Revised, 17 April 1998

Objectivity, Control and Adaptability in Corporate Governance

by

Arnoud W.A. Boot* and Jonathan R. Macey**

* University of Amsterdam, Faculty of Economics and Econometrics, Roetersstraat 11, 1018 WB, Amsterdam, The Netherlands, e-mail: awaboot@fee.uva.nl

** Cornell University School of Law, 306 Myron Taylor Hall, Ithaca, NY 14853-4901, U.S.A, e-mail: macey@law.mail.cornell.edu

N-C:\my docs\boot\papers98\objectivity

OBJECTIVITY, CONTROL AND ADAPTABILITY IN CORPORATE GOVERNANCE

Abstract

Countries appear to differ considerably in the basic orientations of their corporate governance structures. We postulate the trade-off between *objectivity* and *proximity* as fundamental to the corporate governance debate. We stress the value of objectivity that comes with distance (e.g. the market oriented U.S. system), and the value of better information that comes with proximity (e.g. the more intrusive Continental European model).

A superior corporate governance arrangement must balance the benefits of proximity and objectivity. In this context, we also discuss the ways in which investors have "contracted around" the flaws in their own corporate governance systems, pointing at the *adaptability* of different arrangements.

OBJECTIVITY, CONTROL AND ADAPTABILITY IN CORPORATE GOVERNANCE

Introduction

In advanced market economies, one observes significant diversity in the ways that alternative corporate governance systems confront the basic problem of corporate governance, which we take to be providing reasonably credible assurances to suppliers of capital that they will receive a return on their investment[1]. In order to provide suppliers of finance with sufficient assurances to induce them to invest, a corporate governance system must accomplish three things: (1) lower contracting costs by providing minority shareholder protection, well defined property rights and default rules and reliable enforcement of such rules; (2) lower agency costs by providing mechanisms for controlling managers; and (3) protect specific human capital investment, or more broadly defined relationship specific investments.

Countries appear to differ dramatically in the basic orientations of their corporate governance structures, yet these differences do not appear to affect overall productivity or capital formation at least in ways that are capable of precise specification. Indeed, despite the significant differences in corporate governance structures among developed countries, capital structure, as measured by debt-equity ratios, remains remarkably similar across nations. It is this basic insight that motivates this paper, which, at its core, is about the adaptability of corporate governance systems. Differences in corporate governance systems reflect the fact that different systems accomplish the three objectives of corporate governance just described in different ways. Moreover, we point out that making

[1] Shleifer and Vishny (1997) characterize the corporate governance problem as dealing with the ways that suppliers of finance seek to assure themselves of a return on their investments.

improvements in one aspect of a corporate governance system, in order, for example, to improve the way that a corporate governance system reduces agency costs, can weaken the system in other ways, for example by reducing the ability of the system to protect human capital investments. Thus changes to existing governance systems should be made with great care, in light of the complex, chaotic nature of these systems.

Alternative corporate governance systems establish initial sets of legal entitlements among claimants to firms' cash flows, specifying different levels of protection for different types of investors. A cursory look at the corporate balance sheet reveals that, broadly speaking, a corporate governance system can be evaluated on the basis of how well it protects fixed claimants and equity claimants. Those systems that provide protections for both sorts of claimants should, presumably, function the best, since their capital structure will be the least distorted by the flaws in their corporate governance systems. The U.S. system of corporate governance has been singled out for acclaim because of the strong protections it affords to small-stakes equity claimants. The German system has been identified as providing particularly strong protections for fixed claimants. By contrast, corporate governance systems such as Italy's or Russia's, do not protect either fixed or equity claimants. Firms in these countries are cut off from important sources of capital and must resort to primitive corporate governance devices (such as family control) in order to obtain capital.

We develop the point that each corporate governance system attempts to control the (agency) problems that plague the separation of ownership and control. It is not possible to raise outside capital at a reasonable price unless a corporate governance system that adequately addresses these agency problems is in place. One potential interpretation of the alternative corporate governance systems that we observe is that they reflect the ways in which investors have "contracted around" the flaws in their own corporate governance systems in order to make the most efficient investments possible, given the constraints imposed by the extant corporate governance system. This points at the *adaptability* of corporate governance arrangements[2].

The most commonly invoked paradigms of corporate governance are the U.S. system of corporate governance which boasts strong capital markets but weak institutional constraints on management, and the German model, where strong institutional (bank) controls on management may compensate for weak capital markets. Previously, Coffee (1991) and Bhide (1993) have identified a trade-off in corporate governance between the characteristic of liquidity, which provides investors with a ready "exit option" in case their investment goes sour, and the characteristic of voice, which gives investors the ability to affect the performance of the firms in which they have invested if they become dissatisfied. It appears that investors who wish to acquire more voice in the running of their firms must, at least to some extent, sacrifice their exit option by giving up liquidity. Similarly, enhanced liquidity may come at the cost of reduced institutional control.

While this argument is undoubtedly important, we identify a potentially more important tradeoff that must be faced when evaluating a corporate governance system. This is the tradeoff between

[2] An important illustration of the potential powerful incentives toward adaptability is the degree in which incentive compensation contracts are present. Incentive contracts like stock options and other pay-for-performance remuneration schemes are needed whenever lack of control and/or observability leave excessive discretion to managers. How could managers be induced to "use" the discretion in the interest of shareholders, or (potentially) more general, in the interest of the firm rather than (only) serving their self-interest? Here pay-for-performance remuneration schemes might be valuable. We can envision some differences in discretion across corporate governance systems; e.g. a market-oriented corporate governance system with diffused share-ownership *may* leave more discretion to management and thus necessitate incentive compensation contracting. In this sense, systems are "adaptable" and differences in the prevalence

objectivity and *proximity*. In systems like those that exist in Germany, The Netherlands and elsewhere, where there is often an intimate finely textured involvement in monitoring management either by large shareholders or, alternatively by autonomous, but deeply entrenched boards of directors (supervisory boards), it often will be the case that members of these boards effectively become insiders and are "captured" by the firms they are monitoring. Where such capture occurs, the ostensible monitor will tend to adopt the perspective of the firm being supervised. Thus the informational advantage enjoyed by the insiders in certain corporate governance systems is mitigated by the fact that these investors may gradually loose the ability to evaluate the performance of the firms they are monitoring in an objective manner.

