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THE SEPARATION OF OWNERSHIP AND CONTROL

Stephen G. Marks
Professor, Boston University School of Law
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Abstract

The separation of ownership and control refers to the phenomenon associated with publicly held business corporations in which the shareholders (the residual claimants) possess little or no direct control over management decisions. This separation is generally attributed to collective action problems associated with dispersed share ownership. The separation of ownership and control permits hierarchical decision making which, for some types of decisions, is superior to the market. The separation of ownership and control creates costs due to adverse selection and moral hazard. These costs are potentially mitigated by a number of mechanisms including business failure, the market for corporate control, the enforcement of fiduciary duties, corporate governance oversight, managerial financial incentives and institutional shareholder activism.
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1. Introduction

The separation of ownership and control refers to the phenomenon associated with publicly held business corporations in which the shareholders (the residual claimants) possess little or no direct control over management decisions. Reference to the separation of ownership and control, and concern over its effect, go back at least to Adam Smith. In *The Wealth of Nations*, Smith (1776), writing about joint stock companies, stated:

> The directors of such companies ... , being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore,

> must always prevail, more or less, in the management of the affairs of such a company. It is upon this account that joint stock companies for foreign trade have seldom been able to maintain the competition against private adventurers. (Book 5, Chapter 1, Part 3, Art. 1)

Modern interest in the separation of ownership and control is often associated with Berle and Means (1932) who documented the rise of the modern corporation in the United States. This chapter is organized as follows. Section 2 discusses the legal and economic factors that separate ownership and control. Section 3 lays out the economic benefits of this separation. Section 4 outlines the costs of the separation of ownership and control. Section 5 surveys the various mechanisms for mitigating the costs of the separation of ownership and control. Section 6 considers briefly the origins of these mechanisms. Section 7 summarizes. The examples and motivations will be taken from corporate law in the United States. This chapter will lay out some of the important issues and point the reader to some of the literature in this area as well as give some examples of the economic reasoning involving some of the issues.

2. Ownership and Control

We can define the separation of ownership and control with reference to the owner managed firm. In such a firm, the owner/manager possesses two principal attributes. The owner/manager (1) makes management decisions of the firm and (2) has a claim to the profits of the firm. (These claims are sometimes called residual claims to reflect that they accrue after all costs and fixed claims have been satisfied.) In a large publicly-held corporation, the shareholders own residual claims but lack direct control over management decision making. Correspondingly, managers have control but possess relatively small (if any) residual claims.

The lack of control by shareholders is generally attributed to what is variously called free-rider, collective action or coordination problems. Shareholders in a publicly held corporation typically have limited legal rights to control the corporation. Shareholders do not have the right to engage in any day-to-day management of the corporation. Nor are they able to direct policy or to set compensation. And although shareholders have the right to elect directors, the management controls the voting (proxy) machinery. Typically in the US, management may use corporate funds to solicit proxies while insurgents may use corporate funds only if successful. In spite of this, voting could be an effective instrument of control absent collective action problems. However, the existence of collective action problems greatly weakens and, in many cases, eliminates voting as an effective control mechanism. In order for a shareholder to oust current management such a shareholder faces significant expected costs. The expected return on such an investment to the shareholder, however, is a small fraction of the total return and, more importantly, small relative to the costs incurred.

As an example, suppose that a shareholder possesses one-hundredth of 1 percent of a corporation's stock. Suppose that a change in management would be worth $10,000,000 to the corporation and thus $1000 to the shareholder. Let us suppose that the cost of a proxy solicitation is $100,000. Given these costs, a shareholder would be unwilling to engage in a proxy solicitation unless almost certain of winning. (In such a case, the expenses would be reimbursed.) What is the chance of winning? Consider the collective action problems facing the *solicited* shareholder. The likelihood that an individual shareholder's vote will affect the outcome is so small that most shareholders will not take the considerable time and effort of reading and understanding the competing proxy solicitations. (This phenomenon is sometimes called rational apathy.) The result is that the chance that a challenger will win with even a meritorious position, is small. If the chances are, say, 10 percent then the expected gain to the would-be challenger is now $100. The expected costs are 90 percent the chance of failure) times the cost of solicitation. In our example, this expected cost is $90,000. Thus shareholders typically have little incentive to engage in such challenges even where the total expected gain of such an action is large relative to the costs.

