assets to total assets, debt/equity ratios, market/book ratios, price/earnings ratios and total assets (size) for 1977–91. They report that the results for

are likely to be larger than other targets. [113] Indicators of poor target management contribute little or are not significant [Schwert (2000)].[114] The available evidence for the UK also fails to show that the targets of successful hostile bids had poorer pre-bid performance than other targets Franks and Mayer (1996)]. [115]

Table 2. Number of Takeovers by Region

	Australia	Canada	U.S.	EU15 Total	EU15 U.K.	EU15 ex-U.K.	Other
	Number of Announced Uncontested Takeovers[116]						
1989	81	184	1,188	550	316	234	114
1990	69	193	834	597	290	307	188
1991	107	269	790	817	252	565	363
1992	46	194	746	824	181	643	296
1993	100	215	789	803	196	607	456
1994	124	224	1,015	816	221	595	614
1995	162	296	1,106	806	219	587	753
1996	142	277	1,115	676	195	481	745
1997	107	258	1,150	574	201	373	726
1998	103	231	1,203	653	234	419	893
1999	100	289	1,236	801	271	530	1,180
	Number Announced Contested Takeovers[117]						
1989	3	6	45	36	32	4	10
1990	2		12	24	22	2	5
1991	8	1	7	34	31	3	2
1992	10	2	7	20	15	5	4
1993	10	1	11	15	11	4	5
1994	8	11	33	11	8	3	4
1995	18	19	59	22	14	8	7
1996	22	8	45	20	13	7	11
1997	12	17	27	23	11	12	5
1998	12	14	19	14	12	2	5
1999	15	6	19	42	21	21	6

Source: Thomson Financial Services Data (TFSD) and own calculations

hostile takeovers do not differ significantly (p. 34). We discuss the anti-takeover device evidence in Section 7.1.4 below.

[113] This is consistent with the view that bids in the USA are classified as hostile when the target boards have a lot of bargaining power. The boards of larger companies are more likely to reject a bid, at least initially, to obtain a higher premium.

[114] Schwert (2000) covers the period 1975–1996 and considers four definitions of "hostile bid". He concludes that "the variables [. . .] that might reflect poor management, market to book ratios and return on assets, contribute little. The variables [. . .] that probably reflect the bargaining power of the target firm, such as firm size and the secular dummy variables, contribute most explanatory power" (p. 2624).

[115] Franks and Mayer (1996) cover the period 1980 to 1986 and consider the pre-bid evolution of share prices (abnormal returns), dividend payouts, c ash-flows and Tobin's Q. They find a 14 point difference in abnormal returns between successful hostile bids and accepted bids that is not statistically significant, a significant difference in Tobin's Q but no difference in dividend payouts or cash-flows. On Tobin's Q they observe that all values are larger than one, suggesting poor relative rather than absolute performance. Finally, companies with control changes have higher pre-bid stock returns that companies without control changes, the opposite of what the poor management hypothesis predicts.

[116] Under the TFSD definition a tender offer that was recommended by board of the target company to its shareholders.

[117] Under the TFSD definition a tender offer that was initially rejected by the board of the target company.

Hostile takeover activity in the USA sharply declined after 1989. Most observers agree that managers effectively lobbied for protection from the market for corporate control. The tightening of insider trading laws in the second half of the 1980s, a series of landmark cases in Delaware in 1985 and a new wave of anti-takeover laws made it virtually impossible to take over USA corporations without target board consent (see Section 7.1.4 below). As a result, few hostile takeover attempts were made and less than 25% of the bidders succeeded in taking control of the target [Bebchuk, Coates and Subramanian (2002)]. Another explanation attributes the decline in takeover activity to the demise of the junk bond market, the business cycle and the credit crunch associated with the Savings and Loans crisis [Comment and Schwert (1995)]. Takeover activity has recently emerged in continental Europe in a number of spectacular cases where there were none before. Although there is no conclusive evidence in support it is possible that this change has brought about more managerial discipline. It is also a sign of the waning protection of national champions by European governments.

7.1.2. Correction of inefficiencies

If hostile takeovers correct managerial failure and enhance efficiency the value of the bidder and the target under joint control (VAB) should be larger than the value of the bidder (VA) and the target (VB) separately, or D$V \equiv [V\text{AB} - V\text{A} - V\text{B}] > 0$. Generally, the change in value (DV) is taken to be the difference between the standalone pre-bid and the combined post-bid values in event studies. Other measures are based on changes in accounting data, such as cash flows or plant level productivity. Event studies find sizeable average premia (~24%) going to target shareholders in all USA acquisitions [Andrade et al. (2001)] and higher premia for hostile takeovers [Schwert (2000), Franks and Mayer (1996)]. [118] In all USA acquisitions the gain for bidder shareholders[119] and the overall gain are indistinguishable from zero [Andrade et al. (2001)].[120] Although suggestive, the event study evidence cannot conclusively determine whether these premia arose from the correction of an inefficiency or from synergies between bidders and targets,[121] or whether they simply constitute transfers away from bidding shareholders or other constituencies [see Burkart (1999) for an extensive discussion of this issue]. [122]

7.1.3. Redistribution

How can one disentangle redistributive gains from overall efficiency improvements? A number of studies have identified and sometimes quantified the amount of redistribution away from other corporate constituencies resulting from a takeover. The constituencies in the target firm

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[118] Schwert (2000) reports that the total premia under the Wall Street Journal and TFSD definitions of "hostile deal" are 11.5% and 6.7% higher than for all deals, in line with the previous findings of Franks and Harris (1989) who report total premia of 42% for hostile and 28% for uncontested and unrevised bids in the USA. Franks and Mayer (1996) report premia of 30% for successful hostile and 18% for accepted bids in the UK.

[119] Most USA bidders are not individuals, or tightly controlled bidding vehicles, but widely held companies under management control [Shleifer and Vishny (1988)].

[120] The result holds for all subperiods 1973–98 for cumulative abnormal returns from twenty days before the bid to the close. During the announcement period the overall gains are slightly positive (1.8%), especially for large targets (3.0%) and no-stock transactions (3.6%).

[121] See Bradley (1980), and for evidence that this was the case in the 1980s, Bradley, Desai and Kim (1983, 1988).

[122] Positive takeover premia could also result from the correction of market inefficiencies caused by short-term myopia or undervalued targets. The most influential surveys of the evidence of the 1980s rejected these explanations on the grounds that there is evidence that stock markets are efficient and that the stock price of targets that defeat a hostile bid often returns to close to the pre-bid level [Jensen and Ruback (1983), Jarrell, Brickley and Netter (1988)].

that may be on the losing side include bondholders [Higgins and Schall (1975), Kim and McConnell (1977), Asquith and Kim (1982), Warga and Welch (1993)], employees [Shleifer and Summers (1988), Williamson (1988), Schnitzer (1995)] and corporate pension plans [Pontiff, Shleifer and Weisbach (1990), Petersen (1992)]. But there may also be outside losers like the bidding shareholders and unprotected debtholders as well as the tax authorities.

An alternative strategy attempts to pinpoint the sources of efficiency gains through clinical studies, but no general pattern has emerged from a wealth of facts [Kaplan (2000)]. The source of gain for target shareholders, when overall gains are small or non-existent, has not been identified yet with precision.

7.1.4. Takeover defenses[123]

As we have seen there are theoretical arguments for and against takeover defenses. They reduce the disciplining role of hostile takeovers by reducing the average number of bids but they can also help the board extract higher premia from bidders. A large empirical literature has tried to estimate the (relative) size of these effects in the USA. Before turning to this evidence, we review the availability, mechanics and incidence of different defence mechanisms.

Numerous pre-bid and post-bid defenses are at the disposal of target companies in most jurisdictions. Pre-bid defenses include capital structure, classified boards, supermajority requirements, cross-shareholdings, enhanced voting rights, voting right restrictions, subjection of share transfers to board approval and change of control clauses in major contracts.[124] The most potent pre-bid defenses require shareholder approval. However, some important defenses which can be introduced without shareholder approval include control clauses and cross-shareholdings in Europe, poison pills in the USA[125] and, until recently, block acquisitions larger than 10% in Korea [Black et al. (2000), Chung and Kim (1999)]. The incidence of anti-takeover provisions is well documented in the USA [Danielson and Karpoff (1998), Rosenbaum (2000)] but less systematically in Europe and Asia.[126] In the USA, firms protected by poison pills have relatively high institutional ownership, fewer blockholders and low managerial ownership, consistent with the view that institutional ownership presents a threat in a hostile takeover situation and that blockholders can prevent the adoption of poison pills [Danielson and Karpoff (1998)].

The evidence on the consequences of takeover defence adoption is mixed. Mikkelson and Partch (1997) show that CEOs are more likely to be replaced when hostile takeover activity is high, which is consistent with disciplining and entrenchment, i.e., when CEOs are able to protect themselves better they are less likely to be replaced. The wealth effects of pre-bid defence adoption has been measured in numerous event studies that generally find small negative

[123] For a recent, critical survey of takeover defences see Coates (1999).

[124] The list of possible post-bid defenses is much longer and includes litigation, white knights, greenmail and the pac-man defence.

[125] European Counsel M&A Handbook 2000, pp. 26–43. See Weston, Siu and Johnson (2001) for a detailed explanation of USA anti-takeover measures.

[126] Danielson and Karpoff (1998) provide a detailed analysis of the adoption of anti-takeover measures in a sample that roughly corresponds to the S&P 500 during 1984–89. Some form of anti-takeover measure covers most of their sample firms and the median firm is protected by six measures. In Europe the most potent defence against a hostile takeover is a blockholder holding more than 50% of the voting rights; in continental Europe most companies with small (or no) blocks have statutory pre-bid defenses similar to USA companies, for example voting right and transfer restrictions or special shares with the sole right to nominate directors for election to the board [Becht and Mayer (2001)]; see Section 7.2.

abnormal returns. On balance, the results support the view that managerial entrenchment dominates the enhanced bargaining effect. However, contradictory evidence comes from Comment and Schwert (1995) who find that anti-takeover measures have increased bid premia, supporting the view that the enhanced bargaining effect dominates. Here the board literature provides an intriguing piece of evidence. Shareholders of target firms with independent boards (see Section 7.4) receive premia that are 23% higher than for targets with more captive boards [Cotter, Shivdasani and Zenner (1997)], even when controlling for the presence of anti-takeover devices. This suggests that independent boards are more ready to use anti-takeover devices to the advantage of target shareholders than other boards.

The latest panel data evidence suggests that anti-takeover provisions in the USA have had a negative impact on firm value [Gompers, Ishii and Metrick (2001)]. The same study finds that from 1990 to 1998 investors who would have taken long positions in companies with "strong shareholder protections" (as measured by an index they construct) and short positions in companies with "weak shareholder protections" would have earned abnormal returns of 8.5% per year. [127] As striking as these numbers are, however, the authors acknowledge that it is not possible to interpret this finding as measuring the market value of "good governance". The difficulty is that such abnormal returns can represent at best unanticipated benefits from good governance and may reflect changes in the business environment not directly related to governance.

7.1.5. One-share–one-vote

Deviations from one-share–one-vote are often associated with the issuance of dual class stock and have been the source of considerable controversy.[128] Shares with different voting rights often trade at different prices and the resulting premia (discounts) have been related to takeover models (see Section 5) and interpreted as a measure of the value of corporate control and "private benefits" [Levy (1983), Rydqvist (1992), Zingales (1995), Nicodano (1998)].

Theory predicts that dual class premia vary with the relative size of dual class issues, the inequality of voting power, the value of the assets under control, the probability of a takeover (which itself depends on the regulatory environment), and the likelihood of a small shareholder being pivotal.[129] In addition, relative prices are affected by differences in taxation, index inclusion, dividend rights and/or stock market liquidity.

[127] Using data on 24 different "corporate governance provisions" from the IRRC (the data we report in Tables 3A and 3B) the authors compare the returns on two portfolios and relate the provisions to Tobin's Q.

[128] See Seligman (1986) for a comprehensive history of the one-share–one-vote controversy in the USA. In early corporations statutory voting right restrictions were the norm.

[129] Takeover regulation can prevent block transfers, require the bidder to offer the same price to all voting stockholders or force the inclusion of non-voting stockholders. Company statutes can have a similar effect, for example fair-price amendments in the USA. Nenova (2003) attempts to control for these factors across countries using quantitative measures of the legal environment, takeover regulation, takeover defenses and the cost of holding a control block in a cross-section regression, treating the control variables as exogenous.

Table 3. Corporate Takeover Defences in the U.S.

	Fall 1999	Fall 1997	Mid-1995	Mid-1993	Mid-1990
Number of Companies	*1900*	*1922*	*1500*	*1483*	*1487*
	%	%	%	%	%
External Control Provisions					
Blank Check Preferred Stock	89.1	87.6	85.0	n/a	n/a
Poison pill	56.0	51.9	53.3	53.6	51.0
Consider Non-financial effects of merger	7.3	6.6	7.2	7.5	6.5
Internal Control Provisions					
Advance Notice Requirement	61.4	49.2	43.8	n/a	n/a
Classified Board	58.7	58.4	59.7	58.1	57.2
Limit right to call special meeting	36.7	33.6	31.1	28.6	23.9
Limit action by written consent	34.6	32.2	31.1	28.1	23.7
Fair price	24.8	26.4	32.5	33.2	31.9
Supermajority vote to approve merger	15.3	14.8	17.8	18.1	16.9
Dual class stock	11.5	10.7	8.3	8.2	7.5
Eliminate cumulative voting	8.8	8.4	10.4	10.1	8.8
Unequal voting rights	1.6	1.6	2.0	2.1	2.3
Miscellaneous Provisions					
Golden parachutes	64.9	55.8	53.3	n/a	n/a
Confidential Voting	10.2	9.2	11.7	9.4	3.2
Cumulative Voting	10.2	11.4	14.4	15.7	17.7
Antigreenmail	4.1	4.6	6.0	6.3	5.6

	Mid-1999	
State Anti-Takeover Laws		
	Number	% of states
States with Anti-Takeover Laws	42	82.4
featuring		
Control Share Acquisition Laws	27	52.9
Fair Price Laws	27	52.9
2-5 Year Freeze-Out Laws	33	64.7
Cash-Out Laws	3	5.9
Profit Recapture	2	3.9
Severance/Pay Labor Contract Provisions	5	9.8
Greenmail Restrictions	6	11.8
Compensation Restrictions	2	3.9
Poison Pill Endorsement	25	49.0
Directors' Duties	31	60.8
States with No Takeover Provisions (8 + D.C.)	9	17.6

Source : Rosenbaum (2000) and IRRC (2000a).

