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CORPORATE GOVERNANCE AND CONTROL

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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.

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TABLE OF CONTENTS

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.

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 other constituencies can or ought to participate in corporate governance. We also review the comparative corporate governance literature.[1]

The favoured mechanism for resolving collective action problems among shareholders in most countries appears to be partial ownership and control concentration in the hands of

[1] 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).

large shareholders.[2] Two important costs of this form of governance have been emphasised: 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.[3] 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.[4] 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.

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.[5] The early corporate finance textbooks saw "representative government" (Mead 1922:31) as an important advantage

[2] 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.
[3] Black (1990) provides a detailed description of the various legal and regulatory limits on the exercise of power by large shareholders in the US. Wymeersch (2000) discusses legal impediments to large shareholder actions outside the US.
[4] Gilson and Kraakman (1991) provide analysis and an agenda for board reform in the US against the background of a declining market for corporate control and scattered institutional investor votes.
[5] 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".

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.[6] 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).[7]

In the U.S. this was followed by two distinct systems of "corporate feudalism": first, to the voting trusts[8] and holding companies[9] (Cushing 1915, Mead 1905, Liefmann 1909,

[6] 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 1998:18).

[7] 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).

[8] 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

20) originating in the "Gilded Age" (Twain and Warner 1873)[10] and later to the managerial corporation.[11] 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.[12] 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.[13]

Today corporate feudalism of the managerial variety in the U.S. 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 U.S.[14]

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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.

[9] 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 1905, pg. 44) and Rockefeller's Standard Oil in 1892 (Mead 1905, pg. 35).

[10] The "captains of industry" of this era, are also referred to as the "Robber Barons" (Josephson 1934, De Long 1998), were the target of an early anti-trust movement that culminated in the election of Woodrow Wilson as US 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 versus Mead 1922). 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 1932:82-83, cited in Galbraith 1967), another type of feudal lord.

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

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

[13] 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, 32) the point was argued in Lippmann (1914), Veblen (1923) Carver (1925), Ripley (1927) and Wormser (1931); see Hessen (1983).

[14] 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

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) 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" (1959, pg. 47). Similarly, Manne (1964) wrote, "vote selling […] negatives many of the criticisms often levelled at the public corporation" [1964, pg. 1445]. 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.[15] But, Dodd (1932) argued that: "[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" [Dodd 1932 pg. 1162]. 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.[16]

contradiction. The "corporate Jacksonians", as a prominent critic called them (Manning 1968:1489), are named after the 7th U.S.President (1829-37) who introduced universal male suffrage and organised the U.S.Democratic Party that has historically represented minorities, labour and progressive reformers (Encyclopaedia Britannica, *Jackson, Andrew; Democratic Party*).

[15] 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).

[16]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

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 SO PROMINENT TODAY

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 privatisation 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 U.S. scandals and corporate failures that built up but did not surface during the bull market of the late 1990s

3.1 The World-wide Privatisation wave

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

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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.

Inevitably, the privatisation wave has raised the issue of how the newly privatised corporations should be owned and controlled. In some countries, most notably the U.K., part of the agenda behind the massive privatisation program was to attempt to recreate a form of "shareholder democracy"[17] (see Biais and Perotti 2000). In other countries great care was given to ensure the transfer of control to large shareholders. The issues surrounding the choice of privatisation method rekindled interest in governance issues; indeed Shinn (2001) finds that the state's new role as a public shareholder in privatised corporations has been an important source of impetus for changes in corporate governance practices worldwide. In general, privatisations 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.

3.2 Pension Funds and Active Investors

The growth in defined contribution pension plans has channelled 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 U.S. 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 U.K. institutions are added. A significant proportion is held by pension funds (for U.S. and U.K. based funds, 35.1% and 40.1% of total assets

[17] 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

respectively). These funds are playing an increasingly active role in global corporate governance. In the U.S. ERISA[18] 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 reform of the pension systems in both countries and changing savings patterns, however, are likely to change this picture in the near future.[19]

3.3 Mergers and Takeovers

The hostile takeover wave in the U.S. 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 (BNP-Paribas; Elf Aquitaine for Total Fina) have spectacularly shaken up the sleepy corporate world of continental Europe. Interestingly, these deals involve newly privatised giants. It is also

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held company, having a direct interest and – theoretically – say in the affairs of the company.

