PART I

An Economic Overview of Corporate Institutions

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Corporate Governance

In 1932, Berle and Means wrote a pathbreaking book documenting the separation of ownership and control in the United States. They showed that shareholder dispersion creates substantial managerial discretion, which can be abused. This was the starting point for the subsequent academic thinking on corporate governance and corporate finance. Subsequently, a number of corporate problems around the world have reinforced the perception that managers are unwatched. Most observers are now seriously concerned that the best managers may not be selected, and that managers, once selected, are not accountable.

Thus, the premise behind modern corporate finance in general and this book in particular is that corporate insiders need not act in the best interests of the providers of the funds. This chapter's first task is therefore to document the divergence of interests through both empirical regularities and anecdotes. As we will see, moral hazard comes in many guises, from low effort to private benefits, from inefficient investments to accounting and market value manipulations, all of which will later be reflected in the book's theoretical construct.

Two broad routes can be taken to alleviate insider moral hazard. First, insiders' incentives may be partly aligned with the investors' interests through the use of performance-based incentive schemes. Second, insiders may be monitored by the current shareholders (or on their behalf by the board or a large shareholder), by potential shareholders (acquirers, raiders), or by debtholders. Such monitoring induces interventions in management ranging from mere interference in decision making to the threat of employment termination as part of a shareholder- or board-initiated move or of a bankruptcy process. We document the nature of these two routes, which play a prominent role throughout the book.

Chapter 1 is organized as follows. Section 1.1 sets the stage by emphasizing the importance of managerial accountability. Section 1.2 reviews various instruments and factors that help align managerial incentives with those of the firm: monetary compensation, implicit incentives, monitoring, and product-market competition. Sections 1.3–1.6 analyze monitoring by boards of directors, large shareholders, raiders, and banks, respectively. Section 1.7 discusses differences in corporate governance systems. Section 1.8 and the supplementary section conclude the chapter by a discussion of the objective of the firm, namely, whom managers should be accountable to, and tries to shed light on the long-standing debate between the proponents of the stakeholder society and those of shareholder-value maximization.

1.1 Introduction: The Separation of Ownership and Control

The governance of corporations has attracted much attention in the past decade. Increased media coverage has turned "transparency," "managerial accountability," "corporate governance failures," "weak boards of directors," "hostile takeovers," "protection of minority shareholders," and "investor activism" into household phrases. As severe agency problems continued to impair corporate performance both in companies with strong managers and dispersed shareholders (as is frequent in Anglo-Saxon countries) and those with a controlling shareholder and minority shareholders (typical of the European corporate landscape), repeated calls have been issued on both sides of the Atlantic for corporate governance reforms. In the 1990s, study groups (such as the Cadbury and Greenbury committees in the United Kingdom and the Viénot committee in

France) and institutional investors (such as CalPERS in the United States) started enunciating codes of best practice for boards of directors. More recently, various laws and reports[1] came in reaction to the many corporate scandals of the late 1990s and early 2000s (e.g., Seat, Banesto, Metallgesellschaft, Suez, ABB, Swissair, Vivendi in Europe, Dynergy, Qwest, Enron, WorldCom, Global Crossing, and Tyco in the United States).

But what is corporate governance?[2] The dominant view in economics, articulated, for example, in Shleifer and Vishny's (1997) and Becht et al.'s (2002) surveys on the topic, is that corporate governance relates to the "ways in which the suppliers of finance to corporations assure themselves of getting a return on their investment." Relatedly, it is preoccupied with the ways in which a corporation's insiders can credibly commit to return funds to outside investors and can thereby attract external financing. This definition is, of course, narrow. Many politicians, managers, consultants, and academics object to the economists' narrow view of corporate governance as being preoccupied solely with investor returns; they argue that other "stakeholders," such as employees, communities, suppliers, or customers, also have a vested interest in how the firm is run, and that these stakeholders' concerns should somehow be internalized as well.[3] Section 1.8 will return to the debate about the stakeholder society, but we should indicate right away that the content of this book reflects the agenda of the narrow and orthodox view described in the above citation. The rest of Section 1.1 is therefore written from the perspective of shareholder value.

1. In the United States, for example, the 2002 Sarbanes–Oxley Act, and the U.S. Securities and Exchange Commission's and the Financial Accounting Standards Board's reports.

2. We focus here on corporations. Separate governance issues arise in associations (see Hansmann 1996; Glaeser and Shleifer 2001; Hart and Moore 1989, 1996; Kremer 1997; Levin and Tadelis 2005) and government agencies (see Wilson 1989; Tirole 1994; Dewatripont et al. 1999a,b).

3. A prominent exponent of this view in France is Albert (1991). To some extent, the German legislation mandating codetermination (in particular, the Codetermination Act of 1976, which requires that supervisory boards of firms with over 2,000 employees be made up of an equal number of representatives of employees and shareholders, with the chairperson—a representative of the shareholders—deciding in the case of a stalemate) reflects this desire that firms internalize the welfare of their employees.

1.1.1 Moral Hazard Comes in Many Guises

There are various ways in which management may not act in the firm's (understand: its owners') best interest. For convenience, we divide these into four categories, but the reader should keep in mind that all are fundamentally part of the same problem, generically labeled by economists as "moral hazard."

(a) *Insufficient effort.* By "insufficient effort," we refer not so much to the number of hours spent in the office (indeed, most top executives work very long hours), but rather to the allocation of work time to various tasks. Managers may find it unpleasant or inconvenient to cut costs by switching to a less costly supplier, by reallocating the workforce, or by taking a tougher stance in wage negotiations (Bertrand and Mullainathan 1999).[4] They may devote insufficient effort to the oversight of their subordinates; scandals in the 1990s involving large losses inflicted by traders or derivative specialists subject to insufficient internal control (Metallgesellschaft, Procter & Gamble, Barings) are good cases in point. Lastly, managers may allocate too little time to the task they have been hired for because they overcommit themselves with competing activities (boards of directors, political involvement, investments in other ventures, and more generally activities not or little related to managing the firm).

(b) *Extravagant investments.* There is ample evidence, both direct and indirect, that some managers engage in pet projects and build empires to the detriment of shareholders. A standard illustration, provided by Jensen (1988), is the heavy exploration spending of oil industry managers in the late 1970s during a period of high real rates of interest, increased exploration costs, and reduction in expected future oil price increases, and in which buying oil on Wall Street was much cheaper than obtaining it by drilling holes in the ground. Oil industry managers also invested some of their large amount of cash into noncore industries. Relatedly, economists have long conducted event studies to analyze the reaction of stock prices to the announcement

4. Using antitakeover laws passed in a number of states in the United States in the 1980s and firm-level data, Bertrand and Mullainathan find evidence that the enactment of such a law raises wages by 1–2%.

of acquisitions and have often unveiled substantial shareholder concerns with such moves (see Shleifer and Vishny 1997; see also Andrade et al. (2001) for a more recent assessment of the long-term acquisition performance of the acquirer–target pair). And Blanchard et al. (1994) show how firms that earn windfall cash awards in court do not return the cash to investors and spend it inefficiently.

(c) *Entrenchment strategies.* Top executives often take actions that hurt shareholders in order to keep or secure their position. There are many entrenchment strategies. First, managers sometimes invest in lines of activities that make them indispensable (Shleifer and Vishny 1989); for example, they invest in a declining industry or old-fashioned technology that they are good at running. Second, they manipulate performance measures so as to "look good" when their position might be threatened. For example, they may use "creative" accounting techniques to mask their company's deteriorating condition. Relatedly, they may engage in excessive or insufficient risk taking. They may be excessively conservative when their performance is satisfactory, as they do not want to run the risk of their performance falling below the level that would trigger a board reaction, a takeover, or a proxy fight. Conversely, it is a common attitude of managers "in trouble," that is, managers whose current performance is unsatisfactory and are desperate to offer good news to the firm's owners, to take excessive risk and thus "gamble for resurrection." Third, managers routinely resist hostile takeovers, as these threaten their long-term positions. In some cases, they succeed in defeating tender offers that would have been very attractive to shareholders, or they go out of their way to find a "white knight" or conclude a sweet nonaggression pact with the raider. Managers also lobby for a legal environment that limits shareholder activism and, in Europe as well as in some Asian countries such as Japan, design complex cross-ownership and holding structures with double voting rights for a few privileged shares that make it hard for outsiders to gain control.

(d) *Self-dealing.* Lastly, managers may increase their private benefits from running the firm by engaging in a wide variety of self-dealing behaviors, ranging from benign to outright illegal activities. Managers may consume perks[5] (costly private jets,[6] plush offices, private boxes at sports events, country club memberships, celebrities on payroll, hunting and fishing lodges, extravagant entertainment expenses, expensive art); pick their successor among their friends or at least like-minded individuals who will not criticize or cast a shadow on their past management; select a costly supplier on friendship or kinship grounds; or finance political parties of their liking. Self-dealing can also reach illegality as in the case of thievery (Robert Maxwell stealing from the employees' pension fund, managers engaging in transactions such as below-market-price asset sales with affiliated firms owned by themselves, their families, or their friends),[7] or of insider trading or information leakages to Wall Street analysts or other investors.

Needless to say, recent corporate scandals have focused more on self-dealing, which is somewhat easier to discover and especially demonstrate than insufficient effort, extravagant investments, or entrenchment strategies.

1.1.2 Dysfunctional Corporate Governance

The overall significance of moral hazard is largely understated by the mere observation of managerial misbehavior, which forms the "tip of the iceberg." The submerged part of the iceberg is the institutional response in terms of corporate governance, finance, and managerial incentive contracts. Yet, it is worth reviewing some of the recent controversies regarding dysfunctional governance; we take the United States as our primary illustration, but the universality of the issues bears emphasizing. Several forms of dysfunctional governance have been pointed out:

Lack of transparency. Investors and other stakeholders are sometimes imperfectly informed about

5. Perks figure prominently among sources of agency costs in Jensen and Meckling's (1976) early contribution.

6. Personal aircraft use is one of the most often described perks in the business literature. A famous example is RJR Nabisco's fleet of 10 aircraft with 36 company pilots, to which the chief executive officer (CEO) Ross Johnson's friends and dog had access (Burrough and Helyar 1990).

7. Another case in point is the Tyco scandal (2002). The CEO and close collaborators are assessed to have stolen over $100 million.

the levels of compensation granted to top management. A case in point is the retirement package of Jack Welch, chief executive officer (CEO) of General Electric.[8] Unbeknownst to outsiders, this retirement package included continued access to private jets, a luxurious apartment in Manhattan, memberships of exclusive clubs, access to restaurants, and so forth.[9]

The limited transparency of managerial stock options (in the United States their cost for the company can legally be assessed at zero) is also a topic of intense controversy.[10] To build investor trust, some companies (starting with, for example, Boeing, Amazon.com, and Coca-Cola) but not all have recently chosen to voluntarily report stock options as expenses.

Perks[11] are also often outside the reach of investor control. Interestingly, Yermack (2004a) finds that a firm's stock price falls by an abnormal 2% when firms first disclose that their CEO has been awarded the aircraft perk.[12] Furthermore, firms that allow personal aircraft use by the CEO underperform the market by about 4%. Another common form of perks comes from recruiting practices; in many European countries, CEOs hire family and friends for important positions; this practice is also common in the United States.[13]

Level. The total compensation packages (salary plus bonus plus long-term compensation) of top executives has risen substantially over the years and reached levels that are hardly fathomable to the public.[14] The trend toward higher managerial compensation in Europe, which started with lower levels of compensation, has been even more dramatic.

Evidence for this "runaway compensation" is provided by Hall and Liebman (1998), who report a tripling (in real terms) of average CEO compensation between 1980 and 1994 for large U.S. corporations,[15] and by Hall and Murphy (2002), who point at a further doubling between 1994 and 2001. In 2000, the annual income of the average CEO of a large U.S. firm was 531 times the average wage of workers in the company (as opposed to 42 times in 1982).[16]

The proponents of high levels of compensation point out that some of this increase comes in the form of performance-related pay: top managers receive more and more bonuses and especially stock options,[17] which, with some caveats that we discuss later, have incentive benefits.

Tenuous link between performance and compensation. High levels of compensation are particularly distressing when they are not related to performance, that is, when top managers receive large amounts of money for a lackluster or even disastrous outcome (Bebchuk and Fried 2003, 2004). While executive compensation will be studied in more detail in Section 1.2, let us here list the reasons why the link between performance and compensation may be tenuous.

First, the compensation package may be poorly structured. For example, the performance of an oil company is substantially affected by the world price of oil, a variable over which it has little control. Suppose that managerial bonuses and stock options are not indexed to the price of oil. Then the managers can make enormous amounts of money when the price of oil increases. By contrast, they lose little from the lack of indexation when the price of oil

8. Jack Welch was CEO of General Electric from 1981 to 2001. The package was discovered only during divorce proceedings in 2002.

9. Similarly, Bernie Ebbers, WorldCom's CEO borrowed over $1 billion from banks such as Citigroup and Bank of America against his shares of WorldCom (which went bankrupt in 2001) and used it to buy a ranch in British Columbia, 460,000 acres of U.S. forest, two luxury yachts, and so forth.

10. In the United States grants of stock options are disclosed in footnotes to the financial statements. By the mid 1990s, the U.S. Congress had already prevented the Financial Accounting Standards Board from forcing firms to expense managerial stock options.

11. Such as Steve Jobs's purchase of a $90 million private jet.

12. As Yermack stresses, this may be due to learning either that corporate governance is weak or that management has undesirable characteristics (lack of integrity, taste for not working hard, etc.). See Rajan and Wulf (2005) for a somewhat different view of perks as enhancing managerial productivity.

13. Retail store Dillard's CEO succeeded in getting four of his children onto the board of directors; Gap's CEO hired his brother to redesign shops and his wife as consultant. Contrast this with Apria Healthcare: in 2002, less than 24 hours after learning that the CEO had hired his wife, the board of directors fired both.

14. For example, in 1997, twenty U.S. CEOs had yearly compensation packages over $25 million. The CEO of Traveler's group received $230 million and that of Coca-Cola $111 million. James Crowe, who was not even CEO of WorldCom, received $69 million (*Business Week*, April 20, 1998).

15. Equity-based compensation rose from 20 to 50% of total compensation during that period.

16. *A New Era in Governance*, McKinsey Quarterly, 2004.

17. For example, in 1979, only 8% of British firms gave bonuses to managers; more that three-quarters did in 1994. The share of performance-based rewards for British senior managers jumped from 10 to 40% from 1989 to 1994 (*The Economist*, January 29, 1994, p. 69).

plummets, since their options and bonuses are then "out-of-the money" (such compensation starts when performance—stock price or yearly profit—exceeds some threshold), not to mention the fact that the options may be repriced so as to reincentivize executives. Thus, managers often benefit from poor design in their compensation schemes.

Second, managers often seem to manage to maintain their compensation stable or even have it increased despite poor performance. In 2002, for example, the CEOs of AOL Time Warner, Intel, and Safeway made a lot of money despite a bad year. Similarly, Qwest's board of directors awarded $88 million to its CEO despite an abysmal performance in 2001.

Third, managers may succeed in "getting out on time" (either unbeknownst to the board, which did not see, or did not want to see, the accounting manipulations or the impending bad news, or with the cooperation of the board). Global Crossing's managers sold shares for $735 million. Tenet Health Care's CEO in January 2002 announced sensational earnings prospects and sold shares for an amount of $111 million; a year later, the share price had fallen by 60%. Similarly, Oracle's CEO (Larry Ellison) made $706 million by selling his stock options in January 2001 just before announcing a fall in income forecasts. Unsurprisingly, many reform proposals have argued in favor of a higher degree of vesting of managerial shares, forcing top management to keep shares for a long time (perhaps until well after the end of their employment),[18] and of an independent compensation committee at the board of directors.

Finally, managers receive large golden parachutes[19] for leaving the firm. These golden parachutes are often granted in the wake of poor performance (a major cause of CEO firing!). These high golden parachutes have been common for a long time in the United States, and have recently made their way to Europe (witness the $89 million golden parachute granted to ABB's CEO).

The Sarbanes–Oxley Act (2002) in the United States, a regulatory reaction to the previously mentioned abuses, requires the CEO and chief financial officer (CFO) to reimburse any profit from bonuses or stock sales during the year following a financial report that is subsequently restated because of "misconduct." This piece of legislation also makes the shares held by executives less liquid by bringing down the lag in the report of sales of executive shares from ten days to two days.[20]

Accounting manipulations. We have already alluded to the manipulations that inflate company performance. Some of those manipulations are actually legal while others are not. Also, they may require cooperation from investors, trading partners, analysts, or accountants. Among the many facets of the Enron scandal[21] lie off-balance-sheet deals. For example, Citigroup and JPMorgan lent Enron billions of dollars disguised as energy trades. The accounting firm Arthur Andersen let this happen. Similarly, profits of WorldCom (which, like Enron, went bankrupt) were assessed to have been overestimated by $7.1 billion starting in 2000.[22]

Accounting manipulations serve multiple purposes. First, they increase the apparent earnings and/or stock price, and thereby the value of managerial compensation. Managers with options packages may therefore find it attractive to inflate earnings. Going beyond scandals such as those of Enron, Tyco, Xerox,[23] and WorldCom in the United States and Parmalat in Europe, Bergstresser and Philippon (2005) find more generally that highly incentivized CEOs exercise a large number of stock options during years

18. The timing of exercise of executives' stock options is documented in, for example, Bettis et al. (2003). They find median values for the exercise date at about two years after vesting and five years prior to expiration.

19. Golden parachutes refer to benefits received by an executive in the event that the company is acquired and the executive's employment is terminated. Golden parachutes are in principle specified in the employment contract.

20. See Holmström and Kaplan (2003) for more details and an analysis of the Sarbanes–Oxley Act, as well as of the NYSE, NASDAQ, and Conference Board corporate governance proposals.

21. For an account of the Enron saga and, in particular, of the many off-balance-sheet transactions, see, for example, Fox (2003). See also the special issue of the *Journal of Economic Perspectives* devoted to the Enron scandal (Volume 12, Spring 2003).

22. Interestingly, one WorldCom director chaired Moody's investment services, and it took a long time for the rating agency to downgrade WorldCom.

23. A restatement by the Securities and Exchange Commission reduced Xerox's reported net income by $1.4 billion over the period 1997–2001. Over that period, the company's CEO exercised options worth over $20 million.

in which discretionary accruals form a large fraction of reported earnings, and that their companies engage in higher levels of earnings management.

Second, by hiding poor performance, they protect managers against dismissals or takeovers or, more generally, reduce investor interference in the managerial process. Third, accounting manipulations enable firms not to violate bank covenants, which are often couched in terms of accounting performance.[24] Lastly, they enable continued financing.[25]

When pointing to these misbehaviors, economists do not necessarily suggest that managers' actual behavior exhibits widespread incompetency and moral hazard. Rather, they stress both the potential extent of the problem and the endogeneity of managerial accountability. They argue that corporate governance failures are as old as the corporation, and that control mechanisms, however imperfect, have long been in place, implying that actual misbehaviors are the tip of an iceberg whose main element represents the averted ones.

1.2 Managerial Incentives: An Overview

1.2.1 A Sophisticated Mix of Incentives

However large the scope for misbehavior, explicit and implicit incentives, in practice, partly align managerial incentives with the firm's interest. Bonuses and stock options make managers sensitive to losses in profit and in shareholder value. Besides these explicit incentives, less formal, but quite powerful implicit incentives stem from the managers' concern about their future. The threat of being fired by the board of directors or removed by the market for corporate control through a takeover or a proxy fight, the possibility of being replaced by a receiver (in the United Kingdom, say) or of being put on a tight leash (as is the case of a Chapter 11 bankruptcy in the United States) during financial distress, and the prospect of being appointed to new boards of directors or of receiving offers for executive directorships in more prestigious companies, all contribute to keeping managers on their toes.

Capital market monitoring and product-market competition further keep a tight rein on managerial behavior. Monitoring by a large institutional investor (pension fund, mutual fund, bank, etc.), by a venture capitalist, or by a large private owner restricts managerial control, and is generally deemed to alleviate the agency problem. And, as we will discuss, product-market competition often aligns explicit and implicit managerial incentives with those of the firm, although it may create perverse incentives in specific situations.

Psychologists, consultants, and personnel officers no doubt would find the economists' description of managerial incentives too narrow. When discussing incentives in general, they also point to the role of intrinsic motivation, fairness, horizontal equity, morale, trust, corporate culture, social responsibility and altruism, feelings of self-esteem (coming from recognition or from fellow employees' gratitude), interest in the job, and so on. Here, we will not enter the debate as to whether the economists' view of incentives is inappropriately restrictive.[26] Some of these apparently noneconomic incentives are, at a deeper level, already incorporated in the economic paradigm.[27] As for the view that economists do not account for the possibility of benevolence, it should be clear that economists are concerned with the study of the residual incentives to act in the firm's interests over and beyond what they would contribute in the absence of rewards and monitoring. While we would all prefer not to need this sophisticated set of

24. See Section 2.3.3 for a discussion of covenants.

25. For example, WorldCom, just before bankruptcy, was the second-largest U.S. telecommunications company, with 70 acquisitions under its belt.

26. For references to the psychology literature and for views on how such considerations affect incentives, see, for example, Bénabou and Tirole (2003, 2004, 2005), Camerer and Malmendier (2004), Fehr and Schmidt (2003), and Frey (1997).

27. For example, explicit or implicit rules mandating "fairness" and "horizontal equity" can be seen as a response to the threat of favoritism, that is, of collusion between a superior and a subordinate (as in Laffont 1990). The impact of morale can be partly apprehended through the effects of incentives on the firm's or its management's reputation (see, for example, Tirole 1996). And the role of trust has in the past twenty years been one of the leitmotivs of economic theory since the pioneering work of Kreps et al. (1982) (see, for example, Kreps 1990). Economists have also devoted some attention to corporate culture phenomena (see Carrillo and Gromb 1999; Crémer 1993; Kreps 1990). Economists may not yet have a fully satisfactory description of fairness, horizontal equity, morale, trust, or corporate culture, but an *a priori* critique of the economic paradigm of employee incentives as being too narrow is unwarranted, and more attention should be devoted to exactly what can and cannot be explained by the standard economic paradigm.

explicit and implicit incentives, history has taught us that even the existing control mechanisms do not suffice to prevent misbehavior.

1.2.2 Monetary Incentives

Let us first return to the managerial compensation problem and exposit it in more detail than was done in the introduction to the chapter.

The compensation package.[28] A typical top executive receives compensation in three ways: salary, bonus, and stock-based incentives (stock, stock options). The salary is a fixed amount (although revised over time partly on the basis of past performance). The risky bonus and stock-based compensations are the two incentive components of the package.[29] They are meant to induce managers to internalize the owners' interests. Stock-based incentives, the bulk of the incentive component, have long been used to incentivize U.S. managers. The compensation of executives in Germany or in Japan has traditionally been less tied to stock prices (which does not mean that the latter are irrelevant for the provision of managerial incentives, as we later observe). Everywhere, though, there has been a dramatic increase in equity-based pay, especially stock options. For example, in the United States, the *sensitivity* of top executives pay to shareholder returns has increased tenfold between the early 1980s and late 1990s (see, for example, Hall and Liebman 1998; Hall 2000).

Needless to say, these compensation packages create an incentive to pursue profit-maximization only if the managers are not able to undo their incentives by selling the corresponding stakes to a third party. Indeed, third parties would in general love to offer, at a premium, insurance to the managers at the expense of the owners, who can no longer count on the incentives provided by the compensation package they designed. As a matter of fact, compensation package agreements make it difficult for managers to undo their position in the firm through open or secret trading. Open sales are limited for example by minimum-holding requirements while secret trading is considered insider trading.[30] There are, however, some loopholes that allow managers to undo some of their exposure to the firm's profitability through less strictly regulated financial instruments, such as equity swaps and collars.[31]

28. See, for example, Smith and Watts (1982) and Baker et al. (1988) for more detailed discussions of compensation packages.

29. More precisely, *earnings-related compensation* includes bonus and performance plans. Bonus plans yield short-term rewards tied to the firm's yearly performance. Rewards associated with performance plans (which are less frequent and less substantial than bonus plans) are contingent on earnings targets over three to five years. Many managerial contracts specify that part or all of the bonus payments can be transformed into stock options (or sometimes into phantom shares), either at the executive's discretion or by the compensation committee. (Phantom shares are units of value that correspond to an equivalent number of shares of stock. Phantom stock plans credit the executive with shares and pay her the cash value of these shares at the end of a prespecified time period.) This operation amounts to transforming a safe income (the earned bonus) into a risky one tied to future performance. *Stock-related compensation* includes stock options or stock appreciation rights, and restricted or phantom stock plans. Stock options and stock appreciation rights are more popular than restricted or phantom stock plans, which put restrictions on sale: in 1980, only 14 of the largest 100 U.S. corporations had a restricted stock plan as opposed to 83 for option plans. Few had phantom stock plans, and in about half the cases these plans were part of a bonus plan, and were therefore conditional on the executive's voluntarily deferring his bonus. Stock appreciation rights are similar to stock options and are meant to reduce the transaction costs associated with exercising options and selling shares.

