

Top Management, Company Directors and Corporate Control

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Theory and research on the relations among top managers, company directors, investors, and external contenders for corporate control – broadly, the field of *corporate governance* – experienced a remarkable flowering during the 1990s. Early work addressed the central puzzle raised by the widespread separation of ownership and control among large American corporations, namely, why would any sensible person – much less thousands or millions of them – invest their savings in businesses run by unaccountable professional managers? As Berle and Means (1932) framed the problem, those who ran such ‘managerialist’ corporations would pursue ‘prestige, power, or the gratification of professional zeal’ (1932: 122) in lieu of maximizing profits. Weak shareholders could do little to stop them. Yet generations of individuals and financial institutions continued to invest in these firms. Why?

Answering this question led to the creation of a new theory of the firm that portrayed the public corporation as a ‘nexus of contracts.’ In the contractarian model, the managers of the corporation were disciplined in their pursuit of shareholder value by a phalanx of mechanisms, from the way they were compensated, to the composition of the board of directors, to the external ‘market for corporate control.’ Taken together, these mechanisms worked to vouchsafe shareholder interests even when

ownership was widely dispersed. Research in this tradition flourished in the 1980s, as takeovers of under-performing firms became common and restive institutional investors made their influence known. Studies focused on assessing the effectiveness of devices such as having boards numerically dominated by outsiders, tying compensation to share price, or ensuring susceptibility to outside takeover (Walsh and Seward, 1990, provide a review). Following the dictates of financial economics, ‘effectiveness’ was commonly measured via stock market reactions to various actions by top management and/or the board. The results of these studies provided proof of which actions and structures promoted shareholder value, and which promoted ‘managerial entrenchment’ of the sort feared by Berle and Means.

Corporate governance research during the 1990s expanded from a narrow focus on large corporations to a broader concern with issues of political economy. The transition of state socialist societies to market economies, and the spread of financial markets to emerging economies around the globe, infused the puzzle of managerialism with enormous policy relevance. What mechanisms could be put in place to inspire the confidence of investors in businesses housed in distant and often unfamiliar cultures? The place of financial markets

in the project of globalization, as a means to channel investment funds from wealthy nations to emerging markets with limited local capital, assured that corporate governance would be a topic of intense interest for years to come.

The decade of the 1990s saw three developments that moved the governance literature beyond the simple assessment of mechanisms in US firms. The first development was the examination of the governance structure of the firm – the set of devices that evolve within the organization to guide managerial decision-making – as an *ensemble*. Rather than regarding any particular aspect of the firm's structure as essential, researchers began to study them as complements or substitutes. Compensation strongly tied to share price may act as a substitute for a vigilant board, for instance, while a vigilant board is not sufficient to make up for a poorly integrated top management team. Governance structures, in short, were configurations of interdependent elements (Beatty and Zajac, 1994; Anderson et al., 1998).

The second development was the growth of comparative and historical governance research, which highlighted the idiosyncrasy of the American system. American-style corporate governance, aimed at 'solving' the problems created by the separation of ownership and control, is only one of several possible governance systems and reflected a path-dependent developmental trajectory. A range of alternatives is consistent with economic vibrancy, and the American system is not the crown of creation (Roe, 1994). Indeed, even among wealthy economies with well-developed corporate sectors, corporations with separated ownership and control were quite rare as late as the mid-1990s (LaPorta et al., 1999). Moreover, empirical findings on the dynamics of the American system often held only for specific times; for instance, the takeover market of the 1980s, when hostile 'bust-ups' were common, was much different from takeovers of the 1990s, when friendly deals were the norm (Davis and Robbins, 1999). The nexus of contracts approach seemed increasingly like a theory of US corporate governance in the 1980s rather than a general theory of the firm.

The third development was the articulation of a reflexive stance on the theory of governance. While agency theory can be viewed as

an empirical theory of the corporation, it can equally be considered a prescriptive theory, that is, not an explanation of what *is* but a vision of what *could* or *should* be. Its influence on public policy debates during the 1980s is evident in documents of the time (Davis and Stout, 1992) and in the subsequent spread of the rhetoric of shareholder value. But it is important to recognize that corporate managers are quite skillful in their use of this rhetoric (Useem, 1996). Declarations of share buy-backs are met with share price spikes, whether or not they are subsequently implemented (Zajac and Westphal, 1999). The announcement of a new compensation plan is met by more positive reactions from the stock market when described as means of aligning management with shareholder interests than when the identical plan is described as a human resources tool; naturally, managers gravitate toward the sanctioned rhetoric (Westphal and Zajac, 1998). And even earnest attempts to meet the demands of shareholders for transparency and accountability, as prescribed by the agency theory of governance, often have unintended consequences. Firms that improve the quality of their disclosure attract more transient institutional investors, which in turn *increases* the volatility of their share prices – exactly the opposite of what was anticipated (Bushee and Noe, 1999). In short, the dominance of the American system described by the agency theory of governance may take the form more of rhetoric than reality, a point worth bearing in mind in the ongoing debates about the convergence of national systems of corporate governance.

If the prototypical research question in the corporate governance literature of the 1980s was 'Is it better for shareholders for a corporation's board to have more "outside" directors?', the characteristic question of the early 21st century is 'What ensemble of institutions best situates a nation for economic growth in a global, post-industrial, information-based economy?' Put another way, the vital questions going forward are not about why some stalks of corn in a field grow taller than others, but about the characteristics of soil and farming techniques that make corn in some fields grow taller than in others. Thus, research has come to span levels of analysis from within the organization to the nation-state and beyond. Behind this development is a recognition that

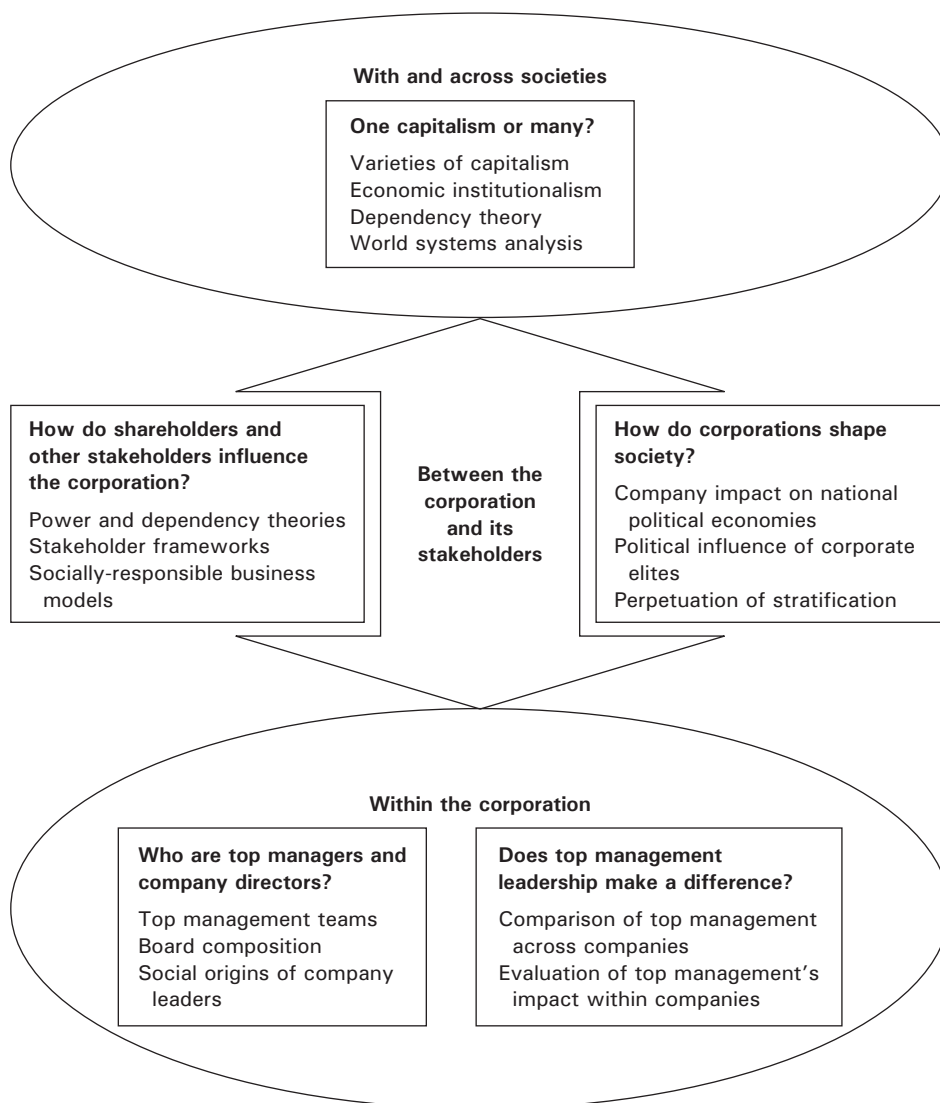


Figure 11.1 *Research on top management, company directors and corporate control*

what works for a particular firm is highly contingent on its institutional surround, that the institutional surround in a particular nation reflects its history and level of economic development; and that 'what works' for a national economy depends in turn on its place in the larger world system. Firms and economies, in short, are embedded in larger social and institutional structures that critically condition their structures and performance (Polanyi, 1957; Granovetter, 1985; Bebchuk and Roe, 1999).

We would like to be able to report that the earlier questions have now been answered

definitively. Much prior research relied on archival data several steps removed from the phenomenon (for example, crudely classifying directors as 'insiders' or 'outsiders' depending on whether they were current employees of the firm). Crude data led, unsurprisingly, to crude results (see Pettigrew, 1992 for a critique). Progress has certainly been made in moving beyond simple dichotomies of directors as inside or outside. Pettigrew and McNulty (1995, 1998), for instance, have done much to unpack the processes and power dynamics of the boardroom through gathering extensive qualitative

data from directors on 'critical incidents.' But an 'embedded' perspective makes clear that there is unlikely to be a generalized answer to questions of corporate governance.

