

# INTRODUCTION



## CORPORATE GOVERNANCE AS PROMISE

The purpose of corporate governance is to persuade, induce, compel, and otherwise motivate corporate managers to keep the promises they make to investors. Another way to say this is that corporate governance is about reducing deviance by corporations where deviance is defined as any actions by management or directors that are at odds with the legitimate, investment-backed expectations of investors. Good corporate governance, then, is simply about keeping promises. Bad governance (corporate deviance) is defined as promise-breaking behavior.

The theory that underlies the way that this book treats corporate governance is that all investors have certain reasonable expectations about what corporate managers should and should not do with their power over the corporations. These I will call investors' legitimate investment-backed expectations. Shareholders' expectations are derived from a variety of sources. They come mostly from law and contract, but market forces and social norms also inform investors' expectations about how managers should perform in very important ways. For example, it is universally understood that managers cannot steal from the companies they work for. It also is well understood that managers and directors should avoid transactions that place them in conflict of interest between their obligations to the corporation and their own personal financial objectives. Law, contract, and social norms all point the same way in this regard, making certain sorts of conflict of interest dealings, such as insider trading, illegitimate as well as illegal. Law and contract have less to say about how diligent and attentive to the interests of shareholders corporate managers must be. Here, social custom (norms) and markets play the dominant role in constraining managerial deviance. Profit maximization sometimes is expressed as a societal norm, but it sometimes also is expressed as a legal requirement, at least in the United States.

In governing the modern corporation, the more work that is done by social norms, the less heavy lifting needs to be done by contract and law. If corporate officers and directors can be deterred by social norms from insider trading or from trading with the firms they work for on excessively

favorable terms, then investors will be forced to rely less on more costly enforcement mechanisms, like lawsuits, to control managerial deviance.

Corporate governance is a broad descriptive term rather than a normative term. Corporate governance describes all of the devices, institutions, and mechanisms by which corporations are governed. Anything and everything that influences the way that a corporation is actually run falls within this definition of corporate governance. Every device, institution, or mechanism that exercises power over decision-making within a corporation is part of the system of corporate governance for that firm.

The governance of an organization such as a corporation is done through a complex framework of institutions and processes, including law. Taken together, these institutions, processes, and mechanisms determine how power within a company is exercised, the extent to which investors are given a voice, and how all sorts of decisions are made.

The purpose of corporate governance is to safeguard the integrity of the promises made by corporations to investors, but investors and companies are left to their own devices (i.e., the contracting process) to define the content of the promises themselves. Generally, the baseline goal is profit maximization. Corporations are almost universally conceived as economic entities that strive to maximize value for shareholders. But the goal of maximizing wealth for shareholders is, or should be, a matter of choice.

Investors should be free to choose to invest in ventures that pursue other goals besides profit maximization. Outsiders, however, should be no more at liberty to dictate the terms of the private arrangements between companies and their shareholders than they are free to dictate the terms of other purely private contractual arrangements.

For many, particularly those in the law and economics movement, any action by managers, directors, or others that is inconsistent with the goal of shareholder wealth maximization is considered a form of “corporate deviance.” Economists call corporate deviance “agency costs” to capture the notion that corporate managers and directors are agents of their shareholders. Since controlling agents is costly, it is inefficient to control all deviant behavior by managers, directors, and others. But, to the extent that investors seek to control their agents, the devices they use are the institutions and mechanisms of corporate governance. The best corporate governance systems are those that do the best job of controlling corporate deviance.

We care about corporate governance because it affects the real economy. Holding other things equal, we can improve corporate performance and provide better access to capital by improving the quality of corporate governance. However, since installing corporate governance devices is not free, we maximize value by optimizing, rather than max-

imizing, the extent to which corporate governance systems monitor and discipline corporate managers.

This is the baseline rule, but it is not inviolate. There is nothing sacred about setting shareholder wealth maximization as the goal for the corporation. Investors can, and do, set up corporations with many goals other than the traditional goal of wealth maximization for outside shareholders. For example, thousands of corporations, from the Boy Scouts to the Red Cross, are expressly organized as charitable, not-for-profit enterprises with social goals wholly unconnected to investors or to their interests. Even some “traditional” closely held corporations appear to be run more to provide rewarding job opportunities for family members than to generate profits for (nonexistent) outside investors. There is nothing deviant or lamentable about this sort of behavior as long as it is consistent with the legitimate investment-backed expectations of those who invest in (or donate to) these enterprises.

