Corporate Governance: a Review of the Literature

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ABSTRACT

This paper reviews the theoretical and empirical literature on the nature and consequences of the corporate governance problem, providing some guidance on the major points of consensus and dissent among researchers on this issue. Also analysed is the effectiveness of a set of external and internal disciplining mechanisms in providing a solution for the corporate governance problem. Apart from this, particular emphases are given to the special conflicts arising from the relationship between managers and shareholders in companies with large ownership diffusion, the issue of managerial entrenchment and the link between firm value and corporate governance.

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1 Introduction

Recent financial scandals associated to accounting and other frauds allegedly blamed to top company managers (e.g. Enron, Worldcom, Adelphia) have brought into public light the recurring question of whether companies are managed on the best interests of shareholders and other company stakeholders such as workers, creditors and the general community. A point that has been made frequently is that top managers may possess too much power inside their companies and that a general lack of accountability and control of their activities is prevalent in companies with wide ownership diffusion.

Although this kind of scandals is certainly not new, there has been a renewed interest on the mechanisms that can effectively curtail managerial discretion over sensitive company issues that can have an impact on the welfare of the remaining stakeholders. At the same, time, and especially after some well publicised company failures in the late 80s / early 90s (Polly Peck, Coloroll, Maxwell Communications, BCCI), numerous sets of recommendations on corporate governance issues have been published worldwide and adopted, in particular, by many stock market regulators since the seminal Cadbury (1992) report in the UK. This has given place to a considerable amount of research on the effectiveness of these recommendations in providing better company governance.

This paper attempts to provide a survey on the fast-growing theoretical and empirical literature on the corporate governance problem, providing some guidance on the major points of consensus and dissent among researchers regarding the nature and effects of the conflicts of interest between managers and other stakeholders, and on the
effectiveness of the set of available external and internal disciplining mechanisms. A particular emphasis will be given to the special conflicts arising from the relationship between managers and shareholders in companies with large ownership diffusion.

2 The corporate governance problem

2.1 Concept of corporate governance

The term “corporate governance” is a relatively new one both in the public and academic debates, although the issues it addresses have been around for much longer, at least since Berle and Means (1932) and the even earlier Smith (1776).

Zingales (1998) expresses the view that “allocation of ownership, capital structure, managerial incentive schemes, takeovers, board of directors, pressure from institutional investors, product market competition, labour market competition, organisational structure, etc., can all be thought of as institutions that affect the process through which quasi-rents are distributed (p. 4)”. He therefore defines “corporate governance” as “the complex set of constraints that shape the ex-post bargaining over the quasi-rents generated by a firm (p. 4)”. Williamson (1985) suggests a similar definition.

Viewing the corporation as a nexus of explicit and implicit contracts, Garvey and Swan (1994) assert that “governance determines how the firm’s top decision makers (executives) actually administer such contracts (p. 139)”. They also observe that governance only matters when such contracts are incomplete, and that a consequence
is that executives “no longer resemble the Marshallian entrepreneur (p. 140)”.

Shleifer and Vishny (1997) define corporate governance by stating that it “deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment (p.737)”. A similar concept is suggested by Caramanolis-Cötelli (1995), who regards corporate governance as being determined by the equity allocation among insiders (including executives, CEOs, directors or other individual, corporate or institutional investors who are affiliated with management) and outside investors.

John and Senbet (1998) propose the more comprehensive definition that “corporate governance deals with mechanisms by which stakeholders of a corporation exercise control over corporate insiders and management such that their interests are protected (p. 372)”. They include as stakeholders not just shareholders, but also debtholders and even non-financial stakeholders such as employees, suppliers, customers, and other interested parties. Hart (1995) closely shares this view as he suggests that “corporate governance issues arise in an organisation whenever two conditions are present. First, there is an agency problem, or conflict of interest, involving members of the organisation – these might be owners, managers, workers or consumers. Second, transaction costs are such that this agency problem cannot be dealt with through a contract (p. 678)”.

These numerous definitions all share, explicitly or implicitly, some common elements. They all refer to the existence of conflicts of interest between insiders and outsiders, with an emphasis on those arising from the separation of ownership and control
(Jensen and Meckling, 1976) over the partition of wealth generated by a company. A degree of consensus also exists regarding an acknowledgement that such corporate governance problem cannot be satisfactorily resolved by complete contracting because of significant uncertainty, information asymmetries and contracting costs in the relationship between capital providers and insiders\(^1\) (Grossman and Hart, 1986, Hart and Moore, 1990, Hart, 1995). And finally, one can be led to the inference that, if such a corporate governance problem exists, some mechanisms are needed to control the resulting conflicts. The precise way in which those monitoring devices are set up and fulfil their role in a particular firm (or organisation) defines the nature and characteristics of that firm’s corporate governance. As the following sections show, such mechanisms can be external or internal to the company.

There are several basic reasons for the growing interest in corporate governance. In the first place, the efficiency of the prevailing governance mechanisms has been questioned (see for instance, Jensen, 1993, Miller, 1997 and Porter, 1997). Secondly, this debate has intensified following reports about spectacular, high-profile financial scandals and business failures (e.g. Polly Peck, BCCI), media allegations of excessive executive pay (see for example, Byrne, Grover and Vogel, 1989\(^2\)), the adoption of anti-takeover devices by managers of publicly-owned companies and, more recently, a number of high visibility accounting frauds allegedly perpetrated by managers (Enron, Worldcom). Thirdly, there has been a surge of antitakeover legislation (particularly in the US) which has limited the potential disciplining role of takeovers on managers (see Bittlingmayer, 2000, for a description of this regulation). And, finally, there has been a

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\(^1\) As Fama and Jensen (1983) observe, “agency problems arise because contracts are not costlessly written and enforced (p. 327)".

\(^2\) See Byrne (1992) for manager’s counter-arguments over such allegations of excessive pay.
considerable amount of debate over comparative corporate governance structures, especially between the US, Germany and Japan models (see Shleifer and Vishny, 1997, for a survey of this debate) and a number of initiatives taken by stock market and other authorities with recommendations and disclosure requirements on corporate governance issues.

2.2 Fundamental determinants of equity agency problems

As referred above, the major conflict analysed in the context of corporate governance is the one between shareholders and managers. The theoretical motives for these agency problems are analysed by Jensen and Meckling (1976), who develop a theory of the ownership structure of a firm. The basis for their analysis is the perspective that a corporation is “a legal fiction which serves as a nexus for contracting relationships and which is also characterised by the existence of divisible residual claims on the assets and cash-flows of the organisation which can generally be sold without the permission of the other contracting individuals (p. 401)”.

The particular focus of the Jensen and Meckling (1976) model is the contract of an agency relationship between a principal (the external owner of the firm) and an agent (the owner-manager, or entrepreneur). They demonstrate that as the owner-manager’s fraction of the equity falls (as more equity is sold to outside investors), the utility-maximising agent has the incentive to appropriate a larger amount of the corporations’ resources in the form of perquisites and to exert less than full effort to create value for shareholders. The principal can limit the effects of this divergence of interests by incurring monitoring costs to curb the agent’s self-serving behaviour. Monitoring expenditures potentially include those related to payments to auditors to inspect the
company’s accounts, costs of providing information to financial analysts, rating agencies, independent directors on the board and so forth. An alternative is for the entrepreneur to credibly bond his behaviour towards a more value-maximising one, by incurring what Jensen and Meckling (1976) call bonding costs. Examples of these include the retention of a larger than desired equity stake by the agent, or the adoption of a riskier than desired compensation plan. Jensen and Meckling (1976) conclude, however, that in general there will always be a residual loss. All these agency costs (of monitoring, bonding and the residual loss) are borne in their model by the owner-manager in the sale of equity to external investors. In equilibrium, marginal agency costs should equal the marginal benefits of monitoring and bonding (that is, the marginal increases in wealth from a reduction in the consumption of perquisites and shirking).

Besides the effort (or shirking) and perquisite problems described by Jensen and Meckling (1976), a further problem is associated with managers having a different horizon than shareholders. This is because while firms have an indefinite life, and thus its shareholders are concerned with an infinite stream of cash-flows, managers’ horizon is usually limited to the cash-flows received during employment. This problem is naturally aggravated as managers approach retirement. This can lead managers to have a short-term perspective on investments, with a preference for projects with quicker cash-flow returns (which are not necessarily value-maximising).

An additional source of conflict between agents and principals is related to different risk preferences. As portfolio theory suggests, shareholders eliminate unsystematic risk by diversifying their portfolios so they are not concerned with company-specific
risk but only with market risk, or the risk associated with market-wide fluctuations of stock returns. In contrast, managers are typically not well diversified as a large portion of their wealth is tied in their company’s fortunes. This is not just because of direct cash-flows received from the firm but also because also their future employment prospects are dependent on the survival of the firm, especially if they have a large human-specific-capital invested in the company.

A compounding problem to these agency costs is the free-rider issue associated with an atomistic dispersion of capital common to most large listed firms. With a large dispersion of capital, individual external shareholders have no incentive to engage in managerial monitoring, preferring to free-ride on other actions. Thus, although it may be in the interests of the collective group of external owners to engage in actions aimed at disciplining management, no single rational individual shareholder will undertake such actions. In this context, in the absence of other mechanisms, the principal will have some additional discretion to run the corporation in her own interests.

Jensen and Meckling (1976) observe that the magnitude of the agency costs can vary from firm to firm. Some of the factors that can have an influence on such variation are

- the shape of managers’ indifference curves;
- the ease with which managers can exercise their own preferences (as opposed to an optimal, value-maximising behaviour);
- the firm-specific costs of monitoring and bonding activities. Jensen and Meckling (1976) view these as dependent, among other factors, on such attributes as the

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complexity of geographic dispersion of a corporation’s operations and the attractiveness of perquisites available in the firm;

- the level of competition in the managerial labour market (when the manager does not have a controlling interest\(^4\)). This can in turn be affected by the level of firm-specific knowledge accumulated by the manager;

- the market for corporate control.

