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Introduction: Recent Developments in Corporate Governance

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1. PURPOSE AND AUDIENCE

Recently, policymakers have taken a keen interest in the economic function of corporate governance systems. The impact of globalization and the recent finance-driven troubles in East Asia and elsewhere have spurred this drive toward policies and institutions that address defects in corporate performance and propose comprehensive reforms said to foster higher firm productivity, more entrepreneurship, and better developed capital markets. In the corporate world today there is a lively debate about how to design an effective corporate governance system that promotes economic efficiency. Initially, policymakers and scholars answered this question by measuring the quality of governance in terms of an idealized set of legal rules. In this regard, a high quality corporate governance system would refer to a set of institutions and mechanisms that ensure: (1) management pursues the welfare of shareholders; (2) the corporate board is staffed primarily by non-executive directors; and (3) corporate law rules protect minority investors and minimize controlling shareholder diversions of private benefits of control (Fox and Heller 2000). This suggests that differences in legal rules will correspond closely to different levels of economic performance. Meanwhile, a new direction in research has opened up which embraces a broader perspective on corporate governance: competition and non-legal techniques are seen as important mechanisms for controlling incentive problems and maximizing the returns to investors (Zingales 1998; Allen and Gale 2000).

The focus on the link between corporate structures and economic growth has prompted considerable comparative empirical work on the institutional differences in ownership structures and legal rules (Carlin and Mayer, Chapter 14, this volume). Until recently, much of the work on comparative corporate governance assumed that the Berle and Means corporation, characterized by a separation of ownership and control, was the model traditionally associated with large enterprises. Contemporary research, however, shows that the Berle and Means model of the corporation is largely limited to Japan, the United States, and Britain (Becht and Mayer 2001). Broadly speaking, there are two systems of corporate ownership and control: market and control-based systems (Cheffins, Chapter 6, this volume). The new comparative research on corporate governance focused initially on the differences between the two dominant regimes (Berglöf 1997). The analytical approach

attempts to incorporate the main aspects of the two corporate governance systems that offer competing approaches to deal with the fundamental agency problems of capitalism. The main corporate governance problem in most western countries is a trade-off between ownership and liquidity. Moreover, to a large extent, the trade-off between liquidity and control suggests that we focus also on another fundamental trade-off: between monitoring and management initiative (Coffee 1999). On the normative side, the continental European system of control focuses on the effect of shareholders on management whereas the market model places more emphasis on monitoring of management and incentives. The strengths and shortcomings of the market-oriented and control-oriented regimes are assessed in terms of their ability to protect shareholders against expropriation and limit managerial agency costs (Bratton and McCahery, Chapter 2, this volume).

Meantime, the debate about the comparative merits of governance regimes has focused on the crucial role of legal rules and institutions that are required to provide a country with a deep, broad, and liquid stock market (along with dispersed ownership). Creating a strong capital market is viewed as especially important for Europe's blockholding countries since it can facilitate economic growth by providing a more efficient way for companies to raise capital (Maher and Andersson, Chapter 17, this volume). It is notable that many continental European firms, which are controlled through extensive cross-ownership and holding structures, tend to have limited access to capital markets due to inadequate disclosure and must rely on internal financing or short-term bank loans (Edwards and Nibler 2001). As a consequence, a large section of European business has been forced, until recently, to suffer higher costs of capital which may account for their performance in relation to foreign firms.

To address this problem, proponents argue that rapid reforms are required in national governance structures to create an environment that would stimulate greater managerial reliance on external finance and a smooth transition to shareholder-oriented acts (Hansmann and Kraakman, Chapter 3, this volume). It has been suggested that European policymakers are changing their securities rules to realize the untapped potential for economic development that may lead to functional convergence (Coffee, Chapter 4, this volume). Yet, changing securities rules alone may not be sufficient to encourage a different pattern in ownership and governance of national institutions (Roe, Chapter 5, this volume). An open question is what explains the material differences in corporate governance systems. Roe (Chapter 5, this volume) argues that the differences in corporate governance regimes are the result of political and social choices about distribution and the resolution of conflict. Others argue that corporate governance systems are shaped by economic and political factors that can lead, in different countries, to either the elimination of systemic differences or resistance to domestic improvements (Bebchuk and Roe 1999). Consequently, path dependence makes structural convergence a highly unlikely prospect.

The aim of the collection then is to provide a framework for readers who are interested in thinking through the key legal and economic issues about the extent that corporate governance systems play a central role in the economic performance of the firm. The issues underlying these questions can also be understood in the context of a parallel debate about the convergence of corporate governance institutions and practices. This volume also explores claims respecting the relative competitive advantage of a governance system, the appropriate course of national level reform, and the circumstances under which the diverse

systems of governance and securities regulation can be expected to converge systematically. These points raise the issue of whether nations undertaking reforms should develop corporate governance policies that mimic the legal rules and institutions of a dispersed ownership regime (Easterbrook and Fischel 1991; Whincop 2001). Or, conversely, should states avoid borrowing from other systems' best practices and pursue a course of internally designed governance reforms.

The thrust of these concerns can also be seen in terms of the debate about whether shareholder pressure is the most important mechanism influencing corporate decisions. This view of corporate governance has been challenged as too narrow (Allen and Gale 2000). Broadly speaking, the question about the institutional structure and mechanisms that are conducive to economic growth can be seen as a debate between those who claim that corporate law should seek only to maximize shareholder value and provide for optimal legal protection of investors and those who would argue that the effectiveness of market-oriented governance rules are mixed and that regulation should promote benefits for some of the other stakeholders (Deakin 2001). From a comparative perspective, it has been argued that there are other mechanisms that help solve the agency problems and enhance economic growth.