18 ERISA stands for the Employee Retirement Income Security Act of 1974.

19 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 U.K., the U.S., 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

remarkable that they have not been opposed by the social 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 US and U.K. pension funds. This has inevitably contributed to the spread of an 'equity culture' outside the US and U.K..

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 centralised and hierarchical industrial groups controlled by management and large investors. There has been a similar reassessment of mass insider privatisation and its concomitant weak protection of small investors in Russia and other transition economies.

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the power to vote the equity in their portfolios and the sheer size of the numbers suggests that fund

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 U.S. 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.[20] 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.

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

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governance is a topic in its own right.

[20] 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).

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 (1984, 1985 and 1986).[21]

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.

[21] A slightly different, sometimes broader perspective, is to describe corporate governance as a multi-principal-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.

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 maximisation 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-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 maximisation 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.[22]

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 maximisation.

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 maximise 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 maximisation 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 U.K. and U.S. 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 favour of shareholder value maximisation in a world of incomplete contracts, first articulated by Oliver Williamson (1984, 1985), 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 open-ended 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 favour 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 labour-

[22] 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 -

managed 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 raised 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 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 minimising 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 minimise their cost of capital, labour and other inputs. It would also maximise 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)

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unanimously espoused by all claimholders - is profit (or value) maximization.

and Diamond (1989) have suggested.[23] 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.[24] 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.[25] Worse still, regulators can be captured by a given constituency and impose rules favouring 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 defences in an attempt to improve the terms of

[23] Interestingly, although reputation building is an obvious way to establish investor protection, this type of strategy has been somewhat under-emphasised 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 US corporations and institutional investors). For a recent survey of the disclosure literature, including voluntary disclosure by management, see Healy and Palepu (2001).

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

[25] 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 (1992)).

takeovers and they will thereby tend to limit hostile takeover activity excessively.[26] Alternatively, shareholders may favour takeovers that increase the value of their shares even if they involve greater losses for unprotected creditors or employees.[27]

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.[28] 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

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

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.[29] 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 organisations.

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:

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[28] 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.

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

[29] A fourth reason for the observed dispersion in shareholdings may be securities regulation designed to

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.[30] Second, the "business judgement" rule (and similar provisions in other countries) severely limits shareholders' ability to prevail in court.[31] Finally, 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 US. 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.[32]

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protect minority shareholders, which raises the cost of holding large blocks. This regulatory bias in U.S. corporate law has been highlighted by Black (1990), Roe (1990, 91, 94) and Bhide (1993).

[30] Most large U.S.corporations have taken out director and officer liability (D&O) insurance policies (see Danielson and Karpoff 2000). See Gutierrez (2000 a,b) for an analysis of fiduciary duties, liability and D&O insurance.

[31] The "director's 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 1986:124). The business judgement rule give 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 1986:123,138).

[32] See Fischel and Bradley (1986), Romano (1991) and Kraakman, Park and Shavell (1994) for an analysis of distortions of litigation incentives in shareholder suits.

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 analysing 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 (1999) who derive the degree of investor protection endogenously from a political equilibrium between 'rentier', management and employees.[70] 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.[71]

6 COMPARATIVE PERSPECTIVES AND DEBATES

As 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

[70] A second paper by Pagano and Volpin (2002) 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.

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[72]; projects with long implementation periods may require different solutions than projects with short horizons.[73] 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.[74]

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[71] 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.

[72] 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.

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

[74] For recent surveys of the comparative corporate governance literature see Roe (1998), Bratton and McCahery (1999) and Allen and Gale (1999).

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 market based 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.[75]

Japanese and German corporate governance looked good in the 1980s when Japan and Germany were growing faster than the U.S. In contrast, in the late 1990s, following nearly a decade of economic recession in Japan, a decade of costly post-unification economic adjustments in Germany, and an unprecedented economic and stock market boom in the U.S., 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 excesses on Nasdaq and the *Neuer Markt,* which have resulted in massive overinvestment in the technology sector, leading to some

[75] 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 long-term bank lending relations, share ownership concentration, stock market capitalisation 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 criticised for overemphasising, leaving out or misunderstanding elements of each country's system. Thus, for example, the declining importance of the market for corporate control in the U.S. has generally been overlooked, as well as the lower anti-director rights in Delaware (see Hansmann and Kraakman 2001). Similarly, bank influence in Germany has often been exaggerated (see Edwards and Fischer 1994, Hellwig 2000), or the importance of stock markets in Japan (La Porta *et al.* 2000).

