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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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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

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[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

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-

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[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

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[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:

[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.

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 U.S. and the U.K. it is relatively rarely used. In most other countries it is almost non-existent. 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 defences, such as super-majority amendments[33], staggered boards[34], fair price amendments (ruling out two-tier tender offers)[35], and poison pills[36] (see section 7.1.4 for a more detailed discussion). These defences 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, and Hirshleifer 1995). Even if one takes the latter perspective, however, Scharfstein's argument suggests that some of these defences should be regulated or banned.

[33] These amendments raise the majority rule above 50% in the event of an hostile takeover.
[34] 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.
[35] 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 U.S., but when they are not companies can ban them by writing an amendment into the corporate charter.
[36] 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 defences 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.

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.[37] Share ownership is completely dispersed; indeed to simplify the analysis they consider an idealised situation with an infinite number of shareholders. It is not difficult to see that a dominant strategy for each shareholder is to tender if $p \geq 1$ 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[38], or to allow raiders to build up a larger "toehold" before they are required to disclose their stake.[39]

[37] A conditional offer is one that binds only if the raider gains control by having more than a specified percentage of the shares tendered.
[38] 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 $p < 1$.
[39] A toehold is the stake owned by the raider before he makes a tender offer. In the U.S.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).

Following the publication of the Grossman and Hart article a large literature has developed analysing different variants of the takeover game, with non-atomistic share ownership (*e.g.* Kovenock, 1984, Bagnoli and Lipman, 1988, and Holmström and Nalebuff 1990), with multiple bidders (*e.g.* Fishman, 1988, Burkart, 1995 and Bulow, Huang and Klemperer 1999), with multiple rounds of bidding (Dewatripont, 1993), with arbitrageurs (*e.g.* Cornelli and Li, 1998), asymmetric information (*e.g.* Hirshleifer and Titman, 1990 and 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 (2000).

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).[40] 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, 1988b) 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 (1996) 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.

[40] A well-known exception to this listing rule was the Ford Motor Company, listed with a dual class stock capitalisation 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 post-takeover 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 maximises 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, and 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 behaviour" 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.[41] In other words, Bebchuk and Hart argue that the

[41] Bebchuk and Hart's conclusions rest critically on their view for why straight proxy fights are likely to be ineffective in practice in removing incumbent management. Alternative reasons have been given for 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 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 (1988), Gilson (2000) and Gilson and Schwartz (2001) have argued among others. Lipton and Rowe (2001) 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

presence of a poison pill requires 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) sceptical 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 scepticism 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 favour 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 behaviour 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 U.S. and U.K.– 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.

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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

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 subsidised to hold larger blocks. Indeed, the main problem in these models is to give greater incentives to monitor to the blockholder.

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

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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.

have the option to sell their stake instead.[42] 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 U.S. secondary markets that makes it difficult to provide incentives to large shareholders to monitor management.

This issue has been analysed 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 summarise, 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

[42] The idea that blockholders would rather sell their stake in mismanaged firms than try to fix the

does the monitoring and the large shareholder may only be necessary to act on the information produced by the market.[43]

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 (1999) and Aghion, Bolton and Tirole (2000). 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 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.[44] [45]

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

management problem is known as the "Wall Street rule" (see Black 1990).

[43] 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.

[44] See Bartlett (1994), Gompers and Lerner (1999), Levin (1995) and Kaplan and Stromberg (2000) for discussions of contractual provisions governing the venture capitalist's 'exit'. See also Berglof (1994) and Hellman (1997) for models of corporate governance of venture capital financed firms.

[45] Another form of complementarity is considered in a recent paper by Chidambaran and John (2000). 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

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 (1997). Thus, another reason for limiting a large shareholder's stake may be to prevent over-monitoring 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.[46]

There 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,

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institutional holdings are associated with larger stock option awards but lower compensation levels for CEOs (see Hartzell and Starks 2002).

[46] 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 block-holders. In such a setting he shows that one of the roles of a large block-holding is to fend off alliances of smaller block-holders 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.

Wolfenzon 1998, Bebchuk 1999 and Bebchuk, Kraakman and Trianis 2000).[47] Most of these commentators go as far as arguing that existing blockholder structures in continental Europe are in fact likely to be inefficient and that U.S.-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.[48] His general conclusion - that if self-dealing 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

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[47] 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 (2000).

[48] The issue of competition for control rents between a large shareholder and the CEO is analysed in Burkart and Panunzi (2000). 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.

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 and 1998b). 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[49] (as is the case in both the U.S and the U.K.) 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' mechanisms (like hostile takeovers). They let underlying

[49] Among U.S. 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).

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 defences are low and monitoring is costly). One implication of their analysis is that corporate governance in Europe and Japan may not converge to US 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.[50]

5.3 Delegated Monitoring and Large Creditors

One increasingly important issue relating to large shareholder 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 U.S.) 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

[50] 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 and 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).

managers themselves have no direct financial stake in the companies they invest in and therefore have no direct or adequate incentives for monitoring.[51]

The issue of institutional investor incentives to monitor has been analysed 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.[52] 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.[53] 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 Khan (1991) and Rajan and Diamond (2000) 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 maintained. In other words, bankers' incentives to monitor are preserved only if banks are disciplined by the threat of a bank run by depositors.[54]

[51] As Romano (1998) has argued and as the empirical evidence to date suggests (see Karpoff, 1998), U.S. institutional activism can be ineffective or misplaced.
[52] 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).
[53] See also Krasa and Villamil (1992) and Hellwig (2000) generalizations of Diamond's result.
[54] Pension fund managers' incentives to monitor are not backed with a similar disciplining threat. Despite mandatory requirements for activism (at least in the US) pension fund managers do not appear to have strong incentives to monitor managers (see Black 1990 for a discussion of US regulations governing pension funds' monitoring activities and their effects).

