The Institutions of Corporate Governance

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THE INSTITUTIONS OF CORPORATE GOVERNANCE

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Abstract

In this review piece, I outline the institutions of corporate governance decision-making in the large public firm in the wealthy West. By corporate governance, I mean the relationships at the top of the firm—the board of directors, the senior managers, and the stockholders. By institutions I mean those repeated mechanisms that allocate authority among the three and that affect, modulate, and control the decisions made at the top of the firm.

Core corporate governance institutions respond to two distinct problems, one of vertical governance (between distant shareholders and managers) and another of horizontal governance (between a close, controlling shareholder and distant shareholders). Some institutions deal well with vertical corporate governance but do less well with horizontal governance. The institutions interact as complements and substitutes, and many can be seen as developing out of a "primitive" of contract law.

In Part I, I sort out the central problems of corporate governance. In Part II, I catalog the basic institutions of corporate governance, from markets to organization to contract. In part III, I consider contract law as corporate law's "primitive" building-block. In Part IV, I briefly examine issues of corporate legitimacy that affect corporate governance by widening or narrowing the tools available. The interaction between political institutions and corporate governance institutions is an inquiry still in its infancy but promises large returns. In Part V, I re-examine corporate governance in terms of economies of scale, contract, markets, and property rights. Then I summarize and conclude.

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INTRODUCTION AND SCOPE: THE ORGANIZATION AT THE TOP OF THE LARGE BUSINESS FIRM

I outline here the institutions of decision-making in the large public firm in the wealthy West, emphasizing those that try to thwart decision-making from going awry.

By corporate governance, I mean the relationships at the top of the firm—the board of directors, the senior managers, and the stockholders. By institutions I mean those repeated mechanisms that allocate authority among the three and that affect, modulate and control the decisions made at the top of the firm.

By taking governance to mean the relationships among the triumvirate at the top—and not taking it to mean their relations with, say, the firm's employees or its labor unions—I right away give the analysis an American cast, not a European one. Although my primary focus here is on American corporate governance institutions, I look at other nations' corporate governance institutions primarily by way of contrast (as opposed to, say, finding the deep functions that all corporate systems must have). Thus, I focus on the division of authority between the board and the CEO on one hand, and the shareholders on the other, with the primary task of the institutions of corporate governance being to make managers inside the firm run that firm well and to make them loyal to shareholders. At the end of this paper, I look at how these relationships relate to basic institutions of contract and political organization in Europe and the United States.

I focus on features that are at the heart of recent academic legal inquiry. Others could, and would, emphasize other governance features: an organizational theorist might look to how a leader motivates the people in a large organization. A psychologist or a sociologist might emphasize how discussion in the boardroom is vibrant, supportive, and inquiring, instead of being stale, formal, and useless. A technology theorist might emphasize the mechanisms by which the firm innovates. Another might emphasize how ideas are transformed into products. One type of economist might relentlessly analyze what goes on inside the firm (and thereby is "governed" within) and what goes on outside it (and is thereby "governed" by contract). These are all worthwhile modes of inquiry. But they are not mine, at least not here.

In Part I, I sort out the central problems of corporate governance. In Part II, I catalog the basic institutions of corporate governance, from markets to organization to contract. In part III, I consider contract law as corporate law's "primitive" building block. In Part IV, I briefly examine issues of corporate legitimacy that could, and do, affect corporate governance. The institutions of corporate governance are usually seen as separated from the institutions of political organization. But they should not be. In Part V,

* This article is forthcoming in Claude Menard & Mary M. Shirley, eds., *Handbook for New Institutional Economics* (Norwell MA: Kluwer Academic Publishers, 2004).

I re-examine corporate governance in terms of economies of scale, contract, markets, and property rights. And then I summarize and conclude.

I. THE CORE PROBLEMS OF CORPORATE GOVERNANCE

The corporate governance triumvirate—the board, the managers, and the stockholders—has a vertical and a horizontal dimension. The vertical dimension is between senior managers and distant shareholders. See Figure 1. The focus there is on keeping the CEO and the top people (the board and the senior officers) loyal to shareholders, and competent for the task of managing the firm. It's this vertical dimension that's especially relevant in the United States.

The horizontal dimension is between dominant stockholders and dispersed stockholders. See Figure 2. The horizontal focus is on preventing or minimizing the shifts in value from dispersed outsiders to controlling inside stockholders. That dimension of inquiry is paler in the United States than it is in Europe, perhaps because controller machinations are resolved well in the United States, or because other forces keep more American firms with dispersed ownership. Lacking a single shareholder-controller, the typical American firm has fewer horizontal problems, but more vertical problems: dispersed ownership fades the horizontal dimension but brings to the forefront the firm's vertical weaknesses. Foreign nations also have legitimacy as a core problem of corporate governance, a muted issue in the United States.

These two corporate governance problems are similar in one dimension—in each a controller extracts rents or private benefits—but less so in other, perhaps more critical dimensions. First, the centrality of each differs around the world—horizontal issues dominate in most of the world, vertical issues in the United States. Second, the means by which the controller extracts benefits differ between the two. And, third, the means to mitigate the costs of each differ. These distinctions are not always made, but should be.

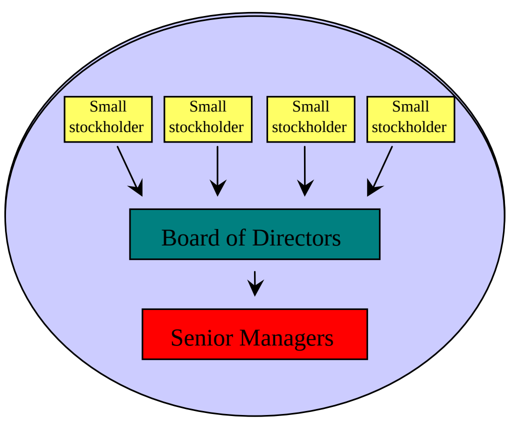

Figure 1. Vertical governance: Diffuse ownership

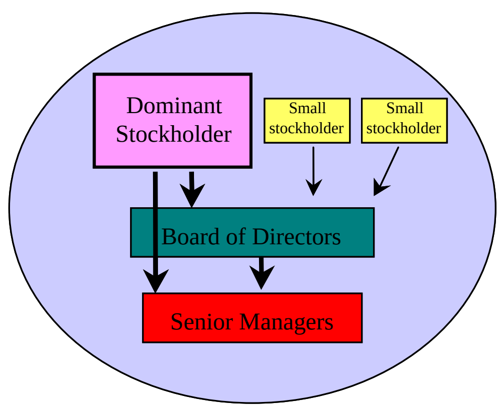

Figure 2. Horizontal governance: Controlling vs. minority stockholders in the public firm

A. Vertical corporate governance: Managerial agency costs

Public firms with full ownership separation have no dominant shareholder. With shareholders dispersed, the task of keeping managers working primarily in shareholders' interests becomes critical. And ownership in the largest American firms is dispersed: Bill Gates' ownership of Microsoft is an exception; General Motors', without a dominant stockholder, is the norm. This diffused ownership is, in the classical analysis, layered over a basic principal-agent problem: the stockholders' agenda—typically maximizing shareholder value—can be at odds with managers' agendas. In that setting, aligning their interests becomes the typical problem of corporate governance. And the institutions of corporate governance are those repeated mechanisms that tie, or fail to tie, managers to stockholders.

This "agency cost," principal-agent, stockholder-manager alignment problem comes in two main varieties. One variety is of diversion, while the other is of competence, "stealing and shirking" in its alliterative form. Managers could divert value from the firm into their own hands: they could have the firm transfer funds to their own bank accounts (or a relative's), or more surreptitiously have the firm sell goods at low prices to (or buy at high prices from) entities that the managers control, or more transparently pay themselves (excessively) high salaries.