Moreover, global financial integration has spurred major changes in corporate governance regimes around the world, for better or worse. Policy in this area is guided to a great degree by research and theory, making it both a vibrant intellectual domain and a consequential one. Law and economics scholars become Federal judges and treasury secretaries, well-known economists serve at the World Bank and IMF, and corporate directors take short courses at business schools to learn their trade. Corporate governance is an area where, at all levels of analysis, good research can have an impact.

Figure 11.1 maps out the terrain and locates research on top management, company directors, and corporate control in the larger academic discourse. Our aim in this chapter is to assay developments in this area at the beginning of the 21st century and outline promising areas for future research. We must, of necessity, be highly selective: research on top management and corporate governance spans multiple disciplines, from accounting and finance, to management and strategy, to sociology and political science. As research has proliferated, so have reviews (see, for instance, Blair, 1995; Shleifer and Vishny, 1997; Zingales, 1997). Even definitions of the object of study vary widely: Shleifer and Vishny state that 'Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment' (1997: 737), while Blair (1995: 3) argues that corporate governance implicates 'the whole set of legal, cultural, and institutional arrangements that determine what publicly traded corporations can do, who controls them, how that control is exercised, and how the risks and returns from the activities they undertake are allocated.' We take the broadest definition, and as such implicate a wide range of disciplines.

As our embedded framing would suggest, we review research across levels of analysis. We start by outlining and critiquing the contractarian model of corporate governance, which has dominated the academic discourse in law and economics as well as the policy debates around economic development. *Within*

the firm, we then ask, who are top managers and corporate directors, and does their leadership make a difference? These questions connect to studies in diverse disciplines, including the sociology of elites, strategy research on top management teams, the study of organizational demography, and research across fields on leadership. Relevant chapters elsewhere in this handbook include Thomas and Porac's chapter on 'Strategy and cognition,' Chakravarthy and White's 'Strategy Process,' and McGrath's 'Entrepreneurship, small firms and wealth creation'. *Between the firm and its stakeholders*, we ask, how do shareholders and stakeholders influence the corporation, and how do corporations in turn shape society? These questions link to stakeholder models of the corporation, research on power and dependence in organization theory, studies of business and society, socially responsible business, the study of political economy, power elites, and inequality. Whetten, Rands and Godfrey's chapter 'What are the responsibilities of business to society', elsewhere in this handbook, reviews additional relevant work. Finally, *at the level of the nation-state*, we ask, is there evidence of convergence in management practice and corporate governance around the world? The question of societal convergence or divergence has been an animating question in economics – particularly in the work of institutionalists such as Douglass North – in the political science literature on 'varieties of capitalism,' in sociological theories of modernization, dependency, and world systems, and in the popular literature on globalization. Interested readers are encouraged to read Kogut's chapter in this handbook on 'Strategy, management, and globalization.'

ONE CAPITALISM OR MANY?

Around the world, large corporations are the most visible institutions of modern capitalism. A few thousand corporations produce the bulk of the world's economic output and employ a significant part of the world's labor force. What forces determine who wields corporate power and how it is used? The answer is best framed in terms of institutions – 'the humanly devised constraints that structure political, economic and social interaction' (North, 1991: 97).

A nation's system of corporate governance can be seen as an institutional matrix (North, 1990) that structures the relations among owners, boards, and top managers, and determines the goals pursued by the corporation. The nature of this institutional matrix is one of the principal determinants of the economic vitality of a society. By hypothesis, getting the institutions of corporate governance right means ensuring that those who run corporations make decisions that lead to superior national economic performance. This means making sure that top managers and their supervisory board are appropriately responsive to signals from the product markets and the capital markets (Gordon, 1997). Thus, corporate governance can be seen as the institutional matrix that links market signals to the decisions of corporate managers.

According to Douglass North (1990: 6), 'The central puzzle of human history is to account for the widely divergent paths of historical change. How have societies diverged? What accounts for their widely disparate [economic] performance characteristics?' Accepted theory in economics predicts that through trade, national economies would converge in institutions and thus performance, as inferior institutions were weeded out and politicians in weaker economies adopted the policies of stronger ones. Yet economies are immensely diverse in their institutional structures and performance, leading to an enormous gap between rich and poor nations (see Firebaugh, 1999 for a recent assessment). Two questions arise from this observation. First, given that large corporations are disproportionately responsible for the economic wellbeing of a society, is there a best model of corporate governance? That is, is there an institutional matrix that reliably encourages corporate managers to make choices leading to economic growth for a society? Second, can an institutional matrix be emulated? The structures of particular organizations may be copied with more or less fidelity, but the institutions of corporate governance, such as a system of corporate and securities law, operate largely at a national level and thus entail political choices. Is it possible for a nation to move from one system of corporate governance to another?

The first question – what is the right model? – is deceptively simple. It should be a

straightforward matter to rank economies by their economic vitality, select the top performer, and abstract the crucial elements of its institutional matrix. The experience of the 1990s suggested to many commentators that the American model of investor capitalism was the obvious winner (see, Soros's [1998] critical account and Friedman's [1999] affirmative account of free market triumphalism). The American economy experienced the longest expansion in its history, generating millions of new jobs, countless new business starts, and a long stock market boom. This contrasted sharply with its rich-country rivals, particularly Japan, as well as with the emerging markets that entered deep slumps in the late 1990s. Moreover, the American model appeared especially amenable to a world of borderless capital, in which geography was of little concern in the process of matching investment flows to business opportunities. In principle, even a nation with little indigenous savings could achieve prosperity by adopting a system of American-style investor capitalism and opening itself to foreign investment. In the words of Treasury secretary Larry Summers, 'Financial markets don't just oil the wheels of economic growth – they *are* the wheels' (*Wall Street Journal*, 8 December 1997).

The institutional matrix that makes up the American system of corporate governance is codified in the contractarian approach to the firm, also known as agency theory. Agency theory was developed primarily within financial economics to describe the various mechanisms that 'solve' the agency problems created by the separation of ownership and control, by ensuring managerial devotion to increasing the company's share price:

Managers' wealth is tied to share price through numerous devices, including outright ownership, stock options, and compensation keyed to stock performance that align executive and shareholder interests. Because share price does not necessarily reflect detailed inside information about how well the firm is being managed, firms have adopted other devices to monitor managers, including shareholder-elected boards of directors that ratify important decisions (Fama and Jensen, 1983), concentrated and thus powerful ownership blocks for firms whose performance is difficult to monitor (Demsetz and Lehn, 1985), efficient managerial

labor markets that ensure that managers are paid over the long run according to their contribution (Fama, 1980), and high debt that compels managers to meet regular payment hurdles and optimal returns to capital markets (Jensen, 1986). If all these mechanisms fail and bad management drives the firm's share price down far enough, superior managers will acquire control of the firm, fire incumbent managers, and run the firm better themselves; they are rewarded for their trouble by their personal gain from the recovery of firm value, while shareholders are compensated by the premium paid. Thus, capital markets ensure that the structure of the nexus of contracts that survives is the one that minimizes agency costs and maximizes shareholder wealth. Managers who sought to sell company shares that, say, made it too difficult for shareholders to remove them if they did a poor job or paid themselves too much would find few buyers. Thus, managers have built-in incentives to propose organizational structures that limit their own discretion (Davis and Thompson, 1994: 144–5).

Each element of the theory – from management compensation and board composition to the structure of ownership and dynamics of takeovers – has received extensive research attention as it applies to large US corporations, particularly during the 1980s (see virtually any issue of the *Journal of Financial Economics* published during this period). If a cross-national adoption of American corporate governance institutions proved desirable, agency theory provides the blueprint: in the words of one recent review, 'the Anglo-American governance system, born of the contractarian paradigm, is the most flexible and effective system available. Indeed, notwithstanding its idiosyncratic historical origins and its limitations, it is clearly emerging as the world's standard' (Bradley et al., 1999: 8).

But questions of institutional transfer are premature. Those with long memories recall that at the beginning of the 1990s, it was the Japanese and German systems that served as the world's models, and pundits advocated a system of bank-centered relationship capitalism to cure the social disruption caused by America's myopic shareholder orientation. The virtues of 'Toyotaism' and the remarkable success of East Asian economies emulating Japanese business organization led the business

press to herald the emergence of American-style keiretsu. 'Unfettered Anglo-Saxon capitalism is finding it difficult to cope with the present' and thus American corporations should be encouraged to form keiretsu-like groups, which 'insulate management from short-term stock-market pressures without creating incompetent managers' (Thurow, 1992: 19, 281). In short, the most productive economies got that way because their systems of corporate governance, sometimes called communitarian or relationship capitalism, muffled the signals from impatient financial markets and encouraged cooperation among firms and their suppliers – exactly the opposite of the American system of investor capitalism.

Determining the best system of governance – investor capitalism, 'crony capitalism,' or something else – thus turns out to be far from trivial. Indeed, choosing which measure of performance to use and which time period to focus on yields rather divergent results – while the US economy expanded continuously from 1992 through 1998, expanding the time horizon to a full decade creates a rather different picture. From 1989 to 1998, both Germany and Japan experienced substantially higher productivity growth than the US, Germany displayed a higher per capita growth in GDP, and Japan recorded lower average unemployment (*The Economist*, 10 April 1999). Locating the effective ingredient in a national economy's institutional matrix may be a hopeless endeavor and the safest course may be to call it a draw among the three major contenders (cf. Roe, 1994).