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 Gorton and Winton 2002 for an extended survey of these issues).[55]

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

[55] The moral hazard problem is exacerbated by bank manager's incentives to hide loan losses as Mitchell (1998) and Aghion, Bolton and Fries (1998) 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) debt-holders banks also have a bias towards liquidation of distressed lenders (see Zender, 1991 and Dewatripont and Tirole, 1994).

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 2001). 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 & 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 many commentators have argued, in firms with dispersed share ownership the board is more of a 'rubber-stamp 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 so-called 'independent' directors.[56] 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, and Mehran

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[56] 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.

1995; see Romano 1998, John and Senbet 1998, and Hermalin and Weisbach 2001 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 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 analysing 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.[57] 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.

Rajeha (2001) 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. Rajeha 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.[58]

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.

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

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.

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 U.S. 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 U.S. 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.[59] This process tends to result in an upward creep in pay standards. U.S. corporations set by far the highest levels of CEO compensation in the world. Although U.S. 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 analyse 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 (1975 1976), 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.

[59] 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

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 Murphy (1992) allows for both types of incentives.[60] 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 scheme 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." [61]

by potential candidates.

[60] 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.

[61] *New York Times*, 2/17/02.

All in all, while the extensive literature on agency theory provides a useful framework for analysing 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).[62]

As important as this issue is there is only a small formal literature on the subject. What is worse, this literature mostly considers highly stylised 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 stylised to address the issue of board representation.

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.

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 maximising. 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.[63] 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

[62] 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.

[63] The analysis of venture capital contracts in terms of contingent control allocations has been pursued and extended by Berglof (1994), Hellman (1997) and Neher (1999). More recently, Kaplan and Stromberg (1999) 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.

(1994), Berglof and Von Thadden (1994) and Aoki (1994a, 1994b). 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 and 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.

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, and Hart, 1995). The central issue in their theory is the so-called 'holdup' problem[64], which refers to the potential ex-post expropriation of unprotected returns from *ex ante* (specific)[65] 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.

[64] See Goldberg (1976) and Klein, Crawford and Alchian (1978) for an early informal definition and discussion of the holdup concept. See also Williamson (1975, 1979, 1985) for a discussion of the closely related concept of opportunism.

[65] 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.

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.[66]

Building on this property-rights theory, Roberts and Van den Steen (2000) and Bolton and Xu (1998) 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 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

[66] The property-rights theory also provides a useful analytical framework to assess the costs and benefits of privatisation of state-owned firms. Thus Hart, Shleifer and Vishny (1997) have argued that privatised 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 privatisation of prisons. Perhaps, a more apt application might have been to the privatisation of railways in the U.K.and the Netherlands, where quality of service has visibly deteriorated following privatisation. 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 also tends to interfere too much (that is the cost). 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 privatisation, 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.

highest possible share of profits as with inducing the highest possible creation of profits through human capital investments.[67]

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 unionisation. 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 unionisation 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 (2000). 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.

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

An extreme result highlighted by Roberts and Van den Steen (1999) 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.[68]

Hansmann (1996) and Hart and Moore (1996 and 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.[69] They compare these

[68] Bolton and Xu (1998) 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 (1998) for an analysis of when a shareholder-controlled firm wants to create internal competition among employees as an incentive scheme).

[69] 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 2000).

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 (1997), 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 and 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 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, or 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 US 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 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

[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-

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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

[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

[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.

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 and cash-flow rights.[104] 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.[105] 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

[104] In the U.S. control changes often require board approval. In countries like the U.K. the bidder bypasses the management *and* the board; the change of control decision is the sovereign right of the target shareholders.

[105] 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).

takeovers are isolated instances and their study has been largely confined to the U.S. and the U.K.

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 U.S. 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).[106] 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 U.S. deals (Schwert 2000).[107] Between 1990 and 1998 only 4% of all U.S. deals were hostile at some stage and hostile bidders acquired 2.6% of the targets (Andrade, Mitchell and Stafford 2001).[108] The paucity of hostile deals is also evident outside the U.S.; 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 U.S. takeover targets are smaller than other companies, but otherwise they do not differ significantly from their peers (Comment and Schwert 1995).[109] The targets of hostile bids are likely to be larger than other targets.[110] Indicators

[106] The causes of such cycles in takeover activity are many, and their relative importance is an open issue. The 1980s U.S. 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.
[107] Other characteristics of U.S. 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).
[108] 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 4,300 completed deals on the CRSP tapes, covering all U.S.firms on the NYSE, AMEX and Nasdaq between 1973-1998.
[109] Comment and Schwert (1995) estimate the probability of a successful takeover as a function of anti-takeover devices, abnormal returns, sales growth, the ration of net-liquid assets to total assets, debt/equity ratios, maket/book ratios, price/earnings ratios and total assets (size) for 1977-91. They report that the

of poor target management contribute little or are not significant (Schwert 2000).[111] The available evidence for the U.K. also fails to show that the targets of successful hostile bids had poorer pre-bid performance than other targets (Franks and Mayer 1996).[112]

Hostile takeover activity in the U.S. 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 U.S. corporations without target board consent (see 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.

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results for hostile takeovers do not differ significantly (pg. 34). We discuss the anti-takeover device evidence below.

[110] This is consistent with the view that bids in the U.S.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.

[111] 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." (pg 2624).

[112] Franks and Mayer (1996) cover the period 1980 to 1986 and consider the pre-bid evolution of share prices (abnormal returns), dividend payouts, cash-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.

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 (V_{AB}) should be larger than the value of the bidder (V_A) and the target (V_B) separately, or $\Delta V \equiv [V_{AB} - V_A - V_B] > 0$. Generally, the change in value (ΔV) is taken to be the difference between the stand-alone 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 U.S. acquisitions (Andrade *et al.* 2001) and higher premia for hostile takeovers (Schwert 2000, Franks and Mayer 1996)[113]. In all U.S. acquisitions the gain for bidder shareholders[114] and the overall gain are indistinguishable from zero (Andrade *et al.* 2001).[115] Although suggestive, the event study evidence cannot conclusively determine whether these premia arose from the correction of an inefficiency or whether they simply constitute transfers away from bidding shareholders or other constituencies (see Burkart (1999) for an extensive discussion of this issue).[116]

113 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 U.S.. Franks and Mayer (1996) report premia of 30% for successful hostile and 18% for accepted bids in the U.K..