By contrast, in a corporate governance system like the one that exists in the U.S., less monitoring comes from directors. Instead the market for corporate control provides for (collective) direct shareholder involvement. In such a system considerable distance exists between monitors (investors and potential investors) and management. Investors may then face an obvious problem in obtaining timely, reliable information. This may negatively impact the effectiveness of their governance. In particular, monitoring in the U.S. often is *ex post* and evaluative rather than *ex ante* and "pro-active". On the positive side, the distance that U.S. investors have from the firms in which they are investing brings with it a degree of objectivity lacking in corporate governance systems where the proximity of monitors subjects them to the risk of capture. The best of both systems would combine proximity and objectivity. While this seems unattainable, a superior corporate governance arrangements must balance the benefits of proximity and objectivity.

---

of incentive compensation contracts may reflect the adaptability of different systems.

This paper has three parts. The first part develops a theoretical framework highlighting the source of the corporate governance problem, the objectives of corporate governance and the importance of shareholders in corporate governance. The second part of this paper discusses the issue of adaptability in the context of the corporate governance arrangements in the U.S. and Italy. The basic point here is Coasean in nature: firms in every country face legal restrictions around which they must bargain in order to obtain the corporate governance regimes that are optimal under the extant legal frameworks under which they must operate. Some of these legal frameworks impede capital formation. In these legal regimes, banking markets may flourish. Other legal frameworks impede large investors, potentially benefiting the development of capital markets.

The third part of the paper builds on our point about adaptability. Here the point is that, systems differ in the proximity and objectivity of supervision and control. A tradeoff inevitably will exist. In order to obtain more of one, investors will have to sacrifice the other. We believe that our conclusions about the nature of alternative corporate governance systems are interesting and important because they show the futility of efforts to design a "perfect" corporate governance system, and they suggest that there is unlikely to be a clear answer to the question "which corporate governance system is best." Rather, the best corporate governance systems will be those that give firms the most freedom to structure the details of their own contracts with suppliers of capital, and then provide a reliable legal system for enforcing these contractual arrangements.

I Corporate Governance: Theoretical Insights

1.1 The corporate governance setting

On a theoretical level the problems of corporate governance result from the existence of incomplete contracts. When contracts are incomplete governance is desired to resolve the gaps left in these contracts in ways consistent with maximizing the value of the firm. The important contribution addressing this issue comes from Grossman and Hart (1986). They introduce the notion of residual rights of control that stresses the importance of allocating decision power (control) in unspecified contingencies. Corporate governance could be defined narrowly as “the set of conditions that shape the ex post bargaining over the quasi-rents generated by a firm” (Zingales (1997)). Under this definition, corporate governance fills in the holes left in incomplete contracts. Corporate governance is irrelevant with complete contracts. These contracts fully specify the desired course of action, and provided that enforcement and time-inconsistency problems are not an issue (and they are not in a complete contracting world), no role exists for corporate governance.

The presence of discretion in incomplete contracts makes the allocation of residual rights of control important. The primary focus. is now the accountability of management vis-a-vis stakeholders and the governance and/or supervision provided by those stakeholders. Management -- in this incomplete contracting world -- may have a substantial informational advantage granting them effectively some residual rights of control. But who should ideally be granted the residual rights of control? We take the point of view that shareholders lack protection in terms of enforceable contractual rights and have weak bargaining power because their investment in the firm is sunk once it has been made. This view points at shareholders as the prime candidate for being allocated control rights[3]. The question now is how corporate governance should be arranged to protect the interests of shareholders.

1.2 Managerial inefficiencies and shareholder involvement

The problem of corporate governance is rooted in the separation of ownership and control. When management and shareholders are the same party, control rights are automatically in the hands of shareholders. Many have argued that direct shareholder control over management is therefore desirable. However, some have suggested that specific problems arise when shareholders try to exercise control. Most notably, free-rider problems due to dispersion of ownership (Grossman and Hart (1988)) might be insurmountable. While having large shareholders (Shleifer and Vishny (1986)) may overcome this, problems also arise when large shareholders participate in management. Large shareholders may face conflicts of interest that undermine their incentives to maximize firm value. For example, they may enjoy private benefits of control that distort their decision making. Alternatively, large shareholders may themselves be part of organizations that face governance problems (e.g. (public) pension funds, see Romano (1993)).

While these are potentially powerful concerns about the effectiveness of shareholder control, recent research suggests that more fundamental tradeoffs may guide the desired involvement of shareholders in corporate control. Burkhart, Gromb and Panunzi (1997) and Aghion and Tirole (1997) both show

[3] Rajan and Zingales (1998) argue that another important consideration guiding the choice of residual claimant concerns the claimants' incentives and ability to choose the specificity of their contribution to the firm. Highly firm-specific contributions may limit ex post bargaining power. Shareholders however could part with their money and thus (partially) distance themselves from the direct decision making but be granted control rights ex post. The suppliers of other inputs including workers (labor) are generally not able to distance themselves. That is, they have a more permanent effect on the quality and usage of their input. Granting them control rights may then be suboptimal: they would seek to affect or manipulate the firm-

that direct shareholder control may discourage new initiatives on the part of managers. A simple example would be a situation where project quality would depend on management initiative (effort) and exogenous characteristics of the project. If shareholders are too involved they may push for a change in projects every time a (marginally) better investment opportunity comes along. Managers would anticipate this possibility and reduce the effort invested in what they perceive as potentially transient projects accordingly. A lower level of shareholder involvement may mitigate these perverse incentives[4].

This recent strand of the literature suggests that *excessive* involvement of shareholders might be counter-productive. These observations are consistent with real world corporate governance arrangements, which almost without exception limit direct shareholder involvement. In some cases -- particularly the U.S. -- this is accompanied by relatively dispersed ownership. This limits *direct* shareholder involvement to at most periodical interference via proxy fights, hostile takeovers or other mechanisms that seek to mobilize shareholders. Simultaneously, on the board level, non-executive directors provide for a more continuous and immediate monitoring of management. Their interests, however, will not be perfectly aligned with those of shareholders[5]. In the Continental European

---

specificity of their contribution.

[4] In the Rajan and Zingales (1998) story -- see footnote 3 -- shareholders may push for non-firm specific investments that would optimize ex post bargaining power at the cost of ex ante efficiency.