3. The Benefits of the Separation of Ownership and Control

The benefits of separating ownership and control come from the interaction of three factors. First, under certain conditions and for certain types of decisions, hierarchical decision making may be more efficient than market allocation. Second, due to economies of scale in both production and decision making, optimal firm size can be quite large. Third, optimal investment strategy requires investors to be able to diversify and pool and to be able to change their allocations in response to changing market conditions.

Under some conditions, hierarchical decision making may be more efficient than market transactions. Both hierarchical structures and market structures impose transaction costs. For some types of transactions, market costs may be particularly high. If so, then hierarchical decision making may be more efficient. (see, among others, Coase, 1937 and Williamson, 1979).

As an example, suppose that a firm is considering either purchasing or making an input product. Let us consider two types of costs. Production costs refer to the cost of making the good or to the purchase price if the good is purchased from an outside supplier. Transaction costs refer to the costs of negotiating the transaction. If the input good is a standardized good then it makes sense for a firm to go to the market and simply buy the input. Since the good is standardized, production costs will be much lower to outside producers who already are producing the good than it will be to produce in-house. In addition, transaction costs will be lower through the market. The purchasing manager simply has to check a couple of prices and then make the purchase. The competitive market will constrain prices and make extensive negotiations unnecessary. In-house production, on the other hand, involves significant transaction costs including communication costs and agency costs. Thus it makes no sense to make the product in-house.

Instead, suppose that the input product is a highly idiosyncratic custom design. Suppose that, because of the uniqueness of the input product, it will cost about the same to build the product in-house as to have someone else build it. In addition, the transaction costs of building it in-house are likely to be lower. Because of the idiosyncratic nature of the product, the amount of negotiation and dispute resolution between a buyer and an outside supplier will be very large. If the product is made in-house, management can communicate to the engineers and the production people what they want. Later, if redesign is necessary, this too can be ordered. (Such redesign negotiations with outside suppliers can be long and tense and can lead to disputes over pricing, delivery dates, and so on.) Although there are principal-agent problems associated with hierarchical decision making within the firm, being able to make command decisions may be much less time-consuming than the extensive negotiations required when dealing with an idiosyncratic product and outside suppliers. Since production costs are the same and the transaction costs are less, the company will likely decide to make the product rather than buy it on the market. (For a more detailed discussion of idiosyncrasy and contractual governance, see Williamson, 1979.)

For many firms, the number of idiosyncratic inputs is large. An organizational form that combines hierarchical organization and large size with diversified and liquid investment may possess informational, transactional and productive efficiencies that make it superior to other organizational forms. The separation of ownership and control permits the existence of an organization with these characteristics. In cases where the benefits outweigh the costs (including agency costs) we would expect to see organizations in which ownership and control are separated (see also, Knight, 1921; Arrow, 1974; Chandler, 1977 and Fama and Jensen, 1983).

4. The Cost of the Separation of Ownership and Control

Much attention has been focused on the costs of the separation of ownership and control and policies that do or might reduce these costs. In this section we will consider the framework for examining these costs and these policies. Section 5 will consider the costs and policies specifically.

Adam Smith considered the separation of ownership and control to be problematic in that managers of such companies would lack the incentives to operate the corporation in the same manner as owner-managers and would thus operate the business in an inefficient manner. Following Adam Smith, Jensen and Meckling (1976) characterized the separation of ownership and control as an agency problem. In the agency approach, shareholders are modeled as principals and managers are modeled as agents. Agents, in this model, maximize personal utility. The issue is how to provide the agent with incentives to induce behavior beneficial to the principals, the shareholders. Agency analysis studies the costs of providing such incentives and the costs resulting from the extent to which agents will still deviate from the interests of the principal even in the presence of such incentives. The costs of the separation of ownership and control are thus the usual principal-agent costs: the monitoring expenditures by shareholders, the bonding expenditures by managers and the residual loss from the divergence of behavior (even with monitoring and bonding) from the ideal.