30. Securities and Exchange Commission (SEC) rules in the United States constrain insider trading and short selling.

31. An interesting article by Bettis et al. (1999) documents the extent of these side deals.

Equity swaps and collars (among other similar instruments) are private contracts between a corporate insider (officer or director) and a counterparty (usually a bank). In an equity swap, the insider exchanges the future returns on her stock for the cash attached to another financial instrument, such as the stock market index. A collar involves the simultaneous purchase of a put option and sale of a call option on the firm's shares. The put provides the insider with insurance against firm's stock price decreases, and the call option reduces the insider's revenue from a price increase.

In the United States, the SEC, in two rulings in 1994 and 1996, mandated reporting of swaps and collars. Bettis et al. argue that the reporting requirements have remained ambiguous and that they have not much constrained their use by insiders (despite the general rules on insider trading that prohibit insiders from shorting their firm's stock or from trading without disclosing their private information).

Swaps and collars raise two issues. First, they may enable insiders to benefit from private information. Indeed, Bettis et al. show that insiders strategically time the purchase of these instruments. Swap and collar transactions occur after firms substantially outperform their benchmarks (by a margin of 40% in 250 trading days), and are followed by no abnormal returns in the 120 trading days after the transaction. Second, they provide insurance to the insiders and undo some of their exposure to the firm's profitability and thereby undo some of their incentives that stocks and stock options were supported to create. Bettis et al. estimate that 30% of shares held by top executives and board members in their sample are covered by equity swaps and collars.

While there is a widespread consensus in favor of some linkage between pay and performance, it is also widely recognized that performance measurement is quite imperfect. Bonus plans are based on accounting data, which creates the incentive to manipulate such data, making performance measurement systematically biased. As we discuss in Chapter 7, profits can be shifted backward and forward in time with relative ease. Equity-based compensation is less affected by this problem provided that the manager cannot sell rapidly, since stock prices in principle reflect the present discounted value of future profits. But stock prices are subject to exogenous factors creating volatility.

Nevertheless, compensation committees must use existing performance measures, however imperfect, when designing compensation packages for the firm's executives.

Bonuses and shareholdings: substitutes or complements? As we saw, it is customary to distinguish between two types of monetary compensation: bonuses are defined by current profit, that is, accounting data, while stocks and stock options are based on the value of shares, that is, on market data.

The articulation between these two types of rewards matters. One could easily believe that, because they are both incentive schemes, bonuses and stock options are substitutes. An increase in a manager's bonus could then be compensated by a reduction in managerial shareholdings. This, however, misses the point that bonuses and stock options serve two different and complementary purposes.[32]

A bonus-based compensation package creates a strong incentive for a manager to privilege the short term over the long term. A manager trades off short- and long-term profits when confronting subcontracting, marketing, maintenance, and investment decisions. An increase in her bonus increases her preference for current profit and can create an imbalance in incentives. This imbalance would be aggravated by a reduction in stock-based incentives, which are meant to encourage management to take a long-term perspective. Bonuses and stock options therefore tend to be complements. An increase in short-term incentives must go hand in hand with an increase in long-term incentives, in order to keep a proper balance between short- and long-term objectives.

The compensation base. It is well-known that managerial compensation should not be based on factors that are outside the control of the manager.[33] One implication of this idea is that managerial compensation should be immunized against shocks such as fluctuations in exchange rate, interest rate, or price of raw materials that the manager has no control over. This can be achieved, for example, by indexing managerial compensation to the relevant variables; in practice, though, this is often achieved more indirectly and only partially through corporate risk management, a practice that tends to insulate the firm from some types of aggregate risks through insurance-like contracts such as exchange rate or interest rate swaps (see Chapter 5 for some other benefits of risk management).

Another implication of the point that managerial compensation should be unaffected by the realization of exogenous shocks is relative performance evaluation (also called "yardstick competition"). The idea is that one can use the performance of firms facing similar shocks, e.g., firms in the same industry facing the same cost and demand shocks, in order to obtain information about the uncontrollable shocks faced by the managers. For example, the compensation of the CEO of General Motors can be made dependent on the performance of Ford and Chrysler, with a better performance of the competitors being associated with a lower compensation for the executive. Managers are then rewarded as a function of their *relative* performance in their peer group rather than on the basis of their absolute performance (see Holmström 1982a).[34] There is some controversy about the extent of *implicit*

32. This discussion is drawn from Holmström and Tirole (1993).

33. The formal version of this point is Holmström's (1979) sufficient statistic result according to which optimal compensation packages are contingent on a sufficient statistic about the manager's unobserved actions. See Section 3.2.5 for more details.

34. A cost of relative-performance-evaluation schemes is that they can generate distorted incentives, such as the tendency to herding; for example, herding has been observed for bank managers (perhaps more due to implicit rather than explicit incentives), as it is sometimes better to be wrong with the rest of the pack than to be right alone.

As Keynes (1936, Chapter 12) said, "Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally."

relative performance evaluation (see, for example, Baker et al. 1988; Gibbons and Murphy 1990), but it is fairly clear that relative performance evaluation is not widely used in *explicit* incentive schemes (in particular, managerial stock ownership).

Bertrand and Mullainathan (2001) provide evidence that there is often too little filtering in CEO compensation packages, and that CEOs are consequently rewarded for "luck." For example, in the oil industry, pay changes and changes in the price of crude oil correlate quite well, even though the world oil price is largely beyond the control of any given firm; interestingly, CEOs are not always punished for bad luck, that is, there is an asymmetry in the exposure to shocks beyond the CEO's control. Bertrand and Mullainathan also demonstrate a similar pattern for the sensitivity of CEO compensation to industry-specific exchange rates for firms in the traded goods sector and to mean industry performance. They conclude that, roughly, "CEO pay is as sensitive to a lucky dollar as to a general dollar," suggesting that compensation contracts are poorly designed.

As Bertrand and Mullainathan note, it might be that, even though oil prices, exchange rates, and industry conditions are beyond the control of managers, investors would like them to forecast these properly so as to better tailor production and investment to their anticipated evolution, in which case it might be efficient to create an exposure of CEO compensation to "luck." Bertrand and Mullainathan, however, show that better-governed firms pay their CEOs less for luck; for example, an additional large shareholder on the board reduces CEO pay for luck by between 23 and 33%.

This evidence suggests that the boards in general and the compensation committees in particular often comprise too many friends of the CEOs (see also Bertrand and Mullainathan 2000), who then de facto get to set their executive pay. We now turn to why they often gain when exposed to "luck": their compensation package tends to be convex, with large exposure in the upper tail and little in the lower tail.

Straight shares or stock options? Another aspect of the design of incentive compensation is the (non)linearity of the reward as a function of performance. Managers may be offered stock options, i.e., the right to purchase at specified dates stocks at some "exercise price" or "strike price."[35] These are call options. The options are valueless if the realized market price ends up being below the exercise price, and are worth the difference between the market price and the exercise price otherwise. In contrast, managerial holdings of straight shares let the manager internalize shareholder value over the whole range of market prices, and not only in the upper range above the exercise price.

Should managers be rewarded through straight shares or through stock options?[36] Given that managers rarely have a personal wealth to start with and are protected by limited liability or, due to risk aversion,[37] insist on a base income, stock options seem a more appropriate instrument. Straight shares provide management with a rent even when their performance is poor, while stock options do not. In Figure 1.1(a), the managerial reward when the exercise or strike price is P^S and the stock price is P at the exercise date is $\max(0, P - P^S)$ for the option; it would be P for a straight share. Put another way, for a given expected cost of the managerial incentive package for the owners, the latter can provide managers with stronger incentives by using stock options. This feature explains the popularity of stock options.

Stock options, on the other hand, have some drawbacks. Suppose that a manager is given stock options to be (possibly) exercised after two years on the job; and that this manager learns after one year that the firm faces an adverse shock (on which the exercise price of the options is not indexed), so that "under normal management" it becomes unlikely that the market price will exceed the strike price at the exercise date. The manager's option is then "under water" or "out of the money" and has little value unless the firm performs remarkably well during the remaining year. This may encourage management to take substantial risks in order to increase the

35. In the United States, stock option plans, when granted, are most often at-the-money options.

36. As elsewhere in this book, we ignore tax considerations. Needless to say, these may play a role. For example, in the United States (and at the time of writing, accounting rules are likely to change in the near future), stock options grants, unlike stock grants, create no accounting expense for the firm.

37. There is a large literature on hedging by risk-averse agents (see, for example, Anderson and Danthine 1980, 1981).

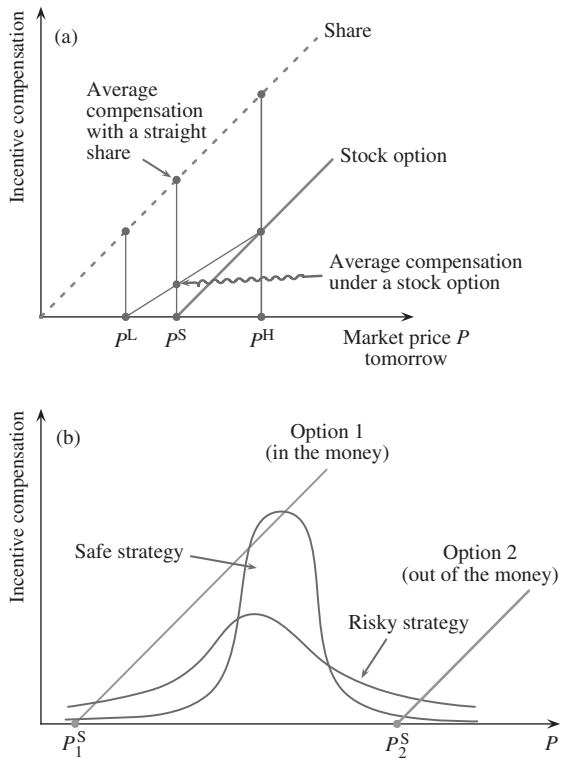

Figure 1.1 Straight shares and stock options. (a) Expected rents (P^L: low price (option "out of the money"); P^S: strike price; P^H: high price (option "in the money")). (b) Risk preferences under a stock option.

value of her stock options. (In Chapter 7, we observe that such "gambling for resurrection" is also likely to occur under implicit/career-concern incentives, namely, when a poorly performing manager is afraid of losing her job.) This situation is represented in Figure 1.1(b) by stock option 2 with high strike price P_2^S. That figure depicts two possible distributions (densities) for the realized price P depending on whether a safe or a risky strategy is selected. The value of this out-of-the money option is then much higher under a risky strategy than under a safe one.[38] The manager's benefit from gambling is much lower when the option is in the money (say, at strike price P_1^S in the figure).[39]

Another issue with "underwater options" relates to their credibility. Once the options are out of the money, they either induce top management to leave or create low or perverse incentives, as we just saw. They may be repriced (the exercise price is adjusted downward) or new options may be granted.[40] To some extent, such *ex post* adjustments undermine *ex ante* incentives by refraining from punishing management for poor performance.[41]

In contrast, when the option is largely "in the money," that is, when it looks quite likely that the market price will exceed the exercise price, a stock option has a similar incentive impact as a straight share but provides management with a lower rent, namely, the difference between market and exercise price rather than the full market price.

The question of the efficient mix of options and stocks is still unsettled. Unsurprisingly, while stock options remain very popular, some companies, such as DaimlerChrysler, Deutsche Telekom, and Microsoft, have abandoned them, usually to replace them by stocks (as in the case of Microsoft).

The executive compensation controversy. There has been a trend in executive compensation towards higher compensation as well as stronger performance linkages. This trend has resulted in a public outcry. Yet some have argued that the performance linkage is insufficient. In a paper whose inferences created controversy, Jensen and Murphy (1990) found a low sensitivity of CEO compensation to firm performance (see also Murphy 1985, 1999). Looking at a sample of the CEOs of the 250

38. Whether the manager is better off under the risky strategy depends on her risk aversion. However, if (a) the manager is risk neutral or mildly risk averse and (b) the risky strategy is a mean-preserving spread or more generally increases risk without reducing the mean too much relative to the safe strategy, then the manager will prefer the risky strategy.

39. In the figure, option 1 is almost a straight stock in that it is very unlikely that the option turns out to be valueless.

40. Consider, for example, Ascend Communications (*New York Times*, July 15, 1998, D1). In 1998, its stock price fell from $80 to $23 within four months. The managerial stock options had strike prices ranging up to $114 per share. The strike price was reduced twice during that period for different kinds of options (to $35 a share and to $24.50, respectively).

41. At least, if the initial options were structured properly. If repricing only reflects general market trends (after all, more than half of the stock options were out of the money in 2002), repricing may be less objectionable (although the initial package is still objectionable, to the extent that it would have rewarded management for luck).

For theories of renegotiation of managerial compensation and its impact on moral hazard, see Fudenberg and Tirole (1990) and Hermalin and Katz (1991). See also Chapter 5.

largest publicly traded American firms, they found that (a) the median public corporation CEO holds 0.25% of his/her firm's equity and (b) a $1,000 increase in shareholder wealth corresponds on average to a $3.25 increase in total CEO compensation (stock and stock options, increase in this and next year's salary, change in expected dismissal penalties). This sounds tiny. Suppose that your grocer kept 0.3 cents out of any extra $1 in net profit, and gave 99.7 cents to other people. One might imagine that the grocer would start eating the apples on the fruit stand. Jensen and Murphy argue that CEO incentives not to waste shareholder value are too small.

Jensen and Murphy's conclusion sparked some controversy, though. First, managerial risk aversion and the concomitant diminishing marginal utility of income implies that strong management incentives are costly to the firm's owners. Indeed, Haubrich (1994) shows that the low pay–performance sensitivity pointed out by Jensen and Murphy is consistent with relatively low levels of managerial risk aversion, such as an index of relative risk aversion of about 5. Intuitively, changes in the value of large companies can have a very large impact on CEO performance-based compensation even for low sensitivity levels. Second, the CEO is only one of many employees in the firm. And so, despite the key executive responsibilities of the CEO, other parties have an important impact on firm performance. Put another way, overall performance results from the combined effort and talent of the CEO, other top executives, engineers, marketers, and blue-collar workers, not to mention the board of directors, suppliers, distributors, and other "external" parties. In the economic jargon, the joint performance creates a "moral hazard in teams," in which many parties concur to a common final outcome. Ignoring risk aversion, the only way to properly incentivize all these parties is to promise each $1,000 any time the firm's value increases by $1,000. This is unrealistic, if anything because the payoff must be shared with the financiers.[42] Third, the work of Hall and Liebman (1998) cited earlier, using a more recent dataset (1980 to 1994), points to a substantial increase in performance-based compensation, which made Jensen and Murphy's estimates somewhat obsolete. They find that the mean (median) change in CEO wealth is $25 ($5.30) per $1,000 increase in firm value.

1.2.3 Implicit Incentives

Managers are naturally concerned about keeping their job. Poor performance may induce the board to remove the CEO and the group of top executives. The board either voluntarily fires the manager, or, often, does so under the implicit or explicit pressure of shareholders observing a low stock price or a low profit. Poor performance may also generate a takeover or a proxy fight, or else may drive a fragile firm into bankruptcy and reorganization. Finally, there is evidence that the fraction of independent directors rises after poor performance, so that top management is on a tighter leash if it keeps its position (Hermalin and Weisbach 1988). As we will see, there is substantial normative appeal for these observations: efficient contracting indeed usually requires that poor performance makes it less likely that managers keep their position (Chapters 6, 7, and 11), more likely that they be starved of liquidity (Chapter 5), and more likely that they surrender control rights or that control rights be reshuffled among investors towards ones who are less congruent with management, i.e., debtholders (Chapter 10).

There is a fair amount of evidence that executive turnover in the United States is correlated with poor performance, using either stock or accounting data (see Kojima (1997, p. 63) and Subramanian et al. (2002) for a list of relevant articles). The sensitivity of CEO removal to performance is higher for firms with more outside directors (Weisbach 1988) and smaller in firms run by founders (Morck et al. 1989). Thus, a tight external monitoring and a less complacent board are conducive to managerial turnover after a poor performance.

42. Suppose a "source" (i.e., an outside financier) brings $(n-1)$ thousand dollars to the firm for any $1,000 increase in firm value, so that the n parties responsible for the firm's overall performance receive $1,000 each. First, this financing source would be likely not to be able to break even, since the n insiders would be unable to pay out money in the case of poor performance. Second, the n insiders could collude against the source (e.g., borrow one dollar to receive n dollars from the source).

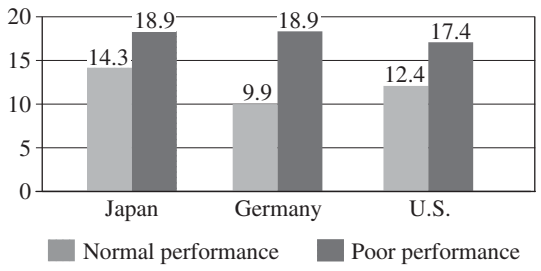

Figure 1.2 Top executive turnover and stock returns.
Source: built from data in Kaplan (1994a,b).

Perhaps more surprisingly in view of the substantial institutional differences, the relationship between poor performance and top executive turnover is similar in the United States, Germany, and Japan: see Figure 1.2, drawn from the work of Kaplan. More recent research (see, for example, Goyal and Park 2002) has confirmed the dual pattern of an increase in forced executive turnover in the wake of poor performance and of an increased sensitivity of this relationship when there are few insiders on the board.

The threat of bankruptcy also keeps managers on their toes. Even in the United States, a country with limited creditor protection and advantageous treatment of managers during restructurings,[43] 52% of financially distressed firms experience a senior management turnover as opposed to 19% for firms with comparably poor stock performance but not in financial distress (Gilson 1989).

Are explicit and implicit incentives complements or substitutes? The threat of dismissal or other interferences resulting from poor performance provides incentives for managers over and beyond those provided by explicit incentives. Explicit and implicit incentives are therefore substitutes: with stronger implicit incentives, fewer stocks and stock options are needed to curb managerial moral hazard. While this substitution effect is real,[44] the strengths of implicit and explicit incentives are codetermined by sources of heterogeneity in the sample and so other factors (analyzed in Chapters 4 and 6 of this book), impact the observed relationship between implicit and explicit incentives (the survey by Chiappori and Salanié (2003) provides an extensive discussion of the need to take account of unobserved heterogeneity in the econometrics of contracts).

First, consider the heterogeneity in the intensity of financial constraints. A recurrent theme of this book will be that the tighter the financing constraint, the more concessions the borrower must make in order to raise funds. And concessions tend to apply across the board. Concessions of interest here are reductions in performance-based pay and in the ability to retain one's job after poor performance, two contracting attributes valued by the executive. Thus, a tightly financially constrained manager will accept both a lower level of performance-based rewards and a smaller probability of keeping her job after a poor performance (see Section 4.3.5), where the probability of turnover is determined by the composition of the board, the presence of takeover defenses, the specification of termination rights (in the case of venture capital or alliance financing) and other contractual arrangements. The heterogeneity in the intensity of financial constraints then predicts a positive comovement of turnover under poor performance and low-powered incentives. Implicit and explicit incentives then appear to be complements in the sample.

Second, consider adverse selection, that is, the existence of an asymmetry of information between the firm and its investors. Investors are uncertain about the likely performance of the executive. An executive who is confident about the firm's future prospects knows that she is relatively unlikely to achieve a poor performance, and so accepting a high turnover in the case of poor performance is less costly than it would be if she were less confident in her talent or had unfavorable information about the firm's prospects. Thus, the confident executive is willing to trade

43. Under U.S. law's Chapter 11, which puts a hold on creditor claims, the firm is run as a going concern and no receiver is designated.

44. Gibbons and Murphy (1992) analyze the impact of implicit incentives on optimal explicit incentive contracts in a different context. They posit career concerns *à la* Holmström (1982b): successful employees receive with a lag external offers, forcing their firm to raise their wage to keep them. Their model has a fixed horizon (and so does not apply as it stands to the executive turnover issue); it shows that implicit and explicit incentives are indeed substitutes: as the employee gets closer to retirement, career concerns decrease and the employer must raise the power of the explicit incentive scheme. Gibbons and Murphy further provide empirical support for this theoretical prediction.

off a high performance-based reward against an increased turnover probability in the case of poor performance (see Chapter 6). By contrast, less confident managers put more weight on their tenure and less on monetary compensation. The prediction is then one of a negative covariation between turnover in the case of poor performance[45] and low-powered incentives. Put differently, implicit and explicit incentives come out as being substitutes in the sample.[46]

Interestingly, Subramanian et al. (2002) find that, in their sample, CEOs with greater explicit incentives also face less secure jobs.

1.2.4 Monitoring

Monitoring of corporations is performed by a variety of external (nonexecutive) parties such as boards of directors, auditors, large shareholders, large creditors, investment banks, and rating agencies. To understand the actual design of monitoring structures, it is useful to distinguish between two forms of monitoring, active and speculative, on the basis of two types of monitoring information, prospective and retrospective.

Active monitoring consists in interfering with management in order to increase the value of the investors' claims. An active monitor collects information that some policy proposed or followed by management (e.g., the refusal to sell the firm to a high bidder or to divest some noncore assets) is value-decreasing and intervenes to prevent or correct this policy. In extreme cases, the intervention may be the removal of current management and its replacement by a new management more able to handle the firm's future environment. Active monitoring is *forward looking* and analyzes the firm's past actions only to the extent that they can still be altered to raise firm value or that they convey information (say, about the ability of current management) on which one can act to improve the firm's prospects.

The mechanism by which the change is implemented depends on the identity of the active monitor. A large shareholder may sit on the board and intervene in that capacity. An institutional investor in the United States or a bank holding a sizeable number of the firm's shares as custodian in Germany may intervene in the general assembly by introducing resolutions on particular corporate policy issues; or perhaps they may be able to convince management to alter its policy under the threat of intervention at the general meeting. A raider launches a takeover and thereby attempts to gain control over the firm. Lastly, creditors in a situation of financial distress or a receiver in bankruptcy force concessions on management.

While active monitoring is intimately linked to the exercise of control rights, *speculative monitoring* is not. Furthermore, speculative monitoring is partly *backward looking* in that it does not attempt to increase firm value, but rather to measure this value, which reflects not only exogenous prospects but also past managerial investments. The object of speculative monitoring is thus to "take a picture" of the firm's position at a given moment in time, that is, to take stock of the previous and current management's accomplishments to date. This information is used by the speculative monitor in order to adjust his position in the firm (invest further, stay put, or disengage), or else to recommend or discourage investment in the firm to investors. The typical speculative monitor is the stock market analyst, say, working for a passive institutional investor, who studies firms in order to maximize portfolio return without any intent to intervene in the firms' management.

But, as the examples above suggest, it would be incorrect to believe that speculative monitoring occurs only in stock markets. A short-term creditor's strategy is to disengage from the firm, namely, to refuse to roll over the debt, whenever he receives bad news about the firm's capacity to reimburse its debt. Or, to take other examples, an investment bank that recommends purchasing shares in a company or a rating agency that grades a firm's public debt both look at the firm's expected value and do not attempt to interfere in the firm's management in order to raise this value. They simply take a picture of the firms'

45. Note that this is indeed a *conditional* probability: confident managers are less likely to reach a poor performance.

46. The theoretical model in Subramanian et al. (2002) emphasizes a third consideration by making learning from performance about talent sensitive to managerial effort. Then a high-powered incentive scheme, by increasing effort, also increases the informativeness of performance. This increased informativeness, if turnover is otherwise unlikely due to switching costs, in turn may raise turnover. Put differently, the manager is more likely to be found untalented if she exerts a high effort and fails.

resources and prospects in order to formulate their advice.

Another seemingly unusual category of speculative monitoring concerns legal suits by shareholders (or by attorneys on behalf of shareholders) against directors. Like other instances of speculative monitoring, legal suits are based on backward-looking information, namely, the information that the directors have not acted in the interest of the corporation in the past; per se they are not meant to enhance future value, but rather to sanction past underperformance. Two kinds of legal suits are prominent in the United States: class-action suits on behalf of shareholders, and derivative suits on behalf of the corporation (that is, mainly shareholders, but also creditors and other stakeholders to the extent that their claim is performance-sensitive), which receives any ensuing benefits.

While the mechanism of speculative monitoring and its relationship with active monitoring will be explored in detail in Part III of this book, it is worth mentioning here that speculative monitoring does discipline management in several ways. Speculative monitoring in the stock market makes the firm's stock value informative about past performance; this value is used directly to reward management through stock options and, indirectly, to force reluctant boards to admit poor performance and put pressure on or remove management. Speculative monitoring by short-term creditors, investment banks, or rating agencies drains liquidity from (or restricts funding to) poorly performing firms. Either way, speculative monitoring helps keep managers on their toes.