Jensen and Meckling (1976) also show that debt may help to overcome the agency costs of equity issues to external owners, although debt can create a different set of agency problems (see section 5.5).

### 3 Evidence on conflicts of interest between shareholders and managers

Following the theoretical arguments on the reasons for conflicts of interest between shareholders and managers, a considerable number of studies have found evidence suggesting the prevalence and importance of agency conflicts between managers and owners associated with the horizon, risk differential, perquisite and shirking problems. These findings relate in particular to conflicts of interest over issues of compensation, diversification, investment, managerial behaviour during takeovers and the adoption of anti-takeover devices.

#### 3.1 Conflicts of interest over compensation

Several studies examine the relationship between managerial compensation and firm

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\(^4\) This particular observation can be linked to the notion of managerial entrenchment (see section 6).
performance and show results consistent with conflicting interests between owners and managers. A classic study is that of Jensen and Murphy (1990), who find only a weak link between compensation and performance. This is compounded by the evidence that managerial wealth is three times more sensitive to asset size than to market value, which contradicts Rosen’s (1982) hypothesis that the size-pay relationship is due to large firms hiring more able executives. Consistent with a divergence between executive’s attitude to compensation policy and shareholders’ interests is also Crystal’s (1991) characterisation of the procedures and tactics undertaken by some compensation consultants to justify top management raises when company performance is weak.

Agrawal and Knoeber (1998) observe that takeover threat has two opposing effects on compensation. The first is a competition effect in the market for managers, which results in less capability for managers to extract higher wages. The second is a risk effect, which leads, in contrast, to increased compensation as higher takeover threat is likely to result in an increased probability of firm-specific human capital loss or implicitly deferred compensation. This in turn makes managers demand higher pay to counterbalance the increased risk. Using a sample of 450 firms, and splitting it into two sets (one where managers face both risk and competition effects and one where only the competition effect is present\(^5\)), Agrawal and Knoeber (1998) find evidence that, as hypothesised, these two effects are significant. This means that, *ceteris paribus*, a lower takeover threat leads, through the competition effect, to higher pay, which is in accordance with the perspective of misalignment of interests between shareholders and managers.
Also, Healy (1985) reports evidence that managers choose income-decreasing or increasing accruals so as to maximise the present value of the bonus component of their compensation. Using confidential data on executive short-term bonus plans, Holtausen, Larcker and Sloan (1995) find evidence consistent with the hypothesis that managers manipulate earnings downwards when their bonuses are at their maximum.

3.2 Perquisite consumption

Suggested by Jensen and Meckling (1976), excessive perquisite consumption is one of the classic examples of conflicts of interest between managers and the company’s owners.

Shleifer and Vishny (1997) view, however, this consumption as one of the least costly manifestations of such agency problems, as compared to the problems arising from empire-building and the pursuit of negative net present-value projects.

Although most evidence on perquisite consumption is anecdotal, some indications exist that a recent trend has been the reduction of many of the most potentially superfluous aspects of executive perks. Holland (1995) argues that one of the reasons for this more thrifty behaviour by managers is increased shareholder activism.

3.3 Diversification and wealth-decreasing investments

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5 This is done by isolating the situations where managers are protected by contract from the risk effect
Another area where conflicts between shareholders and managers are potentially important relates to diversification strategies. Although there are theoretical arguments suggesting that diversification has both benefits and costs for shareholders\(^7\), existing evidence usually favours the costs outweighing the benefits.

Consistent with the assertion that, on average, the costs of diversification are larger than the benefits, Morck, Shleifer and Vishny (1990), Bhagat, Shleifer and Vishny (1990), Lang and Stulz (1994), Berger and Ofek (1995) and Servaes (1996) all find results in accordance with corporate diversification being associated with significant value losses. Also, Comment and Jarrel (1995) report that increases in corporate focus are associated with increases in firm value, while Kaplan and Weisbach (1992) document that divestitures frequently follow diversification strategies.

In addition, Denis, Denis and Sarin (1997a) find evidence consistent with equity agency problems being responsible for firms maintaining value-reducing diversification strategies and with market disciplinary forces being behind corporate focusing. They find that the level of diversification has a negative relationship either with managerial equity ownership or ownership by outside blockholders, and also report that decreases in diversification are associated with external corporate control threats, financial distress and management turnover.

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\(^6\) For a survey of executive perquisite consumption of 400 large American companies see Royal (1998).

\(^7\) These benefits can include the creation of internal capital markets without information asymmetries (Stein, 1997), tax advantages (Lewellen, 1971, Majd and Myers, 1987) and economies of scope (Teece, 1980). Costs include those related to agency problems (Jensen, 1986, Stulz, 1990) and associated with power struggles between divisions of the same diversified corporation (Rajan and Zingales, 1998). See also Weston (1970) and Stulz (1990) for the arguments on the potential benefits and Berger and Ofek (1995) on the potential costs.
Studying the valuation impact of diversification for samples of German, Japanese and British firms, Lins and Servaes (1999) observe significant differences in diversification discount\(^8\), which are associated with differences in corporate governance structures. Specifically, they find that insider ownership concentration reduces the diversification discount, although this effect varies according to the country in question and, in particular, no evidence of such discount is observed for German firms.

Some additional evidence of agency problems can be seen in studies of acquisitions and other investments. Many studies show that bidder returns from the announcement of acquisitions are negative (see Roll, 1986, for a survey). Consistent with Jensen’s (1986) assertion that the worst agency problems occur in firms with poor investment opportunities and excess cash, Lang, Stulz and Walkling (1991) document that bidder returns tend to be the lowest when firms have low Tobin Qs and high cash-flows.

McConnell and Muscarella (1986), on the other hand, find evidence of wealth-decreasing investments in oil exploration, while Lewellen, Loderer and Rosenfeld (1985) show this is especially the case when managers have low ownership stakes.

### 3.4 Resistance to takeovers

Evidence that target managers typically oppose takeovers is documented by Walking and Long (1984), who report such resistance to value-increasing takeovers by

\(^8\) This diversification discount is measured on the basis of a valuation ratio computed as the ratio of total capital to sales, assets or earnings, and the assignment to a particular business segment of a firm the valuation ratio of the median of the single-segment firms that operate in the same industry. The log of the ratio of the actual to imputed market value then defines the diversification premium or discount.
managers with low ownership stakes. As detailed in the following sections, this resistance could, to some extent, be due to the desire to extract a higher price from actual or potential bidders. However, the US evidence of post-acquisition performance of targets (Healy, Palepu and Ruback, 1992), the characteristics of targets (Palepu, 1986) and post-takeover management turnover (see section 4.1) suggests otherwise.

Additionally, several studies show that whenever managers adopt anti-takeover devices, shareholders suffer a corresponding reduction in firm value. These devices include anti-takeover amendments to corporate charters (DeAngelo and Rice, 1983, Jarrell and Poulsen, 1988a), poison pills (Ryngaert, 1988, and Malatesta and Walkling, 1988), dual-class recapitalisations (Jarrel and Poulsen, 1988b) or defensive changes in asset and ownership structure (Dann and DeAngelo, 1988).

In summary, Shleifer and Vishny (1997) interpret the overall evidence on managerial resistance to takeovers and wealth effects of antitakeover announcements as suggestive that “managers resist takeovers to protect their private benefits of control rather than to serve shareholders (p. 747)”.

3.5 Conclusions

To conclude, the existing evidence strongly suggests that some managerial actions are inconsistent with the maximisation of shareholders’ interests. This is particularly the case with the existence of a low sensitivity of pay to performance (as compared to asset size), the manipulation of earnings to boost compensation, the pursuit of wealth-

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9 Studies involving evidence from the UK and other European nations do not reach, however, exactly
reducing diversification strategies and the adoption of self-serving takeover defences by managers.

This is fully consistent with Jensen and Meckling’s (1976) argument that residual agency costs can be significantly present even if agents and principals engage in monitoring and bonding activities to minimise the problems associated with their conflicts of interests. Thus the existence of monitoring mechanisms does not seem to preclude the significance of residual agency costs.

The following sections look at a number of external and internal disciplining mechanisms that firms may face in their efforts to reduce the underlying agency costs, their limitations and applicability to individual firms.

**4 External disciplining mechanisms**

General external controlling mechanisms that have been addressed in the literature include the threat of takeover (Manne, 1965, Fama and Jensen, 1983, Jensen and Meckling, 1976, Grossman and Hart, 1980), competition in product and factor markets (Hart, 1983) and the managerial labour market (Jensen and Meckling, 1976, Fama, 1980). The following sections describe these and other potential monitoring devices.

**4.1 Takeover threat**

Due to the free rider problem, small shareholders have little incentive to monitor

the same conclusions as those using US evidence. See section 4.1.
management but this problem can potentially be avoided by the use of the takeover mechanism. According to this view, if management is inefficient or not acting in shareholders’ interests, a "raider" could make a takeover bid, buying the firm at a low price, managing it better and eventually selling it back with a profit. A feature of the takeover mechanism is that it potentially applies in an indiscriminate way to all firms\textsuperscript{10}, whereas the existence of other mechanisms (like debt or dividends) may depend on managers’ (or shareholders’) decisions. In support of this perspective, Easterbrook and Fishel (1991) and Jensen (1993) regard takeovers in the US as an essential corporate governance mechanism to control managers’ discretionary actions. The empirical evidence showing that takeovers lead to significant positive price impacts\textsuperscript{11} on the takeover target is consistent with this perspective (although also with alternative views, e.g. synergistic gains\textsuperscript{12}).

