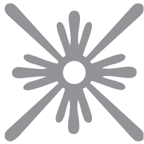
Chapter 3



Shareholder Value, Corporate Governance, and Corporate Performance

A Post-Enron Reassessment of the Conventional Wisdom

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The first two years of the 21st century have been a sobering time for scholars and policymakers interested in corporate governance. As recently as two years ago, leading corporate scholars were prepared to declare that history was over in the ongoing debate about what corporate governance systems produce the best long-term outcomes for society.[1] Yale law professor Henry Hansmann and Harvard law professor Reinier Kraakman (2000) told us that the evidence was in, and that Anglo-Saxon–style market capitalism and shareholder primacy had proven itself to be the only system that could produce sustained economic growth.[2] These scholars based their empirical claims in part on the apparent success of the "shareholder-oriented model" of corporate governance that they claimed characterized the United States in the 1990s.[3]

Now, in the early fall of 2002, it has become clear that much of the stock market boom that had led to high yields on corporate equities and helped fuel strong economic growth in the United States during the 1990s was little more than a bubble, pumped up by the helium of accounting legerdemain. US stock prices have fallen back to where they were in 1997, wiping out most of the spectacular share-price gains that had led business people and policymakers to talk of a "New Economy;"[4] economic growth in the United States remains soft[5] and wave after wave of financial disclosure scandals are devastating investors and employees of US companies that had led the 1990s boom.

In light of these events, what can we say now about the role of corporate governance in the performance of corporations, and the economies of which they are part?

This chapter will review a number of the elements of what, by the year 2000, had become the conventional wisdom about corporate governance, and consider the evidence for the various assumptions and claims behind that conventional wisdom. Then

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it will suggest some alternative ways of interpreting that evidence, and propose the outlines of a new framework for understanding the problem of corporate governance, and for considering how various governance arrangements might help provide the institutional basis of sustainable corporate performance.

THE CONVENTIONAL WISDOM

Throughout the last two decades, economists, finance theorists, corporate legal scholars, and policymakers around the globe have been keenly interested in how corporations are governed, and how they should be governed. How should corporate executives balance pressures from financial markets for high stock returns against the need for long-term investments in innovation, customer and supplier relations, human resources, sustainable environmental performance, and good relations with their communities? How can investors have confidence that managers and directors will pursue the right balance? Are takeovers, for example, good or bad for corporate performance and economic growth? More generally, what institutional arrangements are needed to encourage the right outcome?

At least two broadly defined schools of thought have sought to answer these questions (Blair, 1995). These two views were first framed during the debate that took place in the United States in the 1980s and early 1990s about hostile takeovers and leveraged buyouts. One school argued that US corporations had become fat and lazy because corporate executives were building empires instead of investing only in those projects that added value for shareholders.[6] By this view, hostile takeovers and leveraged buyouts were the mechanisms by which financial markets were trying to impose some financial discipline on corporate executives: they removed executives of poorly performing companies (Palepu, 1986; Morck, Shleifer, and Vishny, 1988a, 1988b, 1989; Martin and McConnell, 1991); they forced their replacements to pay out large amounts of cash flow in the form of debt service (Jensen, 1986, 1988); and they tied the compensation of executives in the reorganized firm to stock price performance through compensation packages loaded with stock and stock options (Jensen, 1986, 1989; Jarrell, Brickley and Netter, 1988; Kaplan and Stein, 1993).

The countervailing view was that the ubiquitous threat of hostile takeovers in the 1980s and other financial pressures forced corporate executives to manage for short-term stock price performance, and prevented them from developing and implementing innovative strategies for long-term growth (Stein, 1989; Twentieth Century Fund, 1992; US GAO, 1993). By this view, financial market pressures for short-term stock price increases helped to explain why US corporations were falling behind foreign competitors in major industries, such as steel, automobiles, consumer electronics, and semiconductors (Dertouzos, Lester, and Solow, 1989). The remedy, according to propo-

nents of this view, was for large financial institutions to take long-term stakes in companies, and provide "patient capital" (Porter, 1992).

From very early in the debate, the financial market discipline view prevailed among most economists and financial and legal scholars. Finance theorists developed a compelling theoretical argument to support this view. They argued that the central problem of corporate governance was a "principal-agent" problem: how to get corporate managers to act as loyal and committed "agents" for the shareholders or "owners" of corporations (Jensen and Meckling, 1976; Fama and Jensen, 1983.). The so-called market for corporate control, through which financial investors could remove poorly performing managers, was viewed as a helpful, even necessary part of the arrangements that reigned in potentially wayward managements. (Jensen, 1986; Shleifer and Vishny, 1988) Advocates of this view produced voluminous evidence that the stock prices of companies rose when they became a target of a hostile takeover, and the fact of higher stock prices was taken as proof that the acquirer expected to manage the companies more efficiently than existing management.[7]

Meanwhile, across the globe, the collapse and breakup of the Soviet Union in the early 1990s seemed to prove that capitalism had won against socialism, lending credibility in general to arguments that markets always allocate resources more efficiently than bureaucracies, and in particular, that financial market discipline was a critical component of good corporate governance. Western advisers rushed to transition countries to tell them that, if they wanted to make their industrial enterprises competitive in world markets, they needed to sell control rights over those enterprises to financial investors, and put in place the institutional supports to create and sustain markets in which the claims and control rights could be traded (see, for example, Black and Kraakman, 1996).

As the 1990s unfolded, the United States pulled out of the recession of 1992 and into the longest peacetime expansion in the country's history. This expansion, led by the dramatic growth in investment in telecommunications, software, biotechnology, and the Internet, seemed to prove that US financial markets, far from being focused only on the short term, were quite capable of directing resources to long-term, innovative ventures, as well as adapting quickly in response to changes in the economic environment. Meanwhile, growth in the Japanese and European economies slowed to a crawl.[8]

All of these developments provided support and vindication for the financial market discipline advocates—so much so, that there seemed little left to debate. In the United States and Britain, all but a handful of scholars and policymakers and a few holdouts in the labor movement adopted the view that the appropriate goal of corporate governance is the maximization of shareholder value, and that the way to achieve this is to give increasing control over corporations to financial investors. By the late

1990s, this view was becoming more and more prominent in Europe and Japan, and in transition and developing countries as well.[9]

This conventional wisdom, that shareholder value should be the single, guiding principle of corporate governance, and that, to support this goal, enhanced investor control and oversight should be encouraged, has a number of assumptions and beliefs behind it, and implications that flow from it, that bear closer examination. The next section subjects these assumptions and implications to careful analysis.

A CLOSER LOOK AT THE SHAREHOLDER VALUE PRINCIPLE

The shareholder value principle of corporate governance incorporates or implies the following set of fundamental beliefs:

- Maximizing value for shareholders is the right social goal for corporations because it is equivalent to maximizing the overall wealth being created by a corporation.
- Financial markets do a good job of assessing the true value of financial securities such as common stock. Hence stock price performance is the best measure of value being created for shareholders.
- Maximizing share value also helps to discipline managers because it involves holding them accountable for a single metric that, in theory, is forward looking. Introducing other metrics would confuse things and make it easier for managers to use their positions to advance their own interests rather than the interests of shareholders.
- Managers and directors will do a better job of maximizing share value if they are given high-powered incentives in the form of compensation packages tied to stock price performance, such as stock options.
- For the full discipline of financial markets to work, outside investors must be free to take control of companies in hostile buyouts, and managers and directors should not be able to entrench themselves by putting up impenetrable barriers to such transactions.
- Except perhaps for a few laws that make it easier for managers to try to deter takeovers, US corporate law generally requires shareholder primacy. And, because it works so well in the United States, other countries should also adopt shareholder primacy regimes.