Agency costs come in a second variety. Managers might not be up to running the firm, either because one or another manager never was up to the task (their selection was a mistake) or more plausibly because changed circumstances made the incumbent manager no longer right for this company. Well-functioning corporate governance institutions put the right manager in the right place and give that manager the right set of incentives and constraints.

The alliterative "stealing and shirking" hides a couple of issues. The first is that each specific corporate governance institution does not uniformly reduce both. Some affect one, some affect the other. "Stealing and shirking" are both costs to shareholders and so it is correct to lump them together as costs, but they cannot be lumped together when evaluating the institutions of corporate governance because the institutions affect the two differently. For example, corporate lawsuits are geared to handling observed "stealing," but less good at "shirking" or managerial error. (In fact, via the "business judgment rule," the American corporate judge won't listen to complaints about managerial error.) Corporate disclosure rules, in contrast, are probably better at affecting "shirking"—distant stockholders can see the bottom line results that managers produce, but less good at handling "stealing" (because for very large firms, lots of personal wealth could be obtained from a large firm without destroying the corporate bottom line).

The second submerged element is that "shirking" doesn't convey the subtlety of the vertical problem. Much of the power of an organization comes from routines and embedded information. These give the organization great power and efficiency. Bureaucracy often has a pejorative connotation, but bureaucracies exist for good reason: they are effective at routinizing action to make for powerful output. But when markets or technologies change, the routines and embedded information can weaken the organization. The old routines repeat and the organization works via its embedded information, despite that neither the old routines nor the embedded information correspond to the demands of the market or the new technologies. Henderson & Clark (1990). Organizational change is necessary, but insiders often cannot refashion the firm, because they are subject to its old routines and its embedded information. In a sense, it's not so much that the managers "shirk" in the primary sense of the word—they desperately *want* to work—but they don't know what to do. Their efforts may be intense, but misdirected.

So, the vertical corporate governance problem is one of vertical agency costs. That problem interacts with a shareholder free-rider problem, due to the large firm's ownership by small, distant shareholders. Some corporate governance institutions seek to overcome the free-rider problem, so that large shareholders can focus their ownership and thereby deal better with managerial agency costs. These focusing institutions include a more responsive board of directors (as a focal point for shareholders' impact on managers), takeovers, blockholders capable of reining in some managerial agency costs, proxy voting, and so on. And this possibility of focused shareholder action, especially large blockholder action to mitigate the vertical agency cost problem, leads us into the second core corporate problem: horizontal governance.

B. Horizontal corporate governance: Taming dominant shareholders

Large firms with a dominant stockholder have a different core problem, one between stockholders, with a focus on a dominant stockholder's potential to shift value from the minority stockholders to itself. Horizontal corporate relationships tend to be the focus of corporate governance in continental Europe, Asia, and Latin America. Again, the alliterative "stealing and shirking" fits, but for these types of firms, the emphasis is less on the "shirking" by managers than on the "stealing" by the dominant stockholders. The recent literature sees the inability to stop controllers' self-dealing as central to developing securities markets and the means to finance large firms. See especially the LaPorta et al. series of articles, and the literature summarized in Denis & McConnell (2003). A consensus has arisen that in the transition nations, especially Russia, failure to develop institutions that would stop dominant stockholders' self-dealing fundamentally flawed the transition. See, e.g., Black, Kraakman & Tarassova (2000).

C. External corporate governance: Corporate legitimacy

Corporate governance can have another dimension. Neither necessarily horizontal nor vertical, nor necessarily governing the relationships among owners and managers, this dimension is of governing the firm so that it is legitimate in its society. One could see it as purely defensive: the inside players act, or build institutions, that they would not otherwise have done or built, to deflect outside incursions into the firm. Or one could see this legitimacy dimension as determined by the outsiders: the polity demands that the firm structure its governing institutions in this way or that way, to implement some public policy.

This dimension is shallow for modern corporate governance in the United States (at least as I write), but has not been completely absent: mechanisms to detect and prevent foreign bribery in the 1970s and 1980s could be seen as having been one such governance goal in the United States One might see anti-takeover laws as resulting in part from the antagonism they attracted from the polity. Romano (1988).

This dimension is deeper in many other nations. For example, in the United States corporate governance vis-à-vis employees is absent from the governance institutions at the top. Employees are typically seen in the academic literature as inputs (like suppliers, capital, etc.), ones that managers transform into sales and profits. Williamson (1985). Employees have to be paid well and think well of their work environment, but this is not usually seen as a corporate governance issue, at least not in terms of vertical or horizontal corporate governance at the "top" of the firm. Not so in other countries, where social considerations and the role of employees have much more impact. Sometimes the impact is formal: German-style codetermination, in which employees end up inside the boardroom, is one such example. Sometimes the impact is indirect: owners might seek to structure the firm so that the outside incursions, or their impact, are minimized. Some of this may be a function of the labor market and general mobility. If people can readily "walk with their feet"—move from, say, Indiana to California if they become disgruntled—they may demand less influence inside the local firm than if they and their ancestors have always lived in the Ruhr Valley and expect to spend their lives working for one big local firm.

These issues of legitimacy also tie into modes of production. By defining the corporate governance inquiry in such stark terms—vertical, horizontal, and legitimacy—I have excluded other perspectives, as I noted in the Introduction. For example, one might view the problem of corporate governance in organizational terms, as how to motivate a team, how to keep it flexible but effective, etc. That kind of an inquiry focuses less on relationships between shareholders and managers or among shareholders. It could have a "legitimacy" angle, and it could have an "efficiency" angle, as such a focus might yield greater productivity and more utility for those inside the organization. (On the idea of legal institutions as reflecting some organization of managers, employees, and capital, see Blair & Stout (1999). On the idea of national systems revolving around varying organizational modes, see Hall & Soskice (2001).)

* * *

This issue of corporate governance and legitimacy can be seen more abstractly: how, normatively can one organize a business entity that survives politically and socially? And, how as a positive matter have corporate institutions adapted to be legitimate in society?

This kind of inquiry gets little attention in the academic literature, although comments are sometimes made that some institutions gain strength from their political stability: E.g., the wide distribution of American stock (among the upper middle class) helps support American stock market institutions. This issue of legitimacy may well be an important force, equal to the imperatives of economic organization and the horizontal and vertical issues of corporate governance. One might frame the issue thus: What if there are fewer basic ways to organize and own the large firm that are politically/socially stable than are economically/organizationally/competitively possible? If there were, then the choice of which institutions survive might be a choice of which institutions are legitimate, which ones don't attract negative attention from the polity, or which ones manage to deflect outside incursions better than others (even if they turned out to be less effective in another dimension).

D. Enduring or ephemeral?

What seems important in corporate governance is not enduring, but tends to arise from the problems and issues of the moment. "Core" may more mean "current" and "transitory" than permanent and enduring.

In the 1980s in the United States, the vertical corporate governance issues of agency costs from managers misdirecting the firm’s operations were center stage. By the late 1990s and the early 21st century, these seemed less central and the focus was on scandals of (a few?) managers’ frauds, not on widespread misdirected operations, perhaps because corporate governance institutions attract most attention when economic performance is weak.

In the late 1990s in Europe and the transition nations, the horizontal corporate governance issues of minimizing controlling shareholders’ abuses have been at center stage. Especially in the transition nations, and particularly in Russia, the inability to control insider machinations seems to be a primary gap, LaPorta et al. (1999), Black, Kraakman & Tarassova (2000), although it has come to be over-applied to the restricted sample of rich nations for reasons we’ll briefly see.

And, during the politicized 1970s in the United States, developing the means to control corporate misconduct, often misconduct just short of violation of law, seemed central. Too many corporate actions seemed to damage society: environmental dumping, or sensitive payments (i.e., bribes) to foreign governments, etc. So regulatory forces sought means to reduce these corporate transgressions.