Agency analysis was important first step for the study of the separation of ownership and control. Agency analysis treated managers as economic actors with utility functions distinct from those of their principals and thus formalized Adam Smith's concern over managerial behavior. Agency analysis focused on incentive schemes by which managers' objective functions could be more closely aligned with those of the principals. Such schemes require the ability to monitor and to reward performance.

Ultimately, however, agency analysis proved to be an imperfect fit for the study of the separation of ownership and control. As Stiglitz (1989) has stated, the problem addressed by the principal-agent literature is 'how one individual, the principal ... can design a compensation system ... which motivates another individual, his agent ... to act in the principal's interest'.

Embodied in this statement are two concepts that are at odds with current analyses of the separation of the ownership and control. First, modern analyses do not take as its ideal the notion that the shareholder should have the ability to monitor or control management. Indeed, policies that encourage shareholder control may undermine the benefits of the separation of ownership and control outlined above. Rather, much modern analysis has focused how actors *other than shareholders* may effectively monitor and constrain managerial behavior. These other actors include other stakeholders (such as bondholders), lawyers (in the prosecution of derivative and class action suits), regulatory authorities (such as the SEC in the United States) and market participants (such as potential acquirers).

Second, and perhaps more importantly, many modern analyses do not assume that it is socially desirable for managers to act in the best interests of their current principals. This is made clear in the following example. Suppose that a publicly-traded company has made an ore discovery. Immediate announcement of the discovery will increase share value by 10 percent. However, if the corporation delays its announcement by eight months, allowing it to buy up property surrounding the ore discovery site, then the share price will double. Finally suppose that this is an actively traded corporation and that it is certain that the shareholders eight months from now will be different from the current shareholders. If we were to require that management act as agents of current shareholders, an immediate announcement would be required. Most modern analyses would reach a different result (see below).

Berle and Means (1932) suggested treating shareholders as investors who have no necessary claims to control:

> On the one hand, the owners of passive property, by surrendering control and responsibility over the active property, have surrendered the right that the corporation should be operated in their sole interest ... Neither the claims of ownership nor the those of control can stand against the paramount interests of the community.

Under this framework shareholders are just another set of investors. The issue thus becomes one of determining socially desirable policies for the governance of the corporation. The goals of such policies could include encouraging the efficient flow of investment funds into production and the efficient production and distribution of goods and services. This, in turn, requires a consideration of shareholder protection and looks to policies that provide managers with optimal incentives. Under this model, managers could have duties toward shareholders, but not exactly the same duties that would be suggested by the agency model. Such a model could also include considerations of social justice and could require duties towards other constituencies.

As an example of an approach that eschews the strict agency framework, consider the argument by Easterbrook and Fischel (1982) that managerial resistance to takeovers is socially counterproductive. Under a strict agency approach management should resist takeovers in situations where resistance and subsequent bargaining would lead to a higher premium for the corporation's shareholders. Easterbrook and Fischel argue that even if resistance produces a higher premium for the shareholders the result is socially inefficient. Gains to the target's shareholders are offset by losses to the acquirer's shareholders. In addition there are a number of deadweight losses such as those flowing from bargaining breakdowns, dilution of managerial incentives for good management and discouragement of search.

Analysis of the costs of the separation of ownership and control is a several step process involving (1) the articulation of societal goals, (2) the determination of how managerial behavior affects those goals and (3) the evaluation of institutional arrangements in terms of how they affect managerial behavior and at what cost. Broadly speaking, there are two reasons why managerial behavior might not conform to the ideal. The first is that managers might not have the incentives to do so. This is sometimes called the moral hazard problem. The second is that managers may not have the ability to do so (that is, managers may be incompetent). This is sometimes called the adverse selection problem. (see, for example, Ayres and Crampton, 1994 and Smith, 1996). In the following section I will consider some of the institutional mechanisms that mitigate the costs of the separation of ownership and control.