2. ISSUE COVERAGE

This volume is divided into seven parts. Part I, broadly speaking, provides not only a means for assessing the key features of market and control-based systems of governance but a standpoint for determining whether national governance systems are likely to converge to an optimal system of governance. Part II introduces the reader to the building blocks of European corporate law and the impact of the European Union (EU) and its harmonization of corporate and securities regulation. Part III examines the complex ownership structures that are found in Western Europe and investigates the consequences that large shareholdings may have for corporate governance. Part IV offers some preliminary analysis aimed at determining the relationship between legal and financial systems and corporate performance. Part V looks at the economic perspectives on the operation of the market for corporate control. After taking stock of the evidence on the effect of the market for corporate control, this section then analyses the key legal rules and institutions of the bankruptcy regimes in the USA and Britain. The authors in this section explore the effect of different legal rules on commercial activity, and introduce procedures that may avoid the practical difficulties associated with a structural bargaining regime. Part VI is devoted to the importance of institutional investors in corporate governance. In the light of their substantial role in corporate governance systems in the USA and Britain, the papers in this section focus on the debate on shareholder proposals, the reform of the voting procedures for institutional investors in Britain, and the performance of companies in which occupational pension funds hold large share stakes. The final section, Part VII, examines the executive compensation arrangements in the USA and Britain as well as in continental Europe (the Netherlands and Spain). These chapters supply a pool of current research on the motivational effect of performance-related remuneration and the substantial increases in top executive remuneration in the USA.

3. OVERVIEW

3.1. *Convergence in Corporate Law*

Is there a single optimal governance regime for the regulation of firms? Comparative corporate governance strives to provide empirical answers to the question about the productive advantage of governance systems. In this sense, economists and lawyers have sought to link the performance of companies to different patterns of distribution of shareholdings in a country and the quality of a country's corporate governance practices.

In the opening chapter, William Bratton and Joseph McCahery take up the main questions addressed by the literature on comparative corporate governance: whether national governance systems can be expected to converge in the near future, and whether the focal point of that convergence will be a new, hybrid governance system comprised of the best practices drawn from different systems. This chapter advances the view that neither global convergence that eliminates systemic difference nor the emergence of a hybrid best practice can safely be projected because each national government regime is an integrated system. Each system, rather than consisting of a loose collection of separable components, is tied together by a complex incentive structure. Interdependencies between each system's components and the incentives of its actors create significant barriers to cross-reference to and from other systems. The cross-reference hypothesis, in contrast, presupposes divisible corporate governance institutions—a world in which one system's components can be adapted for use in the other system.

Drawing on the key models of monitoring and blockholding, articulated in the incomplete contracts theory of the firm, Bratton and McCahery argue that different governance systems have incentive structures that entail different trade-offs—trade-offs between ownership concentration and liquidity, between monitoring and management initiative, and between private rent-seeking and activity benefiting shareholders as a group. The trade-offs delimit opportunities for productive cross reference. More particularly, blockholding systems, such as those in Europe, subsidize monitoring by permitting blockholders to reap private benefits through self-dealing and insider trading. Market systems, such as those in the USA and Britain, regulate such private rent-seeking toward the end of maintaining an institutional framework that supports diffuse share ownership and liquid trading markets. It follows that a legal framework conducive to blockholding may be ill equipped to foster dispersed equity ownership and liquid trading markets, and that a legal framework conducive to liquid trading markets may have properties that discourage blockholding. This gives rise to questions for law reform agendas on both sides of the Atlantic. In the USA, proponents ask for deregulation of controls on institutional investors, looking to encourage more blockholding and more effective monitoring. In Europe, proponents ask for stronger securities regulation, looking to encourage deeper trading markets. This suggests that each reform programme may lead to disappointing results because neither assures conforming adjustments to the pertinent actors' incentives. Alternatively, strict reforms that materially change prevailing incentive patterns could perversely destabilize workable (if imperfect) arrangements without assuring the appearance of more effective alternatives.

Henry Hansmann and Reinier Kraakman argue in Chapter 3 that powerful new forces—ideological and competitive—are pushing corporate structures toward convergence. What does it mean to say that there is convergence in corporate law? In analysing corporate law systems worldwide, this chapter shows that there is significant normative consensus among policymakers and academics on the fundamental issues of corporate governance. To the extent that the shareholder-oriented model of corporate governance is viewed as desirable, this consensus on the appropriate conduct of corporate law is also a consensus about the content of corporate law rules, which in turn should have a strong effect on the further development of corporate law.

While the shareholder-oriented model is the leading corporate governance regime, Hansmann and Kraakman acknowledge, nevertheless, that there are considerable obstacles to the evolution of efficient ownership structures, governance practices, and corporate law. Several scholars have begun to spell out with some precision the forces inhibiting the convergence of corporate structures (Bebchuk and Roe 1999; Milhaupt 1998). In some jurisdictions, large blockholders or powerful managers, with positional advantage inside the firm, will oppose effectively any corporate governance reforms that would force them to share the corporate earnings more equitably. Moreover, corporate structures will tend not to converge for path-dependent reasons. Despite the ability of these groups to influence corporate structure and governance, Hansmann and Kraakman argue that the prospects are decidedly less pessimistic if we resist the idea that the law will deter a controlling shareholder from adopting an efficient corporate law regime by making them share their private benefits and other gains with minority investors. Yet, there is a good likelihood that the law will allow the controlling shareholder to capture the gains associated with efficient restructuring in jurisdictions where incumbent structures support expropriation by insiders. On the whole, corporate practices are likely to converge more rapidly than convergence in legal rules. Shareholder pressure has forced legal changes in the direction of a single tier board, enhanced disclosure systems and accounting standards, and shareholder suits against directors and managers. A key point which Hansmann and Kraakman emphasize is that, while important steps toward convergence have taken place in many jurisdictions, convergence of legal rules does not always reflect efficiency.