Shareholders and other investors are free to organize and invest in corporations that serve whatever legitimate (legal) objectives they choose from wealth maximization to wealth redistribution. There is no legitimate theoretical or moral objection to those who assert that the goals of the modern corporation should be to serve the broad interests of all stakeholders rather than to serve the narrow interests of just the shareholders, *provided that these goals are clearly disclosed to investors before they part with their money*. My response to the oft-heard critique of modern, shareholder-centric corporate governance is that the goals and objectives of the corporation should be determined by the organizers of the corporation and disclosed to participants *ex ante* at the time the corporation goes public or otherwise attracts its first outside (non-controlling) investors. After that, the group in control should act consistently with the legitimate, investment-backed expectations of investors.

In the United States, more than in any other country, the modern publicly held corporation is characterized by the separation of share ownership and managerial control of the corporation itself. This means that non-owner managers and directors control corporations’ assets, and are responsible for the strategies and tactics utilized by companies to earn money. In the meantime, a largely separate group of people, the shareholders, put up the lion’s share of the vast amounts of risk capital that finances the purchase of the corporation’s assets and facilitates all other corporate activities, including raising money from creditors and other fixed claimants. The interlocking directorates and the ownership of control blocks of stock by families and corporate groups common in Europe and Asia are largely absent in the United States.

The more or less unique ownership structure of U.S. corporations presents unique opportunities as well as unique challenges. The ability to

raise vast sums of money from widely disparate investors permits the democratization of capital. Large companies control billions of dollars in resources raised from middle-class investors, whose contributions to insurance premiums, pension funds, and mutual funds pay for the stock that capitalizes corporate America. Without an ownership structure characterized by the separation of share ownership and corporate management, it would not be possible to have both a robust middle class and a large number of powerful, multinational corporations. The U.S. “shareholder culture” remains unique in this way. In other countries, even developed countries like France, Germany, Italy, and Japan, most big companies are controlled by powerful families, other corporations via complex corporate cross-holdings of shares, large banks, and, occasionally, by governments themselves. Shareholders are generally at the mercy of these powerful interests, and shareholders’ interests, not surprisingly, often are mere afterthoughts for the managers of such companies.

In the United States, by contrast, shareholders traditionally have been at the very epicenter of the corporate governance model. In the United States, as distinct from other countries, there is broad (though by no means universal) consensus that the corporation is and should be governed for the benefit of shareholders, subject only to the legal and contractual responsibilities of the company to third parties. For example, when senior managers of U.S. corporations were asked, “Who owns the large public corporation?” 76 percent responded that the corporation is owned by the shareholders. In sharp contrast, in Japan an astonishing 97.1 percent of corporate senior managers said that the corporation was owned not by the shareholders but by “all of the stakeholders” including workers, customers, suppliers, and local communities. Corporate managers in Germany and France were not far behind Japanese executives: 82 percent of German managers and 78 percent of French managers said that German and French companies are owned by all corporate stakeholders rather than just the shareholders.

Survey data about managers’ views of the importance of dividends and the importance of job security for workers confirm the distinction noted here about America’s exceptional approach to the governance of the corporate enterprise. In France, Germany, and Japan most managers think that their primary obligation is to provide job security for workers, while in the United States managers are much more focused on the shareholders’ interests in general and on paying dividends in particular. For example, in the United States 89 percent of corporate senior managers said that providing dividends for shareholders was more important than providing job security for workers. In Japan, only 3 percent of senior managers thought that dividends were more important than job security. Similarly, a survey of 1,000 companies in Japan and 1,000 companies in the United

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States by Japan's Economic Planning Agency reported that U.S. firms view their stock price as far more important than market share, while Japanese companies view market share as more important than share price.

These data are changing and will be out of date soon. Companies all over the world, including China and India, are embracing the U.S. "shareholder-centric" model of corporate governance. The recent emergence of London and Hong Kong as launching pads for initial public offerings reflects the success of companies in both Europe and Asia in convincing investors that they can receive a "fair deal" on their equity investments in non-U.S. companies. It also reflects a growing consensus around the globe that large, well-capitalized corporations can only exist in stable democracies with robust middle-class populations if the ownership structures of such companies are characterized by the separation of ownership and control.