5. Mechanisms for Mitigating the Costs of the Separation of Ownership and Control

The separation of ownership and control gives rise to costs in that managers may act in ways that are inefficient or antisocial. Scholars have explored a number of mechanisms that might give managers an incentive to better conform their behavior to the ideal and that might weed out incompetence. Many (but not all) of these mechanisms rely on actors other than the shareholders. I will group these mechanisms into the following six categories: (1) business failure, (2) the market for corporate control, (3) managerial duties, (4) direct managerial financial incentives, (5) corporate governance oversight and (6) shareholder empowerment. In what follows, I give a brief account of some of the issues and analyses that have arisen in the literature surrounding each mechanism.

5.1 Business Failure

Even in the absence of any other mechanism we would expect business failure to eliminate incompetent managers and thus to mitigate problems of adverse selection. We might also expect business failure to constrain moral hazard. However, absent additional mechanisms to control moral hazard, a market that depended solely on business failure might simply eliminate certain types of otherwise efficient organizations. If managers are unable to credibly commit to behavior that benefits residual claimants, these claimants may be unwilling to make investments in organizations in which they lack direct control. As Akerlof (1970) has demonstrated, asymmetric information can result in the wholesale elimination of markets. In other words, absent other control mechanisms, large publicly owned corporations might not be viable.

In modern corporations, other mechanisms do exist to mitigate the problems of adverse selection and moral hazard. These are discussed in the following sections. Some of these mechanisms operate in conjunction with business failure. For example, managers of failing businesses may be replaced by outside directors or through the market for corporate control. This threat of removal mitigates the problem of moral hazard and removal itself mitigates the problem of adverse selection long before the corporation is actually allowed to fail.

5.2 The Market for Corporate Control

Some scholars have argued that if a market for corporate control is allowed to function, directors will be forced to take action to maximize share value or risk a takeover and the resultant loss of job. The proper functioning of such a market reduces the costs of the separation of ownership and control because, even though shareholders lack direct control, managers will be forced by market pressures to act to maximize share price. In addition, incompetent managers will be removed through the takeover process. In this manner, the market for corporate control mitigates both moral hazard and adverse selection problems. (see, among others, Manne, 1965; Butler, 1989; Easterbrook and Fischel, 1991; Romano, 1992; Macey and Miller, 1995).

Two interesting variants of this story are related to dividend policy and capital structure. Some scholars argue that a corporate policy of paying steady dividends, in spite of adverse tax consequences, signals to the market that the corporation will not squander free cash flows. The market recognizes this signal and elevates stock price. (Presumably, firms that did not engage in this practice would suffer from lower stock price and be subject to a takeover; see, for example Easterbrook, 1984a). Other scholars have suggested that capital structure can provide the same sorts of signals. A capital structure that is weighted towards debt creates an obligation on the part of management to pay out future cash flows. Again this reflects a commitment by management not to squander future cash flows. This commitment is valued by the market and is reflected by higher share prices. Corporations that do not make this commitment have depressed share prices and are subject to takeover. The takeover of corporations in leveraged transactions may represent the market for corporate control operating to impose these debt constraints (see, for example, Jensen, 1986).

The notion that capital markets can help reduce costs of the separation of ownership and control is parasitic on the notion that managerial performance is reflected in stock price. The idea that stock prices reflect information is known as the Efficient Capital Market Hypothesis (ECMH) and it comes in three flavors. Weak-form efficiency occurs when stock prices reflect all past stock price information (if the market is weak-form efficient, then technical analysis is unavailing). Semi-strong-form efficiency occurs when stock prices reflect all public information (if the market is semi-strong-form efficient then both technical and fundamental analysis is unavailing). Strong-form efficiency occurs when stock prices reflect all public and private, information. Empirical evidence seems to suggest that capital markets are semi-strong form efficient in the sense that it is not possible to make abnormal returns through either technical or fundamental analysis (see Brealey and Myers, 1991; Ross et al., 1993).

Critiques of the market for corporate control as a mechanism for mitigating the costs of the separation of ownership and control have had to deal with the efficient market hypothesis. The critiques come in a variety of forms. Note that in order for the market for corporate control to be effective that (1) managerial incompetence or misbehavior must be correlated with takeover activity, and in order for this to occur it is necessary that (2) that there be a correlation between managerial incompetence or misbehavior and stock price.