A second and important point is that monitoring is performed by a large number of other "eyeballs": besides stock analysts, rating agencies assess the strength of new issues. Auditors certify the accounts, which in part requires discretionary assessments such as when they evaluate illiquid assets or contingent liabilities. A long-standing issue has resurfaced with the recent scandals. These eyeballs may face substantial *conflicts of interest* that may alter their assessment (indeed, many reform proposals suggest reducing these conflicts of interest). For example, a bank's analysts may overhype a firm's stocks to investors in order to please the firm from which the investment banking branch tries to win business in mergers and acquisitions and in security underwriting.[47]

Accountants may face similar conflicts of interest if they also, directly or indirectly, act as directors, brokers, underwriters, suppliers of management or tax consulting services, and so forth.[48] Unsurprisingly, a number of countries (e.g., United States, United Kingdom, Italy) have moved from self-regulation of the accounting profession to some form of government regulation. In the United States, the Sarbanes–Oxley Act of 2002 created a regulatory body[49] to set rules for, inspect, and impose penalties on public accounting firms.[50]

1.2.5 Product-Market Competition

It is widely agreed that the quality of a firm's management is not solely determined by its design of corporate governance, but also depends on the firm's competitive environment. Product-market competition matters for several reasons. First, as already mentioned, close competitors offer a yardstick against which the firm's quality of management can be measured. It is easier for management to attribute poor performance to bad luck when the firm faces very idiosyncratic circumstances, say, because it is a monopoly in its market, than when competitors presumably facing similar cost and demand conditions are doing well. There is no arguing that

47. For example, Merrill Lynch was imposed a $100 million penalty by the New York Attorney General (2002) when internal emails by analysts described as "junk" stocks they were pushing at the time. Merrill Lynch promised, among other things, to delink analyst compensation and investment banking (*Business Week*, October 7, 2002). In the same year, Citigroup, or rather its affiliate, Salomon Smith Barney, was under investigation for conflicts between stock research and investment banking activities.

48. In 2001, nonaudit fees make up for over 50% of the fees paid to accounting firms by 28 of the 30 companies constituting the Dow Jones Industrial Average. The California Public Employees' Retirement System (CalPERS) announced that it would vote against the reappointment of auditors who also provide consulting services to the firm.

49. The Public Company Accounting Oversight Board, overseen by the SEC.

50. DeMarzo et al. (2005) argue that self-regulation leads to lenient supervision. Pagano and Immordino (2004), building on Dye (1993), explicitly model management advisory services as bribes to auditors and study the optimal regulatory environment under potential collusion between firms and their auditors. They show that good corporate governance reduces the incentive to collude and calls for more demanding auditing standards.

this benchmarking is used, at least implicitly, in the assessment of managerial performance.

Actually, product-market competition improves performance measurement even if the competitors' actual performance is not observed.[51] The very existence of product-market competition tends to filter out or attenuate the exogenous shocks faced by the firm. Suppose the demand in the market is high or the cost of supplies low. The management of a firm in a monopoly position then benefits substantially from the favorable conditions. It can either transform these favorable circumstances into substantial monetary rents if its compensation is very sensitive to profits, or it can enjoy an easy life while still reaching a decent performance, or both. This is not so for a competitive firm. Suppose, for instance, that production costs are low. While they are low for the firm, they are also low for the other firms in the industry, which are then fierce competitors; and so the management is less able to derive rents from the favorable environment.

Another related well-known mechanism through which product-market competition affects managerial incentives is the bankruptcy process. Management is concerned about the prospect of bankruptcy, which often implies the loss of the job and in any case a reduction in managerial prerogatives. To the extent that competition removes the cosy cash cushion enjoyed by a monopolist, competition keeps managers alert.[52]

While competition may have very beneficial effects on managerial incentives, it may also create perverse effects. For example, firms may gamble in order to "beat the market." A case in point is the intensely competitive market for fund management. Fund managers tend to be obsessed with their ranking in the industry, since this ranking determines the inflow of new investments into the funds and, to a lesser extent due to investor inertia, the flow of money out of the fund. This may induce fund managers to adopt strategies that focus on the ranking of the fund relative to competing funds rather than on the absolute return to investors.

It should also be realized that competition will never substitute for a proper governance structure. Investors bring money to a firm in exchange for an expected return whether the firm faces a competitive or protected environment. This future return can be squandered by management regardless of the competitiveness of the product market. And indeed, a number of recent corporate governance scandals (e.g., Barings, Credit Lyonnais, Gan, Banesto, Metallgesellschaft, Enron, WorldCom) have occurred in industries with relatively strong competition. Similarly, the reaction of the big three American automobile manufacturers to the potential and then actual competition from foreign producers was painfully slow.

1.3 The Board of Directors

The board of directors[53] in principle monitors management on behalf of shareholders. It is meant to define or, more often, to approve major business decisions and corporate strategy: disposal of assets, investments or acquisitions, and tender offers made by acquirers. It is also in charge of executive compensation, oversight of risk management, and audits.

51. This argument is drawn from Rey and Tirole (1986), who, in the context of the choice between exclusive territories and competition between retailers, argue that competition acts as an insurance device and thus boosts incentives. Hermalin (1992) and Scharfstein (1988) study the impact of product-market competition on the agency cost in a Holmström (1979) principal–agent framework.

52. Aghion et al. (1999) develop a Schumpeterian model in which management may be unduly reluctant to adopt new technologies, and show that a procompetition policy may improve incentives in those firms with poor governance structures.

53. We will here be discussing the standard board structure. There are, of course, many variants. One variant that has received much attention is the German two-tier board. For instance, AGs (*Aktiengesellschaften*) with more than 2,000 employees have (a) a management board (*Vorstand*) with a leader (*Sprecher*) playing somewhat the role of a CEO and meeting weekly, say, and (b) a supervisory board (*Aufsichtsrat*) meeting three or four times a year, appointing members of the Vorstand, and approving or disapproving accounts, dividends, and major asset acquisitions or disposals proposed by the Vorstand. The Vorstand is composed of full-time salaried executives with fixed-term contracts, who cannot be removed except in extreme circumstances, a feature that makes it difficult for an outsider to gain control over the firm.

Firm managers cannot be members of the Aufsichtsrat. Half of the members of the Aufsichtsrat are nonexecutive representatives of the shareholders, and half represents employees (both employee delegates and external members designated by trade unions). The shareholders' representatives are nonexecutives but they are not independent in the Anglo-Saxon sense since they often represent firms or banks with an important business relationship with the firm. The chairman is drawn from the shareholders' representatives, and breaks ties in case of a deadlock. For more detail about the German two-tier system, see, for example, Charkham (1994, Chapter 2), Edwards and Fischer (1994), Kojima (1997, Section 4.1.2), and Roe (2003).

Lastly, it can offer advice and connections to management. To accomplish these tasks, boards operate more and more often through committees such as the compensation, nominating, and audit committees. Boards have traditionally been described as ineffective rubber-stampers controlled by, rather than controlling, management. Accordingly, there have recently been many calls for more accountable boards.[54]

1.3.1 Boards of Directors: Watchdogs or Lapdogs?

The typical complaints about the indolent behavior of boards of directors can be found in Mace's (1971) classic book. Directors rarely cause trouble in board meetings for several reasons.

Lack of independence. A director is labeled "independent" if she is not employed by the firm, does not supply services to the firm, or more generally does not have a conflict of interest in the accomplishment of her oversight mission. In practice, though, directors often have such conflicts of interest. This is most obvious for insiders sitting on the board (executive directors), who clearly are simultaneously judge and party.[55] But nonexecutive directors are often not independent either. They may be handpicked by management among friends outside the firm. They may be engaged in a business relationship with the firm, which they worry could be severed if they expressed opposition to management. They may belong to the same social network as the CEO.[56] Finally, they may receive "bribes" from the firm; for example, auditors may be asked to provide lucrative consultancy and tax services that induce them to stand with management.

In the United States, as in France, the chairman of the board (who, due to his powers, exercises a disproportionate influence on board meetings) is most often the firm's CEO, although the fraction of large corporations with a split-leadership structure has risen from an historical average of about one-fifth to one-third in 2004.[57] Nonexecutive chairmen are much more frequent in the United Kingdom (95% of all FTSE 350 companies in 2004) and in Germany and in the Netherlands (100% in both countries), which have a two-tier board.

An executive chairmanship obviously strengthens the insiders' hold on the board of directors. Another factor of executive control over the board is the possibility of mutual interdependence of CEOs. This factor may be particularly relevant for continental Europe and Japan, where cross-shareholdings within broadly defined "industrial groups" or keiretsus in Japan creates this interdependence. But, even in the United States, where cross-shareholdings are much rarer, CEOs may sit on each others' boards (even perhaps on each others' compensation committees!).

Insufficient attention. Outside directors are also often carefully chosen so as to be overcommitted.

54. In France, the corporate governance movement is scoring points, partly due to the increase in foreign shareholdings (70% of stock market value, but only 13% of the seats on the boards in 1997) and to privatizations. Firms publicize their compliance with the 1995 Viénot report setting up a code of behavior for boards. Yet, the corporate governance movement is still in its infancy. There are very few independent directors. A Vuchot–Ward–Howell study (cited by *La Tribune*, March 10, 1997) estimated that only 93 directors among the 541 directors of the largest publicly traded French corporations (CAC40) are independent (although French firms widely advertise "outside directors" as "independent directors"). Many are part of a club (and often went to the same schools and issued from the same corps of civil servants) sitting on each other's boards. The composition of board committees is not always disclosed. And general assemblies are still largely perfunctory, although minority shareholder movements are developing and recent votes demonstrate (minority) opposition to managerial proposals in a number of large companies.

55. The argument that is sometimes heard that insiders should be board members (implying: with full voting rights) in order to bring relevant information when needed is not convincing, since insiders without voting rights could participate in part or all of the board meetings.

56. Kramarz and Thesmar (2004) study social networks in French boardrooms. They identify three types of civil-service related social networks in business (more than half of the assets traded on the French stock market are managed by CEOs issued from the civil service). They find that CEOs appoint directors who belong to the same social network. Former civil servants are less likely to lose their job following a poor performance, and they are also more likely than other CEOs to become director of another firm when their own firm is doing badly.

Bertrand et al. (2004) investigates the consequences of French CEOs' political connections. There is a tight overlap between the CEOs and cabinet ministers, who often come from the same corps of civil servants or more generally belong to the same social networks associated with the Ecole Polytechnique or the Ecole Nationale d'Administration. Bertrand et al. find that firms managed by connected CEOs create more (destroy fewer) jobs in politically contested areas, and that the quid pro quo comes in the form of a privileged access to government subsidy programs.

57. According to a September 2004 study by Governance Metrics International, a corporate governance rating agency based in New York (cited in Felton and Wong 2004). Among the firms that have recently separated the roles of chairman and CEO are Dell, Boeing, Walt Disney, MCI, and Oracle.

Many outside directors in the largest U.S. corporations are CEOs of other firms. Besides having a full workload in their own company, they may sit on a large number of boards. In such circumstances, they may come to board meetings (other than their own corporation's) unprepared and they may rely entirely on the (selective) information disclosed by the firm's management.

Insufficient incentives. Directors' compensation has traditionally consisted for the most part of fees and perks. There has often been a weak link between firm performance and directors' compensation, although there is a trend in the United States towards increasing compensation in the form of stock options for directors.[58]

Explicit compensation is, of course, only part of the directors' monetary incentives. They may be sued by shareholders (say, through a class-action suit in the United States). But, four factors mitigate the effectiveness of liability suits. First, while courts penalize extreme forms of moral hazard such as fraud, they are much more reluctant to engage in business judgements about, say, whether an investment or an acquisition *ex ante* made good economic sense. Judges are not professional managers and they have limited knowledge of past industry conditions. They therefore do not want to be drawn into telling managers and directors how they should run their companies. Since corporate charters almost always eliminate director liability for breaches of duty of care, it is difficult for shareholders and other stakeholders to bring a suit against board members. Second, firms routinely buy liability insurance for their directors.[59] Third, liabilities, if any, are often paid by the firms, which indemnify directors who have acted in good faith. Fourth, plaintiff's lawyers may be inclined to buy off directors (unless they are extremely wealthy) in order to settle. Overall, for Black et al. (2004), as long as outside directors refrain from enriching themselves at the expense of the company, the risk of having to pay damages or legal fees out of their own pocket is very small in the United States,[60] as well as in other countries such as France, Germany, or Japan, where lawsuits are much rarer.

This undoing of the impact of liability suits has two perverse effects: it makes directors less accountable, and, in the case of indemnification by the firm, it deters shareholders from suing the directors since the fine paid in the case of a successful suit comes partly out of their pocket.

Avoidance of conflict. Except when it comes to firing management, it is hard even for independent directors to confront management; for, they are engaged in an ongoing relationship with top executives. A conflictual relationship is certainly unpleasant. And, perhaps more fundamentally, such a relationship is conducive neither to the management's listening to the board's advice nor to the disclosure to the board of key information.

In view of these considerations, it may come as a surprise that boards have any effectiveness. Boards actually do interfere in some decisions. They do remove underperforming managers, as we discussed in Section 1.2. They may also refuse to side with management during takeover contests. A well-known case in point is the 1989 RJR Nabisco leveraged buyout (LBO) in which a group headed by the CEO made an initial bid and the outside directors insisted on auctioning off the company, resulting in a much more attractive purchase by an outsider.

It should be realized, though, that the cosy relationship between directors and management is likely to break down mainly during crises. Directors

58. Yermack (2004b), looking at 766 outside directors in Fortune 500 firms between 1994 and 1996, estimates incentives from compensation, replacement, and opportunity to obtain other directorships. He finds that these incentives together yield 11 cents per $1,000 increase in firm value (shareholder wealth) to an outside director. Thus, performance-based incentives are not negligible for outside directors even though they remain much lower than those for CEOs (e.g., $5.29 per $1,000 increase in firm value for the median CEO in 1994, as reported by Hall and Liebman (1998)).

59. As well as officers (these insurance policies are labeled directors and officers (D&O) insurance policies).

60. It was a shock to directors when ten former executive directors of WorldCom agreed to pay a total of $18 million from their own savings and ten former Enron directors paid $13 million (still, the insurance companies are expected to pay out the bulk of the money: $36 million for WorldCom and $155 million for Enron *The Economist*, January 15, 2005, p. 65). It is hard to predict whether this indicates a new trend, as these cases involved extreme misbehaviors.

D&O insurance policies are less prevalent in Europe because of the lower probability of lawsuits, but they are likely to become very widespread as lawsuits become more common.

are then more worried about liability and more exposed to the spotlight. Furthermore, their relationship with management has shorter prospects than during good times. And, indeed, directors have historically been less effective in preventing management from engaging in wasteful diversification or in forcing it to disgorge excess cash than in removing underperforming managers. Relatedly, there is evidence that decreases in the share price lead to an increase in board activity, as measured by the annual number of board meetings (Vafeas 1999).

Bebchuk and Fried (2004) offer a scathing view of board behavior. They argue that most directors choose to collude with CEOs rather than accomplish their role of guardian of shareholders' interests. Directors dislike haggling with or being "disloyal" to the CEO, have little time to intervene, and further receive a number of favors from the CEO: the CEO can place them on the company's slate, increasing seriously their chance of reelection, give them perks, business deals (perhaps after they have been nominated on the board, so that they are formally "independent"), extra compensation on top of the director fee, and charitable contributions to nonprofit organizations headed by directors, or reciprocate the lenient oversight in case of interlocking directorates. A key argument of Bebchuk and Fried's book is that the rents secured by directors for the CEO involve substantial "camouflage"; that is, these rents should be as discrete or complex as possible so as to limit "outrage costs" and backlash. This camouflage yields inefficient compensation for officers. For example, compensation committees[61] fail to filter out stock price rises or general market trends and use conventional stock-option plans (as discussed in Section 1.2); and they grant substantial ability to managers to unload their options and shares. They also grant large cash payments in the case of an acquisition, generous retirement programs, and follow-on consulting contracts. Directors also happily acquiesce to takeover defenses.[62]

61. Despite their independence (in the United States, and unlike for some other committees, such as the nomination committee, directors sitting on the compensation committee are mostly independent directors).

62. Another example of "camouflaged rent" is the granting of executive loans, now prohibited by the 2002 Sarbanes–Oxley Act.

1.3.2 Reforming the Board

The previous description of indolent boards almost smacks of conspiracy theory. Managers carefully recommend for board nomination individuals who either have conflicts of interest or are overcommitted enough that they will be forced to rubber-stamp the management's proposals at the board meetings. And managers try to remove incentives to monitor by giving directors performance-insensitive compensation and by insuring them against liability suits, and "bribe" them in the various ways described in Bebchuk and Fried's book. Most of these managerial moves must, of course, be approved by the board itself, but board members may find their own benefit to colluding with management at the expense of shareholders.

While there is obviously some truth in this description, things are actually more complex for a couple of reasons.

Teammates or referees? As we observed, board members may actually be in an uncomfortable situation in which they attempt to cooperate with top executives while interfering with their decisions. Such relationships are necessarily strenuous. These different functions may sometimes conflict. The advisory role requires the directors be supplied with information that the top management may be unwilling to disclose if this information is also used to monitor and interfere with management.[63]

Knowledge versus independence? Parties close to the firm, and therefore susceptible to conflict of interest, are also likely to be the best informed about the firm and its environment. Similarly, professional managers are likely to be good monitors of their peers, even though they have an undue tendency to identify with the monitored.

What link from performance to board compensation? Providing directors with stock options rather than fixed fees goes in the right direction, but, for the same reasons as for managers, stock options have their own limitations. In particular, if managers go for a risky strategy that reduces investor value but

63. Adams and Ferreira (2003) build a model of board composition based on this premise and show that, in some circumstances, a management-friendly board may be optimal.

raises the value of their stock options, directors may have little incentive to oppose the move if they themselves are endowed with stock options. Similarly, directors' exposure to liability suits has costs. While the current system of liability insurance clearly impairs incentives, exposing directors fully to liability suits could easily induce them to behave in a very conservative fashion or (for the most talented ones) to turn down directorial jobs.

With these caveats in mind, there is still ample scope for board reform. Save a few legal and regulatory rules (such as the 1978 New York Stock Exchange rule that listed firms must have audit committees made up of nonexecutives), directors and managers faced few constraints in the composition and governance of boards. New regulations and laws may help in this respect, but, as usual, one must ask whether government intervention is warranted; in particular, one should wonder why the corporate charter designers do not themselves draw better rules for their boards, and, relatedly, why more decentralized solutions cannot be found, in which shareholders force (provided they have the means to) boards to behave better. That is, with better information of and coordination among shareholders, capital market pressure may be sufficient to move boards in the right direction.

In this spirit, several study groups produced codes of good conduct or of best practice for boards (e.g., the 1992 Cadbury report in the United Kingdom and the 1995 Viénot report in France). Abstracts from the Cadbury report are reproduced at the end of this chapter. Among other proposals, the Cadbury report calls for (a) the nomination of a recognized senior outside member where the chairman of the board is the CEO,[64] (b) a procedure for directors to take independent professional advice at the company's expense, (c) a majority of independent directors (namely, nonexecutive directors free from business relationship with the firm), and (d) a compensation committee dominated by nonexecutive directors and an audit committee conferred to nonexecutive directors, most of whom should be independent. In contrast, the Cadbury report recommends against performance-based compensation of directors.

64. The UK Combined Code (the successor to the Cadbury Code) states that chairmen should be independent at the time of appointment.

Table 1.1 Compliance of U.S. companies with a few CalPERS criteria in 1997. *Source:* Analysis by the *The New York Times* (August 3, 1997) of data compiled by Directorship from the 861 public companies on the Fortune 1000 list. "Independent" here means "composed of outside directors."

Has outside chairman	5%
Only one insider on the board	18%
Some form of mandatory retirement for directors	18%
Independent nominating committee	38%
Fewer than 10% of directors over 70	68%
Independent governance committee	68%
No retired chief executive on the board	82%
Independent ethics committee	85%
Independent audit committee	86%
A majority of outside directors on the board	90%
Independent compensation committee	91%

In the United States, the largest public pension fund, CalPERS, with $165.3 billion in assets in August 2004, drew in the mid 1990s a more ambitious list of 37 principles of good practice for a corporate board, 23 "fundamental" and 14 "ideal." CalPERS would like the companies to consider the ideal principles, such as a limit on the number of directors older than 70, but has stated it would be more open-minded on these principles than on the fundamental ones. CalPERS monitors the companies' compliance (in spirit, if not the letter) with these principles and publicizes the results, so as to generate proxy votes for companies that comply least. As of 1997, most firms failed to comply with a substantial number of CalPERS criteria, although some of these criteria were usually satisfied by most corporations (see Table 1.1).

While the CalPERS list is stringent and some of its criteria controversial, it illustrates well the investors' current pressure for more accountable boards.

More recently, in the wake of the many corporate scandals at the turn of the century, expert recommendations regarding the board of directors have been bolder. For example, they suggest regular meetings of the board or specific committees in the absence of executives, a policy already adopted by a

number of corporations.[65] Such meetings promote truth telling and reduce individual directors' concern about the avoidance of conflict with management. A number of experts have also recommended self-evaluation of boards; for example, at regular intervals the director with the worst "grade" would be fired.[66] There have also been calls for strict limits (e.g., three) on the number of board mandates that a director can accept, for limited director tenures, and for a mandatory retirement age.

Monetary incentives have also been put forward. The directors' compensation would be more systematically related to the firm's stock value. Here the recommendation is for directors to hold a minimum number of shares in the firm.[67]

Some experts[68] have proposed a direct or intermediated (through an ombudsman) access of whistleblowers to independent directors. This is probably a good suggestion, although it has one flaw and its impact is likely to be limited for two reasons. The drawback of whistleblowing is that companies react to its threat by (a) intensively screening employees in order to pick those who are likely to prove "loyal," and (b) reducing information flows within the firm, which reduces the benefit of whistleblowing in terms of transparency and accountability.[69] Second, employees have relatively low incentives to blow the whistle. If discovered by the company (even formal anonymity does not guarantee that there will not be suspicion about the source of information), they will probably be fired. And whistleblowers notoriously have a hard time finding a new job in other firms, who fear that they will blow the whistle again.[70] In particular, employers routinely check prospective employees' litigation record. The proposal of letting whistleblowers have a direct or indirect access to independent directors is therefore likely to be most effective when (a) the sensitive information is held by a number of employees, so that whistleblower anonymity can really be preserved, and (b) the directors can check the veracity of the information independently, that is, without resorting to the whistleblower. Lastly, it must be the case that directors pay attention to the information that they receive from the whistleblower (the Enron board failed to follow up on allegations by a whistleblower). For this, they must not be swamped by tons of frivolous whistleblowing messages; and, of course, they must have incentives to exercise their corporate governance rights.

Lastly, the Sarbanes–Oxley Act (2002) in the United States requires the audit committee to hire the outside auditor and to be composed only of directors who have no financial dealing with the firm. It also makes the board more accountable for misreporting.

A Few Final Comments

Scope of codes. First, codes are not solely preoccupied with boards of directors. They also include, for example, recommendations regarding reporting (auditor governance, financial reporting), executive

65. Korn/Ferry International (2003) estimated that in 2003 87% of U.S. Fortune 1000 boards held Executive Sessions without their CEO present. By contrast, only 4% of Japanese boards gather without the CEO present.

66. In 2003, 29% of U.S. boards (41% in Asia Pacific) conducted individual director evaluation reviews (Korn/Ferry International 2003).

67. An example often cited by the proponents of this view is that of G. Wilson, who was for twelve years director of the Disney Corporation and held no share of Disney despite a personal wealth exceeding $500 million!

68. See, for example, *Getting Governance Right*, McKinsey Quarterly, 2002.

69. More generally, a cost of using informers is that it destroys trust in social groups, as has been observed in totalitarian regimes (e.g., in Eastern Germany, where people were concerned that family members or friends would report them to the Stasi).

70. Consider the example of Christine Casey, who blew the whistle on Mattel, the toy manufacturer, which reported very inflated sales forecasts to its shareholders (see, for example, *The Economist*, January 18, 2003, p. 60). Some managers kept two sets of figures, and consistently misled investors. In February 1999, Ms. Casey approached a Mattel director. After being screamed at by executives and basically demoted, in September 1999, she telephoned the SEC. She ended up resigning, filed an unsuccessful lawsuit against Mattel, and in 2003 was still without a job.

Zingales (2004) reviews the (rather bleak) evidence on what happens to whistleblowers after they have denounced management and after they quit their firm. To counteract the strong incentives not to blow the whistle, he proposes that whistleblowers receive a fraction (say, 10%) of all fees and legal awards imposed on the company (with, of course, some punishments for frivolous whistleblowing and a requirement to denounce to the SEC rather than in public). Such rewards already exists for people who help the U.S. government to recover fraudulent gains by private agents at its expense (whistleblowers are entitled to between 15% and 30%).