The focus on U.S.-style ownership and control structures inevitably has led to attention on corporate governance in America, which is the subject of this book. The high-profile scandals in corporate America that occurred at the turn of the twenty-first century caused many to wonder whether the U.S. model of corporate governance was working properly. To evaluate the U.S. system of corporate governance, we must first have some idea of what corporate governance is.

In my view, corporate governance describes the various mechanisms and institutions, including law, contract, and norms, by which shareholders and other outside investors attempt to assure themselves that management will be faithful guardians of their investments. One goal of the analysis here is to present a picture of corporate governance that is consistent with the basic economic analysis of the corporation. In particular, modern scholars have never successfully reconciled Ronald Coase's famous "Theory of the Firm," which posits that the modern, publicly held corporation is a nexus of contracts, with the widely accepted notion in law and economics that corporations and their directors should maximize the value of the firm. This notion manifests itself in economics in the doctrine that maximizing shareholder value is the primary objective of the business corporation. The notion manifests itself in law in the doctrine that officers and directors of corporations owe undivided fiduciary duties of care and loyalty to their shareholders and to their shareholders alone.

After all, if Coase is correct, as he surely is, that the corporation is best conceptualized as a complex web or "nexus" of explicit and implicit contracts among the company's various constituencies, including, but not limited to, shareholders, then everything is up for grabs—or up for negotiation—including the issue of what the basic objectives and purpose of the corporation should be. Under this theory, it would seem clear that the various participants in the corporation can and should be left free to

contract among themselves to establish any set of priorities they choose. The fact that corporate managers could, if they wished to do so, try to sell shares in their firms by promising to promote worker primacy, environmental protection, the elimination of poverty, or shareholder wealth in exchange for investors' money supports this conclusion. What corporate managers should not be permitted to do is to sell their shares with the implicit or explicit promise that they will maximize value for shareholders and later, after collecting the investors' money, decide to pursue some other calling that they have themselves determined should be pursued.

Shareholder wealth maximization is and should be both a norm and a default rule, but *only* a norm and a default rule. Shareholders should be, and are, basically free to invest either in companies that maximize profits or in those that do not. The choices for investors range from not-for-profit entities, which, of course, explicitly promise zero returns to shareholders, to the standard, for-profit corporations (including munitions manufacturers and cigarette companies) that typically come to mind when one thinks about investing, with socially or environmentally conscious mutual funds in between.

In May 2007, for example, the *New York Times* reported on a company called Altrushare Securities, a Wall Street broker-dealer firm that has two-thirds of its stock controlled by two charities, which the paper cited as "an example of the emerging convergence of for-profit money-making and nonprofit mission."<sup>2</sup> The nonprofit control of the firm resulted in a different "mission" for Altrushare, whose goal, according to Peter Drasher, the company's founder, is "to support struggling communities with our profits" rather than profit maximization.<sup>3</sup> Other corporations appear to be following this model of blending the efficiency of the for-profit corporation paradigm with different mixes of the social and community ideals of the not-for-profit sector. This hybrid model has not met with success outside of the closely held corporation setting because when share ownership becomes too widely dispersed it becomes practically impossible for the shareholders to agree on any goals beyond simple profit maximization.

Most people want to invest in for-profit enterprises. And the more profit, the better investors like it. This overwhelming tendency may be attributable to greed, but not necessarily. True, people generally invest to maximize their wealth. But some level of modest wealth is a prerequisite to philanthropy. Once investors have accumulated a little wealth, they can decide for themselves how much of it to contribute to charity, and which charities to support. It is not surprising that even in a country as full of beneficent, generous people as the United States, people actually choose to invest in for-profit corporations. Corporations that hold them-

selves out to investors as being good investments are more successful at raising investment dollars than are those that do not.

A contractual, even morally based view of the modern public corporation emerges from the Coasean, contractual perspective of the corporation presented here. Since, as Coase said, the corporation is a nexus of contracts, its purpose should be to conduct itself in a manner that is consistent with both the underlying law of the jurisdictions in which it does business, as well as the complex set of explicit and implicit promises it makes. Of paramount interest are the *promises* that corporations make to investors when selling its shares, but other agreements are relevant as well, which is why I refer to this approach as the “promissory theory” of the corporation, and it is the perspective on corporate law and corporate governance adopted in this book.