Let's consider each of these beliefs in turn.

Everyone is better off if share value is maximized

The belief that maximizing share value serves the broader social good because it is equivalent to maximizing the total value created by a corporation derives from a

theory of the firm adopted by finance theorists and legal scholars in the 1980s, in which a firm is understood to be a "nexus of contracts."[10] The theory highlights the nature of relationships underlying the firm—that is, among managers, employees, suppliers, customers, creditors, and shareholders. But proponents of the theory argue that the relationships of all of the firm's participants to the firm, except for those of shareholders, are governed by contracts that specify what each party is to do, and what each party should get in return. The shareholders' role is to be the "residual claimant": they are not entitled to a fixed amount, but are to get what is left over after all other participants have received what they are contractually entitled to receive (Easterbrook and Fischel, 1991). If the claims of all other participants are fully protected by contract, according to the logic of this theory, then maximizing what is left over for shareholders is equivalent to maximizing the size of the whole pie.[11]

Strictly speaking, the "nexus of contracts" model of the corporation implies that corporations have no "owners" in the traditional sense of that term, since no one can own the "nexus" through which they all engage with each other. But, shareholder value advocates argue, shareholders act as the residual claimants, and also have certain control rights. So, advocates believe, it is a useful, and not misleading, shorthand expression to call shareholders the "owners." The rhetoric of "ownership," however, subtly redefines corporations in terms of the presumed property rights of one class of participants in the firm, thereby adding a tone of moral superiority to the idea that corporations should be run in the sole interest of shareholders, a tone that is not implied by the nexus of contracts theory alone.

To anyone who has worked for a corporation or observed the ways that corporations can externalize some of their costs onto employees, customers, or the communities where they operate, the idea that maximizing share value is equivalent to maximizing the total social value created by the firm seems obviously wrong. But even from the point of view of the finance theorist who adopts a nexus of contracts perspective, finance theory itself demonstrates conclusively that this idea is wrong. Finance theory teaches us that the value of any claim on a firm is a function of the expected flow of payments to the holder of that claim, and the risk associated with the claim. Will the hoped-for payments actually be made? Will they be as much as the claimant hopes, or will the payments vary in size over time? Will they be made on time? Thus, if holders of one type of claim can shift risk onto holders of other types of claims, the value of the first type of claim will be increased at the expense of the value of the other claims.

Under corporate law, shareholders in US corporations have what is called "limited liability." Limited liability is a legal doctrine that means that the shareholders will not be held personally liable for debts (or tort claims) of the corporation. Thus shareholders always gain if the price of the stock goes up, but their potential losses are lim-

ited on the downside. In effect, creditors and other claimants are bearing some of the downside risk—they may be the ones who lose if the firm loses the gamble.

The argument extends to providers of nonfinancial inputs as well. Corporate employees, for example, make investments in specialized knowledge and networks of relationships needed in their jobs as well as in developing a reputation within the firm for working hard. Such investments are specific to the enterprise, and may be worthless to other employers. If the firm does well, the employee hopes to benefit from these specialized investments over the long term as the employee earns promotions and the firm continues to pay salaries, bonuses, and retirement benefits (Blair, 1995).

Hence all investors in corporations share to some degree or other in the risk of the enterprise, and it is often possible to make the holders of one kind of claim (such as stock) better off at the expense of holders of other claims on the firm (such as debt claims), simply by shifting risk. In retrospect, this is what many of the most egregious transactions at Enron were actually about: while they *appeared* to move assets and associated liabilities off of Enron's books, thus reducing the risk borne by Enron investors, in fact, the risk associated with those assets was being retained by Enron through side deals that were not fully reported (Bratton, 2002). So, unbeknownst to most of Enron's investors, Enron's common stock was becoming dramatically more risky during the last two or three years before the firm filed for bankruptcy protection. Substantial risk was also being shifted onto employees and creditors. The increase in risk of the stock, not coincidentally, made Enron stock *options* at least temporarily more valuable.[12] If Enron executives who were taking these gambles with corporate assets had, by chance, won the enormous bets they were placing, they would now be even more dramatically wealthy than they are. As it happens, they overplayed their hands, and when creditors discovered how risky their investments in Enron actually were, they cut off all further credit to Enron, forcing the company into bankruptcy proceedings. In the process, virtually all of the equity value in the company was lost, ultimately making the stock options worthless too.[13]

The fact that shareholders and option holders can often be made better off at the expense of creditors and employees and others with firm-specific investments at risk in the corporation means that, neither in theory nor in practice, is it true that maximizing the value of equity shares is the equivalent of maximizing the overall value created by the firm.[14]

Shareholder primacy advocates often argue, nonetheless, that, in the long run, corporations will have to be fair with their creditors, suppliers, employees, and other "stakeholders" in order to ensure that they will continue to participate in the enterprise (see, for example, Jensen, 2001). In this way, maximizing the "long-run" value of

the equity shares will necessarily require that the other stakeholders be compensated according to their expectations, so that in the "long run," it can still be true that maximizing share value is equivalent to maximizing total social value. To whatever extent this argument is correct, it can be reversed: in the long run, regardless of whose interests are considered primary, a corporation will have to provide an adequate return to shareholders and other financial investors or investors will not continue to supply capital to the firm. In theory, then, a corporate goal of maximizing long-run value for, say, employees, would also produce the maximum social value since all other stakeholders will have to be protected to ensure their long-run participation.[15] So this "in the long run" argument fails to make a case that shareholders' interest should be given precedence over other legitimate interests and goals of the corporation.

Stock prices reflect the true underlying value of the stock

The belief that share prices are a good measure of the actual value of a corporation to its shareholders is based on a financial theory known as the "efficient capital markets hypothesis." This theory says that at any point in time, if financial markets are deep and liquid enough, the price for which a share of stock trades is the best available estimate of the true underlying value of the security. Although finance theorists understand that this theory can never be proven,[16] they nonetheless continue to debate the question of how efficient capital markets are. On the one hand, there is evidence that market prices in US stock markets respond very quickly to good or bad news (Fama, 1970). On the other hand, there is also evidence that financial markets as a whole go through periods of boom and bust in which, in retrospect, it becomes clear that stock prices must have deviated substantially from their underlying fundamental value.[17] Some scholars have argued that, in fact, financial markets respond very quickly to information that is easy to interpret, but they respond to complex information only very slowly and imperfectly.[18] And a growing body of empirical work in "behavioral finance" suggests that financial markets overreact, and that they are susceptible to fads and bandwagon thinking that may allow stock prices to get badly out of line with reality before enough investors will act to sell an overpriced stock, or buy an underpriced one, to cause the stock price to move back into line (see, for example, Fama, 1998; Shiller, 2000; and Shleifer, 2000).

The fact that financial markets overreact and do not absorb complex information quickly and correctly means that there is room for corporate insiders to manipulate stock prices by releasing misleading information into the markets. The experience of the last two years certainly suggests that insiders can sometimes cause stock prices to deviate widely from the true underlying value. But even when insiders are not intentionally misleading the market, they will probably have knowledge that other market

investors do not have, and therefore have reason to know when a stock's market price is out of line with the underlying reality. That is why US securities law forbids trading on "inside information," although, the lessons of the last two years must surely include the reminder that insiders do sometimes trade on information the market does not yet have.