Friebel and Guriev (2004) argue that internal incentives are designed so as to limit whistleblowing. In their theoretical model, division managers may have evidence that top managers are inflating earnings. Top management, however, provides lower-level managers with a pay structure similar to theirs so as to make them allies. Friebel and Guriev thus provide an explanation for the propagation of short-term incentives in corporate hierarchies.

Table 1.2 Some recent codes of good governance.

	Independent directors?	Separation of chairman–CEO roles?	Rotation of external auditor?	Frequency of financial reporting?	'Comply or explain' requirement?	Selected country-specific governance issues
Brazil						
CVM Code (2002)	As many as possible	Clear preference for split	Not covered	Quarterly	No	Adoption of IAS/U.S. GAAP[1] Fiscal boards[1] Tag-along rights[1]
France						
Bouton Report (2002)	At least one-half of board	No recommendation	Regularly, for lead auditors	No recommendation given	No	Dual statutory auditors
Russia						
CG Code (2002)	At least one-quarter of board	Split required by law	Not covered	Quarterly	No	Managerial boards
Singapore						
CG Committee (2001)	At least one-third of board	Recommended	Not covered	Quarterly	Yes	Disclosure of pay for family members of directors/CEOs
United Kingdom						
Cadbury Code (1992)	Majority of nonexecutive directors	Recommended	Periodically, for lead auditors	Semiannually	Yes	
Combined Code (2003)	At least one-half of board	Clear preference for split	Not covered[2]	Semiannually, per listing rules	Yes	
United States						
Conference Board (2003)	Substantial majority of board	Separation is one of three acceptable options	Recommended for audit firm[3]	Quarterly, as required by law	No	

Source: Coombes and Wong (2004).

1. IAS, International Accounting Standards; GAAP, generally accepted accounting principles; fiscal boards are akin to audit committees, but members are appointed by shareholders; tag-along rights protect minority shareholders by giving them the right to participate in transactions between large shareholders and third parties.

2. In the United Kingdom, the accounting profession's self-regulatory body requires rotation of lead audit partner every seven years. Combined Code recommends that companies annually determine auditor's policy on partner rotation.

3. Sarbanes–Oxley Act requires rotation of lead audit *partner* every five years. Circumstances that warrant changing auditor *firm* include audit relationship in excess of ten years, former partner of audit firm employed by company, and provision of significant nonaudit services.

compensation, shareholders voting, or antitakeover defenses. Second, they are now commonplace. As of 2004, fifty countries had their own code of governance, emanating from regulators, investor associations, the industry itself, or supranational organizations. They differ across countries as shown by Table 1.2, which reports some key features of a few recently drawn codes.

Do codes matter? Codes are only recommendations and have no binding character. Probably the main reason why they seem to have an impact is that they educate the general public, including investors. To the extent that they are drawn by expert and independent bodies they carry (real) authority in indicating the conditions that are conducive to efficient governance. They further focus the debate on pointing at some "reasonable" or "normal" practices, a deviation from which ought to be explained. For example, it is often asserted that the 1992 Cadbury Code of Best Practice, by pointing at the cost of conflating the positions of chairman of the board and CEO, was instrumental in moving the fraction of the top U.K. companies that operated a separation from 50 to 95% in 2004. In performing this educative role, the codes finally may help the corresponding practices enjoy the "network externalities" inherent in familiar institutions: investors, judges, and regulators in charge of enforcing the laws gain expertise in the understanding of the meaning and implications of most often used charters; contractual deviations by individual firms therefore run the risk of facing a lack of familiarity by these parties.

Do codes suffice? Unlike codes, corporate laws do have a binding impact on the design of corporate charters, even though the exact nature of the regulatory constraint is subject to debate as courts are sometimes willing to accept contractual innovations in corporate charters in which the parties opt out of the legal rules and set different terms.[71] In the long-standing normative debate on contractual freedom in corporate law, there is relative agreement on the usefulness of corporate law as creating a default point that lowers the cost of contracting for all parties who do not want to spend considerable resources into drafting agreements.[72] Legal experts in contrast disagree on the desirability of the compulsory nature of the law. Advocates of deregulation, such as Easterbrook and Fischel (1989), argue that one size does not fit all and that a mandatory law at the very least prevents contractual innovations that would benefit all parties; they may further argue that existing rules need not be optimal even in the set of rigid rules. Others are opposed to permitting shareholders to opt out from the mandatory core of corporate law. Arguments in favor of keeping corporate law mandatory include: the absence of some concerned parties at the initial bargaining table (see Chapter 11 of this book); the possibility that inefficient governance allows managers to change the rules of the game along the way thanks to investors' apathy;[73] and the possibility that asymmetric information at the initial contracting stage engenders dissipative costs (see Chapter 6).

Even if it is not mandatory, corporate law matters for roughly the same reasons that codes are relevant. First, the transaction costs of contracting around the default point may be substantial. Second, there are the "network externalities" alluded to above in the context of codes. In particular, abiding by the statutes provides for a more competent enforcement by the legal infrastructure. These network externalities could, of course, suggest an equilibrium focus on contractual provisions that differ from existing rules; but the existence of transaction costs (the first argument) tends to make the rule a focal point.

Finally, note that a state or a country's codes and legal rules matter most when firms cannot choose where to incorporate and/or be listed. Competition among codes and legal rules[74] encourages international convergence towards standards that facilitate the corporations' access to financing (although, as will be studied in Chapter 16, firms' interests with respect to the regulatory environment may not be aligned).

1.4 Investor Activism

Active monitors intervene in such matters as the firm's strategic decisions, investments, and asset sales, managerial compensation, design of takeover defenses, and board size and composition. We first describe various forms of investor activism, leaving aside takeovers and bank monitoring, which will be discussed in latter sections. We then point to a number of limitations of investor activism.

1.4.1 Investor Activism Comes in Many Guises

Active monitoring requires control. As will be stressed in Part IV of this book, monitoring per se does not alter corporate policy. In order to implement new ideas, or to oppose bad policies of managers, the active monitor must have *control*. Control can come in two forms:[75] formal and real. Formal control is enjoyed by a family owner with a majority of voting shares, by headquarters over divisions in a conglomerate, or by a venture capitalist with explicit control rights over a start-up company. Formal control thus enables a large owner to, directly

71. On the role of courts, see, for example, Coffee (1989).

72. On this, see, for example, Ayres and Gertner (1989, 1992). Easterbrook and Fischel (1989), among others, point out that the story that corporate law is there to provide off-the-shelf terms for parties who want to economize on contracting costs is incomplete in that the default rules could be designed alternatively by law firms, corporate service bureaus, or investment banks. They argue nonetheless that the supply of default rules has the nature of a public good, if only because the court system can develop a set of precedents on how to deal with contract incompleteness.

73. Bebchuk (1989) emphasizes that the questions of contractual freedom in the initial charter and in midstream (after the charter has been drawn) are different. The amendment process is imperfect, as the shareholders's insufficient incentive to become informed may not preclude value-decreasing amendments.

74. There is a large literature on competition between legal environments. See, for example, Bar-Gill et al. (2003) and Pagano and Volpin (2005c) and the references therein.

75. This dichotomy is an expositional oversimplification. Actual control moves more continuously than suggested by the dichotomy.

Table 1.3 Ownership of common stock (as a percentage of total outstanding common shares in 2002) for (a) all equity and (b) listed equity.

	(a)				(b)			
	U.S.	Japan	France	Germany	U.K.	Japan	France	Germany
Banks and other financial institutions	2.3	9.0	12.1	10.5	12.6	7.42	12.6	33.5
Insurance companies	7.3	4.3	4.5	9.9	19.9	7.32	7.0	7.4
Pension funds	16.9	5.4			15.6	5.62		
Mutual funds	19.5	1.9	5.9	11.3	4.5	6.58	19	4.6
Households	42.5	14.0	19.5	14.7	14.3	16.84	6.5	22.9
Nonfinancial business	n.a.	43.7	34.3	34.2	0.8	38.12	20.2	11.7
Government	0.7	14.0	4.5	2.7	0.1	4.12	3.6	1.9
Foreign	10.6	7.7	19.2	16.6	32.1	13.98	31.2	18.1

This table was assembled by David Sraer. The details of its construction can be found in an appendix (see Section 1.11.1).

and unencumbered (except perhaps by fiduciary duties), implement the changes he deems necessary. In contrast, real control is enjoyed by a minority owner who persuades other owners, or at least a fraction of them sufficient to create a dissenting majority, of the need for intervention. The extent to which a minority owner is able to convince other owners to move against management depends on two factors: ease of communication and of coalition-building with other investors, and congruence of interest among owners. The degree of congruence is determined by the active monitor's reputation (is he competent and honest?), by the absence of conflict of interest (will the monitor benefit from control in other ways than his fellow shareholders?), and by his stake in the firm (how much money will the monitor lose in case of a misguided intervention?). The latter factor explains why minority block shareholders are often described (a bit abusively) as having a "control block" even though they do not formally control the firm, and why dissidents in proxy contests are less trusted if their offer is not combined with a cash tender offer.

Proxy fights. In a proxy contest, a stockholder or a group of stockholders unhappy with managerial policies seeks either election to the board of directors with the ultimate goal of removing management, or support by a majority of shareholders for a resolution on a specific corporate policy. Sometimes, the *threat* of a proxy contest suffices to achieve the active monitor's aims, and so the contest need not even occur. For example, active monitors may use a political campaign to embarrass directors and force them to remove the CEO; or they may meet with directors or management and "convince" them of the necessity to alter their policies.

Proxy fights are an important element of corporate discipline in the United States. For example, in 1992–1993, financial institutions claimed the scalps of the CEOs of American Express, Borden, General Motors, IBM, Kodak, and Westinghouse. They also pressed for smaller boards and a larger fraction of outside directors, and forced large pay cuts on the bosses of ITT, General Dynamics, and U.S. Air (*The Economist*, August 19, 1996, p. 51). Proxy fights are associated with low accounting earnings, but, perhaps surprisingly, seem to have little relationship with the firm's stock returns (see de Angelo 1988; de Angelo and de Angelo 1989; Pound 1988).

As we discussed, the existence and success of proxy fights depend not only on whether the initiator is trusted by other shareholders,[76] but also on their cost and feasibility. The competition between management (who can use corporate resources) and dissidents must be fair. And shareholders must be able to communicate among themselves. Until 1992, U.S. regulations made it very difficult for institutional investors (many of whom typically own a small piece

76. Proxy votes may be ineffective if the dissenters do not succeed in building a majority. For example, in 2003, Disney was able to ignore in large part a proxy vote in which about 40% of the votes were cast against management.

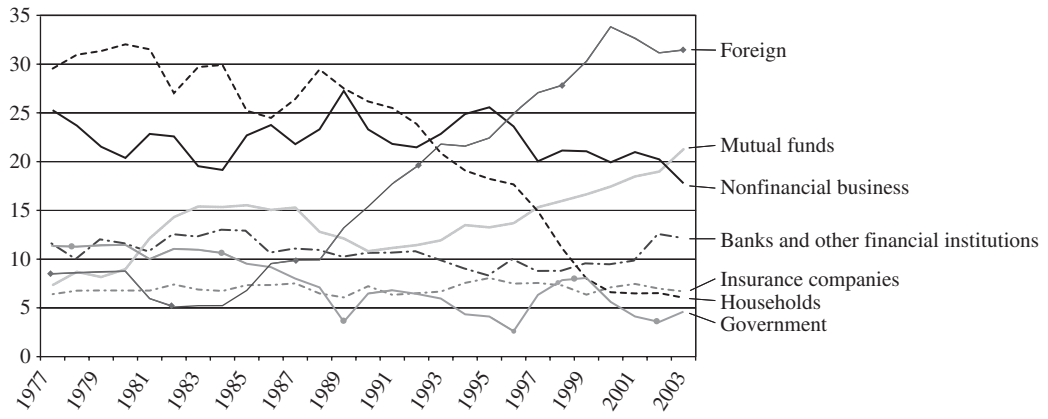

Figure 1.3 Evolution of listed-equity ownership by sectors in France (1977–2003). (Assembled by David Sraer.)

of the firm, as we will see) to communicate. A 1992 SEC rule change has allowed freer communication. Furthermore, the 1992 new SEC rules have lowered the cost of a proxy fight from over $1 million to less than $5,000 (*The Economist*, January 29, 1994, p. 24 of a survey on corporate governance).

Proxy fights are rare in many other countries, and almost unheard of in Japan, where general assemblies tend to be perfunctory.

1.4.2 Pattern of Ownership

Investor activism is intimately linked to the structure of ownership. A brief review of this structure (in the context of publicly held companies) is therefore in order.

Table 1.3 looks at the ownership of common stock for listed and unlisted companies. It shows that, as of 2002, countries differ substantially as to who owns equity. In the United States, households and institutional investors other than banks hold most of the shares.[77] Households (other than owners of family firms) have much lower stockholdings in France, Germany,[78] and Japan.

Table 1.3(b), for the same year, specializes to *listed companies*. Note that foreign ownership is substantially higher, indicating that foreign equity portfolios tend to specialize in listed companies.

Figures 1.3 and 1.4 describe the intertemporal evolution of listed-equity ownership in France and the United Kingdom, respectively.

Institutional investors do not all have the same incentives to monitor, as we will later discuss. It is therefore interesting to have a closer look at the decomposition of shareholdings among these investors. Table 1.4 describes this decomposition for the United States in 2004.

Pension funds play a much more minor role in other countries such as France, Germany, Italy, or Japan; in these countries, they are quasi-nonexistent, because retirement benefits are publicly funded on a pay-as-you-go basis (as in France), or because pension funds are just a liability item on the firms' balance-sheet and do not stand as independent investors (as in Germany).

The absence or weakness of pension funds is not the only characteristic of non-Anglo-Saxon countries. As we will see, *ownership concentration* is substantial. Also, *cross-shareholdings* among firms is widespread, as shown by the ownership share of nonfinancial business. There is a complex web of

77. We here focus on the ownership of common stock. Needless to say, the ownership pattern for assets in general may be quite different. For example, U.S. banks held almost no equity due in part to the prohibition contained in the 1933 Glass–Steagall Act, an act passed by Congress prohibiting commercial banks to participate in investment banking or to collaborate with full-service brokerage firms (this act was repealed in 1999). In contrast, their market share of total assets among U.S. financial institutions in 1994 was 28.7% (as opposed to 15.3% for insurance companies, 14.6% for private pension funds, 7.1% for public pension funds, 9.5% for mutual funds, 3.5% for money market funds, and 21.3% for other institutions). *Source:* Board of Governors of the Federal Reserve System, Flow of Funds Accounts 1995, cited by Sametz (1995).

78. For further information about the ownership of German corporations, see Franks and Mayer (2001).

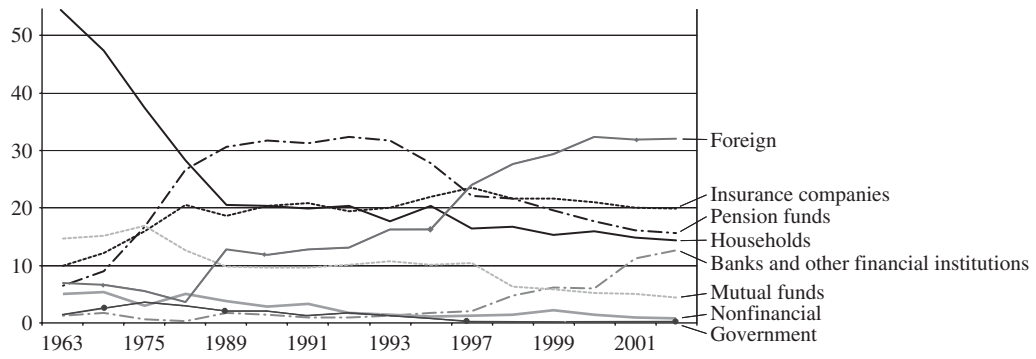

Figure 1.4 Evolution of listed-equity ownership by sectors in the United Kingdom (1963–2002). (Assembled by David Sraer.)

Table 1.4 Institutional investors' equity holdings as a percentage of the total U.S. equity market by category. (IEH, institutional equity holdings ($ billion); TEM, total equity market.)

Type of institution	IEH	TEM (%)
Banks	213.7	1.8
Commercial Banking	3.5	0.0
Savings Institutions	29.1	0.2
Banks, personal trusts and estates	181.1	1.5
Insurance companies	861.2	7.3
Life Insurance companies	708.9	6.0
Other Insurance companies	152.3	1.3
Pension funds	2015.0	17.0
Private pension funds	1096.7	9.2
State and local government retirement funds	869.8	7.3
Federal government retirement funds	48.5	0.4
Investment companies	2394.8	20.2
Mutual funds	2188.0	18.4
Closed-end funds	33.7	0.3
Exchange-traded funds	98.2	0.8
Brokers and dealers	74.9	0.6
All institutions	5484.7	46.2

This table was assembled by David Sraer. The details of its construction can be found in an appendix (see Section 1.11.2).

cross-participations within loosely defined or more structured industrial groups. For example, Table 1.5 reproduces findings of a study of the Japanese Fair Trade Commission summarizing cross-shareholdings in the major Japanese industrial groups.

Table 1.5 Average percentage of shares owned by firms in the keiretsu divided by total outstanding shares in 1992. *Source:* Kojima (1997, p. 57).

Mitsui	19.3%
Mitsubishi	38.2%
Sumitomo	28%
Fuyo	16.9%
Sanwa	16.7%
Dai-ichi Kangin	14.2%

Another interesting international difference relates to the *size of the stock market*. Anglo-Saxon countries have well-developed stock markets; the capitalizations of the U.S. and U.K. stock markets in June 1996 made up about 90% and 120% of their respective GDPs (gross domestic products). With some exceptions (e.g., Japan and Switzerland), other stock markets are smaller (under 40% of GDP in France; Germany and Italy around the same date); for example, many relatively large German firms choose to remain private.

Ownership concentration. There are also wide variations in the concentration of shares across countries.

In the majority of publicly listed Italian firms, for example, one shareholder holds above 50% of the shares (Franks et al. 1996). Family-owned firms there play an important role, as they do in France, Germany, and Sweden (see Table 1.6). Using a sample of 5,232 listed firms in 13 countries, Faccio and Lang (2002) provide a systematic analysis of ownership in Western Europe, pointing out the wide diversity of

Table 1.6 The identity of controlling owners in Europe (%) (1996–2000).

Country	France	Germany	Italy	Sweden	U.K.
Widely held	14	10	13	39	63
Family	65	64	60	47	24
Identified families	26	27	39	23	12
Unlisted firms	39	38	20	24	11
State	5	6	10	5	0
Widely held corporation	4	4	3	0	0
Widely held financial	11	9	12	3	9
Miscellaneous	1	3	1	6	3
Cross-holdings	0	2	1	0	0
Number of firms	607	704	208	245	1953

Source: Faccio and Lang (2002). Reprinted from *Journal of Financial Economics*, Volume 65, M. Faccio and L. Lang, The ultimate ownership of Western European corporations, pp. 365–395, Copyright (2002), with permission from Elsevier. A detailed description can be found in an appendix (see Section 1.11.3).

institutions (dual-class shares, cross-holdings, pyramidal structures[79]) and concentration. They find that 54% of European firms have only one controlling owner and that more than two-thirds of the family-controlled firms have top managers from the controlling family. Widely held firms account for 37% of the sample and family-controlled ones for 44%.

Similarly, Claessens et al. (2000) investigate the ownership structure of 2,980 publicly traded firms in nine East Asian countries (see, in particular, Table 1.7). In all countries, control vastly exceeds what would be predicted by cash-flow rights and is enhanced through pyramid structures and cross-holdings between firms. In their sample, more than two-thirds of the firms are controlled by a single shareholder, and about 60% of the firms that are not widely held are managed by someone related to the family of the controlling shareholder. There are significant variations across countries, though: for example, corporations in Japan are often widely held while those in Indonesia and Thailand are mainly family owned.

In contrast, ownership concentration is much smaller in Anglo-Saxon countries. For example, the mean and the median of the "three-shareholder concentration ratio," namely, the fraction of ownership by the three largest shareholders, for the largest listed firms, are 0.19 and 0.15 for the United Kingdom, 0.34 and 0.68 for France, and 0.48 and 0.50 for Germany (La Porta et al. 1998).

Ownership is extremely dispersed in the United States. While Shleifer and Vishny (1986) report that above 50% of the Fortune 500 firms have at least one shareholder holding a block exceeding 5%, large blocks are relatively rare (except, of course, in the case of leveraged buyouts or family-held firms). The median largest shareholder has only 9% of the firm's equity, and a number of moderate size block shareholders typically coexist; 20% (respectively, 15%) of firms traded on the New York Stock Exchange, the Amex, and the over-the-counter market have a nonofficer (respectively, officer) holding more than 10% of shares (Barclay and Holderness 1989). Institutional investors often hold (individually) a very small amount of the firm's stock; for example, in 1990, the most visible "active investor," CalPERS, reportedly held less than 1% of the firms it invested in (Kojima 1997, p. 22).

Stable holdings versus active portfolio management. Another point of departure among countries is the degree of stability of stock holdings.

Simplifying somewhat, Japanese and German investors have traditionally been in for the long haul, while Anglo-Saxon investors reshuffle their portfolios frequently. Institutional investors dominate liquidity trading in the United States. Mutual funds

79. Pyramids refer to the indirect control of one corporation by another that does not totally own it.

Table 1.7 The identity of controlling owners in Asia (%) (1996).

Country	Hong Kong	Japan	Korea	Malaysia	Singapore	Taiwan	Thailand
Widely held	7	79.8	43.2	10.3	5.4	26.2	6.6
Family	66.7	9.7	48.4	67.2	55.4	48.2	61.6
State	1.4	0.8	1.6	13.4	23.5	2.8	8
Widely held corporation	19.8	3.2	6.1	6.7	11.5	17.4	15.3
Widely held financial	5.2	6.5	0.7	2.3	4.1	5.3	8.6
Number of firms	330	1240	345	238	221	141	167

Source: Claessens et al. (2000). Reprinted from *Journal of Financial Economics*, Volume 58, S. Claessens, S. Djankov, and L. Lang, The separation of ownership and control in East Asian corporations, pp. 81–112, Copyright (2000), with permission from Elsevier. A detailed description can be found in an appendix (see Section 1.11.3).

and actively managed pension funds hold their shares, on average, for 1.9 years (Kojima 1997, p. 84). In contrast, shareholdings are very stable in Japan. Kojima (1997, p. 31) assesses that, for a typical Japanese firm, about 60% of shareholdings are stable. In Japan, business corporations (which hold substantial amounts of stocks through cross-shareholdings) and financial institutions view themselves as engaged in a long-term relationship with the firms they invest in.[80] Table 1.8 confirms the low turnover rate for corporate and institutional investors.

Table 1.8 Stock trading by type of investor in terms of average percentage turnover rates (for the years 1990–92).

Life and casualty insurance companies	sales	4.9
	purchases	5.0
Business corporations	sales	8.5
	purchases	8.4
Banks	sales	12.3
	purchases	12.8
Individuals	sales	24.9
	purchases	24.7
Foreigners	sales	61.4
	purchases	65.1
Investment trusts	sales	65.3
	purchases	64.9

Source: Kotaro (1995, p. 15) and Economic Planning Agency White Papers (1992).

1.4.3 The Limits of Active Monitoring

For all its benefits, investor activism encounters a number of limits, studied in Chapters 9 and 10 and grouped below in four categories.

Who monitors the monitor? Active monitors are in charge of mitigating the agency problem within the firms they invest in. The same agency problem, however, often applies, with a vengeance, to the monitors themselves. In particular, pension and mutual funds have a very dispersed set of beneficiaries and no large shareholder! Coffee (1991) argues that there are very few mechanisms holding U.S. institutional money managers accountable: most face no threat of hostile takeover or proxy fights; pension funds have no debt and therefore face less pressure to generate profits than ordinary corporations; and executive compensation is hard to design, as well as constrained by the regulatory framework (compensation is a function of assets under management rather than an incentive compensation based on the fund's capital appreciation, which is contrary to federal securities laws).

Thus, monitoring may be impaired by the fact that monitors may not act in the interest of the beneficiaries. Corporate managers usually argue, in this respect, that institutional investors are too preoccupied by short-term profit, presumably because the managers of pension and mutual funds are keen to keep their positions and to manage larger funds. Some corporate managers also complain that the institutions' managers monitoring them have limited managerial competency.

80. See Aoki (1984, 1990), Aoki and Patrick (1995), Kotaro (1995), and Kojima (1994, 1997) for discussions of long-term financial relationships in Japan.

Congruence with other investors. Even if the agency problem between the active monitor and its beneficiaries is resolved (say, because the two coincide, as in the case of a large private owner), the active monitor does not internalize the welfare of other investors and therefore may not monitor efficiently. This may give rise to:

Undermonitoring. A pension fund owning 1 or 2% of a corporation has vastly suboptimal incentives to acquire strategic information and launch a proxy fight, as it receives only 1 or 2 cents per dollar it creates for the shareholders. Substantial free riding may thus be expected, for example, when institutional ownership is very dispersed.