The starting point for the analysis in this book is that the corporation is a nexus of contracts, and as with other contracts, the contracts made by a corporation constitute a set of promises to investors, workers, suppliers, customers, local communities, and others. The clear, longstanding, and unambiguous default rule in corporate law is that corporations are organized to maximize value for shareholders, subject to the constraint that, in doing so, they act consistently with both applicable law and with prior agreements with other constituencies such as employees and creditors.

The law governing the corporation is consistent with the economic analysis presented here. Shareholders are distinctive in the corporation because they are residual claimants: they are entitled to the profits of the firm, but only after all of the other, fixed claimants’ claims have been satisfied. As residual claimants, the shareholders are the group with the best incentives to make discretionary decisions about corporate strategy. Decisions about such things as new investments, strategic direction, and corporate strategy should be effectuated for the shareholders, because they are the group with the biggest stake in the outcomes of these decisions. In contrast, as Frank Easterbrook and Daniel Fischel have observed, “all the actors, except the shareholders, lack the appropriate incentives. Those with fixed claims on the income stream (generated by a corporation) may receive only a tiny benefit (in increased security) from the undertaking of a new project. The shareholders receive most of the marginal gains and incur most of the marginal costs. They therefore have the right incentives to exercise discretion.”<sup>4</sup>

Business organizations in general, and corporations in particular, are standard form contracts. Corporate governance works when it encourages corporate officers and directors as well as other corporate decision-makers to act in ways that are consistent with the explicit and implicit contractual understanding between investors and the firms. Whatever else one might say about famous examples of corporate deviance, like Enron



or Tyco, they represent situations in which officers and directors did not keep their legal and fiduciary promises to investors.

Starting with the premise developed in this introduction that corporate governance is about promise, this book is about what I regard to be the most important and interesting institutions and mechanisms that exist to ensure that companies that sell stock to the public keep their promises to investors. Taken together, all of these devices make up the corporate governance infrastructure that a particular economy makes available to its investors and entrepreneurs. The term “corporate governance” includes law, policy, and social norms, as well as contracts that regulate and motivate behavior within the corporation. For example, chapter 1 considers the way that contracts, in the form of a corporation’s charter and bylaws, articulate the contractual relationship between a corporation and its shareholders.

While all corporations need capital to finance their various endeavors, not all capital is created equal. For many sorts of investments, particularly risky investments such as research and development, equity is vastly preferred over debt because such risky investments produce uncertain cash flows that are unsuitable for fixed claims like bank loans or bonds and there is no way to devise the schedule for the repayment of principal and interest that fixed claimants require. For this reason, corporate governance is, and should be, primarily directed toward the goal of maximizing value for shareholders.

A large and diverse array of mechanisms and institutions of corporate governance are credited with playing central roles in corporate governance. The list includes all sorts of gatekeepers, such as lawyers, investment bankers, and accountants, as well as corporate boards of directors and financial institutions, which monitor companies to which they have loaned money. Shareholders rely on the institutions of corporate governance to solve the problems inherent in the separation of share ownership and management of large public corporations. The persistent willingness of investors to purchase residual equity interests in firms controlled by others is an astonishing and distinctive feature of U.S. capital markets, which are characterized by far more widely dispersed ownership than are other capital markets throughout the world. The proclivity of investors to part with their investment dollars in far-flung ventures over which they have no practical control and no legal rights either to the repayment of their principal or to receive periodic returns (dividends) on their capital requires a lot of trust on the part of investors. This trust, in turn, depends critically on the efficient operations of the institutions of corporate governance.

In chapter 1, and throughout the book, I attempt to identify and distinguish among the three primary sources of influence over decision-making

within the firm: contract, law, and societal norms and customs. Taken together, these three sources of corporate governance, intrafirm contract, legal rules, and societal norms, dictate how the corporation is governed. The interactions among these sources of governance are highly complex. Contracts, legal rules, and societal norms serve as complements for each other and as substitutes. Take, for example, something as basic as the voting rights of shareholders, the subject of chapter 13. The three sources of corporate governance, taken together, describe the various ways of affecting the policies, strategies, direction, and decisions of an organization.