In Chapter 4, John Coffee focuses on the debate over convergence in corporate governance, particularly the strong convergence thesis, which predicts that product and capital market competition will compel convergence, and the path dependence thesis that identifies powerful forces and interests impeding governance structures from converging. There is another position, however, that explains convergence of legal systems. Coffee argues that functional substitutes can provide a framework for convergence when formal convergence is blocked by legal, political, or institutional barriers. For example, he notes that firms whose home country has a weak securities market can seek a US or UK listing in order to access the benefits associated with the depth and liquidity of these trading markets. At the same time, European exchanges have, in order to increase their scale to compete globally, adopted tighter governance rules as a result of competitive pressures. The foregoing examples are but a small list of confirming examples that demonstrate the importance of functional substitutes.

In this essay, Coffee expands on the concept of functional convergence to show that self-regulation, as opposed to mandatory rules, may be a way to overcome the barriers to the emergence of a strong securities market. There are many studies that show that stock market development and liquidity are not likely to appear in a jurisdiction in which there are large concentrations of ownership. He stresses that while securities markets require strong legal protections for minority investors, the cause and effect relationship is backwards. He notes, having analysed the early development of the New York and London Stock Exchanges, that dispersed shareholders must arise initially before they can organize politically to gain legal protection. Coffee's central thesis is that legal change, which can be effectively constrained by interest groups, is often outpaced by economic change. Finally, Coffee casts doubt on Mark Roe's hypothesis that social democracy and strong securities markets are unlikely to coexist in Europe. According to Roe's thesis, continental European investors prefer concentrated ownership and limited transparency because it offers them protection against potential government expropriation of their corporate assets. The empirical accuracy of this claim has been challenged by Brian Cheffins (Chapter 6, this volume) who argues that England provides an example where a social democracy exists alongside a strong securities market. Coffee suggests, moreover, that the reason for the slow development of European securities markets is due to the dominance of the banks and their political allies that benefited from the persistence of a bank-dominated system of financing.

Mark Roe argues in Chapter 5 that there is evidence that in social democratic countries the norms and institutions supporting shareholder wealth maximization are relatively weak. He stresses that social democracies press managers to stabilize employment, to forgo some profit-maximizing risks with the firm, and to deplete existing capital rather than downsize the firm when markets are no longer aligned with a firm's production capacity. In practice, labour markets in continental Europe and Japan have tended to be protected, and the development of Anglo-American style instruments to discipline managers and reduce agency costs has been slow in taking root. Roe reasons that these labour market regularities and different corporate governance norms have an effect on the ownership structure of firms. Accordingly, the concentration of ownership is more common in large firms in continental Europe and Japan than it is in the USA. Roe notes a correlation between, on the one hand, closely-owned businesses and social democracies and, on the other hand, diffusely-owned firms and capitalist countries. Roe maintains that the origins of these differences may be due to a craving for stability, differences in fairness norms, and a difference in reconciliation of political and social conflicts. Evidence on the different political systems and economic performance does not emerge clearly from the empirical studies. Yet evidence on the positive effects of social democracy shows that it may enhance total social welfare, although with fewer public firms than less socially-responsive nations.

In terms of answering his critics, Roe acknowledges that there are other foundations, besides politics, for why nations develop strong securities markets and dispersed shareholding and others do not. Not only must nations achieve a requisite level of economic and technological development, but also the presence of legal rules and institutions are indeed necessary to the development of a securities market. Viewed in this light, it is unlikely that the political hypothesis can be undermined by monocausal counter-examples that focus on

one salient political feature (e.g. pro-labour social democracy) in a nation. On the contrary, the counter-examples that have emerged, according to Roe, do not seem particularly challenging and, in turn, tend to reinforce the political theory.

Brian Cheffins provides a critique of the 'law matters' thesis in Chapter 6. The key assumption of the 'law matters' hypothesis is that a number of legal rules and regulatory institutions are required to provide a country with a deep, broad and liquid stock market, and dispersed share ownership. This work emphasizes the centrality of laws that provide investors with good information about the value of a company and protect them from the self-dealing transactions of the company's insiders. There is evidence that, to the extent that a country undertakes to initiate legal and institutional reforms along these dimensions, a country can expect to enhance the development of its stock market. For instance, support for the 'law matters' thesis can be derived from the work of Rafael La Porta and his collaborators (1998; 1999), which shows that legal factors are fundamental for the growth rates of firms in many jurisdictions. As a consequence, because so much evidence is emerging about the benefits of good corporate governance and disclosure for strong stock markets, countries worldwide attempt to ameliorate the deficiencies of their existing regimes by introducing governance arrangements designed to counter insider trading, share price manipulation, and other abuses.

The importance of the 'law matters' view is that it highlights the importance of showing the causal explanations of poor corporate governance and the implications these structures have for shareholders, corporate finances, and the economy. Nevertheless, Cheffins argues that the 'law matters' approach has yet to fulfil its promise. The critical thrust of the chapter is to attack the 'law matters' thesis by showing that a liquid and deep securities market can prosper without the assistance of strong legal rules that protect minority investors. Cheffins shows that there is a clear analytical link in the theory. The British experience appears to counter the suggestion that good legal protections are crucial for the development of a strong stock market. Apparently, investor protection was not a fundamental norm in UK law until recently. If there was no legal support for investors, then there must have been support from other institutions to ensure that investors would not be exposed unduly to moral hazard and other agency problems. There were two distinct and powerful reasons why British investors would have felt comfortable investing in securities between 1900 and 1979. First, in its capacity as regulator of share offerings, the London Stock Market played an active role in British corporate governance. Second, the presence of financial intermediaries in the market reduced the concealment of information prompting investors to have greater confidence in the authority of the disclosure statements of companies.