Even the pleasing simplicity of an abstract 'governance model' may imply more coherence than is warranted. The American system is often referred to as the Anglo-American system because key elements are held to be common between the US and the United Kingdom. Yet even these two are rather divergent on several dimensions, which suggests strong limits on the extent to which institutions can be adopted across cultures. In the UK, for instance, the positions of chairman of the board and the chief executive officer are held by different persons on more than four out of five boards among the largest 500 firms; the shared understanding is that 'the CEO runs the company and the Chair runs the board' (Pettigrew and McNulty, 1998). In contrast, three quarters of *Fortune* 500 firms in 1999 were led by CEOs who also held the chair's job,

and seasoned directors are virtually unanimous in viewing the forced separation of the two jobs as undesirable because of the ambiguity it creates about 'who's in charge' (Neiva, 1995). On another contrasting front, 22% of the typical *Fortune* 1000 firm's directors are 'insiders' (executives of the firm), while the comparable figure in the UK is roughly 50%. These facts are attributed to cultural differences in the boardrooms of the two nations, and neither nation shows much sign of budging in the other direction (Davis, 1998). Thus, even between the two named practitioners of Anglo-American corporate governance, there are sharp divergences on such basic matters as the organization and composition of the board. There are also, notably, sharp differences in economic performance, favoring the US. Adopting Anglo-American governance practices is evidently not sufficient to ensure superior economic performance for an economy, even supposing one could determine what these practices were.

These cultural differences notwithstanding, the attractions are undeniable in emulating American corporate governance for firms seeking outside investment. The number of non-US firms listed on the New York Stock Exchange increased from 96 in 1990 to 379 in 1998, while the value of US equity investment abroad increase more than six-fold during the same period (Useem, 1998; New York Stock Exchange, 1999; Federal Reserve, 1999). Effectively borderless financial markets are perhaps the strongest force in encouraging the adoption of American corporate governance and its valorization of 'transparency' and 'accountability.' But while a particular *firm* may come to adopt an American model of governance – just as many manufacturers sought to adopt the Toyota model of production in the 1980s and 1990s – a system of governance, as an institutional matrix embedded in a particular culture, is far less prone to such wholesale change (cf. Coffee, 1998). Species may adapt, but it is far more difficult for an entire ecosystem to do so.

WHO ARE TOP MANAGERS AND COMPANY DIRECTORS?

Though market capitalism can epitomize impersonality – and some company headquarters

seem as remote as Kafka's castle – they are nonetheless intensely personal at the top. A handful of individuals make the defining decisions, whether to launch a new product, enter a promising region, or resist a tender offer. It is they who set the rules and fix the procedures that come to constitute the impersonal bureaucracy.

Top management is the catch phrase for those who work at the apex, and companies often define their 'top' as no more than the seven or eight most senior officers. Their color photos adorn the annual report's early pages. They speak for the company to inquisitive journalists and skeptical analysts. They are *the* 'they' when employees grumble about nasty work or shareholders gripe of shortchanged expectations.

To much of the world beyond the company walls and capital markets, however, top management is personified almost solely by the chief executive. Readers of the American business press know that Jack Welch 'runs' General Electric, Michael Eisner rules Walt Disney Company, and Warren Buffett *is* Berkshire Hathaway. Attentive Japanese recognize that Fujio Cho drives Toyota and Germans that Jurgen Schrempp steers DaimlerChrysler. It is enough to know the commanding general, it seems, to anticipate the strategy of attack. The upper apex of top management is what really counts.

Academic researchers had long been drawn to the same pinnacle of the pyramid, partly on the conceptual premise that the chief executive is the manager who matters, and partly on the pragmatic ground that little is publicly known about anybody except the CEO. We have thus benefited from a long accumulation of work on their family histories, educational pedigrees, and political identities, and we know as a result that their origins are diverse, credentials splendid, and instincts Republican. More contemporarily, we have learned much about their tangled relations with directors and investors as well. To know the CEO's personal rise and board ties is to anticipate much of the firm's strategic intent and performance promise. They are also a good predictor of the CEO's own fortunes – an elite MBA degree accelerates movement to the top, a prestigious background attracts outside directorships, and a handpicked board enhances pay and perquisites (Belliveau et al., 1996; Useem and Karabel, 1986).

The conceptual and pragmatic underpinnings for shinning the light solely on the CEO, however, have eroded in recent years, as companies redefined their operations and researchers reconceived their methods. A central thrust of company restructuring during the past two decades has been to transform the chief executive's office into the office of the executive. At many companies, CEOs have fashioned teams among their top officers that meet frequently and resolve jointly, their vertical control giving way to lateral leadership. Henry Schacht served as chief executive of Lucent Technologies from 1995 to 1997, and upon taking office, he devoted his first six months to building a shared strategy and culture among his top 14 officers. Unless his top managers were all working from the same script, he believed, the spin-off from AT&T would not succeed. He certainly would not be capable of making it succeed on his own.

Observers and consultants during the 1990s consequently came to extol the pragmatic virtues of 'top management teams.' If well formed, executive teams could assure prosperity; if poorly led, they could spell disaster. Predictably, stock analysts and professional investors frequently came to appraise not only the capabilities of the chief but also the lieutenants before they recommend stock or buy shares (Hambrick et al., 1998; Katzenbach, 1997; Katzenbach and Smith, 1992).

Similarly, academic researchers expanded their field of view from the chief executive to the entire upper echelon. They applied fresh strategies, ranging from personal interviews to direct observation and internet surveys, to acquire data on top managers other than the chief executive who now matter far more to company performance and stock analysts – if still not to the editors of *Who's Who*. A host of studies have subsequently confirmed what many executives already appreciated – a better predictor of a company's performance than the chief executive's capability is the quality of the team that now runs the show. To pinnacle analysis has been added top team appraisal (Finkelstein and Hambrick, 1996; Useem, 1995).

In conducting such studies, researchers have also discovered that the devil is in the detail, with a top team's composition and culture affecting company actions and results in ways that do not neatly fit into tidy frameworks. Some research results are straight-forward. A

study of 54 US multinational corporations, for example, found when top managers brought more foreign experience to the executive suite, their companies moved more production offshore and booked more sales abroad.

But other inquiries yielded more complex results, as seen in a study of 32 US airline companies in the wake of industry deregulation in 1979. The researchers focused on competitive moves such as price-cutting, advertising campaigns, and fresh routes. They assessed the extent to which the companies' top executives varied in their educational backgrounds (engineering, economics, business, law), functional specialization (finance, marketing, operations), and years with the company, and they discovered that the airlines with top management teams diverse in these areas were more likely to take competitive actions but slower to make their moves. Overall, they found that companies with greater diversity at the top built greater market share and generated greater operating profits (Sambharya, 1996; Hambrick et al., 1996).

Yet even this widening of research attention beyond the chief executive has not broadened enough. Many companies have expanded the concept of top management to include one, two, or even three hundred senior managers whose decisions have significant bearing on firm performance. Prior to its merger with Travelers in 1998, for instance, Citibank had designated the bank's senior-most 300 executives as its 'corporate leverage population,' and its 300 most vital jobs as its 'corporate leverage positions.' For Citibank, its future lay in the hands of 300 managers, not 3. Or consider how top management is defined at ARAMARK Corporation, a \$6.5-billion managed-services firm with 150,000 employees worldwide. Its chief executive, Joseph Neubauer, formed an Executive Leadership Council in the 1990s comprising the top 150 executives in the company, including business unit presidents, staff vice presidents, top general managers, and corporate department heads. The Council charts company strategy and exchanges best practices, and it is, in the words of Neubauer, the firm's 'leadership team.' Its members are 'free to make their own decisions,' says the CEO, but also 'as leaders,' they're 'all accountable' for company results.

Top management, then, has expanded in the minds of company managers and, to lesser

extent, academic researchers, from the boss to the boss's team to the boss's court. Presiding over them are the directors, those elected representatives who in law must serve as fiduciaries of the investor electorate but in fact have virtually no contact with their electoral base. Their working contact is almost entirely confined to the top management team, and in the nexus of that relationship – the 'commanding heights' of the market economy – are fashioned the strategies and decisions that drive the company's future and determine the country's prosperity (Yergin and Stanislaw, 1998).

If companies make semiconductors and concrete much the same way the world around, they organize their directors in almost as many ways as their national economies. Boards of large publicly-traded companies in the US range in size from 4 to 35 directors (at least among the *Fortune* 1000), averaging 11 members. Boards average 12 directors in Italy, 11 in France, and 9 in UK, with standard deviations of 3 to 4 directors. But cross-national comparability in size is about as far as it goes. American boards tend to include only two or three insiders, while Japanese boards rarely include even two outsiders. German and Dutch governance is built around a two-tier governance structure, employees holding half of the upper tier seats. British and Swiss governance is designed around a single-tier, management-dominated structure. Some systems give formal voice to labor, others none – German law requires that labor representatives serve on the board, while French law places labor observers in the boardroom. American law mandates nothing, but some boards have added a labor leader on their own (Charkham, 1994; Charkham and Simpson, 1999; Chew, 1997; Conyon and Peck, 1998; Franks, 1997; Hunter, 1998).

Such variety of national practices may well diminish for two reasons. First, as equity markets internationalize, with companies seeking capital from all corners of the globe, investors predictably prefer relatively consistent director models that they believe will optimize shareholder value and performance transparency. Their mental models of what's right may not indeed be right, but that is beside the point. Consider the preference expressed by some institutional investors in the US for a board chair who is not a sitting executive, believing that separation improves monitoring. Under pressure from investors in the wake of a \$6 billion

loss in 1992, for instance, General Motors did split the roles, installing an outside chairman – John G. Smale, retired chief executive of Procter & Gamble – to breathe down the neck of new chief executive Jack Smith. Whatever the separatist penchant and however well it may have served General Motors, research reveals that such a division creates no advantage for company performance. But for some investors, persuasive preconceptions still prevail over research facts, and they press for common practices around the world (Baliga et al., 1996).