However, the takeover mechanism is not without problems. Grossman and Hart (1980) point out that this mechanism can be undermined if shareholders can free ride on the raider’s improvement of the corporation (by refusing to sell their shares) unless the corporate charter or law includes exclusionary devices able to deal with this free-riding problem\textsuperscript{13}. In addition, takeovers involve not just the costs needed to induce reluctant shareholders but also search costs, bidding costs and other transaction costs (Williamson, 1970) that make takeovers in practice a very expensive solution. Therefore, in the presence of this monitoring mechanism alone, managers are free to

\textsuperscript{10}It is in this sense that one may call it a general disciplining mechanism.

\textsuperscript{11} See Bittlingmayer (2000) for a recent survey.

\textsuperscript{12} For a survey of possible explanations for mergers and acquisitions see Weston, Kwang and Hoag (1990).

\textsuperscript{13} Grossman and Hart (1980) point out that a takeover bidder may have to pay part of the expected benefits of improved performance under his management to target shareholders to motivate them to accept the offer.
deviate from an optimal performance as long as they don’t cause the firm price to
decline more than the costs of a takeover. Moreover, in recent years the adoption of
defensive tactics, corporate charter amendments or even anti-takeover legislation have
further increased the costs and risks of takeovers, notably in the US\textsuperscript{14}.

Also, takeover corrections of managerial failure have the disadvantage that they are
\textit{ex-post} corrections, whereas other mechanisms may be \textit{ex-ante} or "deterring"
disciplining devices. As such, when disciplining takeovers occur, it is usually too late
to avoid the huge direct and indirect costs associated with the effects of past sub-
optimal managerial actions. Thus, in this sense one can argue that the takeover \textit{threat}
is a more efficient mechanism than the takeover itself\textsuperscript{15}, although the credibility of
that threat may require the observation of some hostile takeover activity in the market.

Consistent with the view that takeovers are a source of managerial discipline, Martin
and McConnell (1991) find evidence of increased management turnover after
successful takeovers, and more frequent turnover when acquired companies
previously underperformed their industry. Shivdasani (1993) shows results consistent
with the view that hostile takeovers provide discipline when internal governance
mechanisms such as the board of directors fail to control management’s non value-
maximising behaviour. Also, Mikkelson and Partch (1997) document that the
decrease in takeover activity in the US from 1984-88 to 1989-93 was accompanied by
a reduction in disciplinary pressure on managers. They show that the relation between

\textsuperscript{14} Shleifer and Vishny (1997) observe that “the takeover solution practised in the United States and the
United Kingdom, then, is a very imperfect and politically vulnerable method of concentrating
ownership (p. 757)”.

\textsuperscript{15} One should note that the eventual observation of only a small number of disciplining takeovers taking
place in the marketplace does not by itself prove that the takeover threat mechanism is absent or
management turnover and performance is significant only during the period where the takeover market was more active.

In most of Continental Europe, with the exception of the UK, hostile takeovers are, however, rare. Franks and Mayer (1994) attribute this fact to the particular structure of most European capital markets, characterised by a small number of listed companies and a relatively high concentration of ownership as compared to the US and UK.

In their analysis of UK takeovers, Franks and Harris (1989) report shareholder wealth impacts of takeovers similar to those observed in the US. Kennedy and Limmack (1996) analyse the performance of takeover targets in the pre-takeover period and its relationship with subsequent CEO turnover and find evidence consistent with takeovers acting in the UK as disciplinary mechanisms on managers. They observe that CEO turnover tends to increase following takeovers, and that target firms that do replace CEOs after takeovers (“disciplinary takeovers”) experience lower returns before takeover than other targets. In contrast, Franks and Mayer (1996) reject the hypothesis that in the UK hostile takeovers perform a disciplining function. They assert that the apparent rejection of hostile bids by target management seems to be derived not from managerial entrenchment but from opposition to post-takeover redeployment of assets or renegotiation over bid terms. In another UK study, Sudarsanam, Holl and Salami (1996) present the result that a better previous relative performance of bidder over target (measured by their relative market-to-book ratio) is a significantly positive influence on target’s abnormal returns surrounding a takeover inefficient. The same absence of those transactions would occur if the takeover threat were a perfect controlling mechanism which forced all managers to behave in a value-maximising way.
bid announcement but a negative one bidder’s returns. This result is not strictly in accordance with a disciplinary perspective of takeovers where value enhancements would be expected to occur for both targets and bidders. Sudarsanam, Holl and Salami (1996) interpret their evidence, instead, as consistent with Roll’s (1986) hypothesis that bidder managers may suffer from “hubris” that leads them to overestimate the benefits of a takeover and pay excessive takeover premia. The UK evidence on the disciplinary role of takeovers thus appears to be, in contrast to US studies, inconclusive.

4.2 Product-market competition

Hart (1983) presents a formal model where managerial slack is lower under competition than when the manager’s firm is a single non-profit maximising monopolistic firm. This suggests that the level of competition in product and factor markets may also act as a general constraint on the manager’s non-wealth maximisation behaviour. However, as Jensen (1986) observes, “product and factor market disciplinary forces are often weaker in new activities and activities that involve substantial economic rents or quasi-rents (p. 323)”. Jensen (1986) concludes that in these cases alternative monitoring mechanisms would become more relevant.

Similarly, Shleifer and Vishny (1997), although recognising that product market competition may be a powerful force toward economic efficiency, are “sceptical that it alone can solve the problem of corporate governance (p. 738)”.

4.3 Managerial labour market and mutual monitoring by managers
Fama (1980) argues that "each manager has a stake in the performance of the managers above and below him and, as a consequence, undertakes some amount of monitoring in both directions (p. 293)". This is related to the view that the managerial labour market may use the performance of the firm to determine each manager’s opportunity wage. Additionally, each manager may sense that her marginal product is likely to be a positive function of the efficiency of managers not just below but also above her. Managers are then reckoned to perceive a gain in stepping over inefficient managers located above. Fama (1980) thus reckons that the existence of a managerial labour market is a key factor influencing the level of mutual monitoring by managers. Alongside this indirect influence, Fama (1980) sees this market as exercising a direct pressure on the firm to sort and compensate managers according to their performance in order to prevent the best managers from leaving and keep the firm’s attractiveness to potentially highly performing managers.

Consistent with the monitoring role of the board of directors, Coughlan and Schmidt (1985) present evidence that poor performance increases the likelihood of top management turnover and that corporate boards managerial compensation decisions are related to the firm’s performance.

In accordance with Fama’s (1980) assertion that the managerial labour market uses information on past performance to set wages and define alternative job opportunities for executives, Gilson (1989) analyses the subsequent careers of executives resigning from firms that experienced financial distress. He finds that these executives hold around one-third fewer seats on the boards of other companies. Also, Kaplan and Reishus (1990) report evidence consistent with top executives of dividend-reducing
firms being 50% less likely to receive additional directorships than executives of non dividend-reducing companies. Cannella, Fraser and Lee (1995) report similar results in their study of the careers of executives of failing Texan banks. In addition, they find that the labour market distinguishes between managers who lose their prior positions for reasons beyond their control and those that were directly involved in the institution’s failure. They report that managers associated with banks that fail for reasons arguably beyond the managers’ control are twice more likely to regain comparable banking posts than managers at other failed banks.

However, the effectiveness of mutual monitoring by managers has been questioned. As Hansen and Torregrosa (1992) observe, "imprecise measurement of manager efforts (due to bad judgement, moral hazard or poor information) and managerial entrenchment limit the effectiveness of the internal assessment mechanism (p. 1539)". Fama (1980) concedes that, at board level, top management may engage in collusive arrangements, which might result in the expropriation of security holders’ wealth. Consistent with these assertions, Warner, Watts and Wruck (1988) present evidence of inefficient internal assessment mechanisms over top management. They report that only when unfavourable firm performance is extreme do internal mechanisms seem to lead to management changes and, even so, the response to bad performance doesn’t seem to come without a considerable time lag. Also, Mace (1986) and Lorsh and MacIver (1989) find that CEOs tend to dominate the nomination process of new board members.

4.4 Security analysts
Jensen and Meckling (1976) suggest that security analysts, employed by investment bankers, brokerage houses and large institutional investors, play a monitoring role that affects the opportunities available to managers to capture excessive pecuniary and non-pecuniary benefits from the owners of the corporation. This is because of Jensen and Meckling’s (1976) argument that monitoring activities should “become specialised to those institutions and individuals who possess comparative advantages in these activities (p. 127-128)”. Given that manager’s decisions are closely monitored and publicised by these financial analysts, their activities conceivably help to discipline managers. Thus, in the absence of such monitoring, managers will be more likely to engage in non-value maximising activities, all else constant.

Not all public firms, however, are subject to this potential monitoring force. Typically, firms followed by financial analysts tend to be those that are larger and whose shares are more liquid and dispersed. Thus, firms that do not meet these conditions may have to rely on alternative monitoring mechanisms (either internal or external).

Also, Lin and McNichols (1998) present results suggesting that underwriting relationships may hamper the potential monitoring role of financial analysts. They find that lead and co-underwriter analysts’ forecasts are significantly more favourable than those made by unaffiliated analysts although their earnings forecasts are not generally greater.

Moyer, Chatfield and Sisneros (1989) find evidence consistent with a monitoring role by financial analysts. They document that the level of analysts monitoring activities
(proxied by the number of analysts following each firm) is related (after controlling for size and other variables) not just to the informational demands of investors but also to agency related variables. Additionally, Chung and Jo (1996) present evidence that the intensity of analysts’ activities has a positive impact on the market value of firms, after controlling for risk, size, R&D, advertising expenditures and profitability. They attribute this to a reduction of agency costs effect, although they observe that the supply of security analysts’ activities is also partly determined by the marketing considerations of brokerage firms.