114 Most U.S.bidders are not individuals, or tightly controlled bidding vehicles, but widely held companies under management control (Shleifer and Vishny 1988).

115 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%).

116 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).

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 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 defences[117]

As we have seen there are theoretical arguments for and against takeover defences. 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 U.S. Before turning to this evidence, we review the availability, mechanics and incidence of different defence mechanisms.

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

Numerous pre-bid and post-bid defences are at the disposal of target companies in most jurisdictions. Pre-bid defences 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.[118] The most potent pre-bid defences require shareholder approval. However, some important defences which can be introduced without shareholder approval include control clauses and cross-shareholdings in Europe, poison pills in the U.S.[119] 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 U.S. (Danielson and Karpoff 1998, Rosenbaum 2000) but less systematically in Europe and Asia.[120] In the U.S., 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 abnormal returns. On balance, the results support the view that

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[118] The list of possible post-bid defences is much longer and includes litigation, white knights, greenmail and the pac-man defence.
[119] European Counsel M&A Handbook 2000, pg. 26-43. See Weston , Siu and Johnson (2001) for a detailed explanation of U.S. anti-takeover measures.
[120] Danielson and Karpoff (1998) provide a detailed analysis of the adoption of anti-takeover measure 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 defences similar to

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 board section) receive premia that are 23% higher than for targets with more captive boards (Cotter, Shivdasani and Zenner 1996), 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 United States 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.[121] 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.

U.S.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 large investor section.

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

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.[122] Shares with different voting rights often trade at different prices and the resulting premia (discounts) have been related to takeover models (see theory section) 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.[123] In addition, relative prices are affected by differences in taxation, index inclusion, dividend rights and/or stock market liquidity.

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 U.S.[124] 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

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

[123] 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 U.S.. Nenova (2000) attempts to control for these factors across countries using quantitative measures of the legal environment, takeover regulation, takeover defences and the cost of holding a control block in a cross-section regression, treating the control variables as exogenous.

[124] Canada 8-13%, Jog and Riding (1986), Robinson, Rumsey and White (1990), Smith and Amaoako-Adu (1995); France, mean 1986-1996 51.4%, Muus (1998); Germany, mean 1988-1997 26.3%, in 2000 50%, Hoffmann-Burchardi (1999, 2000); 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); U.K. 13.3%, Megginson (1990); U.S., 5.4% Lease *et al.* (1983), mean 1984-90 10.5%, median 3% Zingales (1997); see also DeAngelo and DeAngelo (1985) for the US. Lease *et al.* (1985) analyse the value of control in closely held corporations with dual class shares.

interpreted with caution. While premia have been rising from 20% in mid-1998 to 54% in December 1999 in Germany (Hoffmann-Burchardi 2000), 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[125], and in Denmark from 30% to 2% (Bechmann and Raaballe 2000). In Norway the differential was actually negative in 1990-93, 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 U.S.; Nicodano and Sembenelli 2000 for Italy; Böhmer 2000 for Germany; Dyck and Zingales 2002 for 412 control transactions in 39 countries).[126] Control Premia vary between –4% and 65% (Dyck and Zingales 2002).[127]

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

[125] Personal communication from Kristian Rydqvist.
[126] 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.
[127] 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

takeover defences. The net effect of the adoption of takeover defences on target stock market value is slightly negative, suggesting that the entrenchment effect is somewhat larger than the bargaining effect.[128] 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 1996).

Despite the widespread interest in hostile takeovers, the available empirical evidence is surprisingly sketchy. Although hostile takeovers are no longer confined to the U.S. and the U.K., 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 unfavourable 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

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mandatory bid threshold are considered. This imposes serious limits on the comparability of the results across countries.

corporate charters. For example, some countries' corporate law prescribes discrete control thresholds that give a blocking minority veto power over major decisions.[129] In Germany employees appoint 50% of the board members in large corporations (Prigge 1998). In the U.K. 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.[130] 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.[131] In the U.S. shareholders cannot initiate fundamental transactions like mergers, and boards are broadly shielded from direct shareholder influence (Hansman and Kraakman 2001). In contrast, shareholder proposals can force mergers or charter amendments if they receive a majority in the U.K., Japan or France.[132] Ratification rights,

[128] 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).

[129] 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.

[130] A 30%+ blockholder cannot appoint more than 5 out of 12 directors (Wymeersch 2000). In the U.K.the distribution of blockholdings in listed companies tapers off abruptly at 30% (Goergen and Renneboog 2001).

[131] Initiation rights differ across the U.S., depending on the state and, within any one state, the company bylaws (Clark 1986:105). Initiation rights are always strong in the the U.K., 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.

[132] In some unlisted companies shareholders exert direct control of the company through voting, for example in Germany and France (Hansman and Kraakman 2001).

on the other hand, are strikingly similar in most jurisdictions. 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 the theory section, with the exception of the U.S. some form of concentration of ownership and/or voting control is the most common corporate governance arrangement in OECD and developing countries.[133] 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 by Warshow (1924). His study records an astonishing 250% increase in the

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

number of shareholders between 1900 and 1923.[134] 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 U.S. corporations in 1929 no large investors were found, leading to the conclusion that "control is maintained in large measure separate from ownership" (Means 1931, Berle and Means 1932).[135] This hypothesis has become received wisdom for corporations in the U.S. (Larner 1966, 70[136]; Herman 1981; La Porta *et al.* 1999), but also for the U.K. (Florence 1947, 53, 61; Leech and Leahy 1991; La Porta *et al.* 1999), although other studies found that blockholders had never disappeared entirely in the U.S. (Temporary National Economic Committee 1940[137]; Eisenberg 1976, Demsetz and Lehn 1985, Holderness and Sheehan 1988) and the U.K..[138] The latest research confirms that blocks are indeed rare in the U.S. (Edwards and Hubbard 2000; Becht 2001), but in the U.K. 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).