[5] An important issue is the obligations that (corporate) law imposes on directors. While the system of corporate law is endogenous, and in the end potentially an outcome of the search for an optimal corporate governance arrangement, the specification of the law is still of interest and a determinant of corporate governance practices as well. In this context Shleifer and Vishny (1997) emphasize the fiduciary duty of managers and directors vis-à-vis shareholders. This duty is deeply entrenched in U.S. law. Hamermesh (1997) formulates this as follows : “Delaware law fully supports the proposition, dismissed in some quarters as myopic, that the business and affairs of a Delaware for profit stock corporation are to be managed so as to maximize the value of the investment of one group and one group only, its stockholders”. Similarly, U.S. courts have ruled that “A board may have regard for various constituencies in discharging its responsibilities provided there are rationally related benefits accruing to the stockholders” (Revlon, Inc., V. MacAndrews &

context more concentrated ownership is dominant. However, this ownership does *not* (necessarily) translate into *direct* control. In countries like The Netherlands and -- to a lesser extent -- Germany rather autonomous supervisory boards operate (semi) independently from shareholders and effectively shield management from direct shareholder involvement. Therefore, as in the U.S., direct shareholder control over management is limited[6, 7].

The main issue, however, is how to facilitate sufficient shareholder control to overcome managerial inefficiencies and address the other objectives of corporate governance.

1.3 Objectives of corporate governance

Corporate governance is needed for three reasons. First, and foremost, the necessarily incomplete nature of the corporate contract (coupled with the costliness of the contracting process) implies a need for background rules to supply solutions to the unforeseen contingencies that confront investors. Second, the relationship between investors and managers presents a straightforward agency problem that must be addressed. This relates to the problems inherent in the separation of investment ("ownership") and management ("control"), in particular measures to overcome managerial inefficiencies. Third, the modern corporate enterprise requires a wide variety of firm-specific capital investments. Thus an important, though frequently ignored, characteristic of a properly functioning

---

Forbes Holdings, Inc. 506 A.2d 619, 624 (Del. 1984)). Blair and Stout (1997) take the controversial point of view that American corporate law (should) dictate directors to act in the interest of the firm, and not only those of shareholders. This focus mimics Continental European corporate governance arrangements, e.g. Dutch corporate law explicitly states that directors should serve the interests of the firm as an entity.

[6] Observe that shareholder control becomes more powerful when financial difficulties or managerial control problems emerge. We then generally observe concentration of shareholdings.

[7] Shareholder control is very real in cases where no separation exists between ownership and control, as may be the case in family businesses. Note, however, that the corporate governance debate does *not* focus on these businesses but rather focuses on large(r) public firms characterized by a separation between ownership and

corporate governance system is to protect the firm-specific investments made by those contributing human capital to the firm. By protecting these asset-specific investments, corporate governance systems provide firms and individuals with the necessary incentives to make such investments. Unfortunately, there might be a trade-off between the different objectives of corporate governance. Consequently, improving the performance of a corporate governance system along one vector may weaken the ability of that system to perform along another vector. For example, the weaknesses of the Italian corporate governance system in providing useful background rules and in resolving the agency problems that exist between investors and managers are well known. However, the strength of the Italian system in nurturing and protecting firm-specific human capital investments is not widely recognized (Macey (1998)).

One of the most striking things about the corporate governance debate is how divorced the rhetoric is from the reality. By this we mean two things. First, the rhetoric of corporate governance is divorced from reality in that many of those corporate governance systems that are characterized as defective somehow appear to produce impressive economic results. Specifically, a number of countries, France, Italy, and by some accounts, even the U.S., which are categorized for various reasons as having deficient corporate governance systems, over time have nevertheless produced superior results in terms of productivity[8]. How can it be that such "defective" systems are capable of generating so much wealth? Why for example does Italy, which appears by all accounts to have a completely dysfunctional corporate governance system, have a higher GDP per capital than Britain, whose corporate governance system appears, on the basis of existing theories to be among the best?

---

control.

[8] See Osterland (1997) and Fento (1997) for France, Zingales (1994) and Barca (1995) for Italy, and Jensen (1989-93) and Porter (1992) for the USA.

The second way that the existing rhetoric about corporate governance appears to us to be divorced from reality is that two paradigmatic governance systems -- the German model and the U.S. model -- are not really models at all. The reality is that these systems are *sui generis*. The German system is not even a model for the rest of Europe. Nowhere else, for example, exists the “co-determination” of workers and shareholders that is a key characteristic of the German model. Countries such as Italy and France on the one hand (extensive cross holdings and interference by the state), and the Netherlands and Sweden on the other (autonomous boards insufficiently (?) accountable to shareholders), have corporate governance systems that scarcely resemble the German “model”. Similarly, the U.S. system of corporate governance differs in important ways from the governance systems in place in other common law countries such as Britain and Canada.

In Part II, we will discuss the corporate governance structures in two countries (U.S. and Italy) in some detail. This will provide detail to the notion of adaptability of corporate governance arrangements and also illustrate differences in objectivity and proximity across systems.

II Corporate governance in the U.S. and Italy: adaptability and resilience

2.1 Basic insights

No corporate governance system is perfect. But all are complex. The purpose of the following subsections which discuss the U.S. and Italy, is to show how corporate governance systems can be evaluated on the basis of how well they fill gaps in contingent contracts, resolve agency problems, and promote investments in human capital. Only by focusing on all three of these elements is it possible to gain a more or less complete picture of the strengths and weaknesses of each system. And, only by understanding the strengths and weaknesses of each system can we understand how these systems adapt to overcome their weaknesses.

We stress the fact that firms that operate within competitive product, labor and capital markets face strong incentives to innovate around any defects that may exist within the framework of any particular set of corporate governance rules. This is the notion of adaptability. In this context we discuss the tradeoff between the value of objectivity that comes with distance, and the value of information that comes with proximity. The U.S. fits our example of a corporate governance system in which the entities that provide monitoring and discipline potentially lack information but enjoy objectivity. Italy provides an example of a country with a defective corporate governance structure. The Italian corporate governance structure permits neither the separation of ownership and control together with "distance" that brings objectivity (e.g. the U.S.), nor the continuous and textured monitoring and discipline by institutions or supervisory boards that provide monitors potentially with real-time information about corporate performance (e.g. Germany and The Netherlands). While it is possible to identify corporate governance systems that lack both objectivity and continued and textured monitoring (Italy), it is not possible to identify any systems that feature both traits. The notions of proximity and objectivity are further developed in Part III.