of the largest bankruptcies in corporate history, often accompanied by corporate governance scandals.[76]

Critics of U.S. 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[77], 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 U.S. and the U.K. As a result, Japanese corporations had higher investment rates than their U.S. counterparts (Prowse 1990). Interestingly, a revisionist perspective gained prominence in the early 90s 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 U.S. gradually gained a lower cost of equity capital as the unprecedented bull market gained steam. This lower cost of equity capital in the U.S. 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 U.S. exchanges and why the *Neuer Markt* was booming (see Coffee 2000, La Porta *et al.* 2000). Similarly the Asian crisis has been attributed to poor investor protections (see Johnston *et al.* 2000; and Shinn and Gourevitch 2002 for the implications for U.S. policy to promote better governance worldwide). Exchanges that adopted NASDAQ-style IPO strategies and investor

[76] Enron is the landmark case, but there have been many smaller cases on *Neuer Markt* that have these characteristics.

[77] The cost of equity was significantly lower in Japan in the 1980s. This advantage has of course disappeared following the stock market crash.

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 U.S. (Shleifer and Summers 1980).[78]

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 (1992) and Stein (1988, 1989), among others, have argued that U.S. managers are myopically 'short-termist' and pay too much attention to potential takeover threats. Porter, in particular, contrasts U.S. 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 and Hoshi, Kashyap and Scharfstein 1990). This view has also been backed by critics in the U.S., 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 U.S. financial institutions and other large investors, leading these authors to call for larger and more active owners (see Roe 1990, 91, 94; Black 1990).[79]

In the 1990s the positive sides of Anglo-American corporate governance have gradually gained greater prominence. Hostile takeovers were no longer criticised for bringing about short-termist behaviour. They were instead hailed as an effective way to break up inefficient conglomerates (Shleifer and Vishny 1997).[80] 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 U.S. has essentially collapsed.[81] Indeed, following the wave of anti-takeover laws and charter amendments introduced at the end of the 1980s, most U.S. corporations are now extremely well protected against hostile takeovers.[82] Their control is generally no longer contestable.[83] In contrast, in the U.K. the City Code prevents post-bid action that might

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[78] As 'lean production' methods have successfully been implemented in the U.S., however, it has become clear that these methods do not depend fundamentally on the implementation of Japanese-style corporate governance (Sabel 1996).

[79] Interestingly, even the former chairman of the Securities and Exchange Commission argued against 'over-regulation' and 'short-termism' (Grundfest 1990) and for"investors' ability to monitor corporate performance and to control assets that they ultimately own", an ability that the U.S. regulatory systems has "subordinated to the interests of other constituencies, most notable corporate management" (Grundfest 1992:89-90). The call for more active (and larger) owners is also typical of US shareholder activists (see Monks and Minnow 2001).

[80] See Stein (2001) in this handbook for survey of the conglomerate literature.

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

[82] See Danielson and Karpoff (1998) for a detailed analysis of takeover defences in the U.S.. 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."

[83] 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, entitled "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

frustrate the bid and few companies have put in place pre-bid defences, thus making the U.K. the only OECD country with an active and open market for corporate control.[84]

An influential recent classification of corporate governance systems has been provided by La Porta *et al.* (1997, 98). 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).[85] In a series of papers the authors go on to show that legal origin correlates with the size of stock markets,[86] ownership concentration, the level of dividend payments[87], corporate valuation and other measures of the financial system across a large cross-section of countries (La Porta *et al.* 1997, 1999, 2000a, 2002).[88]

In the same vein the regulatory constraints in the U.S. that hamper intervention by large shareholders, previously criticised for giving too much discretion to management (*e.g.* by Roe 1990, 91, 94 , Black 1990 and Grundfest 1990), have been painted in a positive light as providing valuable protections to minority shareholders against expropriation or self-

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.

84 In the U.K. institutional investors have larger holdings and regulation allows them to jointly force companies to dismantle their pre-bid defences. For example, in the mid-1970s Lloyds Bank wanted to cap votes at 500 votes per shareholders, 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 privatisation.

85 The La Porta et. al. (1997, 98) indices do not cover securities regulation and have been widely criticised, 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 privatisations (opted for ownership dispersion), concluding that corporate finance drives changes in the index levels, not legal origin.