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134 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) pp. 198 for a survey of these and other classic studies using the Warshow method.

135 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 "½ a company" was assigned to each category (pg. 109). Berle and Means (1932) used the same definition.

136 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".

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

138 Florence (1961) reported that the median holding of the largest 20 holders in large U.K.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, 76) observation that it was possible for bidders to bypass family controlled boards only as late as the 1950s. See Cheffins (2000) for a survey.

Means's method (see footnote 135) for measuring shareholder concentration has been criticised and extended by numerous authors, for example by Gordon (1940)[139], Florence (1947)[140] and Eisenberg (1976). One particular source of measurement error is due to disclosure rules[141]. 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 a the percentage of shares held by these shareholders, of 48.5% (51.1% in 1975; Hoshi and Kashyap 2001:252). Inevitably, much research has been undertaken on the U.S. and the U.K. 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.[142] Fortunately for researchers, modern securities regulation has begun to overcome this problem, at least in Europe.[143]

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[139] 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, pg. 24, footnote 20).

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

[141] 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 (1991:1421). 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.

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

[143] In the U.S. 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.

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 management when required (see Manne 1966 and Bolton and von Thadden 1998). 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.[144] Dynamic measures of concentration based on power indices can address some of these issues[145] but they have been considered in only a few studies (Leech 1987[146], Holderness and Sheehan 1988 and Nicodano and Sembenelli 2000).[147]

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

[144] 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.
[145] They do not take into account statutory anti-takeover devices.
[146] 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 87b), the TNEC data (Leech 1987c) and 470 U.K.listed companies between 1983-85 (Leech and Leahy 1991).

control dummy.[148] 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 U.K. (Radice 1971, Steer and Cable 1978, Cosh and Hughes 1989, Leech and Leahy 1991),[149] profitability is higher with family control in France (Jacquemin and de Ghellinck 1978).[150]

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 hump-shaped relationship between concentrated ownership and market capitalization.[151] Outside ownership merely shifts the locus. Morck, Shleifer and Vishny (1988) find some evidence of such a relationship. Similarly, 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 U.K.[152]

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[147] 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).
[148] See above.
[149] Holl (1975) found no significant difference between owner and manager controlled firms.
[150] See Gugler (2001) for further details.
[151] Corporate value first increases as more concentrated insider ownership aligns incentives, but eventually decreases as the probability of hostile takeovers declines.
[152] They find a maximum at 15.6% insider ownership and a minimum at 41.9%.

The third generation continues to test the Stulz hypothesis but vastly improves the econometrics, showing reverse causation.[153] Using instrumental variable and panel techniques the studies find corporate performance causing managerial ownership (Kole 1996, Cho 1998) or both determined by similar variables (Himmelberg, Hubbard and Palia 1999). 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.[154]

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.[155] They find no effects for European countries (Faccio and Lang 2001) and a negative effect of large investors in Asia (Claessens *et al.* 1999).[156] 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.[157] It seems inevitable that a fifth generation study will emerge that addresses the econometric problems of the fourth generation.

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[153] Typical econometric shortcomings of 1st and 2nd generation ownership-performance studies are reverse causality (endogeneity), sample selection, missing variables and measurement in variables. For example, Andersen and Lee (1996) show that many 2nd 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.

[154] 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.

[155] 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.

[156] 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.

[157] La Porta et.al. (1999) perform a number of bivariate comparisons of Means-Larner control groups for a larger set of variables.

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 U.S.).

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[158]

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.[159]

Within this narrow view there is an empirical consensus that bank-industry ties in the U.S. were strong at the beginning of the century but became weak through anti-trust regulation and the Glass-Steagall act[160], were never strong in the U.K. but always strong in Germany[161] and Japan (Hoshi and Kashyap 2001). A popular explanation for these patterns has been the different regulatory history in these countries (Roe 1994).[162]

The empirical literature has documented that equity holdings by banks are not very common[163], but the presence of bankers on boards and their involvement in interlocking directorates is common.[164] Based on these empirical measures the literature has compared

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[158] For a more general review of banks and financial intermediation see Gorton and Winton (2002).
[159] This approach has a long tradition, for example Jeidels (1905) for Germany and the Pujo Committee (1914) for the U.S..
[160] See, for example, Carosso (1970, 73, 85), 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 (1996) the impact of the Act itself.
[161] Edwards and Fischer (1994), Edwards and Ogilvie (1996) and Guinnanne (2001) argue that bank influence and involvement in Germany is, and has been, very limited.
[162] The regulatory explanation of (low) bank involvement in industry is convincing for the U.S., but less so for other countries. In the U.K. 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.
[163] In Germany banks hold many but not the largest blocks (Becht and Böhmer 2002). 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).
[164] Interlocking directorates started to become common in Germany towards the end of the 19th century (Fohlin 1999). 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 1998:959 for further references). Most of the links were created by representatives of banks and insurance companies (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 2000). In the U.S. 31.6% of the Forbes 500 companies in 1992 had a banker on board, but only 5.8% of the main main bank lenders had

the performance of companies under "bank influence" to other companies, with mixed results.[165] 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, 39)[166], a view that has been challenged recently.[167]

Relationship banking[168] is a broader concept that emphasises 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 1998:4)[169]. 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[170],depending on the country and sample.[171] Relationships last longer when the

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board seats. Lenders are discouraged from appointing directors because of concerns about conflicts of interest and liability during financial distress (Kroszner and Strahan 2000).

[165] For surveys of this evidence see Prigge (1998:1020) for Germany, Gugler (2001) and Section 7.2for 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 (2000).

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

[167] Within the traditional view Fohlin (1999) shows that the contribution of Italian and German banks to mobilising capital was limited. Da Rin and Hellmann (2001) argue that banks helped to overcome coordination failures and played the role of "catalysts" in industrial development.