II. THE BASIC INSTITUTIONS OF CORPORATE GOVERNANCE

We now have some texture to the notion of corporate governance. Some of it is vertical: whether managers stay loyal to shareholders. Some of it is horizontal: whether dominant stockholders shift firm value into their own pockets. And some of it is external, based on issues of legitimacy: what does the rest of society force the firm to do, or how do players inside the firm react to outside pressures?

Which institutions align the players? In particular, given my American focus here, which institutions align American managers with their shareholders? We have about ten such institutions: markets, boards, compensation, gate-keeping professionals, coalescing share-holders (via takeovers and otherwise), information distribution, lawsuits, capital structure, and bankruptcy.

A. Markets

Markets are often the most important institution of corporate governance. Three markets are central: the firm’s product market, its capital market, and the managerial labor market. If the firm cannot sell its product in time it disappears. If the firm cannot raise capital, it cannot grow. If the firm cannot get and retain good managers (and employees), it will fritter away its resources.

This sometimes leads commentators to belittle the importance of other corporate governance institutions, because one or all of the three markets punish deviant firms and reward well-performing firms. This criticism is surely correct as a response to a view that failure in a non-market corporate governance institution would, say, necessarily destroy all firms. But using the market to belittle institutional analysis can go too far, as we see next.

1. Markets vs. institutions? Even if markets roughly aligned the players, a markets-are-everything idea would still face three substantial defects. First, each market is imperfect, sometimes substantially so. Corporate governance institutions might pick up the slack where markets cannot reach. Markets can sometimes deal with extremely gross deviations, while the institutions of corporate governance then deal with middle-sized deviations. Markets often draw an outer limit, but not a tight constraint.

Second, the corporate governance institutions can "prime" or charge-up each one of the market institutions. Good internal decision-making can make the firm react well to product market changes, economize on capital, or make sure good managers come, stay, and perform. Good governance institutions can feed back and become one of the bases for marketplace competition in all three markets. They can facilitate, or retard, the firm's adaptation to the three markets' pressures.

Third, markets may be good for some governance tasks, weak for others. Markets may be good at limiting the most egregious types of "shirking," but be less good at limiting "stealing," especially if the stealing represents a small part of the firm's total value. (If a low percentage of a firm's assets is stolen in relation to forgone market opportunities, the market may not deter the manager. The manager may never get another job, but that manager will leave rich.) Law and other institutions are probably more important here than markets. That is, sometimes the non-market institutions are better, cheaper, and faster at governing the firm than any of the market constraints.

2. What markets cannot do. So, each market-based institution is incomplete in optimizing the firm's organizational structure. Let us take them each in turn, glancing at their strengths and limits.

Product markets can discipline managers. If there is no marketable product, there will shortly be no firm. But product markets have two serious limits in disciplining managers. Oligopolistic and monopolistic product markets leave slack. The product market doesn't punish managers severely until the product cannot be sold profitably. That means that managers in non-competitive markets can "lose" for shareholders some of the monopoly profit, but as long as customers don't flee and new entry isn't triggered, managers will only be mildly affected. Profits come from finding a way to free the firm from the chains of atomistic competition: a better product, a market niche, some monopoly power. By freeing itself from atomistic competitive constraints, the firm acquires a value, an asset, something, which corporate governance institutions can affect: good corporate governance institutions keep that value for shareholders; bad corporate governance institutions lose it for shareholders. (Or, on the other hand, good corporate governance propels the firm to find that niche; bad corporate governance lets it fall into lassitude.) The public interest and the interest of the firm's shareholders are not coterminous: monopoly profits may or may not be good for society (depending on whether they're a return for innovation or just the profits that come from restricting output). But the point is that the product market constrains managers incompletely.

Product markets have a second serious limit in disciplining managers. Many firms have deep invested capital. Once that capital is invested, the managers need "only" recover the firm's variable costs to survive for the life of that capital (which may be longer than their own working lives). When costs are sunk and long-lived—distinctive features of the "old" economy of steel mills and factories—the constraints on managers weaken. Eventually the badly governed firm would wither and disappear, but that eventuality could be a long time in coming; in the meanwhile, good corporate governance could maximize the value obtained from that firm with heavy invested capital.

Capital markets constraints are also incomplete. The importance of the constraint is simple: firms must raise capital for new projects. Firms with debt must return to capital markets and must pump cash out of operations to pay off that debt. Jensen (1986). And firms and their managers that perform poorly cannot return easily to capital markets: poor performers will face a higher cost of capital. Extremely poor performers cannot get new capital. They wither and disappear, with the strong performers getting more capital, more cheaply, and thereby expanding.

The limit here is that of retained earnings and, again, sunk costs. For some firms, capital once invested, if invested badly, means they cannot eventually return easily to capital markets. But, again, that eventuality could be a very long run if the sunk capital is substantial, if the retained earnings are adequate, or if monopoly profits give them slack. This scenario is especially relevant for the firm that has large fixed investments that cannot be used in other businesses. I.e., once the automotive plant is built, the machinery has no obvious alternative use. True, such badly-governed firms will wither in the long run, but improved corporate governance institutions—given the market's limits here—can make managers better stewards of the resources they control in the medium run. Moreover, given the depth of invested capital, governance institutions can be seen as the constraints on ex post bargaining and maneuvering over the quasi-rents created. When governance institutions are good, they facilitate the ex ante investment. Cf. Williamson (1985); Zingales (1997). When they're bad, an economy may have to forgo a key class of investments.

Managerial labor markets also have their limits. True, directors usually want to be on boards and managers want to be compensated and promoted. If they do badly, they'll jeopardize their compensation and their future career prospects. But many senior managers are at the end of their careers. They aren't usually moving anywhere except into retirement. Labor markets may be important in selecting the "right" people for these final positions, in the competition to get the prized jobs, but thereafter, once "selected" for their final jobs, managers face labor market constraints that are weak.[1] And, although the following idea is not boldly highlighted in the academic analyses, most of these senior managers at large firms are already very rich. While they would surely welcome yet more money, yet more money may only motivate these people weakly.

3. Limits vs. irrelevance? The point here is *not* that these markets utterly fail to constrain managers, but that they are not tight, perfect constraints. Each leaves lots of "play at the joints." Eventually if the firm gets seriously out of line, it will hit a limit in one or another of these markets. But it can, depending on its market setting, waste major corporate resources before hitting that market-imposed limit. In a sense, corporate governance institutions fill in the gaps and detail of these three primary colors of the markets of corporate governance.

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1. Employee labor markets can be important to labor-management relations, a dimension of governance that's not my focus here. And, again, labor markets, despite their strengths, have their limits: True, a firm that treats employees badly or fails to motivate them or doesn't induce them to be productive, will usually face labor market problems: good ambitious employees will leave, less productive employees will stay. But this labor market has its limits, in that in many nations external labor markets are much less fluid than they've been in the United States. And this lack of fluidity could have contributed to the greater demand for labor input into corporate governance in these nations. E.g., Gilson & Roe (1999).

B. The board of directors

The Board is the quintessential vertical corporate governance institution. It's the board that hires and fires the CEO, makes key business decisions, and reviews the work of the firm's senior managers. (Because a dominant stockholder typically controls the board, the board is less important as an institution of horizontal governance.) Indeed, one could see the other institutions as primarily interacting with the board. (I.e., the means that coalesce shareholders are means to select a new board. Or, law, in the form of rules regulating proxy contests and takeovers, affect the composition of the board of directors. Or, information distribution and transparency allow outside stockholders to see what's happening inside the board. Or, designing CEO incentive compensation is a tool to align managers with shareholders, but it's a tool that can only be as good as the board makes it.)