2.2 Strengths and weaknesses of U.S. corporate governance

The U.S. system of corporate governance gets high marks for its ability to fill in gaps in contingent contracts, mediocre marks for its ability to resolve agency problems, and poor marks for its ability to promote human capital investments. With regard to filling in gaps in contingent contracts, the U.S.

system, while far from perfect, does a good job of policing efforts by management to divert corporate assets to their own uses. U.S. law has rules that protect minority shareholders from exploitation, even those who own subsidiaries of firms that are part of larger corporate groups[9].

U.S. law also polices rather vigorously against director conflict of interest transactions[10]. More importantly, U.S. directors owe a fiduciary duty of undivided loyalty to their shareholders under basic U.S. corporate governance principles (Scott (1983))[11]. In addition to these protections for shareholders, a critical element of U.S. corporate law is that most of its provisions are enabling rather than mandatory: investors can customize their own arrangements with the firms in which they have invested in order to tailor these arrangements to correspond to their own particular needs.

Turning now from mitigating contracting costs to ameliorating the agency problems that exist within the firm, the U.S. system produces much more mixed results. While it is true that U.S. law does a good job of dealing with crude efforts by managers to abscond with corporate assets, the U.S. system does not deal nearly so well, at least in recent years, with other, more complex aspects of the agency problem facing investors in public companies. In particular, the U.S. system performs rather poorly with respect to controlling more subtle forms of agency costs. It is well known that the U.S. system of corporate governance is categorized by a degree of separation between ownership and control that is pronounced relative to that in other countries. The U.S. depends more on capital markets and less on banks and large shareholders than other countries (Murray (1997)). As a consequence of this historical phenomenon, which is at least partially attributable to political causes (Roe (1994)), the

[9] Cite Sinclair Oil V. Levien

[10] See, for example, Subchapter F (sections 8.60-8.63) of the Model Business Corporation Act.

[11] The duty of care is somewhat more controversial than the duty of loyalty. See Scott (1983): “very little of any value would be lost by outright abolition of the legal duty of care and its accompanying threat of a lawsuit”.

performance of the American system of corporate governance hinges in part on its ability to resolve agency problems that result from the separation of ownership and management that uniquely characterize the U.S. public corporation.

The way that the U.S. system historically has confronted these problems is through takeovers. A wealth of theoretical arguments and empirical evidence supports the proposition that takeovers address corporate governance problems in general and agency problems in particular by controlling managerial discretion. Shleifer and Vishny (1997) have observed that "takeovers are widely interpreted as the critical corporate governance mechanism in the United States, without which managerial discretion cannot be effectively controlled". Since takeovers decrease the agency costs that plague the U.S. corporate governance system, it stands to reason that an increase in domestic legal and cultural impediments to the market for corporate control would raise the costs of this corporate governance mechanism, and lead to an increase in agency costs. And this is exactly what has happened in the U.S. The market for corporate control was weakened considerably when Drexel, Burnham Lambert dissolved. The collapse of this firm contributed to the end of the takeover wave of the 1980s by depriving bidders of ready access to the significant capital needed to finance a hostile acquisition (Shleifer and Vishny (1997), p. 756)[12].

In addition to the collapse of the junk bond industry, state legislatures and state judiciaries in virtually all important U.S. jurisdictions have succumbed to political pressure to impose legal curbs on the

[12] As Fischel (1995) has observed, the collapse of Drexel may have been due to non-economic factors. In particular, rival firms wanted to destroy the firm and the career of Michael Milkin in particular, in order to end their domination of the lucrative high-yield bond market. And, the legal initiatives against Drexel were attributable in large part to political opportunism of ambitious government officials seeking to exploit ambivalence and hostility to takeovers within popular American culture.

market for corporate control. State legislatures have responded to this political pressure by incumbent management by enacting anti-takeover legislation, some of which is quite draconian in nature[13]. State judges have responded to the current Zeitgeist by relaxing judicial scrutiny of poison pill defensive measures and permitting the board of directors of corporations that are the subject of unsolicited outside bids to utilize the "just-say-no" defense to block acquisition bids indefinitely, regardless of the premia that bidders are willing to pay[14].

These political considerations have led some commentators, unfamiliar with the dynamic aspects of U.S. law to conclude that the "takeover solution (to the corporate governance problem) practiced in the United States and the United Kingdom is a very imperfect and a politically vulnerable strategy" (Shleifer and Vishny (1997), p. 757). But takeover entrepreneurs -- and their legal and financial strategists -- are much more dynamic and inventive than many suppose. Following the collapse of Drexel, the junk bond market collapsed, but only for a time. Soon, not only were high-yield bonds back, but their role in financing takeovers has been supplemented by the growth of hedge funds, and by the increased availability of bank financing. The total capital available to finance arbitrage and other takeover related activities is greater today than it was in the 1980s. More importantly, institutional shareholders have become more activist in recent years. These large block shareholders increasingly have come to oppose poison pills. These institutional investors do not involve themselves in managing the firms in which they have invested, even to the limited extent that German

[13] See Pennsylvania statute.

[14] The recent takeover battle between Pennzoil and Union Pacific Resources illustrates this phenomenon. Union Pacific made an uninvited bid for Pennzoil at a significant premium. Despite the fact that the bid was all-cash for 100% of Pennzoil's stock, and despite the fact that over 61% of Pennzoil shareholders tendered their shares. Pennzoil utilized a "just say no" defense in which it claimed that a secret, undisclosed, strategic plan justified refusing to redeem its pill, seek another buyer, or even to negotiate with Union Pacific. Ultimately Union Pacific abandoned its takeover attempt (Fritsch (1997)).

and Japanese banks engage in such textured and continuous monitoring. Rather, these institutional investors simply use their political leverage to insure that the balance of power in the market for corporate control does not tip too far in favor of incumbent management (Fisch (1994)).

Another important adaptation in U.S. corporate governance is the bundling of hostile bids with consent solicitations and proxy fights in order to place additional pressure on target firm boards of directors. While this strategy is not always successful, it has changed the dynamics of the takeover game by shifting the momentum away from target management and back towards outside bidders. As a result of these innovations, hostile takeovers, which had virtually disappeared as a corporate governance device at the start of the 1990s, reappeared around 1995, and have continued[15].