This raises a question whether or to what extent legal rules, designed to protect minority shareholders, can be substituted by a combination of market mechanisms and non-legal rules. The 'law matters' argument is effectively challenged for either of two reasons: (1) that private market mechanisms can be implemented successfully and that investors' interests are adequately served by the existence of these enforcement mechanisms; and (2) that quite apart from whether market mechanisms existed for the protection of minority investors, self-regulation can play an effective role as a substitute for legal institutions. Thus, there is no reason to assume that a specific set of principles and structures are necessary for the emergence of deep capital markets and dispersed ownership. In the end, however, it is an

empirical question as to whether and to what extent various kinds of structures will tend to support the development of securities markets.

3.2. *Harmonization in European Law*

In Chapter 7, Klaus Hopt analyses the forces that are influencing change in the fields of corporate law across Europe, particularly in Germany and Britain. In particular, he discusses the German and European Commission (EC) law influences on the development of British corporate law and practice. He observes that, despite the differences in German and British company law, the standard of conduct for directors and the practical functioning of boards are similar in both countries. Hopt argues that an even more impressive example of convergence is takeover regulation. While he points out takeover regulation is mainly self-regulatory in Britain, the British approach has emerged as the standard for policymakers across Europe and at the EC. He shows how several principles of the City Takeover Code concerning information provision and disclosure, takeover procedures, corporate directors' conduct during the offer period, neutrality, and the mandatory bid rule, were incorporated into the now-defunct draft 13th Directive on Takeovers.

Hopt contends that, despite the overlap in some aspects of corporate law and practice, there remain fundamental differences between corporate governance mechanisms in continental Europe and in Britain. He stresses that German law varies considerably from the Anglo-American view that the aim of the corporation is the maximization of shareholder value. The wider and more open differences between British and German law as to stakeholder interest appear in the context of boardroom co-determination. In practice, labour co-determination works quite well in Germany and the Netherlands because it serves to better integrate and motive the labour force, and provides an effective technique for the board to make unpopular decisions about corporate restructuring. We can also distinguish the role played by large banks in Germany and Britain. In Germany, where there is concentrated ownership, universal banks are the source of considerable influence on corporate actions and consequently may limit the impact that equity markets have on managers. While recognizing the path-dependent differences in corporate governance systems, Hopt argues, nevertheless, that market forces are likely to prompt the harmonization of legal rules and practices across the different political and economic systems in Europe.

In Chapter 8, Theo Raaijmakers examines the structure and design of the draft 13th Directive on Takeovers in light of the Williams Act in the USA. He argues that the draft directive, which dates back to 1989, had as its main purpose: the obligation to make a mandatory bid for all the shares of a target company; equal treatment for all holders of securities; adequate information; prohibition of certain defensive tactics; and supervision of the bid at the member state level. In contrast with the 13th Directive—which was drafted as a company law directive—the Williams Act is part of federal securities law aimed primarily at regulating the procedural and disclosure process in the tender process. He observes that the function of the Williams Act is to create a level playing field. The rules tend to prevent creeping acquisitions, leaving aside corporate law issues on governance and internal affairs, as well as exit mechanisms and appraisal disputes. In contrast, the draft 13th Directive, which was designed initially to harmonize the securities law aspects of the bid process, has

to a considerable degree commingled corporate law principles and securities law disclosure standards and is limited only to takeover bids. He praises the Williams Act for its neutrality and focus on the regulation of decent behaviour and proper disclosure. Raaijmakers argues that the challenge for EC lawmakers is to promulgate federal rules on public tender offers, which could serve to stimulate the development of European-wide takeover market. In light of the recent demise of the draft 13th Directive, one thing is clear: the EC will be forced to reconceptualize its approach to the regulation of cross-border takeovers.

In Chapter 9, Eddy Wymeersch analyses developments at the level of regulation and practice to ascertain whether corporate governance patterns are converging in Europe. He agues that there are a number of factors that have brought about change in corporate governance practices across the European Union. An increase in observable competition among business groups, a changed role in the business operations and philosophy of European states, and the renewed interest for equity investment have triggered the demand for changes in corporate law practices. Wymeersch argues that the competition between securities markets has also led to improved governance standards and listings standards. We have also witnessed the proliferation of codes of conduct at the national level in the wake of sluggish pace of reform at the European level. Some of the codes have directly impacted corporate governance practices. Particularly noteworthy is that many national codes share common features.

It is important to emphasize that there has been significant convergence in the law of takeovers across Europe. Indeed, the draft 13th Directive on Takeovers would have completed the process by imposing a mandatory bide rule, investor protection and eliminating post-bid takeover defences at the European level. Less visible, Wymeersch argues that European firms are explicitly taking important legal steps to align their firm-level corporate governance to a largely shareholder-oriented standard. Notwithstanding these developments, however, the barriers to convergence in European company law are formidable, due to the persistence of concentrated ownership structures, which serves to highlight the difficulty of changing legal rules.

3.3. *Concentration of Ownership and Control in Europe*

Marc Goergen and Luc Renneboog take up the question why the corporate landscapes in Germany and Britain are so different in terms of ownership and control in Chapter 10. They provide a partial answer to this question by focusing on the evolution of control in German and UK Initial Public Offerings (IPOs). They investigate whether differences in stock exchange listing regulation, in fiscal (inheritance) law, in securities regulation (e.g. the issuance of dual class shares) or in economic factors (like corporate growth, performance, risk) can explain why relatively more companies are widely held in the UK and why control transfers take place more frequently via mergers and acquisitions in the UK. Goergen and Renneboog empirically reject some of the legal theories (like differing inheritance regulation and listing requirements) that could explain the differences in ownership structures, but find that the mandatory takeover threshold of 30 per cent in the UK imposes in many cases an upper limit of control concentration. They also find an important impact on control of the nature of the controlling shareholder. Whereas the largest shareholder

class, dominating two-thirds of the German companies with concentrated ownership are families, (domestic) companies control almost 30 per cent of the UK firms with concentrated ownership which went public six years prior.