Note : classification taken from Danielson and Karpoff (1998)

Empirical estimates of voting premia range from 5.4 to 82% and, taken at face value, suggest that the value of corporate control is large in Italy and relatively small in Korea, Sweden and the USA.[130] In practice the studies at best imperfectly control for all the factors affecting the price differential, making it an unreliable measure of "the value of corporate control". Time-series evidence also suggests that dual class premia should be interpreted with caution. While premia have been rising from 20% in mid-1998 to 54% in December 1999 in Germany [Hoffmann-Burchardi (1999)], in Finland they have dropped from 100% in the 1980s to less than 5% today. Similarly in Sweden premia have declined from 12% in the late 1980s to less than 1% today, [131] and in Denmark from 30% to 2% [Bechmann and Raaballe (2003)]. In Norway the differential was actually negative in 1990–1993, but has risen to 6.4% in 1997 [Odegaard (2000)]. It is, of course, possible that changes in the value of control explain these changes in premia but further research is required before one can conclude with any confidence that this is the case.

7.1.6. Hostile stakes and block sales

Takeover bids for widely held companies are, of course, not the only way corporate control can be contested and sold. In blockholder systems, hostility can take the form of "hostile stakes" [Jenkinson and Ljungqvist (2001)] and control is completely or partially transferred through block sales [Holderness and Sheehan (1988) for the USA; Nicodano and Sembenelli (2000) for Italy; Böhmer (2000) for Germany; Dyck and Zingales (2003) for 412 control transactions in 39 countries]. [132] Control premia vary between −4% and 65% [Dyck and Zingales (2004)]. [133]

7.1.7. Conclusion and unresolved issues

Hostile takeovers are associated with large premia for target shareholders, but so far the empirical literature has not fully identified the source of the premia. It is difficult to disentangle the opposing entrenchment and bargaining effects associated with hostile takeover defenses. The net effect of the adoption of takeover defenses on target stock market value is slightly negative, suggesting that the entrenchment effect is somewhat larger than the bargaining effect.[134] Recent evidence from the board literature suggests that independent boards implement defences to increase the bargaining position of target shareholders while captured boards tend to implement defences that increase entrenchment [Cotter, Shivdasani and Zenner (1997)].

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[130] Canada, 8–13% [Jog and Riding (1986), Robinson, Rumsey and White (1996), Smith and Amoako-Adu (1995)]; France, mean 1986–1996 51.4% [Muus (1998)]; Germany, mean 1988–1997 26.3%, in 2000 50% [Hoffmann-Burchardi (1999)]; Israel, 45.5% [Levy (1982)]; Italy 82% [Zingales (1994)]; Korea, 10% [Chung and Kim (1999)]; Norway, −3.2–6.4% [Odegaard (2000)]; Sweden, 12% [Rydqvist (1996)]; Switzerland, 18% [Kunz and Angel (1996)]; UK, 13.3% [Megginson (1990)]; USA, 5.4% [Lease et al. (1983)], mean 1984–90 10.5%, median 3% [Zingales (1995), see also DeAngelo and DeAngelo (1985) for the USA]. Lease et al. (1984) analyse the value of control in closely held corporations with dual class shares.

[131] Personal communication from Kristian Rydqvist.

[132] Like dual-class premia, block premia can be interpreted as an indirect measure of "private benefits". However, block premia have the advantage that they are based on actual control transactions, not the marginal value of a vote in a potential transaction.

[133] In countries with a mandatory bid rule control transfers must be partial. A control block cannot be sold without making an offer to the minority shareholders. In such countries only block sales below the mandatory bid threshold are considered. This imposes serious limits on the comparability of the results across countries.

[134] This is corroborated by comparisons of announcement effects of anti-takeover amendments with a larger bargaining component relative to devices where entrenchment is likely to be prominent, e.g., Jarrell and Poulsen (1987).

Despite the widespread interest in hostile takeovers, the available empirical evidence is surprisingly sketchy. Although hostile takeovers are no longer confined to the USA and the UK, there appears to be no recent study of hostile takeovers in other countries.

7.2. Large investors

Shareholder rights can differ significantly across OECD countries and even across firms within the same country. These institutional differences make it difficult to compare the actions and effects of large shareholders across countries or firms.

Most of the time large shareholder action is channelled through the board of directors. Large shareholders are in principle able to appoint board members representing their interests. When they have majority control of the board they can hire (or fire) management. Large shareholders can also exercise power by blocking ratification of unfavorable decisions, or possibly by initiating decisions.

In practice corporate law, corporate charters and securities regulations impose limits on these powers, which vary significantly across countries. Even a basic right like corporate voting and appointments to the board varies considerably across governance systems and corporate charters. For example, some countries' corporate law prescribes discrete control thresholds that give a blocking minority veto power over major decisions. [135] In Germany employees appoint 50% of the board members in large corporations [Prigge (1998)]. In the UK the listing requirements of the London Stock Exchange require large shareholders to keep an arm's length relationship with companies, limiting the right of blockholders to appoint directors to the board.[136] Under the Dutch "structural regime" the corporate boards of larger companies must appoint themselves and their successors, with a consequent negative impact on corporate valuations [De Jong et al. (2001)]. In some Anglo-Dutch corporations special classes of shares have the sole right to nominate directors for election to the boards or to veto their removal [Becht and Mayer (2001)].

Initiation rights also vary considerably across jurisdictions. Thus, to remove a director, shareholders might have to show "cause", wait for three years, vote separately by share-class, pass a supermajority resolution or simply pass an ordinary resolution by majority vote.[137] In the USA shareholders cannot initiate fundamental transactions like mergers, and boards are broadly shielded from direct shareholder influence [Kraakman et al. (2004)]. In contrast, shareholder proposals can force mergers or charter amendments if they receive a majority in the UK, Japan or France. [138] Ratification rights, on the other hand, are strikingly similar in most jurisdictions.

[135] For example, corporate law in the Netherlands, Germany and Austria prescribes supermajorities for major decisions. Often the threshold can be increased via the statutes, but not decreased.
[136] A 30%+ blockholder cannot appoint more than 5 out of 12 directors [Wymeersch (2003)]. In the UK the distribution of blockholdings in listed companies tapers off abruptly at 30% [Goergen and Renneboog (2001)].
[137] Initiation rights differ across the USA, depending on the state and, within any one state, the company bylaws [Clark (1986, p. 105)]. Initiation rights are always strong in the UK, where directors can be removed at any time by an ordinary resolution brought by a 20%+ blockholder or coalition and a majority vote (Section 303 of the Companies Act 1985). The same is true in Belgium, where Article 518 of the company law explicitly states that the board cannot resist such a shareholder resolution. Obviously, removal rights are closely related to the anti-takeover devices we discussed previously.
[138] In some unlisted companies shareholders exert direct control of the company through voting, for example in Germany and France [Hansmann and Kraakman (2001)].

The law prescribes a list of decisions that require shareholder approval, which can be extended in the charter.

Most empirical work on large investors has focused on simple hypotheses which are not always grounded in rigorous theoretical analysis. Much of the early work on large shareholders has been concerned with the implications of the trend towards shareholder dispersion and the effects of the decline of shareholder influence. We begin this section by tracing the available evidence on ownership and control patterns across countries and through time. We then address the empirical evidence on the causes and effects of ownership dispersion. In particular, we shall address the following questions: Does the presence of large investors or "relationship investing" improve corporate performance? Do large shareholders abuse their voting power? Do alternative forms of shareholder intervention (activism) improve company performance? Is there an empirical link between share blocks and stock market liquidity?

7.2.1. Ownership dispersion and voting control

As we pointed out in Section 5, with the exception of the USA some form of concentration of ownership and/or voting control is the most common corporate governance arrangement in OECD and developing countries. [139] The full impact and scope of this observation has only emerged very recently after a long period of confusion originally caused by Berle and Means (1932) with their assertions and empirical methodology.

The hypothesis that risk diversification leads to growing shareholder dispersion was first tested in 1924 byWarshow (1924). His study records an astonishing 250% increase in the number of shareholders between 1900 and 1923.[140] The test of the consequences for voting control followed. Means (1930) proposed that the new owners of the "modern corporation" no longer appointed the majority of directors on the board and, therefore, no longer controlled it. For 44% of the largest 200 USA corporations in 1929 no large investors were found, leading to the conclusion that "control is maintained in large measure separate from ownership" [Means (1931b), Berle and Means (1932)]. [141] This hypothesis has become received wisdom for corporations in the USA [Larner (1966, 1970), [142] Herman (1981), La Porta et al. (1999)], but also for the UK [Florence (1947, 1953, 1961), Cubbin and Leech (1983), Leech and Leahy (1991), La Porta et al. (1999)], although other studies found that blockholders had never disappeared entirely in the USA [Temporary National Economic Committee (1940),[143] Eisenberg (1976),

[139] For supporting evidence see La Porta et al. (1999), Claessens et al. (2000) and Faccio and Lang (2002) and voting block statistics based on modern disclosure standards [ECGN (1997), Barca and Becht (2001)].

[140] Warshow (1924) could not determine the exact number of shareholders because they were masked by custodians (nominee accounts, banks) or, in modern parlance, "street names". There are no comparative early studies for other countries because his method relied on the existence of registered shares and in many countries corporations have always issued bearer shares. Warshow's study was updated by Means (1930) and additional evidence is reported in Berle and Means (1932). See TNEC (1940, p. 198) for a survey of these and other classic studies using the Warshow method.

[141] A corporation was classified as management controlled if it had no known shareholder holding at least 5% of voting stock. Cases falling between 5 and 20% were classified as jointly management and minority controlled and " 12 a company" was assigned to each category. Berle and Means (1932) used the same definition.

[142] Larner (1966) reduced the "management control" threshold to 10% and found that the fraction of management-controlled firms had increased from 44% to 84.5%. Eisenberg (1976) argues that Larner's study was biased towards finding "management control".

[143] The Temporary National Economic Committee (1940) (TNEC) relied on the SEC to collect this data for the 200 non-financial corporations in 1937.

Demsetz and Lehn (1985), Holderness and Sheehan (1988)] and the UK.[144] The latest research confirms that blocks are indeed rare in the USA [Edwards and Hubbard (2000), Becht (2001)], but in the UK a coalition of the largest 1–5 blockholders – usually institutional investors – can wield a substantial amount of voting power in most listed companies [Goergen and Renneboog (2001)].[145]

Means's method (see Footnote 139) for measuring shareholder concentration has been criticized and extended by numerous authors, for example by Gordon (1945),[146] Florence (1947)[147] and Eisenberg (1976). One particular source of measurement error is due to disclosure rules. [148] Depending on how disclosed holdings are treated one can obtain significantly different measures of concentration. Thus, La Porta et al. (1999) and Claessens et al. (2000) – using the Means method – find very little ownership concentration in Japan. However, adding the ten largest holders on record in Japan in 1997 gives a concentration ratio, defined as the percentage of shares held by these shareholders, of 48.5% (51.1% in 1975; Hoshi and Kashyap (2001, p. 252). Inevitably, much research has been undertaken on the USA and the UK because the information about shareholdings in these countries is relatively easy to obtain. In contrast, in countries where corporations issue bearer shares information about shareholdings is generally not available.[149] Fortunately for researchers, modern securities regulation has begun to overcome this problem, at least in Europe. [150]

From a theoretical point of view static measures of concentration are not always satisfactory. What matters is not whether ownership and/or voting power are more or less concentrated on a permanent basis but the ability of shareholders to intervene and exercise control over

[144] Florence (1961) reported that the median holding of the largest 20 holders in large UK companies fell from 35% in 1936 to 22% in 1951, a finding that was widely cited by Marris (1964) and other British managerial economists. However, Chandler (1976) argues that personal capitalism lasted longer than these numbers suggest and that British firms only adopted managerial capitalism in the 1970s. Consistent with Chandler's view is Hannah's (1974, 1976) observation that it was possible for bidders to bypass family-controlled boards only as late as the 1950s. See Cheffins (2002) for a survey.

[145] Goergen and Renneboog (2003) explore the determinants of post-IPO diffusion rates in the UK and Germany.

[146] Gordon (1945) argued that we should "speak [. . .] of the separation of ownership and active leadership. Ordinarily the problem is stated in terms of the divorce between ownership and "control". This last word is badly overused, and it needs to be precisely defined [. . .]. Our procedure [. . .] will be to study the ownership of officers and directors and then to ascertain the extent to which non-management stockholdings are sufficiently concentrated to permit through ownership the wielding of considerable power and influence (control?) over management by an individual, group or another corporation" [Gordon (1945, p. 24, footnote 20)].