The approach taken here is designed to provide a framework with which to evaluate the assertion that a particular company has “good” or “bad” corporate governance, and also with which to evaluate the assertion that a particular legal system has “good” or “bad” corporate governance. Take, for example, the thorny topic of executive compensation. The average pay for chief executives of large public companies in the United States is now well over \$10 million a year. Top corporate executives in the United States are paid more than executives in any other country. They get about three times more than their counterparts in Japan and more than twice as much as their counterparts in Western Europe. A lot of people think that corporate directors are overpaid, while others think that the process by which executive compensation is determined has been corrupted by acquiescent, docile, pandering, and otherwise “captured” boards of directors (the subject of chapter 4), lax accounting rules (chapter 11), ineffective shareholder voting (chapter 13), or captured regulators (chapter 7).

These people may well be right. If, however, I am correct in arguing that corporate governance is about controlling corporations’ proclivities to deviate from the legitimate, investment-backed expectations of investors, we can evaluate executive compensation in a new light. First and foremost, it seems clear that as long as a corporation is meeting its payroll, paying its suppliers, current on its taxes, and fulfilling all of its other obligations to its fixed claimants, then these corporate constituencies have no legitimate reason to complain about executive compensation. In particular, the concern that executive pay is not sufficiently linked to executives’ job performance is of concern to companies’ shareholders and to its shareholders alone.

And it is not at all obvious that shareholders have a legitimate complaint about executive compensation. Take the famous controversy over Jack Welch’s undisclosed compensation while he was CEO of General Electric. Long criticized for his high compensation while at the helm of GE, during divorce proceedings in 2001 it was disclosed that GE had been paying for a variety of Welch’s personal expenses during his retirement, including the maintenance on his \$15 million apartment on Central Park

West, twenty-four-hour, unlimited access to private jets, and tickets to shows and sports events, in addition to his \$9-million-a-year pension. On the other hand, as well-known compensation attorney Gerson Zweifach pointed out at a recent conference on corporate governance at Yale Law School, the value of GE stock increased by an incredible \$250 billion during Welch's tenure. Shareholders who owned small stakes in GE in the 1970s literally became millionaires by the time of Welch's retirement. Suppose Jack Welch had approached each of these shareholders in 1970 and said that in return for his services as CEO of GE, which would make most long-term shareholders millionaires, he expected to receive hundreds of millions of dollars in compensation, and upon retirement to have tons of perks, including flowers delivered weekly to his Manhattan apartment. No rational shareholder would turn down this deal.

The interactions between Jack Welch (as representative of GE) and GE shareholders involved a hypothetical contract, rather than an actual promise because neither Welch nor GE had ever made an actual promise regarding such things as flower arrangements and other perks. Actual, not hypothetical or implicit, promises are the best indications of what shareholders have bargained for, but hypothetical bargains such as the one described above are also useful and illustrate the sort of work that the corporate-governance-as-promise approach suggested here might do.

Beginning in chapter 3, I discuss the various institutions and mechanisms of corporate governance and discuss which of these, in my view, function better than others. Although the book is meant to cover the broad field of corporate governance more or less in its entirety, this book reflects a particular point of view. It is not meant as a general survey.

Chapters 4 through 15 analyze what I regard as the most interesting and important institutions and mechanisms of the corporate governance infrastructure. The question I hope to answer is whether the dominant social and legal institutions are evenhanded in the way that they encourage or discourage these various corporate governance mechanisms. The argument developed here is that U.S. law is not evenhanded. Fewer constraints, and even outright encouragement and regulatory subsidies, are provided for the least effective mechanisms and institutions of corporate governance. In contrast, efforts are made to constrain and discourage the corporate governance devices that are most effective at harnessing managerial opportunism.

For example, historically, the most effective corporate governance mechanism, the market for corporate control, has been the subject of an intense regulatory backlash. This market has been crippled by statutes and regulations, rendering the hostile takeover virtually obsolete. The initial public offering is another effective corporate governance tool that is seldom used because of litigation risk and regulatory burdens. At the

same time, relatively ineffective institutions, such as administrative agencies, credit-rating agencies, and even boards of directors, enjoy regulatory “subsidies.”

Innovative entrepreneurs have developed new corporate governance devices to respond to those that have been rendered too costly by regulations. In particular, hedge funds and private equity funds now carry much of the corporate governance burden shouldered historically by the market for corporate control. Thus it is no surprise that these emergent corporate governance institutions are facing an increasingly loud chorus of voices clamoring for new, more, and better regulation.