In other words, the depiction of the U.S. corporate governance system as vulnerable because of the extent to which it relies on takeovers to resolve agency problems between managers and shareholders cannot withstand analysis. This is true not only because the U.S. system is far more dynamic and

[15] Perhaps most significantly, takeover entrepreneurs and arbitrageurs have introduced an innovation, the shareholder rights by-law, that is likely to do even more to invigorate the market for corporate control by eliminating the ability of target company boards of directors to keep their poison pill defensive devices in place once an outside bid has been made. (The new technique is simple. A shareholder proposes an amendment to his firm's bylaws requiring the company's poison pill (and other defensive measures) to expire automatically whenever the firm receives an all cash offer for 100 percent of the firm's stock at a price at least 25 percent above the market. The only way the firm can keep its poison pill is if the shareholders vote to keep the pill within 90 days of receiving the offer.) The Securities and Exchange Commission is requiring firms to include these shareholder rights by-laws in their proxy solicitation materials at their own expense under SEC Rule 14a-8. By refusing to permit companies to exclude shareholder proposals from their proxy solicitations, the SEC has set the stage for a major legal battle. This battle will come when shareholders approve a proposed shareholder rights by-law, and the by-law is then challenged in court by directors claiming that their right to run the company was wrongfully usurped. If Delaware judges refuse to respect the rights of the shareholders by upholding the legality of rights by-laws, institutional investors may start demanding that their firms reincorporate to jurisdictions that provide more rigorous protection for shareholders. However, even if the Delaware judiciary is not persuaded by legal arguments, pressure by institutional investors to find a jurisdiction hospitable to these arrangements may well insure their long-term viability even if Delaware's judges are reluctant to enforce them.

robust than many believe, but also because *any system* that deals decisively with the agency cost problem is going to be politically controversial because of political pressure from managerial lobbies. The federalist system of fairly robust jurisdictional competition for corporate charters is the most effective known means for dealing with this issue. Thus, Shleifer and Vishny (1997) may be right that takeovers are politically vulnerable, but they are no more politically vulnerable than the solutions to corporate governance problems that exist in other jurisdictions.

As noted at the outset, corporate governance systems work to reassure suppliers of capital. Among the more important and illusive sorts of capital is firm-specific human capital. It is here that the vaunted U.S. system of corporate governance reveals its deepest flaws. The distinguishing features of the U.S. system are its reliance on capital markets, and the pressure that these markets place on corporate managers to deliver profits. The market for corporate control is a cornerstone of this system. Another key attribute of this system is its extreme objectivity. The U.S. system of corporate governance is based on markets that are highly impersonal, and largely anonymous. But the fluidity and flexibility of U.S. markets have costs as well as benefits. The benefits in terms of flexibility are offset, to some extent by costs, which result from the fact that high-level managers cannot make credible, long-term commitments to their firms that provide their firms with incentives to encourage these managers to make firm-specific investments in their employment relationships. Similarly, managers have few incentives to make firm-specific investments in their firms due to the unstable nature of their employment relationship.

While the unstable nature of U.S. managerial labor markets is the weakest aspect of the U.S. corporate governance system, it is not the only weak aspect of this system. The objective nature of

U.S. “market for corporate control” orientation is a byproduct of the fact that U.S. investors are not relational investors: they move in and out of their investor status through arms-length market transactions. As such, they depend on publicly available information that is inevitably incomplete, crude and back-ward looking. This explains why the U.S. corporate governance system has great difficulty dealing with more subtle agency problems. The implication is that a cost of the objective nature of the U.S. corporate governance system is that U.S. investors lack the same priviliged, detailed information about the firms that they have invested in that institutional investors in other countries may enjoy. U.S. law has attempted to compensate for this deficiency by creating complex and extensive disclosure requirements. But these disclosure obligations are historic and episodic, and do not provide the depth and texture of information that investors would need to make key personnel decisions or to permit investors to make informed choices among the various projects that may be competing for a firm's resources. As we will argue in Part III, Continental European systems with large shareholders or direct control by supervisory boards and/or banks may allow a finer information partitioning and thus more informed monitoring. However, an element of “capture” may enter that prevents effective governance. Thus both the U.S. and the Continental European models may fail to adequately address more subtle agency problems.

2.3 Corporate governance in Italy

The Italian system of corporate governance is a virtual mirror image of the U.S. system. The Italian system gets low marks for its ability to fill in gaps in contingent contracts, due to its poor legal system and absence of protections for investors' rights. Italian corporate governance also does not perform well in terms of its ability to resolve agency problems, as evidenced by the fact that the duty of loyalty is not an operational concept in Italy for several reasons, not the least of which is that courts have no expertise or inclination to provide protections for non-controlling investors (see Weigmann (1974), Barca (1995), and Macey (1998)). In the Italian corporate governance system two things substitute for the lack of the market-based control systems that characterize U.S. corporate governance. The first is politics. The second is small firms that finance themselves internally.

The state historically has controlled the nation's banks and large companies, and has “constantly made up for failures in the governance environment of private companies by providing them with a steady flow of resources” (Barca (1995), p. 38). The role of the state in corporate governance is hardly salutary. The politicization of capital investment decisions inevitably results in politicized, sub-optimal decisions about capital allocation in corporate governance systems in which the state plays a decisive role. This is because politicians struggle for survival in political markets, and therefore they evaluate capital allocation decisions in political terms rather than in economic terms. This means that decisions about everything from plant closings and relocations to capital budgeting, and hiring will be made with reference to politics rather than to economics.

In addition to state ownership, the Italian corporate governance system is characterized by complicated cross and pyramidal ownership structures. This system of shareholdings entrenches management, disadvantages minority shareholders, prevents capital market discipline, and stifles the development of a market for corporate control. However, these ownership structures do result in the emergence of a clearly identified, highly stable, controlling coalition. This control group has close ties to management and timely access to whatever information, including confidential corporate information, that it wants. This would allow for a finely textured involvement including the ability to make instantaneous changes whenever necessary. The complicated and pyramidal ownership structures do however distort and confuse incentives. Also the proximity of investors to management leads to “joint responsibility” and lack of objectivity that weakens the monitoring role of investors (see Part III). Moreover, legal protection for shareholders in Italy is so poor that external financing is barely feasible for investors who do not receive control rights.