[147] Florence (1947) proposed a measure of "oligarchic" minority control based on the full distribution of the largest 20 blocks and actual board representation.

[148] Statistics based on shareholder lists underestimate concentration unless the cash-flow and voting rights that are ultimately held by the same person or entity are consolidated. At the first level, it has been common practice to add the holdings using surnames, addresses and other obvious linkages; see for example Leech and Leahy (1991, p. 1421). First level blocks held through intermediate companies are consolidated by tracing control (or ownership) chains and adding those that are ultimately controlled by the same entity. Means (1930) applied a discrete variant of this method and classified a closely-held corporation controlled by a widely-held corporation as widely held.

[149] Obviously, when companies issue bearer shares there is no shareholder list.

[150] In the USA voting blocks are disclosed under Section 13 of the 1934 Act that was introduced with the Williams Act in the 1960s. The standard provides for the disclosure of ultimate voting power of individual investors or groups, irrespective of the "distance" to the company, the control device used or the amount of cash-flow rights owned. A similar standard exists in the European Union (Directive 88/627/EEC). It is also spreading to Eastern Europe via the Union's accession process.

management when required [see Manne (1965) and Bolton and von Thadden (1998b)]. If there is a well functioning market for corporate control (takeovers or proxy fights) managerial discretion is limited even when companies are widely held. On the other hand, when anti-takeover rules and amendments are in place shareholder intervention is severely limited, whether a large investor is present or not. In the Netherlands, relatively few corporations are widely held, yet the ability of shareholders to intervene is very limited. [151] Dynamic measures of concentration based on power indices can address some of these issues, [152] but they have been considered in only a few studies [Leech (1987b,c),[153] Holderness and Sheehan (1988), Nicodano and Sembenelli (2000)]. [154]

7.2.2. Ownership, voting control and corporate performance

We distinguish four generations of empirical studies that have tested the proposition that there is a link between ownership dispersion, voting control and corporate performance (value).

The first generation has tested the hypothesis that free-riding among dispersed shareholders leads to inferior company performance. Starting with Monsen et al. (1968) and Kamerschen (1968) numerous authors have regressed performance measures like profit rates and returns on assets on a Means–Larner type or Gordon type corporate control dummy. [155] In most regressions the dummy was not significant and the authors have rejected the hypothesis that greater dispersion results in lower performance [see the surveys by Short (1994) and Gugler (2001)].

The method was also applied in other countries, finding the owner-controlled firms significantly outperform manager-controlled firms in the UK [Radice (1971), Steer and Cable (1978), Cosh and Hughes (1989), Leech and Leahy (1991)], [156] profitability is higher with family control in France [Jacquemin and de Ghellinck (1980)]. [157] Demsetz and Lehn (1985) explain that ownership concentration is endogenous. Some firms require large shareholder control while others don't. They argue that without accounting for this endogeneity it is to be expected that a regression of firm performance on a control dummy in a cross-section of heterogeneous firms should produce no statistically significant relation if the observed ownership-performance combinations are efficient.

Following Stulz (1988) a second generation of studies focuses on inside ownership by managers and considers the effects of takeover threats. The hypothesis is a humpshaped relationship between concentrated ownership and market capitalization. [158] Outside ownership merely shifts the locus. Morck, Shleifer and Vishny (1988) find some evidence of such a relationship. Similarly,

[151] Under the structural regime corporate boards operate like the board of the Catholic Church and its chairman: the bishops appoint the Pope and the Pope the bishops; Means (1930) illustration of what he meant by management control.
[152] They do not take into account statutory anti-takeover devices.
[153] Leech (1987a) proposed a set of power indices that are related to the size and distribution of blocks for a given probability of winning a board election and applied it to Berle and Means original data [Leech (1987b)], the TNEC data [Leech (1987c)] and 470 UK listed companies between 1983–85 [Leech and Leahy (1991)].
[154] The exception is the "value of corporate votes" literature that uses Shapley values and other power indices to measure the value of corporate control, for example Zingales (1995).
[155] See footnotes 139 and 144 above.
[156] Holl (1975) found no significant difference between owner and manager-controlled firms.
[157] See Gugler (2001) for further details.
[158] Corporate value first increases as more concentrated insider ownership aligns incentives, but eventually decreases as the probability of hostile takeovers declines.

McConnell and Servaes (1990) find a maximum at 40–50% insider ownership (controlling for ownership by institutional investors and blockholders). Short and Keasey (1999) find similar results for the UK.[159]

The third generation continues to test the Stulz hypothesis but vastly improves the econometrics, showing reverse causation. [160] Using instrumental variable and panel techniques the studies find corporate performance causing managerial ownership [Kole (1995), Cho (1998)], or both determined by similar variables [Himmelberg, Hubbard and Palia (1999)], or no relationship between ownership and performance [Demsetz and Villalonga (2001)]. The impact of corporate performance on managerial ownership is not significant. An alternative approach looks for instruments in institutions where ownership concentration is not endogenous, for example in co-operatives with many members. However, these studies are likely to suffer from other biases, in particular sample selection (by definition) and missing variables. [161]

The fourth generation returns to the first generation specification and econometrics, but adds two missing variables, the legal system and voting rights held in excess of cash-flow rights.[162] They find no effects for European countries [Faccio and Lang (2002)] and a negative effect of large investors in Asia [Claessens et al. (2000)]. [163] La Porta et al. (1999b) run a *Q*-regression for 27 countries but neither the cash-flow rights of controlling blockholders nor the legal system have a significant effect on corporate valuation. [164] It seems inevitable that a fifth generation study will emerge that addresses the econometric problems of the fourth generation.

7.2.3. Share blocks and stock market liquidity

The empirical link between secondary market liquidity and shareholder dispersion is well documented. Starting with Demsetz's (1968) classic study, measures of liquidity such as trading volume and bid-ask spreads have been shown to depend on the number of shareholders, even when controlling for other factors [Demsetz (1968), Tinic (1972), Benston and Hagerman (1974)]. Equally, increases in the number of shareholders, for example after stock splits [Mukherji, Kim and Walker (1997)] or decreases in the minimum trading unit [Amihud, Mendelson and Uno (1999)] lead to higher secondary market liquidity. The inverse relationship also holds. An increase in ownership concentration, or a decrease in the 'free float', depresses liquidity [Becht (1999) for Belgium and Germany; Sarin et al. (1999) for the USA].

[159] They find a maximum at 15.6% insider ownership and a minimum at 41.9%.
[160] Typical econometric shortcomings of first- and second-generation ownership-performance studies are reverse causality (endogeneity), sample selection, missing variables and measurement in variables. For example, Anderson and Lee (1997) show that many second-generation studies used data from unreliable commercial sources and correcting for these measurement errors can flip the results. See Börsch-Supan and Köke (2002) for a survey of econometric issues.
[161] Gorton and Schmid (1999) study Austrian cooperative banks where equity is only exchangeable with the bank itself and one member has one vote, hence the separation of ownership and control is proportional to the number of members. They find that the log ratio of the average wages paid by banks, relative to the reservation wage is positively related to the (log) of the number of co-operative members, controlling for other bank characteristics, period and regional effects. They conclude that agency costs, as measured by efficiency wages, are increasing in the degree of separation between ownership and control.
[162] However, the hypothesis is reversed. The authors do not expect to find that firms without a block perform worse than firms with a block, but expropriation of minority shareholders by the blockholders.
[163] The studies regress "excess-value" [the natural logarithm of the ratio of a firm's actual and its imputed value, as defined by Berger and Ofek (1995)] on Means–Larner control dummies and other control variables.
[164] La Porta et al. (1999) perform a number of bivariate comparisons of Means–Larner control groups for a larger set of variables.

The positive effect of stock market liquidity is also well documented. More liquid stocks command a price premium and offer a concomitantly lower risk adjusted return, reducing the cost of capital for the company [Stoll and Whaley (1983), Amihud and Mendelson (1986)]. Hence, companies have a measurable incentive to increase the number of shareholders, providing further evidence on the existence of a monitoring– liquidity tradeoff.

To our knowledge the role of liquidity in spurring monitoring has not been explored empirically. Instead the literature has focused on asymmetric information problems and informed investors as a source of illiquidity. Empirically, higher insider ownership reduces liquidity because it increases the probability of trading with an insider [Sarin, Shastri and Shastri (1999), Heflin and Shaw (2000)].

7.2.4. Banks [165]

Traditionally the empirical corporate governance literature has taken a narrow view of delegated monitoring by banks and sought to measure bank involvement through the intensity of bank–industry links such as equity holdings, cross-holdings and/or (blank) proxies, board representation and interlocking directorates. [166]

Within this narrow view there is an empirical consensus that bank–industry ties in the USA were strong at the beginning of the century but became weak through antitrust regulation and the Glass–Steagall Act, [167] were never strong in the UK, but always strong in Germany[168] and Japan [Hoshi and Kashyap (2001)]. A popular explanation for these patterns has been the different regulatory history in these countries [Roe (1994)]. [169]

The empirical literature has documented that equity holdings by banks are not very common,[170] but the presence of bankers on boards and their involvement in interlocking directorates is common.[171] Based on these empirical measures the literature has compared the performance of

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[165] For a more general review of banks and financial intermediation see Chapter 8 in this Volume by Gorton and Winton.

[166] This approach has a long tradition, for example Jeidels (1905) for Germany and the Pujo Committee (1913) for the USA.

[167] See, for example, Carosso (1970, 1973, 1985), Chernow (1990), Tallman (1991), Tabarrok (1998), Calomiris (2000), Ramirez and DeLong (2001). The relative performance of J.P. Morgan-controlled and other corporations has been investigated by DeLong (1991) and Ramirez (1995). Kroszner and Rajan (1997) investigate the impact of commercial banks on corporate performance before Glass–Steagall, Kroszner and Rajan (1994) and Ramirez (1995) the impact of the Act itself.

[168] Edwards and Fischer (1994), Edwards and Ogilvie (1996) and Guinnane (2001) argue that bank influence and involvement in Germany is, and has been, very limited.

[169] The regulatory explanation of (low) bank involvement in industry is convincing for the USA, but less so for other countries. In the UK no restrictions apply and banks have always kept an arm's length relationship to industry. In Japan the Allied occupation forces sought to impose Glass–Steagall type restrictions, yet the keiretsu found other ways of maintaining strong ties.

[170] In Germany banks hold many but not the largest blocks [Becht and Böhmer (2003)]. However, they exert considerable voting power through blank proxies for absent blockholders [Baums and Fraune (1995)]. There is also indirect evidence that banks' holdings of equity in non-financial firms were small at the end of the 19th century [Fohlin (1997)].

[171] Interlocking directorates started to become common in Germany towards the end of the 19th century [Fohlin (1999b)]. At the beginning of the 1990s only 12.8% of companies were not connected to another by some personal link and 71% had a supervisory board interlock [Pfannschmidt (1993); see Prigge (1998, p. 959) for further references]. Most of the links were created by representatives of banks and insurance companies

companies under "bank influence" to other companies, with mixed results.[172] Also, the influence of banks has been identified as an important driver of economic growth and for overcoming economic backwardness [Tilly (1989), Gerschenkron (1962), Schumpeter (1934, 1939)], [173] a view that has been challenged recently. [174]

Relationship banking [175] is a broader concept that emphasizes the special nature of the business relationship between banks and industrial clients. Relationship banking, broadly defined is "the connection between a bank and customer that goes beyond the execution of simple, anonymous, financial transactions" [Ongena and Smith (1998)]. [176] The ability of banks to collect information about customers and their role in renegotiating loans gives them a role in corporate governance even if they hold no equity and have no board links.

The empirical literature documents that banking relations last from 7 to 30 years on average, [177] depending on the country and sample.[178] Relationships last longer when they are exclusive [Ongena and Smith (2000)], depending on interest rates and the range of services provided by the bank to the firm [DeGryse and Van Cayseele (2000)].
Most firms have multiple banking relationships. [179]

Event study evidence suggests that changes in banking relationships have an impact on stock prices. The announcement of a bank loan agreement (new or renewal) is associated with positive abnormal returns, while private placements or public issues have no or a negative effect [James (1987)], a finding that has been consistently confirmed for renewals [Lummer and McConnell

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[Pfannschmidt (1993)]. The same was true for about half of the companies in Japan, also when the bank has extended a loan to the company [Kroszner and Strahan (2001)]. In the USA 31.6% of the Forbes 500 companies in 1992 had a banker on board, but only 5.8% of the main bank lenders had board seats. Lenders are discouraged from appointing directors because of concerns about conflicts of interest and liability during financial distress [Kroszner and Strahan (2001)]. Banks also drive board seat accumulation and overlap in Switzerland [Loderer and Peyer (2002)].

[172] For surveys of this evidence, see Prigge (1998, p. 1020) for Germany, Gugler (2001) and Section 7.2 for a review of the econometric problems. In addition to the usual endogeneity problems blocks held by banks can arise from debt-to-equity conversion. The classic study for Germany is Cable (1985), the most recent study Gorton and Schmid (2000b).

[173] Banks collected capital, lent it to able entrepreneurs, advised and monitored them, helping their companies along "from the cradle to the grave" [Jeidels (1905)].

[174] Within the traditional view Fohlin (1999a) shows that the contribution of Italian and German banks to mobilising capital was limited. Da Rin and Hellmann (2002) argue that banks helped to overcome coordination failures and played the role of "catalysts" in industrial development.

[175] For a recent survey with emphasis on the empirical literature see Ongena and Smith (1998), with emphasis on the theoretical literature see Boot (2000).