When German and UK IPOs are risky and poorly performing, the probability of ending up with concentrated ultimate control increases. In such a case, the need for a strong shareholder with good monitoring abilities and a long-term investment horizon arises, which is brought about by mergers and acquisitions in the UK and by controlling block transfers in Germany. The probability that an IPO will evolve towards diffuse ownership increases if the founder does not own a substantial share stake at the moment of the public offering (which is more frequently the case in the UK than in Germany) and if the company experiences a high growth rate. In addition, specifically for German IPOs, the probability that the company's majority control is held by a new large shareholder augments when non-voting shares are issued at flotation and when the company experiences fast growth in turnover. The company's founders tend to maintain control in smaller, profitable companies with limited risk and limited growth. Finally, Goergen and Renneboog conclude that if one regards full takeovers in the UK as similar—in terms of control—to control changes resulting from controlling block sales (partial takeovers) in Germany, the overall picture of corporate ownership and control in the UK and Germany is less diverging than is usually ascertained.

In Chapter 11, Ekkehart Boehmer discusses data on the concentration of ownership and control of German firms. The average German firm is not only characterized by strong ownership concentration but the corporate sector also has controlling interests in itself. Boehmer focuses on the most powerful shareholders in Germany and illustrates that it is frequently difficult to ascertain which group exerts ultimate control over the shareholding firm itself. Turning to the financial services industry, Boehmer shows that the top five banks and top three insurance companies are closely related through direct ownership and voting control. Jointly, these eight firms control over 14 per cent of all listed firms. But Boehmer argues that this figure underestimates the true value under control of these shareholders. As it turns out, the large ownership links exist between the large shareholders that do not trigger legal reporting requirements.

In Chapter 12, Piet Moerland examines the corporate governance regime in the Netherlands, and evaluates the effectiveness of Structure Regime, which creates complete separation of ownership and control. The current Dutch company law was enacted in 1971. Moerland argues that the legislators, in response to a concern to increase management's accountability to a broader set of stakeholders, increased accountability to include the possibility of three boards: a supervisory board, the board of directors, and works council, each with a defined set of legal responsibilities. Moerland notes that the Stucture Regime has three variations, the most prevalent being the Full Structure Regime, legally required for Dutch companies with more than 100 employees, a legally installed works council and a book value of shareholders' equity in excess of 12 million dollars. The Full Structure Regime requires a supervisory board that takes the following powers from shareholders: establishment of annual accounts, the election of the board of directors, and the election of the supervisory board. Moreover, the supervisory board has authority over many of the main decisions made by the board of directors. Recently the Structure Regime has been seen as a weak basis for board legitimacy and oversight. There are few incentives for the

supervisory board to monitor and advise the board of directors. Moerland argues that the Structure Regime ought to be designed to create higher accountability. Strengthening shareholder (voting) power would be useful to the Dutch system of supervision.

In Chapter 13, Isabelle Dherment-Ferere and Luc Renneboog argue that the standard agency approach to corporate governance relies on a combination of internal and external devices to help overcome the incentive problem between management and shareholders. There is some evidence that when the corporate governance mechanisms have been insufficient to limit the agency problem—and management has been insulated—markets will react positively to Chief Executive Officer (CEO) departures. Indeed, Dherment-Ferere and Renneboog confirm these studies by showing that forced CEO dismissals trigger small but positive abnormal returns in listed French companies. A more detailed analysis reveals that the increase in abnormal returns is much stronger when the performance-related forced CEO departure coincides with the nomination of an external manager. The cumulative abnormal return of an internal CEO promotion in a poorly performing firm drops by almost 1 per cent on the day of the announcement. Presumably, this is because the internal manager is held (partially) responsible for past poor performance. In companies with good past performance and CEO departure, there is a price decline reflecting the loss of human capital.

In terms of assessing the forces responsible for CEO turnover, they suggest that institutional investors, banks, financial holding companies and the government—even if they are controlling blockholders—do not appear to prompt CEO departures. On the positive side, Dherment-Ferere and Renneboog did find evidence that forced turnover is facilitated if corporations hold large equity blocks, if these corporations have a large number of non-executive directors on the board and if creditors have a board representative. Finally, founding families involved in the executive management of the firm seem somehow insulated against shareholder disciplining.

3.4. *Economic Performance and Governance Structures*

In Chapter 14, Wendy Carlin and Colin Mayer focus on the important question as to whether specific corporate governance regimes, defined as the interrelation among the structure of financial systems, corporate ownership, and corporate and securities law, influence the distribution of economic activity and economic performance. Corporate governance regimes matter as they determine the returns on investment demanded by suppliers of external finance. As a consequence, policymakers in many countries diagnose weaknesses in their existing legal regimes and propose new arrangements said to foster higher firm productivity, more entrepreneurship and better-developed capital markets. Carlin and Mayer's concern is the existence of a causal connection between productivity and given financial and corporate governance structures.