In other words, a flaw in the U.S. corporate governance system is that takeovers are so expensive that it is only cost-effective to address large-scale managerial failures. By contrast, the controlling shareholders who manage the Italian corporate governance system can make changes at a far lower cost, since they already are in control. However, because of their personal involvement in the management of the firm and the complicated ownership structures, these investors are likely to lack the objectivity necessary to make the hard decisions necessary to control agents' behavior.

The success of the Italian economy is due, in large part, to the fact that the country has a disproportionately large number of small firms that perform exceedingly well. An astonishing 98% of Italian firms have fewer than 20 workers (Macey (1998)). These firms solve corporate governance problems in the simplest way possible: they lack the separation of ownership and management that generates the agency problems that define the corporate governance puzzle in more complex systems. In other words, “corporate governance doesn't matter very much in Italy because there are so few large and medium sized firms” (Macey (1998), p. 29). Complex solutions to corporate governance problems are not necessary in these small firms because individual entrepreneurs and their families in Italy both finance and manage these small family firms, and they have both the incentives and the ability to monitor and control shirking.

The rigid, inflexible industrial structure of the Italian corporate governance system also creates strong incentives for managers to make firm-specific human capital investments. This is true in small Italian firms because these firms “are often staffed with family members or close friends of the owner, who can make credible, long-term commitments to employees that, in turn, provide the employees with incentives to make such firm-specific capital investments” (Barca (1995), p. 7).

In other words, the Italian system of corporate governance does not compare favorably with the U.S. system in terms of its ability to protect minority investments, fill in gaps in contingent contracts, or reduce agency costs. Therefore it is not surprising that Italy has weak capital markets and virtually no venture capital. But Italy has flourished because investors and entrepreneurs have innovated around the deficiencies in its corporate governance system by utilizing the closely held corporation. These small, often family-centered businesses have obviated the need for mechanisms that reduce agency cost problems by eliminating the agency relationship. An often overlooked virtue of this system is that it provides strong incentives for managers to make the firm-specific human capital investments necessary to develop specialized skills. Managers in these intimate firms can make these investments secure in the knowledge that they won't be exploited.

III Proximity and Objectivity

3.1 Some observations

Having established the point the rival corporate governance systems can thrive despite enormous handicaps, we turn now the trade-off between proximity and objectivity that exists in more developed corporate governance systems. As noted at the outset, the work by Coffee (1991) and Bhide (1993) suggests a trade-off between liquidity and control. Coffee and Bhide observe that share ownership in the U.S. is very dispersed and may not permit effective discipline of management. On the positive side, the dispersion in ownership may promote liquidity. The link between dispersed ownership and (lack of) control has been challenged by Berglof (1996) and also by Bolton and Von Thadden (1995)). Berglof argues that dispersed ownership of shares not necessarily implies lack of control. In particular, he states that "the link between liquidity and control is less direct than suggested […]. Investors and issuers have found a number of ways of keeping control concentrated while increasing liquidity and limiting the capital committed" [16],[17]. Bolton and Von Thadden (1995) come with a more subtle argument. A large shareholder might be very desirable, but he may still desire an exit option. Without sufficient liquidity in the market he realizes that exit is costly (via the price-impact of his trade), he may therefore refuse to take a large ownership stake. Bolton and Von Thadden's analysis therefore points at the complementarity of large stakes and dispersed ownership to facilitate liquidity.

Also the *empirical* observation that shareholders are very dispersed has been challenged. The ownership structure in the U.S. is *not* as dispersed as is sometimes suggested. While a cross-country comparison indeed shows more dispersion in the U.S. than elsewhere, ownership of shares has become more concentrated. Much of this comes from the proliferation of pension funds, mutual funds and other institutional investors.

---

[16] Berglof points at cross holdings and pyramidal ownership structures in particular. These could allow for disproportional voting rights vis-a-vis capital committed.

[17] Another argument could be based on Holmstrom and Tirole (1993). They argue that liquidity may facilitate more effective stock-based executive compensation schemes, and thus improve managerial incentives.

These observations are important and qualify the trade-off between liquidity and control. From our perspective however the questions of *how* control is exercised and what makes control effective are more important. In the U.S., shareholders exercise control via two different channels. One is their impact via the board of directors, the other is direct interference via the "market for corporate control". As the liquidity/control trade-off suggests, corporate governance systems in the world may differ in the effectiveness of both channels. The Continental European model focuses primarily on the impact of shareholders on managerial decision making via board or directors, with a marginal role for the market for corporate control. The Anglo-Saxon model differs in that it puts more emphasis on the market for corporate control and possibly less on the board. We do not want to put too much emphasis on this general characterization of corporate governance arrangements, but want to focus on the fundamental issue concerning the way these systems actually work. Here we identify a primary trade-off between *proximity* and *objectivity* in supervision and monitoring. Effective supervision and monitoring is best performed if the board (or shareholders) is both well informed and objective. To see this, observe that monitoring and disciplining management are the primary issues in the corporate governance debate. Such monitoring and discipline may require timely corrective actions. However, a potential problem is that objectivity requires sufficient "distance" between management and board, while being well informed is best accomplished by being "close" and thus intrusive. This suggests a trade-off between *proximity* and *objectivity*.

While it is obvious why being well-informed is best accomplished by proximity, it may be less clear why objectivity requires a sufficient distance between management and monitors. Here we draw on literature in public choice and psychology to make our point. There is ample evidence in the literature on social psychology to support our point that boards with close proximity to management are likely to become captured by management. For example, the “theory of escalating commitments” predicts that board members will come to identify strongly with management because they have begun a pattern of agreeing with management's decisions, those earlier decisions, once made and defended, will affect future decisions such that those later decisions will comport with earlier decisions (Myers (1983)). In fact, social psychologists have shown that occupational choices, such as the choice to accept a particular position as a corporate director, will have a strong influence on our attitudes and values (Bachman and O'Malley (1977)). People tend to internalize their vocational roles. In the context of boards of directors, this means that board members tend to internalize the perspective of management. This causes them to lose objectivity. This problem does not arise with shareholders in public capital markets who have little or no contact with management.