Another example can be seen in US investor preference for non-executive directors, believing the board's capacity for vigorous monitoring of top management to be a direct function of its independence from top management. The California Public Employees' Retirement System advocates that 'a substantial majority of the board consists of directors who are independent.' The Council of Institutional Investors avows that 'at least two-thirds of a corporation's directors should be independent.' TIAA-CREF prefers that 'the board should be composed of a substantial majority of independent directors.' Yet recent studies yield ambiguous support for the premise. Yes, independent directors often behave in more shareholder-friendly ways, but they also may be less likely to dismiss under-performing executives and less prone to render useful strategic guidance (California Public Employees' Retirement System, 1999; Council of Institutional Investors, 1999; Millstein and MacAvoy, 1998; TIAA-CREF, 1999; Ocasio, 1994; Westphal, 1999; Bhagat and Black, 1999).

The diversity in directorship practices is likely to diminish, however, for a second, more factual reason. Certain practices do engender better performance, regardless of the setting, and as companies increasingly compete worldwide for customers and investors, they are likely to adopt what indeed does prove best. A case in point here is the number of directors on the board. Research on team success suggests that bigger is not better when boards exceed 15 or 20 members. When the number of directors climbs far above middle range, the engagement of each diminishes, and so too does their capacity to work in unison. Study of the boards of 450 large US industrial firms in 1984–91 reveals that, net of company size, manufacturing sector, and inside ownership, companies with smaller boards displayed: stronger incentives

for their chief executive, greater likelihood of dismissing an under-performing CEO, and larger market share and superior financial performance. In parallel study, the same is found to prevail among large companies in Denmark, France, Italy, Netherlands, and UK (Yermack, 1996; Conyon and Peck, 1998).

It is not surprising, then, to see companies worldwide migrating toward smaller boards in a search of improved performance. In their 1999 report to the stockholders, Sony's chief executive Norio Ohga and co-CEO Nobuyuki Idei, wrote that they had launched a new 'corporate reorganization' to 'maximize shareholder value.' A central feature of their reorganization is to improve their directors' 'monitoring ability,' and, to that end, Sony reduced its roster of 35 directors to just 9. Japan Airlines moved parallel fashion. The company had reported losses during three of its past five years, and its largest investor, Eitaro Itoyama (holding 3.4% of its shares), had announced a campaign to oust top management to 'save JAL.' To improve its directors' effectiveness and, hopefully, company performance, the airline shrank its board from 28 directors to 15 and required that they stand for election yearly rather than bi-annually (Institutional Shareholder Services, 1999; Sony, 1999).

Directors in principle protect owner interests, direct company strategy, and select top management. In practice, they had concentrated more on strategy and selection and less on owner interests. But the rising power of investors has made for greater director focus on creating value and less coziness with top management. American and British directors, following the 'Anglo-Saxon' model, are already more focused on value than most. But directors in other economies can be expected to slowly gravitate toward the mantra of shareholder supremacy as well.

HOW DO SHAREHOLDERS AND OTHER STAKEHOLDERS INFLUENCE THE CORPORATION?

The Uncommon Problem of the Separation of Ownership and Control

Imagine that the owners of a public corporation had a simple goal: to maximize the value

of their investment at minimum risk. The most straightforward measure of the achievement of this goal is growth in the price of the firm's shares, and effective managers are those that successfully endeavor to maximize share price. Governance systems vary widely in the means by which owners can influence managers – owners might have a direct say in corporate strategy and in selecting members of the top management team, they might delegate these functions to a board but ensure that compensation and other incentives are aligned with share price maximization, or they might rely on mechanisms such as takeovers to ensure managerial devotion to share price. Corporations where management was not held accountable for achieving the corporation's goals would attract little outside support: as Gilson (1996: 333) puts it, 'any successful [governance] system must have the means to replace poorly performing managers.' This is the essence of the 'agency problem' identified by Berle and Means (1932) in managerialist corporations with dispersed ownership.

The problem of managerialism, however, turns out to be of surprisingly little relevance outside the US and the UK. In virtually every other economy, even the largest businesses are typically owned by controlling shareholders. A study of the largest 20 corporations in 27 of the world's richest economies found that 'controlling shareholders – usually the State or families – are present in most large companies' (La Porta et al., 1999: 473), while another survey found that 'a large majority of listed companies from Continental European countries have a dominating outside shareholder or investment group' (Goergen and Renneboog, 1998: 2). While minority shareholders may have little direct influence on the management of such firms, controlling shareholders presumably act to ensure the pursuit of shareholder value since it is their own. Outside the wealthiest tier of nations, stock markets are of relatively less significance, and thus managerialist corporations are unimportant. The influences of owners on managers are direct and unproblematic.

The general idiosyncrasy of the American system received surprisingly little attention from corporate governance scholars before the publication of Mark Roe's book *Strong Managers, Weak Owners* in 1994. Prior to this, 'the corporate governance systems of other

nations were largely ignored because the American system was thought to represent the evolutionary pinnacle of corporate governance. Other systems, with different institutional characteristics, were either further behind the Darwinian path, or at evolutionary dead-ends; neither laggards nor Neanderthals compelled significant academic attention' (Gilson, 1996: 331).

In the late 1990s, however, a flourishing research interest focused on documenting and explaining the diversity of systems of governance. New systems of corporate and securities laws were installed in transitional East European economies to facilitate the process of privatization (with varied success – see Spicer and Kogut, 1999), and enthusiasm for financial markets as a tool for development in emerging markets created a practical need for understanding of cross-national variation in institutional structure (see the World Bank's corporate governance agenda at www.worldbank.org/html/fpd/privatesector/cg/index.htm). Nations vary in the extent of legal protection for shareholders and the quality of enforcement, and the strength of legal protection for shareholders is positively related to the degree of ownership dispersion. In other words, managerialist corporations are most common in countries with strong investor protections, while concentrated ownership is most common when investor protection is weak (La Porta et al., 1998). Stock markets are larger, and there are more public corporations per person, when investor protections are stronger (La Porta et al., 1997).

The single biggest factor distinguishing nations with strong legal protections for investors, and thus large capital markets and more dispersed ownership, was the origin of the legal system. Countries whose commercial law derived from a common law tradition, which includes most English-speaking countries as well as former British colonies, have stronger shareholder protections than countries with civil or 'code' law (La Porta and Lopez-de-Silanes, 1998). Absent strong legal protections against the types of self-aggrandizing managers contemplated by Berle and Means, and sensible people would avoid investing in companies with dispersed ownership because they would fear the loss of their investment. Concentrated ownership allows control of management without relying on uncertain legal enforcement.

The pole for market-centered (as opposed to relationship-based) capitalism is clearly the United States. In contrast to corporations throughout the rest of the world, large American corporations have relatively dispersed ownership. Roughly three-fourths of the 100 largest US corporations lack even a single ownership block of 10% or more. Of the 25 largest companies in 1999, the largest single shareholder averaged only 4% of the holdings, while the comparable percentages are 11 in Japan, 18 in Germany, and 19 in France (Brancato, 1999).

The dispersion of ownership in the US effectively rules out the direct control available in firms where a single family or bank owns most of the shares. Dispersed shareholders therefore delegate control to a board of directors that they elect to act as their agents in choosing and supervising the top management team. Control by minority shareholders generally extends only as far as buying and selling shares, and voting for directors and other matters on the annual proxy. Minority shareholders almost never have a say in the selection of top managers, or even in who ends up on the board. Indeed, by some accounts inattention is the only sensible course of action for dispersed shareholders ('rational ignorance'), as the cost of being well informed about the governance of the firm is not outweighed by the marginal benefit of improved corporate performance that might result from informed voting or activism (Fama, 1980). But while in other contexts this collective action problem would result in management unaccountable to shareholders, investors in US corporations can rest easy because of the well-developed set of institutions that have arisen to ensure share price maximization without their active participation (see Easterbrook and Fischel, 1991).

Takeovers

The most essential mechanism for enforcing attention to share price is the takeover market or 'market for corporate control.' By hypothesis, a poorly-run corporation will suffer a low stock market valuation, which creates an opportunity for outsiders with better management skills to buy the firm at a premium from shareholders, oust the top management team, and rehabilitate the firm themselves, thus increasing its value (Manne, 1965). This provides an

economic safety net for shareholders and an opportunity for outsiders who detect undervalued firms. Moreover, it provides a mechanism to discipline top managers that fail to serve shareholder interests, as they generally end up unemployed following a takeover. In the contractarian model, the market for corporate control is the visible hand of Darwinian selection, weeding out badly run firms and protecting shareholders from bad management. Internal control mechanisms may fail, as boards are compromised by 'cronyism,' and thus the hostile takeover – as an objective, market-based mechanism – is an essential weapon in the armory of the contractarian system (Jensen, 1993). US public policy in the 1980s made it considerably easier for outsiders to mount hostile takeover bids, and the result was a massive wave of takeovers in which nearly one-third of the largest publicly-traded manufacturers faced takeover bids (Davis and Stout, 1992).

Reams have been written about the US takeover wave of the 1980s (see Blair, 1993) but the high points are easily summarized. The typical target had a low stock market valuation relative to its accounting or book value, as one would predict based on the contractarian model (Manne, 1965; Marris, 1964), and the source of this low valuation was often excessive diversification by conglomerate firms (Davis et al., 1994). Conglomerates were typically purchased with the intention of busting them up into more focused components, which were sold to buyers in related industries (Bhagat et al., 1990), while non-targets restructured to achieve industrial focus and avoid unwanted takeover (Davis et al., 1994). In the US, takeovers are regulated both at the federal and state level, and by the early 1990s most states had passed legislation to make takeovers attempted without the consent of the target's board of directors extremely difficult. Thus, hostile takeovers virtually disappeared in the US after 1989.