[176] "Relationship banking" might involve board and equity links, but not necessarily. The labels "Hausbank system" for Germany and "Main Bank System" for Japan [Allen and Gale (2000)] are often associated with exclusive debt links cemented by equity control rights, but exclusive bank–firm relationships are also found in countries where banks hold little or no industrial equity, for example the USA.

[177] At the beginning of the 1990s the average relationship in Italy lasted 14 years [Angelini et al. (1998)], 22 in Germany [Elsas and Krahnen (1998)], 30 years in Japan [Horiuchi et al. (1988)], 15–21 years in Norway [Ongena and Smith (1998)], but only 7.8 years in Belgium [DeGryse and Van Cayseele (1998)] and 7 years in the USA [Cole (1998)]. In a German sample that is more comparable to the USA samples the mean duration is only 12 years [Harhoff and Korting (1998)]; see Ongena and Smith (2000, Table 2) for further references.

[178] The cross-country and cross-study comparison must be treated with some caution because the studies suffer from the usual econometric problems that are typical for duration analysis to different degrees: right and left-censoring, stock sampling and other sampling biases.

[179] For large firms, the median number of bank relationships is 13.9–16.4 in Italy, 6–8 in Germany, 7.7 in Japan, and 5.2 in the USA; see Ongena and Smith (2000, Table 3) for further details and references.

(1989), Best and Zhang (1993), Billett, Flannery and Garfinkel (1995)].[180] The stock price reaction to loan commitments is also positive, in particular with usage fees [Shockley and Thakor (1997)]. Acquisitions financed by bank loans are associated with positive bidder announcement returns, in particular when information asymmetries are important [Bharadwaj and Shivdasani (2003)]. Equally, Kang, Shivdasani and Yamada (2000) show that Japanese acquirers linked to banks make more valuable acquisitions than acquirers with more autonomous management.

7.3. Minority shareholder action

7.3.1. Proxy fights

Corporate voting and proxy fights received considerable attention in the early theoretical literature, drawing on the analogy between political and corporate voting [Manne (1965)]. In the USA today, proxy fights are potentially very important because they allow dissident shareholders to remove corporate boards protected by a poison pill (see Section 5.1). Proxy fights are however not very common; occurring on average 17 times a year in the period 1979–94, with 37 contests in 1989, at the peak of the hostile takeover boom [Mulherin and Poulsen (1998, p. 287)].[181] This timing is no coincidence; 43% of these proxy fights were accompanied by a hostile takeover bid [Mulherin and Poulsen (1998, p. 289)]. [182] Proxy fights are usually brought by minority shareholders with substantial holdings (median stake 9.1%). [183] In other countries with dispersed shareholdings (see Section 7.2.1), such as the UK, proxy fights are very rare.[184] The latest evidence suggests that proxy fights provide a degree of managerial disciplining and enhance shareholder value. Gains in shareholder wealth are associated with contest-related acquisitions and restructuring under new management [Mulherin and Poulsen (1998)]. [185]

7.3.2. Shareholder activism

After the decline in hostile takeovers in the USA at the beginning of the 1990s, shareholder activism has been identified as a promising new avenue for overcoming the problems of dispersed holdings and a lack of major shareholders [Black (1992)].[186] Typical forms of activism are shareholder proposals, "focus lists" of poor performers, letter writing and other types of private negotiations. Typical activist issues are calls for board reforms (see Section 7.4), the adoption of confidential voting and limits on excessive executive compensation (see Section 7.5).

[180] The evidence is mixed for new loans; see Ongena and Smith (2000, Table 1).
[181] Mulherin and Poulsen (1998) is the most complete study of proxy contests in the United States to date. Previous studies for smaller samples and/or shorter time periods include Dodd and Warner (1983), Pound (1988), DeAngelo and DeAngelo (1989), Borstadt and Zwirlein (1992) and Ikenberry and Lakonishok (1993). An interesting case study is Van-Nuys (1993).
[182] In the full sample 23% of the firms involved in contest were acquired.
[183] Furthermore, most proxy contests (68%) aim to appoint the majority of directors, just more than half are successful (52%), and most result in management turnover (61%) [Mulherin and Poulsen (1998, p. 289)].
[184] There are notable exceptions, for example the small shareholder action at Rio Tinto PLC (in the United Kingdom) and Rio Tinto Ltd (in Australia) in May 2000 (http://www.rio-tintoshareholders.com/).
[185] Mulherin and Poulsen (1998) sought to resolve the inconclusive findings of previous research. In agreement with theory, event studies had shown that proxy fights occur at underperforming firms and that they increase shareholder wealth when the contest is announced and over the full contest period. However, some studies found that targets did not underperform prior to the contests, and that shareholder wealth declines after the announcement, in particular after the contest has been resolved – and relatively more when the challenger is successful in placing directors on the board of the target [Ikenberry and Lakonishok (1993)].
[186] As we reported in Section 3.2, this development is closely related to the size of pension funds in the USA, the largest in the OECD.

There is anecdotal evidence that activism is also on the rise in other countries, focusing on similar issues. [187]

In the USA, the filing of ordinary shareholder proposals[188] is much easier than a full proxy solicitation but these proposals are not binding for the board or management, making such proposals the preferred tool of USA activists. In Europe most countries allow shareholders to file proposals that are put to a vote at shareholder meetings [Baums (1998), Deutsche Schutzvereinigung für Wertpapierbesitz (2000)].

The empirical literature on shareholder activism in the USA is surprisingly large and there are no less than four literature surveys [Black (1998), Gillan and Starks (1998), Karpoff (1998), Romano (2001)]. They concur that shareholder activism, irrespective of form or aim, has a negligible impact on corporate performance. However, authors disagree on the cause and interpretation of this result.

Black (1998) concludes that institutional investors spend "a trivial amount of money" on overt activism and that their ability to conduct proxy fights and appoint directors is hindered by regulation[189] and other factors.[190] In contrast, Romano (2001) argues that shareholder activism in the USA has a limited impact because it focuses mainly on issues that are known to matter very little for company performance and value. Fund managers and/or trustees engage in this type of activism because they derive private benefits from it, such as promoting a political career.

The two explanations are, in fact, linked. Pension funds are subject to the same agency problems as corporations and pension fund regulation is concerned with minimizing investment and management risk for beneficiaries. Institutional activism pushes the corporate governance problem to a higher level, with even higher dispersion this time of policy holders (often with no voting right or "one-holder–one-vote" rules), no market for pension fund control and boards with poorly paid and/or trained trustees. [191] In the USA, trustees of 401(k) plans are appointed by the corporation, raising conflict of interest issues laid bare in the recent collapse of Enron. [192]

[187] Shareholder activism is the logical next step from the adoption of corporate governance codes and principles, pressing companies to implement the recommendations put forward in these documents (see http://www.ecgi.org for a listing and full-text copies of corporate governance codes).

[188] In the USA shareholder proposals are filed under Rule 14a-8 of the SEC's proxy rule. They are precatory in nature, i.e., even if a majority of the shares outstanding vote in favor of the proposal the board is not obliged to implement the resolution.

[189] Initially Black (1992) argued that shareholder activism could overcome (regulation induced) shareholder passivity in the USA.

[190] In the UK there are fewer regulatory barriers than in the USA, but there are other reasons why institutional investors are reluctant to exercise voice, for example "imperfect information, limited institutional capabilities, substantial coordination costs, the misaligned incentives of money managers, a preference for liquidity, and uncertain benefits of intervention" [Black and Coffee (1994)].

[191] See Myners (2001) for a recent policy report on pension-fund management and governance in the UK. His survey of UK pension-fund trustees revealed that they received one day of training prior to taking up their job. Leech (2003) analyses the incentives for activism in the UK. Stapledon (1996) compares institutional shareholder involvement in Australia and the UK.

[192] Conflicts of interest and outright looting of pension-fund assets were at the bottom of the collapse of the Maxwell media empire in the UK in 1992; Bower (1995) and Greenslade (1992).

7.3.3. Shareholder suits

Shareholder suits can complement corporate voting and potentially provide a substitute for other governance mechanisms. Once again the institutional details differ across countries.[193] In the USA shareholder litigation can take the form of derivative suits, where at least one shareholder brings the suit on behalf of the corporation, and direct litigation, which can be individual or class-action.[194] The incidence of shareholder suits in the USA is low. Between 1960–1987 a random sample of NYSE firms received a suit once every 42 years and including the OTC market, 29% of the sample firms attracted about half of the suits [Romano (1991)].[195] In Europe enforcing basic shareholder rights usually falls upon public prosecutors but direct shareholder litigation is also possible on some matters.

Three main hypotheses have been tested: who benefits more from shareholder suits, shareholders or lawyers; is there any evidence that managers are disciplined by shareholder litigation; and does shareholder litigation boost or replace other forms of monitoring?

The most comprehensive empirical study for the USA covers the period 1960–1987 [Romano (1991)].[196] She finds that shareholders do not gain much from litigation, but their lawyers do. Most suits settle out of court, only half of them entail a recovery for shareholders and when they do the amount recovered per share is small. [197] In contrast, in 90% of the settled suits the lawyers are awarded a fee. There are some structural settlements but they are mostly cosmetic. The market is indifferent to the filing of a derivative suit but exhibits a negative abnormal return of −3.2% for class action. [198] There is little evidence that managers are disciplined by litigation. Executive turnover in sued firms is slightly higher, but managers almost never face financial losses.[199] Suits both help and hinder other types of monitoring. For example, blockholders are likely to get sued[200] but they also use the threat of a suit to force change or reinforce their voting power. There seems to be no comparable empirical evidence for other countries.

[193] In most countries shareholders can appeal to the courts to uphold their basic rights, for example their voting and cash-flow rights. However, the extent and incidence of shareholder litigation differs substantially. Here we only deal with suits brought against managers or directors.

[194] The details of procedure and financial incentive differ for the two types of action [Clark (1986)]. For derivative suits the recovery usually goes to the corporation, but it must reimburse a plaintiff 's legal expenses, reducing the problem of shareholders at large free-riding on the shareholders bringing the suit. In practice lawyers have an incentive to seek out shareholders and offer to bear the cost if the suit is unsuccessful and take a large fee if it is successful. This provides lawyers with an incentive to settle for a low recovery fee and a high lawyer's fee [Klein and Coffee (2000, p. 196)].

[195] For more recent descriptive statistics on class action, see Bajaj et al. (2000).

[196] Unfortunately the study has not been updated (Romano, personal communication).

[197] The recovery in derivative suits is only half as large as in direct (class) action.

[198] This could be related to the fact that the recovery in derivative suits is only half as large as in direct (class) action and that the class action recovery goes to shareholders, not the company itself. Indeed, the latter might be selling shareholders, i.e., no longer hold any shares in the company [Romano (1991, p. 67)].

[199] Compensation packages are unchanged and settlement fees are met by special insurance policies taken out by the company.

[200] As we pointed out elsewhere this is consistent with the view that shareholder suits limit self-dealing, but also with the view that they generally discourage block holding [Black (1990)].

7.4. Boards [201]

7.4.1. Institutional differences

In practice the structure, composition and exact role of boards varies greatly between individual corporations (charters) and governance systems. The same is true for the rules governing the appointment and removal of a board member and their duties.[202] In formal terms, boards can have one or two tiers. One-tier boards are usually composed of executive directors and non-executive directors. In theory the executives manage and the non-executives monitor, but in practice one-tier boards are often close to management.[203] In a two-tier board system there is a separate management board that is overseen by a supervisory board. Supervisory board members are barred from performing management functions. [204] Informally, both types of board can be more or less "captured" by management or dominated by blockholders.[205] To avoid the problem of capture by such interests, corporate governance recommendations emphasize the role of "independent directors", non-executive directors who have no links with the company other than their directorship and no links with management or blockholders. [206]

The role of the board in approving corporate decisions also varies. In one system a decision that can be ratified by the board requires shareholder approval in another. Major decisions, like mergers and acquisitions, almost always require shareholder approval. In most systems the shareholders appoint and remove the board, but the rules vary substantially (see Section 7.2). The board appoints the managers. In some countries boards have a formal duty vis-`a-vis the employees of the company or, as in Germany, employees have the right to appoint directors. In the USA statutes that require boards to take into account the interests of non-shareholder constituencies are commonly portrayed as "anti-takeover rules" [Romano (1993)]. [207]

7.4.2. Board independence

There are few formal models of boards (see Section 5) and the empirical work has focused on loose hypotheses based on policy or practical insights and recommendations. The bulk of this work has investigated whether board composition and/or independence are related to corporate performance and typically rejects the existence of such a relationship.

In order to measure the degree of board independence, several criteria have been proposed. [208] Is the chief executive officer the chairman of the board? What is the proportion of independent

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[201] Recent surveys on the role of boards include Romano (1996), Bhagat and Black (1999) and Hermalin and Weisbach (2003).

[202] Despite these differences, the OECD Principles (1999) contain a long list of board responsibilities and prescribes basic elements of board structure and working required to fulfill its objectives.

[203] For example, it is (or used to be) common that the chairman of the board and the chief executive officer are the same person and in some countries they must be by law.

[204] Most countries have either one or the other system, but in France companies can choose.

[205] For example, it is common that the supervisory board is staffed with former members of the executive board, friends of the CEO or the blockholder.

[206] Not surprisingly the exact definition of "independent" also varies a great deal and is the subject of constant debate. See the ECGN codes page (www.ecgn.org) for full text copies of such recommendations and definitions.

[207] See Kraakman et al. (2004) for a comprehensive discussion of the role of boards in a comparative perspective.