Managers must have a single metric against which to measure their performance

The argument is commonly advanced that directors and managers must be held accountable for a single metric such as shareholder value, because otherwise they cannot be held accountable at all.[19] In its own way, this argument is an admission that the other rationales for shareholder primacy are bankrupt, but that we should nonetheless use share value to measure the performance of corporate officers and directors because it is simple and easy to apply, while other metrics are complex, subject to manipulation by managers, and inevitably involve tradeoffs that require subjective rather than objective judgment. Here again, the events of the past few years should disabuse all of us of any notion that share price is not a manipulable metric. While it is true that share prices respond to new information, and perhaps even true that over any 5- to 10-year period share prices on deep and liquid markets will tend, on average, to reflect the true underlying value of a corporation (whatever that means), the long run can be quite long relative to the financial health of a given corporation, which can change dramatically in 5 to 10 years. Meanwhile, the damage done in the short-run, while the market is being fooled, can be substantial. The point is not that share price is irrelevant, but that it is overly simplistic—in fact, dangerously so, as I will argue below—to focus too much attention on share price to the exclusion of other measures of corporate and managerial performance.

The importance of high-powered incentives

The belief that managers and directors should be compensated in stock and stock options in order to create high-powered incentives for them to maximize share value follows naturally from the approach of using the economists' model of human behavior to analyze corporate governance questions. Economic analysis is based on a set of assumptions about the way people work in groups. In particular, part of the conventional wisdom has been that directors and managers of companies will always make decisions in ways that serve their own personal interests unless they are either tightly monitored and constrained (which is costly, and raises the question of who will monitor the monitors), or given very strong incentives to manage in the interests of shareholders (e.g., Shleifer and Vishny, 1997). This premise about the way the world works has led to a small industry of compensation consultants who have advised firms to pay corporate executives and directors in stock options, so that they would be highly motivated to get the company's stock price to go up. The problem has been that stock options, as discussed

above, create skewed incentives for executives—option holders win big if the stock goes up, but they are not penalized if the stock price goes down. Furthermore, the models used by the compensation consultants often provide that if the stock price goes down, then options should be repriced, or executives should be awarded a large number of additional options (with a lower strike price) so that they will again be well-motivated to get the stock price to go up from wherever it is at the time (Gillan, 2001).

The result has been a veritable orgy of stock option awards to CEOs and other senior managers of US companies. Just 20 years ago, salary, benefits, and performance bonuses typically accounted for 65 percent of CEO compensation, and stock option gains and grants no more than 35 percent (Blair, 1994). Total CEO compensation was also, on average, about 42 times the earnings of the average factory worker.[20] By 2001, total CEO compensation, of which stock option gains and new stock option grants accounted for more than 85 percent,[21] had ballooned to 400 times the earnings of the average worker.[22]

Although stock options do help tie CEO pay to the performance of the stock price, they create other incentives that can be quite perverse. As noted above, stock options are more valuable the more risky the underlying security, so that stock option compensation can encourage CEOs to pursue very risky strategies. This is especially true if the options are "out of the money" (meaning that the current stock price is below the strike price of the options) or just barely "in the money" (meaning that the current stock price is just barely above the strike price of the options). In such situations, the stock option holder stands to win big if a corporate gamble pays off, but can lose little or nothing if the gamble fails.

An additional danger arises from the fact that compensation packages that depend heavily on stock options can encourage corporate executives to play games to try to manipulate the stock price so that their options will be in the money when it is time for the executive to exercise his options. This can encourage executives to focus on stock price, rather than focusing on the underlying fundamentals of the business they are in. Al Dunlap, for example, was given USD 2.5 million three-year options, plus one million shares of restricted stock, when he was hired as CEO at Sunbeam in 1996 (plus an annual salary of USD 1 million) (Hill, 1999, p. 1101), and he handed out large stock option packages to more than 250 of the top Sunbeam executives and managers. In 1997 the company reported sharply increased sales and profits so that in February, 1998, Sunbeam's board gave Dunlap a raise in salary to USD 2 million, and USD 3.75 million more options.[23] But it turned out that those high sales and profits had been achieved by manipulating the accounting—taking an oversized restructuring charge in 1996, for example, and using the surplus to pad income in 1997 (Byrne, 1999). Dunlap was caught and fired, and thus lost the game he was playing.[24] But when faced with

potentially huge upside potential and little or no downside financial risk, the incentives to play such games are quite powerful, putting enormous pressure on corporate executives to meet or beat the numbers that Wall Street analysts are predicting.

Another result of stock option-based compensation has been the widespread practice of "earnings management." At its most benign level, earnings management is simply using the flexibility available in the accounting rules to smooth earnings or cash flow numbers. But once the practice is sanctioned, it can lead to egregious abuses and, as the Sunbeam experience indicates, and as we have seen in recent months at WorldCom and other companies, outright fraud.[25]

Stock option compensation can be incredibly seductive. In fact, the temptation it creates to focus solely on stock prices, regardless of how they are achieved, can be so powerful that it appears that during the last few years before Enron filed for bankruptcy, the entire board of directors, including CEO Kenneth Lay, had lost track of what actual business the company was in—what goods and services it was providing for sale to sell to consumers, for example—and came to believe the company was making huge amounts of money in some kind of "New Economy" commodities trading business, although no one seemed to be able to actually explain the business. In reality, it turns out, the trading activity amounted to little more than a massive con game to create the appearance of growing revenues and profits, to try to keep the stock price rising.

The dangers of accounting manipulation extend beyond the companies where executives are actually engaging in such practices. Because many corporations operate in highly competitive industries, manipulation at one company can help to set an unrealistically high performance hurdle at competing companies, which adds to the pressures on corporate executives at those companies to pursue risky strategies, or to also begin manipulating their numbers.[26]

Financial market discipline requires an unfettered market for corporate control

Most proponents of the share value principle also believe that financial market discipline in the form of an active market for corporate control is an important part of any corporate governance system (Manne, 1965; Jensen, 1988; 1993; Scharfstein, 1988; Easterbrook and Fischel, 1991). According to these theorists, an active takeover market should make shareholders better off because it makes it easier for control of corporations to be transferred to those who can manage them best. Early empirical evidence based on what happens to the stock price of firms that become targets seemed consistent with this theory (Jensen and Ruback, 1983). Some of the gains to target company shareholders in hostile takeovers in the 1980s were later explained by the subsequent sell-off of assets in the target firms to other firms in related lines of business (Bhagat, Shleifer, and Vishny, 1990), and some were apparently explained as the transfer of value

from workers through layoffs and reductions in wages and benefits (Shleifer and Summers, 1988; Neumark and Sharpe, 1996; and Pontiff, Shleifer, and Weisbach, 1990). But much of the gain remains unexplained, and as the 1980s takeover wave played itself out, many of the transactions that took place toward the end of the decade failed to produce improved performance (Long and Ravenscraft, 1993; Kaplan and Stein, 1993).

But regardless of the source of the gains, one of the implications of the shareholder value principle is the belief that if shareholders could get a higher price for their shares *now* by selling out to a "raider," they ought to be permitted to do so, and the existing board should not be allowed to get in the way. Arguments by existing managers that directors should be allowed to reject hostile takeovers when they believe that shareholders would be even better off later if the firm is not taken over contradict the efficient capital markets hypothesis, so they were never accepted by most finance-oriented scholars.

This faith in the importance of the market for corporate control has led to ongoing debates among corporate legal scholars in the United States about institutional arrangements and response tactics designed to deter takeovers. Shareholder value proponents have been convinced that such arrangements and tactics ought to be bad for shareholders, and by extension, bad for corporate performance and for the economy as a whole.