86 Rajan and Zingales (2001) show that the correlation of legal origin and the size of stock markets did not hold at the beginning of the century.

87 On corporate governance and payout policies see Allen and Michaely (2002).

88 La Porta et. al. (2000b) provide a summary of this view.

dealing by large shareholders, reversing the causality of the argument (see La Porta *et al.* 2000 and Bebchuk 1999, 2000).[89] 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.

Recently, some commentators have gone as far as predicting a world-wide convergence of corporate governance practice to the U.S. model (see e.g. Hansmann and Kraakman 2000).[90] In a variant of this view, world-wide competition to attract corporate headquarters and investment is seen like the corporate law competition between U.S. 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 U.S. SEC (see Coffee 1999).[91]

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

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

[90] Hansman and Kraakman (2000) 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 principle measure of the interests of the public corporation's shareholders is the market value of their shares in their firm." [2000, pg. 2-3] They contrast this "standard model" with the "manager oriented model", the "labour oriented model", the "state-oriented model" and the "stakeholder model".

[91] In Europe, The Netherlands now seems to be taking on Delaware's role.

because they eliminate partial bids "of a coercive character" (Kraakman and Hansman 2000:21). Others have also argued that the market for corporate control in the U.S. 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 U.S. governance "has reinvented itself, and the rest of the world seems to be following the same path".[92]

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 U.S. 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.[93] The most visible manifestations are corporate governance codes that have been adopted in most markets, except the U.S.[94]

6.2 Views Expressed in Corporate Governance Principles and Codes

Following the publication of the Cadbury Report and Recommendations (1992) in the U.K., there has been a proliferation of proposals by various committees and interest

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[92] Holmstrom and Kaplan (2001) emphasise that the lucrative stock option plans of the 90s have replaced the disciplinary role of hostile takeovers and debt (see compensation section). They also stress the role of activist boards and investors (*op. cit.*, pg. 140).
[93] Indeed, on takeover regulation many countries are explicitly rejecting the U.S.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".
[94] There are indications that, as a result of the Enron collapse, the U.S. too will join in this global development originating from other shores.

groups on corporate governance principles and codes.[95] These policy documents have been issued by institutional investors and their advisors, companies, stock exchanges, securities markets regulators, international organisations and lawmakers.[96] 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).[97]

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

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[95] 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).

In the U.K.Cadbury was followed by Greenbury (1995), Hampel (1997) and the "Combined Code". Other Commonwealth countries followed suit: Canada (1994), South Africa (1994), Thailand (1997), India (1998), Singapore (1998), Malaysia (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 Report (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 in 2002. The European Association of Securities Dealers was first to issue European Principles and Recommendations (2000), followed by Euroshareholders (2001). From the investor side, there have been statements from France (AFG-ASFFI 1998), Ireland (IAIM 1992), Germany (DSW 1998), the U.K. (PIRC 1993, 96, 99; 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 U.S., 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 U.S.case law.

[96] 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".

[97] 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 a,b) can be found on the codes pages of the European Corporate Governance Institute (www.ecgi.org).

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.[98] 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.[99] Interestingly, many of the most prominent concerns articulated in codes are not echoed or supported in current empirical 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, 98) criticises U.S. 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 U.S. governance

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[98] Gregory (2002) 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 a,b).

to look like (Black 2000).[100] 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 Fishel 1994). 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.[101] 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 & shareholder suits. Each of these approaches has been examined extensively and recent surveys have appeared on takeovers (Burkart, 1999),[102] the role of boards (Romano, 1998 and Hermalin and Weisbach, 2001), shareholder activism (Black, 1998; Gillan and Starks, 1998; Karpoff, 1998; and Romano, 2001), CEO compensation (Core, Guay and Larcker 2002; Bebchuk, Fried and Walker 2001; Gugler 2001; Perry and Zenner 2000; Loewenstein 2000; Abowd and Kaplan 1999; Murphy 1999) and large shareholders (Short 1994, Gugler 2001[103] and Holderness 2001).

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[99] Again, see Gregory (2002, 2000 a,b) for an extensive listing and comparisons.
[100] See Avilov *et al.* (1999) and Black (1996, 2000) in the context of emerging markets.
[101] An earlier general survey taking an agency perspective is Shleifer and Vishny (1997).
[102] Andrade, Mitchell and Stafford (2001) survey the stylised facts on takeovers and mergers in the U.S. 1973-98.
[103] 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.