[208] Motivated by casual observation some studies have also investigated whether board size is related to performance.

directors on the board? Are there any board committees and how are they staffed? Coded into variables, the answers are related to performance measures like abnormal returns, Tobin's Q and/or the usual accounting measures with simple regression analysis. The evidence from the USA suggests that board composition and corporate performance are "not related" [Hermalin and Weisbach (2003)], the relationship is "uncertain" [Bhagat and Black (1999)], or is "at best ambiguous" [Romano (1996)].

7.4.3. Board composition

Most of these studies are subject to the econometric criticisms we highlighted in Section 7.2. In the model of Hermalin and Weisbach (1998) board composition is endogenous and what we observe in a cross-section might be efficient. Hence, we would not expect to see a significant relationship between board structure and general performance. Does board composition affect performance or do the needs of companies affect their board composition? The empirical analysis of boards is also in need of third generation studies.

Warther's (1998) model predicts that boards only play a role in crisis situations and there is some evidence that this is true for independent boards. In the takeover context bidder shareholders protected by outsider-dominated boards suffer less from overbidding (get smaller negative abnormal returns) than when boards are management-dominated [Byrd and Hickman (1992)]. Also, outside boards are more likely to remove CEOs as a result of poor company performance [Byrd and Hickman (1992)].

7.4.4. Working of boards

Recommendations of "best practice" [e.g., EASD (2000)] advance the practical hypothesis that the working as well as the composition of boards matters for performance. This proposition has been tested indirectly since it is virtually impossible to devise a quantitative measure of the way a board is run on the inside. [209] Hence a practitioner's interpretation of the results of this empirical literature might be that the studies have simply failed to measure the dimension of boards that matters most for corporate performance – their functioning.

7.4.5. International evidence

The international evidence on the role of boards in corporate governance and their impact on corporate performance is sketchy or the relevant studies are not easily accessible. A notable exception is the UK where a number of studies have broadly confirmed the findings for the USA [Franks, Mayer and Renneboog (2001)].

[209] Vafeas (1999) finds a positive relationship between the frequency of board meetings and corporate performance, but obviously this too is a very crude measure of the effectiveness of the working of the board. In a study that has been very influential in the management literature, Lorsch and MacIver (1989) use the survey method to provide direct evidence on the working of boards. Adams (2003) uses board remuneration as a proxy for board effort, but doesn't control for endogeneity.

7.5. Executive compensation and careers [210]

7.5.1. Background and descriptive statistics

Executive compensation in the USA has risen continuously since 1970 [see Murphy (1999)] and in 2000 reached an all-time high, with the bulk of the increase stemming from option plans. [211] Compensation consultants estimate that for a comparable US CEO the basic compensation package alone is higher than the total package in Germany, Spain, Sweden and Switzerland, and not much lower than in France or Japan (Figure 2).[212] In contrast, the total compensation of other management is similar across OECD countries and higher in Italy than in the USA [Abowd and Kaplan (1999)]. The differential remains large when data are adjusted for company size. [213]

Executive contracts are supposed to provide explicit and implicit incentives that align the interests of managers with those of shareholders, as discussed in Section 5. The bulk of the empirical literature has focused on sensitivity of pay[214] (explicit incentives) and the dismissal of executives (implicit incentive) to corporate performance.[215] High levels of pay were justified with the extraordinary gains in wealth shareholders reaped through most of the 1990s and incentive pay was characterized as one of the drivers behind the high market valuation of USA corporations [Holmstrom and Kaplan (2001)]. Recently, while stock prices plummeted and executive pay did not, attention has shifted to asymmetries in the pay–performance relationship and the potential for self-dealing by CEOs.

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[210] For recent surveys see Bebchuk, Fried and Walker (2002), Gugler (2001, p. 42), Perry and Zenner (2000), Loewenstein (2000), Abowd and Kaplan (1999) and Murphy (1999). Core, Guay and Larcker (2003) survey the specialized literature on equity-based compensation and incentives.

[211] Total compensation for the average US CEOs increased from $1 770000 in 1993 to $3 747000 in 1997 (in 1992 CPI-deflated dollars). The value of options in this package rose from $615 000 to $1914000 and bonuses from $332 000 to $623 000; [Perry and Zenner (2001, p. 461, Table 1)].

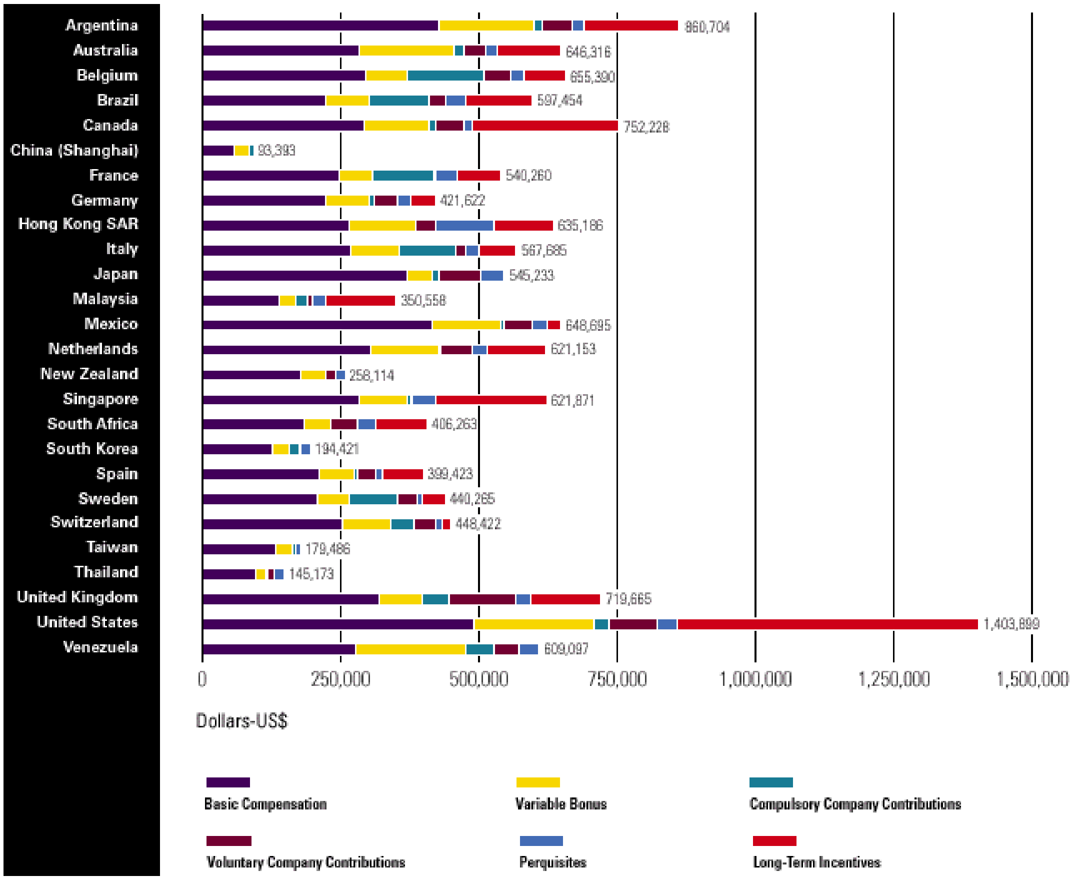
[212] The value of an executive compensation package is typically measured by the "after-tax value of salaries, short-term bonuses, deferred retirement bonuses, stockholdings, stock bonuses, stock options, dividend units, phantom shares, pension benefits, savings plan contributions, long term performance plans, and any other special items (such as a loan to the executive made at a below market rate)" [Antle and Smith (1985)]. As we shall see, the most important and controversial item are stock options, an unprecedented rise in their use throughout the 90s and the terms on which they are granted.

[213] Cheffins (2003) explores whether there will be global convergence to U.S. pay levels and practices: how can U.S. pay levels remain so much higher than anywhere else, and why has this gap only opened up in the last decade and not earlier.

[214] See Rosen (1992) for an early survey of this literature.

[215] The accounting literature also emphasizes the technical problem of estimating the monetary value of top executive compensation packages. See Antle and Smith (1985), based on early work by Burgess (1963) and Lewellen (1968).

Figure 2. Total Remuneration of Chief Executive Officer



Source : Tower Perrins Worldwide Total Remuneration Survey 2000
Note : Data based on remuneration consultants' estimate for a typical CEO in a large industrial company. See Murphy (1999:2495) or www.towersperrin.com for more information.

7.5.2. Pay–performance sensitivity

In the early 1990s the consensus view in the literature was that the sensitivity of pay to performance in the USA was too low [see Baker et al. (1988), Jensen and Murphy (1990)].[216] Executives did not receive enough cash after good corporate performance and did not incur sufficient losses, through dismissal, after poor performance. The same conclusions were reached for other countries, most notably Japan [see Kaplan (1994a)]. In the USA the sensitivity of executive pay to performance reached levels 2 to 10 times higher than in 1980 by 1994 [see Hall and Liebman (1998)]. The dollar change in executive wealth normalized by the dollar change in firm value appears small and falls by a factor of ten with firm size, but the change in the value of the CEO's equity stake is large and increases with firm size.[217] The probability of dismissal remained unchanged between 1970 and 1995 [Murphy (1999)].[218]

[216] The point was also emphasized in an early survey by Jensen and Zimmerman (1985).
[217] Baker and Hall (2004) document the firms size effect and discuss the merits of each measure. During 1974–86 the median CEO gained or lost $3.25 for $1000 gained or lost by shareholders, adjusted for the risk of dismissal; but money equivalent of this threat was only $0.30 [Jensen and Murphy (1990)]. In 1997 and 1998

The sensitivity of equity-based compensation with respect to firm value is about 53 times higher than that of the salary and bonus components [Hall and Liebman (1998)]. However, even for median performance the annualized percentage increase in mean wealth for CEOs has been 11.5% for the period between 1982 and 1994 [Hall and Liebman (1998)] and the size of CEO losses relative to the average appreciation of their stock holdings has been modest.

In other countries too, the use of equity-based compensation and pay–performance sensitivity has risen, but nowhere close to the USA level. In the UK the percentage of companies with an option plan has risen from 10% in 1979 to over 90% in 1985 [Main (1999)]. However, the level of shareholdings and pay–performance sensitivity are about six times lower than in the USA [Conyon and Murphy (2000)].

7.5.3. Are compensation packages well-designed?

Agency theory predicts that incentive pay should be tied to performance relative to comparable firms, not absolute performance. And indeed, early studies found that changes in CEO cash compensation were negatively related to industry and market performance, but positively related to firm performance [Gibbons and Murphy (1990)].[219] In contrast, equity-based compensation is hardly ever corrected for industry or market stock index movements, leading to a solid rejection of the relative performance evaluation (RPE) hypothesis in all recent surveys [Core et al. (2003, pp. 38–39), Bebchuk, Fried and Walker (2002), Abowd and Kaplan (1999), Murphy (1999)]. [220]

Agency theory can be used to determine the optimal exercise price of options when they are granted. The optimal price is a function of numerous factors and not the same for different firms. In practice most options are granted at the money (i.e., with an exercise price equal to the company's stock price on the day), a clear contradiction of the predictions of theory [Bebchuk, Fried and Walker (2002, p. 818)].

Theory also predicts that incentive schemes and the adoption of such schemes should result in net increases in shareholder wealth. The latest evidence (based on "abnormal *Q*" regressions) rejects this prediction. An increase in CEO option holdings leads to a decrease in Tobin's *Q*, suggesting that CEOs hold too many options but not enough stock [Habib and Ljungqvist (2002)]. However, event study evidence generally supports the theory [Morgan and Poulsen (2001), DeFusco et al. (1990), Brickley, Bhagat and Lease (1985), Larcker (1983)].[221]

Agency theory further predicts that incentive pay and blockholder monitoring or takeover threats are substitutes. Firms subject to blockholder monitoring or with family representatives on

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the gain or loss was $10–11 per $1000 (unadjusted) [Perry and Zenner (2000), Hall and Liebman (2000)]. For an executive holding stock and options worth $20000000, a 10% change in stock prices implies a $2 000000 change in wealth.

[218] Among S&P 500 firms average CEO turnover rates for low performers were 15% on and 11% from the 25th performance percentile upwards [Murphy (1999)].

[219] See Murphy (1999, p. 2535)] for additional references.

[220] Several explanations of this puzzle have been put forward including accounting problems, tax considerations, the difficulty in obtaining performance data from rivals, worries about collusion between companies, the ability of managers to get back to absolute performance plans with appropriate financial instruments, but not a single one is very satisfactory.

[221] Note that DeFusco et al. (1990) found a negative reaction in bond prices, interpreting the adoption of stock option plans as means for transferring wealth from bondholders to stockholders. An influential early study is Masson (1971).

the board are less likely to implement stock option plans [Mehran (1995), Kole (1997)] because more discipline substitutes for more sensitivity of pay.

In contrast, without blockholder monitoring, CEOs are not paid as the theory predicts [Bertrand and Mullainathan (2001, 2000)]. Boards protected by state anti-takeover laws [Bertrand and Mullainathan (1998)] or anti-takeover amendments [Borokhovich, Brunarski and Parrino (1997)] (see Section 7.1) provide more incentive pay to compensate for less discipline from hostile takeovers, while in the UK takeover threats are higher while incentive pay and the level of pay are lower than in the USA [Conyon and Murphy (2000)]. However, there are inconsistencies. Companies in industries with more disciplining takeovers should pay less, while in fact they pay more [Agrawal and Walkling (1994), Agrawal and Knoeber (1998)]. Although these results are suggestive, self-dealing is a plausible rival explanation – boards that are monitored less give more pay to their CEO cronies.[222]

7.5.4. Are managers paying themselves too much?

Few direct tests of the rival 'self-serving manager' explanation of USA pay practices are available, but some studies attempt to get at the issue indirectly. Thus, there is evidence that management manipulates the timing of stock option grants [Yermack (1997)] and times the flow of good and bad news prior to the option grant [Aboody and Kasznik (2000)]. This can be interpreted as evidence of self-dealing [Shleifer and Vishny (1997a)].