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

[169] "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 2001) 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 U.S..

[170] 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 (Onega and Smith 1998), but only 7.8 years in Belgium (Degryse and Van Cayseele 1998) and 7 years in the U.S. (Cole 1998). In a German sample that is more comparable to the U.S.samples the mean duration is only 12 years (Harhoff and Körting 1998); see Onega and Smith (2000), Table 2 for further references.

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

relationship is exclusive (Onega and Smith 2001). Most firms have multiple banking relationships.[172]

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 1989, Best and Zhang 1993, Billet, Flannery and Garfinkel 1995).[173] The stock price reaction to loan commitments is also positive, in particular with usage fees (Shockley and Thakor 1998). Acquisitions financed by bank loans are associated with positive bidder announcement returns, in particular when information asymmetries are important (Bharadwaj and Shivdasani 2002). 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 U.S. 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

[172] 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 U.S.; see Onega and Smith (2000), Table 3 for further details and references.
[173] The evidence is mixed for new loans; see Onega and Smith (2000), Table 1.

(Mulherin and Poulsen 1998:287).[174] This timing is no coincidence; 43% of these proxy fights were accompanied by a hostile takeover bid (Mulherin and Poulsen 1998:289).[175] Proxy fights are usually brought by minority shareholders with substantial holdings (median stake 9.1%).[176] In other countries with dispersed shareholdings (see section 7.2.1), such as the U.K, proxy fights are very rare.[177] The latest evidence suggests that 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).[178]

7.3.2 Shareholder Activism[179]

After the decline in hostile takeovers in the U.S. 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).[180] 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 board section), the adoption of confidential voting and limits on excessive

[174] 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).
[175] In the full sample 23% of the firms involved in contest were acquired.
[176] 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 (1998:289).
[177] 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-tinto-shareholders.com/).
[178] 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).
[179] The empirical evidence on shareholder activism in the United States has been surveyed by Black (1998); Gillan and Starks (1998); Karpoff (1998); and Romano (2001).
[180] As we reported in the facts section, this development is closely related to the size of pension funds in the U.S., the largest in the OECD.

executive compensation (see compensation section). There is anecdotal evidence that activism is also on the rise in other countries, focusing on similar issues.[181]

In the United States, the filing of ordinary shareholder proposals[182] 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 U.S. 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 U.S. is surprisingly large and there are no less than four literature surveys (Black 1998; Gillan and Starks 1998; Karpoff 1998 and 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[183] and other factors.[184] In contrast, Romano (2001:21) argues that shareholder activism in the U.S. 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.

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[181] 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).
[182] In the U.S. 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 favour of the proposal the board is not oblidged to implement the resolution.
[183] Initially (Black 1992) argued that shareholder activism could overcome (regulation induced) shareholder passivity in the U.S.
[184] In the U.K.there are fewer regulatory barriers than in the U.S., but there are other reasons why institutional investors are reluctant to exercise voice, for example "imperfect information, limited

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 minimising 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.[185] In the U.S., trustees of 401(k) plans are appointed by the corporation, raising conflict of interest issues laid bare in the recent collapse of Enron.[186]

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.[187] In the U.S. 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.[188] The incidence of shareholder suits in the U.S. 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

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institutional capabilities, substantial coordination costs, the misaligned incentives of money managers, a preference for liquidity, and uncertain benefits of intervention" (Black and Coffee 1994).

[185] See Myners (2001) for a recent policy report on pension fund management and governance in the U.K. His survey of U.K.pension fund trustees revealed that they received one day of training prior to taking up their job.

[186] Conflicts of interest and outright looting of pension fund assets were at the bottom of the collapse of the Maxwell media empire in the U.K.in 1992; Bower (1992) and Greenslade (1992).

[187] 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.

[188] 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, pp. 196).

the suits (Romano 1991).[189] 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 U.S. covers the period 1960-87 (Romano 1991)[190]. 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.[191] 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.[192] 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.[193] Suits both help and hinder other types of monitoring. For example, blockholders are likely to get sued[194] 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.

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189 For more recent descriptive statistics on class action see Bajaj *et al.* (2000).
190 Unfortunately the study has not been updated (Romano, personal communication).
191 The recovery in derivative suits is only half as large as in direct (class) action.
192 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 1991:67).
193 Compensation packages are unchanged and settlement fees are met by special insurance policies taken out by the company.
194 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[195]

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.[196] 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.[197] 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.[198] Informally, both types of board can be more or less "captured" by management or dominated by blockholders.[199] To avoid the problem of capture by such interests, corporate governance recommendations emphasise 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.[200]

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

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[195] Recent surveys on the role of boards include Romano (1996), Bhagat and Black (1999) and Hermalin and Weisbach (2001).
[196] 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 fulfil its objectives.
[197] 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.
[198] Most countries have either one or the other system, but in France companies can choose.
[199] 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.

substantially (see the large investor section). The board appoints the managers. In some countries boards have a formal duty vis-à-vis the employees of the company or, as in Germany, employees have the right to appoint directors. In the U.S. statutes that require boards to take into account the interests of non-shareholder constituencies are commonly portrayed as “anti-takeover rules” (Romano 1990).[201]

7.4.2 Board Independence

There a few formal models of boards (see theory section) 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.

To measure the degree of board independence, several criteria have been proposed.[202] Is the chief executive officer the chairman of the board? What is the proportion of independent 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 U.S. suggests that board composition and corporate performance are “not related” (Hermalin and Weisbach 2001), the relationship is “uncertain” (Bhagat and Black 1999) or is “at best ambiguous” (Romano 1998).

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[200] 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.
[201] See Hansmann and Kraakman (2001) for a comprehensive discussion of the role of boards in a comparative perspective.
[202] Motivated by casual observation some studies have also investigated whether board size is related to performance.