Collusion with management. Relatedly, a monitor may enter into a quid pro quo with management or be afraid of retaliation in case it dissents (for example, noncooperative fund managers in a proxy fight may not be selected to manage the firm's pension plan).

Self-dealing. Large blockholders monitoring a firm may use their private information to extract rents from the firm through transactions with affiliated firms and the like. How much they can extract depends on the strength of legal enforcement of shareholders rights as well as on the (non)existence of other large shareholders who are not made part of the sweet deals and can denounce the abuse.

Cost of providing proper incentives to the monitor. Again, leaving aside agency problems within the monitor, several authors, most notably Coffee (1991), Porter (1992), and Bhide (1993a), have argued that only "long-term players" are good monitors. Their basic idea is that investors have little incentive to create long-run value improvement (exert voice) if they can easily exit by reselling their shares at a fair price. They further argue that illiquidity, promoted, say, by privately placed equity, large blocks with limited marketability, taxes on realized capital gains, or equity with limited resale rights (letter stocks), would enhance the quality of monitoring, and they point at the long-term, stable relationships in Japan and Germany between the investors and the corporations they invest in.[81] These authors recognize that illiquidity is costly to the institutional investors but they argue that this cost is limited for some institutional investors such as pension funds. While Chapter 9 will qualify the view that active monitoring requires a long-term involvement, the point that properly structuring the active monitor's incentives may entail some illiquidity costs is valid.

Perverse effects on the monitorees. While monitoring is generally beneficial, it does not come without side effects for the monitoree. There may be overmonitoring and a reduction in initiative (see Chapter 9), and the firm's managers may become overly preoccupied by short-run news that will determine their tenure in the firm. They may then devote much time to manipulating short-term earnings (see Chapter 7) and trying to secure the cooperation of the largest institutional investors.

Legal, fiscal, and regulatory obstacles. A number of authors, most notably Roe (1990), Coffee (1991), and Bhide (1993a), have emphasized the legal, fiscal, and regulatory impediments to investor activism in the United States, and argued that U.S. regulators have discouraged efficient governance.

First, stockholders who sit on a firm's board are exposed to SEC and class-action suits.[82] Furthermore, an individual or a group that possesses "control" of a company is deemed an "affiliate" and faces volume and holding-period restrictions on reselling shares;[83] Section 16(b) of the Securities Exchange Act of 1934 stipulates that any gain that an officer, director, or 10% holder of a security receives on purchases or sales of the security within six months of an earlier purchase or sale must be paid back to the corporation. These rules create illiquidity, which add to the natural illiquidity of big blocks. These are therefore particularly costly for mutual funds, which face redemptions and therefore must be able to sell.

Another rule affecting institutional control is the diversification rule. In order to receive favorable tax

81. With respect to this last point, it should be noted that these contributions were written in the late 1980s to early 1990s when the "GJ" model (for "Germany–Japan") was fashionable. The economic evolution of the 1990s made observers much less keen on endorsing this model, and more keen (probably too keen) on embracing the Anglo-Saxon paradigm.

82. Section 20 of 1934 Securities Exchange Act.

83. Securities Act of 1933.

treatment as a diversified fund, a pension fund or mutual fund cannot hold more than 10% of the stock of any firm (even though a holding above 10% may be small relative to the fund's total managed assets, so that the rule has no virtue in terms of diversification and prudential regulation!). It is therefore not surprising that U.S. institutional investors hold small fractions of shares of individual firms so as to avoid restrictions on short-term (insider) trading and receive favorable tax treatment, and that they avoid sitting on boards.

While the details of regulation are country- and time-specific, it should be borne in mind that they can have a nonnegligible impact on corporate governance.

1.5 Takeovers and Leveraged Buyouts

One of the most controversial aspects of corporate governance, and certainly one that varies most across countries, is the market for corporate control. The explosion of hostile takeovers and of leveraged buyouts (LBOs) in the United States in the 1980s[84] has been perceived with awe, horror, and admiration. In Japan and continental Europe, where acquisitions are usually negotiated with management, they represent the worst of an American capitalism based on greed and myopia. In Anglo-Saxon countries, in contrast, many view them as an original mode of corporate governance that substitutes efficient teams for entrenched, money-wasting managers (Manne 1965).[85]

Although they are divided on the topic, economists are in agreement on many of the costs and benefits of takeovers (reviewed in Chapter 11), and hold much more dispassionate views on the topic than practitioners and laymen. On the managerial side, takeovers may be needed to keep managers on their toes, if the board and general assembly are ineffective monitors and thus traditional corporate governance fails. But, as for other forms of incentive based on the termination of employment, they may induce managers to act "myopically" and boost their short-term performance at the expense of the long-term one. On the corporate policy front, takeovers may put in place a new managerial team with fresh ideas on how to run the firm and less keen on sticking to former strategy mistakes. But they may also let a value-reducing raider gain control from uncoordinated shareholders. Finally, takeovers may shatter implicit contracts with other stakeholders. Chapter 11 will therefore study private and social inefficiencies arising in the market for corporate control.

Let us begin with three salient features of the U.S. corporate environment of the 1980s. First, while definitely smaller than that of the subsequent merger wave (see below), the volume of mergers and acquisitions was very high by historical standards during the decade. Indeed, 143 of the 1980 Fortune 500 firms had become acquired by 1989. About $1.3 trillion changed hands in the 1980s. Of course, most acquisitions were or looked "friendly" (it is hard to measure the extent to which negotiated acquisitions are influenced or driven by the threat of a takeover); out of 3336 transactions that occurred in 1986, only 40 were hostile[86] and 110 corresponded to tender offers unopposed by management. Yet the size of some hostile takeovers, their wide media coverage, the personality characteristics of the participants,[87] and the anxiety of managers (few keep their job after a successful raid, so that one of a manager's worst nightmares is to become the target of a takeover bid) all concurred to draw substantial attention to the phenomenon.

84. There are several excellent reviews of the takeover and LBO boom of the 1980s, including Bhagat et al. (1990), Holmström and Kaplan (2001, 2003), Kaplan (1993), Milgrom and Roberts (1992, Chapter 15), and the papers by Shleifer and Vishny, Jensen, Jarrell et al., and Scherer in the 1988 symposium of the *Journal of Economic Perspectives*.

85. This view is, of course, far from being uniform. For example, Peter Drucker, a leading management guru, argued in 1986 that "there can be absolutely no doubt that hostile takeovers are exceedingly bad for the economy." He characterized the high leverage of acquired companies as "severely impairing the company's potential for economic performance." And he condemned the sell-off of the most valuable parts of the acquired businesses (see Bhide 1993b).

86. "Hostile" refers to the fact that the raider invites shareholders to accept the offer whether the board recommends it or not.

87. Bosses under siege, and raiders such as Boone Pickens, Goldsmith, Perelman, Campeau, and Icahn became almost household names. Books about hostile acquisitions, such as *Barbarians at the Gate* by B. Burrough and J. Helyar (New York: Harper & Row, 1990) relating the $25 billion takeover of RJR Nabisco by KKR (a spectacular takeover which started as a management buyout (MBO), but in which management ultimately lost to KKR, who paid more than twice the price prevailing before the bidding war began), turned into bestsellers.

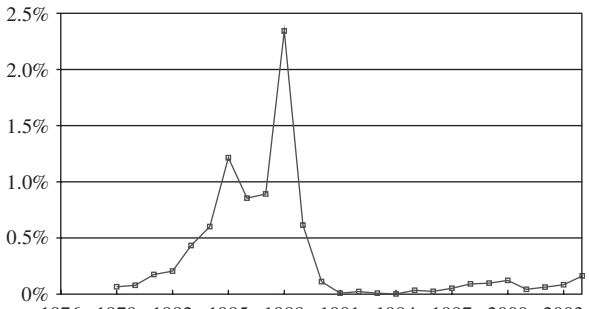

Figure 1.5 Going private volume as percentage of average total stock market value 1979–2003. *Source:* Holmström and Kaplan (2001) and S. Kaplan (personal communication, 2005).

Second, many publicly traded firms were turned back private through leveraged buyouts, especially management buyouts (see Figure 1.5).

Third, corporate leverage increased substantially during the decade. Firms bought back their own shares, and sometimes put them into Employee Stock Ownership Plans. Furthermore, and associated with the takeover and LBO wave, a new form of public debt, namely, risky or junk bonds, appeared and grew remarkably fast: $32.4 billion of junk bonds were issued in 1986, and the stock of junk bonds had swollen to $175 billion by the fall of 1988 (Stigum 1990, p. 100).

The trend stopped around 1989–1990. The junk bonds used for LBOs and takeovers, especially those issued in the second half of the decade, started defaulting. A number of Savings and Loans, who had been big buyers of junk bonds, went bankrupt.[88] The creator of junk bonds (Michael Milken) and his employer (the investment bank Drexel–Burnham–Lambert, which subsequently went bankrupt) were sued and found guilty of a number of misdemeanors and criminal offenses (insider trading, stock manipulation, fraud, falsified records). Hostile takeovers declined (see Figure 1.6).

While the risky bond market recovered around 1992–1993 (see Figure 1.7), it was then much less related to mergers and acquisitions.

88. The difficulties faced by the S&Ls did not stem from junk bonds, but with the interest rate shock of the late 1970s, and several mistakes of prudential regulators in the 1980s. However, the S&L disaster added to the general negative feelings about junk bonds.

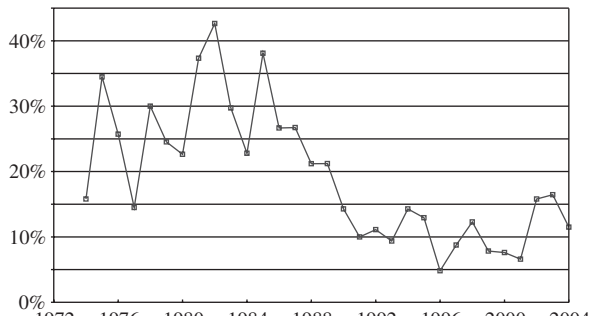

Figure 1.6 Contested tender offers as percentage of total 1974–2004. *Source:* Holmström and Kaplan (2001) and S. Kaplan (personal communication, 2005).

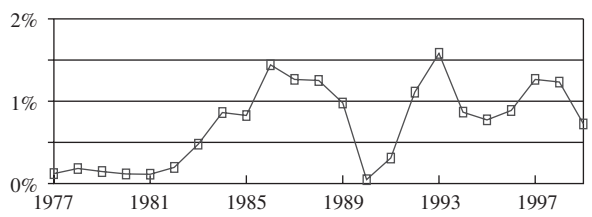

Figure 1.7 Noninvestment grade bond volume (as a percentage of average total stock market capitalization) 1977–1999. *Source:* Holmström and Kaplan (2001).

Simultaneously, the popularity of LBOs had waned. Buyouts of public corporations fell from $60 billion in 1988 to $4 billion in 1990 (W. T. Grimm's Mergerstat Review 1991). Takeovers in general collapsed in 1990. Most states had by then put in place restrictive antitakeover laws, partly under the pressure of the Business Roundtable (composed of the CEOs of the 200 largest U.S. corporations).

It should be noted, though, that the volume of mergers and acquisitions was substantially higher in the 1990s than in the 1980s. The recent merger wave,[89] culminating in the 1998–2001 period, was the largest in American history and associated with high stock valuations and the use of equity as a form of payment; but more takeover defenses were in place than in the 1980s. What died out in the 1990s were hostile takeovers.[90]

89. Documented, for example, in Moeller et al. (2003).

90. Meanwhile, hostile takeovers have gained a bit more prominence in Europe, where they have traditionally been very rare. British-based Vodafone's 2000 takeover of the German company Mannesmann for $183 billion, for example, attracted much attention, caused several

Lastly, firms tried to accomplish internally very much what takeovers and LBOs were about. Cost-cutting and leanness became fashionable through concepts such as reengineering, downsizing, focus, and EVA.[91] Share repurchases allowed firms to increase their leverage. And proxy fights such as those led by institutional investors and facilitated by the 1992 new SEC rules provides a substitute mechanism for interfering with management when takeover defenses and antitakeover laws made it difficult to acquire control by purchasing a large number of shares. Before discussing these phenomena, we first review some of the institutional innovations of the decade.

1.5.1 Takeover Bids and Defenses

Although it is generally preceded by a purchase of a "toehold" by the potential acquirer, a takeover process really starts with a tender offer, that is, with an invitation to buy the firm's shares at an announced price. The offer may concern part or all of the stock. And it may be conditional on a certain number of shares being effectively tendered, the idea being that the bidder is often interested in the shares only if he obtains a controlling stake. The bid may also be multitiered, that is, specify a different price for shares beyond some threshold level, or may offer a uniform price for all shares (multitier offers are allowed in the United States, but British raiders cannot pay less to minority shareholders once 30% of the shares have been acquired).

While hostile takeovers have long been part of the American corporate scene, there has been a phenomenal volume of such takeovers in the 1980s, with a peak in 1988–1989. They have been particularly prominent in such industries as oil and gas, mining and minerals, banking and finance, and insurance. Jensen (1988) has argued that takeovers facilitate exit and cash disgorgement in slow-growth industries, where management refuses to unwind its empire and uses the available cash, where there is any, to engage in wasteful diversifications. Relatedly, Morck et al. (1990) find that firms in industries with low ratios of market value of securities over the accounting value of assets (that is, with low "Tobin's Qs") are more likely to be the target of takeover bids.

Management reacted not only by lobbying for restrictive antitakeover laws,[92] but also by adopting (or by convincing shareholders or the board to adopt) takeover defenses. Takeover defenses (which will also be studied in Chapter 11) come in many guises and are sometimes quite ingenious. (See Jarrell et al. (1988) and Malatesta (1992) for more detailed discussions.)

Some defenses, called corporate charter defenses, just *make it technically difficult for the raider to acquire control*. With a *staggered board*, only a fraction of members rather than all directors are up for reelection in a given year, so that a successful raider has to wait for some time after the acquisition to acquire full control. Under a *supermajority rule*, a raider needs x% of the votes in order to effect a merger or another significant corporate reorganization, such as large asset sales, where x may be 80 or 90 rather than 50 (as it would be under a simple majority rule). *Fair price clauses* attempt to force an acquirer to offer a premium for all shares by imposing a very stringent supermajority clause (nearing shareholder unanimity) unless a high and uniform price is offered for all shares (where "high," for example, means that the bid must exceed the highest share price during the preceding year). Another variation on the supermajority rule consists in placing a number of shares in an Employee Stock Ownership Plan (ESOP). To the extent that employees will vote with management in the event of a takeover (which is likely), ESOPs make it more difficult for a raider to gain control.[93] In the same spirit, *differential voting rights* provide privileged voting rights

law suits, and created a public debate about the large golden parachutes for Mannesmann executives (including 31 million euros for its chairman).

91. EVA refers to "economic value added," a technique promoted by management consulting companies such as Stern Stewart, and which consists in imputing a cost of capital to guide internal investment decisions. See Rogerson (1997) for more detail.

92. For a description of the main antitakeover laws (control share laws, fair price laws, and freeze-out laws), see, for example, Malatesta (1992).

Comment and Schwert (1995) express skepticism about the deterrence effect of antitakeover laws and argue that the collapse of the market for corporate control at the end of the 1980s is due to other factors, such as the recession and the resulting credit crunch. They find, however, that takeover premia paid by raiders are higher when target firms are protected by state laws or by poison pills.

93. See, for example, Pagano and Volpin (2005a) for the deterrent effect of ESOPs in hostile takeover attempts. Dhillon and Ramirez

to shares that are held for an extended period (and so the raider cannot benefit from the corresponding privileges); and *dual-class recapitalizations* provide management or family owners with more votes than would be warranted by their shares. Still another way for a firm to deter takeovers is to change its state of incorporation and *move to a state with tougher antitakeover statutes*.

A second group of takeover defenses amount to diluting the raider's equity, often at the expense of the corporation. The idea is to make the firm less attractive to the raider, perhaps at the cost of making the firm less attractive to anybody else as well. *Scorched-earth policies* consist in selling, possibly at a low price, assets which the raider is particularly keen on acquiring, either because they would create synergies with his own operations or because they would generate a steady flow of cash that would help finance the often highly leveraged acquisition (relatedly, management may try to increase leverage or reduce the amount of corporate cash that can be enjoyed by a potential raider). Entering *litigation* against the raider may also prove an effective deterrent. For, even if the raider is reasonably confident of winning the case, the very cost of litigation may make the prey much less desirable.

Lastly, a wide variety of *poison pills* have been conceived. Poison pills generally refer to special rights of the target's shareholders to purchase additional shares at a low price or sell shares to the firm at a high price conditionally, say, on a raider acquiring a certain fraction of the target's shares. That is, poison pills are call or put options for the target shareholders that have value only in case of a hostile takeover. Poison pills thus reduce the value of equity in the event of a takeover. Popular poison pills include flip-over plans, which, inter alia, allow the shareholder to buy shares in the surviving or merged firm at a substantial discount, say 50%.[94]

To complete this brief description, let us also mention two common practices used by managers, once the takeover process has started, to repel raiders at the expense of shareholder value. Managers sometimes look for a *white knight*, namely, an alternative acquirer with a friendlier attitude vis-à-vis current management and willing to bid up the price; the presence of the white knight may discourage the raider (who, remember, has to find the funds for the takeover attempt) and the firm may end up being sold at a relatively low price to the white knight. Perhaps the most controversial defense of all is the practice of *greenmail* (or targeted block stock repurchases), through which management, using company money, purchases at a premium the raider's block of the target's stock. Greenmail can be viewed as a form of collusion between management and the raider at the expense of other shareholders.

Let us conclude this discussion of takeover institutions and strategies with a puzzle (that will be discussed in Part IV of the book). Leaving aside statutory defenses, which lie outside the firm's control, one may question the process through which corporate charter (supermajority amendments, fair price clauses, staggered boards, changes in the state of incorporation) and other defenses (greenmail, litigation against the raider, poison pills) come about. The former require ratification by the shareholders, while the latter are subject to board approval without shareholder ratification. In view of the substantial conflict of interest faced by management in such matters and of the fact that greenmail and the adoption of poison pills are usually greeted by a negative stock price reaction,[95] it is not *a priori* clear why boards exert so little control and why corporate charter defenses are so often approved by shareholders. This rubber-stamping of managerial

(1994) point out that ESOPs, like many other antitakeover devices, have two effects: a reduction in the occurrence of takeovers and an increase in the relative bargaining power of the firm vis-à-vis the raider (see Chapter 11 for a study of these two effects); using the 1989 Delaware court decision on Polaroid's ESOP, establishing the legality of ESOPs as a takeover defense, Dhillon and Ramirez find that the overall stock price reaction upon the announcement of an ESOP tended to be positive over their sample period, consistent with the relative bargaining power effect, but that, after the Delaware court decision, it was strongly negative for those firms that were already subject to takeover speculation, consistent with the managerial entrenchment hypothesis.

94. The term "flip-over" refers to the fact that formally the plans are call options given as dividends to the target shareholders. The shareholder can exercise these options at a high price in the case of a takeover and the firm can redeem these options at a nominal fee before a bid or acquisition. The impediment resides mainly in the flip-over provision, which gives old shareholders the right to dilute the firm after a takeover.

95. See, for example, Jarrell et al. (1988) and Malatesta (1992) for reviews of the evidence.

proposals in the matter of takeover defenses raises the question of whether they increase incumbent shareholders' wealth (for one thing, they may force the raider to bid a higher price: on this see Chapter 11), or whether this is just another illustration of managerial entrenchment and poor corporate governance.

1.5.2 Leveraged Buyouts

Roughly speaking, a leveraged buyout (LBO) consists in taking a firm private by purchasing its shares and allocating them to a concentrated ownership composed of management, a general partner, and other investors (the limited partners or LBO fund). Due to the dearth of equity of the owners, the new entity is highly leveraged. Typically, top-level managers (either incumbent managers, often under the threat of a takeover, or a dissenting team) ally with an LBO specialist who brings equity of his own and also finds investors to cofinance the LBO. An LBO involving current management is called a management buyout (MBO).[96] Either way, the coalition acquires the outstanding shares and divides equity in roughly the following fashion: management receives 10–30%,[97] and the buyout partnership, namely, the LBO specialist (who sits on the board) and the investors, pick up the remainder. An LBO specialist such as KKR (Kohlberg–Kravis–Roberts) as a general partner typically has 20% of the nonexecutive shares while the limited partners purchase the remaining 80%.[98]

The flip side of concentrated ownership is that the coalition must also issue a substantial amount of debt. Leverage ratios in LBOs were as high as 20:1 in the 1980s (and fell below 5:1 in the 1990s; typical debt-to-equity LBO ratios have only been 40–60% in recent years). In Kaplan's (1990) sample, the average ratio of long-term debt over debt plus equity for firms subject to a buyout was about 20% before the buyout and 85% after completion of the buyout.

Substantial managerial stock ownership is all the more important as the LBO sponsor usually has a very lean structure. The sponsor intervenes actively in key strategic decisions, but must operate arm's-length vis-à-vis everyday operating choices. Jensen's (1989a) survey of LBO partnerships finds an average staff of 13 professionals and 19 nonprofessionals in an LBO partnership. The world's largest LBO partnership, KKR, had 16 professionals and 44 additional employees.[99]

Typically, banks provide two types of loan: long-term senior loans with maturity of, say, seven years, and short-term loans that are used as bridges until junk bonds are issued. Junk bonds are public debt which is junior to bank debt in several respects: they are unsecured and include few covenants; their principal is not amortized before maturity; and their maturity, ten years, say, exceeds that of bank loans. Junk bonds are evidently risky and are often renegotiated (towards reduced interest payments, stretched-out maturities, and equity-for-debt swaps). In 1986, they were held mainly by mutual funds (32%), insurance companies (32%), pension funds (12%), individuals (12%), and thrifts (8%).[100]

The proclaimed virtues of the buyout partnership arrangement are (a) stronger monetary incentives for the firm's managers relative to those of a publicly traded corporation,[101] (b) active monitoring taken seriously, in which the general partner has both the incentives and the means of intervention, and (c) high leverage, which forces management and the partnership to work out cost reductions and improvements in efficiency, and to sell divisions (possibly in the form of MBOs with the managers of these divisions!).

It is worth emphasizing that buyout partnerships do not function as conglomerates. For example, KKR,

96. The ownership pattern much resembles the financing of start-ups by venture capitalists, described in Chapter 2. There are a couple of differences, though. In particular, start-ups generate lower income, and are therefore not much leveraged, while LBOs often concern firms with steady cash flows and are highly leveraged.

97. The median management equity ownership of the post-buyout companies in the Kaplan and Stein (1993) sample of MBOs was 22.3% (as opposed to 5% in the pre-buyout entities).

98. All shares are owned by the private equity group. The sharing rule just alluded to governs the split of the capital gains once the investment is exited.

99. Interestingly, it took over companies with large headquarters, sometimes exceeding 5,000 employees.

100. S. Rasky, "Tracking junk bond owners," *The New York Times*, December 7, 1986, cited in Perry and Taggart (1993).

101. Jensen (1989a,b) estimates that in the 1980s the average CEO in an LBO firm receives $64 per $1,000 increase in shareholder value, as opposed to $3 for the average Fortune 1000 firm.

a well-known general partner in LBOs,[102] keeps its companies[103] separate. The companies thus operate as stand-alone entities and do not cross-subsidize each other. As a matter of fact, cross-subsidization is prohibited by the statutes of the partnership. The LBO sponsor must ask its institutional investors for permission to transfer any cash from one LBO division to another. And LBO funds must return capital from exited investments to the limited and general partners and are not allowed to reinvest the funds.

Another point worth noting is that KKR sticks to the companies for five to ten years before exiting. This gives it nonnegligible incentives to invest for the long run. When successful, it resells its share to another large investor or takes the company public again. As is the case for a venture capitalist, these exit options allow KKR to free equity to invest in new ventures (on this, see Chapter 9).[104]

Concerning leverage, LBO targets have to generate large and steady cash flows in order to service the high debt payments. Thus LBOs can be successful only for mature industries with these cash-flow characteristics. Examples of such industries that have been mentioned in the literature are oil and gas, mining and chemicals, forest products, broadcasting, tobacco, food processing, and tyres.[105] Still, there have been a number of defaults, mainly for the deals that took place in the second half of the decade. Kaplan and Stein (1993) analyze a sample of 124 large MBOs completed during the 1980s. Of the 41 deals completed between 1980 and 1984, only one defaulted on its debt; in contrast, 22 of the 83 deals put together between 1985 and 1989 defaulted. Kaplan and Stein find that the MBOs put together in the second half of the decade were characterized by (a) high purchase prices (relative to cash flows), (b) riskier industries, (c) smaller and more secured positions held by banks, and substantial junk bond financing, and (d) more up-front payments to management and deal makers. In a nutshell, the MBOs became riskier during the decade. As Kaplan and Stein note, this evidence is consistent with loose statements about an "overheated buyout market" and "too much financing chasing too few good deals" in the second half of the decade, but it does not quite explain why financial markets made such mistakes.