In the UK, Marston (1997) provides an analysis of the determinants of the number of analysts following a firm, although she doesn’t specifically address the agency hypothesis that analysts are a source of monitoring. Her results, however, are partly consistent with the monitoring role of financial analysts as she finds that the number of analysts is negatively associated with insider holdings\(^\text{16}\). Nonetheless, this could also be interpreted as being the result of the demand for analysts’ services being a function of the importance of external shareholdings.

4.5 The legal environment

Another external factor that can influence corporate governance is the legal environment. This may manifest itself in several ways. One is in the form of legislation that directly affects the efficiency, or the cost, of one or more monitoring devices. For instance, in the US many States have passed legislation designed to avoid

\(^{16}\text{See section 5.3 for the reasons why this result can be seen as consistent with an agency explanation.}\)
or increase the costs of hostile takeovers\textsuperscript{17}. This causes a severe impact on the existence of the takeover device as a general mechanism to control managerial actions within these States. Another example is the existence of legal rules giving a particular importance to dividend policy as a potential instrument for dealing with potential equity agency problems. This is the case with Brazil, Chile, Colombia, Greece and Venezuela, countries where companies face mandatory dividend rules.

In other nations, the role of the legal environment can be somewhat more subtle. In the UK, this has taken the form of a number of committees that set up recommendations destined to improve corporate governance practices at the board of directors’ level. These have been materialised in the Cadbury (1992), Greenbury (1995) and Hampel (1998) Reports. Recommendations emanating from these reports have been adopted by the London Stock Exchange in the form of an official requirement for listed companies to state the extent of their compliance with these recommendations, although the rules formulated by these committees have not been made directly compulsory\textsuperscript{18}.

An important insight on the consequences of this kind of state-originated recommendations has been given by Dahya, McConnel and Travlos (2002), who analyse the relationship between CEO turnover and corporate performance before and after the publication of the Cadbury (1992) Code in the UK. They find that after the issuance of the Code, the negative relationship between CEO turnover and performance becomes much stronger, with the increase in sensitivity between these

\textsuperscript{17} See Roe (1993) and Bittlingmayer (2000) for a perspective of the recent history of US antitakeover legislation.
two variables being concentrated among adopters of Cadbury’s (1992) recommendations.

Another important area of the legal environment, which also may influence corporate governance devices, is that concerned with the protection of minority shareholders. Laporta, Lopez-de-Silanes, Shleifer and Vishny (1997) find that the existence and efficiency\textsuperscript{19} of legal rules protecting investors are a major determinant of the development of local capital markets\textsuperscript{20}. If the extent of the corporate governance problem is conceivably a deterrent to external capital raising, this can be interpreted as suggesting that the quality of the legal system of investor protection is a major determinant on the ability of firms and investors to set up appropriate corporate governance structures.

Some other aspects of the general legal environment may also lead to consequences for corporate governance. For instance, the UK Company Law defines a mandatory rights issue requirement (pre-emptive rights) for equity issues\textsuperscript{21} that can be waived in general terms by means of a special resolution approved annually by shareholders\textsuperscript{22}. As Franks, Mayer and Renneboog (1998) observe, this requirement affects the relative costs of alternative forms of corporate control, providing investors in the UK

\textsuperscript{18} For arguments in favour of this UK approach, as opposed to the imposition of statutory rules, see Hart (1995).

\textsuperscript{19} Viewed in terms of the nature and quality of the rules and their enforcement.

\textsuperscript{20} Consistent with this, Laporta, Lopez-de-Silanes, Shleifer and Vishny (1999) document that, in a sample of 27 wealthy economies, widely held firms are more frequently observed when there is a high level of shareholder protection by the legal system.

\textsuperscript{21} See section 89(1) of the Companies Act 1985.

\textsuperscript{22} In practice, the Investment Committee of the Association of British Insurers and the National Association of Pension Funds recommend their institutional shareholders members to approve a resolution for an annual disapplication of pre-emptive rights provided that it is restricted to an amount of shares that does not exceed 5% of the issued ordinary share capital as shown in the last published annual accounts.
with the power to impose control changes as part of the condition of the provision of new finance. In the US, although similar rights issues requirements are allowed to be included in companies’ articles of association, they are not compulsory and seldom exist in practice. This in effect may be in part responsible for the different governance structures observable in these countries23.

Also consistent with the perspective that the legal environment has a significant impact on the structure of corporate governance is Black and Coffee’s (1994) comparative study of the legal structures in the US and the UK surrounding institutional investors’ behaviour. They observe that the regulation of each type of institutional investor is a partial determinant of institutional investors’ willingness to be involved in monitoring managerial actions. They also point out that another potentially important factor influencing institutional shareholders’ activism is the existence of legal barriers to institutional coalition formation. Similarly, Black (1998) suggests that some legal rules, namely the 13D filing requirement with the SEC for groups of shareholders acting together on a voting issue, are a plausible partial explanation for the general lack of shareholder activism by American institutional investors.

4.6 The role of reputation

Fama (1980) takes the view that even when a manager’s compensation contract has no link whatsoever with shareholder wealth, still the manager may act so as to maximise shareholder welfare as a result of the desire to protect her reputation in the

23 See also Miller (1998) for a comparison between US and UK corporate governance structures.
labour market.

Holmstrom (1982), however, presents a model where concerns with reputation are not sufficient to drive agency costs to zero. Holmstrom and Costa (1986) go even further as they suggest that managers’ career concerns may actually lead them to behave against shareholders’ interests.

Also, as Garvey and Swan (1994) observe, “a related weakness with the reputational story is that it must assume that hiring decisions are always made in the interests of shareholders. Reputation-induced distortions are far greater if an executive believes her future employers will be Berle-Means firms that are more interested in how much her talent will contribute to the utility of incumbent managers rather than their shareholders (p 145)”24.

Additionally, the different horizon problem between shareholders and managers (see section 2.2) can substantially reduce the potential importance of reputation considerations. Consistent with this, Gibbons and Murphy (1992) find evidence of misalignment of interests between managers and shareholders when managers approach the end of their careers.

4.7 Conclusions

The preceding sections looked at several external mechanisms that can act as disciplining vehicles on managers, encouraging their alignment of interests with

24 This reasoning assumes, however, that external governance mechanisms are inefficient.
The first of these is the takeover mechanism. Although this is frequently regarded as a highly important disciplining device, it was observed that the free riding problem and other takeover costs might limit its efficiency, giving managers some degree of freedom to deviate from a value-maximising behaviour. Moreover, in most European countries, the specific structure of capital markets and the nature of corporation’s ownership mean that this device is in practice a rarely observed one (with the exception of the UK). Although the US evidence on this managerial monitoring device is generally consistent with its importance in disciplining managers and with substitution effects with other disciplining devices, the empirical record in the UK does not unequivocally favour the disciplining hypothesis over alternative explanations for hostile takeover activity.

In addition, it was noted that the legal environment could directly affect the efficiency of disciplining devices. This has been particularly the case with hostile takeovers in the US, although some other legal experiments (like some recent ones in the UK) are aimed at improving corporate governance practices at the firm level.

Some evidence exists that financial analysts can be an important source of monitoring, although this role may be mixed with that of providing information to market participants. In many firms, however, their lack of market visibility (namely due to a small size or little share dispersion) can diminish the importance of such monitoring by financial analysts, thus making other disciplining mechanisms potentially more relevant.
Other general managerial controlling devices that were addressed included product-market competition, managerial reputation, the labour market for managers and mutual monitoring by managers. Although basis for these mechanisms is an intuitive one, there is, however, some consensus that these mechanisms are limited in practice and usually are important only in some extreme circumstances. For instance, mutual monitoring can become important only in extremely negative company performance, or product market competition when markets become exceedingly competitive that no value-reducing strategies are allowed, etc. Under more normal circumstances, several factors make these mechanisms have important limitations in solving the corporate governance problem. Such factors include the domination, by the CEO, of appointments to the board, managerial collusion, the possibility of managerial entrenchment (in its several forms – see section 6), conflicts of interest (e.g., those affecting the monitoring role of analysts), and less than perfectly competitive markets.

One is therefore led to the conclusion that, possibly in addition to the external disciplining mechanisms analysed above, it is reasonable to infer that corporations must rely on other devices adopted (or somehow present) at the firm level, i.e., internal disciplining mechanisms. At least some of these could be rightly characterised into the Jensen and Meckling (1976) category of bonding mechanisms. These internal disciplining devices will be the subject of the following sections.

5 Internal disciplining mechanisms

5.1 Large and institutional shareholders
Large shareholders and institutional investors (Demsetz, 1983, Demsetz and Lehn, 1985, Shleifer and Vishny, 1986) can be seen as potential controllers of equity agency problems as their increased shareholdings can give them a stronger incentive to monitor firm performance and managerial behaviour. This potentially helps to circumvent the free rider-problem associated with ownership dispersion. Another potential benefit relates to the potential challenge that large shareholders offer to outside raiders, thus increasing the takeover premium (Burkart, 1995).

Consistent with these benefits, Mikkelson and Ruback (1985) and Holderness and Sheehan (1985) report positive abnormal returns around the announcement of outsiders’ acquisition of large equity positions. In the UK, Sudarsanam (1996) looks at the relation between block acquisitions and subsequent takeover attempts for the target companies and reports that large block acquisitions (between 5% and 30% of the target’s shares) not just lead to significant abnormal returns surrounding its announcement but also influence the likelihood of takeover bids, hostile bids and the success of bids. However, Holderness and Sheehan (1988) cannot find significant changes in performance between a sample of firms in which a single shareholder owned 50% or more of the shares and another where the ownership just exceeded 20%. McConnell and Servaes (1990), on the other hand, find a significantly positive association between Q and the percentage of shares held by institutional investors, but not when block ownership enters the regression as an independent variable.