7.4.3 Board Composition

Most of these studies are subject to the econometric criticisms we highlighted in the large investor section. 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 devise a quantitative measure of the way a board is run on the inside. [203] 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.

[203] 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.

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 U.K. where a number of studies have broadly confirmed the findings for the U.S. (Franks, Mayer and Renneboog 2001).

7.5 Executive Compensation and Careers[204]

7.5.1 Background and descriptive statistics

Executive compensation in the U.S. 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.[205] Compensation consultants estimate that for a typical U.S. CEO the basic compensation package alone is higher than total package in Germany, Spain, Sweden and Switzerland, and not much lower than in France or Japan (Figure 2).[206] In contrast, the total compensation of other management is similar across OECD countries and higher in Italy than in the US (Abowd and Kaplan 1999). The differential remains large when data are adjusted for company size.

Executive contracts are supposed to provide explicit and implicit incentives that align the interests of managers with those of shareholders, as discussed in the theory section. The

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

[205] Total compensation for the average US CEOs increased from $1,770,000 in 1993 to $3,747,000 in 1997 (in 1992 CPI-deflated dollars). The value of options in this package rose from $615,000 to $1,914,000 and bonuses from $332,000 to $623,000; Perry and Zenner (2001:461), Table 1.

[206] 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.

bulk of the empirical literature has focused on sensitivity of pay[207] (explicit incentives) and the dismissal of executives (implicit incentive) to corporate performance.[208] High levels of pay were justified with the extraordinary gains in wealth shareholders reaped through most of the 90s and incentive pay was characterised as one of the drivers behind the high market valuation of US corporations (Kaplan and Holmström 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.

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 U.S. was too low (see Baker *et al.* 1988, Jensen and Murphy 1990).[209] 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 U.S. 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 normalised 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.[210] The probability of dismissal remained unchanged between 1970 and 1995 (Murphy 1999).[211]

[207] See Rosen (1992) for an early survey of this literature.
[208] 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).
[209] The point was also emphasized in an early survey by Jensen and Zimmerman (1985).
[210] Baker and Hall (1998) 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 gain or loss was $10-11 per $1000 (unadjusted) (Perry and Zenner 2000; Hall and Liebman

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 annualised percentage increase in mean wealth for CEOs has been 11.5% for the period between 1982 and 94 (Hall and Lieberman 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 U.S. level. In the U.K. 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 U.S. (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)[212]. 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. 2002:33-36, Bebchuk, Fried and Walker 2001:51-66, Abowd and Kaplan 1999, Murphy 1999).[213]

2000). For an executive holding stock and options worth $20,000,000, a 10% change in stock prices implies a $2,000,000 change in wealth.

[211] Among S&P 500 firms average CEO turnover rates for low performers were 15% on and 11% from the 25th performance percentile upwards (Murphy 1998).

[212] See Murphy (1999:2535) for additional references.

[213] 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

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 2001:69).

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).[214]

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 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 1999) or anti-takeover amendments (Borokhovich, Brunarski and Parrino 1997) (see takeover section) provide more incentive pay to compensate for less discipline from hostile takeovers, while in the U.K. takeover threats are higher while incentive pay and the level of pay are lower than in the U.S. (Conyon and Murphy 2000).

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companies, the ability of managers to get back to absolute performance plans with appropriate financial instruments, but not a single one is very satisfactory.

[214] 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).

However, there are inconsistencies. Companies in industries with more disciplining takeovers should pay less, while in fact they pay more (Agrawal and Walking 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.[215]

7.5.4 Are managers paying themselves too much?

Few direct tests of the rival 'self-serving manager' explanation of US 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 1997).

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. In 2000 almost 99% of the plans proposed at major U.S. corporations have received shareholder approval (IRRC 2000). However, the average percentage of votes cast against stock-option plans has increased from under 4% in 1988 to about 18% in 1995-1999 (IRRC 2000) and there is rising concern about exemptions for "broadly based plans"[216], potential dilution of voting rights[217], broker voting[218], option repricing,

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[215] Bebchuk, Fried and Walker (2001) 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.

[216] Stock option plans that do not need shareholder approval if they benefit more than a certain proportion of non-officer employees; in July 2000 only 52 of 1157 plans in S&P 1500 companies had not been approved by shareholders (IRRC 2001).

[217] 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.

[218] 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 2000).

payments in restricted stock, loans for share purchases, "evergreen plans"[219] 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).[220] These results are not strong direct evidence support for the self-serving manager hypothesis, but they can be re-interpreted as yet another failure of shareholder monitoring in the US.

In parallel with the takeover literature, yet another approach for distinguishing between self-serving and efficient behaviour brings in board composition and the power of the CEO vis-à-vis the board. Outside and independent directors on the board or on remuneration committees are thought to be (more) resistant to awarding self-serving compensation packages. In contrast, CEOs who are also the chairman of the board ("duality") are thought to lean more towards self-dealing. In the U.S., most corporations have a compensation committee comprising outside directors.[221] As a direct result of the Cadbury (1992) and Greenbury (1995) reports[222], U.K. issuers have remuneration committees[223] and in 1994 already they were 91% staffed with outside directors. Similarly, during 1991-94 the proportion of U.K. boards with "duality" fell from 52% to 36% (Conyon and Peck 1998). Both developments are also gaining ground in continental Europe.[224] So far, empirical studies have failed to detect that institutions and reforms have any impact on pay structure. In the U.S. committees staffed with directors close to management do not grant unusually generous compensation packages (Daily *et al.* 1998).

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[219] 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 (Martin and Thomas 2000:62).
[220] The AFL-CIO has recently opened a Website campaigning against "runaway pay" in the U.S. see (http://www.paywatch.org).
[221] If not US tax law compensation is not tax deductible for executives mentioned in the proxy statement (Murphy 1998).
[222] Committee on the Financial Aspects of Corporate Governance (1992) and Study Group on Directors' Remuneration (1995).
[223] See Conyon and Mallin (1997).