Two such takeover defenses have been the focus of considerable empirical research in an attempt to determine their impact on corporate performance and shareholder value: "poison pills," which are rights granted to existing shareholders that have the effect of imposing substantial costs on potential acquirers; and "staggered" boards, in which (typically) the term of each board member is three years, and only a third of the board is elected each year.

Early research suggested that poison pills reduce shareholder wealth (Ryngaert, 1988; Malatesta and Walkling, 1988). But subsequent research suggested that poison pills give managers leverage, helping them to negotiate a higher price in the event of a takeover offer, and later empirical studies could no longer find evidence of reduced shareholder value from poison pills (Comment and Schwert, 1995). In fact, Danielson and Karpoff 2002, find evidence that operating performance improves modestly in the five years after a company adopts a pill. Also, it is interesting to note that most young firms adopt poison pills at the time that they go public in an "initial public offering" (IPO) (Daines and Klausner, 1999). Theorists have argued that the original entrepreneurs in a firm can be expected to put governance arrangements in place that will make the firm as valuable as possible to outside investors when they go public, so the fact that most IPO firms have poison pills suggests either that pills do not reduce value to shareholders, or that the protection they provide to management is valuable enough to the original entrepreneurs for other reasons that they are willing to sacrifice some value in the shares they sell to the public.

Most public companies in the United States have staggered or "classified" boards (Bebchuk, Coates, and Subramanian, 2002). The benefits of a staggered board include continuity and stability of the board, as well as a greater independence from management (Koppes, Ganske, and Haag, 1999). But, some scholars argue, staggered boards provide a potent takeover defense—especially when combined with poison pills—because they require an acquirer to wait through at least two election cycles to replace enough members of the board to gain control. Bebchuk, Coates, and Subramanian (2002) provide evidence that the takeover defense provided by staggered boards reduced the returns earned by shareholders of target firms in the late 1990s.[27] Sanjai Bhagat and Richard Jeffris (2002) find conflicting evidence, however. Using a simultaneous equation model that takes into account the interactions among takeover activity, takeover defenses, managerial turnover, and corporate performance, they conclude that a wide variety of so-called "takeover defenses" (including poison pills and staggered boards) are not actually effective at deterring takeover activity in firms where performance has been poor. In other words, takeover activity and managerial turnover are linked to firm performance, regardless of the presence or absence of poison pills or staggered boards (Bhagat and Jeffris, 2002, p. 13)

US law requires shareholder primacy

Since the early 1990s, advisers from US-based multinational financial institutions have been preaching the message of shareholder primacy to transition economy countries looking to reform their economies, and even to other developed countries.[28] One of the reasons has been a belief that US law requires shareholder primacy, and that, since it has worked so well in the United States, other countries should adopt similar legal rules. One of the ironies in the whole international debate about corporate governance, however, is that US corporate law does not actually require shareholder primacy. Rather, US corporate law comes closer to requiring "director primacy"(Blair and Stout, 1999; Bainbridge, 2002).[29] State laws governing the incorporation of firms typically provide that "all corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed by or under the direction of, its board of directors"(Model Business Corporation Act §8.01(b)). Shareholders are allowed to vote each year on a slate of directors nominated, generally, by the existing directors, and they are allowed to vote on certain major transactions (such as a sale of the business or a liquidation). But other than that, shareholders in large, publicly-traded corporations have few formal powers.

Meanwhile, the law regards directors as fiduciaries for the corporation, not agents of shareholders (Clark, 1987). For this reason, courts give directors very wide discretion in the choices they make about a firm's strategy or transactions. Directors can only be held liable for breach of their fiduciary duties if they are grossly negligent in

approving corporate actions, or if they engage in transactions that benefit themselves at the expense of the corporation. (See detailed discussion in Blair and Stout, 1999.)

Nonetheless, although corporate law has not changed significantly in recent years to give shareholders more formal power, a few large institutional investors have taken an active role in voicing concerns about the performance of certain corporations, and about corporate governance in general.[30] Because these investors have the ability to sell their shares, as well as to voice their criticisms publicly, thereby putting downward pressure on stock prices, corporate directors and managers have learned to listen when institutional investors speak. Thus, in US companies in which institutional investors hold substantial blocks of shares, those institutional shareholders sometimes exercise considerable clout, making the system look on the surface more like a true shareholder primacy system.

Scholars have debated whether, in this way, the presence of a large institutional shareholder might help to reduce the "agency problem" in corporations, and whether activism by such shareholders might improve corporate performance (Black, 1992; Jacobs, 1991). Early evidence suggested that firm financial performance rises as the holdings of the largest shareholder rise, up to a relatively low point (such as 5 or 10 percent), and then falls as the holdings of the largest shareholder gets larger (Morck, Shleifer, and Vishny, 1988b; Wruck, 1989; and McConnell and Servaes, 1990). One explanation that has been offered for this phenomenon is that, as the holdings of the largest shareholder rise to levels in which he or she can begin to exercise control, that shareholder becomes better able to extract private benefits from his position, sometimes at the expense of the firm as a whole. In any case, empirical studies have been unable to find a consistent, robust, relationship between evidence of large shareholder activism and corporate performance (Black 1992; and Bhagat, Black, and Blair, 1999).

DOES CORPORATE GOVERNANCE, IN FACT, MATTER FOR CORPORATE PERFORMANCE?

As we have already discussed above, it turns out to be hard to find evidence that features of the governance of US corporations that corporate scholars originally thought were important, actually matter very much. The threat of hostile takeover in an active market for corporate control may help to discipline management, but the evidence on whether actual takeovers improve corporate performance is mixed. Institutional arrangements such as staggered boards and poison pills that were put in place to deter takeovers may have little or no actual deterrence effect, or measurable effect on performance,[31] and activism by large-block shareholders does not, so far, seem to produce consistent improvement in corporate performance.

What about board "independence"—the idea that directors should not have close personal, financial, or business relationships with CEOs or other members of the

management team that could influence their attitude toward management and perhaps deter them from disciplining management when needed? This idea has become so widely viewed as necessary for good corporate governance that during the summer of 2002, both the New York Stock Exchange and the Nasdaq proposed new rules that would require that firms registered on those exchanges have a majority of independent directors, as well as increase the role that independent directors must play on the boards (NYSE 2002; Nasdaq 2002). Yet, here again, the idea sounds sensible, but the evidence is sparse. Bhagat and Black (2002), among others, find "no convincing empirical evidence that the proportion of independent directors impacts future performance as measured by a variety of stock price and accounting measures."[32]

The bottom line is that researchers have been unable to find strong and consistent evidence that variations in corporate governance arrangements among US companies have much impact one way or the other. Some studies show small effects of some arrangements in some narrow circumstances, but often the results have not held up in other samples. And in any case, the effects tend to be small.

Yet, when corporations around the globe are compared with each other, there are dramatic differences in corporate performance from one country to another (Shleifer and Vishny, 1997). Such differences are apparently related to broad institutional arrangements such as whether the country has an active and efficient financial market, an independent accounting profession, court systems that are uncorrupted and capable of adjudicating complex contractual disputes, and effective securities regulation. Shleifer and Vishny (1997, p. 739), for example, suggest that the essential element for effective corporate governance is some mechanism of "legal protection for the interests of at least some of the investors, so that mechanisms of extensive outside financing can develop." Beyond that, they conclude that the evidence is not even compelling enough to decide whether or not the US system of corporate governance, with widely-traded shares, liquid markets, and reasonably effective securities regulation, is better than the systems in other developed countries in Europe or in Japan, where corporate shares tend to be much more closely held by dominant financial institutions that are actively involved in corporate governance. If it is impossible to decide between systems in developed countries, it is even less realistic to expect to find strong effects of, say, staggered boards, or independent auditing committees, within a given system.