LBOs are, most likely, a circumscribed phenomenon. Most observers (including Jensen) agree that they can apply only to firms with specific characteristics, namely, strong and predictable cash flows. As will be emphasized in Chapter 5, it would be a mistake, for example, to burden firms in growth industries (in which investment needs exceed the cash flows) with high levels of debt; similarly, debt may be a dangerous form of finance for firms with risky cash flows. Rappaport (1990) further argues that the "reliquification objective" implies that LBOs are a transitory form of organization. LBO sponsors and limited partners want to be able to cash out, in the form of a return to public corporation status or negotiated sales, in order to be able to invest in new firms (sponsors) or to face their liquidity needs (institutions). Not only do most LBO limited-partnership agreements have a limited duration (often ten years), but the exit option is often exercised before the end of the partnership. Rappaport cites a Kidder Peabody study on 90 initial public offerings (IPOs) for buyout corporations between 1983 and 1988, in which 70% of the companies were taken public within three years of their LBO date.

1.5.3 The Rise of Takeovers and the Backlash: What Happened?

There are several competing hypotheses for what happened in the 1980s in the United States. None of these hypotheses is a satisfactory explanation by itself, but all offer some insights about the events.[106]

102. KKR is not only known for spectacular takeovers such as the RJR Nabisco one. It has also rewarded its investors (wealthy individuals, commercial banks, pension funds) over a span of 20 years with a 23.5% annual return, compared with around 15% for the stock market index (S&P 500) (*The Economist*, August 2, 1997, p. 77).

KKR itself has been very profitable. Its profits do not come solely from the capital gains on its equity investments (merchant banker activity). As an agent for the investors, it receives a 1.5% management fee, a retainer fee for monitoring performance, and a fee for servicing on boards of directors (agency activity). Lastly, it receives a 1% fee after the deals are completed (investment banking activity). See Kaufman et al. (1995, Chapter 10).

103. That is, 15 in April 1991, with combined revenues $40 billion.

104. The exit may be fully planned in the original deal; for example, the limited partnership may be limited to last ten years.

105. One-third of the LBOs in the manufacturing sector between 1978 and 1988 took place in the food and tobacco industries. Seventy percent of LBOs in the nonmanufacturing sector concerned retail trade and services (Rappaport 1990).

106. A more complete, and very useful discussion, of the hypotheses can be found in Holmström and Kaplan (2001, 2003).

Hypothesis 1: Decline of corporate governance. The first possibility, stressed by Jensen (1984, 1988, 1989a,b) and Jensen and Ruback (1983) among others, is that the previous system of corporate governance was basically broke. The lack of monitoring by the board and large shareholders was, of course, nothing new in 1980, but it may have been particularly costly in a period of excess liquidities, i.e., in a period in which managers had substantial amounts of cash to spend. According to Jensen, entrenched managers refused (and were not forced by boards) to disgorge their excess cash flow and rather invested it in unattractive projects. Furthermore, international competition, deregulation and technological change implied that a number of firms had to exit or downsize. The proponents of this hypothesis thus argue that the capital market substituted for a deficient corporate governance, and helped fire inefficient managers, allocate corporate cash to its most efficient uses, and create an efficient exit.

Hypothesis 2: Financial innovation. Another and complementary hypothesis, also often associated with Jensen, holds that LBOs created a new and superior form of corporate governance for mature industries. High-powered executive compensation, "external management" by active monitors such as KKR, and high leverage all created, according to Jensen, better incentives for efficiency.[107] The financing of these LBOs was facilitated by the development of a junk bond market during the decade. The fact that few industries are good candidates for LBOs and the decline of LBOs in the 1990s imply that this explanation has only limited scope.

Hypothesis 3: Break-up of conglomerates. According to this hypothesis, takeovers targeted the conglomerate empires built in the 1960s and 1970s. These conglomerates had proved unmanageable, but managers did not want to reduce the size of their empires through "bust-ups" (sales of divisions to other companies) and "spin-offs" (transformations of divisions into independent companies). An external intervention was called for that had to downsize these conglomerates and make them focus on their core business.[108]

A variant of this hypothesis demonstrates the lenient enforcement of antitrust statutes under the Republican administrations of the 1980s. This relaxation of competition policy resulted in new opportunities for horizontal and vertical mergers. In this variant, the driver for the bust-ups is not the lack of focus of the existing conglomerates, but rather the nonrealization of "synergies" (understand: exploitation of market power) under the existing structures.

There are a number of other hypotheses for the takeover wave of the 1980s, including speculative excesses and transfers from employees, the bondholders, and the Treasury (to which we come back shortly).

What is the *verdict for the 1980s?*

Large gain for target shareholders. The winners were without doubt the target shareholders. While estimates differ and also vary with the type of takeover,[109] a 30% premium is definitely in the ballpark.

Neutral outcome for the acquirer. Most estimates show that the bidders neither gained nor lost, or else that they lost slightly in value (see Kaplan (1997) for a review). There are several possible explanations for this fact. The first is consistent with the notion that takeovers create value and is based on Grossman and Hart's (1980) free-riding argument (see Chapter 11). According to this argument, a raider cannot offer less than the post-acquisition value of the firm and have the target shareholders tender their shares; for, it would then be optimal for an individual shareholder to refuse to tender his shares and to enjoy the higher value of the post-acquisition firm. But if all shareholders behave this way, the raider cannot acquire control and the value-increasing changes are never implemented. While the free-rider problem is important and certainly contributes to explaining low returns for the acquirers, it depicts only an extreme case and there is every reason to believe that a raider should be able to make some profit (see

107. Kaplan (1989) provides evidence of improvements in operating profits in a sample of leveraged buyouts pulled together in the 1980s.

108. See, for example, Bhagat et al. (1990) and Kaplan and Weisbach (1992). Kaplan (1997), reviewing the evidence, argues that there was no deconglomeration in the 1980s in the United States. But there was, perhaps, unwinding of bad diversification.

109. For example, Kaplan and Stein find a 43% premium for their sample of MBOs.

Chapter 11). So, another argument seems needed if we want to explain the neutral or negative effect of takeovers on the acquirers' value. One possibility, less consistent with the view that takeovers are value enhancing, is that acquirers themselves are agents and misuse the resources entrusted to them. And, indeed, acquisitions are a quick and easy way for managers to expand the scope of their control and build empires.[110]

Where does the overall gain come from? Takeovers are associated with an increase in total value (target plus acquirer). Somehow, investors must believe that gains will result from the change in control. Where do these gains come from? Again, there are two possible views on this. The antitakeover view asserts that they primarily result from transfers from stakeholders (laid-off employees, expropriated bondholders and Treasury, consumers hurt by the merged firms' market power) to shareholders. There is little evidence that takeovers reduce wages and generate unemployment,[111] although they may do so in particular instances: the takeover of TWA by Icahn implied wage losses for unionized workers (Shleifer and Summers 1988). More likely, white-collar employees may be laid off when a merger leads to a cut in redundant headquarters personnel. In any case, the transfers from employees to shareholders do not seem commensurate with the overall gain to shareholders.[112] Several papers have similarly studied the possibility the increased leverage could have hurt the bondholders, or the Treasury due to tax shields (see Jarrell et al. 1988). These studies too conclude that these effects are small on average (although they can be significant in specific transactions). All these studies combined suggest that the pro-takeover view, according to which takeovers are efficiency enhancing, must have at least some validity for the 1980s (see below for a contrast with the 1990s). It is quite possible that takeovers indeed prevented some managers from wasting free cash flow and forced some exit or curtailments in excess capacity. And it seems that takeovers did not have a large negative impact on long-term investments such as R&D expenditures (see, for example, Hall 1990).

Contrast with subsequent mergers and acquisitions. As discussed above the merger wave that peaked in the 1998–2001 period was the largest in American history. It differs from that of 1980s not only through its reduced emphasis on hostile takeovers: it also seems to have led to wealth destruction. Moeller et al. (2003) estimate that, from 1998 through 2001, shareholders of acquiring firms lost $240 billion and that this loss was not offset by a larger gain by shareholders of the target firms. Indeed, the combined loss when adding the targets' gains was still $134 billion.

How meaningful is the overall-gain test? Suppose that it is established empirically that a sizeable fraction of the net gains from takeovers to shareholders does not come from transfers from other stakeholders. This still does not quite settle the takeover debate for two reasons. First, there are hidden benefits and costs of takeovers that may not be properly accounted for. On the benefit side, those managers whose firm ends up not being taken over may still operate value enhancements through fear that inaction would trigger a takeover. Such benefits from the "contestability" of the managerial position may be hard to measure. On the cost side, the possibility of takeovers creates incentives to underinvest in unobservable long-term investments. Takeovers may also induce managers to engage in costly defenses or to focus most of their attention on producing good earnings reports or looking for white knights (see Chapters 7 and 11). Such costs are also hard to measure. A second issue is that of the reference point. In particular, one must ask whether the benefits of takeovers cannot be achieved in other ways, for example, through improved corporate governance and whether these alternative ways would not generate the same costs as takeovers. More theoretical and

110. Shleifer and Vishny (1988). Morck et al. (1990) point out that half of the announcements of takeovers are greeted with a negative stock price reaction from the bidder's shareholders. Behavioral hypotheses (in terms of managerial hubris) have also been offered to explain the lack of profits of acquirers: see the introduction to the book for references to the behavioral literature.

111. Bhagat et al. (1990) and Lichtenberg and Siegel (1990) find a limited impact of hostile takeovers on employment (except, perhaps, for redundant white-collar employees).

112. For a review of the evidence, see Kaplan (1997), who further points out that many firms that did not undergo a takeover laid off workers over the 1980s and early 1990s; for example, General Motors and General Electric reduced the workforce by over 200,000 and 100,000, respectively.

empirical work is needed in order to have a better assessment of the benefits and costs of takeovers.[113]

1.6 Debt as a Governance Mechanism

Our discussion so far has largely focused on the impact of shareholders in corporate governance. We now turn to that of debt claims.

1.6.1 Debt as an Incentive Mechanism

Leaving aside the possible tax advantages of debt, which are sometimes an important consideration in the design of financial structures but are country- and time-specific, debt is often viewed as a disciplining device, especially if its maturity is relatively short. By definition, debt forces the firm to disgorge cash flow. In so doing, it puts pressure on managers in several related ways (the theoretical foundations and implications of these informal arguments will be studied in Chapters 3, 5, and 10).

• By taking cash out of the firm, it prevents managers from "consuming" it. That is, it reduces their ability to turn their "free cash flow" into lavish perks or futile negative net present value investments.

• Debt incentivizes the company's executives. Managers must contemplate their future obligation to repay creditors on time, and therefore must pay attention to generate cash flows beyond the future debt repayments or else enhance their firm's prospect so as to facilitate future issues of claims. Absent such efforts, they may become cash-strapped and be unable to sink even desirable reinvestments. This threat of illiquidity has a positive disciplining effect on management.

At the extreme, the firm may be liquidated in the context of a bankruptcy process, leading to an increase in the probability of termination of employment, frustration, and stigma for the managers who led the firm to its end.[114]

• Under financial distress, but in the absence of liquidation, the nonrepayment of debt puts the creditors in the driver's seat. Roughly speaking, creditors acquire control rights over the firm. They need not formally acquire such rights. But they hold another crucial right: that of forcing the firm into bankruptcy. This threat indirectly gives them some control over the firm's policies.

As we will later discuss, management is not indifferent as to who exercises control over their firms: different claimholders, through the cash-flow rights attached to their claims, have different incentives when interfering with the firm's management. In particular, debtholders tend to be more "conservative" than equityholders, as they get none of the upside benefits and in contrast suffer from downside evolutions. They are therefore more inclined to limit risk, especially by cutting investment and new projects.[115]

• Finally, when the managers hold a substantial amount of claims over the firm's cash flow, debtholding by investors has the benefit of making managers by and large residual claimants for their performance. An (extreme) illustration of this point arises when an entrepreneur's borrowing needs are relatively small and there is enough guaranteed future income (collateral, or certain cash flow) to repay the corresponding debt. Then, issuing debt to investors implies that any increase in the firm's profit goes to the entrepreneur. Put differently, the entrepreneur fully internalizes the increase in profit brought about by her actions, and so faces the "right incentives" to minimize cost and maximize profit.

1.6.2 Limits to Debt as a Governance Mechanism

Throughout this book, we will also emphasize that debt is by no means a panacea. There are several

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113. Despite obvious selection biases, clinical analyses may also shed some light about value creation and destruction in mergers and acquisitions. For example, the analysis of two acquisitions in Kaplan et al. (1997) sheds some light on the potential pitfalls: lack of understanding of the target by the managers of the acquiring firm, failure to realize synergies, diversion of the acquiring firm's management's attention, complexity of compensation design, and so forth.

114. In Zwiebel (1996), managers choose debt as a commitment to produce high profits in the short run. The bankruptcy process is viewed as facilitating managerial turnover in the case of poor performance, relative to equity-based channels of managerial turnover (takeovers, or dismissal via the board, or a proxy fight). Issuing debt or distributing dividends (or, more generally, any policy that makes a liquidity crisis in the case of poor performance more likely) therefore increases sensitivity of turnover to poor performance and makes shareholders more comfortable with current management.

115. At the extreme, debtholders are more keen on liquidating a firm than shareholders: for the former, a bird in the hand—the value of liquidated assets—is worth two in the bush—the uncertain prospect of full repayment.

reasons why this is so; this section emphasizes two such reasons.

Cost of illiquidity. The flip side of threatening management with a shortage of future cash flow is that cash disgorgements may actually end up depriving the firm from the liquidities it needs to finance ongoing projects and start on new ones, since the firm's cash flow and reinvestment needs are affected by uncertainty that lies beyond the reach of managerial control: input prices may rise, competitors may enter the market, projects may face hardships over which managers have no control, and so forth. Furthermore, risk management opportunities may be limited; that is, the firm may not be able to insure at a reasonable cost against these exogenous shocks.

The firm, when facing an adverse shock to its cash flow or its reinvestment needs, could, of course, return to the capital market and raise funds by issuing new securities (bonds, bank debt, equity), as stressed, in particular, by Myers (1977). For several reasons, though, returning to the capital markets is unlikely to provide enough liquidity. First, issuing new securities in good conditions may take time and liquidity needs, for example, for paying employees and suppliers, may be pressing. Second, and more fundamentally,[116] the capital market may be reluctant to refinance the firm. They will not be able to recoup fully the benefits attached to refinancing as some of these benefits will necessarily go to insiders. Furthermore, they may be uncertain about the firm's prospects and the value of existing assets, and therefore worry about adverse selection—the possibility that securities have low value. Consequently, debt claims, especially of short maturity, expose the firm to the risk of liquidity associated with credit rationing in the refinancing market.

Bankruptcy costs. At the extreme, the firm's inability to repay the debt coupons may push it into bankruptcy. Bankruptcy processes vary substantially across the world, but to fix our ideas, it may be useful to take the U.S. case as an illustration (with the caveat that the U.S. bankruptcy institutions are particularly lenient on managers as compared with other countries). There are two main forms of bankruptcy. Under Chapter 7, the firm's assets are liquidated by a court-appointed trustee; the priority of claims (who is paid first?) is respected.[117] Firms rarely file bankruptcy under Chapter 7 directly, however. Rather, they use Chapter 11, which allows for a workout in which a reorganization plan is designed and thus liquidation is at least temporarily avoided.[118] Indeed, it may be the case that the firm is unable to pay its debt, but has a positive ongoing value for investors as a whole. To let the firm continue, it is then necessary for creditors to make concessions, for example, by forgiving some of their debt and taking equity in exchange.[119] Management is then given six months (or more if the bankruptcy judge extends the period) to formulate a reorganization plan. Creditors can propose their own plan afterwards. A reorganization plan must be approved by a qualified majority (e.g., one-half in number, two-thirds in amount).[120] In the absence of approval, creditors can finally force the firm into entering Chapter 7.

Chapter 11 is often heralded by its proponents as enabling firms to design plans that let them continue if they have valuable assets or prospects; its critics, in contrast, argue that management, equityholders, and junior, unsecured creditors have the ability to delay the resolution, at great cost to senior creditors. They further argue that the bankruptcy process is not as strong a disciplining device as it should be. Gilson (1990), based on a study of 111 U.S. firms, reports that 44% of CEOs (and 46% of directors) are still in place four years after the start of the bankruptcy

116. Note that the two reasons are related. Suppose, for example, that information about the firm's state is widely available. Then it should not take long to raise cash by issuing new securities. It is in part because investors are uncertain about the firm's prospects and the value of existing assets that they need time to analyze the firm's condition and that it takes time to issue securities.

117. The "Absolute Priority Rule" (APR) distributes the firm's payoffs according to priority. In particular, junior claimholders receive nothing until senior claimholders are fully paid.

118. Under Chapter 11, all payments to creditors are suspended (automatic stay), and the firm can obtain additional financing by granting new claims seniority over existing ones. A number of proposals have been made in the literature to replace Chapter 11, deemed too slow in removing inefficient management, by a new bankruptcy procedure that would still facilitate the renegotiation of existing claims (see, in particular, Bebchuk 1988; Aghion et al. 1992).

119. Exchange offers are only one of the actions that can be taken to reorganize the company. Others include asset sales, reduced capital expenditures, and private debt restructuring.

120. See Asquith et al. (1994) and Gertner and Scharfstein (1991) for empirical evidence and theoretical considerations relative to workouts.

process. Even if managers must cope with stricter covenants and often more powerful monitoring (by a large block shareholder) after bankruptcy, the process still proves relatively lenient towards them.

Workouts are desirable if they serve to protect stakeholders (including employees) who would suffer from a liquidation, and are undesirable if their main function is to hold up senior creditors and delay a liquidation that is socially efficient.

The workout *process* may fail for several reasons.

Transaction costs. It is difficult to bring to the bargaining table many groups of stakeholders. Even leaving aside employees and fiscal authorities, who have claims over the firm, a number of claimholders with very dissonant objectives must be induced to engage in serious bargaining: holders of debt claims with various covenants, maturities, degree of collateralization, and trade creditors (just think of the number of trade creditors involved in the bankruptcy of a large retailer!). Other stakeholders may have a stake in the firm without having formal claims over its cash flow. For example, if a supplier of Boeing or Airbus is about to go bankrupt, then the airplane manufacturer may bend over backwards and enter into a long-term supply agreement in order to keep the supplier afloat. This example illustrates the fact that even parties without an existing claim in the firm may need to be brought to the bargaining table.

Bargaining inefficiencies. Bargaining between the various parties may be inefficient—the Coase Theorem may not apply—for a variety of reasons. Prominent among them is asymmetric information, between insiders and outsiders and among outsiders.[121] Each party may be reluctant to enter a deal in which it suspects that other parties are willing to sign because it is favorable to them. Relatedly, some bargaining parties may attempt to hold up other parties by delaying the resolution.[122] Their ability to do so depends on the specifics of the bankruptcy process. A unanimity rule, applied either within a class of claimholders or across classes of claimholders, aims at protecting all claimholders; but it gives each individual claimholder or each class of claimholders the ability to hold up the entire reorganization process: they can threaten not to sign up and wait until they are bought out at a handsome price. This is why bankruptcy processes often specify only qualified majorities.[123]

Costs of the bankruptcy process can be decomposed into two categories:

Direct costs include the legal and other expenses directly attached to the process. Most studies have found that direct costs are relatively small, a few percent of market value of equity plus book value of debt (see, for example, Warner 1977; Altman 1984; Weiss 1990).

Indirect costs, associated with managerial decisions in anticipation of or during bankruptcy, are much harder to define and to measure; but they seem to be much more substantial than direct costs. In principle, bankruptcy costs may include the actions, such as gambling, taken by incumbent management in order to avoid entering the bankruptcy process, and the costs of cautious management during the process.[124]

1.7 International Comparisons of the Policy Environment

The book will emphasize the many contractual concessions firms make to investors in order to boost pledgeable income and raise funds: covenants, monitoring structures, control rights, board composition, takeover defenses, financial structure, and so forth. Bilateral and multilateral agreements between firms and their investors do not occur in an institutional vacuum, though. Rather, the firms' ability to

121. Asymmetric information between insiders and outsiders is stressed, for example, in Giammarino (1989).

122. Free riding was first emphasized in Grossman and Hart (1980).

123. The debate between unanimity and qualified majority rules has a long-standing counterpart in international finance. In particular, many sovereign bonds are issued under New York law, which requires unanimity for renegotiation (i.e., agreement to forgive some of the debt). In contrast, sovereign bonds issued under U.K. law specify only a qualified majority for approval of a deal renegotiated with the issuing country. Proponents of the New York law approach argue that it is precisely because renegotiations are difficult that discipline is imposed on the government. Critics, in contrast, point at the holdups and inefficiencies brought about by the unanimity rule. Much more detailed descriptions and analyses of the debate can be found in, for example, Eichengreen and Portes (1997, 2000) and Bolton and Jeanne (2004).

124. We refer to Senbet and Seward (1995) for a discussion of these as well as for a broader survey of the bankruptcy literature.

commit to return funds to their investors depends on a policy environment that is exogenous to individual firms. As defined in Chapter 16, "contracting institutions" refer to the laws and regulations that govern contracts and contract enforcement, as well as, more broadly, to the other policy variables such as taxes, labor laws, and macroeconomic policies that affect pledgeable income and value.[125] Contracting institutions vary substantially across countries, and so, as a result, do financial development and corporate governance.[126]

An active line of research, initiated by La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1997, 1998, 1999, 2000),[127] studies the relationship between countries' legal structures and corporate finance. La Porta et al. consider two broad legal traditions. *Common law*, which prevails in most English-speaking countries, emphasizes judiciary independence, reactivity to precedents, and limited codification. *Civil law*, in contrast, stresses codification (e.g., the Napoleonic and Bismarckian codes) and is historically more associated with politically determined careers for judges (judges have only recently gained their independence in France, for example); furthermore, its more centralized determination makes it easier for interest groups to capture it than under common law. There are three broad subcategories of civil law: French, German, and Scandinavian. Both common law and civil law have spread through conquest, colonization, import, or imitation.[128]

La Porta et al. derive some interesting correlations between legal systems and investor protection. They measure investor protection through a list of qualitative variables: e.g., one-share–one-vote, proxy by mail allowed, judicial venue for minority shareholders to challenge managerial decisions, preemptive rights for new issues of stocks, ability to call extraordinary shareholders' meetings, in the case of *shareholder protection*; and creditors' consent to file for reorganization, inability for the debtor to retain administration of property during a reorganization, ability for secured creditors to gain possession of that security, respect of priority rules in bankruptcy, in the case of *creditor protection*. Shareholder rights are then aggregated in an "antidirector rights index," and creditor rights in a "creditor rights index."

A key finding is that the protection of shareholders is strongest in common law countries, weakest in French-style civil law countries, with German- and Scandinavian-style law countries somewhere in between.[129]

As one would expect, the extent of investor protection impacts the development of financial markets. Indeed, the work of La Porta et al. was partly motivated by country-specific observation. La Porta et al. (1997) documented a positive covariation between shareholder protection and the breadth of the equity market.[130] For example, in Italy (French-origin civil law system) (see Pagano et al. 1998), companies rarely go public, and the voting premium (the price difference between two shares with the same cash-flow rights but different voting rights) is much larger than in the United States (a common law country).[131] Similarly, Germany's stock market capitalization is rather small relative to GDP.

More generally, common law countries have the highest ratio of external capital (especially equity) to GDP. (But, as Rajan and Zingales (2003) note, legal origins alone cannot explain why, in 1913, the ratio of stock market capitalization over GDP was twice as high in France as in the United States.) Common law countries also have the largest numbers of firms undergoing IPOs. The reader will find in Rajan and Zingales (2003) both a series of measures of countries'

125. Chapter 16 will further study "property rights institutions," referring to the permanence of the contracting institutions and the time-consistency of government policies.

126. This section briefly reviews some of the empirical work on comparative corporate governance. As we discussed in this chapter, there is also a large institutional literature comparing the main financial systems (see, for example, Allen and Gale 2000, Part 1; Berglöf 1988; Charkham 1994; Kindelberger 1993).

127. See also La Porta, Lopez-de-Silanes, and Shleifer (1999).

128. Glaeser and Shleifer (2002) argue that the foundations for English and French common and civil laws in the twelfth and thirteenth centuries were reactions to the local environments.

129. The exception to this rule is that *secured* creditors are best protected in German- and Scandinavian-origin legal systems.

130. Pagano and Volpin (2005b) also find a positive covariation, although a weaker one, for their panel data. They show, in particular, that the dispersion in shareholder protection has declined since the La Porta et al. study, in that the La Porta et al. measures of shareholder protection have substantially converged towards the best practice in the 1993–2002 interval.

131. Premia commanded by voting shares are 5.4% for the United States, 13.3% in the United Kingdom, 29% in Germany, 51.3% in France, and 81.5% in Italy (compilation by Faccio and Lang (2002) of various studies).

financial development[132] as well as a discussion of the relevance of such measures.