The corporate-governance-as-promise approach adopted here is, from the American perspective, both normative and descriptive. That is, it describes not only what corporate governance in the United States *ought* to do but also what corporate governance *actually* does in action. Law, regulation, contract, and social norms are all *intended*, at least ostensibly, to serve the interests of investors. Norms and rules that maximize the value of the firm directly, that create incentives for others to maximize firm value, or that, at the very least, provide investors with sufficient information through corporate disclosures to enable them to decide for themselves which firms will generate the best returns for investors are consistent with the promissory theory of the corporation.

The corporate-governance-as-promise approach to corporate governance is universal and applies across borders to every economic system that purports to be guided by the rule of law. However, the U.S. approach, which styles the default corporate governance promise as shareholder wealth maximization, is by no means the only, or even the dominant, approach to corporate governance that one observes throughout the world. In many places, particularly Germany and Japan, the fundamental premise behind the corporation is not the notion of a promise to maximize value for shareholders. Instead, the fundamental corporate governance premise in many companies is that the corporation is a creation of the state, whose goals are to serve myriad and often conflicting societal interests. In places that embrace this theory of corporate governance, as a legal matter, corporations in many countries, including Germany, are not free to commit themselves contractually to maximize profits for investors, though market pressures and concerns about international competitiveness may force them to do so, despite the lack of legal pressures.

The approach taken in this book also is distinctive because it suggests that in many contexts, less rather than more corporate governance may actually be better from the point of view of investors. For example, much of the recent talk among legal scholars and regulators has focused heavily on the question of how to “improve” shareholder democracy by expanding shareholders’ voting rights. The implicit assumption in this

discussion is that more voting is necessarily better for shareholders. As explored in more depth in chapter 13, however, from a promissory perspective, more is not necessarily better. The real question is not how to *increase* shareholder voting but how to *limit* shareholder voting to the contexts in which the benefits associated with such voting outweigh the costs. From the corporate-governance-as-promise perspective, shareholders should be assumed to be maximizing the value of their shares. Issues about voting for other reasons, such as to engage in self-expression or to manifest one's sense of being a "citizen" of the corporation, do not factor into the promissory perspective embraced here.

Shareholders should be free to expand (or to contract) the range of issues over which they can vote. The corporation-as-promise perspective on corporate governance embraced here views the goal of shareholder wealth maximization as merely the default rule that exists for U.S. corporations. Shareholders who think that they can make themselves better-off by expanding the range and scope of the issues over which they can vote clearly should be allowed to do so. Moreover, even shareholders who believe that they will make bad decisions in the election process should be able to bargain for increased voting rights if they prefer voting to wealth. Here again, the critical issues for society should not be whether a corporation and its shareholders should be free to choose the legal arrangements to which they are subject. Rather, the critical issues are what is the default rule and what is the proper way to disclose proposed departures from the default rule.

Any time shareholders feel they need special voting rights to constrain agency costs (in this context agency costs means managerial deviations from shareholder preferences), courts should rush to their defense. For example, shareholders understandably may think that managers and directors might resist a hostile outside bid for control of the corporation to hold onto their lucrative, powerful, and prestigious positions. It is not hard to imagine that senior managers' wealth and egos might sorely tempt them to put their own interests ahead of those of the shareholders. And even the most shareholder-focused CEOs may easily deceive themselves into thinking that they can do a better job at the helm than would an outsider, despite the outsider's willingness to offer shareholders a handsome premium for their shares. For these reasons, shareholders have frequently gone to the courts to ask for greater voting rights in control contests. Generally what shareholders are asking for is the ability to approve outside offers against the wishes of their boards of directors. Specifically, shareholders often seek to prevent (or, at a minimum, to require a shareholder vote on) defensive tactics by management that can thwart outside offers.

This tension between the interests of the shareholders under the corporate-governance-as-promise approach and the law is one of the major themes of this book. Though corporate law rules and Securities and Exchange Commission (SEC) regulations *should* strengthen shareholders' contracting power within the firm, they do not always do this. As just mentioned (and as elaborated on in chapter 8), state and federal regulations thwart the market for corporate control and fail to permit shareholders to vote in control situations where such voting threatens the traditional powers of directors. Similarly, I argue in chapter 9 that despite the important corporate governance benefits of frequent public offerings, regulations have strangled the market for such offerings (known as initial public offerings [IPOs]) in the United States.