Another way of determining whether there has been self-dealing is to see whether CEO stock option plans (or bonus packages) have been approved by a shareholder vote. Even though in 2000 almost 99% of the plans proposed at major US corporations received shareholder approval, the average percentage of votes cast against stockoption plans has increased from 4% in 1988 to about 18% in 1995–1999 [IRRC (2000b)], 20.2% in 1999 and 23.3% in 2001 [IRRC (2002)]. In some cases dilution levels are 70% or more, especially in the technology sector, often associated with "evergreen" features [IRRC (2002)]. There is rising concern about exemptions for "broadly based plans",[223] potential dilution of voting rights,[224] broker voting,[225] option repricing, payments in restricted stock, loans for share purchases, "evergreen plans"[226] and discount options [Thomas and Martin (2000)]. In addition, activists are now worried that "at the same time that stock prices are falling, CEO pay continues to rise" [AFL-CIO (2001)].[227] These results are not strong direct-

[222] Bebchuk, Fried and Walker (2002) express general skepticism about the substitution effect between incentive pay and disciplining through takeovers. They argue that boards can pay themselves and the CEO large amounts of money without reducing the value of the company enough to justify a takeover.
[223] Stock option plans that do not need shareholder approval if they benefit more than a certain proportion of non-officer employees.
[224] The IRRC (2001) estimates that the average potential dilution of the voting power of the currently outstanding shares from stock option plans was 13.1% for the S&P 500 and 14.6% for the S&P 1500 in 2000, higher than in previous years.
[225] Under NYSE rules brokers can vote shares without instructions from the beneficial owners. A recent study estimates that routine proposals that benefit from broker votes receive 14.2% more "yes" votes than other routine proposals of the same kind, making broker votes marginal for 5.2% of routine proposals [Bethel and Gillan (2002)].
[226] Evergreen plans reserve a small percentage of stock for award each year. Once approved the awards are made without shareholder approval. "Quasi-evergreen plans" have a limited lifetime, regular plans run indefinitely [Thomas and Martin (2000, p. 62)].
[227] The AFL-CIO has recently opened a Website campaigning against "runaway pay" in the USA, see (http://www.paywatch.org).

evidence support for the self-serving manager hypothesis, but they can be re-interpreted as yet another failure of shareholder monitoring in the USA.

In parallel with the takeover literature, yet another approach for distinguishing between self-serving and efficient behavior brings in board composition and the power of the CEO vis-`a-vis the board. Outside and independent directors on the board or on remuneration committees are thought to be (more) resistant to awarding selfserving compensation packages. In contrast, CEOs who are also the chairman of the board ("duality") are thought to lean more towards self-dealing. In the USA, most corporations have a compensation committee comprising outside directors. [228] As a direct result of the Cadbury Committee (1992) and Greenbury Committee (1995) reports, UK issuers have remuneration committees[229] and in 1994 already they were 91% staffed with outside directors. Similarly, during 1991–1994 the proportion of UK boards with "duality" fell from 52% to 36% [Conyon and Peck (1998)]. Both developments are also gaining ground in continental Europe.[230] So far, empirical studies have failed to detect that institutions and reforms have any impact on pay structure. In the USA committees staffed with directors close to management do not grant unusually generous compensation packages [Daily et al. (1998)]. In the UK in 1991–1994, the proportion of non-executive directors serving on boards and duality had no effect on compensation structure [Conyon and Peck (1998)].[231] CEOs monitored by a board with interlocking directors get more pay [Hallock (1997)].[232]

There is evidence that the extensive use of compensation experts and peer review increases pay in excess of what is warranted from a pure agency perspective. For example, CEOs with pay packages that lie below the median of their peers see their pay increase more quickly, *ceteris paribus* [Bizjak, Lemmon and Naveen (2000)].

7.5.5. Implicit incentives

Implicit incentives typically take the form of executive dismissal or post-retirement board services. Post-retirement appointment to a board can be a powerful implicit incentive or, once again, a sign of self-dealing. In the USA, CEO careers continue after retirement with 75% holding at least one directorship after two years. Almost half (49.5%) stay on their own board after retirement, in 18% of the cases as chairman [Brickley et al. (1999)].[233]

Most explicit and implicit incentives are written into CEO contracts that, under USA Federal Law, must be disclosed but had not been collected until recently [Minow (2000)]. Preliminary analysis reveals that contracts range from "short and to the point" [Minow (2000)] to guaranteed benefits and perks of epic proportions.[234] Implicit benefits include severance pay for dismissal

[228] If not, under U.S. tax law compensation is not tax deductible for executives mentioned in the proxy statement [Murphy (1999)].
[229] See Conyon and Mallin (1997).
[230] See http://www.cgcodes.org for reports on the implementation of the pertinent governance recommendations in continental Europe.
[231] We are not aware of a direct test that exploits the time series variation of the UK reforms.
[232] Fich and White (2005) investigate the determinants of interlocks.
[233] Many corporate governance codes oppose the appointment of CEOs to their own boards after retirement.
[234] See http://www.thecorporatelibrary.com/ceos/. One of the more lavish contracts included a $10 million signing bonus, $2 million stock options at $10 a share below market, a "guaranteed bonus" of at least half a million dollars a year, a Mercedes for the executive and his wife, a corporate jet for commuting and first class air for the family once a month, including the executive's mother [Minow (2000)].

without "cause"[235] or in case of changes in control (acquisition of 15, 20 or 51% of the voting shares).[236] We expect that more analytic studies based on this data will shed more light on these issues.

7.5.6. Conclusion

To conclude, it has become difficult to maintain the view, based on data from the bull market of the early 1990s, that US pay practices provide explicit and implicit incentives for aligning the interests of managers with those of shareholders. Instead, the rival view that US managers have the ability, the opportunity and the power to set their own pay at the expense of shareholders [Bebchuk, Fried and Walker (2002)], increasingly prevails. We know relatively less about pay practices in other countries, but attempts to implement USA practices are controversial, as the long-standing debate in the U.K.[237] and recent rows in France[238] show. The institutional investor community is drawing its own conclusions and has tabled global guidelines on executive pay,[239] while corporate America is under pressure to report earnings net of the cost of stock options.

7.6. Multiple constituencies

In addition to shareholders there are four major other constituencies: creditors (and other non-equity investors), employees, suppliers and clients. In parallel to Section 5, we focus on the role and impact of the debtholder and employee constituencies in a comparative corporate governance perspective.

7.6.1. Debtholders

Many aspects of the role of debtholders in corporate governance are addressed in the empirical financial contracting literature.[240] These studies investigate the evolution impact and choice of general capital structures, or the effect of changes in leverage on stock prices, particularly in the context of corporate control transactions (see Section 7.1).

The main theoretical rationale for sharing control between managers, shareholder *and* debtholders is their different role in restructuring and, in particular during financial distress (see Section 5).

Is debt a commitment device for liquidation after poor performance? As usual, the role of debtholders differs appreciably between countries. For example, in the USA insolvency law is "softer" than in the UK,[241] and judges are more lenient [Franks and Sussman (2005)].

[235] The definition of cause is often stringent, for example "felony, fraud, embezzlement, gross negligence, or moral turpitude" [Minow (2000)].
[236] The latter, once again, weakens the potential monitoring role of blockholders in the USA.
[237] Recently, coalitions of UK institutional investors have been successful at curbing pay packages, even in the case of perceived excess among their own kind: Andrew Bolger, Prudential Bows to Revolt Over Executive Pay, FT.com; May 08, 2002.
[238] Pierre Tran and David Teather, Vivendi Shareholders Turn on Messier, The Guardian; April 25, 2002.
[239] The proposed standard prescribes, inter alia, individual disclosure for individual executives, reporting of stock options as a cost to the company, shareholder voting on pay policy, appointment of an independent pay committee and limits on potential channels of self-dealing (e.g. loans to executives); ICGN (2002).
[240] For a comprehensive earlier survey see Harris and Raviv (1992).
[241] Under Chapter 11 of the 1978 Bankruptcy Code the debtor is allowed to stay in control and try to raise new cash. In the UK floating charge holders take control through the appointment of an Administrative Receiver who acts in their interest and replaces the board [Franks and Sussman (2000), Davies et al. (1997)].

Furthermore, regulation in the USA is subject to political intervention and lobbying, which further weakens the usefulness of debt as a commitment device [Berglöf and Rosenthal (1999), Franks and Sussman (2005), Kroszner (1999)].[242] Basic statistics lend support to this view. In the USA the rate of deviation from absolute priority rules is 77–78%[243] but it is close to zero in the UK [Franks and Sussman (2000)]. [244]

Recent work on venture capital financing lends more direct support to the importance of debtholder involvement by analysing the actual contracts signed between firms and the providers of finance.[245] Consistent with the theory they find that the financial constituencies[246] have control and liquidation rights that are contingent on performance and that control shifts between constituencies, again depending on performance [Kaplan and Strömberg (2003)].

7.6.2. Employees

The literature on employee involvement has focused on two questions: does employee involvement come at the expense of shareholders (reduce shareholder wealth), and if contracts are incomplete, is employee involvement efficient? There is little empirical evidence in support of the first question and, to our knowledge, no empirical evidence that would allow us to formulate an answer to the second question.

The incidence of employee involvement is often thought to be limited to Germany's mandatory codetermination and two-tier boards. In fact, employee involvement is also mandatory in Austria and the Netherlands[247] (two-tier boards), Denmark, Sweden, Luxembourg and France[248] (one-tier board). Companies operating in two or more member states of the European Union must have a "European Works Council". [249] Voluntary codetermination can be found in Finland and Switzerland [Wymeersch (1998)]. In contrast, employees in Japan are not formally represented on the board [Hoshi (1998)], although Japanese corporations are run, supposedly, in the employees' and not the shareholders' interest [Allen and Gale (2000)]. Compared to the wealth of opinions on employee involvement, the empirical literature is small, even for countries where such institutions are known to exist, such as Germany.

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242 Theory predicts that ex-ante commitment from dispersed debt is stronger than concentrated debt, yet systems that give creditors strong liquidation rights often do so through an agent, making it easier to renegotiate (e.g., the UK and Germany).

243 See, for example, Franks and Torous (1989).

244 Note that these basic statistics are methodologically problematic. The USA studies suffer from sample bias, looking primarily at large companies with publicly traded debt and conditional on the outcome of the bankruptcy procedure. Hence, the results could be distorted towards more or less actual commitment in the USA at large. The statistics of Franks and Sussman (2000) do not suffer from this problem because they were sponsored by a government-working group on the reform of insolvency law.

245 Sahlman (1990), Black and Gilson (1998), Kaplan and Strömberg (2003).

246 In theory a venture capitalist (universal bank) holding debt and equity represents two constituencies.

247 In the Netherlands the board members of large structuur regime corporations have a duty to act "in the interest of the company" and shareholders do not appoint them. Formally the incumbent board members appoint new board members. In practice they are chosen jointly by capital and labor because the shareholders and the employees can challenge appointment in a specialised Court [Wymeersch (1998, p. 1146)].

248 The French system provides for weak representation and has been called "a mockery" [Wymeersch (1998, p. 1149)].

249 Council established under the European Works Council Directive (94/45/EC) to ensure that all company employees are "properly informed and consulted when decisions which affect them are taken in a Member State other than that in which they are employed". The Directive applies to companies and groups with at least 1000 employees in the European Economic Area (the EU15, Norway, Iceland and Liechtenstein) as a whole and at least 150 in each of two or more Member States.

German codetermination provides for mandatory representation of employees on the supervisory board of corporations[250] with three levels of intensity: full parity for coal, iron and steel companies (since 1951),[251] quasi-parity for other companies with more than 2000 employees (since 1976)[252] and 13 parity for those with 500–2000 employees (since 1994). [253] Media companies are exempt.

Does the degree of codetermination adversely affect shareholder wealth or company performance? If codetermination reduces shareholder wealth, shareholders will resent codetermination and they will try to bypass[254] or shift board rights to the general assembly. There is some evidence of the former but none for the latter. In 1976 most supervisory boards of corporations subject to the quasi-parity regime did not have to be consulted on important management decisions[255] [Gerum et al. (1988)], a clear violation of the recommendations in most corporate governance codes (see Section 6.2). [256]

If there are losses in shareholder wealth from codetermination, how large are they? Econometric studies of codetermination compare company or sector performance "before and after" the 1951, 1952, 1972 and 1976 reforms or their enforcement by the courts. These studies find no or small effects of codetermination [Svejnar (1981, 1982), Benelli et al. (1987), Baums and Frick (1999)] and/or their samples and methodology are controversial [Gurdon and Rai (1990), FitzRoy and Kraft (1993)].[257] A recent study relies on the cross-section variation of codetermination intensity, controlling for different types of equity control and company size. It finds codetermination reducing market-to-book-value and return on equity [Gorton and Schmid (2000a)]. Codetermination intensity and its incidence correlate with other factors that are known to matter for stock price and accounting measures of performance, in particular sector and company size, and it is doubtful that one can ever fully control for these factors.

8. Recent Developments

Since we wrote our earlier survey there have been several important developments in corporate governance both on the regulatory front and in academic research.