Carlin and Mayer report a significant relationship between market-based systems, the development of banking systems and legal protection of investors, and the growth of equity financed and skill-intensive industries. Market-oriented financial systems and those with dispersed ownership are expected to be associated with high risk R&D type activities. In some developing countries there is a positive relation between activity in bank-dependent sectors of the economy and the bank-oriented system of the country. Carlin and Mayer

conclude that there is not necessarily a dominant financial and corporate system that is appropriate across jurisdictions, economies, or industries within an economy. There may be important trade-offs in matching systems with the industrial bases of countries and their stages of economic development and regulatory and legal policies. Financial and corporate systems need to be sensitive to these potential impacts on corporate activities. Davide Lombardo and Marco Pagano analyse how the law and its enforcement affects equilibrium equity market rates of return and the cost of capital (demand for external funds) in Chapter 15. Within a specific institutional setting and given a specific degree of international stock market segmentation, improvements in the legal system are expected to generate positive effects on equity returns, which vary across governance systems. In this chapter, Lombardo and Pagano attempt to clarify an important point about which the literature has been silent; microeconomic models of corporate finance have usually taken the opportunity cost of funds as exogenously given.

Lombardo and Pagano develop two reasons why better legal institutions influence equity rates of return and the demand for equity finance by companies. First, good laws and efficient courts curtail the private benefits of managers. Consequently, legal institutional improvement will increase the return paid to external shareholders as well as the availability of external equity finance. Second, better laws and more effective courts facilitate the contractibility of corporate relations with customers and suppliers and the enforceability of such contracts. As a result, companies are more profitable which hence raises their rate of return and the amount of external financing. Lombardo and Pagano analyse these reasons by developing two different experiments. In the first one, they reduce managerial private benefits by introducing legal limits to transactions with other companies that may dilute the income rights of minority shareholders (mergers, asset sales, etc.). In the second experiment, they reduce the legal and auditing costs that shareholders must bear to prevent managerial opportunism. Such cost reduction may for example result from the introduction of class action suits or voting by mail. The authors find that the size of these effects on the equilibrium rate of return is increasing in the degree of international segmentation of equity markets.

In Chapter 16, Enrico Perotti and Ernst-Ludwig von Thadden look at the effect of the diffusion of information in bank-dominated financing relationships, which have been found to be less transparent. In practice, bank financing may lead to a lower level of trading liquidity, which serves as a disincentive for the gathering of information by market investors. Perotti and von Thadden offer a new explanation to the quality of information gathering by banks. They acknowledge that when information may be disclosed to more than one person, it will have strategic effects in a context of imperfect competition. In this context, the authors argue that less transparent firms reveal less to competitors based on their competitive strength, which creates strategic advantages and disadvantages. They explain that when firms act on the basis of less information, their expectations are not of sufficiently fine grade. Badly run firms will not be affected but strong firms will be hurt since they will be forced to be more aggressive. Perotti and von Thadden argue that, given the lack of transparency, expected profits are lower and the volatility of profits and output are also lower. This argument supports the view that reduced volatility has the effect of increasing the return to investors who have a fixed claim on the firm. The explanation of Perotti and von Thadden is that lender-dominated firms will work hard to avoid

transparency since this would reduce the value of lenders' claims. Evidence suggests that shareholder-dominated firms, however, will prefer price information since it has an effect on profitability.

In Chapter 17, Maria Maher and Thomas Andersson consider the relation between corporate governance and economic performance. They concentrate on the standard mechanisms employed in different systems to limit governance problems and examine the cross-country evidence to determine which corporate governance instruments show a clear effect on economic growth. Most studies reveal that there is no unambiguous relation between corporate governance systems and firm performance. Nevertheless, they point out that the role of corporate governance can have a positive effect on the development of equity markets, R&D, and innovative activity, and the development of an active small and medium sized business (SME) sector. They conclude by arguing that the identification of good corporate governance practices should be based on a particularized inquiry into the specific corporate and regulatory domain.

3.5. *The Value of Corporate Control and the Reorganization of the Firm*

Chris Robinson, John Rumsey, and Alan White investigate the value of a vote in the market for corporate control in Chapter 18. The authors build on earlier research that has shown that superior voting shares tend to be worth more than restricted or non-voting shares: the premium varies widely across countries and is, for example, about 5–10 per cent in the US and even 81 per cent in Italy. This premium results from the value of control but also from a takeover premium. Non-controlling voting shareholders may share in any premium paid in a takeover while the non-voting shareholders are unlikely to do so. Thus, the two classes of equity will differ in price by the present value of the expected takeover premium. In addition, the normative message embedded in the voting rights' studies has been to show that the level of shareholder protection is related inversely to the size of the premium over the market price per share paid for a majority voting block.

The authors find that the value of a vote ranges from 3.5 to 13 per cent for samples of firms listed on the Toronto Stock Exchange. The Canadian situation allows a unique experiment because half of the non-voting shareholders of the sample firms have a takeover protection (a so-called 'coat-tail'). If a takeover offer made to the non-voting shareholders differs from the offer made to the shareholders' controlling voting rights, the non-voting shares are convertible into voting shares. By investigating samples of Canadian firms with and without takeover protection (coat-tail), the authors conclude that the takeover premium explains to a large extent the premium paid for voting rights.

In Chapter 19, Julian Franks, Colin Mayer, and Luc Renneboog argue that although hostile takeovers may be significant in board restructuring, takeovers in the UK do not seem to focus on board restructuring in poorly performing companies. Therefore, the authors investigate the disciplinary role of large shareholders and of (new) shareholders who increase voting power. In other words, the role of ownership concentration and the role of the market for partial control (the market for equity blocks of less than 30 per cent) are analysed.

Franks, Mayer, and Renneboog document an interesting observation: there is a dynamic relation between ownership, control, and performance. Where poor performance is observed,

sales of share stakes occur between different investors. Findings suggest that substantial changes in these share stakes occur in the absence of tender offers or mergers, and without a violation of the UK Takeover Code's mandatory offer rule (acquiring 30 per cent of the voting rights triggers a mandatory tender offer for all other outstanding shares). These trades in shares are associated with significant changes in boards of poorly performing companies. Consistent with the literature on free rider problems and large share stakes, concentrated ownership is associated with more active corporate governance than dispersed share ownership. However, the chapter also finds that the nature of the owner is of critical importance: corporate investors exercise more control than institutional investors and those with private benefits of control, such as directors, may impede the exercise of good governance. Managerial entrenchment is present most often in recent IPOs where director shareholdings are particularly high. There is not much evidence that the presence of non-executive directors and the separation of the role of chairman and chief executive exert a significant impact on corporate governance.