Several other studies find results suggesting that large shareholders play a role in corporate governance. For instance, Shivdasani (1993) reports that the presence of large blockholders significantly increases the probability that a firm will be taken
over. Also, Denis and Serrano (1996) look at unsuccessful control contests and document that management turnover following these is concentrated among poorly performing firms where outside blockholders acquire a stake in the company. They also report that in the absence of such blockholders, managers tend to retain their positions in spite of poor pre-contest performance and the use of value-destroying defence tactics during the control contest. In contrast, Pound (1988) reports that in proxy contests the probability that management will prevail increases with institutional ownership. Possible explanations for this are that institutional investors may have other profitable business relationships with the firm or may perceive some other reciprocal benefits from co-operation.

The notion that large blockholders help to align the interests of shareholders and managers is not uncontested. In this regard, Shleifer and Vishny (1997) observe that large shareholders may have incentives to pursue their own interests at the expense of other outside shareholders. Demsetz and Lehn (1985) suggest that another possible cost is that blockholders might forgo some risk diversification gains due to their large exposure to a company. Holmstrom and Tirole (1993) argue that large shareholdings may inhibit the production of information in the market. Burkart (1995) suggests that aggressive counter-bidding by incumbent blockholders may actually reduce the likelihood of takeover attempts. Burkart, Gromb and Panunzi (1997) present a model where there is a trade-off between the benefits and costs of the presence of large shareholders. The costs involved are associated with an ex-ante expropriation threat that reduces managerial initiative. The level of ownership concentration is then an outcome of a trade-off between these factors.
But even if large blockholders are *a priori* willing to perform a monitoring role, several institutional and other constraints may act as inhibiting forces to their activism. Black (1998) points out that legal rules, agency costs within the institutions, information costs, competition (e.g., between mutual funds), collective action problems and limited institutional competence are some of the partial explanations for the alleged lack of activism by American institutional investors. Consistent with this view, Wahal (1996) finds no evidence that pension fund activism can compensate for an active market for corporate control.

Mallin (1997) presents evidence that UK institutions are less active than their US counterparts as they report that their voting levels are markedly below those observed in the US. Black and Coffee (1994) provide a general description of the legal and institutional environment facing most large shareholders in the UK. They suggest that institutional activism is mostly crisis-driven, institutions are usually reluctant to be involved in proxy fights, and usually prefer informal, behind-the-scenes interventions to formal coalitions. However, they note that the existence of pre-emptive rights for new issues embedded in UK’s Company Law provides institutional shareholders with an important source of leverage over managers. In contrast with Mallin (1997), Black and Coffee (1994) conclude that UK institutions are more involved in corporate governance than their US counterparts (partly due to fewer regulatory controls). They note, however, that UK institutional activism still faces several constraints. These include the costs related to the formation and maintenance of coalitions, little incentives for money managers to invest in monitoring, conflicts of interest within the

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25 See Roe (1994) for an analysis of the legal restrictions in the US on ownership and control by financial institutions. Coffee (1991) contends that the primary reason for institutional investors’ lack of activism in the US is not overregulation but insufficient incentives for money managers to engage in monitoring.
same institutional entity (e.g. between its pension fund and merchant banking activities) and insider-trading or control-person liability worries.

In spite of the constraints facing blockholders (especially institutional investors), Carleton, Nelson and Weisbach (1998) argue that the increasing size of financial institutions (usually the most important blockholders) in the most recent decades is an important factor encouraging large investors’ greater activism. They argue that a larger stake in a company can encourage potential institutional monitors to deviate from the more traditional “Wall-Street” or “vote-with-the-feet” rules, whereby institutions prefer to sell their stock than to engage in active monitoring. Consistent with this, they find evidence of significant influence of a large institution (TIAA-CREF) on corporate governance issues through private negotiations. Similarly, Smith (1996) also finds evidence of relevant monitoring activism by a large institutional investor (CalPERS). Finally, Brickley, Lease and Smith (1994) document increasing institutional activism in proxy fights and point out that recent changes in SEC rules facilitate the formation of coalitions among investors.

Mallin (1997) observes significant activism by some of the largest UK institutional investors (Postel, Prudential and Standard Life) and reports significantly larger voting levels by UK’s twenty largest institutional investors than by all institutional investors. She also finds that the largest voting levels can be found in insurance companies, pension funds and unit trusts.

Brickley, Lease and Smith (1988) find that opposition by institutional shareholders to
antitakeover amendments is greatest when proposals reduce stockholders’ wealth. McConnell and Servaes (1990) find evidence that the fraction of shares owned by institutions is positively associated with performance (measured by Tobin Q) and that institutional ownership reinforces the positive impact of insider ownership on performance. In the UK, Short and Keasey (1997) observe no independent effect of institutional ownership on performance, but find evidence of a positive interaction between insider and institutional ownership in the determination of firm performance. All these studies interpret the above evidence as consistent with the assertion that institutions exert a monitoring role over managers.

5.2 Board of directors

Fama and Jensen (1983) characterise the responsibilities of the board of directors as being both the ratification of management decisions and the monitoring of management performance. This means that the likelihood of managerial collusion (Fama, 1980) may be reduced by the presence of outside directors, who may thus be regarded as another potential source of corporate monitoring (Winter, 1977, Fama, 1980 and Weisbach, 1988). These are ideally regarded as professional referees who have the task of overseeing the competition between top managers and are disciplined themselves by an external labour market which judges and prices their services according to their performance as referees. Critics of the efficiency of this monitoring mechanism point out that managers inherently dominate the board by choosing outside directors and providing the information they analyse (Mace, 1986). The question is thus ultimately an empirical one.

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26 See also Hirshman (1970) for a framework describing institution’s “exit” and “voice” options and
Against the hypothesis that board composition is a relevant source of monitoring, Bhagat and Black (1997) find no evidence that the proportion of outside directors affects future firm performance. This is, however, a notably weak test for the hypothesis that board composition is a source of corporate monitoring given that, following, for instance, Demsetz (1983), different monitoring mechanisms may be used in an optimal way, in which case no relation between these and performance would be observed.

Consistent, however, with the importance of external directors as monitors, Weisbach (1988) documents that CEOs of poorly performing firms are more likely to be replaced if the firm has a majority of outside directors. However, Dahya, Lonie and Power (1998) show that the probability of removal of a senior executive from office is negatively associated with his equity stake.

Similarly, Borokhovich, Parrino and Trapani (1996) find a positive relation between the percentage of outside directors and the likelihood that an outsider is appointed as CEO.

Also consistent with the monitoring importance of outside directors, Rosenstein and Wyatt (1990) report abnormal increases in firm value after the appointment of additional outside directors. Also, Hermalin and Weisbach (1988) find that following a period of weak performance, firms tend to increase the number of appointments of outside directors relative to insiders.

Brickley, Coles and Terry (1994) document a positive stock price reaction to the
adoption of poison pills when boards are dominated by outside directors, and a
negative one when outside directors are a minority. Byrd and Hickman (1992) show
that the share market response to bidding companies that announce tender offers is
more favourable when boards include independent directors.

Cotter, Shivadsani and Zenner (1997) analyse the role of target firm’s independent
outside directors during takeover attempts. They find that boards with a majority of
independent directors are more likely to use resistance strategies that enhance
shareholders’ wealth.

In the UK, Vafeas and Theodorou (1998) find no significant association between
performance and board structure. However, Dahya, McConnel and Travlos (2002)
point out that the increase in sensitivity of CEO turnover to performance which they
observe for companies complying with the Cadbury (1992) code can be traced to the
presence of more external directors in the board of those companies, precisely one of
Cadbury’s (1992) major recommendations. Their results are therefore consistent with
an increase in board monitoring activity in those firms, but they provide no evidence
on whether such increase in sensitivity of turnover to performance is subsequently
followed by better performance in those firms.

5.3 Insider ownership

One rather intuitive way by which equity agency costs can be reduced is by increasing
the level of managers’ stock ownership, which may permit a better alignment of their
interests with those of shareholders. In fact, in the extreme case where the manager’s
share ownership is 100%, equity agency costs are reduced to zero (Jensen and
Meckling, 1976). As managerial ownership increases, managers bear a large fraction of the costs of shirking, perquisite consumption and other value-destroying actions. Further, larger share ownership by managers reduces the problem of different horizons between shareholders and managers if share prices adjust rapidly to changes in firm’s intrinsic value.

A limitation, however, of this mechanism as a tool for reducing agency costs is that managers may not be willing to increase their ownership of the firm because of constraints on their personal wealth. Additionally, personal risk aversion also limits the extension of this monitoring device as the allocation of a large portion of the manager’s wealth to a single firm is likely to translate into a badly diversified portfolio (Beck and Zorn, 1982).

Management buyouts, whereby insiders increase dramatically their shareholdings in the firm, provide a natural field study for the effects of insider ownership in the reduction of conflicts between owners and managers. In accordance with the proposition that larger managerial ownership reduce agency costs, Kaplan (1989) finds that following large management buyouts, firms experience significant improvements in operating performance. He interprets this evidence as suggesting that operating changes were due to improved management incentives instead of layoffs or managerial exploitation of shareholders through inside information. Smith (1990) reports similar results and notes that the amelioration observed in operating performance is not due to reductions in discretionary expenditures such as research and development, advertising, maintenance or property, plant and equipment.
In a study of the effects of changes in ownership structure on performance for a sample of thrift institutions that converted from mutual to stock ownership, Cole and Mehran (1998) find that changes in performance are significantly associated with changes in insider ownership. They document that the greater the increase in insider ownership, the greater the performance improvement, which is consistent with the alignment of interests hypothesis arising from a larger insider ownership. Also consistent with that hypothesis, Subrahmanyam, Rangan and Rosenstein (1997) find evidence, in a sample of successful bidders in bank acquisitions, of a positive association between bidder returns and the level of insider ownership when the latter exceeds 6%.