In other words, once a country has in place the basic institutional arrangements to support the use of the corporate legal form (including sophisticated, but uncorrupted courts, reasonably honest trading of financial securities, an independent accounting profession, and effective security markets regulators), and flexibility to custom-design governance arrangements at the level of each firm, it may be that the details of

board structure and the degree of management independence versus shareholder involvement, really do not matter very much, at least in a way that we can measure in a broad cross-section of firms. The details of corporate governance are worked out in each company on a case by case basis, and sometimes the arrangements appear to work very well, and sometimes they fail and must be reworked. Economic reasoning, in fact, would predict that institutional arrangements would tend to vary across firms according to what works in each firm. But if each firm has chosen the best approach for that firm, with only random errors, we would not necessarily be able to observe performance differences that vary systematically with the details of governance structures.

Nonetheless, the broadly-defined institutional setting in which corporations act, and the norms and standards supported by those institutions, may matter significantly.[33]

A NEW FRAMEWORK FOR THINKING ABOUT CORPORATE GOVERNANCE

The first three parts of this chapter critiqued the shareholder value principle and argued that structural and institutional details of corporate governance may not have a substantial and consistent impact on corporate performance. So what does matter? Can we say anything of importance about the relationship between corporate governance and corporate performance, beyond the importance of basic legal and institutional infrastructure? I believe we can, and in this section I offer an alternative way to understand the goals and purposes of corporations that I believe can better support sustainable corporate performance. I begin by suggesting that the central problem to be addressed by forming a corporation is what my colleague Professor Lynn Stout and I have elsewhere called the "team production" problem (Blair and Stout, 1999).

A "team production problem" arises any time that a group of individuals agree to work together on a complex production task, in a situation in which it is difficult to agree in advance about what everyone is supposed to contribute, and what everyone can expect to get out of the joint effort.[34] The problem arises because team members will have to make investments in the joint enterprise—by contributing time, effort, money, and/or ideas—that may be sunk in the business and hence not recoverable except by carrying out the enterprise and sharing in the income it generates. Since most team members' investments are, in this sense, enterprise-specific, team members must make themselves vulnerable to each other as they undertake the business venture. Each team member is vulnerable not only because the venture itself is inherently risky, but because any one of the other team members could try to "hold-up" the team by threatening to pull her contributions back out unless she gets a larger share of the proceeds. For individuals who make especially important contributions, the potential threat of being held up by some other team member can be troubling enough that it can prevent individuals from working together as a team in the first place.

When a team is small, very often team members can develop trusting relationships and work out terms on which they will work together as they go, without elaborate corporate governance arrangements or rules. But a large enterprise that involves hundreds or thousands of participants requires some basic institutional arrangements or ground rules to facilitate cooperation among team member. For business enterprises in the developed world, the most common institutional arrangement is to be "incorporated." Incorporation provides a unique solution to the contracting problems in team production. Through the incorporation process, the law creates a separate legal entity that has many of the same rights and powers under the law as a flesh-and-blood person would have.[35] In particular, it can own property, enter into contracts, and be held liable for debts or tort claims. In the typical business corporation, shareholders receive stock in the corporation in exchange for their contribution of financial capital. Executives and employees receive some cash compensation, but they may also receive stock, or options, or promises of deferred compensation, as well as the expectation of future raises and promotions if the enterprise is successful. Suppliers, bondholders, and other creditors also get claims on the corporation, some of which are short-term claims that are rapidly paid off, and others that are more long-term.

But, importantly, while each participant has some kind of claim against the corporation, none of them "owns" the corporation; the corporation is an entity separate from all of its participants. Moreover, by the incorporation process, the corporation itself—not any of its individual participants—becomes the owner of all the assets contributed by the various participants for use in production, as well as of any output from the enterprise (at least until such output is distributed). The fact that the corporation owns the assets used in production means that, in forming the corporation, the team members all give up much of their ability to "hold up" the enterprise. Once they contribute their input, it becomes the property of the corporation and is no longer subject to the control of the contributor. Thus the corporate form of organization can be seen as a legal mechanism that facilitates cooperation among team members by making it easier for team members to credibly commit to each other that they will not hold up the team once production gets under way.

The team production approach to understanding corporations suggests a very different role for directors than the principal-agent approach favored by shareholder primacy advocates. In the principal-agent model, shareholders are seen as the "owners" of corporations,[36] who hire directors to run the corporation for them because they are too busy to do it for themselves. In the team production model, directors are the people who are given the legal responsibility to act for the corporation (since it, obviously, cannot act on its own). By forming a corporation and selecting directors, corporate participants agree to yield ultimate control rights over the corporate enterprise

to the board. The effect of this agreement is to tie their hands, so they cannot easily snatch control back and use it to hold up the other participants. Board members, then, are part of the institutional mechanism intended to facilitate trust among all the team members. An important role of directors in this model is to serve as the mediators for the team members, the final arbiters of any disputes that may arise among them over enterprise strategy, or over the division of enterprise output (Blair and Stout, 1999). As such, it is important to the long-term health and prosperity of the enterprise that team members view board members as fair and trustworthy.

Under team production analysis, several features of US corporate law that are inconsistent with shareholder primacy make sense. For example, shareholders may not dictate tactics or policy to directors,[37] or demand dividends.[38] And the law is extremely deferential to the decisions of directors.[39] If this were not true, if directors' decisions could easily be challenged in court, or if directors were subject to the direct command and control of any of the team members, those team members could not credibly commit to the other team members not to attempt a hold up. Hence, as long as directors do not use their positions to steal from the team (the corporation) or otherwise enrich themselves at the expense of the team, and as long as directors exercise a reasonable amount of care in carrying out their duties, courts will not second-guess them.

Team production theory also explains why so few corporate decisions must be put to a vote of shareholders.[40] It also offers an explanation for why directors owe fiduciary duties to the corporation itself, and not directly to shareholders.[41] And it explains why shareholders may not sue directors on their own behalf for violations of directors' fiduciary duties, but must undertake what is called a "derivative" suit.[42] In a derivative suit, the shareholder may seek court permission to act for the corporation as a whole in suing directors for violations of their fiduciary duties and in attempting to collect damages. But she must first convince the court that she, and not the directors, should be entitled to act for the corporation.[43] Moreover, if she wins the suit and directors are required to pay damages, the payments go not to the shareholder who sued but to the corporation (see Clark, 1986, p. 659).

The team production approach suggests that corporate performance must be measured in multiple dimensions, and that no single measure of corporate performance can tell the whole story of how well the corporation is doing. Share price is important, because, even though it is noisy and subject to manipulation, it should at least reflect what one subset of financial investors on any given day think is the value of their claim on the corporation. But it also matters whether the corporation is meeting the expectations of other participants, not to mention whether it is fairly and accurately presenting its financial position to investors. Are bills from suppliers being paid on time? Are the operations and assets acquired in the last merger being well integrated into the company's opera-

tions? Are assets, liabilities, and risks to all corporate participants being fairly valued and accurately reported to investors? Are appropriate wages and benefits being paid? Are new technologies being developed and new products being introduced? Are the company's brands being effectively promoted? Are managements' growth plans realistic? Is the company on track to deliver planned growth and profits, and if not, what is the cause of the delay? Are employees being trained and prepared for increased or changing responsibilities? Is there a suitable succession plan in place for the top management team?[44]

The allure of shareholder value is that it is so easy: easy to use to monitor executives, and easy to incorporate in a compensation system. But being simple to understand and easy to measure doesn't make it the right measure of performance, and certainly not the only measure of performance that counts. The ease and simplicity of the share price metric, in fact, is part of what makes it such a dangerous measure to rely upon. Focusing only on share price performance encourages managers, directors, analysts, and investors to be lazy, to take short cuts in developing corporate strategies and plans, and in evaluating how well the firm is doing.[45] Or worse, by sending the message that only financial gain matters, a monomaniacal focus on share value can inadvertently also send the message that personal integrity and trustworthy behavior do not matter. By contrast, the team production approach emphasizes the complexity of the problem of governing and managing a corporation, points to the demanding nature of the job of corporate executives and directors, and signals that directors and other team members are expected to cooperate with each other rather than try to extract gains at each others' expense.