Relatedly, we would also expect systems with poor investor protection to resort to substitute mechanisms. La Porta et al. (1998) consider two such mechanisms. One is the use of bright-line rules, such as the possibility of mandatory dividends in countries with poor shareholder protection. More importantly, one would expect such countries to have a more concentrated ownership structure, since such a structure creates incentives for high-intensity monitoring and curbs managerial misbehavior (see Chapter 9). La Porta et al. (1998, Table 8) indeed find a sharply higher concentration of ownership in countries with French-style civil law.[133]

La Porta, Lopez-de-Silanes, and Shleifer (1999) more generally document that large firms in non-Anglo-Saxon countries are typically controlled by large resident shareholders or a group of shareholders. Looking at the top 20 firms in each country as ranked by market capitalization of common equity at the end of 1995, they show that, on average, 36% are "widely held," 31% "family controlled," 18% "state-controlled," and 15% in "residual categories" (defining categories is no straightforward task; see their paper for details). Quite crucially, widely held firms are much more common in countries with a good investor protection; for example, all top 20 firms in the United Kingdom and 16 out of the top 20 firms in the United States are widely held.[134] A similar picture emerges for medium-size firms. Specific evidence on the control of European firms can be found in the book edited by Barca and Becht (2002), whose findings (summarized by Becht and Mayer) confirm the sharp contrast between continental Europe and Anglo-Saxon countries. Control is concentrated in Europe not only because of the presence of large investors, but also by the absence of significant holdings by others. In the United States and the United Kingdom, in contrast, the second and third shareholders are often not noticeably smaller than the first.

Davydenko and Franks (2004) make similar observations on the debt side using a sample of small firms defaulting in their bank debt in France, Germany, and the United Kingdom. Of the three countries, France clearly exhibits the weakest protection of creditor rights: court-administered procedures are mandated by law to pursue the preservation of the firm as a going concern and the maintenance of employment; and, in the case of liquidation, even secured lenders rank behind the state and the employees in terms of priority. By contrast, U.K. secured creditors can impose the privately contracted procedure specified by the debt contract and they receive absolute priority in recovering their claims. Davydenko and Franks indeed find that medium recovery rates for creditors are 92% in the United Kingdom, 67% in Germany, and 56% in France.[135] The theory developed in Section 4.3 predicts that French firms will want to offer more collateral in order to make up for the shortage in pledgeable income. Davydenko and Franks show that collateralization (in particular of receivables) is high in France.

This analysis raises a number of interesting questions. First, the relative convergence between common and civil law systems makes it unlikely that legal origins by themselves can explain the current differences in corporate governance and financial institutions, between, say, the United States and the United Kingdom on the one hand, and continental Europe on the other. Some source of hysteresis must be involved that preserves systems with strong (weak) investor protection. This brings us to a second point: legal institutions, and more broadly contracting institutions, are endogenous; they are fashioned by political coalitions, which themselves depend, among other things, on financial outcomes (see Chapter 16). A case in point is the emergence of stricter antitakeover legislation in the United States in the wake of the hostile takeover wave of the 1980s. The broader theme of a political determination of

132. For example, equity issues over gross fixed capital formation for the corporate sector, deposits over GDP for the banking sector, stock market capitalization, or number of companies listed related to GDP.

133. They also find that large economies and more equal societies have a lower ownership concentration.

134. While La Porta et al. attribute dispersed ownership in the United States to good investor protection, Roe (1994) in contrast emphasizes populist regulatory impediments to concentrated ownership in that country.

135. Their sample covers the 1996–2003 period, except for France (1993–2003 period).

corporate finance institutions is developed at length by, for example, Roe (2003).[136,137]

Remark (determinants of institutions). La Porta et al.'s correlation between legal system and investor protection is revisited in Acemoglu et al. (2001), who look at European colonization and argue that the mode of settlement, more than the legal system, had a bigger impact on contracting institutions. They divide colonies into two broad categories: those (Africa, Central America, Caribbean, South Asia) where the Europeans had little interest in settling—perhaps due to high mortality rates—and developed "extractive institutions," which allowed little protection for private property and few checks and balances against government expropriation; and those in which Europeans settled in larger numbers (United States, Canada, Australia, New Zealand) and therefore developed institutions that were far more protective of private property. There is, of course, a correlation between the British Empire and the latter category.[138]

1.8 Shareholder Value or Stakeholder Society?

The corporate governance debates reviewed in this chapter are framed in terms of shareholder value; as we noted in the introduction to this chapter, economists, and for that matter much of the legal framework, have always asserted, on the grounds that prices reflect the scarcity of resources, that management should aim at maximizing shareholder wealth. To many noneconomists, economists in this respect appear "oblivious to redistributional issues," "narrow-minded," or "out of touch with social realities." A widespread view in politics and public opinion is that corporations should serve a larger social purpose and be "responsible," that is, they should reach out to other stakeholders and not only to shareholders.

1.8.1 The Corporate Social Responsibility View

An economist would rephrase the position of the proponents of the stakeholder society as the recommendation that management and directors internalize the externalities that their decisions impose on various groups. Examples of such externalities and concomitant duties toward stakeholders, according to the proponents of the stakeholder society, can be found in the following list.

Duties toward employees. Firms should refrain from laying off workers when they make sizeable profits (the "downsizing" move of the 1990s and events such as the January 1996 laying off of 40,000 employees by a record-profit-making AT&T and the $14 million annual compensation of its chairman created uproars on the left and the right of the American political spectrum); firms should also protect minorities, provide generous training and recreational facilities, and carefully monitor safety on the job.

Duties toward communities. Firms should refrain from closing plants in distressed economic areas except when strictly necessary; in normal times they should contribute to the public life of its communities.

Duties toward creditors. Firms should not maximize shareholder value at the expense of creditor value.

Ethical considerations. Firms ought to protect the environment even if this reduces profit. They should refrain from investing in countries with oppressive governments, or with weak protection of or respect for the minorities (child labor, apartheid, etc.). Firms should not evade taxes, or bribe officials in less developed countries, even when such behavior raises profit on average.

136. See also Krosner and Strahan (1999) on bank branching regulation, Hellwig (2000) on corporate governance regulation, and Rajan and Zingales (2003), who argue that incumbent firms may be leading opponents to reforms facilitating financial development.

The endogeneity of political institutions is, of course, a broader theme in economics: see Laffont (2000) (other theoretical books emphasizing the political determination of policy include Dixit (1996), Laffont and Tirole (1993), and Persson and Tabellini (2000)).

137. Corporate governance systems may also be forced to converge if companies can cross-list in jurisdictions (countries) with better shareholder protection or engage in cross-border merger and acquisition activity. The literature on convergence towards best practice corporate governance includes Coffee (1999), Gilson (2001), and Pagano and Volpin (2005c).

138. The impact of extractive institutions as upsetting existing ones is further explored in Acemoglu et al. (2002), who attempt to account for a reversal of prosperity after the sixteenth century between the then poor (United States, Canada, Australia, etc.) and rich (India, China, Incas, Aztecs, etc.) colonies.

Many managers view their role within society in an even broader sense (satisfaction of consumer wants, support of the arts, political contributions, etc.) than suggested by this list.

According to Blair (1995, p. 214), even in the United States, which traditionally has been much less receptive to the stakeholder society idea than most other developed countries (especially outside the Anglo-Saxon world), "by the late 1960s and early 1970s corporate responsiveness to a broad group of stakeholders had become accepted business practice." Charitable contributions, divestitures from (apartheid-practicing) South Africa, and paid leave for employees engaging in public service activities, for example, became commonplace and were upheld by the courts. The consensus for some internalization of stakeholder welfare partly broke down in the 1980s. Proponents of shareholder value gained influence. Yet, the hostile takeover wave of that decade sparked an intense debate as to whether the increase in shareholder wealth associated with the takeover did not partly come to the detriment of employees and communities (see, for example, Shleifer and Summers 1988).

The popularity of the stakeholder society view in the public is to be contrasted with the strong consensus among financial economists that maximizing shareholder value has major advantages over the pursuit of alternative goals. A particularly influential advocate of the shareholder-value approach has been Milton Friedman (1970).[139]

Economists have long argued in favor of a proper internalization of externalities. And certainly the vast majority of them have no objections to the goals advanced by the proponents of the stakeholder society. A scientific debate therefore focuses on how to achieve these goals, rather than on the goals themselves.

1.8.2 What the Stakeholder Society Is and What It Is Not

Some management gurus have surfed the stakeholder society wave and have argued that "stakeholding" makes commercial sense. In a nutshell, the recommendation is to treat employees fairly through job security, training facilities, etc. The reasoning is that, by building a reputation for fairness, the firm will be able to attract the most talented employees and to induce them to invest in the firm, as the employees will know that they are engaged in a long-term relationship with the firm and that their firm-specific investments will be rewarded. This argument can, of course, be extended to, say, suppliers and communities, who are inclined to offer lower prices or larger subsidies, respectively, to a more trustworthy firm.

Such recommendations smack of social responsiveness; but in fact they are about shareholder value: intertemporal value maximization often trades off short-run sacrifices (investments) for the prospect of higher long-term profits.[140] Treating stakeholders fairly in order to raise intertemporal

139. "In a free-enterprise, private-property system, a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires, which generally will be to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom. Of course, in some cases his employers may, of course, have a different objective. A group of persons might establish a corporation for an eleemosynary purpose—for example, a hospital or a school. The manager of such a corporation will not have money profit as his objective but the rendering of certain services.

"Of course, the corporate executive is also a person in his own right. As a person, he may have many other responsibilities that he recognizes or assumes voluntarily—to his family, his conscience, his feelings of charity, his church, his clubs, his city, his country. He may feel impelled by these responsibilities to devote part of his income to causes he regards as worthy, to refuse to work for particular corporations, even to leave his job, for example, to join his country's armed forces. If we wish, we may refer to some of these responsibilities as 'social responsibilities.' But in these respects he is acting as a principal, not an agent; he is spending his own money or time or energy, not the money of his employers or the time or energy he has contracted to devote to their purposes. If these are 'social responsibilities,' they are the social responsibilities of individuals, not of business.

"The stockholders or the customers or the employees could separately spend their own money on the particular action if they wished to do so. The executive is exercising a distinct 'social responsibility,' rather than serving as an agent of the stockholders or the customers or the employees, only if he spends the money in a different way than they would have spent it.

"But if he does this, he is in effect imposing taxes, on the one hand, and deciding how the tax proceeds shall be spent, on the other.

"Here the businessman—self-selected or appointed directly or indirectly by stockholders—is to be simultaneously legislator, executive and jurist. He is to decide whom to tax by how much and for what purpose, and he is to spend the proceeds—all this guided only by general exhortations from on high to restrain inflation, improve the environment, fight poverty and so on and on."

140. To again quote from Friedman (1970), who is highly critical of the stakeholder society concept: "Of course, in practice the doctrine of social responsibility is frequently a cloak for actions that are justified on other grounds rather than a reason for those actions.

profit is not what the stakeholder society is about. Rather, *the "socially responsible corporation" is one that consciously makes decisions that reduce overall profits.*[141]

Similarly, we do not classify actions whose primary interest is to restore the firm's public image under the corporate social responsibility heading. It is perhaps no coincidence that multinationals, and in particular ones that, for good or bad reasons, have a poor public image (tobacco, oil, pharmaceutical companies), have eagerly embraced the concepts of corporate social responsibility and sustainable development and created senior executive positions in charge of the firm's social responsibility.

Before discussing the implementation of the stakeholder society, let me address the issue of what the concept exactly refers to. On the one hand, the stakeholder society may refer to a *broad mission of management*. According to this view, management should aim at maximizing the sum of the various stakeholders' surpluses (adopting an utilitarian approach); and, if management is not naturally inclined to do so, incentives should be designed that induce management to account for the externalities imposed on all stakeholders. On the other hand, the stakeholder society may refer to the *sharing of control by stakeholders*, as is, for example, the case for codetermination in Germany.[142] Presumably, the two notions are related; for instance, it would be hard for a manager to sacrifice profit to benefit some stakeholder if a profit-maximizing raider can take over the firm and replace her, unless that very stakeholder can help the manager deter the takeover (see Pagano and Volpin 2005a).[143] In what follows, we will take the view that the stakeholder society means both a broad managerial mission and divided control.

We focus on optimal contracting among stakeholders (including investors) and wonder whether managerial incentives and a control structure can be put in place that efficiently implement the concept of stakeholder society. Another layer of difficulty is added by the existence of a regulatory environment that restricts the set of contracts that can be signed among stakeholders. Interestingly, countries such as France, Germany, and Japan, which traditionally are more sympathetic to the stakeholder society than the United States and the United Kingdom, also have legal, regulatory, and fiscal environments that are assessed by most economists as creating weaker governance systems (see Section 1.7).

As in other areas of contract law, a hard question is, why does one need a law in the first place? Couldn't the parties reach efficient agreements by themselves, in which case the role of courts and of the government is to enforce private contracts and not to reduce welfare by constraining feasible agreements? For example, why can't a mutually agreeable contract between investors and employees allow employee representation on the board, stipulate reasonable severance pay for laid-off workers, and create incentives that will induce management to internalize the welfare of employees, thus substituting for an enlarged fiduciary duty by the management

"To illustrate, it may well be in the long run interest of a corporation that is a major employer in a small community to devote resources to providing amenities to that community or to improving its government. That may make it easier to attract desirable employees, it may reduce the wage bill or lessen losses from pilferage and sabotage or have other worthwhile effects. Or it may be that, given the laws about the deductibility of corporate charitable contributions, the stockholders can contribute more to charities they favor by having the corporation make the gift than by doing it themselves, since they can in that way contribute an amount that would otherwise have been paid as corporate taxes.

"In each of these and many similar cases, there is a strong temptation to rationalize these actions as an exercise of 'social responsibility.' In the present climate of opinion, with its wide spread aversion to 'capitalism,' 'profits,' the 'soulless corporation' and so on, this is one way for a corporation to generate goodwill as a by-product of expenditures that are entirely justified in its own self-interest.

"It would be inconsistent of me to call on corporate executives to refrain from this hypocritical window-dressing because it harms the foundations of a free society. That would be to call on them to exercise a 'social responsibility'! If our institutions, and the attitudes of the public make it in their self-interest to cloak their actions in this way, I cannot summon much indignation to denounce them. At the same time, I can express admiration for those individual proprietors or owners of closely held corporations or stockholders of more broadly held corporations who disdain such tactics as approaching fraud."

141. Interestingly, in the 1960s and 1970s, U.S. courts accommodated socially responsible activities such as donations to charities by arguing that short-run diversion of shareholder wealth may be good for the shareholders "in the long-run." Courts thereby avoided conceding that directors did not have a primary duty to maximize shareholder wealth (see Blair 1996, p. 215).

142. Porter (1992) argues in favor of board representation of customers, suppliers, financial advisors, employees, and community representatives.

143. In this sense, there may be some consistency in the German corporate governance system between shared control, the absence or small level of managerial stock options, and the inactivity of the takeover market.

toward employees, legal restrictions on layoffs, or mandated collective bargaining?

Besides the standard foundations for the existence of laws (transaction-costs benefits of standard form contracts well understood by all parties, *ex post* completion of a (perhaps rationally) incomplete contract by judges in the spirit of the original contract, contract writing under asymmetric information or under duress, etc.), a key argument for regulatory intervention in the eyes of the proponents of the stakeholder society has to do with tilting the balance of bargaining power away from investors and toward stakeholders. This position raises the questions of whether redistribution is best achieved through constraining feasible contractual arrangements (as opposed to through taxation, say), and whether regulation even serves its redistributive goals in the long run, to the extent that it may discourage investment and job creation and thereby end up hurting employees' interests.

Whatever its rationale, regulatory intervention in favor of stakeholder rights plays an important role in many countries. Thus, besides the normative question of whether laws protecting stakeholders can be justified on efficiency grounds, the positive question of how such laws actually emerge is also worthy of study. Clearly, political economy considerations loom large in the enacting of pro-stakeholder regulations. In this respect, one may also be suspicious of the motives behind the endorsement of the stakeholder society concept by some managers, to the extent that they do not propose to replace shareholder control by a different, but strong, governance structure. That is, the stakeholder society is sometimes viewed as synonymous with the absence of effective control over management. (That the shareholder–stakeholder debate neglects the role of management as a party with specific interests has been strongly emphasized by Hellwig (2000), who discusses extensively the "political economy" of corporate governance.)

1.8.3 Objections to the Stakeholder Society

Four different arguments can be raised against a stakeholder-society governance structure. The first, which will be developed in Chapter 10, is that giving control rights to noninvestors may discourage financing in the first place. For example, suppose the community of "natural stakeholders" is composed of management and employees, who do not have the funds to pay for investment themselves, and that the investors are concerned that they will not be able to recoup their investment in the firm if they share control with the stakeholders; that is, there may not be enough "pledgeable income" that the stakeholders can credibly promise to pay back when they have a say in the governance structure. The stakeholders probably will then want to hand control over to the investors, even in situations in which control by investors reduce total surplus. "Shareholder value" may be the only way to obtain the required money.

The second and third objections are developed in a bit more detail in the supplementary section. The second objection is also relative to the governance structure. The issue with the sharing of control between investors and natural stakeholders is not only that it generates less pledgeable income and therefore less financing than investor control, but also that it may create inefficiencies in decision making. On many decisions, investors and natural stakeholders have conflicting objectives. They may not converge to mutually agreeable policies. In particular, deadlocks may result from the sharing of control.

The third issue with the concept of stakeholder society is managerial accountability. A manager who is instructed to maximize shareholder value has a relatively well-defined mission; her performance in this mission—stock value or profit—is relatively objective and well-defined (even though this book will repeatedly emphasize the substantial imperfections in performance measurement). In contrast, the socially responsible manager faces a wide variety of missions, most of which are by nature unmeasurable. Managerial performance in the provision of positive externalities to stakeholders is notoriously ill-defined and unverifiable. In such situations managerial incentives are known to be poor (see Dewatripont et al. 1999b).

Concretely, the concern is that the management's invocation of multiple and hard-to-measure missions may become an excuse for self-serving behavior, making managers less accountable. For example, an empire builder may justify the costly acquisition

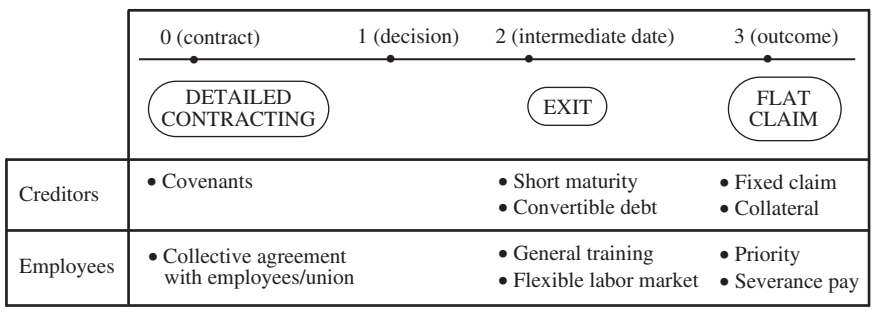

Figure 1.8 Protecting noncontrolling stakeholders.

of another firm on the grounds that this acquisition will save a few jobs. Or a manager may select a costly supplier officially on the grounds that this supplier has a better environmental policy, while actually entering in a sweet deal with a friend or reciprocating a favor. As a last example, an inefficient manager may install antitakeover defenses on the grounds that employees must be protected against potential layoffs implemented by a profit-maximizing raider.

The fourth argument is that a successful popular push for corporate social responsibility de facto imposes a tax on business, whose proceeds escape control by political process. While there are sometimes good reasons to subtract public policy from political pressures by handing it over to less politically accountable bodies such as independent agencies and nongovernmental organizations, it is not obvious that social goals are best achieved by directors and officers eager to pander to their own constituencies (in particular, their customers and policy makers who affect their firm's stake).

1.8.4 The Shareholder-Value Position

Proponents of the maximization of shareholder value (hopefully) do not object to the goals of the stakeholder society. Rather, they disagree on how these goals are to be reached. Implicit in their position is the view that externalities are best handled through the contractual and legal apparatus, rather than through some discretionary action by the firm's officers and directors. Shareholders can substantially expropriate creditors by picking risky moves, or by disgorging cash and assets, leaving the creditors with an empty shell? Then, creditors should (and actually do on a routine basis—see Chapter 2) insist on a set of covenants that will protect them against expropriation. Maximization of value can come at the expense of the firm's workforce? Then, employees and unions should enter collective agreements with the firm specifying rules for on-the-job safety, severance pay, and unemployment benefits.[144] And so forth.

We just saw that it is important to use the contractual apparatus in order to reduce the externalities imposed by the choices of the controlling shareholders. There are *two ways of creating contractual protections* for the noncontrolling stakeholders. The first is to circumscribe the action set available to the controlling stakeholder by ruling out those actions that are more likely to involve strong negative externalities on other stakeholders; this reduction in the size of the action set involves transaction and flexibility costs, but it may still create value. The second is to make the claims of noncontrolling stakeholders as insensitive to biased decision making as possible. This idea is illustrated in Figure 1.8 for the case of creditors and employees.

As we discuss in Chapter 2, debt contracts impose a large number of positive and negative covenants, which can be summarized as defining the action set for shareholders. Making the creditors' claim less sensitive to shareholders' actions has two aspects: *flat claims* and *exit options*. First, the creditors' final claim is often a fixed nominal claim; and collateral further helps limit the creditors' potential losses in the case of nonreimbursement of the debt. Second, debt contracts often provide creditors with exit

144. This position underlies the use of layoff taxes and experience rating (see Blanchard and Tirole (2004, 2005) for a policy discussion and an optimal mechanism approach, respectively).

options that can be exercised before the value of the claim's payout is realized. This is most evident in the case of short-term debt, which gives debtholders the choice between rolling over the debt and getting out if bad news accrues; debt that is convertible into equity protects debtholders against excessive risk taking by shareholders. Debt contracts thus often limit the creditors' exposure to biased decision making by shareholders.

The same logic can be applied to the protection of employees. Let us here focus on the exit options. Exit options are, of course, facilitated by the firm's policies with respect to general training, vesting of retirement plans, and so forth. But quite importantly, exit options for employees as well as their welfare when they are laid off depend heavily on a variable over which the employment contract between the firm and its employees has no control, namely, the firm's economic environment and the flexibility of the labor market. While being laid off is always quite costly to a worker, this cost is currently much higher in a country like France, which has high unemployment (in particular, long-term unemployment) and low mobility for a variety of reasons (such as close family ties and the fiscal environment[145]), than in Anglo-Saxon economies, where it is currently easier for laid-off workers to find a job of comparable quality. One could therefore conjecture that one of the reasons why shareholder value is currently less controversial in Anglo-Saxon countries than in continental Europe is that the externalities exerted by shareholder control on employees are smaller in the former.

Of course, proponents of shareholder value recognize that contracts are imperfect. They then point at the role of the legal environment. Courts can fill in the details of imprecise or incomplete contracts as long as they abide by the spirit of the original contracts. And, in the case of externalities not covered by any private contract (as is the case, for instance, with diffuse pollution externalities), courts (in reaction to lawsuits), or regulators (say, through environmental taxation), can substitute for the missing contracts.

145. For example, high real estate transaction taxes have traditionally reduced owners' mobility. Similarly, for nonowners, laws related to rentals have made the rental market rather illiquid.

The counterargument to this last point is that the legal and regulatory framework is itself imperfect. It sometimes lags the collective will (if such a thing exists). And it is often influenced by intense interest group lobbying (see, for example, Pagano and Volpin 2005b). So, when laws are "suboptimal," managers may need to substitute for the required reforms (but, as noted above, nothing guarantees that they will better represent the "collective will" than the courts or legislators).

While incentive and control considerations plead in favor of shareholder value and against social responsibility,[146] shareholder-value maximization is, of course, very much a second-best mandate. In view of some imperfections in contracts and the laws, extremist views on shareholder value are distasteful. It implies, for instance, that management should bribe dictators or government officials in less developed countries when this practice is not sanctioned in the firm's home country; or that firms should have little concern for the environment when environmental taxes are thwarted by intense lobbying or measurement problems. New forms of intervention should then be designed in order to reconcile shareholder value and social responsibility in such instances of contract failure, although it should be recognized that proper incentives are then hard to design.

Green funds (investing in businesses that exert efforts to protect the environment) or more broadly ethical funds and consumer boycotts have attempted to do just that. They are interesting and well-meaning attempts at substituting for an imperfect regulation of externalities, but have their own limitations. (a) One limitation is that both investors and consumers have poor information: incentives provided by individual investors and consumers require these actors to be well-informed about the actual facts as well as to be capable of interpreting these facts (for example, the social and economic impacts of a policy are often misunderstood). Presumably, trustworthy informational intermediaries are needed to guide their choice. (b) Another limitation

146. An early exponent of this view was Berle himself. He argued that "you cannot abandon emphasis on the view that business corporations exist for the sole purpose of making profits for their stockholders until such time as you are prepared to offer a clear and reasonably enforceable scheme of responsibilities to someone else" (1932, cited by Blair 1995).

is free riding in the (costly) production of sanctions against socially irresponsible firms: as the evidence shows, a nonnegligible fraction of investors are willing to accept a slightly lower rate of return in order to avoid funding firms that behave in an unethical way. Most are, however, unlikely to be willing to take a low rate of return, in the same way that households are indignant when a park or an old neighborhood is converted into luxury condominium buildings but rush to acquire the resulting units.