In the U.K. in 1991-94, the proportion of non-executive directors serving on boards and duality had no effect on compensation structure (Conyon and Peck 1998).[225] CEOs monitored by a board with interlocking directors get more pay (Hallock 1997).[226]

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 U.S., 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).[227]

Most explicit and implicit incentives are written into CEO contracts that, under U.S.Federal Law, must be disclosed but had not been collected until recently (Minnow 2000). Preliminary analysis reveals that contracts range from "short and to the point" (Minnow 2000) to guaranteed benefits and perks of epic proportions.[228] Implicit benefits include severance pay for dismissal without "cause"[229] or in case of changes in control

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[224] See http://www.cgcodes.org for reports on the implementation of the pertinent governance recommendations in continental Europe.
[225] We are not aware of a direct test that exploits the time series variation of the U.K.reforms.
[226] Fich and White (2001) investigate the determinants of interlocks.
[227] Many corporate governance codes oppose the appointment of CEOs to their own boards after retirement.
[228] 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 (Minnow 2000).
[229] The definition of cause is often stringent, for example "felony, fraud, embezzlement, gross negligence, or moral turpitude" (Minnow 2000).

(acquisition of 15, 20 or 51% of the voting shares).[230] 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 90s, 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 2001), increasingly prevails. We know relatively less about pay practices in other countries, but attempts to implement U.S. practices are controversial, as the long-standing debate in the U.K.[231] and recent rows in France[232] show. The institutional investor community is drawing its own conclusions and has tabled global guidelines on executive pay[233], 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 the theory section we focus on the role and impact of the debtholder and employee constituencies in a comparative corporate governance perspective.

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[230] The latter, once again, weakens the potential monitoring role of blockholders in the U.S.
[231] 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.
[232] Pierre Tran and David Teather, *Vivendi shareholders turn on Messier*, The Guardian; April 25, 2002
[233] 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).

7.6.1 Debtholders

Many aspects of the role of debtholders in corporate governance are addressed in the empirical financial contracting literature.[234] 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 takeovers section).

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 theory section).

Is debt a commitment device for liquidation after poor performance? As usual, the role of debtholders differs appreciably between countries. For example, in the U.S. insolvency law is "softer" than in the U.K.[235], and judges are more lenient (Franks and Sussman 2001). Furthermore, regulation in the U.S. is subject to political intervention and lobbying, which further weakens the usefulness of debt as a commitment device (Berglof and Rosental 1999, Franks and Sussman 2001, Krozner 1999).[236] Basic statistics lend support to this view. In the U.S. the rate of deviation from absolute priority rules is 77-78%[237] but it is close to zero in the U.K. (Franks and Sussman 2001).[238]

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[234] For a comprehensive earlier survey see Harris and Raviv (1992).

[235] Under Chapter 11 of the 1978 Bankruptcy Code the debtor is allowed to stay in control and try to raise new cash. In the U.K. 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 1997).

[236] 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 U.K.and Germany).

[237] For example Franks and Torous (1989).

[238] Note that these basic statistics are methodologically problematic. The U.S.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 U.S.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.

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.[239] Consistent with the theory they find that the financial constituencies[240] have control and liquidation rights that are contingent on performance and that control shifts between constituencies, again depending on performance (Kaplan and Strömberg 2000).

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[241] (two-tier boards), Denmark, Sweden, Luxembourg and France[242] (one-tier board). Companies operating in two or more member states of the European Union must have a "European Works Council".[243] Voluntary codetermination can be found in Finland and Switzerland (Wymeersch 1998).

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[239] Sahlman (1990), Black and Gilson (1998), Kaplan and Strömberg (2000).

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

[241] 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 labour because the shareholders and the employees can challenge appointment in a specialised Court (Wymeersch 1998:1146).

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

[243] 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 1,000 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.

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 were such institutions are known to exist, such as Germany.

German codetermination provides for mandatory representation of employees on the supervisory board of corporations[244] with three levels of intensity: full parity for coal, iron and steel companies (since 1951)[245], quasi-parity for other companies with more than 2000 employees (since 1976)[246] and 1/3 parity for those with 500-2000 employees (since 1994).[247] 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[248] 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[249] (Gerum *et al.* 1988), a clear violation of the recommendations in most corporate governance codes (see section 6.2).[250]

[244] See Hopt (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.
[245] 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.
[246] The chairman is chosen by the shareholder representatives and has a casting vote.
[247] Between 1952-1994 this regime applied to all corporations, and still does for corporations registered before 1994.
[248] For example by delegating sensitive tasks to shareholder dominated committees or allowing the shareholder appointed Chairman to add items to the agenda at will.
[249] The catalogue of decisions is long and includes mergers and acquisitions, patents and major contracts.
[250] 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.

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.

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Tables

Table 1. Financial Assets of Institutional Investors in OECD Countries

	Value Assets Billion U.S.$ 1990	Value Assets Billion U.S.$ 1996	Asset growth 1990-96	% Total OECD Assets 1996	Assets as % GDP 1990	Assets as % GDP 1996	% Pension Funds 1996	% Insurance Companies 1996	% Invest. Companies 1996	% of Assets in Equity 1996	% OECD Equity 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.