In the abstract, it's simple: shareholders elect the board. Distant shareholders lack information and focus; they can neither run the company, nor understand its business in any deep sense, nor select or motivate the CEO. So the board manages the company in general, hiring managers to do the job day-to-day. In practice though the board's role has been in flux for decades. It was often seen as captive to senior managers, who "suggested" people for vacancies and, through their control of information, were thought to dominate the board. Davis (1993); Lorsch & MacIver (1989). In recent years, this situation has changed, with many boards bringing on more independent directors, with many getting active audit committees, and with some having membership committees that took the nomination function away from the CEO (or at least shared it). Useem (1992). Evidence of the effectiveness of independent directors is mixed**.** Franks, Mayer & Renneboog (2001); Hermalin & Weisbach (1998); Bhagat & Black (1999). But the trend is clear: Independent directors have increased as a proportion of the board and dominate important committees, although the level of independence falls short of professional director proposals that would have the directors see themselves as primarily shareholders' agents, not managers' advisors. Gilson & Kraakman (1991). The board, board committees, and reporting systems to the board, are central to the Sarbanes-Oxley Act of 2002, a corporate governance measure responding to the Enron and WorldCom scandals in the United States.

There are enduring understandings: Organizations are thought to improve their decision-making when the people who make proposals are separated from those who approve them. Fama & Jensen (1983), at 303-04, 308. And there is an understanding of the value of committees in making decisions.[2] But beyond that there's empirical uncertainty about the significance of the importance of board size, the degree of independence, and other board characteristics, despite that independence, size, and related issues have been "planks" in corporate governance reforms. Eisenberg, Sundgren & Wells (1998); Yermack (1996).

C. Information distribution and gate-keeping

Distant shareholders need information about their companies. They (not all of them, of course) need information so that they can price their securities (and, via that

2. Alan B. Krueger, *Economic Scene: A study shows committees can be more than the sum of their members*, N.Y. TIMES, Dec. 7, 2000, at C2, citing Alan Blinder & John Morgan, Are Two Heads Better Than One (available at www.princeton.edu/rjmorgan/working.htm).

pricing, *other* corporate governance institutions like incentive compensation or board action, which can be triggered by bad pricing results, come into play). They need information so that they can decide whether a corporate control transaction (ousting the board, taking over the company, engaging in a proxy fight) makes sense. And they need information so that they can decide whether legal action makes sense. If the managers engage in a related party transaction but the shareholders know nothing about it, legal remedy might not arise, because no shareholder would know to sue. More generally, they need information so that they can help capital markets to function properly in corporate governance (by denying or rewarding firms with new capital).[3]

The institutions here are the securities law mandates of periodic disclosure (and the penalties for non-compliance). The gate-keepers are those not deeply embedded inside the firm who verify or sometimes warrant the information about the firm. They are the lawyers, accountants, securities analysts, underwriters, and outside directors.

D. Coalescing shareholders: Takeovers, proxy fights, and shareholder voice

If the core problems in American vertical corporate governance arise from the dispersion of stockholders, then a core solution could be to coalesce stockholders. Building big blocks has its costs in owner liquidity and diversification, but one would expect coalesced interests to arise when the costs from dispersion are so high that they overcame the costs of coalescing shareholders.

The obvious American mode of coalescing stockholders, overcoming free-rider issues, and then directing and controlling managers has been the takeover. An outsider, or another firm, offers to buy up the stock of the target firm. If the target firm was badly run, then its stock price should have sagged. The offering company can buy up the stock, run the firm better and profit from the transaction.

Takeovers are not the only means of coalescing shareholders. Proxy fights have one team seeking the votes of other shareholders with a view (usually) to gaining control of the board. Leveraged buyouts are another: a management team (or a group of outsiders) borrows heavily to buy out a division of a conglomerate (or an entire firm). Ownership concentrates.

Institutional investor voice is another means of coalescing shareholders. Institutional investors complain to boards, make lists of badly managed firms, and send around proposals on better governance, such as an improved committee structure for boards. Managers and boards then react, presumably for two reasons: one, many want to do a better job, and if institutional investors have gathered good information, boards can economize by relying on the institutional investors' recommendations of good practice; two, campaigns by institutional investors could indicate incipient disquiet among the firm's shareholder base. The targeted boards and managers might react because they don't want to activate another corporate governance institution, such as a takeover, a proxy fight, or a melt-down of the company's stock price.

Blockholding also coalesces shareholder interests. A large investor takes a big block of stock, the often sits in the boardroom, and either way has the means and the motivation to make managers work better and smarter for shareholders. Bethel, Liebeskind & Opler (1998). Blockholding would then raise the issues of horizontal

3. Allocative efficiency may be the more important economic task facilitated by good information distribution. Accurate information flow helps both allocative efficiency and corporate governance.

governance: it would be most efficacious if the system minimized the horizontal problems so that the blockholders could then act on the vertical issues. For very large firms, only very rich people or very large financial institutions could play this role. In the United States, the “supply” of very rich people is relatively small against the number of firms that could have blocks (surprisingly). Cf. Kafka & Newcomb (2001) (Forbes list of richest Americans). The richest Americans *already* have blocks (think of Gates, the Waltons, Dell). But there are *many* other diffusely-owned firms available for blockholding. Among the largest 10 firms, only a few Americans could take big blocks, but the few who could are *already* occupied with their own blocks at their own firms. Peculiar as it is to think so, there’s a relative “shortage” of very rich potential individual blockholders relative the number of very large American firms.

For financial institutions, historical, political, and social considerations took them off the table as American blockholders. At the time of the rise of the large American firm, at the end of the 19th century and the beginning of the 20th, the financial institutions in play were the banks and the large life insurance companies. But American populism stopped this form of blockholding (common in modern Germany and Japan), by denying these institutions national scope (such as via cross-state branching restrictions), restricting their panoply of products (such as the 19th National Bank Act and the more famous Glass-Steagall confirmation of stock trading restrictions), and by barring their basic authority to own stock (such as via the laws resulting from the 1906 Armstrong investigation for life insurers, and via the banking regulatory statutes generally). See Roe (1994).

Other means to coalesce stockholders have arisen, and in the 1980s the takeover was a primary American institution in constraining managers who strayed too far in producing shareholder value. But takeovers also have their limits. The first limit is how much they can do. The typical American premium is about 50%, suggesting takeovers set an outer limit for vertical governance, not a tight one.

Second, the efficacy and purpose of takeovers is uncertain. Two common features are not positive: Takeovers might reflect the *offering* company’s empire-building or market-power gains (i.e., violations of perfect antitrust policy). And one positive feature—pure synergy gains—does not implicate corporate governance directly. The gains from takeovers are not always corporate governance gains. And although ex ante event studies suggest shareholder gain, ex post results are less clear in doing so. Post-merger firms display too many operational and financial failures for us to be unconstrained admirers of takeovers as the perfect corporate governance remedy. Caves (1989); Ravenscraft & Scherer (1987).

And third, it’s possible that widespread blockholders would raise legitimacy problems. Indeed it’s plausible that takeovers are not as widespread as they otherwise would be in the United States because of such legitimacy issues. See Romano (1988); Roe (1994). Other nations would probably face, and probably have faced, more severe legitimacy restrictions on takeovers, making them less efficacious as a tool of vertical governance (and thereby demeaning widespread incidence of diffusely-owned firms). And for the United States it’s plausible that one path to coalesce shareholders—that of financial institutional blockholding—wasn’t taken because of such legitimacy considerations. In nations where it is taken (as it was in Germany and Japan), it might well bring other governance issues into play, such as an enhanced demand for governmental oversight and stakeholder voice to counteract the very audible financial voice and very visible financial control. The institutions of corporate governance cannot easily be kept in separate domains.

E. Executive compensation

Compensation, especially stock-based compensation, would seem a quite promising way to align senior mangers with shareholders, and thereby reduce the vertical corporate governance problem.

The theory is simple: managers get, say, options to buy the company's stock. If their management of the firm induces stock price to rise, the managers cash in valuable options and make money. If their management of the firm doesn't induce its stock price to rise, then the managers' options are without value. (Note the interplay with the institutions of information disclosure and gate-keeping: for incentive compensation to be effective, stock analysts must have good information so that the stock on which the options are written is accurately priced. Or: for it to work well, the board must be sufficiently functional to make incentive-compatible compensation deals and then monitor performance.)