Supplementary Section

1.9 The Stakeholder Society: Incentives and Control Issues

This supplementary section, which draws in part on Tirole (2001), develops the analysis of Section 1.8.3 on the implementation of the stakeholder society in a little more detail.

1.9.1 Monetary Incentives

To implement the stakeholder society, managerial incentives should be designed so as to align the managers' incentives with the sum of the stakeholders' surpluses rather than just the equityholders' surplus. We thus consider sequentially the provision of explicit and implicit incentives.

As discussed in this chapter, managerial incentives that explicitly emphasize shareholder value are provided through bonuses and stock options that encourage management to devote most of its effort to enhancing profitability and favor this objective when trading off the costs and benefits of alternative decisions. Similarly, managerial incentives that would explicitly emphasize stakeholder value would be provided by rewarding management on the basis of some measure of the aggregate welfare of the stakeholders (including investors). The key issue here is whether such a measure of aggregate welfare is readily available. I would argue that it is harder to measure the firm's contribution to the welfare of employees, of suppliers, or of customers than to measure its profitability. For one thing, there is no *accounting* measure of this welfare, although in some examples one can find imperfect proxies, such as the number of layoffs.[147] For another thing, there is no *market* value of the impact of past and current managerial decisions on the future welfare of stakeholders; that is, there is no counterpart to the stock market measurement of the value of assets in place, since the employment, supply, or other relationships with the firm are not traded in liquid markets, unlike the shareholder relationship. (Besides, if a measure of the impact of managerial decisions upon stakeholders' welfare were available (which I do not believe to be the case), then there would be no objection to shareholder value since the firm could be forced to internalize the externalities through contracts specifying that the firm will compensate the stakeholders for the externalities!)

Relatedly, to avoid giving management a blank check to pursue whatever policy pleases it, management could be made subject to an enlarged fiduciary duty: stakeholders could take management to court and try to demonstrate that managerial actions do not follow the mandate of the stakeholder society. An enlarged fiduciary duty would therefore be an attempt to make management accountable for the welfare of stakeholders.

Those familiar with the difficulty of implementing the restricted concept of fiduciary duty toward shareholders will easily imagine the limitations of an enlarged fiduciary duty. In a nutshell, management can almost always rationalize any action by invoking its impact on the welfare of *some* stakeholder. An empire builder can justify a costly acquisition by a claim that the purchase will save a couple of jobs in the acquired firm; a manager can choose his brother-in-law as supplier on the grounds that the latter's production process is environmentally friendly.

In the absence of a reliable measure of stakeholders' welfare that could be incorporated into a formal compensation contract, managers could still receive profit-based compensation as under the paradigm of shareholder value. Unfortunately, multitask explicit incentives theory (e.g., Holmström and Milgrom 1991) has taught us that designing pay

147. And their duration. A clever aspect of the experience rating system for layoff taxes is that the amount paid by the company depends on the level of benefits received by the employee it laid off, and so firing someone who remains unemployed for two years is much more costly than firing someone who will find a job the next day.

that is sensitive to the performance of a single task leads to a neglect of the other tasks.[148] We therefore infer that the stakeholder society is likely to be best promoted through *flat* managerial compensation, that is, through a fixed wage rather than performance-based incentives. There is in this respect some consistency between the lenient views in the French, German, and Japanese populations toward the stakeholder society and the historically low power of the managerial incentive schemes in these countries.[149]

1.9.2 Implicit Incentives and Managerial Missions

The previous discussion raises the issue of what management will maximize under flat explicit incentive schemes. The optimistic view is that management will choose what is best for society, that is, will maximize the sum of the stakeholders' surpluses. This view is sometimes vindicated: consider caritative organizations. Such organizations by definition aim at raising the welfare of the poor, of the hungry, or at providing access to cultural services to a broad audience, to give a few examples. Profit-maximizing behaviors would obviously defeat the purpose of such organizations. The key to success for caritative organizations is to empower idealistic employees who will derive private benefits from promoting social welfare.

While this paradigm works relatively well in some contexts, it would, however, be naive to trust it can be transposed to general environments. Most economic agents indeed place their own welfare above that of society. Thus, we cannot assume that managers facing flat compensation schemes will maximize the total surplus. Their incentives are then generally governed by their career concerns. The existence of multiple missions associated with the welfare of each stakeholding group suggests an investigation of the economics of multitask career concerns (which are actually the incentives faced by politicians, bureaucrats, and most employees, who have little performance-related pay).

Implicit incentives stem from an economic agent's desire to signal characteristics, such as ability, to what is broadly called the agent's "labor market," namely, whoever will in the future take actions that reflect beliefs about these characteristics and will impact the agent's welfare: board of directors, potential employers, voters, and so forth (Holmström 1999). Implicit incentives substitute (imperfectly) for explicit ones in environments in which performance cannot be well-described *ex ante*, but can be better assessed after the fact due to the accrual of new information.[150]

Implicit incentives are less proficient than explicit ones simply because the link from performance to reward cannot be fully controlled by a contract. This is particularly the case in a multitask environment. Indeed, multitasking impairs informal incentives just as it impairs formal ones (Dewatripont et al. 1999a,b). One reason is that managerial performance becomes noisier when the manager pursues multiple missions; the absence of "focus" on a specific task is therefore costly. Another reason is that multitasking may give rise to "fuzzy missions," that is, to situations in which the agent's labor market no longer knows which missions the agent is trying to pursue (although it tries to infer them by looking at what the agent has done best). The manager then does not know along which lines he will be evaluated. This uncertainty can be shown to further reduce the agent's incentives.

We are thus led to the view that the design of (explicit and implicit) managerial incentives for the stakeholder society is a particularly complex issue. This conclusion should not come as a surprise. After all, governments may be the ultimate stakeholder-society organizations, since they are instructed to balance the welfares of many different interest groups. It is well-known that proper incentives for bureaucrats and politicians are hard to design.

148. Unlike Sinclair-Desgagne (1999), we assume that the nonmonetary dimension cannot be subjected to an audit. Otherwise, in some circumstances, it may be possible to provide high-powered multitask incentives (as Sinclair-Desgagne shows) through a combination of compensation based on the monetary dimension together with an audit of the other tasks when monetary performance is high.

149. As discussed in the text of the chapter, entrepreneurial incentive schemes have become more high-powered in the last decade in non-Anglo-Saxon countries as well.

150. More technically, a missing "deciphering key" does not allow the contracting parties to describe at the contracting stage the meaning of a "good performance"; it is only later when the uncertainty unfolds that it becomes clearer what a good performance means.

1.9.3 The Costs and Benefits of Shared Control: Lessons from Input Joint Ventures for the Stakeholder Society

We now come to the second aspect of the stakeholder society: the control structure. The stakeholder society is unlikely to be promoted by the undivided control structure that prevails under the shareholder-value paradigm. Nor is it likely to be sustainable if control goes entirely to nonfinanciers; for, consider undivided control by other stakeholders such as employees or customers. Such control structures are not mirror images of shareholder control. Employee or customer control makes it difficult to protect investors by contractual means. While covenants can restrict the payment of dividends to shareholders (so as to prevent shareholders from leaving creditors and other stakeholders with an empty shell), it is much harder to prevent employees or customers from paying themselves large "dividends" when they have control. For this point, the distinction between "natural stakeholder" (management, employees, customers, etc.) and "stakeholder by design" (the investors) is crucial. Dividends paid to shareholders are highly visible and verifiable; dividends paid to natural stakeholders may not be: employees may enjoy large perks and customers may select gold-plated designs. The partial lack of control over dividends in kind severely impairs the effectiveness of governance structures in which investors are not represented.

Let us therefore discuss the sharing of control among stakeholders in the form of a generalized codetermination.[151] To help us think through alternative control structures, let us use the analogy of the organization of a production process with multiple users needing a common input. This input can be manufactured by a third party, either a not-for-profit or a for-profit corporation, controlled by players that are independent from the users (structural separation); or by one of the users, who then sells it to the other users (vertical integration); or else by a specific-purpose entity controlled jointly by the users (joint venture or association). For example, an electricity transmission network may be controlled by a distribution company or a generator (vertical integration), a group of users (joint venture), or an independent organization (not-for-profit as in the case of an independent system operator, or for-profit as in the case of a transmission company).

We can gain some insights into the costs and benefits of shared control from looking at the familiar case of a production of a joint input and apply them to the corporate governance debate. Indeed, input joint ventures are quite common: credit card associations such as Visa and MasterCard,[152] some stock exchanges, Airbus, research and farm cooperatives, telecommunications, biotechnology, and automobile alliances are all examples of joint ventures. Joint ventures, partnerships, and associations can be viewed as instances of stakeholder societies to the extent that players with conflicting interests share the control. But it should also be noted that the first argument in favor of shareholder value, the dearth of pledgeable income (see Section 1.8.3), may not apply to them: partners in joint ventures can more easily bring capital than employees in a corporation; the need for borrowing from independent parties is therefore much reduced. In other words, self-financing by the users of the input of a joint venture implies that the dearth of pledgeable income is not a key factor here.

An interesting lesson drawn from the work of Hansmann (1996) and from much related evidence is that the heterogeneity of interests among the partners of a joint venture seriously impedes the joint venture's efficacy. As one might expect, conflicts of interest among the partners create mistrust and lead to deadlocks in decision making.[153]

151. We focus here on the sharing of all major control rights among stakeholders. Alternatively, multiple control rights could be shared among stakeholders, but some could be allocated fully to specific shareholders. In some circumstances, the two can be closely related: different stakeholders may threaten to hurt each other substantially through the exercise of their proprietary control rights; the parties must then cooperate on a global deal as if they shared all control rights. A case in point is the failed attempt in the mid 1990s by Mr. Schrempp, the chairman of Daimler-Benz, to take advantage of a newly passed law in Germany offering firms the possibility of limiting the payments to sick employees. The board of directors took back the decision a few days later because the envisioned restructuring of Daimler-Benz required the cooperation of employees. The chairman, up to that time a strong proponent of shareholder value, declared that he would never mention the phrase shareholder value again.

152. MasterCard became for-profit in 2003.

153. These deadlocks can be attributed primarily to asymmetries of information, but sometimes may stem from limited compensation abilities of some of the parties. This is where the Coase Theorem fails.

Appendixes

1.10 Cadbury Report

Report of the Committee on the Financial Aspects of Corporate Governance

Introduction

1. The Committee was set up in May 1991 by the Financial Reporting Council, the London Stock Exchange, and the Accountancy profession to address the financial aspects of corporate governance.

2. The Committee issued a draft report for public comment on 27 May 1992. Its final report, taking account of submissions made during the consultation period and incorporating a Code of Best Practice, was published on 1 December 1992. This extract from the report sets out the text of the Code. It also sets out, as Notes, a number of further recommendations on good practice drawn from the body of the report.

3. The Committee's central recommendation is that the boards of all listed companies registered in the United Kingdom should comply with the Code. The Committee encourages as many other companies as possible to aim at meeting its requirements.

4. The Committee also recommends:

   (a) that listed companies reporting in respect of years ending after 30 June 1993 should make a statement in their report and accounts about their compliance with the Code and identify and give reasons for any areas of non-compliance;

   (b) that companies' statements of compliance should be reviewed by the auditors before publication. The review by the auditors should cover only those parts of the compliance statement which relate to provisions of the Code where compliance can be objectively verified (see note 14).

5. The publication of a statement of compliance, reviewed by the auditors, is to be made a continuing obligation of listing by the London Stock Exchange.

6. The Committee recommends that its sponsors, convened by the Financial Reporting Council, should appoint a new Committee by the end of June 1995 to examine how far compliance with the Code has progressed, how far its other recommendations have been implemented, and whether the Code needs updating. In the meantime the present Committee will remain responsible for reviewing the implementation of its proposals.

7. The Committee has made clear that the Code is to be followed by individuals and boards in the light of their own particular circumstances. They are responsible for ensuring that their actions meet the spirit of the Code and in interpreting it they should give precedence to substance over form.

8. The Committee recognises that smaller listed companies may initially have difficulty in complying with some aspects of the Code. The boards of smaller listed companies who cannot, for the time being, comply with parts of the Code should note that they may instead give their reasons for non-compliance. The Committee believes, however, that full compliance will bring benefits to the boards of such companies and that it should be their objective to ensure that the benefits are achieved. In particular, the appointment of appropriate non-executive directors should make a positive contribution to the development of their businesses.

The Code of Best Practice

1. The Board of Directors

1.1. The board should meet regularly, retain full and effective control over the company and monitor the executive management.

1.2. There should be a clearly accepted division of responsibilities at the head of a company, which will ensure a balance of power and authority, such that no one individual has unfettered powers of decision. Where the chairman is also the chief executive, it is essential that there should be a strong and independent element on the board, with a recognised senior member.

1.3. The board should include non-executive directors of sufficient calibre and number for their views to carry significant weight in the board's decisions. (Note 1.)

1.4. The board should have a formal schedule of matters specifically reserved to it for decision to ensure that the direction and control of the company is firmly in its hands. (Note 2.)

1.5. There should be an agreed procedure for directors in the furtherance of their duties to take independent professional advice if necessary, at the company's expense. (Note 3.)

1.6. All directors should have access to the advice and services of the company secretary, who is responsible to the board for ensuring that board procedures are followed and that applicable rules and regulations are complied with. Any question of the removal of the company secretary should be a matter for the board as a whole.

2. Non-executive Directors

2.1. Non-executive directors should bring an independent judgement to bear on issues of strategy, performance,

resources, including key appointments, and standards of conduct.

2.2. The majority should be independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement, apart from their fees and shareholding. Their fees should reflect the time which they commit to the company. (Notes 4 and 5.)

2.3. Non-executive directors should be appointed for specified terms and reappointment should not be automatic. (Note 6.)

2.4. Non-executive directors should be selected through a formal process and both this process and their appointment should be a matter for the board as a whole. (Note 7.)

3. Executive Directors

3.1. Directors' service contracts should not exceed three years without shareholders' approval. (Note 8.)

3.2. There should be full and clear disclosure of directors' total emoluments and those of the chairman and the highest-paid UK director, including pension, contributions and stock options. Separate figures should be given for salary and performance-related elements and the basis on which performance is measured should be explained.

3.3. Executive directors' pay should be subject to the recommendations of a remuneration committee made up wholly or mainly of non-executive directors. (Note 9.)

4. Reporting and Controls

4.1. It is the board's duty to present a balanced and understandable assessment of the company's position. (Note 10.)

4.2. The board should ensure that an objective and professional relationship is maintained with the auditors.

4.3. The board should establish an audit committee of at least three non-executive directors with written terms of reference which deal clearly with its authority and duties. (Note 11.)

4.4. The directors should explain their responsibility for preparing the accounts next to a statement by the auditors about their reporting responsibilities. (Note 12.)

4.5. The directors should report on the effectiveness of the company's system of internal control. (Note 13.)

4.6. The directors should report that the business is a going concern, with supporting assumptions or qualifications. (Note 13.)

Notes

These notes include further recommendations on good practice. They do not form part of the Code.

1. To meet the Committee's recommendations on the composition of sub-committees of the board, boards will require a minimum of three non-executive directors, one of whom may be the chairman of the company provided he or she is not also its executive head. Additionally, two of the three non-executive directors should be independent in the terms set out in paragraph 2.2 of the Code.
2. A schedule of matters specifically reserved for decision by the full board should be given to directors on appointment and should be kept up to date. The Committee envisages that the schedule would at least include:
   (a) acquisition and disposal of assets of the company or its subsidiaries that are material to the company;
   (b) investments, capital projects, authority levels, treasury policies and risk management policies.

   The board should lay down rules to determine materiality for any transaction, and should establish clearly which transactions require multiple board signatures. The board should also agree the procedures to be followed when, exceptionally, decisions are required between board meetings.
3. The agreed procedure should be laid down formally, for example in a Board Resolution, in the Articles, or in the Letter of Appointment.
4. It is for the board to decide in particular cases whether this definition of independence is met. Information about the relevant interests of directors should be disclosed in the Directors' Report.
5. The Committee regards it as good practice for non-executive directors not to participate in share option schemes and for their service as non-executive directors not to be pensionable by the company, in order to safeguard their independent position.
6. The Letter of Appointment for non-executive directors should set out their duties, term of office, remuneration, and its review.
7. The Committee regards it as good practice for a nomination committee to carry out the selection process and to make proposals to the board. A nomination committee should have a majority of non-executive directors on it and be chaired either by the chairman or a non-executive director.
8. The Committee does not intend that this provision should apply to existing contracts before they become due for renewal.
9. Membership of the remuneration committee should be set out in the Directors' Report and its chairman should be available to answer questions on remuneration principles and practice at the Annual General Meeting. Best practice is set out in PRO NED's Remuneration Committee Guidelines published in 1992.
10. The report and accounts should contain a coherent narrative, supported by the figures of the company's performance and prospects. Balance requires that setbacks

should be dealt with as well as successes. The need for the report to be readily understood emphasises that words are as important as figures.

11. The Committee's recommendations on audit committees are as follows:
    (a) They should be formally constituted as subcommittees of the main board to whom they are answerable and to whom they should report regularly; they should be given written terms of reference which deal adequately with their membership, authority and duties; and they should normally meet at least twice a year.
    (b) There should be a minimum of three members. Membership should be confined to the nonexecutive directors of the company and a majority of the non-executives serving on the committee should be independent of the company, as defined in paragraph 2.2 of the Code.
    (c) The external auditor and, where an internal audit function exists, the head of internal audit should normally attend committee meetings, as should the finance director. Other board members should also have the right to attend.
    (d) The audit committee should have a discussion with the auditors at least once a year, without executive board members present, to ensure that there are no unresolved issues of concern.
    (e) The audit committee should have explicit authority to investigate any matters within its terms of reference, the resources which it needs to do so, and full access to information. The committee should be able to obtain outside professional advice and if necessary to invite outsiders with relevant experience to attend meetings.
    (f) Membership of the committee should be disclosed in the annual report and the chairman of the committee should be available to answer questions about its work at the Annual General Meeting.

    Specimen terms of reference for an audit committee, including a list of the most commonly performed duties, are set out in the Committee's full report.

12. The statement of directors' responsibilities should cover the following points:
    - the legal requirements for directors to prepare financial statements for each financial year which give a true and fair view of the state of affairs of the company (or group) as at the end of the financial year and of the profit and loss for that period;
    - the responsibility of the directors for maintaining adequate accounting records, for safeguarding the assets of the company (or group), and for preventing and detecting fraud and other irregularities;
    - confirmation that suitable accounting policies, consistently applied and supported by reasonable and prudent judgements and estimates, have been used in the preparation of the financial statement;
    - confirmation that applicable accounting standards have been followed, subject to any material departures disclosed and explained in the notes to the accounts. (This does not obviate the need for a formal statement in the notes to the accounts disclosing whether the accounts have been prepared in accordance with applicable accounting standards.)

    The statement should be placed immediately before the auditors' report which in future will include a separate statement (currently being developed by the Auditing Practices Board) on the responsibility of the auditors for expressing an opinion on the accounts.

13. The Committee notes that companies will not be able to comply with paragraphs 4.5 and 4.6 of the Code until the necessary guidance for companies has been developed as recommended in the Committee's report.

14. The company's statement of compliance should be reviewed by the auditors in so far as it relates to paragraphs 1.4, 1.5, 2.3, 2.4, 3.1 to 3.3 and 4.3 to 4.6 of the Code.

1.11 Notes to Tables

1.11.1 Notes to Table 1.3

Sources: (a) Federal Reserve, Banque de France, Bank of Japan, and Eurostat; (b) Bank of England, Banque de France, Bank of Japan, and Eurostat. Data are not available for (a) the United Kingdom or (b) the United States.

Construction for both parts is as follows.

United States. 1. *Sources:* Federal Reserve of the United States, Flow of Funds Accounts of the United States (Release of December 9, 2004), Level Tables, Table L.213 (http://www.federalreserve.gov/releases/zl/Current/zlr-4.pdf).

2. *Details:* Corporate equities are shares of ownership in financial and nonfinancial corporate businesses. The category comprises common and preferred shares issued by domestic corporations and U.S. purchases of shares issued by foreign corporations, including shares held in the form of American depositary receipts (ADRs); it does not include mutual fund shares. Data on issuance and holdings of corporate equities are obtained from private data-reporting services, trade associations, and regulatory and other federal agencies. Purchases of equities by the households and nonprofit organizations sector are found as the residual after the purchases of all other sectors have been subtracted from total issuance. *Construction:* "insurance companies" = "life insurance companies" + "other insurance companies"; "banks and other financial institutions" =

"commercial banking" + "saving institutions" + "bank and personal trusts and estate" + "brokers and dealers"; "mutual funds" = "mutual funds" + "closed-end funds" + "exchange-traded funds"; "pension funds" = "private pension funds" + "state and local government retirement funds" + "federal government retirement funds."

France. 1. *Sources:* Banque de France, Comptes Nationaux Financiers, Séries Longues, Accès par Opération, Encours, Actif: F5I Actions et Autres Participations hors titre d'OPCVM, 2002 (http://www.banque-france.fr/fr/stat_conjoncture/series/cptsnatfinann/html/tof_ope_fr_encours_actif.htm).

2. *Construction:* "insurance companies" + "pension funds" = "sociétés d'assurance et fonds de pension"; "mutual funds" = "autres intermédiaires financiers"; "banks and other financial institutions" = "sociétés financières" – "autres intermédiaires financiers" – "sociétés d'assurance et fonds de pension."

Germany. 1. *Sources:* Eurostat, Comptes des patrimoines, Actifs financiers, Actions et autres participations, à l'exclusion des parts d'organismes de placement collectif, 2002 (http://europa.eu.int/comm/eurostat/).

2. *Construction:* see France.

Japan. 1. *Sources:* Bank of Japan, Flow of Funds (Annual Data (2002)/Financial assets and liabilities), Column AP (shares and other equity) (http://www2.boj.or.jp/en/dlong/flow/flow12.htm#01).

2. *Construction:* "banks and other financial institutions" = "financial institutions" – "insurance" – "pension total" – "securities investment trust."

(b) *Sources:* National Statistics Bureau of the U.K., 2002 Share Ownership Report, Table A: Beneficial Ownership of U.K. Shares, 1963–2002 (http://www.statistics.gov.uk/downloads/theme_economy/ShareOwnership2002.pdf).

2. *Description:* contains details on the beneficial ownership of U.K. listed companies as at December 31, 2002. The survey uses data downloaded from the CREST settlement system to assign shareholdings to National Accounts sectors.

3. *Construction:* "mutual funds" = "unit trust" + "investment trust" + "charities"; "banks and other financial institutions" = "banks" + "other financial institutions"; "pension funds" = "insurance companies"; "insurance companies" = "insurance"; "mutual funds" = "securities investment trust."

1.11.2 Notes to Table 1.4

Sources: Federal Reserve of the United States, Flow of Funds Accounts of the United States (Release of December 9, 2004), Level Tables, Table L.213 (http://www.federalreserve.gov/releases/zl/Current/zlr-4.pdf). *Other financial institutions:* includes securities held by brokers and security dealers investing on their own account rather than for clients; venture capital companies; unauthorized investment trusts; unauthorized unit trusts; and other financial institutions not elsewhere specified.

1.11.3 Notes to Tables 1.6 and 1.7

Description of Table 1.6: ultimate control of publicly traded firms. Data relating to 5,232 publicly traded corporations are used to construct this table. The table presents the percentage of firms controlled by different controlling owners at the 20% threshold. Data are collected at various points in time between 1996 and 2000, depending on countries. Controlling shareholders are classified into six types:

Family. A family (including an individual) or a firm that is unlisted on any stock exchange.

Widely held financial institution. A financial firm (SIC 6000-6999) that is widely held at the control threshold.

State. A national government (domestic or foreign), local authority (county, municipality, etc.), or government agency.

Widely held corporation. A nonfinancial firm, widely held at the control threshold.

Cross-holdings. The firm Y is controlled by another firm, which is controlled by Y, or directly controls at least 20% of its own stocks.

Miscellaneous. Charities, voting trusts, employees, cooperatives, or minority foreign investors.

Companies that do not have a shareholder controlling at least 20% of votes are classified as widely held.

Description of Table 1.7: assembled data for 2,980 publicly traded corporations (including both financial and nonfinancial world) and supplemented with information from country-specific sources. ln all cases, the ownership structure was collected as of the end of fiscal year 1996 or the closest possible date. This table presents result defining control on a 20% threshold of ownership.

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