In Chapter 20, Julian Franks and Walter Torous provide a comprehensive overview of the legal insolvency regimes in the USA and UK, noting that the procedures can be classified according to the outcome that they are directed toward—liquidation or reorganization. While Chapter 7 settles the debts of the firm through liquidation, Chapter 11 provides a mechanism to reorganize a firm's debt. Having classified the respective regimes in terms of their form and function, Franks and Torous then proceed to analyse the appropriate goals of insolvency law. They note that there is substantial debate about the goals that a well-designed bankruptcy regime should pursue. Nevertheless, Franks and Torous argue that the aim of bankruptcy law should be to minimize premature and protracted liquidations, maintain pre-bankruptcy priorities, and limit the dead-weight costs of bankruptcy. In terms of evaluating the respective regimes, they emphasize that each system has its tradeoffs. For instance, the USA code encourages lengthy bargaining, has high direct and indirect costs, can lead to deviations from pre-bankruptcy priorities, and has a strong continuation bias. Conversely, the studies show that the UK insolvency procedures are designed to minimize costs, which can increase the size of repayment to the creditors. They conclude that UK law is not fully effective since minority creditors are not fully protected and weak companies often find it impossible to resolve their financial difficulties under the current insolvency regime.

Ulrich Hege and Pierre Mella-Barral explore the relationship between creditor structure and reorganization law in Chapter 21. The restructuring advantage of bank loans is contrasted with the cost advantage of going public. Specifically, they show how, due to incomplete information and hold-out incentives, the informal reorganization process will frequently fail for dispersed public debt. Typically, the introduction of Chapter 11-style renegotiation will benefit public debt firms and will be harmful for private debt firms. Hege and Mella-Barral argue that, in light of the recent US experience, the Chapter 11 reorganization procedure reduces the role of private debt in corporate borrowing. From an efficiency perspective, the fundamental features of US reorganization law are ambiguous. It is, however, argued that the three prominent shortcomings of Chapter 11 (its cost and delay, equity deviations and inefficient continuation) are shown to do little harm or to be even welfare improving as they increase the incentives for parties to renegotiate out-of-court and

to choose private debt. Hege and Mella-Barral conclude that the cost of a low-cost reorganization procedure is likely to be positive in a market-based financial system.

In Chapter 22, Lucian Bebchuk introduces the idea of employing options in corporate bankruptcy, a proposal that he puts forward to reduce the severity of the creditor bargaining problems described in Chapter 11. Bebchuk's view is that corporate insolvency should be implemented through the distribution of appropriately designed options. He argues that the reorganization process under the existing bargain-based rules, is costly and time-consuming, contributing to the deterioration of the firm's asset value. Moreover, the bargaining-based approach often results in a division of value that derives from pre-bankruptcy priorities. The introduction of an options procedure, mandating the allocation of a fixed number of shares of the distressed firm's equity, would improve efficiency by supplying creditors with the incentives necessary to value the firm appropriately. The number of shares issued should be equal to the face value of equal proportion of all senior claims. As a consequence of exercising the options, it will be possible for the company to emerge from the bankruptcy process. This may in turn induce the company's shareholders to pursue an efficient course of action, namely maximizing firm value. The options procedure provides the key to the emergence of a reorganization approach that is ultimately welfare enhancing.

3.6. *The Role of Institutional Investor in Corporate Governance*

In Chapter 23, Roberta Romano critically assesses the impact of institutional investor activism in corporate governance activities in the USA. The shareholder participation movement has had modest success. Institutional investors have challenged the authority of managers of firms by making use of a federally-mandated privilege to have shareholder governance proposals included in the management's annual proxy statement and submitted to a vote. Since the 1980s, public pension funds and other institutions have submitted proposals to eliminate defensive tactics to takeovers, to adopt proxy voting, to enhance board independence, and to restrict executive compensation to many firms. More recently, unions are more involved than public pension funds in sponsoring proposals. As these discrete, issue-based interventions have become more important as means to exert pressure on management, economists have attempted to measure the impact of the proposals on the performance of targeted firms. Romano evaluates the corporate law and finance literature that shows that shareholder proposals have little impact on targeted firms' performance. These results are especially surprising because both activists and economists have been extremely positive about the role of shareholder activism in corporate governance.

Possibly, because the empirical findings were so different from the normative literature, some commentators have attempted to reconcile the diverse empirical studies. Yet others, such as Bernard Black, have been less reluctant to accept the normative implications of these studies. In contrast to his earlier view, Black doubts the significance of shareholder activism. A number of factors explain their limited impact: (1) precatory proposals are ignored by management; (2) institutional investors are poorly organized and do not understand well the issues they propose; (3) and the general level of activism is modest. Romano challenges Black's position, arguing that the precatory content of shareholder proposals does not explain the insignificant price effects. Moreover, she argues that institutional investors

are often very knowledgeable and some may actually benefit from submitting worthless proposals. Although noting the level of shareholder activism tends to be low, she counters that it is the objective of their activism that is responsible for the absence of a positive price effect. This causation analysis provides an analytical framework to her main argument that most corporate governance structures, which are the subject of shareholder proposals, may not work to produce positive results. On the positive side, Romano recommends the adoption of a mechanism of internal control wherein institutional investors review their shareholder programme to determine which techniques are most effective. There is every reason to believe that these evaluations will yield more information and in turn improve the efficiency of a fund's activism. Moreover, Romano proposes a change in the Securities Exchange Commission (SEC) proxy rules that would require a proposal to obtain substantial voter support before receiving proxy expense reimbursement. Her proposal is attractive because it would shift incentives which could lead to changes in the shareholder proposal regime.