This is the theory, and incentive compensation certainly is an important institution of corporate governance. But it too has its limits. First, with shareholders scattered and not themselves writing the incentive contract, the options may not fully motivate managers but may successfully enrich them. Since the common options contracts seem to fall short of an ideal contract, there's good reason to think that the options actually used don't resolve the vertical governance problem as well as they could. (They have typically been based on a general rise in the company's stock price and not its performance compared to that of other firms.) Bebchuk, Fried & Walker (2002); Jensen & Murphy (1990). True, others conclude that incentive compensation is best seen over the long run, and does better in that time-span. Over approximately a decade, managers at strongly performing companies do indeed earn much more than managers at weakly performing companies. Hall & Liebman (1998); Murphy (2002). On the general issues, see Aggarwal & Samwick (1999); Murphy (1999); and Core, Guay & Larcker (2003).

A second problem with the incentive compensation institution is not noted in the literature but ought to be. Even if the compensation is nicely attuned to performance, senior managers quickly become rich. But the successful managers do not, once they become multi-millionaires, turn the firm over to a new crew of hungry but impoverished managers. They instead continue, while wealthy, running the firm. For these people surely more money remains better than less money, but one can question how strongly incentive compensation motivates truly wealthy people. (Its role might the be more to motivate managers *seeking* to be truly wealthy—those lower down in the firm's hierarchy—*not* those already there.)

F. Professionalism and norms

Managers do not act solely for remuneration, but also for the satisfaction of doing a good job. And "doing a good job" is defined by circumstance, psychology, and culture. Professionals want the firm to do well. They are often acculturated to work for shareholders, and often do so even when the other institutional constraints are not tight. Or, managers who get a new product out, who succeed, who innovate, who turn a division around feel good about themselves, and in turn shareholders profit. Or, organizations depend on managers' capacity for collaboration, cooperation, and trust. These notions of norms and professionalism are softer and less well understood than the other institutions, but that doesn't mean that they're absent, or that they're unimportant.

G. Corporate lawsuits

Directors can be sued. In the United States there are two broad bases for stockholders to sue directors and managers: breach of state law fiduciary duties and breach of federal securities law obligations. The latter relate most basically to the company's quality of information disclosure, and can involve SEC enforcement actions as well as private lawsuits. Significant resources in the United States are spent on *private* lawsuits, a feature not matched even in nations like Britain that are usually seen to have similar legal structures. Many directors dread the aggressive adversarial questioning of a long deposition is a securities lawsuit.

In the United States, lawsuits arising from state corporate law largely grow from fiduciary duties. Controllers who steal from the firm have typically violated one of those duties. Controllers who divert business opportunities from the firm to themselves will typically violate one of those duties. Controllers who force the firm to sell a product at a low price to the controller's (or the controller's relative's) wholly-owned private firm will typically violate one of those duties.

It's here that market restraints are not likely to strongly reduce insiders' misbehavior, because the value moved might not be large in relation to the size of the firm, or because the value even if large is a one-shot deal that the market will not adequately punish. Moreover, markets cannot work well if they don't know about the wrong-doing, and law-based institutions typically force the information to be disseminated. In the United States, these disclosure-forcing rules primarily come from federal securities law, not state law.

State lawsuits don't go much further though. Managers may make poor decisions on behalf of shareholders, but judges won't hear their complaints. The American business judgment rule precludes shareholder actions against directors for mistakes. Since managers can lose much money for shareholders by mistakes, corporate lawsuits here are less important than the other institutions of corporate governance. Thus key aspects of vertical corporate governance—"shirking"—aren't governed by shareholder lawsuits.

One might see the institutions here, especially markets and lawsuits, as specializing. Lawsuits are more effective in controlling conflicts of interest than are markets; market institutions, coalescing institutions, and the incentive institutions are better primed to channel managers toward pro-shareholder decision-making. The first problem American fiduciary duties seek to control; the latter it typically ignores. Thus domain of the burgeoning "law and finance" literature (e.g., La Porta et al. (1999)) may be more limited than generally seen in the finance literature, as basic corporate law deals with one core problem of corporate governance—that of diversions, or "stealing"—but only indirectly (and sometimes not at all) with "shirking" and bad business decisions, or with managers who lose sight of shareholder interests. Other institutions beyond corporate law must be key in reducing "shirking."

H. Capital structure

Capital structure—especially the amount and terms of the company's debt—can affect the way managers work. The theory is simple: An all-common stock structure, especially one with diffuse ownership, gives managers slack. Earnings can be low, and if they don't need new external capital, the constraints on them are weak. But if the company were capitalized with debt having massive pay-out obligations, then managerial incentives would change. If they fail to earn enough to pay off the creditors, then their working lives are made miserable, as creditors breathe down their necks, pursue covenant defaults, and, at the limit, force the firm into bankruptcy. If much of the firm's expected cash flow is dedicated to repaying creditors, managers' discretion declines. Moreover, with a thinner equity, managers who become equity owners have a greater upside potential (than when they own a smaller fraction of a wider equity base); their upside motivation increases as well. Carrots as well as sticks.

This kind of capital structure constraint would seem particularly important in firms that have high cash flow that cannot be utilized well, such as oil firms in the 1980s who had huge inventory profits, but few profitable drilling opportunities. Jensen (1986). By binding themselves not to explore for oil (Wall Street then saw exploration as a money-loser), the firm's total value increased. See also Jensen & Meckling (1976); Grossman & Hart (1982), at 108.

Capital structure is not the same institution as the capital market prong of our market triumvirate. It's not so much that getting access to capital motivates managers or denies them resources here, but that the incentives of the ongoing structure—and the repeated pressures to come up with lots of cash—motivate managers and owners.

Like the other corporate governance institutions, capital structure has its limits. It's best attuned to firms with predictable cash flow. Volatile firms would need to repeatedly restructure their financings. And lots of debt can distort equity owners' incentives, pushing them toward unwarranted high risks; limiting financing of future projects, due to the debt-overhang effect (Myers (1977)); or inducing other bankruptcy and recapitalization costs.

Moreover, it might work best in corporate governance structures in which the creditors have an institutional role, perhaps directly inside the boardroom, one in which they could, apart from their contract, control managers, mitigate the stockholders' excessive risk-taking incentive, and gather better information. This though is not the American model. Roe (1994).

Once more, we have a useful but imperfect corporate governance institution, one that limits the incidence and magnitude of error for a class of firms.

I. Bankruptcy

Bankruptcy aligns incentives, although in its pure, theoretical form, it doesn't so much align managers with equity, as it has the firm restructure its liabilities to match its reduced operational capabilities. When bankruptcy works well, it can align managerial incentives with creditors' goals, reduce the debt overhang problem by allowing new financing (although it's possible that American bankruptcy goes "too far" in this direction), and remove managers incapable of engineering a turnaround.

Focus on this last feature. It may not be bankruptcy's most important institutional characteristic, but it's probably the bankruptcy characteristic most important for the core of corporate governance. Consider the firm that's failing. As it slouches toward bankruptcy, its debt is risky, with a significant chance of not being paid off. This "debt overhang" impedes new financing, as potential new creditors don't want to "subsidize" the old debt, knowing that if they—the new guys—lent, they'd have to share the firm's cash flow and bankruptcy division with the old creditors. The "overhang" can stymie new lending. This much is well known.

Less well known is that overhang can stymie the *other* institutions of corporate governance as well. Takeovers and proxy fights might be mounted to oust the incumbent managers, but the "overhang" means that creditors not the offerors would profit first from ousting the failed managers. Potential offerors may desist, realizing that they cannot reap profits from the takeover: if they fail, they fail; if they succeed, the creditors and not they are the winners. Roe (2000, at 451-57; 1983).