Two results of the 1980s hostile takeover wave stand out. The first is that the manufacturing sector overall ended the decade much more focused than when it began, and the trend toward within-firm focus continued unabated through the mid-1990s (Davis and Robbins, 1999). With a few notable exceptions, such as General Electric, the industrial conglomerate would appear to be a thing of the past in the US, in spite of its prevalence

elsewhere in the world. The second result is a decisive shift in the rhetoric of management toward 'shareholder value,' to the virtual exclusion of other conceptions of corporate purpose. This is realized in efforts at managing investor relations (Useem, 1996), in the kind of spin that management puts on practices such as compensation plans (Westphal and Zajac, 1998), and in more tangible actions such as acquisition and divestiture strategies. US manufacturers in the 1990s eschewed diversification in favor of 'strategic' (horizontal) mergers and acquisitions, resulting in behemoths in oil, defense, autos, and other sectors that would have been unthinkable in previous decades. Notably, this shift toward a monomaniacal focus on shareholder value occurred in spite of the fact that – in stark contrast to the 1980s – hostile takeovers had virtually disappeared in the 1990s, and takeover targets were no longer 'underperforming' firms but rather those that were strategically attractive to acquirers (Davis and Robbins, 1999). Evidently, the hostile takeover is less essential to investor capitalism than had previously been thought.

Shareholder Activism

Hostile takeovers are a rather blunt instrument for transferring corporate control, and the message they send is not especially fine-grained. But short of takeover, the channels of shareholder influence are surprisingly limited in the US (see Davis and Thompson, 1994). The formal means of shareholder voice is through proxy voting at the annual meeting. Shareholders vote on who serves on the board of directors, which accounting firm audits the firm's books, whether to approve certain types of executive compensation plans, and other significant matters such as mergers, changes in the corporate charter, or changes in the state of incorporation. Almost without exception, these votes consist of approving (or not) proposals put forth by the current board of directors—competing director candidates, or competing proposals, are extremely rare. The primary means of direct shareholder voice is through shareholder proposals. Any shareholder owning a non-trivial stake in the corporation can submit a proposal relevant to the corporation's business to be included in the proxy statement and voted on by shareholders.

But the board may exclude proposals relating to the 'ordinary business' of the corporation, a term of art defined fairly broadly by the Securities and Exchange Commission, the regulatory body responsible for governing the proxy process.

The most famous and controversial case of the 1990s involved Cracker Barrel Old Country Stores, Inc., a restaurant chain headquartered in Tennessee. In 1991, the corporation announced a policy that it would not employ individuals 'whose sexual preferences fail to demonstrate normal heterosexual values' and fired more than a dozen gay employees. Subsequent public protests led the company to rescind the policy, but it did not explicitly include gays in its anti-discrimination policy, and gays continued to be fired. An institutional investor, the New York City Employees' Retirement System (NYCERS), submitted a proxy proposal in 1991 calling for Cracker Barrel to add explicit prohibitions against employment discrimination based on sexual preference to its employment policy statement. Cracker Barrel sought to exclude the proposal under the ordinary business exception, which had previously been considered to cover employment matters, and in October 1992 the SEC issued a 'no-action letter' (indicating that it would not take action against Cracker Barrel for excluding the proposal from its proxy materials). The SEC's position prevailed in court in 1994, and thus all employment-based matters were put beyond the scope of shareholder voice. The business case for NYCERS' position seemed clear: employment discrimination may subject the corporation to protests, tarnished reputation, lost business, and class action lawsuits, to the detriment of shareholder value; yet the SEC held even such highly consequential employment matters to be ordinary business by definition (McCann, 1998). In May 1998, the SEC eventually reversed its position on Cracker Barrel to allow 'employment-related proposals that raise sufficiently significant social policy issues' (cited in Ayotte, 1999). In October of that year, after a year-long battle, NYCERS' proposal appeared on Cracker Barrel's proxy statement, receiving 5.5 million votes (shares) in favor and 26.5 million votes against.

What is perhaps surprising is that even if NYCERS' proposal had won a solid majority,

it would have had no binding force on Cracker Barrel's board. Shareholder proposals are advisory ('precatory') only and cannot be used to compel management or the board to take any specific actions (see Davis and Thompson, 1994, for a discussion of the limits of shareholder voice). In other words, once they have delegated authority to the board of directors, dispersed shareholders have almost no legal standing to intervene further on matters of strategy and management. Why, then, do activist shareholders bother? In the US, the most prominent corporate governance activists are public pension funds run by political appointees, and thus some skeptics see their motivation as political rather than economic, and their qualifications as wanting (Useem et al., 1993). One seasoned director said of activist pension fund officials, 'These guys are not part of the business community. They're politicians' (Neiva, 1996). In its 1994 proxy statement, Cracker Barrel management said of NYCERS: 'Your management is convinced that the proponents of Proposal 3 are attempting to circumvent the legislative process by using corporate proxies as a forum to promote a 'social policy' concerning gay and lesbian sexual preferences, thereby forcing your Company to do what Congress has declined to force companies to do. Your management is also convinced that the proponents of this proposal are more interested in gay and lesbian concerns as a social issue than in any economic effect these concerns may have on your Company.'

Yet research suggests that activist pension funds are motivated by financial concerns, not politics. Funds that pursue a buy-and-hold indexing strategy (which benefit from a general rise in the value of their portfolios) tend to field generic proposals for the purpose of promoting shareholder-oriented governance generally, while actively-managed funds (which can realize shorter-term trading gains) tend to focus on firm-specific governance proposals, consistent with the argument that the economically appropriate style of activism varies with the fund's investment style (Del Guercio and Hawkins, 1998). Proposals sponsored by pension funds (as opposed to individuals or religious groups) get higher favorable votes on average, occasionally achieving a majority vote (Gillan and Starks, 1998). And while there is little evidence that shareholder

activism has an immediate positive impact on the share price of target firms, targeted firms do respond with significantly more governance changes than non-targets (Del Guercio and Hawkins, 1998). Thus, one survey of the literature on shareholder activism concludes that activism has had modest effects on governance structures but negligible impact on earnings and share price (Karpoff, 1998). It is possible that activism has a more diffuse impact by raising the visibility of directors who had previously toiled in anonymity; as one director put it, 'If you kill one wildebeest, then all the other wildebeests will start running a little faster' (Neiva, 1996). Perhaps activism serves to raise the general awareness of shareholder value and shareholder-oriented governance practices. It is hard not to conclude, however, that this would be pushing through an open door.

Financial Analysts

If takeovers are too blunt an instrument and shareholder activism too diffuse, then financial analysts may serve as a more intermediate form of influence on behalf of shareholders. Analysts investigate companies in order to render judgments on their prospects (to be realized in future earnings) and thus to estimate their appropriate valuation. Analysts are often allowed privileged access to corporate executives and facilities and are in a position to give strategic and governance advice directly to senior managers, something rarely afforded to the firm's own shareholders (Useem, 1996). In principle, the rewards go to the most accurate analysts, giving them incentives to act as corporate watchdogs. In practice, however, analysts are rarely dispassionate observers: those that work for firms doing business with a corporation they follow give systematically more positive evaluations than those that work for other firms, and analysts are discouraged from giving negative evaluations of potential clients of their employer (Hayward and Boeker, 1998). As *New York Times* financial writer Gretchen Morgenstern put it, 'What analysts are selling increasingly today is not the ability to plumb a company's business and uncover investment gems or scams but rather the ability to make investors buy the stocks they follow' (*New York Times*,

July 18, 1999). 'Sell' recommendations are therefore almost non-existent. Moreover, on average analysts are not especially accurate: according to Malkiel (1996: 169), 'Security analysts have enormous difficulty in performing their basic function of forecasting earnings prospects for the companies they follow.... Financial forecasting appears to be a science that makes astrology respectable.' In short, while analysts may be seen as a means to promote shareholder interests, this function frequently goes unrealized.

Although takeovers, shareholder activism, and financial analysts are fixtures on the American corporate landscape, and are uniquely suited to managerialist corporate governance, in the 1990s they spread beyond the borders of the US and the UK. In continental Europe, 1999 was a watershed year for hostile takeovers. In the first three months of the year, 13 hostile bids were unveiled, compared to 55 in the prior nine years, and the value of the proposed deals was far greater than the value of all prior hostile deals in the history of Europe (*Economist*, 17 April 1999). In Italy, Olivetti made a successful bid for the far larger Telecom Italia, the former Italian state telephone company and the sixth-largest telecom organization in the world. In France, Banque Nationale de Paris (BNP) simultaneously bid for banking rivals Societe Generale and Paribas, while oil giant TotalFina bid for Elf Aquitaine. Remarkably, Paribas, which was advising Total on its bid, had executives on the boards of both Total and Elf; Societe Generale's chair was on the board of Total, BNP's chair was on the board of Elf; Elf's chair was on the board of BNP, while Total's chair was a BNP director. Even the dense ties of the French financial elite were not sufficient to withstand the economic attractions of these deals. Due to much more stringent legal restrictions, it remains to be seen whether hostile takeovers will catch on outside Europe.