Professor Stout and I have suggested elsewhere (Blair and Stout, 2001b) that one way to understand the job of corporate directors is that they are charged with making the trade-offs that are required to keep a productive team together, to make sure all of the essential members of the team play fairly with each other, share the necessary information with each other, and continue to contribute. In some cases, boards may also be called upon to help team members develop a new strategy or work out a different way to create value for the team.

One common criticism of the team production analysis of corporate governance is that, while it may explain why corporate law *permits* directors to make trade-offs among competing interests instead of compelling them to act only in the interests of shareholders, it does not explain why directors *would bother* to work hard or make decisions for the benefit of the corporation and not just for their own personal benefit. In response, we have argued that the effectiveness of the system ultimately relies on corporate directors being trustworthy (Blair and Stout, 2001a). Although to scholars steeped in the logic of economic and legal reasoning, such a response may seem naive, substantial empirical evidence from cooperative game experiments suggests

that human beings are not always the coldly-rational, self-interested creatures that populate economic models. Instead, human beings seem to respond to social and cultural messages. If the social signals tell them that they are expected to trust the other players, and to be trustworthy themselves, and if the economic incentives to break trust or "defect" are not overwhelming, then the vast majority of people will choose to cooperate. Alternatively, if the social signals tell them that the game they are playing (or the social interaction they are involved in) is a competitive one in which they are expected to, say, win as much money as they can, even if doing so is harmful to the group, then that is what most people will do (Blair and Stout, 2001a).

Professor Stout and I further argue that, in practice, legal constraints rarely bind tightly enough to compel people to cooperate, and economic incentives often tilt against cooperation (Blair and Stout, 2001a). So when we observe cooperative, trustworthy behavior in the business world, chances are that this result is driven by strong social norms and expectations of trustworthy behavior in the particular context, rather than by law or economic incentives (Blair and Stout, 2001a and 2001b).

In other words, we believe that trust is the necessary glue that holds long-term business relationships of any kind together.[46] This is true even where an adequate legal and institutional infrastructure is in place, and it is probably especially true where such infrastructure is missing. And, it is clearly true for the relationships among all team members in a corporation, since even where law and institutions are strong, courts nearly always decline to adjudicate disputes between participants in a corporation over the allocation of assignments and rewards.[47] Professor Stout and I argue that it is the special role of corporate directors, in this context, to be people whom the team members feel they can trust, the wise elders, persons of honor and integrity, as well as of wisdom and good judgment. Just as the board as a whole is part of an institutional arrangement to facilitate trust, board members must be seen as the keepers and upholders of the team's trust. If the team members perceive directors to be these things, they will all be more willing to make themselves vulnerable to the other members of the team—to trust—by making necessary enterprise-specific investments.

CONCLUSION

This chapter argues that the notion that the primary, or in extreme versions, the only legitimate goals of corporate management and governance should be to maximize the value of the shareholders' interest in the company is based on a series of elegant and facile, but deeply flawed assumptions about the nature of the relationships among corporate participants, about how financial markets work, about how human beings work together in groups, and about what the law requires. Contrary to these assumptions, shareholders are neither the "owners" of corporations, nor the only

claimants with investments at risk; stock prices do not always accurately reflect the true underlying value of equity securities; managers will not necessarily do a better job of running corporations if they focus solely on share value, or if they are heavily incentivized with stock options, or if they are constantly vulnerable to being ousted in a hostile takeover; and corporate law does not require shareholder primacy.

Instead, this chapter suggests that, once the basic institutional framework is in place (rule of law, sophisticated and uncorrupted courts, an independent accounting profession, liquid financial markets and an adequate securities regulation system), the principal element needed to foster wealth-creating productive activity may be a powerful set of cultural norms emphasizing personal and group integrity, cooperative behavior among team members, and responsibility in the team's relationships to the larger communities in which it operates.[48] Organizing productive activities within a corporation provides one mechanism for encouraging cooperative engagement by a number of participants in a complex enterprise, each with different roles to play, and each making contributions that are at risk in the venture. The corporate form facilitates cooperation because it permits the participants to make credible commitments to each other to cooperate, and not to try to hold up the other participants by threatening to prematurely withdraw their contribution. They do so by yielding ultimate control over their contributions and over output from the enterprise to a board of directors.

The team production theory of corporate law points to the central and crucial role played by corporate directors. It also suggests that the norms and standards established for corporate directors and other corporate participants—the mutual expectations of trustworthy behavior—may be at least as important to corporate performance as laws and institutional arrangements.

Of course, there may be "bad apples" in any bushel. Some corporate actors will occasionally betray the trust that other corporate participants have placed in them even if the laws and institutional arrangements are strong, and the cultural messages supportive of trustworthy behavior on the part of corporate executives and board members.[49] But, if corporate leaders are continuously bombarded with messages that shareholder value is the only performance metric that matters, and if corporate directors and officers are compensated in ways that give them high-powered incentives to focus solely on shareholder value, then we should not be surprised to find that those officers and directors are more likely to neglect such niceties as honesty, personal integrity, and commitment to the mutual benefit of all the participants in the corporate enterprise.

The corporate scandals of the last year in the United States have caused even the most strident advocates of the shareholder primacy principle to begin to question the wisdom of a system too focused on share value. Harvard professor Michael Jensen, for example, now argues that the goal of corporations should be "enlightened value

maximization" which recognizes that "value maximization is not a vision or a strategy or even a purpose," but only a "scorecard" (Jensen 2001, p. 15). A team production approach to understanding corporations would suggest the same role for shareholder value, with the amendment that shareholder value is only one of a number of scorecards, all of which must be considered in judging overall corporate performance.

NOTES

1 See Hansmann and Kraakman (2001).

2 The "consensus on a shareholder-oriented model of the corporation results in part from the failure of alternative models of the corporation . . . . Since the dominant corporate ideology of shareholder primacy is unlikely to be undone, its success represents the 'end of history' for corporate law" (Hansmann and Kraakman, 2001). Professors Hansmann and Kraakman were not the only prominent specialists to believe that the market capitalism and shareholder primacy outperformed all other approaches to corporate governance. During the last few years of the 1990s and continuing at least to the fall of 2002, the World Bank has sponsored a series of training seminars in various developing and transition countries to preach the benefits of American-style corporate governance arrangements. The World Bank web site notes that "the activities of the Bank in corporate governance focus on the rights of shareholders, the equitable treatment of shareholders, the treatment of stakeholders, disclosure and transparency and the duties of board members." As of September 2002, the Bank had produced assessments of corporate governance practices in 15 countries, including Brazil, India, Turkey, Poland, the Philippines, and Georgia, and has, in partnership with the Organisation for European Co-operation and Development (OECD), organized regional "roundtables" on corporations to promote best practice. See http://www.worldbank.org/privatesector/cg/index.htm (accessed on Sept. 12, 2002).