First and foremost, in response to the corporate scandals that were unfolding while we were writing our survey, "the most sweeping securities law reforms since the New Deal"[258] have been

[250] See Hopt et al. (1998) and Prigge (1998) for an overview; in what follows we only discuss corporations (AGs). The German-language literature is vast; see Streeck and Kluge (1999) or Frick et al. (1999) for recent examples.
[251] Shareholders and workers each appoint 50% of the board members. The chairman is nominated by the board and must be ratified by the general meeting and both sides of the board by majority vote.
[252] The chairman is chosen by the shareholder representatives and has a casting vote.
[253] Between 1952–1994 this regime applied to all corporations, and still does for corporations registered before 1994.
[254] For example, by delegating sensitive tasks to shareholder-dominated committees or allowing the shareholder appointed Chairman to add items to the agenda at will.
[255] The catalogue of decisions is long and includes mergers and acquisitions, patents and major contracts.
[256] In coal, iron and steel companies, where codetermination is most intense, more management decisions required formal approval from the supervisory board, an apparent contradiction to the general finding. However, one can argue that worker influence is so intense in these companies that the capital side of the supervisory board is too weak to apply a de facto opt-out of codetermination.
[257] Frick et al. (1999), Gerum and Wagner (1998).
[1] As characterized by David Skeel (2005).

implemented in the U.S. with the passage of the Sarbanes-Oxley act in July 2002, and also the reforms brought about subsequently by New York attorney general Eliot Spitzer in his settlement with the Wall Street investment banking industry. In Europe ongoing reform efforts were accelerated by the extraterritorial reach of the U.S. reforms and Europe's own corporate governance scandals.

Second, on the scholarly research front, the same corporate scandals have renewed interest in three major issues in corporate governance : i) conflicts of interest among auditors, financial analysts and in investment banking more generally, ii) executive compensation and earnings manipulation and, iii) the role of the board of directors.

Third, despite these research efforts the gaps between scholarly research and the fast moving world of corporate governance we identified in our original survey has probably widened. Practitioners and policy makers were fast off the mark in implementing reform and it will take several years for academia to digest the flurry of reform activity and other developments we have observed since the scandals broke. In particular we still know very little about : i) the comparative merits of mandatory rules preferred by U.S. reformers versus the more market oriented reforms pursued in Europe (through voluntary codes and "comply or explain"); ii) the growing importance of corporate governance ratings and indices; iii) the role of hedge funds and private equity firms in European corporate governance and restructuring[259]; iv) the advantages and disadvantages of different board election systems; v) the mechanisms that allow an economy like China, with vaguely defined property rights and minimal shareholder protections to raise external capital and grow at astonishing rates.

We shall briefly review here the major developments in these areas, the debates they have given rise to, and also mention what in our view are the most significant advances in scholarly research in the past two years. Inevitably, given the enormous literature the corporate scandals and subsequent reforms have spawned, our brief discussion in this section could not be comprehensive. The changes that have taken place in the past three or four years have been so momentous that only a historian standing back from these events will be able to piece the whole picture together.

8.1. Regulatory responses to Corporate Scandals

8.1.1 The Sarbanes-Oxley Act

The Sarbanes-Oxley act (SOX) is a direct response to key governance failings at Enron and Worldcom. It targets primarily the kinds of abuses in earnings manipulation and financial reporting uncovered by the Enron and Worldcom failures. Its main aim is to restore confidence in company financial statements by dramatically increasing penalties for misreporting earnings performance and reducing conflicts of interest for two main groups of monitors of firms, auditors and analysts. In addition, SOX provides stronger protections for whistle-blowers.

The provision in SOX that has perhaps drawn the most attention is the stiff criminal penalties CEOs and CFOs face if they are now found to knowingly or willingly falsify financial statements. Post SOX, CEOs and CFOs must personally certify public accounts and if they are later found

[259] A coalition of minority investors led by a London based hedge fund recently forced the resignation of the CEO of the Deutsche Börse AG. During the heyday of Deutschland AG corporate governance such a development would have been unthinkable.

to have falsely reported earnings they may face steep jail sentences. What is more, to the subsequent great irritation of the management community, SOX requires CEOs to also assess and attest to internal controls (for small companies, the costs involved can be a significant deterrent to going public). To limit CEO's incentives to manipulate earnings, SOX also now requires CEOs to reimburse any contingent payments they received based on past overstated earnings. What is more, companies are now forbidden from extending loans to CEOs (repayable in company shares), thus banning a dubious practice that had taken extreme proportions in the case of Worldcom[260].

To further strengthen financial reporting SOX reduces the conflicts of interest in auditing that have arisen with the rapid growth in consulting activities by the major auditing firms. It has been argued that an important reason why Arthur Andersen has been so lax in monitoring Enron' s accounts is that by probing the firm's accounting practices too deeply it risked losing its most valuable consulting client. The SOX legislation targets this basic conflict with several new regulations. First, the auditor of a firm is strictly limited in its consulting activities for that firm. Second, the auditing firm is now selected by an audit committee entirely composed of independent directors instead of by the CFO. Third, the entire accounting profession is now regulated by a new body, the public chartered accountants oversight board, charged with monitoring the accounting firms. Fourth, to further reduce the risk of collusion between the auditor and firm, the lead accounting partner must rotate every five years[261]. Finally, SOX also requires greater disclosure of off-balance sheet transactions to reduce the risk of Enron-style accounting manipulation.

Another interesting provision that is aimed at reducing the risk of financial fraud is the greater protections given by SOX to whistle-blowers. Should they lose their jobs for exposing financial wrongdoing then SOX guarantees whistle-blowers' reinstatement, as well as back pay and legal fees. Unfortunately however, SOX requires that whistle-blowers file a complaint with the Occupational Safety and Health Administration (OSHA) a division of the Labor Department, which has little financial or accounting expertise and so far has dismissed most cases as frivolous complaints. Inevitably the OSHA' s extreme conservatism has quickly undermined the effectiveness of this important reform[262].

There are many interesting aspects of this new securities law that merit a deeper discussion than we can provide here: the political battles surrounding the passage of the law; what its effects have been; whether it is an adequate response to the types of abuses that have been uncovered by the corporate scandals; and whether its benefits in terms of strengthening the quality of financial reporting outweigh the greater compliance and auditing costs. Several recent contributions provide such an in depth analysis, among which Ribstein (2002), Gordon (2003), Romano (2004) and Skeel (2005).

[260] Bernie Ebbers received loans from Worldcom worth a staggering total of $400 million.
[261] The reforms stopped short of implementing more radical proposals requiring rotation of the entire auditing firm after a fixed period of time, as in Italy (every 9 years). Interestingly, it is the implementation of this rule that prompted Parmalat to do all its accounting manipulation off-shore, where it was allowed to continue to retain its old auditor. Had Italy required this rotation of auditors for all activities, including off-shore ones chances are that the Parmalat scandal would never have happened.
[262] See Deborah Solomon and Kara Scannell, "SEC Is Urged to Enforce 'Whistle-Blower' Provision", The Wall Street Journal, 15 November, 2004.

8.1.2 Other U.S. Reforms

Congress was not the only U.S. institution to pursue corporate governance reform. The New York Stock Exchange revised its listing rules and imposed de facto mandatory rules. It now requires, for example, that listed companies must have a majority of independent directors, with a tightened definition of independence. It also requires companies to have a nominating/corporate governance committee and a compensation committee composed entirely of independent directors.

The SEC also swung into motion and attempted to reform the proxy voting process, making shareholder voting more effective, in particular board elections.[263] This proposal met with considerable resistance from the corporate sector and has been defeated. The SEC's proposed reforms on board elections have also re-ignited a peripheral debate among U.S. legal scholars on the old question of the respective positions of federal regulations and state law (in particular the role of Delaware corporate law) in regulating corporate governance.[264] We discuss the core economic issues in this debate at greater length in section 3.

8.1.3 Eliot Spitzer and Conflicts of Interest on Wall Street

The Corporate Scandals of 2001 also led to investigations by Eliot Spitzer at the major Wall Street investment banks into possible conflicts of interest among "sell-side" analysts. It was alleged that these conflicts may have induced some leading analysts (most notoriously Henry Blodget and Jack Grubman) to produce misleading research and rosy earnings forecasts, and thereby participate in a vast peddling scheme of new equity deals underwritten by their firms. Spitzer quickly uncovered striking evidence of widespread tainted investment advice designed to support the placement of lucrative IPO's and mergers of client firms. At the same time a number of academic studies have appeared that report related evidence of, i) investment bank-affiliated analysts providing excessively optimistic recommendations (see in particular Hong and Kubik, 2003), ii) analysts' compensation being tied to profits generated at the underwriting arm of their firm (see, for example, Michaely and Womack, 1999) and, iii) of small unsophisticated investors being influenced more by the recommendations of analysts that have clear potential conflicts of interest than the more seasoned institutional investors (see Malmendier and Shantikumar, 2004).

Spitzer's investigations and law suits against the major Wall Street investment banks eventually gave rise to a major settlement in December 2002, whereby the investment banks agreed to set aside $450 million to finance independent research over a five year period and to pay fines amounting to $900 million. In addition, the settlement required stronger separation between in-house analysts and their bank's underwriting arm, as well as greater disclosure of their potential conflict of interest. Thus, for example, analysts are now prohibited from going on road shows to market new issues.

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[263] See Bebchuk (2003a,b)

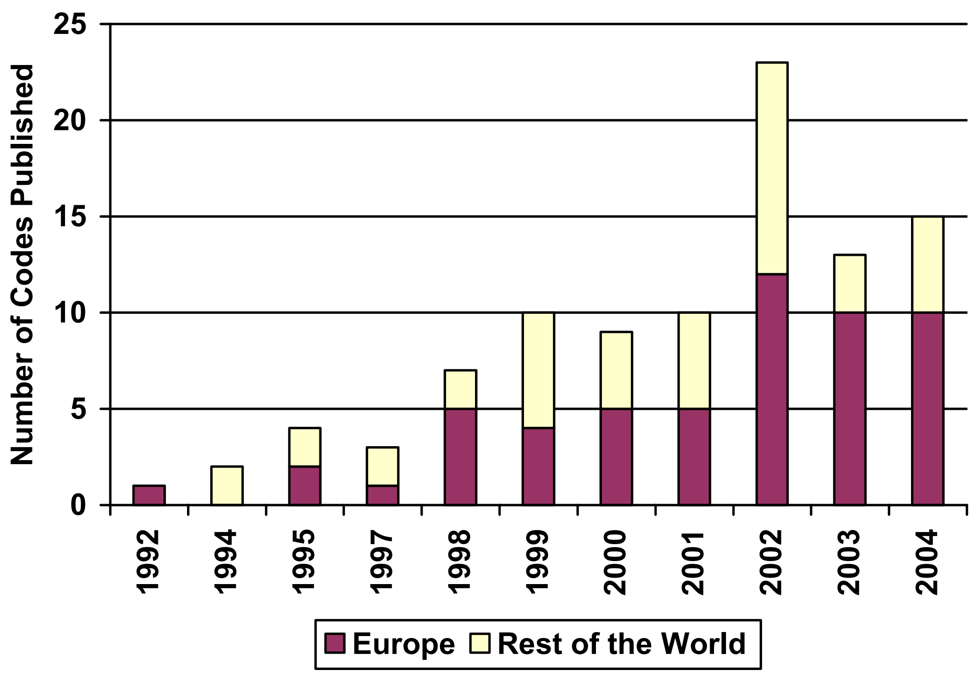
[264] Roe (2005) argues that the "federal response" (by Congress, the NYSE and the SEC) shows that there is no regulatory competition between U.S. states: Delaware has a monopoly and when Delaware law gets out of bounds, the Federal authorities step in. Romano (2005) argues that the U.S. corporate scandals cannot be attributed to shortcomings of Delaware law.

As striking as these reforms are, however, they stop way short of proposals that were hotly debated during the settlement negotiations, mainly, i) the branding of in-house research as "sales literature" and, ii) the establishment of completely independent research and advisory institutions to be financed collectively according to a pre-specified formula by the investment banking industry. Arguably, the reinforced "Chinese walls" that now separate analysts from their corporate finance colleagues can still be circumvented, so that the potential for a conflict of interest among sell-side analysts remains and could again give rise to rosy recommendations in the next IPO wave[265].

8.1.4 European Reforms

In Europe the response to the corporate scandals has been more restrained and has relied more on self regulation, corporate governance codes and the "comply or explain" principle. Codes play a bigger role in Europe than in the rest of the world and their adoption has increased substantially after the publication of the first set of OECD Principles (1999) and again after the collapse of Enron (see Figure 3). European corporate governance practice has also been affected to some extent by the extra-territorial reach of U.S. reforms and corporate efforts to harmonize standards with the United States, in particular for auditing.

Figure 3. Number of Corporate Governance Codes Published by Year



Source : ECGI Codes Database (www.ecgi.org/codes) and own calculations.

[265] See Randall Smith, "Regulators set accord with Securities Firms, But Some Issues Persist", Wall Street Journal, 23 Decmber 2003. See also, Bolton, Freixas and Shapiro (2005) for an analysis of the merits and drawbacks of fully independent research and advisory institutions.

8.2 *Executive Compensation and Earnings Manipulation*

Following the string of corporate scandals of 2001-2002, many commentators did not fail to notice that the executives of Enron, WorldCom, and the other failed corporations had been richly compensated almost all the way up to the failure of their companies. While there had been concerns about excesses in executive compensation and the insufficient sensitivity of CEO pay to performance prior to the corporate scandals, these concerns were largely muffled by the extraordinary rise in stock prices over the 1990s. However, when the technology bubble burst, the lofty rewards CEOs had been able to secure no longer seemed justified given the companies' subsequent dismal performance[266]. How could CEOs be paid so much when their stock-performance was so poor?