The basic idea is that once boards of directors have been in place for a while, they are likely to embrace management's perspective. Once an original decision is made and defended by a board, it will affect future decisions such that those decisions will comport with the earlier actions (Rabin (1998)). For example, studies of the decision-making process that contributed to the escalation of the Vietnam War showed that leaders often paid more attention to new information that was compatible with their earlier decision to make a military commitment in Southeast Asia. They tended to ignore information that contradicted those earlier assumptions. As one researcher observed, “there was a tendency, when actions were out of line with ideas, for decision-makers to align their actions” (White (1971)). Once ideas and beliefs become ingrained in the mind of a board of directors, the possibility of altering these beliefs decreases substantially. As Tom Gilovich has argued, “beliefs are like possessions”, and “when someone challenges our beliefs, it is as if someone criticized our possessions” (Gilovich (1992)).

Economic theory also provides support for the lack of objectivity by boards. From an economic perspective board supervision tends to make the board jointly responsible with management for the state of the firm. The degree of joint responsibility depends on how much the board has been involved with the firm. Like Boot and Thakor's (1993) analysis of weak regulatory oversight by intrusive bank regulators, the board may abstain from corrective action to preserve its reputation[18]. This is because taking corrective action may reveal that the board had previously failed to take the proper course of action. Boards may resist action for other reasons as well. They invest considerably in information that is specific to the existing management. Changing management would then potentially dilute the value of this investment. Moreover, to a very large extent, boards of directors can be viewed as legislatures with essentially one interest group constituency: management. Management not only has the time and the resources to cultivate management, it is also the group that presents the board with the information it must have to make its decisions. Thus it is not surprising that boards often lack objectivity. Over a wide range of issues, all management must do is to present information in a way that is likely to generate support for its perspectives; or in a way that is slightly slanted; or in a selective way, to achieve effective capture of the board.

These insights would let us characterize the U.S. system of corporate governance as more objective. However, monitors in such systems may lack detailed information (no proximity). Germany fits our example of a corporate governance system in which monitors (the board or bank) have superior access to information, but may lack objectivity. The Italian system (see Section 2.3) may have neither the benefits of proximity nor objectivity.

[18] In this interpretation the board monitors management. In a two-tier system (e.g. The Netherlands and Germany), this is a clearly defined task for the supervisory board. In the case of a one-tier system (e.g. US and UK) non-executive directors have a role as monitors.

3.2 A framework: formalization

One way of modeling the effect of joint responsibility between managers and boards is by assuming that the ability of the board is initially unknown to outsiders but could be learned from observed decisions. At any given level of proximity/intrusion, lower board quality increases the likelihood of the firm realizing states where intervention would be beneficial. If the action of intervention is visible to outsiders, it may involve a reputation loss to the board (i.e. weak boards are more likely to reach a state where intervention is needed). Proximity now comes in because the more the board intruded in the past, the higher the sensitivity of the state of the firm to the board's ability. Hence, it is likely that reputation effects become more pronounced, and, consequently, that less intervention occurs at higher levels of intrusion.

This reputational story also highlights why shareholders should have an impact on the board. In particular, shareholders need to ensure that they align the board's incentives sufficiently with their own. Is this the case then the reputational distortions are (partially) mitigated and the board may optimally choose to intrude more and facilitate for itself access to better information. If reputational distortions are sufficiently mitigated, this may improve their supervision. These observations also suggest a potential *complementarity* between the monitoring provided by boards (or non-executive directors) and the market for corporate control. More specifically, a takeover threat may not only discipline management but also discipline the monitors (the board). If the board knows that it will be ousted following a successful (disciplinary) takeover, the board may become more vigilant to pre-empt the need for corrective takeovers (Hirshleifer and Thakor (1994)).

IV Final Observations

We have postulated the corporate governance problem in developed corporate governance systems as a trade-off between proximity and objectivity. This does not imply that either one of the extremes is optimal. Excessive intrusion (proximity) is bad: it makes the board reluctant to intervene for reputational reasons (i.e. the joint responsibility effect). The board is, however, *able* to intervene: it has full information. At the other extreme, the board is fully separated from management and would not hesitate to intervene were it not for lack of information. The board is now willing but not able to intervene.

Ideally, corporate governance arrangements should be tailor made to fit the desired governance structure of a particular industry. In some industries the disadvantages of proximity might dominate; in others the lack of information in case of "distance" and objectivity might be prohibitively costly. Issues of adaptability play a role as well. For example, stronger disclosure requirements may overcome some of the information shortages and facilitate more "distance" and thus objectivity.

At this stage, we can conclude that observed corporate governance arrangements -- be they intrusive or objective -- do not deal satisfactorily with subtle agency problems, either because of lack of information (the "objective" U.S. system) or "capture" (the "intrusive" Continental European model). The U.S. model is superior in filling in gaps in contingent contracts thereby lowering contracting costs, but poor in generating high quality information and in protecting human capital and relationship specific investments[19]. The Continental European model provides less satisfactory solutions to

[19] Observe that the contracting environment in an "objective" type system like the U.S. *depends on* having enforceable contracts. With proximity, more discretion could possibly be allowed in contracts because the

contingent contracts, but generates high quality information and is superior in protecting specific human capital investments. The latter holds particularly in a malfunctioning corporate governance system like that of Italy[20].

What can we say about the convergence of corporate governance systems? While we have emphasized the adaptability and resilience of different arrangements, we do believe that systems are converging along some dimensions. In Continental Europe ownership stakes have indeed traditionally been more concentrated. More recently, however, substantial pressure has come about to improve the liquidity of stock markets. The ownership of shares of the general public has grown substantially. This has increased dispersion. In the U.S., we observe more concentration and an increase in institutional investor involvement. Observing the U.S. and Continental European trends, convergence of stock ownership patterns seem underway where concentrated ownership goes hand in hand with dispersed ownership. In other ways, corporate governance systems are also converging. Boards of directors in two-tier systems and non-executive directors have become more and more accountable vis-a-vis shareholders, and are forced to divorce themselves from management. Cozy arrangements between directors and management therefore become less and less acceptable.

---

parties to the contracts are "close" and could immediately respond to the gaps in the contract.

[20] Observe that in the case of Italy -- as we discussed -- solutions to the problem of contingent contracts are totally inadequate and also subtle agency problems are addressed poorly.

REFERENCES

Acemoglu, D., 1995, “Corporate Control and Balance of Powers”, mimeo.