Shareholder activism, on the other hand, has achieved a global reach, partly through the actions of American institutional investors and partly through indigenous governance activists. The California Public Employees' Retirement System (CalPERS), a pension fund for government employees in California, promulgated corporate governance standards for Britain, France, Germany and Japan, and formed an alliance with Hermes (the pension fund manager for British Post Office and British

Telecom staff) to increase their mutual heft in issues of international corporate governance (CalPERS document can be found at www.calpers-governance.org/principles/international/). Given the vast growth of US institutional investment in equities outside the US, American-style investor activism is poised to go global. Already, investor pressures are credited with forcing the ousters of Cie. De Suez's chair in 1995 and Olivetti's chair in 1996 (Useem, 1998). In South Korea, Jang Ha Sung formed the People's Solidarity for Participatory Democracy to press for corporate governance reform, and while he met with little success prior to the Asian financial crisis of 1997, he has subsequently become 'the darling of the international crowd' and has formed successful alliances with foreign institutional investors to press for governance changes (*Economist*, 27 March 1999). In France, Colette Neuville formed the Association for the Defense of Minority Shareholders to push for corporate governance reform and to strengthen investor protections in takeovers (*Business Week*, 18 September 1995). Both non-local and indigenous investors can draw on the principles and tactics of shareholder activism in the US. Given the relatively weak minority shareholder protections outside common law countries, however, it is likely that any such activism will have modest impact at best (La Porta et al., 1998).

DO TOP MANAGERS REALLY MAKE A DIFFERENCE?

If shareholders are increasingly insistent that board directors require top managers to deliver steadily rising returns on their investments, investor activism is premised on a critical assumption that top managers can make the difference. While the premise may seem intuitively obvious to those inhabiting this world, it is far from self-evident to those who study it. Observers diverge from the assumption of influential executives in two opposing directions, one viewing top managers as all-powerful, others seeing them as all but powerless. Jay Lorsch had examined company boards with both views in mind, and his book title well captures the bi-polar thinking about the clout of company executives as well: *Pawns or Potentates* (1989).

Gaetano Mosca, Vilfredo Pareto, and kindred 'elite' theorists early articulated the all-powerful view, but C. Wright Mills captured it best in his classic work, *The Power Elite* (1956). Company executives, in his acid account, had joined with government officials and military commanders in an unholy alliance that later observers, including US president Dwight D. Eisenhower, would later dub the 'military-industrial complex'. Seen from this parapet, top management and their allies exercise commanding control over the company and the country. In E. Digby Baltzell's critique, *The Protestant Establishment* (1987) and G. William Domhoff's rendering, *Who Rules America* (1967), they have even come to constitute a self-conscious class, favoring descent over deed. Others discern comparable customs in British business and elsewhere (Bottomore, 1993; Scott, 1990, 1997). To the extent that top management is indeed all-powerful, shareholders and directors possess a silver bullet for righting whatever has gone wrong: install new management.

For the community of management scholars, Jeffrey Pfeffer (1978, 1981) well articulated the opposite, all-powerless view with the contention that market and organizational constraints so tied top management's hands that it was much the captive, not a maker, of its own history. Production technologies and competitive frays in this view are far more determining of company results than the faceless executives who sit in their suites. Structures matter, personalities don't. It counts little who serves in top management, and, by extension, on the board. Managers and directors are controlling and caste-conscious in Mills' and Domhoff's critique, while they are both powerless and classless in Pfeffer's hands. If top management is quite as powerless as the latter imagery suggest, investors seeking new management are surely wasting their time.

Though probably less often than university deans, company executives do complain of a seeming helplessness at times. Yet almost anybody in personal contact with top managers reports just the opposite. Direct witnesses typically describe instead a commanding presence of their top management, an organizational dominance. It is the senior executives who shape the vision and mobilize the ranks, and it is they who make the difference between success and failure (Tichy, 1997;

Charan and Tichy, 1998). Also consistent with the concept of the prevailing executive is evidence from the flourishing executive search industry, where companies pay hundreds of headhunting firms millions of dollars to find the right men and women for the executive suite. They are engaged, in the phrasing of a widely circulated assessment by McKinsey & Co. (1998), in a 'war for talent.' It would hardly be deemed warfare or worth millions if senior managers made so little difference when they arrived in office.

Investors themselves think otherwise as well. When companies announce executive succession, money managers and stock analysts are quick to place a price on the head of the newly arrived, and, depending on the personality, billions can be added to or subtracted from the company's capitalization. On the addition side, consider the appointment of Christopher Steffen as the new chief financial officer of Eastman Kodak in 1993. Steffen had been hired to help turn around a company whose earnings and stock price had been languishing. He was characterized as the 'white-knight chief financial officer who could save stodgy Eastman Kodak.' Investors applauded his hiring. The company's stockprice soared in the days that followed, adding more than \$3 billion to the company's value. In an immediate clash with chief executive Kay Whitmore, however, Steffen resigned just 90 days later. Investors dumped Kodak shares with vigor, driving the company's value down the next day by \$1.7 billion, further affirming his worth in the eyes of discerning investors. It would seem that just a single individual with the right talent could augment a company's value by billions in days (Useem, 1996).

On the subtraction side, consider the selection of John Walter as the new chief operating officer and CEO-apparent of AT&T in 1996. In the five trading days that followed, in a period when little else was transpiring in the market, AT&T's value dropped by \$6 billion. One business writer had hailed Christopher Steffen as the 'three-billion-dollar man.' John Walter might comparably be dubbed the 'six-billion-dollar disappointment' (Rigdon, 1993).

The importance that investors and directors attribute to top management for growing their fortunes can also be seen in the ultimate punishment for failure to do so: dismissal. Whether the US, Japan, or Germany, the

likelihood of a CEO's exit in the wake of a stock free fall is increased by as much as half. And investors are often the engines behind the turnover. Study of Japanese companies stunned by a sharp reversal of fortune, for example, reveals that those whose top ten shareholders control a major fraction of the firm's stock are more often than others dismiss the president and even bring in new directors (Kaplan, 1994a, 1997; Kang and Shivdasani, 1997).

To obtain a metric for the longer-term value that a chief executive brings to a company, we turn to several studies that have examined company results several years after a chief executive has left office, not just several days. The successor brings a distinctive blend of talents to the office, and if those talents make a difference, the firm's performance should be different as well. Net of confounding factors such as the company's sector and economy's momentum, investigators do find that company performance does vary with executive personality. Yet compared to the firm's structure and identify, the chief executive's contribution can seem modest. After all, if Bill Gates retired as chief executive at Microsoft or Jack Welch at General Electric, these companies are such product juggernauts that their successors are sure to look good for some years to come. But in absolute terms, the studies report, performance can rise or fall by as much as 10 to 15% over several years after the CEO's departure depending upon the specific successor. To put that in perspective, think of a new manager of a professional baseball team that had won 80 games and lost 80 games during the past season. If the new manager's limited talents lead the team to win 15% fewer games next season, the team's win-loss record would drop from .500 to .425, and the coach will become the heel. If instead the new manager's excellent talents would yield 15% more wins, the team's record rises to .575, and coach will be the hero (Lieberson and O'Connor, 1972; Thomas, 1988).

As strong as they are, these results may still underestimate the difference that top management makes now compared to the past. In a study of 48 large manufacturing firms among the *Fortune* 500, the researchers asked two immediate subordinates of the chief executives of the extent to which their boss, the CEO: was a visionary: showed strong confidence in self and others, : communicated high

performance expectations and standards, personally exemplified the firm's vision, values, and standards, and demonstrated personal sacrifice, determination, persistence, and courage. The investigators also assessed the extent to which the firms faced environments that were dynamic, risky, and uncertain. Taking into account a company's size, sector, and other factors, they found that these executive capabilities made a significant difference in the firm's net profit margins among companies that faced highly uncertain environments. When the firms were not so challenged, however, the chief executive's qualities had far less of an impact on performance (Waldman et al., 1999).

Top management matters more, it seems, when it is less clear what path the company should pursue. Given the intensification of global competition and technological change in many markets, leadership is thus likely to make more of a difference in the future than in it has in the past. We remember wartime prime ministers and presidents better than peacetime leaders, and the same is likely to be true for company executives. Thus, it not surprising that directors are observed to replace failing executives more quickly now than in years past (Ocasio, 1994). Similarly, directors are observed to more generously reward successful executives than in the past. For each additional \$1,000 added to a company's value in 1980, directors on average provided their chief executive an extra \$2.51. By 1990, the difference in their payments had risen to \$3.64, and by 1994 to \$5.29. Put differently, in 1980 the boards of companies ranked at the 90th percentile in performance gave their CEOs \$1.4 million more than did boards whose firms ranked at the 10th percentile (in 1994 dollars). But by 1990, the boards had expanded that gap to \$5.3 million, and by 1994 to \$9.2 million (Hall and Liebman, 1998).

The specific leadership or teamwork capabilities that do account for the varying performance among top managers is beyond the scope of this chapter. But broadly speaking, leadership within the company is a critical component. Unless the troops are mobilized and their mission understood, they are unlikely to deliver the value top management wants. But so too is leadership out and up, building confidence and understanding among the money managers and stock analysts who can

turn against a poorly appreciated or understood company as quixotically as they did against the Asian nations when Thailand devalued its currency in July 1997.

Skillful top management work with professional investors is thus becoming more of a virtue since money managers and stock analysts have become less tolerant of languishing results and are better able to demand stellar performance. Moreover, globally minded investors are now comparing opportunities worldwide, and top managements and their performance are judged less against their domestic neighbors and more against the best anywhere. To assure investor favor and assuage doubt, companies and directors are therefore increasingly likely to stress executive ability to deliver the strategy story to the stock analysts and, ultimately, share value to the money managers. Research confirms that when chief executives present their strategies to groups of stock analysts, institutional interest and stockholding does indeed rise (Byrd et al., 1993). While some top managements will be tempted to create defenses against shareholder pressures, more are likely to be drawn to affirmative measures, including improved disclosure of information and stronger governing boards (Useem, 1998).