Research by Morck, Shleifer and Vishny (1988), McConnell and Servaes (1990) and Hermalin and Weisbach (1991) is also consistent with the view that insider ownership can be an effective tool in reducing agency costs, although they report a non-monotonic relation. This functional form has been related to the observation that, within a certain ownership range, managers may use their equity position to entrench themselves against any disciplining attempts from other monitoring mechanisms (see section 6).

However, some other studies find no evidence of a positive relationship between insider ownership and performance (see, for instance, Demsetz and Lehn, 1985, Loderer and Sheehan, 1989, Holderness and Sheehan, 1988, Denis and Denis, 1994, and Loderer and Martin, 1997). Moreover, the studies that find a positive relationship typically present results that have very low explanatory power ($R^2$'s usually between 2% and 6%).
A possible explanation for these mixed results is that many of the studies do not properly distinguish the possibility of alignment of interests across a certain range of ownership values and of entrenchment over another range (see section 6). Furthermore, these analyses usually do not take into account the possibility that several different mechanisms for alignment of interests can be used simultaneously, with substitution effects with insider ownership. It is quite conceivable that different firms may use different mixes of corporate governance devices (Rediker and Seth, 1995). These different mixes can, however, all be optimal as a result of varying marginal costs and benefits of the several monitoring instruments available for each firm. If so, then one would not be able to observe a relationship between performance and any of these particular mechanisms.

5.4 Compensation packages

A different type of monitoring vehicle is related to the potential links between managerial compensation and firm performance. In theory, a strong relation between compensation and firm performance would enable a better alignment of interests between shareholders and managers (Jensen and Murphy, 1990). Relevant elements of the compensation package typically include stock related rewards, deferred cash compensation and dividend policy-dependent compensation.

Evidence of such a significant link is, however, not strong. Lewellen, Loderer and Martin (1987), for example, find evidence in support of the hypothesis that compensation packages are designed to reduce agency costs. However, a comprehensive analysis of CEO pay in the US by Jensen and Murphy (1990)
concludes that most compensation contracts are characterised by a general absence of real management incentives and that observed compensation patterns are inconsistent with the implications of formal agency models of optimal contracting. Similarly, Yermack (1995) reports that observed stock options performance incentives have no significant association with explanatory variables related to agency costs reduction. In the UK, Gregg, Machin and Szymansky (1993) reach similar conclusions as they find a very weak relation between pay and performance for the period 1983-88 and no relation after that. They observe however, a strong association between pay and asset growth.

Jensen and Murphy (1990) and Shleifer and Vishny (1997) argue that the empirically observed lack of sensitivity of pay to performance is caused by legal and political external factors common to many countries. In addition, Haubrich (1994) shows that it may not be optimal to include a large sensitivity of pay to performance in managers’ compensation contracts as this would require a large risk tolerance from the part of managers, which is not an efficient incentive system for more risk-averse managers.

Furthermore, Yermack (1997) documents that managers can time stock options to their advantage as he finds that stock options are granted just before the announcement of good news and tend to be delayed until after bad announcements.

Shleifer and Vishny (1997) view the overall evidence on the relationship between pay and performance as suggesting that it is “problematic to argue that incentive contracts completely solve the agency problem (p. 745)”.
5.5 Debt policy

Debt was rationalised by Jensen and Meckling (1976) as a vehicle for reducing agency problems in several ways. One is that using more debt reduces total equity financing and the need for external equity to be issued in the first place by the initial owner-manager, thus diminishing the scope of the manager-shareholder conflict. In other words, the issue of debt instead of equity facilitates an increase in managerial ownership and therefore a greater alignment of interests between managers and shareholders.

Additionally, debt can represent a bonding commitment by the manager to pay out cash-flows to debtholders thus helping to overcome the free cash-flow problem (Jensen, 1986). Stulz (1988) shows that leverage limits management discretion and hence reduces the agency costs of managerial non-value maximisation behaviour.

Also, increased debt imposes on management a higher threat of bankruptcy as a penalty for defaulting on debt interest or principal repayments. This threat brings potentially serious consequences for management, as a result of potential loss of reputation or dismissal, and is therefore likely to encourage efficiency.

On the other hand, debt frequently possesses a tax advantage as corporations receive tax deductions from interest payments made to debtholders27. Another potential

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27 However, Miller (1977) derives a model where, in equilibrium, there is no optimal debt-to-equity ratio associated with the potential tax benefits of interest on debt, so that the value of each firm is independent from its capital structure. Miller (1977) shows that the equilibrium level of debt is, instead, determined for the corporate sector as a whole, and no single firm can influence that level. This result contradicts previous conclusions by Modigliani and Miller (1963) that recognise the value-relevance of
benefit of debt is related to Myers and Majluf’s (1984) argument that debt may reduce information asymmetry problems about firm value associated with equity financing.

However, leverage also brings its own agency problems arising from conflicts of interest between shareholders and debtholders. Such conflicts include those which result from the incentive for equityholders to invest suboptimally either by investing in high-risk assets or underinvesting in new profitable projects (Myers, 1977). Debt is therefore the source of what is called debt agency costs. Jensen and Meckling (1976) characterise debt agency costs as consisting of (i) the opportunity wealth loss caused by the impact of debt on the investment decisions of the firm, (ii) monitoring and bonding expenditures by debtholders and the firm, and (iii) bankruptcy and reorganisation costs. Debtholders compensate themselves for these agency costs by charging higher interest rates, thus increasing the cost of debt. Titman and Wessels (1988) and Smith and Watts (1992) report extensive evidence consistent with significant debt agency costs.

Besides creating its own agency costs, debt can reduce a firm’s resilience because interest payments are inflexible and this inflexibility may lead to suboptimal managerial risk taking. The cost and use of debt as a managerial monitoring mechanism are likely to vary among firms according to size, level of tangible assets that may be collateralised, firm reputation, business risk, and ownership structure. For many firms, especially those with volatile profits or few tangible assets, maintaining a significant level of debt may be very impractical, and moderate levels of debt may not translate into a sufficient bonding commitment to discipline managers. In addition, debt’s interest tax shields, but is in accordance with previous results by Modigliani and Miller (1958) that did ignore these.
debtholders frequently may be reluctant to exercise their right to file for their debtor’s bankruptcy and may prefer out of the court reorganisations, especially if they have high financial stakes at risk (Ghoshen, 1995). This may also compromise the bonding commitment of debt.

Thus, in terms of its managerial disciplining role, debt can perhaps best be seen as setting a minimum performance requirement on management, above which managers may deviate from optimality with some degree of impunity. This means that debt can assume the role of an important disciplining mechanism only if the threshold for managers is high enough and the associated bankruptcy risk is perceived as sufficiently important or credible. In addition, these equity agency cost reduction benefits (along with tax advantages) have to be balanced against debt agency and other, non-agency, costs referred above. Thus, notwithstanding the importance of debt in many contexts, it may be optimal for a particular firm to rely less on debt and more on alternative monitoring mechanisms.

Harris and Raviv (1991) provide a survey on the theory and empirical evidence of the use of debt to mitigate equity agency costs. They conclude that, in general, the evidence is supportive of the proposition that debt can reduce equity agency costs. Megginson (1997) reaches similar conclusions. McConnell and Servaes (1995) present results consistent with Stulz’s (1990) hypothesis that, because of its influence on corporate investment decisions, debt may have a positive or a negative effect on firm value. They document that the latter effect dominates the former one in firms with many profitable growth opportunities. This is in general agreement with the use of debt to reduce agency costs being variant across firms and dependent on company-
specific characteristics.

In accordance with the proposition that debt plays a role in dealing with equity agency costs, Garvey and Hanka (1999) document that firms that become protected by state antitakeover laws substantially reduce their usage of debt, while those without such protection do the opposite. Similarly, Safieddine and Titman (1999) present results consistent with the use of debt being positively associated with an alignment of interests between shareholders and managers as they report that targets of failed takeovers that subsequently increased their leverage ratios tend to experience significantly better performance than those that do not.

5.6 Dividend policy

Easterbrook (1984) and Jensen (1986), among others, provide the rationale for a monitoring role of dividends. According to Easterbrook (1984), dividends may control equity agency problems by facilitating primary capital market monitoring of the firm’s activities and performance. The reason is that higher dividend payouts increase the likelihood that the firm will have to sell common stock in primary capital markets. This in turn leads to an investigation of management by investment banks, securities exchanges and capital suppliers. Studies by Smith (1986), Hansen and Torregrosa (1992) and Jain and Kini (1999) have recognised the importance of monitoring by investment bankers in new equity issues. Recent theoretical work by Fluck (1998), and Myers (2000) also presents agency-theoretic models of dividend behaviour where managers pay dividends in order to avoid disciplining action by
shareholders. In Myers’ (2000) model, outside equity only works if sufficient dividends are paid.

Additionally, Jensen (1986) sees expected, continuing dividend payments as helping to dissipate cash which might otherwise have been wasted in non-value maximising projects, therefore reducing the extent of overinvestment by managers.

In Rozeff’s (1982) model, an optimal dividend policy is the outcome of a trade-off between equity agency costs and transaction costs. Consistent with such trade-off model, Rozeff reports evidence of a strong relationship between dividend payouts and a set of variables proxying for agency and transaction costs in a large sample composed of one thousand US firms for the period 1974 to 1980.

A cross-sectional analysis of dividend policy by Crutchley and Hansen (1989) also shows results consistent with dividend policy acting as a corporate monitoring vehicle and with substitution effects between dividend payments and two other control mechanisms, managerial ownership and leverage.