Bankruptcy of the large public firm has the potential to reduce this problem, by being the institution that replaces managers. But criticism has been made that American bankruptcy is lax here, in that it favors incumbent managers. And indeed the remedy of court-ordered replacement (via Bankruptcy Code § 1104) has been viewed as an extraordinary judicial remedy. This and chapter 11's other features led some analysts to explain American bankruptcy as a pro-managerial protection against ouster, one similar to the anti-takeover laws and decisions of the 1980s. Bradley & Rozenzweig (1992). But some indicators suggest that managerial turnover around the time of a chapter 11 filing is, despite the managerial-friendly formal structure, quite high, Gilson (1990), and anecdotally seems to be rising.

J. Complements and substitutes

Are these imperfect corporate governance institutions complements or substitutes? Or both?

Clearly each can independently affect the quality of management. True, some primarily affect insider diversions of value, and others align managers with shareholders. But of those institutions that induce managers to produce the goods for shareholders each can operate independently and substitute for one another. Substitution effects influence institutional arrangements: if one institution is demeaned in a nation, or becomes too costly for ancillary reasons, then the demand for the other corporate governance institutions should rise.

Consider product markets. Product markets confine managerial discretion, and in that sense product markets and the other governance institutions are substitutes. But better product market competition can enhance the other institutions: fierce competition can sharply lower corporate profitability if the managers misstep. Lower profits should lower the firm's stock price, make the incentive compensation less remunerative, and signal takeover entrepreneurs that an opportunity is brewing. Thus, in the United States, which historically has been seen as having had fairly strong product market competition (at least as compared to pre-EU Europe), some large firms could prosper without really strong constraints on managers because product market competition kept managers working effectively.

Or, take the opposite causal direction. Markets might be structured competitively, but *all* incumbent managers could be lackadaisical. Charge up one institution or another of corporate governance in *one* of the competitors—say, incentive compensation or a more dynamic board—and then one group of managers in one firm ramps up production and innovation, grabbing market share away from other firms. To survive, the other competing firms must react. They react by innovating as well, and some of that innovation is, say, better R& D, but some of it is also to improve *their* own internal corporate governance systems, with better boards, better compensation, and so on.

Or take the complementarity of information disclosure. Better information leads investors to price securities more accurately than if they had inferior information. Better information could then "prime" the pump of other institutions. Managers who are professionals would be chagrined to see their stock price decline. Managers who are looking at the value of their stock options would be motivated to make the value of those options rise. Boards who got the feed-back of declining stock prices would be on notice that action might be needed. Takeover entrepreneurs might also be primed to act.

Or: better boards could design better compensation plans. Better boards could foster the professionalism of managers. Better boards could induce a capital structure geared toward the firm's product markets and management.

And so on.

III. CONTRACT LAW AS THE CORPORATE LAW "PRIMITIVE"?

In a handbook on institutions, one ought to inquire whether corporate law institutions can be broken down further toward a "primitive"—a basic institution on which the corporate governance institutions rest, like chemists looking inside the gas to find the molecule, then inside the molecule to find the atom. Are there more basic building-blocks upon which corporate governance institutions, and, since I am a law professor, upon which corporate law institutions, are built?

A. Corporate law as standardized corporate contract

Consider contract. It's a basic exercise in teaching corporate law to analyze how most of the corporate charter—the document governing relations among shareholders and between the board and its shareholders—could be created out of contract law, without a separate corporate law. The rules governing, say, meeting frequency, voting rights, the mechanism of vote solicitation, the question of who pays for the proxy solicitation, and so on could all be created via contract. And, indeed the contractarian view of corporate law is an important theoretical strain here: in its normative form, contractarians maintain that corporate law should be a pure contract. Corporate law should be the contract that the shareholders and managers would have come to naturally if bargaining and transaction costs were cheap. Or, it should be the charter that the parties would find easiest to bargain around. Easterbrook & Fischel (1991).

Moreover, the institutions that minimize the opportunism in the corporate charter could be seen as contract-based institutions. Fiduciary duties, in this view, are the terms that the parties, had they anticipated the questionable transaction, would have negotiated toward. Easterbrook & Fischel (1991); but cf. Brudney (1985).

Hence, if contract law is good, then a) much that is useful can be done by contract and b) the primitive institution that could make for good corporate law is in place.

B. Contract law's limits

But contract law has its limits in making the corporation work here. Corporate law has its criminal component. Insider trading can destabilize share ownership. It can also land the perpetrator in jail. A contract against insider trading cannot send a violator to jail.

And corporate contracting entails multi-party contracts that the players cannot immediately standardize. Corporate contract could, one supposes, lead to audit firms and audit firm liability. But building a system up from the two-party contract would not immediately lead to standardized financial information. Even here though, standardized formats may eventually arise without more than contract law. Private associations, such as stock exchanges in the United States, can standardize rules and formats. There's evidence that stock exchanges and other organizations came first, followed by corporate (securities) laws later. Cheffins (2001); Coffee (2001); Macey & Kanda (1990); Mahoney (1997); Miwa and Ramseyer (2002); Roe (2000).

IV. INSTITUTIONAL LEGITIMACY

Thus far we have focused on the "internal" effects and purposes of corporate governance institutions, principally those that align managerial and shareholder interests, and secondarily those that prevent massive diversions of value from dispersed shareholders to the insiders. These institutions are needed to stabilize the corporation.

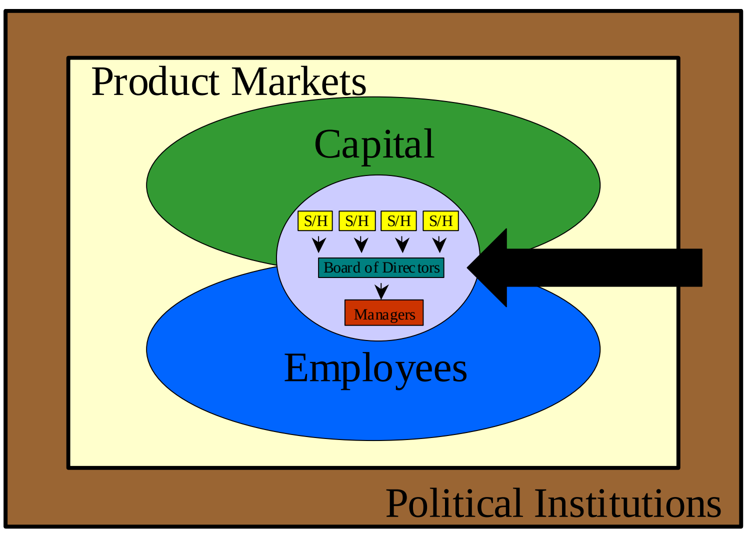


Figure 3. The corporate governance environment

Corporate governance institutions have another role. Players outside the corporation can affect the corporation: if corporate arrangements appear unfair, then the outsiders can intervene through political institutions. They can ban some arrangements, raise the costs of others, and subsidize yet others. They can, and they do, everywhere in the world. When they do so, they can deeply affect the institutions of corporate governance, as illustrated in Figure 3.

And players inside the corporation who cannot get what they want via internal arrangements might appeal to the outsiders, making external political alliances that then press the firm internally. They can sometimes leverage their position inside the firm by calling on institutions outside the firm.

The institutions of corporate governance are not just organizational and technical. They are, or they are affected by, political institutions as well. Three examples follow.

A. American legitimacy light: Populism and anti-takeover laws

Takeovers constrain managers. But managers can call on political allies—labor at target firms, or by-standers who sympathize with targets and continuity over offerors and rapid change, and politicians who see more votes in opposing takeovers than in promoting them. Roe (1993. 1994); Romano (1988).