If executive compensation and stock options could no longer be rationalized straightforwardly as incentive-efficient pay, what were the true determinants of CEO pay? This question has received a lot of attention from corporate governance scholars in recent years and a number of competing explanations have been proposed. One hypothesis put forward by Bebchuk and Fried (2004) is that CEO pay is mainly driven by CEO power to extract rents and by failures in corporate governance. They argue that the most highly compensated CEOs have essentially been able to set their own pay through captured boards and remuneration committees. However, to camouflage the extent of their rent extraction activities CEOs have cloaked their pay packages in the guise of incentive efficient pay.

An alternative line put forward by Bolton, Scheinkman and Xiong (2003), Jensen (2004), and Jensen and Murphy (2004) links the excesses of CEO pay to the technology bubble of the 1990 and the excess emphasis over this period on short-term stock performance. Bolton, Scheinkman and Xiong (2003) expand the classical principal-agent framework of optimal incentive contracting to incorporate the possibility of stock price bubbles and characterize the optimal CEO compensation contract in this context. They find that when large differences of opinion among shareholders fuel a bubble, the optimal compensation contract induces a greater short-term CEO orientation and encourages actions that fuel speculation and short-term stock price performance at the expense of long-run firm fundamental value. This provides an explanation for why compensation committees and boards representing the interests of shareholders may have chosen to structure CEO pay in such a way that CEOs were able to profit early from a temporary speculative stock price surge.

Staying within the classical agency framework, Hermalin (2004) proposes yet another explanation. He points to the trend over the 1990s towards greater board independence, a higher proportion of externally recruited CEOs, a decrease in the average tenure of CEOs, and higher forced CEO turnover to suggest that these trends alone could explain why CEO pay has increased so much over this period. In a more competitive environment, with riskier and more demanding jobs, CEOs may simply have required better compensation.

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[266] In the summer of 2002 The Financial Times published a survey of the 25 largest financially distressed firms since January 2001 and found that top executives in these firms walked away with a total of $3.3 billion in compensation. In particular, Kenneth Lay, the CEO of Enron received total compensation of $247 million, Jeffrey Skilling, the former CEO and President of Enron received $89 million and Gary Winnick, the CEO of Global Crossing received $512 million in total cumulative compensation (see The Financial Times, July 31, 2002).

Several other explanations have been proposed, too numerous to survey comprehensively in this short update. We shall only discuss briefly another important line of research linking executive compensation with accounting and stock-price manipulation. Besides the major accounting frauds uncovered in the Enron, WorldCom and more recently the AIG scandals, it has been widely documented that the technology bubble has been accompanied by a substantial growth in earnings restatements. Thus, Levitt (2002) points out that while there were only 6 restatements in 1992 and 5 in 1993, there were over 700 restatements over the period of 1997 to 2000. In addition, a number of recent empirical studies have uncovered a positive statistical relation between stock-based compensation and earnings manipulation as measured by restatements,[267] discretionary accruals[268] and SEC accounting enforcement actions.[269] More generally, stock-based compensation also appears to have led to other forms of corporate malfeasance beyond just earnings manipulation. Indeed, one of the main findings of Peng and Röell (2004) is that there is a direct statistical link between CEO compensation and the incidence of securities class action lawsuit filings, over and above the indirect link through earnings manipulation.

8.3. Reforming the Board of Directors

The corporate scandals have also set off a raging debate on the role of the board of directors and its effectiveness in monitoring management. Many observers have pointed out that Enron had an exemplary board by the corporate governance standards of the day, with a larger than average number of independent directors and with greater incentive compensation for directors. Nevertheless, Enron's board clearly failed to protect Enron's shareholders.

At Worldcom the failures of the board were more obvious. Interestingly, in an effort to restore trust and to signal that the new company would have impeccable corporate governance standards, the bankruptcy court commissioned a study by Richard C. Breeden – former SEC chairman -- to recommend new rules for the board of directors and the compensation and audit committees. As a result, part of the bankruptcy-reorganization agreement for Worldcom has been to require the new company to emerge from chapter 11 (renamed MCI) to introduce a strengthened and more independent board as well as other corporate governance changes.

In his report, Breeden (2003) made several concrete proposals for reforming the board, which define a new benchmark for spotless corporate governance. Breeden recommends that all directors should be independent, that the chairman of the board should not be the CEO, that at least one new director be elected each year to the board, that shareholders be allowed to nominate their own candidates for election to the board (by allowing them to include their chosen candidates in the management's proxy statement), that the CEO be banned from sitting on other boards, that directors of MCI be banned from sitting on more than two other company boards, that board members be required to visit company facilities and meet with the CFO and General Counsel in the absence of the CEO, etc.

Needless to say, most publicly traded companies in the US today are far from living up to this standard. Perhaps the Breeden standard is just excessive, especially if the company already has gained the trust of its shareholders. But, it is less clear whether one of Breeden's proposals initially advocated by the SEC, to allow shareholders to include their own candidates for election

[267] Burns and Kedia (2003) and Richardson, Tuna and Wu (2003).
[268] Bergstresser and Philippon (2002), Gao and Shrieves (2002), Cheng and Warfield (2003) and Peng and Röell (2004).
[269] Johnson, Ryan and Tian (2003) and Erickson, Hanlon and Maydew (2004).

on the board in the management proxy statement, is excessive[270]. Some corporate governance scholars, in particular Bebchuk and Fried (2004), have strongly argued in favor of this reform. But the business community and other commentators generally perceive this to be a radical overly interventionist rule (see Symposium on Corporate Elections, 2003).

At the heart of this debate on board reform lies a fundamental unresolved economic question on the exact role of the board. Should the board of directors be seen as having only an (inevitably adversarial) monitoring role, or should directors also play an advisory role? And, even if the board's role is mainly one of oversight, will the board be able to effectively play this role if it has to rely on a CEO wary of the directors' response to disclose the relevant information about the company's operations? Beyond the role of the board there is also an unresolved question as to the exact role of the CEO. Is the CEO simply an agent for shareholders whose excesses need to be reigned in, or does he play a more important leadership role? If it is up to the CEO to determine and implement the overall strategy for the corporation then shouldn't one expect that even directors with the best intentions will defer to the CEOs judgment? All these questions have not received much attention prior to the corporate scandals and much more analysis and research is needed to be able to answer them conclusively and thus come to a determination of the appropriate policy towards boards.

8.4. *Other major research themes*

Besides the three issues we have touched on so far, several other themes have received a lot of attention since the publication of our survey. We briefly discuss the ones that have caught our attention in this section.

8.4.1 Corporate Governance and Serial Acquisitions

During the 1980s and early 1990s bidder shareholders did not gain much from corporate acquisitions but, on average, bidders did not overpay either. New evidence, however, shows that during the last takeover wave this was no longer true (see in particular Moeller *et al.*, 2005). Between 1998 and 2001 bidders incurred significant losses from acquisitions. This loss distribution is highly skewed, with only a few acquirers exhibiting very large abnormal returns in the days surrounding the announcement of the deal. The losses for acquirer shareholders were larger than the gains for target shareholders, so that on net corporate value was dissipated on a massive scale through the last merger wave. Many examples of poor acquisitions were driven by poor corporate governance at the acquiring firms. The anecdotal evidence on the major corporate governance scandals at least highlights how a corporate governance breakdown made it possible for management to engage in runaway acquisition programmes at WorldCom, Enron, Hollinger, Vivendi and Parmalat, among others.

8.4.2 Stock returns and corporate governance

As we have highlighted in our survey, the debate on how much value good governance can produce has been revived by the striking finding of Gompers, Ishii and Metrick (2003) that from 1990 to 1998 investors long on companies with good governance and short on companies with

[270] The SEC proposal was that instead of forcing shareholders, who want to propose a candidate for the board in opposition to the candidates nominated by management, to undertake a full-scale proxy fight, to facilitate the nomination through a two-step procedure. The first step being some event to be defined that forces the company to open the proxy to shareholder nominees, and the second step being a vote on candidates nominated by the shareholders.

bad governance (as measured by an index they construct) would have earned abnormal returns of 8.5% on average per year. Although the authors themselves cautioned about the interpretation of their findings many subsequent commentators were less careful and took their study to provide conclusive evidence of the link between good governance and high stock returns. As the recent study by Core, Guay and Rusticus (2005) shows, however, the interpretation that good stock performance is driven by good governance that most commentators have adopted is problematic. In particular, they find that although governance appears indeed to be related to profit performance, there is no evidence from analysts' forecasts and earnings announcements that the stock market was in any way surprised by firms' performance. As they argue, one cannot, therefore, attribute the differences in stock returns to market surprises about earnings performance.

8.4.3 Corporate Governance and Ownership Structure

Why is ownership of listed companies in the United Kingdom, the United States and Japan so much more dispersed than in other countries? We reviewed a broad range of hypotheses in our original survey and concluded that we could not distinguish them properly because the available ownership data was limited to recent cross-sections. Fortunately, data collection of long ownership time-series is starting to shed new light on this question. In two important recent studies Franks, Mayer and Rossi (2004, 2005) put together an ownership time-series for the United Kingdom and establish that ownership in the United Kingdom has dispersed very quickly once a company has been taken public or following mergers and acquisitions. They find, in particular, that rapid dispersion occurred and substantial amounts of external finance were raised even in the early 19^{th} century, at a time when corporate law gave very little protection to minority shareholders.

Other recent studies have revisited the link between ownership concentration and shareholder monitoring. Thus, Anderson and Reeb (2003) study the performance of family-controlled listed firms, which they point out represent a significant proportion of the largest listed companies even in the U.S. (18% of the S&P 500). They find that family firms consistently outperform their peers, as measured by both accounting yardsticks like return on assets and market-valuation measures such as Tobin's *q*. This above average performance can also be seen in the lower cost of debt financing for family-run firms (Anderson, Mansi and Reeb, 2003). This evidence thus provides strong support for the view that ownership concentration improves governance and performance at least for family owned firms.

8.4.4 Shareholder activism and Fund voting patterns

Since August 2004, a new SEC regulation requires U.S. mutual fund companies and registered investment management companies voting on behalf of investors to divulge how they have voted on proxy issues. The SEC data on fund voting patterns has recently become available, and it has been analyzed in two recent studies. Interestingly, Rothberg and Lilien (2005) have found that mutual funds almost always vote with management on operational issues and social or ethical issues, but they often vote against management on anti-takeover (34% vote against) and executive compensation (59%) issues. In addition, Stock pickers tend to vote against management less often than index funds, and in particular less often than big fund families, which abstain or vote against management 19% of the time. Davis and Kim (2005) focus more specifically on conflicts of interest arising from business ties between mutual funds and their corporate clients: many mutual fund companies derive substantial revenues from their involvement in corporate benefit plans. They find no sign that proxy voting depends on whether a firm is a client or not. However, in the aggregate, mutual fund families with heavy business ties are less likely to vote in favour of shareholder proposals opposed by management.

8.4.5 Corporate governance and the media

The watchdog role of the media is a very new area of inquiry that is starting to yield sketchy but tantalising insights.[271] Dyck and Zingales (2003a) point out that journalists, like analysts, are under pressure to accentuate the positive as a means of ensuring continued preferential access to company information sources. They measure media capture by the degree to which the presentation of material in company press releases – in particular, the emphasis on GAAP earnings versus unstandardized and possibly massaged "Street" earnings - is mirrored in press reports. They find that, in particular, non-WSJ coverage and that of less well researched firms (in terms of analyst following) is more likely to echo the company's "spin" in stressing "Street" earnings whenever the company's press release does so. There is an interesting cyclicality in spin. In the post-2000 downturn, even though company press releases emphasised Street earnings more, the press became more focused on GAAP; and Dyck and Zingales (2003b) also find that Harvard Business School case-writers rely more on independent sources during downturns. The authors attribute the cyclicality in spin to higher demand for news during stock market boom periods: if company news sources are in relatively fixed supply, they are able to exert more pressure on journalists during booms. This line of work is plausible but still somewhat speculative; we can expect it to be a growing area of research.

8.4.6 Corporate governance and taxes

Desai, Dyck and Zingales (2004) point out that government tax enforcement can play a useful role in deterring false disclosure and theft by company insiders. They find that the increased vigor of tax enforcement under Putin reduced control premia in Russia, especially in the extractive industries (oil, gas and minerals) that were targeted most by the stricter enforcement policies. Paradoxically, announcements of increased tax enforcement had a positive stock price impact, especially for companies that seemed to be diverting shareholder value and avoiding taxes the most by selling oil at suspiciously low prices. Conversely, poor corporate governance is found to hinder the collection of corporate tax revenue in cross-country comparisons.

9 Conclusion

Our earlier survey concluded by attempting to take stock of the voluminous research output on corporate governance over the past two decades. There is no need to repeat the same exercise again here even if some of our assessments and conclusions might well be different in light of the important events that have unfolded over the past three years and in light of the new research we have discussed. What is certainly apparent from our brief review of the most recent developments is that research on corporate governance has continued with ever greater intensity. Remarkably, despite this voluminous outpouring of research there is still enormous interest in the field and in the issues. However, although much ground has been covered some of the long-standing deepest questions are still poorly understood, such as the role of the state in the economy, how corporate governance should be approached in emerging market countries, the link between politics, sociology and governance, and why there is such a diversity of governance arrangements around the world. In this respect, the ambitious new book by Gourevitch and

[271] Sherman (2002) describes the surprising blindness of the financial press to obvious red flags in Enron's publicly available financial reports in the period before the scandal broke.

Shinn (2005), which takes on some of these core issues, may well show the way to a promising new area of research.

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