Aghion, P. and J. Tirole, 1997, “Real and Formal Authority in Organizations”, *Journal of Political Economy*, Vol. 105, p. 473-94.

Bachman, J. and P. O'Malley, 1977, “Self Esteem in Young Men: A Longitudinal Analysis of the Impact of Educational and Occupational Attainment”, *Journal of Personality and Social Psychology*, Vol. 35, p. 365-84.

Barca, F., 1995, “On Corporate Governance in Italy: Issues, Facts and Agency”, Bank of Italy, Rome, manuscript.

Berglof, E., 1996, “Corporate Governance”, in: B. Steil (ed.), *The European Equity Markets*, London: The Royal Institute of International Affairs, Chapter 5, p. 147-184.

Bhide, A., 1993, “The Hidden Costs of Stock Market Liquidity”, *Journal of Financial Economics*, Vol. 34 (1), p. 31-51.

Blair, M.M. and L. Stout, 1997, “A Theory of Corporation Law as a Response to Contracting Problems in Team Production”, Brookings Institution, Working paper.

Bolton, P. and E.L. von Thadden, 1995, “Blocks, Liquidity and Corporate Control”, Working paper.

Boot, A.W.A. and A.V. Thakor, 1993, “Self-Interested Bank Regulation”, *The American Economic Review*, Vol. 83 (2), p. 206-212.

Burkart, M., D. Gromb and F. Panunzi, 1997, “Large Shareholders, Monitoring, and the Value of the Firm”, *Quarterly Journal of Economics*, Vol. 112, p. 693-728.

Coffee, J.C., 1991, “Liquidity Versus. Control: The Institutional Investor as Corporate Monitor”, *Columbia Law Review*, p. ??.

Cremer, J., 1995, “Arm’s Length Relationships”, *Quarterly Journal of Economics*, Vol. 110, p. 275-95.

Fanto, J., 1997, “Corporate Governance in American and French Law”, p. ??.

Fisch, J.E., 1994, “Relationship Investing: Will it Happen? Will it work?”, *Ohio State Law Journal*, Vol. 55, no. 5, p. 1009-1048.

Fischel, D.R., (1995), Payback.

Fritsch, P., 1997, "Pennzoil Holder Proposes Limiting 'Poison Pill' Use", *The Wall Street Journal*, November 19, B5.

Gilovich, T., 1992, "How We Know What Isn't So: The Fallability of Human Reason in Everyday Life", p. 86.

Grossman, S. and O. Hart, 1986, "The Costs and the Benefits of Ownership: A Theory of Vertical and Lateral Integration", *Journal of Political Economy*, Vol. 94, p. 691-719.

Hamermesh, L.A., 1997, "The Shareholder Rights By-Law: Doubts from Delaware", *Corporate Governor Adviser* 9, Vol. 5.

Hirshleifer, D. and A.V. Thakor, 1994, "Managerial Performance, Boards of Directors and Takeover Bidding", *Journal of Corporate Finance,* Vol. 1, p. 63-90.

Holmstrom, B. and J. Tirole, 1993, "Market Liquidity and Performance Monitoring", *Journal of Political Economy*, Vol. 101, p. 678-709.

Jensen, M., 1989, "Eclipse of the Public Corporation", *Harvard Business Review* , Vol. 60, p. 67.

Jensen, M., 1993, "The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems", *Journal of Finance* , Vol. 48, p. ??.

Macey, J.R., 1998, "Corporate Governance in Italy: One American's Perspective", (forthcoming), *Columbia Business Law Review*.

Maug, E., 1997, "Board of Directors and Capital Structure: Alternative Forms of Restructuring", *Journal of Corporate Finance,* Vol. 3, p. 113-38.

Mayer, C., 1997, "Financial Systems and Corporate Governance: A Review of the International Evidence", University of Oxford, Working paper.

Milbourn, T., 1997, "Comment on Mayer's 'Financial Systems and Corporate Governance", London Business School, Working paper.

Murray, A., 1997, "New Economic Models Fail While America, Inc. Keeps Rolling; Why?", *The Wall Street Journal*, Monday, December 8, p. A2, col. 1.

Myers, D.G., 1983, *Social Psychology*, p. 46-47.

Osterland, A., 1997, "France is a Banana Republic: Corporate Governance is Changing in France... Slowly", *Financial World*, July/August, p. ??.

Porter, M., 1992, “Capital Disadvantage: America’s Failing Capital Investment System”, *Harvard Business Review*, Sept.-Oct., p. 65-83.

Rabin, M., 1998, “Psychology and Economics”, *Journal of Economic Literature,* Vol. 34, no. 1, p. 11-46.

Rajan, R. and L. Zingales, 1998, “Power in a Theory of the Firm”, *Quarterly Journal of Economics*, May (forthcoming.

Roe, M., 1994, “Strong Managers, Weak Owners, The Political Roots of American Corporate Finance”, *Princeton University Press.*

Romano, R., 1993, “Public Pension Fund Activism in Corporate Governance Reconsidered”, *Columbia Law Review,* p. 795-85.

Scott, K., 1983, “Corporation Law and the American Law Institute Corporate Governance Project”, 35 *Stanford Law Review,* p. 935-37.

Shleifer, A. and R.W. Vishny, 1986, “Large Shareholders and Corporate Control”, *Journal of Political Economy,* Vol. 94, p. 461-88.

Shleifer, A. and R.W. Vishny, 1997, “A Survey of Corporate Governance”, *Journal of Finance*, Vol. 52, p. 737-81.

Strausz, R., 1997, “Delegation of Monitoring in a Principal-Agent Relationship”, *Review of Economic Studies,* Vol. 64, p. 337-57.

Warther, V.A., 1994, “Board Effectiveness and Board Dissent: A Model of the Board’s Relationship to Management and Shareholders”, mimeo.

Weigmann, R., 1974, “Responsibilita' e potere legittimo degli amministratori”, p. 104-13.

White, R., 1971, “Selective Inattention”, *Psychology Today*, November, p. 47, 82.

Zingales, L., 1994, “The Value of the Voting Right: A Study of the Milan Stock Exchange Experience”, *Review of Financial Studies*, Vol. 7, p. 125-148.

Zingales, L., 1997, “Corporate Governance”, forthcoming in *The New Palgrave Dictionary of Economics and Law*.