More fundamentally, American populism made visibly powerful financial institutions such as J.P. Morgan's end-of-the-nineteenth century investment bank or a Japanese-style main bank or a German-style universal bank incompatible with American political culture (of an earlier era). Roe (1994). The consequence was that one form of concentrated ownership—that of financial institutions—was largely removed from the menu by American politics. This made the diffusely-owned firm inevitable in the United States.

B. Legitimacy heavy: European left-right politics

Left-right political orientation affects corporate governance institutions. Ownership by diffuse, dispersed shareholders calls for tools that keep managers loyal to those distant shareholders. (Or at least shareholders do better if they get some of these tools.) Incentive compensation, shareholder primacy norms, and other shareholder-enhancing mechanisms need to be efficacious. But if a nation was lodged toward the left of the modern political spectrum, political institutions tended not to provide these supports.

Nations lodged toward the left would tend to disrupt managerial-shareholder alliances, and promote activities that favor employees with existing jobs. Firms would be encouraged to expand without regard to profitability, delay down-sizing when their production is misaligned with the product market, and go slow in taking profitable but disruptive risks. These pressures, and the denigration of some pro-shareholder tools, would lead firms to have more concentrated ownership than otherwise, so that managers could be more directly controlled. Roe (2003). Moreover, these are the kinds of managerial actions that cannot readily be contained by corporate law, which focuses on diversions of value more than pro-shareholder operating decisions. Roe (2002, 2003). These kinds of political pressures—to expand, to avoid down-sizing, and to avoid profitable risks—map exactly onto the kinds of agency costs that are thought to be managers' natural tendencies unless otherwise checked. Jensen (1986).

In nations where labor institutions—whether via social democracy or corporatist power-sharing or other cooperative arrangements—are strong, one would expect managerial agency costs to shareholders to often be higher for firms that had ownership and control divided than in nations where such labor institutions were weaker.

Two channels would be in play, one through the firm and the other through institution-building: First, through the firm, the polity would encourage the firm to expand, irrespective of profitability, and would impede it from down-sizing when its capabilities are misaligned with markets. And, there'd be more bargaining over the surplus, with some of that bargaining at the national political level and some inside the firm. Concentrated ownership would be relatively more profitable for shareholders than in other polities, because the concentrated owner could bargain more effectively and resist some of the political pressures.

Second, nations where labor held significant political power could be unwilling to build the institutions that facilitate distant shareholding, such as building good securities regulation, promoting profit-building institutions, facilitating shareholder control over (or influence on) managers, and enhancing shareholder primacy norms that induce managers to align themselves with stockholders, even those stockholders that cannot control the managers day-to-day.

If one or both of these channels is strong, then one could hypothesize a basic model with testable implications. Greater labor protection should predict weaker ownership separation. Consider these results from OECD data indexing the level of job protection in the OECD.

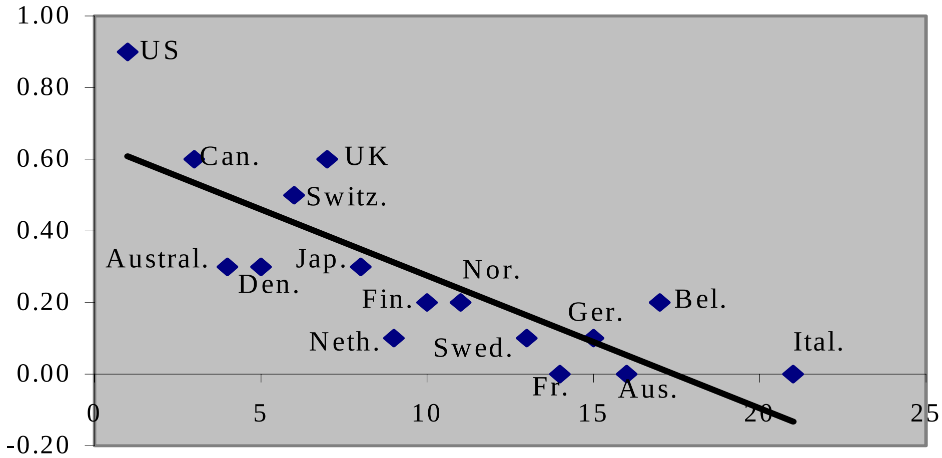
Substantial evidence exists for the strong pressure of politics on corporate governance institutions. Look at the world's richest nations and compare the degree of ownership separation with the strength of labor protection. The correlation is powerful. And even when controlling for the quality of legal institutions and the size of the firms involved, the correlation is quite robust.

In Figure 4, I show the relationship between national employment protection laws in the wealthy West in 1995 and the degree of ownership separation in a sample of similarly-sized firms from each nation. The figure shows the strength of employment protection laws—a rough measure of the left-right shift described earlier in this sub-section—in predicting ownership separation. Similar left-right measures—the GINI index, the ratio of government spending to GDP, and political scientists' ratings of leftness—all similarly predict ownership separation and a separate measure of the size of a nation's stock market (the ratio of stock market capitalization to GDP). See Roe (2003, 2000).

Table 1 controls this result for the quality of corporate law. True, when we run corporate law against ownership separation, it predicts ownership separation. (I use two measures of corporate law. The first is an index developed by financial economists, which in widespread use among financial economists, despite some legal academics' doubts about its strength, see Vagts (2002). The second is a measure of the premium a controller gets over the trading price of diffuse stock when the controller sells its block of stock.) But when we run the regression with both a legal index and the political index as predictors of ownership dispersion, the political index always survives and often surpasses the legal measure in importance.

These results strongly suggest that political institutions are deeply related to, and often determinative of corporate institutions, opening up a new and not yet deeply investigated field for important research. For efforts to link political and corporate institutions, see Roe (1994, 2003); Pagano & Volpin (2002); Perotti & von Thadden (2003); Rajan & Zingales (2003).

Figure 4. Employment protection vs. ownership dispersion



(Y-axis is dispersion; X-axis is employment protection)

Technical data: med20 v. employment protection	
Regression	y = -0.04x + 0.65
Adj R-S q	0.64
t-stat	-5.24***

*** Significant at the .0005 level. Sources: OECD (1994) (employment protection); La Porta (1999) (ownership dispersion of mid-sized firms: percentage of sample of medium-sized firms without a dominant, 20%+ stockholder).

Table 1. Law and politics as predicting ownership separation

Dependent variable: ownership separation in mid-cap companies					
Corp. law: La Porta	.14 (3.69***)			-.03 (.57)	
Corp. law: control premium		-1.07 (-1.94*)			.43 (.87)
Employment protection			**-.04** **(-5.24***)**	**-.03** **(-2.62**)**	**-.05** **(-4.39***)**
R^2	.53	.18	.64	.71	.72

Sources: ownership separation and employment protection are the same as for Figure 4 (which graphs the relationship in the third numerical column; the La Porta measure of corporate law quality is from La Porta (1999) and the control premium is from Dyck & Zingales (2003).

The political shift rightward in Europe in the past 10 years may thus be one of the most important of the recent corporate governance changes there, perhaps even more important than changes in any particular corporate governance institution. The shift *allows* corporate governance institutions to strengthen, and makes those that already exist more useful to shareholders. The rightward, pro-market (or less anti-market) move is not always via electing conservative parties; sometimes it's via a left-wing party abandoning its wariness of markets. That movement makes it easier to develop shareholder-oriented institutions.

Table 2. Europe's social democratic parties move to the right

Country	**1984**	**1995**
Austria	3.00	4.80
Belgium	2.50	4.20
Denmark	3.80	4.20
Finland	3.00	4.40
France	2.60	4.10
Germany	3.30	3.80
Italy	3.10	3.50
Netherlands	2.60	4.20
Sweden	2.90	4.10
United Kingdom	2.30	4.40

Source: Lipset & Marks (2000), at 275, who array Europe's social democratic parties on a left-right scale, using political scientists' assessments. Lower scores are more left, higher more right.