HOW DO CORPORATIONS SHAPE SOCIETY?

At stake in discussions of corporate governance and top management are questions of corporate power and accountability, and ultimately of the welfare of society. Corporations are *legal fictions*, created by systems of law to serve social ends for consumers, workers, and investors. Systems of corporate governance are, in essence, genres – styles of thinking about the corporation, its purposes, to whom it is accountable. There is a long-standing antinomy between the social entity model of the corporation and the property or contractarian conception (Allen, 1992). The entity conception, central to organization theory, sees corporations as 'containing' members, for whom the corporations provide various goods (for example, income security, social identity) as part of a social contract. In the most expansive version of this view, corporations directly

shape almost every aspect of society. According to Perrow (1991), 'the appearance of large organizations in the United States makes organizations the key phenomenon of our time, and thus politics, social class, economics, technology, religion, the family, and even social psychology take on the character of dependent variables.... [O]rganizations are the key to society because *large organizations have absorbed society*.' The social entity conception of the corporation is associated with communitarian or relationship-based capitalism, in which law and custom accord the corporation obligations beyond shareholder wealth maximization (Thurow, 1992; Bradley et al., 1999; Blair and Stout, 1999).

In contrast, the contractarian model takes the notion of the corporation as a legal fiction to its logical extreme: it is nothing more than a nexus of contracts among freely contracting individuals, with no further 'entitivity.' This yields a substantially more circumscribed view of how the corporation shapes society, namely, through its impact on economic growth. Although the contractarian model denies the existence of the corporation as a social entity with obligations to any constituencies other than shareholders, the most sophisticated theoretical rationale for the contractarian model is framed in terms of social welfare. In stylized form, it runs as follows. Firms maximize social welfare by maximizing profits. The pursuit of profit leads firms to offer goods or services that the public will voluntarily pay for (thus benefiting consumers), and creating those products provides employment (thus benefiting workers). A firm's share price is the best measure of its sustainable profitability into the future, according to the well-documented efficient market hypothesis (according to Jensen [1988] 'no proposition in any of the sciences is better documented' than the efficient market hypothesis). Thus, as a measure of corporate performance, share price is ideal, and devices that encourage corporate managers to maximize share price thereby achieve a trifecta of benefiting consumers, workers, and shareholders simultaneously. These benefits may be unintentionally undermined when firms pursue other ends in addition to shareholder value (as advocated in the social entity conception), because serving two (or more) masters may lead in effect to serving none (Friedman, 1970). As 'residua claimants',

shareholders are the appropriate constituency for the corporation to serve because maximizing their interests automatically serves the interests of the corporation's other constituencies. Shareholders have the best incentives to monitor and, if necessary, replace management that goes astray. As Gilson (1981) memorably put it, 'if the statute did not provide for shareholders, we would have to invent them'.

Note that this case does not rest on anything sacred or mystical about shareholders and their property rights. Compare the apologia provided by Al Dunlap, former CEO of Sunbeam famous for his expansive approach to layoffs: 'The shareholders own the company. They are my number-one constituency, because they take all the risk. If the company goes bust, they lose their life's savings. I can't give them their money back.' Of course, actual ownership patterns are quite different from this 'widows and orphans' portrayal: most large US firms are owned primarily by highly diversified institutional investors, and individuals who focus their investments in one particular firm are typically employees of that firm, whose interests are more complex. In the sophisticated version of contractarianism, shareholders are as much a legal fiction as the corporation itself. It just happens that they are, by hypothesis, part of a social welfare-maximizing genre of corporate governance. As Allen (1992) puts it, this conception of the corporation 'is not premised on the conclusion that shareholders do "own" the corporation in any ultimate sense, only on the view that it can be better for all of us if we act as if they do'.

As a corporate genre, the contractarian approach is as distinctive to the US as Faulkner and Hemingway. The emphasis on voluntarism and individual liberty, and the suspicion of viewing the corporation as a social entity with obligations to constituencies other than shareholders, are recurrent themes in American law and economics (Allen, 1992; Bradley et al., 1999). According to Roe (1994), these individualist themes coupled with a populist mistrust of concentrated economic and political power to produce the managerialist corporation as we know it. Roe's (1994) study told a path-dependent tale of the American system in which the obvious 'solution' to the problem of managerialism – concentrated ownership in the hands of financial intermediaries – was repeatedly prevented by

legislation driven by fears of concentrated economic power. At each point when corporate control threatened to become concentrated in a few hands, populist political pressures prevented such centralization. Thus, American corporate governance evolved like an ecosystem in an idiosyncratic climate, getting by as best it could, given its constraints. Along the way a number of means to ensure corporate attentiveness to share price evolved, including most notably the takeover mechanism. In many cases, these were second-best solutions that arose because the first-best was ruled out; the end product is the institutional equivalent of a Rube Goldberg invention: it ain't pretty, but it gets the job done – in this instance a riveting on shareholder value.

The histories of present-day institutions lend themselves to alternative interpretations, even within a general evolutionary framework. In contrast to Roe, Coffee (1998) argues from the recent evidence that the managerialist corporations characteristic of the American system are the product of legal success. Rather than seeing political pressures as *preventing* concentrated ownership, he sees strong legal protections as *allowing* managerialism and all the benefits of a system of arms' length investment without the intervention of powerful intermediaries. Along similar lines, Modigliani and Perotti (1998) portray arms' length financing (via securities markets) and network-based relationship capitalism as functional alternatives—if reliable legal enforcement is available, then a managerialist system centered on financial markets is possible. In contrast, the absence of reliable legal enforcement prompts the formation of 'noncontractual enforcement mechanisms'—often realized in bank-centered networks. In other words, it is relationship-based systems that are the poor cousins of the more arms' length system, and not the other way around.

The value of having a dominant corporate owner with direct control over management, as opposed to dispersed (and presumably powerless) shareholders that delegate authority to a board, has been an object of faith since Berle and Means wrote their famous book. But research in the 1990s, echoing the populist sentiments described by Roe (1994), has instead emphasized the social and economic costs of concentrated economic power. After the East Asian financial crisis of the late

1990s, systems of relationship capitalism, in which dominant owners (banks or families) are tied together into social networks, came to be called 'crony capitalism,' reflecting the changing evaluations of personalistic vs arms' length business ties. Dominant shareholders may encourage profit maximizing, but they may instead use the corporation to pursue their own ends, which need not contribute to general economic welfare. Managers in family-controlled firms are difficult for outside shareholders to oust, no matter how bad their performance, and the impact can extend to dozens of firms through control pyramids (Morck et al., 1998). While the ventures of well-connected cronies may be lavishly funded, promising business ideas generated by those outside the network are denied access to capital and die on the vine. 'The opacity and collusive practices that sustain a relationship-based system entrench incumbents at the expense of potential new entrants,' rendering the economic system resistant to reform (Rajan and Zingales, 1999: 14). Moreover, economies characterized by concentrated wealth in the hands of 'old money' families grow more slowly than economies without such families, again suggesting a political entrenchment that limits economic adaptability (Morck et al., 1998).

Recent research in financial economics thus suggests that social welfare is enhanced by a strong independent state and undermined by concentrated inherited wealth and power. The implications are ironic. Whereas Berle and Means feared that dispersed ownership would create a class of managers with control over large corporations but little accountability to shareholders, the late 20th century assessment suggests that *concentrated* ownership leads to cronyism, political favoritism, and weak economic growth. The irony runs deep. 'Managerialist' firms in the US pursue shareholder value with little regard for other stakeholders, while firms with concentrated ownership elsewhere in the world cannot help but attend to other stakeholders. Yet the explicit ignoring of other stakeholders may ultimately yield more favorable benefits for them.

The tradeoffs in social welfare of treating the corporation as a social entity vs as a nexus-of-contracts are thus quite subtle. The difficulty of displacing managers that are unsatisfactory to investors is seen as a critical failing of

relationship capitalism because it renders firms too lethargic in the face of change (see Gordon, 1997). Without the prospect of outside takeover or other mechanisms that focus decision making on shareholder value, corporations are too slow to exit low-growth industries by closing plants and laying off employees (Jensen, 1993). When Krupp-Hoesch Group made a hostile takeover bid for steel rival Thyssen in March 1997, Thyssen workers fearful of the inevitable job losses mounted a demonstration at Krupp headquarters, pelting Krupp's CEO with eggs and tomatoes. Krupp was convinced by local political leaders to suspend the bid and enter into friendly negotiations. As the two firms sought to hammer out a joint venture agreement, 25,000 workers massed at Deutsche Bank headquarters in Frankfurt to protest the bank's role in the takeover – Deutsche Bank was helping to finance Krupp's bid, but it also had a representative on the Thyssen board – and the final, friendly agreement resulted in considerably fewer lost jobs at Thyssen. One person's 'industrial lethargy' is another person's job security.

In the US, by contrast, layoffs are so common as to arouse little comment, and it is difficult to imagine mass protests in response to takeovers. (The US Department of Labor estimates that 40% of the American labor force changes jobs in any given year.) It is hard to imagine mass protests against dispersed shareholders, and public debate over the social obligations of the corporation has virtually disappeared. Indeed, those corporations that try to serve the ends of stakeholders other than shareholders find it difficult to do so. In the 1919 case of *Dodge vs Ford Motor Co.*, the Michigan Supreme Court laid down a foundational view of the purpose of the corporation in a contractarian world:

There should be no confusion of the duties which Mr. Ford conceives that he and the stockholders owe to the general public and the duties that he and his co-directors owe to protecting minority shareholders [i.e., the Dodge brothers]. A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to

a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes.