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 (Svenjar 1981, Benelli *et al.* 1987; Baums and Frick 1998) and/or their samples and methodology are controversial (Gurdon and Rai 1990; FitzRoy and Kraft 1993).[251] 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 Schmidt 2000). 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 CONCLUSION

As the length of this survey indicates, there has been an explosion of research on corporate governance in the past two decades. Having taken the reader through this lengthy overview it is only fair that we attempt to draw the main lessons from this massive research effort and also try to determine the main areas of agreement and disagreement.

If there is one point on which most researchers and policy commentators agree today it is that corporate governance is a pillar of wealth creation and a fundamental aspect of corporate finance. As the Asian and Russian financial crises of 1997-98 or the recent collapse of the Enron corporation have dramatically highlighted, poor or corrupt corporate governance practices in banks and corporations can significantly worsen the depth of financial crises if not trigger them. It is now widely accepted that the textbook

[251] Frick *et al.* (1998), Gerum and Wagner (1998).

characterization of firms as profit maximizers subject to technological production constraints is a major oversimplification and that agency problems and corporate control issues are fundamental for corporate finance and the investment process. A major part of the story is left out by reducing securities to their cash-flow characteristics. Equity capital has valuable voting rights besides rights to residual cash flow and so does debt in the event of default. As we have highlighted, there are by now numerous empirical studies attempting to measure the value of these control rights by measuring block premia or voting rights premia in dual-class share structures.

Another general point of agreement is that dispersed ownership results in a "power vacuum" and gives rise to a managerial agency problem. Unless corporate executives are given appropriate financial incentives or are adequately monitored they will not just take actions that maximize the net present value of the firm. They will also make decisions that benefit them at the expense of the firm.

Executive stock options have become an increasingly popular and controversial form of financial incentive for CEOs in the past decade. It is widely recognized, however, that these options are at best an inefficient financial incentive and at worst create new incentive or conflict-of-interest problems of their own. The options are inefficient if they are not based on some relative performance measure such as the excess stock performance relative to an industry or market index. They create new incentive problems by inducing CEOs to manipulate earnings or "cook the books" in order to support stock prices. Finally, they create major conflict-of-interest problems when the CEO borrows from the firm to "purchase" his or her stock options.

It is also widely recognized that boards of directors are weak and ineffective monitors of managers. As we have highlighted, the empirical research on boards and independent directors has produced disappointing results. The New York Stock Exchange is proposing to remedy this glaring deficiency by both increasing the number of independent directors that are required to sit on a board and by tightening the definition of "independent". Under the proposed new rules an independent director should have no "material" relationship with the company. This is likely to be seen as a step in the right direction by most commentators.

Board weakness calls for additional mechanisms for monitoring management. We have discussed extensively the role of hostile takeovers, large shareholders, shareholder activism in the form of proxy fights and shareholder suits, or the role of banks, large creditors and employee supervisory committees. It is fair to say that there is much less consensus on the effectiveness and relative benefits of each of these mechanisms.

It is generally accepted that hostile takeovers are rare and increasingly so. They are a rather blunt instrument of corporate control. Generally widely held companies are shielded from hostile takeovers through anti-takeover defences (with the exception of the UK). It has been widely documented that the main beneficiaries of hostile takeovers are target company shareholders and the main losers acquiring company shareholders and target management. Also, the average combined value of the acquiring and target companies in hostile takeovers is not significantly different from zero. In other words, there is no robust evidence of net value creation in the average hostile takeover. Finally, existing evidence suggesting that threat of hostile takeovers has a disciplining effect on management is weak.

Another widely documented fact is that most companies around the world (except in the U.S., and to a lesser extent the U.K. and Japan) have at least one blockholder with concentrated voting power. Also, deviations from "one-share-one-vote" are commonly observed but there are major variations across countries. It is generally accepted that large shareholders tend to use their control rights to both monitor management and to divert resources disproportionately to themselves. To what extent large shareholders benefit the firm on net, however, is disputed. One complication is that there are large variations across countries. In countries where "self-dealing" by large shareholders is tightly regulated the net contribution of large shareholders is likely to be positive according to some observers. In countries where it is not, large shareholders are often seen as the source of the corporate governance problem rather than the solution. Empirical research on these issues is held back by the lack of reliable and systematic panel data on control rights around the world. No doubt more evidence will emerge as more data becomes available over time.