3 "A simple comparison across countries adhering to different models—at least in very recent years—lends credence to the view that adherence to the standard model [the 'shareholder-oriented' model] promotes better economic outcomes. The developed common law jurisdictions have performed well in comparison to the principal East Asian and continental European countries, which are less in alignment with the standard model. The principal examples include, of course, the strong performance of the American economy in comparison with the weaker economic performance of the German, Japanese, and French economies" (Hansmann and Kraakman 2000, p. 12).

4 The return on a very broad-based market index, the Wilshire 5000, averaged a modest 8.36 percent return per year from 1995 through 2002. See *S&P US Indices.* Rev. Sept. 16, 2002. Online. Available at http://www.spglobal.com/June2002(USA).pdf.

5 See, e.g., J. E. Hilsenrath, "Growth in Productivity Slows; Forecasts for Economy Worsens," *Wall Street Journal*, Aug. 12, 2002, p. A2. See also J. M. Barry, "Economy Still Soft, Greenspan Warns; Fed Chief Cited Subdued Sectors," *Washington Post*, Dec. 20, 2002, p. E-1.

6 Shleifer and Vishny (1997, p. 746) summarize evidence that corporations made bad diversification decisions in the 1960s, 1970s, and 1980s, and in general paid too much for acquisitions.

7 Jensen and Ruback (1983) summarizes the early evidence. See Stout (1990) for an argument that the premia paid for acquired companies is not necessarily evidence that the acquirer expects to do a better job of managing the company.

8 Real (inflation adjusted) Gross Domestic Product (GDP) grew at 1.1 percent per year in

the last decade in Japan, at 1.99 percent per year in Europe, and at 3.3 percent per year in the United States. (Calculated from Organisation for Economic Co-operation and Development [OECD]. 2002. *Annual National Accounts: Comparative Tables Based on Exchange Rates and PPPs*. Rev. Sept. 16, 2002. Online. http://cs4hq.oecd.org/oecd/selected_view.asp?tableId=561&viewname=ANAPart2.)

9 See, e.g., OECD (1998, p. 27), in which the Business Sector Advisory Group on Corporate Governance stated that "most industrialized societies" recognize that the "generation of long-term economic profit to enhance shareholder value" is the corporation's primary objective. The *Principles of Corporate Governance*, adopted by the OECD in 1999 (OECD, 1999), took a somewhat attenuated shareholder primacy perspective, emphasizing shareholder rights, but also noting that "the competitiveness and ultimate success of a corporation is the result of teamwork that embodies contributions from a range of different resource providers . . .," and that "it is, therefore, in the long-term interest of corporations to foster wealth-creating co-operation among stakeholders" (OECD 1999, p. 33). See also Lazonick and O'Sullivan (2002).

10 The phrase is usually attributed to Jensen and Meckling (1976, p. 310), who argued that organizations "are simply legal fictions which serve as a nexus for a set of contracting relationships among individuals."

11 Yale professor Shyam Sunder (2001) notes that conventional accounting measures calculate the value created by corporations solely in terms of the value left over after other participants in the enterprise have been paid. He provides a fascinating discussion of the possibility of measuring the value created by the firm from the vantage point of participants other than shareholders.

12 Options, which are "derivative" securities that give the holder the right to buy the underlying security at a fixed price until some expiration date, become more valuable the more risky the underlying stock is because, like stockholders who have limited liability, option holders capture all the potential gain from gambles, but do not bear the downside risk.

13 But not before quite a few senior executives had managed to exercise their options and sell their stock, thus locking in their gains and leaving other stockholders and corporate claimants holding a greatly depleted bag.

14 See Blair and Stout (2001b) for an expanded explanation, based on options theory, of why maximizing value for shareholders is not equivalent to maximizing the total value created by the corporation.

15 Sunder (2001) notes that, since markets for financial capital are among the most liquid and efficient in the world, shareholder returns should, on average at least, always be equal to the opportunity cost of capital, and there should be no excess returns. By contrast, suppliers of other resources used in the corporation often provide specialized or unique inputs that might be able to demand a premium. From this point of view, one would expect that the only wealth being created by the firm would generally be captured by other participants, and not by the providers of financial capital. Sunder makes this point to call attention to the arbitrariness of measuring the value of a firm by looking only at its value to shareholders.

16 To prove that a market-determined price accurately reflects the true value of the security would require some independent way to measure the "true value." Hence any test of how close stock prices are to their true value is simultaneously and unavoidably a test of whether the model being used to measure the "true value" is a good model. If the market price varies from the price predicted by the model, we can never tell whether the problem is that the model is wrong, or the problem is that the market is not efficient in determining the price.

17 See, e.g., Shiller (2000), Stout (1990), and Stout (1997). Were stock prices in US financial markets overvalued in the early months of 2000 when the Dow peaked at more than 11,000, for example? Are they undervalued now? Is it conceivable that the fundamentals actually changed so much between the spring of 2000 and the summer of 2002 and that stock prices were accurate at both times?

18 Stout (2000) reviews the empirical evidence that complex information is incorporated into stock prices only slowly and incompletely.

19 Shareholder primacy advocate Michael Jensen (2001, p. 5) attacks "stakeholder theory," which he views as the only alternative to shareholder primacy, on the grounds that "it is logically impossible to maximize in more than one dimension at the same time," and that "stakeholder theory … leaves boards of directors and executives in firms with no principled criterion for problem solving" (p. 11). See also Monks and Minow (1995, p. 25). Of course this is only an issue if one feels compelled to describe corporate goals in terms of "maximization." Economists prefer the language of maximization because mathematical models can be used to describe a decision-making process based on maximization. But most organization theorists believe that in practice, no one knows what it means to "maximize" business goals, so that managers operate instead by setting challenging goals and trying to at least reach them. See Cyert and March (1963), on "satisficing."

20 See G. Ip. "New York Fed President Chides CEOs on Hefty Compensation: McDonough Urges Officials to Cut Their Pay, Citing Years of Outsized Gains," *Wall Street Journal*, Sept. 12, 2002, p. A-2.

21 Calculated from data in G. Strauss. "Why Are These CEOs Smiling? Must Be Payday; Analysis Shows That Top Executives Rarely Felt Shareholders' Financial Pain Last Year," *USA Today*, March 25.

22 See Ip, supra note 20.

23 "Dunlap Wants Stock Options Re-priced," *Palm Beach Post*, April 7.

24 Fraud charges were brought against Dunlap by the Securities and Exchange Commission (SEC), and numerous shareholders filed lawsuits after the accounting manipulations were revealed and Sunbeam's share price collapsed in 1998. These charges were finally settled in early September, 2002, when Dunlap agreed to pay out USD 15 million to settle the shareholder suits, and $500,000 to settle the fraud charges. Dunlap was also permanently banned by the SEC from ever serving as an official of a public company. See M. Schroeder, "Dunlap Settles Fraud Charges with the SEC," *Wall Street Journal*, Sept. 5, 2002, p. C-1.

25 Even shareholder primacy advocate Michael Jensen and his colleagues have come around to the view that corporate managers should not pursue short-term shareholder value maximization, noting that "an overvalued stock can be as damaging to the long-run health of a company as an undervalued stock," and warning of the dangers of the earnings expectations game. See Fuller and Jensen (2001). This concession, it should be noted, seriously undermines arguments Jensen and others made in the 1980s justifying hostile takeovers on the grounds that they offered shareholders of target firms an immediate gain on their investment.