In Chapter 24, Geoff Stapledon and Jonathan Bates explain the difficulties that UK institutional investors face when voting their shares. The evidence shows that institutions hold more than 70 per cent of shares in UK listed companies. Even though UK institutions are not mandated to vote their shares, there is increasing interest among investors to vote their shares. Still, there are a number of factors that account for the difficulty of institutions exerting their voting rights. The main problem is that while institutions invest in shares, the share custodian's name is entered in the company register. This has led to a costly process whereby institutional voting instructions were routed to custodians. Stapledon and Bates offer a proposed revision of the law that involves a clear distinction between the operational (share-voting) and property incidents of shareholding. The reform promises to reduce the costs and simplify the process by eliminating the transfer of documentation and voting instructions from custodian to institutional investor.

Mara Faccio and Ameziane Lasfer examine the role of blockholders, and more specifically that of occupational pension funds, in corporate governance in Chapter 25. They report that, on the one hand, pension funds do not add value to the companies in which they hold large stakes, while on the other hand, these occupational pension funds, despite the relatively poor performance of the companies in which they invest, do not opt for an 'exit' strategy. Faccio and Lasfer show that pension funds are 'locked in': it is costly to monitor because their holdings tend to represent relatively small fractions of the total values of the funds' assets. Still, they cannot also sell their holdings for fear of selling at a discount or conveying information to the market. They may also refrain from intervening on account of using insider information.

3.7. *Executive Compensation*

In Chapter 26, Martin Conyon and Kevin Murphy assess the differences in CEO pay and stock incentives in the USA and the UK. Over the last decade there has been a dramatic surge in CEO compensation in the USA. For example, CEOs of the largest US corporations earned compensation in 1998 that was 419 times as high as their respective employees (Loewenstein 2000). Conyon and Murphy show that American CEOs receive 35 per cent

higher cash compensation and 121 per cent more in total compensation, after controlling for firm size, sector and management position, than UK CEOs. Conyon and Murphy doubt that traditional principal–agent models can explain the differences in levels of managerial pay.

CEO compensation arrangements in the USA and UK contain many of the same elements: base salaries, share option grants, annual bonuses, long-term incentive plan share awards, and benefits. Still, the level and structure of compensation in the USA and UK are significantly different for the following reasons. First, Conyon and Murphy explain that the divergences in top wages in the UK and US are due to differences in corporate tax deductibility rules, which encourages option compensation in the USA while discouraging the practice in the UK. Second, they identify economic, political, and cultural factors that encourage large share option grants in the USA. The authors conclude that the differences in international pay practices would not be a real issue if managerial labour markets were isolated. But competition in a global marketplace may encourage executives to migrate to the higher paid labour markets.

In Chapter 27, Rafel Crespi, Carles Gispert, and Luc Renneboog examine the relationship between top executive cash-based compensation and corporate performance for the market-oriented and control-oriented systems of governance in Europe. Arguably, one might expect a stronger relationship between pay and corporate performance in market-oriented than in control-oriented regimes. Surprisingly (but in line with other UK research), they show that in UK companies with high control concentration, there was no signification pay-for-performance relation uncovered. The CEO's cash remuneration in the UK is strongly related to sales growth but not to the creation of shareholder value. Executive compensation in Spain (an example of a blockholder-oriented system) does not appear to depend solely on corporate sales growth but relies to a large extent on share price and accounting performance. Crespi, Gispert, and Renneboog show that executive directors of Spanish firms controlled by strong groups will benefit from large increases in cash remuneration provided that these executive directors generate significant shareholder value. However, this positive relation is only valid in so far as share returns exceed those of their industry peers. For Spanish firms without high control concentrations, modifications in managerial remuneration depend upon changes in accounting returns in prior years. Thus, in these companies, the lack of blockholders allows management more discretion to employ remuneration benchmarks that can be more easily adjusted to increase short-term profitability in order to maximize executive compensation. So, it seems that an efficient remuneration scheme is not a substitute to large shareholder monitoring, but large monitoring shareholders are needed to impose a compensation policy providing management with the right incentives to create value.

In Chapter 28, Piet Duffhues, Rezaul Kabir, Gerard Mertens, and Peter Roosenboom explain why stock-based compensation had been so limited in the Netherlands until the mid-1990s. Over the last few years, however, the recent rise of stock options in CEO compensation led to a sharp rise in criticism from political parties and interest groups. In response to the sharp debate about the appropriate use and level of stock option awards, policymakers and other reformers recommended increased disclosure standards on CEO compensation and employee stock options for listed firms. Against this background, Duffhues,

Kabir, Mertens, and Roosenboom examine the compensation practices of Dutch companies for the fiscal year 1998. Based on their sample of 168 industrial firms listed on the Amsterdam Exchanges, they show that executive board members and top executives hold 73 per cent of the total employee stock options. In terms of analysing the options and pay-for-performance link, they show that employee stock option grants strongly correspond to a firm's accounting performance. In addition, they find evidence that the introduction of stock option schemes leads to higher subsequent operating performance.

4. CONCLUSION

The debate on convergence and diversity in corporate governance regimes and capital markets has forced us to reconsider our assumptions on which legal rules and institutions promote efficiency and social welfare. The contributions to this book have offered insights on the different approaches to the problem of the role of boards of directors, the importance of capital markets in corporate governance, the position of institutional investors in corporate governance, the practice of executive compensation, the optimal design of bankruptcy law, and the problem of separation of ownership and control. The essays in this volume, which present new ideas from a number of disciplines, will contribute to the new research on comparative corporate governance.

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