V. CORPORATE INSTITUTIONS IN THEIR SETTING

A. Contract

1. Firm size. Corporate governance institutions have technological predicates. Corporate governance institutions govern the interface between the capital-providers and the firm's management (at least as we've defined the essential corporate governance problem). For there to be a problem to be governed, especially for vertical corporate governance between shareholders and distant managers, there must be a demand for firms where not all capital-providers are inside the firm. For that condition to arise, there must be heavy demand for capital inside the firm and there must be technologies that demand a size of operation beyond that which managers would ordinarily be able to control directly with their own capital.

In its simple form, there thus must be economies of scale. But in addition those economies of scale must induce capital needs greater than that which a single investor, or a very small group of investors could provide.

The historical story usually told is that advances in communication, production, and transportation technologies facilitated the growth of the large, vertically-integrated firm. Chandler (1990). These new organizations had capital demands that led to the large public firm and its concomitant corporate governance problems, raising the 20th century demand for better standard corporate governance institutions. In its theoretical form, one would cite Coase's *Nature of the Firm* article: Economic activity can be organized inside the firm or across firms. When the transaction costs of bringing the next transaction or the next operation inside the firm exceed the costs of contracting through the market, the firm stops growing. Coase (1937); Williamson (1985).

2. Decentralization vs. centralization. This story can be turned around. If new technologies *reduce* the costs of transacting in the market *across* firms—new internet and information technologies come to mind—then the demand for large integrated organizations would decline. If they declined enough, the needed capital might be within reach of a handful of managers, making the separation problem less acute. One would still have institutional issues—those say of relations among a network, cf. Piore & Sabel (1984), perhaps of a contractual dimension—but they wouldn't be the classic vertical and horizontal problems of corporate governance. One might see the computer's advance in the past half-century as having corporate governance implications. In the age of the mainframe, information was best processed at the central headquarters. The M-form corporation, with centralized strategic decision-making, fit that technology well. In the age of the personal computer and the internet, information is better distributed, and decentralized decision-making becomes relatively favored. Firms decompose, spinning off unrelated operations, as each operation can process its own information well, without the need of a centralized mainframe. Or management's ability to get good information fast facilitates more centralized management. Technology, if it strongly tilted one way or the other, could determine whether and which corporate governance issues are important.

3. The quality of contract. And one could see another role for law here. If the institutions of contract improve greatly relative to the institutions of corporate governance, then one would expect to see pressure on the size of firms. Corporate governance rises in importance when the transactions to be governed cannot be handled well informally, or via contract.[4]

If production needs to be brought inside a single firm (think: the vertical integration that was central to the mid-20th-century American economy), because of the Fisher Bodies problem, see Klein, Crawford & Alchian (1978), then the economy puts pressure on the institutions of corporate governance. But if contractual capacity improves (because of, say, better judges, better information on contractual performance, better third-party verifiers, and so on), then the units of production can be kept in separate firms. When they're in separate firms the problems of horizontal and vertical corporate governance (to the extent those problems arise from large-sized firms) diminish; contract takes over from the institutions of corporate governance.

4. Markets again. This trade-off between firm and contract as the mode of governance sets us up for another market-oriented perspective. Markets constrain corporate governance failures. Firms must operate within product, capital, and managerial labor markets, each of which we have seen prods the firm toward efficiency and toward using the best corporate governance institutions.

The market can constrain corporate governance failures in another way. The firm's *internal* governance system brings activities into the firm that could have been transacted *across* the market. The firm is not just competing in the product market with other firms that have brought a similar quantity and scope of activities inside the organization (an organization which hence needs governance institutions to make it work well).

The firm *also* competes with disaggregated units that make the same product. If the disaggregated units can produce the same quality product cheaper, etc., then more resources will go to the disaggregated units, fewer resources to the integrated units, until the integrated units learn—presumably via better corporate governance institutions—how

4. Consider this small contract riddle: Part of the technology that favors decentralized production is better contract law. If contract law (and related contract institutions) improved, while holding the quality of corporate law constant, that improvement would favor operational decentralization. But better contract law is the corporate law primitive, and corporate law is one of the institutions that facilitates large organizations. Hence, the two should move in tandem, not separately. And if both improve simultaneously, the improvement's effects on relative decentralization are unpredictable.

to reduce their governance costs, improve their organization, etc. This mechanism is the Coasean theory of the firm, applied to corporate governance institutions.

B. Property rights

Ownership separation has two related underlying property rights problems. The first is simple: for firms to get capital, there must be enough savings somewhere in the system to invest. But if property rights are fragile, savers will be unwilling to save, fearing confiscation. Cf. North & Weingast (1989); Mahoney (2001); Williamson (1985): "the suppliers of finance [face the risk that t]he whole of their investment in the firm is potentially placed at hazard. By contrast, the productive assets (plant and equipment; human capital) of suppliers of raw material, labor, intermediate product, electric power, and the like normally remain[] in the suppliers' possession." Some other mechanism of gathering capital would be needed, such as the State, and what now passes for corporate governance problems in the wealthy West would focus on the relationship between the State as capital-provider and large enterprises.

The second property rights problem is more nuanced, but similar: Separation of ownership from control exposes capital-providers. They provide their capital to the firm, but might not get it back. Managers can take it for themselves. Other shareholders might maneuver to grab it. These two risks to investors are the usual focus for corporate governance. But we shouldn't stop there. The State, or employees, might figure out how and why that capital really belongs, or should belong, in their own pockets. When investors feel unprotected in this dimension, they are likely to adopt institutional arrangements that would minimize their losses to the State, or to those favored by the State.

Thus, one can find correlations between, say, weak corporate law and weak ownership separation. And while it's logically possible that it's the weakness in *corporate* law that directly weakens separation, because investors fear dominant stockholders, it's equally logically possible that *it's a more basic weakness in property rights in that society that deters such investment. Investors could fear that others, such as the State or its patrons, will grab the investment*. There must be property rights institutions that make savers relatively comfortable with saving and with visibly investing in distant enterprise. If they fear expropriation, they won't put their savings into public view even if they trust the firm's controllers not to steal from them. In much of the world, such property rights are not in place. In some parts of the wealthy West, putting the money out there in some corporate forms is riskier than in other forms. Hence, there is less reason in such nations to develop strong institutions of corporate governance, because even if developed they wouldn't be widely used.

One might go further. Once basic property rights institutions are in place, corporate law institutions can adapt, usually easily. In this sense, corporate law institutions are not central to social and business organization—to the chagrin perhaps of the corporate law professor—but basic property rights are. If property rights are secure, and if the society has the "primitive" foundation on the ground of good basic contract law, then the institutions of corporate governance become (relatively) easy to build. Corporate governance institutions here are derivative and secondary to the more basic institutions of property and contract.

SUMMARY

We have reviewed the institutions of corporate governance. The institutions in general respond to two distinct problems, one of vertical governance (between distant shareholders and managers) and another of horizontal governance (between a close, controlling shareholder and distant shareholders).

The principal institutions are about ten: the market, the board, gate-keeping, coalescing (via takeovers, proxy fights, and shareholder voice), incentive compensation, professionalism, lawsuits, capital structure, and bankruptcy. Some institutions deal well with vertical corporate governance but do less well with horizontal governance. The institutions interact as complements and substitutes, and many can be seen as developing out of a "primitive" of contract law. Arguably a system must get contract enforcement, as well as basic property rights, satisfactory before it embarks on more sophisticated corporate governance institutions.

Institutional legitimacy affects the institutions of corporate governance. In the United States, intervention inside large firms from powerful financial institutions was seen as politically illegitimate and was largely banned or made more costly. In modern Europe, the institutions of shareholder value have been denigrated. Each legitimacy issue affects corporate institutions, as firms seek substitutes defensively, for example. The interaction between political institutions and corporate governance institutions is an inquiry still in its infancy but promises large returns. Even simple regressions suggest that political institutions may strongly influence the construction and survival of corporate governance institutions.

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