Also in accordance with an agency view of dividends, Farinha (2003) shows that dividend payouts in the UK have a U-shaped relationship with ownership by insiders with a critical turning point close to 30% of insider ownership. This agrees with the notion that up to a critical entrenchment level dividends and insider ownership are substitute vehicles for aligning the interests of managers and shareholders, but after such level increasing ownership by managers will create further, entrenchment-related agency problems that induce the need for larger dividend payouts as a compensating
factor. Such result is particularly interesting since the prediction of a non-linear relationship between insider ownership and dividends is unique to the agency perspective, unlike most other results reported in the literature on dividend policy which are usually also in accordance with competing signalling or tax-based stories.

Broadly speaking, there is a rising degree of consensus that dividend policy as a role to play in managerial monitoring. Megginson (1997) refers to this under the terms that “the agency costs-contracting model of dividends represents the mainstream of current economic thought”.

5.7 Conclusions

The sections above suggested that several internal governance mechanisms are available for firms to reduce equity agency problems. It was noted that large shareholders can be an important potential monitoring device as large stakes can compensate for the free riding problem associated with small shareholders’ lack of motivation for engaging in monitoring. However, large institutions’ disciplining actions might be severely limited in practice because of, among other factors, legal constraints, internal agency problems, conflicts of interest, and competition between institutions. The empirical record is, nonetheless, usually consistent with large shareholders being associated with an increased probability of takeover, larger management turnover and better performance, although some mixed results have emerged. Monitoring actions also seem to be more intense with some particularly large US and UK institutional investors. The level of activism can be dependent, however, on the type of institution as a result of the specific legal and other constraints
facing each category, with some studies suggesting that insurers, pension funds and
unit trusts can be the most active institutions. Other evidence also suggests the
possibility of positive interactions between insider and institutional ownership in the
determination of performance.

The board of directors has also been analysed as a potential device for controlling
equity agency problems. Some evidence has been reported which is consistent with
the value relevance of the appointment of outside directors and also with the
importance of outsiders in the context of the adoption of takeover defences and
acquisitions. The evidence on the effect of outside directors on firm performance is,
however, mixed calling for more research on the effect of this potential corporate
monitoring device on firm performance. However, there are some recent encouraging
results like those of Dahya, McConnel and Travlos (2002) pointing out that the
emergence of Cadbury (1992) -type sets of state-backed recommendations may have
important consequences on the quality of corporate governance at the board level.

Another important managerial monitoring vehicle that has been the subject of
numerous studies is that of insider ownership. Consistent with such a role, many
studies are supportive of insider ownership being an important determinant of
performance and positively affecting the likelihood of better acquisitions. Some other
studies find, however, no evidence of links between insider ownership and
performance. These mixed results can be attributed to the possibility of managerial
entrenchment, and similarly to problems that can be encountered in the analysis of
other single monitoring mechanisms, to the possibility that firms can rely on a bundle
of disciplining devices (that can be either substitute or complementary ones).
Compensation packages have also been addressed in the literature given that potential links between pay and performance can help align the interests of managers and shareholders, although a strong link can in theory be non-optimal because of managers’ risk aversion. The evidence, however, suggest that the sensitivity of pay to performance is typically a poor one and that asset size is a much more significant determinant of compensation. In addition, managers seem to time the granting of stock options to their advantage.

Finally, debt and dividend policies have also been seen as additional potential internal devices to reduce equity agency costs. Although some evidence suggests that debt fulfils that role, the usage of debt for such purpose can be limited in practice for several reasons. These are that debt can create its own agency problems, increase the threat of bankruptcy, reduce firm’s resilience and be constrained by, among other factors, the level of tangible assets, business risk, and firm reputation. In contrast, a growing consensus exists regarding a managerial monitoring role for dividend policy where recent empirical results have been taking away the focus from signalling or tax-based as the main explanations for corporate dividends.

A general conclusion that emerges from the analysis of these potential instruments is that each cannot be universally adopted by any firm in the same manner. This is essentially because these devices have limitations, marginal costs and marginal benefits that, most likely, are not identical across firms (or industries). As a result, one might expect that firms would rather rely on mixes of such monitoring mechanisms, and interactions among these are also a strong possibility that should not be ruled out.
6 Managerial entrenchment

6.1 The entrenchment hypothesis

Since Berle and Means (1932) and, more recently, Jensen and Meckling (1976), it is widely agreed that when managers hold little equity and shareholders are too dispersed to take action against non-value maximisation behaviour, agency problems arise. With little or no holdings in the firm, insiders may deploy corporate assets to obtain personal benefits, such as shirking, perquisite consumption and the pursuit of wealth-reducing investments (see section 3). Thus, as insider ownership increases, agency costs may be reduced since managers bear a larger share of these costs.

However, as Demsetz (1983) and Fama and Jensen (1983), among others, point out, managers holding a substantial portion of a firm’s equity may have enough voting power to ensure that their position inside the company is secure. As a result, they may become to a great extent insulated from external disciplining forces such as the takeover threat or the managerial labour market. Berger, Ofek and Yermack (1997) define entrenchment as “the extent to which managers fail to experience discipline from the full range of corporate governance and control mechanisms (p. 1411)”.

Along these lines, Stulz (1988) presents a model where high ownership by managers and the associated large voting power leads to managers being more likely to become entrenched in their positions inside the firm. This means that moderately high levels of stock ownership can aggravate, not diminish, conflicts between shareholders and managers. This entrenchment can effectively preclude the possibility of a takeover,
but also may imply diminished monitoring effectiveness of the other external disciplining devices (like product and factor markets) and the various internal governance mechanisms.

Shleifer and Vishny (1989) also develop a model whereby managers are able to entrench themselves by making manager-specific investments that increase their value to shareholders. A consequence of these investments is that managers can reduce the likelihood of replacement and are able to extract higher salaries and larger perquisites from shareholders, as well as getting more discretion in determining corporate strategy.

6.2 Evidence on managerial entrenchment

Consistent with the entrenchment hypothesis, Weston (1979) reports that firms where insiders held more than 30% have never been acquired in hostile takeovers. Also, Morck, Shleifer and Vishny (1988) and McConnell and Servaes (1990) find non-monotonic relationships between insider ownership and firm performance in accordance with a managerial entrenchment view.

Morck, Shleifer and Vishny (1988) estimate a piecewise linear regression where the dependent variable is Tobin Q and the primary explanatory variable is insider ownership. They find that Tobin Q first rises from 0% to 5% of insider ownership, then falls as insider ownership increases to 25%, then rises again slightly at higher ownership stakes. Morck, Shleifer and Vishny (1988) interpret these findings as consistent with an alignment of interests when insider ownership increases from 0% to 5% and with an entrenchment hypothesis when ownership increases beyond the 5%
threshold. At larger insider ownership levels then interest alignment becomes once
again important.

McConnell and Servaes (1990) expand Morck, Shleifer and Vishny’s (1988) results
by regressing Tobin Q against various measures of ownership which account for the
stakes in the firm held not just by insiders but also individual atomistic shareholders,
blockholders and institutional investors. Using a quadratic specification for insider
ownership, McConnell and Servaes (1990) find an inverse U-shaped relationship
between Tobin Q and insider ownership where Q is maximised at a 37.6% level of
insider ownership in 1976 and 49.4% in 1986.

Hermalin and Weisbach (1991) model the relation between performance, board
composition and insider ownership, allowing for the endogenous determination of
insider ownership and board composition. Their results are generally consistent with
those of Morck, Shleifer and Vishny (1988) and McConnell and Servaes (1990). In
the UK, Short and Keasey (1999) also find evidence in accordance with entrenchment
when analysing the relationship between performance (measured by an approximation
to Tobin Q or return on equity) and insider ownership. They document a positive
association at low levels of ownership, followed by a negative relation (roughly
between 10% and 40% insider ownership), and then a positive one again at higher
levels of insider holdings. This is consistent with an alignment of interests between
insiders and shareholders being dominant at the lowest and highest levels of insider
ownership, while entrenchment effects become preponderant in the middle range.

Denis, Denis and Sarin (1997b) model the probability of top management turnover as
a function of ownership structure. Consistent with managerial entrenchment, they find that the likelihood of top management turnover is significantly greater in poorly performing firms with low managerial ownership than in poorly performing firms with higher managerial ownership. They conclude that larger equity ownership by managers insulates them from internal monitoring efforts. Consistent with this, Dahya, Lonie and Power (1998) find UK evidence that forced departures of CEOs tend to occur only when the top manager has less than 1% of the firm’s capital and that, as the level of ownership increases, managers become increasingly entrenched in their positions.

In the context of capital structure policy, Berger, Ofek and Yermack (1997) note that managers may have a preference for lower than optimal debt so as to reduce firm risk and protect their personal, under-diversified, firm-related, wealth (Fama, 1980) or to avoid disgorging free cash flows (Jensen, 1986). On the other hand, managers may wish to increase debt so as to inflate their voting power and reduce the likelihood of takeovers. In their empirical analysis, Berger, Ofek and Yermack (1997) document that leverage decisions are related to the level of entrenchment by managers, and that, in general, entrenched managers try to avoid debt. They observe that leverage tends to be lower when the CEO has a longer tenure, low stock and compensation incentives and has little monitoring from the board of directors or major shareholders. To test if the observed relationships are causal ones, Berger, Ofek and Yermack (1997) look at the aftermath of entrenchment-reducing events and report that leverage tends, as expected, to increase after those events.

Consistent with managerial entrenchment (but also with signalling), Vafeas (1997)
finds support for the argument that stock repurchases serve to entrench managers by increasing the percentage of managerial ownership. He finds evidence that firms are more likely to use self-tender offers when pre-buyback insider ownership is high and when the post-buyback ownership shift is greatest.