26 Executives at companies that were competing with WorldCom reported such pressures to the *New York Times*. "Our performance did not quite compare and we were blaming ourselves," said Sprint chief executive William T. Esrey. See S. Schiesel, "Trying to Catch WorldCom Mirage," *New York Times*, June 30, 2002, Sect. 3, p. 1.

27 Stout (2002) notes that even if Bebchuk, Coates, and Subramanian are correct that the combination of staggered boards and poison pills reduces the returns to shareholders of companies that become takeover targets, this does not imply that the presence of takeover defenses in a firm are bad for shareholders. The problem is that Bebchuk et al. measure only the effect of the takeover defenses *ex post*, once the firm has become a takeover target, and they fail to measure the potential *ex ante* benefits to the firm and its shareholders from having the defenses in place. Takeover defenses may enhance a firm's ability to attract human capital and other resources, for example, precisely because they make the firm less likely to be taken over and broken up. See discussion below of the importance of "team production" in corporations.

28 See cites supra, note 3.

29 Bainbridge (2002) coined the phrase "director primacy."

30 For a summary of the efforts of TIAA-CREF to improve corporate governance, see Biggs (2002). For a summary of the corporate governance activities of CalPERS, see CalPERS web site at www.calpers-governance.org/forumhome.asp. See also the web sites of the Council of Institutional Investors, at www.cii.org/corp_governance.htm, and of the International Corporate Governance Network at www.icgn.org, and the chapter by W. D. Crist, chapter 16 in this volume. For an example of relatively intrusive engagement by an institutional shareholder in corporate governance, see B. Orwall, "Forum to Allow Disney Investors to Air Grievances," *Wall Street Journal*, Sept. 12, 2002, p. A-6, noting that Providence Capital of New York was planning to host a meeting of institutional investors for the purpose of finding out their views on the corporate governance practices at Walt Disney Co.

31 Coates (1999, Abstract) notes that "two decades of empirical research on poison pills and other takeover defenses does not support the belief—common among legal academics—that defenses reduce firm value."

32 MacAvoy and Millstein (1999) argue that nominal independence of board members may not by itself bear any strong relationship to whether a board is active and independent in its action. They construct a measure of board independence based on a survey of board practices (including such things as whether nonmanagement directors meet independently of management on a regular basis), and find that evidence of independent board action is positively correlated with a measure of performance that is a variation on Economic Value Added (EVA). See Rappaport (1986) for an explanation and discussion of the concept of and method of measuring EVA.

33 Professor Bernard Black has suggested that corporate governance details may be very important in settings where courts aren't functioning, regulation is corrupt, and there are no institutions in place that can prevent theft of corporate resources by insiders. For example, he compares the performance of 21 major Russian corporations that have publicly-traded securities with their rankings on an index of their corporate governance practices. He finds that all of the companies trade at a huge discount relative to their Western counterparts, but that companies with good corporate governance practices are discounted much less than companies with poor governance practices. The most well-governed company in the sample, telephone company Vimpelcom, trades at a discount of about 50 percent relative to comparable companies in Europe and the United States, while the worst-governed company, Yuganskneftegas, an oil company, trades at 100th of 1 percent of its estimated potential value in the west.

34 It is virtually impossible to draft and enforce complete contracts, fully specifying the terms of the long-term relationships among the team members, without introducing perverse

incentives into the relationship. If team members agree in advance that they are going to split the proceeds evenly, for example, then everyone will have an incentive to shirk, since they will get the same share of the output no matter how hard they work. But if they do not agree to a distribution rule in advance, the team could easily fall apart as they argue with each other over the proceeds.

35 See, e.g., Del. Code Ann. tit. 8, §106.

36 Recall the discussion above, however, in which I argue that such designation is not accurate legally, but is at best a convenient, if misleading, metaphor.

37 See, e.g., *Auer v. Dressel*, 118 N.E. 2d 590, 593 (NY 1954), holding that directors have no obligation to respond to a shareholder resolution demanding reinstatement of a dismissed officer.

38 See, e.g., *Kamin v. American Express Co.*, 86 Misc.2d 809, 383 N.Y.S.2d 807 (1976), aff'd on opinion below, 54 A.D.2d 654, 387 N.Y.S.2d 993 (1st Dept. 1976) noting that whether or not to pay a dividend is "exclusively a matter of business judgment for the Board of Directors".

39 The "business judgment rule" is a doctrine adopted by the courts which says that the courts should presume that "in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company" (Aronson v. Lewis, 473 A.2d 805, 812 [Del. 1984]).

40 Shareholders must be given a chance to vote for directors, but existing directors nearly always nominate the slate to be voted on. Shareholders must also be given a chance to vote on certain fundamental corporate changes such as a sale of all or substantially all of the assets of the firm, or a merger in which the company will cease to be an independent firm. See discussion of shareholder voting rights in Blair and Stout (1999, pp. 309–315). And, under proposed new stock exchange rules, shareholders must be given a chance to vote on stock option-based compensation plans. See NYSE 2002; Nasdaq 2002. These are the only decisions that must be subjected to shareholder vote by law, although incorporators may specify in the corporate charter that a vote of shareholders is required for other decisions.

41 See Restatement (Second) of Agency § 14C cmt.a (1958), stating that directors owe duties to "the corporation itself rather than to the shareholders individually or collectively". Some case law describes directors' fiduciary duties as running to the corporation and its shareholders, but extensive case law authorizing directors to consider nonshareholder interests in deciding what is best for the corporation makes it clear that directors' duties are not limited to shareholders but are owed to the corporation generally. Blair and Stout (1999, note 105).

42 See discussion of rules of derivative suits in Blair and Stout (1999, pp. 292–297).

43 This requires a showing that directors have a conflict of interest that is so substantial that it would influence their judgment in deciding whether to pursue the case.

44 Most management literature addresses corporate performance in a multidimensional way, and even economic analysis of firm performance from the perspective of industrial organization theory (as opposed to finance theory) uses a multidimensional approach. Scherer and Ross (1990, pp. 4–5), for example, suggest that corporate performance should be evaluated on the basis of "production and allocative efficiency, progress, full employment [and] equity."

45 Business consultant Allan Kennedy has argued that many companies in the last two decades have been "mortgaging their future in pursuing shareholder value to the exclusion of other stakeholders—employees, governments, communities, suppliers, and customers." See "The

End of Shareholder Value," interview with Kennedy by Jane Christophersen, published in *ShareholderValue Magazine*, July/Aug. 2001, p. 38. See also Kennedy (2000).

46 Tirole (1986, p. 208) notes that "it is widely recognized by sociologists that without the countless acts of cooperation that take place everyday between members, most organizations would break down."

47 Williamson (1985, p. 249) notes that courts refuse to get involved in disputes between divisions of a corporation over transfer prices or the allocation of a bonus pool, referring to matters such as these as within the "zone of acceptance," in which participants of the corporation must accept the decision of the internal hierarchical decision-making process of the corporation.

48 Former Chancellor of the Delaware Court William T. Allen has emphasized the importance of factors such as "reputation, pride, fellowship, and self-respect" in determining how active and effective corporate directors are in guiding a corporation toward strong overall performance. See Allen (1993, p. 11).

49 Sally (1995) finds evidence that the cooperation rate in social dilemma games can be made to vary from as low as 5 percent to as high as 95 percent, depending upon a variety of contextual variables and social signals. While dramatizing the importance of social and cultural context in eliciting cooperative behavior, this finding also confirms that there will be some "bad apples" no matter what, which may explain why law and institutions also matter.

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