A frequent topic in international corporate governance circles is the role that banks and other lenders should play in corporate governance (chapter 14). Proponents of banks taking a lead role in corporate governance consider big financial institutions a species of über institutional investor, with the resources, sophistication, and wherewithal necessary to monitor and control managers of even the biggest and most sophisticated public companies. The popular notion that universal banks should be at the epicenter of corporate governance is driven by the view that *somebody* needs to stand guard over management's stewardship of the corporation. While unsophisticated, widely dispersed shareholders do not seem capable of monitoring and controlling incumbent managers and directors, big banks certainly do.

The problem with this view is that the economic perspective of banks is fundamentally different from that of shareholders. As detailed in chapter 14, banks' primary interest in corporations stems from their relationship as lender to these firms. As lenders, banks are concerned first and foremost with making sure that the principal and interest due on their commercial loans to corporate borrowers are repaid. Lenders' first concern is with borrowers who take big risks on new ventures or who focus on projects that are riskier than absolutely necessary. In sharp contrast, shareholders care most about generating cash (making profits) *above and beyond what is necessary to pay off fixed claimants like banks*.

The differing perspective of fixed claimants and equity claimants regarding risk creates genuine tension among these sometimes rivalrous classes of claimants about what course of action is best. Shareholders generally prefer investments that feature higher risks and higher potential payoffs than lenders, who generally prefer safer investments to maximize the probability that their loans will be repaid when they come due. As such, banks are not a perfect solution to the corporate governance problems that face shareholders, although they may be better than nothing when better alternatives are not available. In the United States, laws sepa-

rating commercial banking and investment banking and commercial banking and commerce have prevented commercial banks from taking the active role in corporate governance that they take elsewhere. But generally speaking, these laws have been relaxed.

In addition to considering corporate governance devices that work well for shareholders, this book pays attention to a number of corporate governance devices that are less successful. At the same time that certain regulations are stifling a large number of the more effective and powerful corporate governance devices, other regulations are actually encouraging and subsidizing a number of the more ineffective corporate governance tools.

One highly touted, but overrated, corporate governance device is shareholder voting, which has already been mentioned in this introduction. I will argue (in chapter 13) that shareholder voting's role in corporate governance is important but rather limited. Shareholders do not have the time, expertise, incentives, or inclination to vote more than they do. For this reason, I categorize shareholder voting as an ineffective corporate governance mechanism. (See chapter 3 for my taxonomy of effective and ineffective corporate governance mechanisms.)

Other corporate governance devices have proven even less reliable than shareholder voting as mechanisms to control managerial deviance. For example, in my view, perhaps the most important contribution of this book is chapter 6, which describes the role of corporate boards of directors. Here I point out that certain theories and assumptions about the role of corporate boards of directors lie at the heart of every theory of corporate governance ever devised. In my view, each of these extant theories suffers from one or two major flaws. First, many of these theories assume, without analysis, that boards of directors can be trustworthy and reliable monitors. Failed boards, like those of Enron, WorldCom, Tyco, and Adelphia, are criticized for being too trusting of management and not sufficiently skeptical about the sorts of things these companies were doing. In fact, all of these boards had a majority of independent directors. Indeed everybody on the Enron board except one person (Ken Lay, the company's CEO and board chair) was independent of management.

Perhaps the most controversial argument in this book is contained in chapter 4, which challenges the old but untested assumption that we can improve the quality of corporate governance in public companies simply by increasing the number of independent directors on these companies' boards of directors. The problem with this assumption is that even the so-called independent directors crowding into boardrooms these days are highly susceptible to being captured by the very management teams that they are supposed to be monitoring. Chapter 5 presents a number of case studies to illustrate the problem of board capture and to drive home the argument that boards that *appear* to all the world to be paradigms of

independence often end up being the most captured. Enron is a powerful, but by no means unique, illustration of this general problem.

Chapter 6 considers a new form of “super-independent” director known as the dissident director. These are directors nominated and elected outside of the traditional management-dominated nominating committee structure of incumbent boards. Such directors are not nearly as susceptible to capture as traditional directors who come to the company with the approval of the incumbent managerial group. The directors nominated by hedge funds and private equity firms (discussed in chapter 15) are the best sources of dissident directors for public companies.

Everybody agrees that boards of directors, even ostensibly independent directors, are prone to capture. Nobody has even *suggested* a test for sorting out the directors who are truly independent of management from those who merely appear to be independent. Until such a test is devised, in my view, independent directors cannot be relied on to solve the agency problem that lies at the heart of corporate governance.