Indeed, as we have seen from our discussion of the Cracker Barrel case, the board of an American corporation would not necessarily be required to attend to other constituencies even if their own shareholders wanted it! (Blair and Stout [1999: 251] make a compelling case that the discretion of the board of directors over the use of corporate resources is 'virtually absolute' under American corporate law, and this discretion can be used to implement something like a social entity model. They recognize, however, that custom among law and economics scholars – if not the law itself – treats the shareholders as the sole owners and legitimate 'stakeholders' of the corporation, and this notion has achieved the status of doxology among American corporate managers in the 1990s [Davis and Robbins, 1999].)

The beneficial effects of the shareholder-oriented corporation on society thus rest on the stylized argument at the beginning of this section – that corporations serve consumers, workers, and shareholders best when they focus exclusively on maximizing share price.

IS A WORLDWIDE MODEL FOR TOP MANAGEMENT AND CORPORATE GOVERNANCE EMERGING?

We have described corporate governance as an institutional matrix that structures the relations among owners, boards, and top managers and determines the goals pursued by the corporation. The corporation is a legal fiction, and different systems of governance represent different genres, with relationship capitalism (in which the corporation is treated as a social entity) and investor capitalism (in which the corporation is a nexus-of-contracts) as the two major distinct sub-types. Can both types survive, or will global trade and investment flows prompt a Darwinian struggle in which one system drives out the other, leading to global convergence?

The question of societal convergence – is it possible, likely, or desirable – has been mulled over by sociologists (Guillen, 1999)

and economists (North, 1990) for decades. It is fair to say that the majority opinion, if not the consensus, is that convergence has not occurred in the past and is unlikely to occur in the future. But the institutions of corporate governance, and the means of organizing top management, are considerably more circumscribed in scope. While the flow of trade across national borders may not induce convergence (North, 1990), the flow of global capital dwarfs that of trade and can have far more important impacts for corporate organization. The economic benefits of opening an economy to international investment, particularly through financial markets, are great, at least in theory – it can increase the availability and reduce the cost of capital for both new and established businesses, thereby boosting economic growth overall. But these benefits of financial markets require corporate governance practices that reassure arms' length investors that they will get a return. The US in particular is seen as having evolved a well-articulated system of institutions for ensuring that shareholders can make arms' length investments in corporations with a reasonable degree of confidence that management will do its job as well as possible. Given the manifest benefits of the contractarian model, some commentators see movement toward this system as 'inexorable.... The nature of this movement is unarguably in the Anglo-American direction rather than the other way around' (Bradley et al., 1999: 80). Others see a global spread of American-style management as extremely unlikely, and the purported benefits as ephemeral (Guillen, 1999). In short, there is no sign of convergence in the scholarly literature on convergence.

Before answering the question, it is worth asking it well. Those examining convergence often focus on very different unit of analysis. At the *national* level, impediments to convergence on American-style corporate governance institutions are imposing. Common law, which is an inheritance of many former British colonies and relatively few other nations, is especially shareholder-friendly, civil law, which characterizes most nations in the world, is not (La Porta et al., 1998). The quality of legal enforcement also varies widely by nation. Entrenched and politically powerful economic interests are unlikely to abandon the basis of their economic dominance easily

(Morck et al., 1998). Moreover, relationship capitalism centered around powerful financial institutions has clear advantages over financial market-based in facilitating rapid economic development; a well-trained government bureaucracy guiding investment flows through affiliated banks can create an infrastructure of basic industry quite rapidly (Evans, 1995). Thus, the most sophisticated accounts of the link between national systems of corporate governance and economic vitality do not assume that there is one best way, but that the best system is contingent on a nation's level of economic development. In an exemplary work of this sort, Carlin and Mayer (1998) find that 'there is a positive relation in the less developed countries between activity in bank financed industries and the bank orientation of the countries and a negative relation between concentration of ownership and activity in high skill and external financed industries. In more developed countries, the relations are precisely reversed.' Thus, forcing an American system of governance on less-developed nations could be disastrous. On the other hand, it suggests that nations that have moved from 'emerging' to 'developed' may benefit by affecting a shift from relationship capitalism to investor capitalism, however unlikely this may be in practice (Rajan and Zingales, 1999).

The picture shifts when one considers not nations but firms. For the largest global corporations with the greatest need for capital, such as those listing on the New York Stock Exchange, movement toward the American style appears almost inevitable, just as adoption of the Toyota system of manufacturing seemed inevitable for the largest manufacturers (see Useem, 1998). In his thoughtful discussion of the convergence debate, Coffee (1998) argues that formal convergence is unlikely but 'functional convergence' is plausible. His argument runs as follows. Firms with higher stock market valuations have advantages in acquiring other firms around the globe and thus are more likely to survive global industry consolidations. As large global corporations seek the benefits of higher market valuations by listing on American stock exchanges, they thereby become subject to US legal standards. This moots the issues raised by La Porta et al. (1998): firms, in effect, choose their legal regime, and nations need not seek to become 'more American' for their indigenous firms to

gain the benefits of American-style governance. The outcome of this process could be a world in which the largest global corporations 'look American,' while nations retain their distinct national institutions of governance for smaller domestic firms.

In short, the most plausible scenario is for a global standard of governance to emerge for the largest global corporations, while national variation persists both in institutions of governance and in the practices of small- and medium-sized domestic corporations. The impediments for nations to move substantially toward the American system are almost certainly too large to be readily overcome, even if such a transition were desirable: many national distinctions will inevitably persist.

THE ROAD AHEAD

Top company managers have always drawn academic and applied interest, if for no other reason than they can seem larger than life at those pivotal moments when a company's ownership and its executive careers hang in balance. The loss of control of RJR Nabisco by chief executive F. Ross Johnson to leverage-buyout king Henry Kravis in 1987 provided ample material for a best-selling book and subsequent film (Burroughs and Helyar, 1991). The two CEOs – Gerald M. Levin and Stephen M. Case – who merged America Online and Time Warner in 2000 drew enormous media interest. Corporate directors have attracted less attention, partly because they avoid the limelight but also because few outsiders believed directors brought much to the table, vanquished as they were by Berle and Means' managerial revolution. For understanding company strategy, production technologies, and market dynamics, neither senior executives nor company directors could be viewed as fertile ground for theory building.

With the rise of professional investors and their subjugation of national boundaries, however, those who occupy the executive suite and those who put them there are drawing far more research and policy attention, and justifiably so. In a bygone era when markets were more steady and predictable, when airline and telephone executives confidently knew what to expect next year, the identity of top

management mattered little. When shareholders were far smaller and decidedly quieter, when airline and telephone directors comfortably enjoyed inconsequential board meetings, the composition of the governing body mattered little either. During the past decade, however, all of this has changed in the US and UK, with other economies close behind. As shareholders have sought to reclaim authority over what they owned, they have brought top management and company directors back in. Company strategy and financial results can no longer be understood without understanding the capabilities and organization of those most responsible for delivering them.

Research investigators have risen to the occasion. A solid flow of studies has sought to discern and dissect the dynamic relations that now characterize the world of investors, directors, and managers. The market is no longer viewed as so impersonal, the company no longer so isolated. Economic and financial decisions are embedded in a complex network of working relations among money managers, stock analysts, company directors, senior executives, and state regulators. Given the right combination of features, that lattice can yield high investment returns and robust national growth. Given the wrong amalgam, it can lead instead to self-dealing, frozen form, and economic stagnation.

The road ahead will thus depend on how well researchers understand what governance arrangements and leadership styles work well both within national settings and across cultural divides, and on the extent that top managers, company directors, and active investors learn and apply what is best. Five key areas deserve concerted research attention if we are to know what works and what does not, and which theories are useful and which are not:

Boards and directors: What does the decision process inside the boardroom look like? What are the sources of power and influence of inside and outside directors? How are the decision process and director influence contingent on the 'institutional matrix' in which a board is embedded? (Example: Pettigrew and McNulty, 1998a, b.)

Comparative governance: What really accounts for the astonishing and remarkably persistent diversity in the national systems of corporate governance? How do national institutions, cultures, and social structures shape

and constrain the evolution of corporate governance systems? (Examples: Kogut and Walker, 1999; Bebchuk and Roe, 1999.)

Financial globalization: If the surge of cross-border investing is a major driver of corporate change, what can we expect of financial flows and their regulation in the years ahead? How is the evolving organization of investors and companies likely to affect the internationalization of capital flows? What aspects of corporate governance will affect the attractiveness of a national economy for international investors? How are actions by the International Monetary Fund and World Bank likely to affect national systems of corporate governance? (Example: Evans, 1995; Mizruchi, 2000.)

Inequality in a 'globalized' world: How do systems of corporate governance affect distributions of wealth within and among nations? What is the likelihood that social movements for change may mobilize in the face of – or to resist – globalization? Does the globalization of finance lead to a leveling up or a leveling down of national standards for labor relations, environmental protection, and income inequality? (Example: Firebaugh, 1999.)

Business and Political Leadership: To what extent is a shared leadership style emerging among top company managers and government officials around the world? Are such institutions as the World Economic Forum creating a global network among those who govern the major commercial and political institutions in the leading economies? As worldwide relations among business and political elites do emerge, are they undermining traditional relations among elites within economies? (Examples: Davis and Mizruchi, 1999; Khanna and Palepu, 2000.)

The research is unlikely to reveal worldwide best practices in corporate governance, but it is likely yield a host of better measures that, when deftly combined, adapted to legal context, and sensitive to cultural nuance, should produce what executives, directors, and stockholders all want. The academic and policy debate will wisely focus not on whether the opening of capital markets and ascendance of global companies will flatten alternative forms, but rather on what forms of organization and leadership are best suited for success in local or regional operations in an era when equity investing and company competitors can

move in and out of markets with the click of mouse.

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