Also in accordance with a managerial entrenchment hypothesis, Peasnell, Pope and Young (2003), using UK data, find that the relationship between managerial ownership and the percentage of outsiders on the board of directors is U-shaped. They estimate that the turning point of that relationship (or entrenchment level) is around 40% but that the U-shaped association is mainly confined to larger firms.

McNabb and Martin (1998), on the other hand, examine the efficiency of internal governance mechanisms in the case of highly entrenched managers (the founder CEOs). They find that the existence of such entrenchment is a deterrent to an improvement in performance and that shareholders typically receive substantial wealth gains when the founder leaves both the firm and the board.

Another potential instrument for managerial entrenchment is that of Employee Stock Ownership Plans (ESOPs), through which managers can have voting rights without the corresponding cash-flow rights.

Consistent with the use of ESOPs by management as an entrenchment tool, Gordon and Pound (1990) find that ESOPs established during takeover activity reduce share values by an average of approximately 4%. They also report that ESOPs reduce share values if they are structured to transfer control away from outside shareholders by
creating a new ownership block with veto power over takeover bids. However, when ESOPs are established with nonvoting stock, so as to preclude any immediate control transfers, the consequence is a significant increase in share values.

Chang and Mayers (1992) also examine the value impact of ESOP announcements and observe that shareholders benefit the most when insiders initially control between 10% and 20% of the outstanding votes. When, however, directors and officers control 40% or more of the outstanding shares, a negative association is found between announcement abnormal returns and the fraction of shares contributed to the ESOP. The incremental benefits are thus small (but positive) for low ownership levels and negative for high levels of insider control. These results are, like those of Gordon and Pound (1989), consistent with the usage of ESOPs by insiders for entrenchment purposes when these have already substantial voting rights. In a sample of thrift institutions converting from mutual to stock ownership, Cole and Mehran (1998) find that improvements in performance are negatively associated with changes in ownership by ESOPs, “consistent with the view that ESOPs are often used to impede takeovers (p. 293)”.

A different potential tool for entrenchment is that of dual-class recapitalisations. These are plans that restructure the equity of a firm into two types of shares with different voting rights. Similar to the use of ESOPs, dual-class shares provide management (or family owners) with a voting power that is disproportionately greater than that under a “one-share, one vote” rule.

In theory, dual-class recapitalisations can be beneficial if these allow management to
extract a higher bid in a takeover (the optimal contracting hypothesis), or harmful if these insulate managers from the external market for corporate control (the management entrenchment hypothesis). Therefore, once again, the issue is an empirical one. In this regard, the evidence is mixed. Partch (1987) reports non-negative price effects around the announcement of dual-class recapitalisations for 44 firms. Moyer, Rao and Sisneros (1992) look at changes in firms and external monitoring forces following dual-class recapitalisations. They document that alternative monitoring mechanisms do emerge following such events and conclude that dual-class recapitalisations are undertaken with the purpose of increasing managerial efficiency and protecting shareholders from undervalued takeover bids. In contrast, Jarrel and Poulson (1988b) find significant negative effects for companies that create dual-class shares and take the view that these actions increase managers’ ability to insulate themselves from the discipline of hostile takeovers. Bacon, Cornett and Davidson, III (1997) analyse the characteristics of the board of directors of firms announcing dual-class recapitalisations but find no clear evidence in support of either the management-entrenchment or the optimal-contracting hypotheses. They concede, however, that “some firms in the sample may be pursuing shareholder-wealth maximisation, while others may be pursuing management entrenchment (p. 20)”. They show that some of the characteristics that may be associated with these different objectives are the level of insider ownership (which impacts positively on abnormal returns at the announcement), the tenure of the insiders on the board (with a negative influence) and the existence of staggered board elections (with a positive impact).

Other potentially entrenching actions that have been analysed in the literature include several other anti-takeover devices such as
- supermajority amendments (through which a large majority of votes is required to approve mergers or other important transactions, or a “fair” price for such transactions);

- poison pills (a legal device usually triggered in the event of a hostile takeover bid which provides target shareholders with the right to buy or sell company shares at very attractive prices, thus increasing the cost of a takeover);

- greenmail (or targeted block stock repurchases), by which the management of the target firm ends an hostile takeover threat by repurchasing at a premium the stock held by the bidder (or potential bidder); and

- white knight intervention, whereby management calls upon a friendly investor to intervene in a takeover battle by entering a new bid in the contest.

The evidence on the effects of such defensive actions is usually consistent with significant negative impacts on the share prices of firms undertaking them (see Jensen and Ruback, 1983, and Jarrell, Brickley and Netter, 1988, for surveys of this literature).

6.3 Conclusions

Managerial entrenchment was defined as a situation where managers experience some degree of insulation from disciplining mechanisms. Several situations giving rise to managerial entrenchment were analysed, which included high levels of insider ownership, manager-specific investments, ESOPs, dual class share recapitalisations and several anti-takeover devices.
The empirical evidence surveyed is consistent with several observations, all of which consistent with the relevance of managerial entrenchment. One is that above a certain level of ownership, increased managerial holdings on a firm can have a negative impact on performance. Others are that high managerial ownership is associated with a lower probability of management turnover, lower levels of debt and a larger percentage of outsiders on the board (in large firms). Also, turnover by founders leads to positive abnormal returns.

Also consistent with the hypothesis of managerial entrenchment is the evidence on the creation of ESOPs, dual class recapitalisations and anti-takeover mechanisms. Typically, in situations where the creation of these devices is particularly prone to cause entrenchment, there is usually an adverse impact on stock prices.

A consequence of these results is that an analysis of the impact of the adoption of any of the management disciplining mechanisms described in the precedent sections must necessarily take into consideration the possible existence of entrenchment effects. This entrenchment can be caused by a number of potential devices, the most important of which being probably the control of voting rights, either directly through their personal holdings, or indirectly through dual class-shares and other stakes where voting rights are disproportionate to cash-flow rights. This is because the presence of entrenchment can neutralise or alter the marginal impact or one or several monitoring mechanisms and thus potentially lead to wrong inferences about the individual properties of these disciplining devices. Also, given the close links between the notion of equity agency problems and the issue of managerial entrenchment, the managerial entrenchment hypothesis offers an important basis for testing the agency explanation
for the cross-sectional variation of a particular potential managerial monitoring device.

7 The link between corporate governance and firm value

Following the renewed media interest in corporate governance after major accounting scandals and large-scale corporate failures, there has been a growing interest in creating corporate governance indices28 and finding an empirical link between these and firm value. On this last issue, Gompers, Ichii and Metrick (2003) find a significant association between a corporate governance index built from 24 provisions and stock returns. They reckon that an investment strategy where investors buy firms with the highest ranks in such index would yield substantial abnormal returns of 8.5%. They also observe that firms with weaker governance measures have generally lower accounting-based performance measures, lower Tobin Qs, and are engaged more actively in acquisitions and capital investments. Along the same lines, Black (2001), using a small sample of Russian firms, finds a similar relation as he observes that a change in corporate governance scores from the lowest to the highest rank significantly increases firm market value.

This particular research is of course still in its early stages. Apart from the problems in defining consensual measures of firm performance (and indeed also of corporate governance indexes) and correctly controlling for all non-corporate governance related factors, which most certainly will underline future research in this, a problem

28 Some recent attempts to produce commercial providers of corporate governance indices include those of Standard & Poor’s Corporate Governance Scores and Governance Metrics International. Attempts, however, have also taken place in the not-for-profit sector like the joint launching of the Japan Corporate Governance Index Research Group by the Universities of Tokyo and Hitotsubashi.
to be solved lies on the possibility of inverse causality. Specifically, one may argue that performance may drive to a certain extent a stronger compliance with corporate governance provisions. Therefore, similar to the analysis of the determination of the set of corporate governance devices for a particular firm, once again we may find that a correct specification of the corporate governance problem in the context of performance analysis may have to take endogeneity in consideration.

8 Summary and conclusions

This paper analysed the concept of corporate governance, the theoretical reasons for the corporate governance problem and the evidence on the existence of unsolved agency problems in corporations. Some major conclusions were that residual agency costs (Jensen and Meckling, 1976) are significant and that mechanisms for controlling the dimension of these agency costs are available and include external and internal disciplining devices. It was observed that due to important theoretical and practical limitations, external disciplining devices including takeover threat, the managerial labour market, mutual monitoring by managers, reputation, competition in product-factor markets and financial analysts cannot alone solve the corporate governance problem, although they may be important in some particular circumstances. Firms therefore have to adopt complementary internal disciplining devices in order to minimise their total agency costs. These internal devices include the composition of the board of directors, insider ownership, large shareholders, compensation packages and financial policies (dividends and debt). It was also observed that these monitoring devices may carry benefits but also costs, and are not unlimited in their effectiveness at reducing agency costs. Moreover, their marginal benefits and costs are likely to
vary across firms or industries, making it likely that firms may choose different mixes of monitoring mechanisms according to their own specific characteristics. Finally, it was noted that managers can, to some degree, insulate themselves from many of these monitoring mechanisms by controlling voting rights (with or without proportionate cash-flow rights), manager-specific investments or antitakeover devices. This possibility should be taken into consideration (alongside the notion that firms are likely to adopt bundles of management controlling mechanisms) when modelling the analysis of a particular monitoring device or interactions between different disciplining mechanisms. In accordance with this, an increasing number of studies have been recognising the simultaneous (or interactive) nature of many of the corporate governance mechanisms, suggesting that single-handed interventions on a particular mechanism may not be feasible or effective. Along the same lines, a promising area for future research is the link between the corporate governance characteristics of firms and performance. After some encouraging exploratory results, many empirical issues will have to be addressed before one can draw strong conclusions, in particular the question of the potential endogeneity of both the corporate governance characteristics of firms and their performance.
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