It is generally agreed that direct shareholder intervention is difficult and only modestly effective. Proxy fights challenging incumbent management are immensely difficult to win. Shareholder suits are similarly challenged in the absence of strong evidence of malfeasance; and empirical evidence, available for the U.S. only, shows that while the lawyers involved undoubtedly benefit, the gain to the shareholders they represent are less clear; moreover the disciplinary effects of shareholder legal action on managerial wealth and position are minimal, and the impact on alternative forms of monitoring is ambiguous. Meanwhile, empirical studies find the impact of shareholder activism by large pension funds to be minimal.

Regarding the role of banks and large creditors, there is an emerging consensus that they have an important role to play in corporate governance, but only if they are themselves well managed. The East Asia crisis of the late 1990s has demonstrated that bad corporate governance, as exemplified by cronyism and connected lending, can be a source of major corporate governance failures throughout the economy. Meanwhile, where banks are sound and well-managed, as for instance Germany, there is evidence of their effectiveness in disciplining management.

Turning now to open issues, one of the most hotly debated topics is the relative merit of market-based and bank-based systems of corporate governance. There is no evidence that the cost of capital is lower in the U.S. or the U.K. It is commonly argued that the Anglo-Saxon market-based setting provides a better environment for startups, new technologies and the redeployment of resources into new, more profitable lines of business, while bank-based systems are perhaps more suitable for effective management of existing technologies. No convincing evidence on these points is available.

Open questions also arise in the context of findings that better legal enforcement of minority shareholder rights is associated with greater reliance on stock market financing. How important is this finding for the availability of suitable financing? And which way does the causality run?

Very recently, problems associated with the growth in both levels of executive pay and CEO stock participation via option plans have come to the fore. It is not clear whether the intended effect on efficiency has outweighed the negative impact of self-serving behavior by unmonitored CEOs, whose ability to manipulate earnings creates a whole new set of incentive problems. Similarly the role of executive pay in encouraging excessive merger activity needs attention. Both theory and empirical research need to be brought into this general area.

Some neglected issues in corporate governance research have recently become focal points in the debate about the Enron collapse. The role of large auditing firms in corporate governance is under scrutiny, and better ways to manage the tradeoffs between toughness in auditing and generating consulting business are being discussed. Similarly, there are conflict of interest issues relating to Wall Street analysts whose firms are also involved in corporate financing. For both the accounting profession and the financial services industry, this raises underresearched issues such as the potential impact of excessive scope of activities concentrated on one firm, and the degree to which self-regulation is effective in limiting inappropriate behaviour.

There is also surprisingly little theoretical and empirical research on the role of boards, given that the codes of practice and other reform proposals formulated by practitioners focus mainly on this area. There is a need for theoretical or empirical work that gives insight into appropriate ways to enhance board effectiveness.

Lastly, progress is needed in modelling and measuring how different monitoring mechanisms interact: and in garnering non-U.S. evidence on the roles of shareholder suits and regulatory change.

Regarding policy issues, steps that could be taken in the U.S. include a reduction in the costs and risks of large investor intervention, the strengthening of boards and their independence, a possibly greater degree of employee representation, a re-evaluation of the trend towards greater anti-takeover protection, and facilitation of shareholder activism in general.

In Europe, there is again a battle to be fought against excessive arsenals of anti-takeover devices. Other policy measures that might be of benefit include measures to proscribe self-dealing by large shareholders in some countries, and the strengthening of boards. In many respects the U.K. model of regulation seems to be the most appealing, though it has not resolved the problems of institutional investor passivity and fund governance; even so, EU policy proposals have generally tended in the U.K. direction.

To conclude, corporate governance is concerned with the resolution of collective action problems among dispersed investors and the resolution of conflicts of interest between various corporate claimholders. In this survey we have reviewed the theoretical and empirical research on the main mechanisms of corporate control, discussed the main legal and regulatory institutions in different countries, and examined the comparative corporate governance literature. A fundamental dilemma of corporate governance emerges from this overview: regulating large shareholder intervention appears necessary, especially in Continental Europe, Asia and emerging markets; but limiting the power of large investors can also result in greater managerial discretion and scope for abuse. This is of particular concern in the U.S. as the recent corporate governance crisis has highlighted.