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[252]							
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[253]							
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

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

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

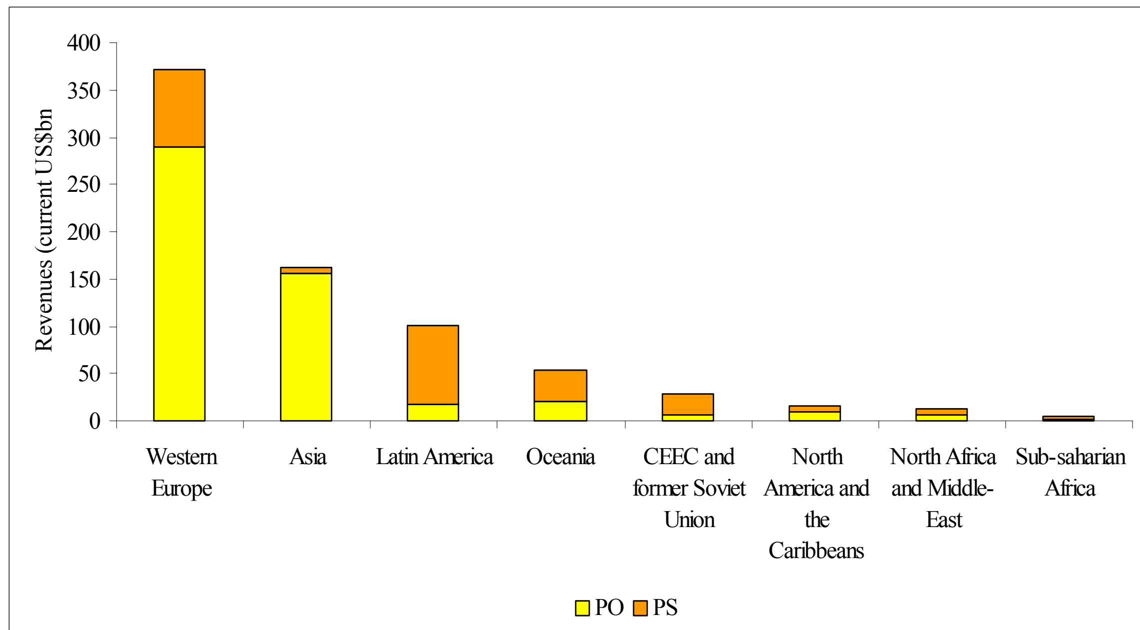
	Mid-1999	
State Anti-Takeover Laws		
	Number	% of states
States with Anti-Takeover Laws	42	82.4
featuring		
Control Share Acquisition Laws	27	52.9
Fair Price Laws	27	52.9
2-5 Year Freeze-Out Laws	33	64.7
Cash-Out Laws	3	5.9
Profit Recapture	2	3.9
Severance/Pay Labor Contract Provisions	5	9.8
Greenmail 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 : Virginia K. Rosenbaum (2000), Corporate Takeover Defenses, Washington D.C. : IRRC; IRRC (2000), State Takeover Laws, Washington D.C. : IRRC

Note : classification taken from Danielson and Karpoff (1998)

FIGURES

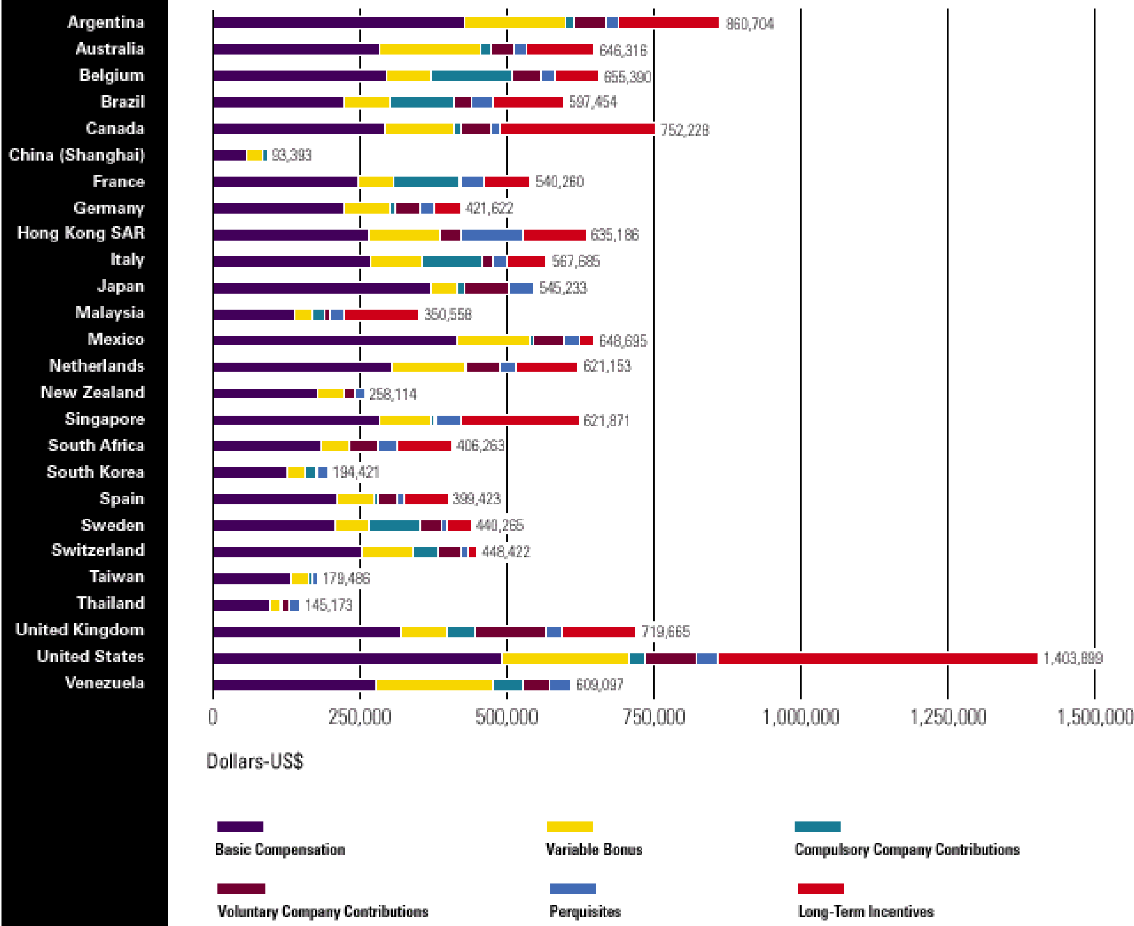
Figure 1. Privatisation Revenues by Region 1977-97



Source : Bortolotti, Fantini, Siniscalco (2001)

Note : PO – Public Offerings; PS – Private Sales

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.