What is worse, directors chosen for their independence alone often know little if anything about the actual operations or strategic challenges that face the companies on whose boards they serve. Shareholders may be better-off abandoning the myth of independent directors and moving back to boards of directors with several insiders on the board. If senior managers are superior managers but not inferior monitors, then shareholders would be wise to bring more of them onto their companies’ boards of directors. The costs to shareholders of having only one senior manager on their companies’ boards may be worse than the benefits.

Having identified corporate boards of directors as a rather ineffective corporate governance device in chapter 4, I attempt in succeeding chapters to identify other corporate governance tools, some of which are effective and some of which are not. To be clear, when I say that a corporate governance device is ineffective I do not mean, of course, that it is completely ineffective. Rather, I simply mean that it is ineffective relative to alternative highly effective mechanisms like the market for corporate control *and* that it does not live up to its hype. Boards of directors, shareholder voting (chapter 13), outside accountants (chapter 11), and corporate whistle-blowers (chapter 12), as well as credit-rating agencies, stock market analysts, and regulators (all treated in chapter 7), have been proven to be rather ineffective in my view.

One of the main points developed in this book is that the corporate governance mechanisms that are the least effective are the ones that are most encouraged by regulators and lawmakers. At the same time, the corporate governance devices that are the most effective, particularly hedge funds and private equity firms (chapter 15), dissident directors (chapter 6), the market for corporate control (chapter 8), and IPOs



(chapter 9), are the corporate governance devices that are the most heavily regulated. The key exceptions to the generalization that regulation follows superior performance are private equity firms and hedge funds. It is not coincidental that these are the governance mechanisms most threatened with being regulated. The threats are constant, and corporate managers are hardly opposing the chorus of voices urging tighter control over hedge funds and private equity firms.

That is not coincidental either. Only occasionally, as in the summer of 2002 when Sarbanes-Oxley was passed, does corporate governance become a highly visible, salient political issue. And only when corporate governance is a visible, salient issue is legal reform possible. When, as was the case in 2002, corporate governance becomes an important issue on the political landscape and politicians believe that they must enact reforms to satisfy public opinions, they are still heavily influenced by organized special interest groups. Shareholders are not well organized into effective political coalitions; managers are. Managers will staunchly resist corporate governance reforms that put their jobs in jeopardy or threaten their ability to remain independent from outside entities such as activist hedge funds and corporate raiders or that otherwise make their lives more difficult. They will support (or decline to oppose) governance reforms that “merely” raise costs on shareholders.

High on the list of corporate governance measures that managers oppose are reforms that liberalize the market for corporate control or that make it easier for shareholders to control (or even to understand fully) their compensation. In contrast, managers are likely to find little to complain about measures that bolster their already captured boards of directors or require them to expand their already bloated central office bureaucracies.

The theory that the best corporate governance devices are taxed by regulation while the worst are subsidized by regulations is consistent with the simple theory that regulators and politicians are following the path of least resistance when they regulate. They can satisfy the public’s outcry that they “do something” about corporate governance by passing laws like Sarbanes-Oxley that increase the power of “independent” directors and like the Williams Act that weaken the market for corporate control without upsetting the top managers of public companies or any other well-organized special interest group.

The main purpose of this introduction is to define the key phrase in this book, which is “corporate governance.” I conceptualize corporate governance in contractual terms. By this I mean that I view the corporation as a nexus of contracts, and I see corporate governance as one of many societal, legal, cultural, and economic factors that can, if used properly, make the contracting process more efficient and more reliable. The purpose of corporate governance, in my view, is to control corporate devi-

ance, by which I mean deviance from the terms of the contracts between the various contractual participants in the corporate enterprise and the company itself. Simply put, contracting parties should get what they pay for. I call this the “promissory theory” of the corporation because the contracts that constitute the corporation also can, and should be, viewed as a series of promises by management to investors of all types.

The particular contract that shareholders have with the firm is not more important than the contract that other corporate constituencies have with the firm—but it is more poorly specified. Non-shareholder constituencies want simple promises to be kept. These include promises about such things as terms and conditions of employment, wages, and the payment of principal and interest. In contrast, shareholders, as residual claimants, want managers and directors to maximize the value of the company in which they have invested. This far more vague promise is the promise of corporate governance. The following chapters provide my rather unromantic and perhaps idiosyncratic perspective on the various institutions and mechanisms that function to try to ensure that these promises to investors will be kept.