Various critiques of the market for corporate control attack one or both of the above correlations. For example, one critique attacks the notion that managerial behavior and stock price are highly correlated. Even if stock prices reflect fundamental values, the determinants of these values contain a large random element (that is, random events unrelated to managerial performance are a significant factor in success). This random element weakens the correlation between managerial performance and stock price.

Another critique allows that while the efficient market hypothesis may be correct in that it prevents the extraction of abnormal profits, it nonetheless does not imply that stock prices reflect the fundamental values of the firm. For example, noise traders could randomly cause stocks to diverge from fundamental value. Again, this random element weakens the correlation between managerial performance and stock price (see, among others, Black, 1986 and Stout, 1988).

Another set of critiques attacks the correlation between managerial activity and takeover activity. Under this critique, takeovers are the result not only of managerial incompetence or misbehavior but also of synergies, the accumulation of market power, expropriation (of creditors or of the government, *vis à vis* taxes, or of labor), of empire-building, and so on. All of these other reasons weaken the correlation between managerial performance and takeover activity. For evaluations of possible determinants of takeover activity, including some empirical studies, see, among others, Kaplan (1989), Lee (1992), Ippolito and James (1992) and Romano (1992).

Other critiques focus on the observability of managerial performance by the market participants. If managerial performance is not observable, or is systematically misobserved, then the market is unable to correctly correlate managerial performance and stock price. One such critique focuses on the informational asymmetry between the market and management. Managers may simply have better information than the market but may have difficulty in conveying this message to the markets. A version of this story is known in the literature as 'signal jamming' and involves the classic prisoner's dilemma (see Fudenberg and Tirole, 1986). Consider a manager who has the choice between Strategy L (long term) and Strategy S (short term). Neither strategy is certain. Associated with each strategy are two outcomes, one better than the other, and two probabilities:

Strategy S (Short term):
Outcome S1 (0.2 probability): Short-term earnings = 10, Total discounted earnings = 60
Outcome S2 (0.8 probability): Short-term earnings = 20, Total discounted earnings = 80
Strategy L (Long term):
Outcome L1 (0.5 probability): Short-term earnings = 10, Total discounted earnings = 80
Outcome L2 (0.5 probability): Short-term earnings = 20, Total discounted earnings = 100

In this example, Strategy L is clearly superior (the worst outcome under Strategy L is equal to Strategy S's best outcome). Suppose, however, that the market cannot observe the chosen strategy or the expected total discounted earnings flowing therefrom. Rather, only current earnings are observable in the short term. Management chooses a strategy, short-term earnings are revealed, and, on the basis of these short-term earnings, the market values the shares. The market uses the short-term earnings as a signal for total discounted earnings.

The signal the market uses depends on what firms in the market typically do. As an example, suppose that every other firm picks Strategy S. In this case, the market will associate short-term earnings of $20 with total discounted earnings of $80, and thus bid the short-term share price to $80. The market will associate short-term earnings of $10 with total discounted earnings of $60, and thus bid the short-term share price to $60. The manager in this environment faces the following choice:

Strategy S (Short term):
Outcome S1 (0.2 probability): Short-term earnings = 10, Market valuation = 60
Outcome S2 (0.8 probability): Short-term earnings = 20, Market valuation = 80
Expected Market Valuation = 76
Strategy L (Long term):
Outcome L1 (0.5 probability): Short-term earnings = 10, Market valuation = 60
Outcome L2 (0.5 probability): Short-term earnings = 20, Market valuation = 80
Expected Market Valuation = 70
Note that the market is valuing solely on the short-term earnings signal. Instead, if every other firm adopted strategy L, the signals would be different:

Strategy S (Short term):
Outcome S1 (0.2 probability): Short-term earnings = 10, Market valuation = 80
Outcome S2 (0.8 probability): Short-term earnings = 20, Market valuation = 100
Expected Market Valuation = 96
Strategy L (Long term):
Outcome L1 (0.5 probability): Short-term earnings = 10, Market valuation = 80
Outcome L2 (0.5 probability): Short-term earnings = 20, Market valuation = 100
Expected Market Valuation = 90

This leads to the following prisoner's dilemma.

		Every other firm:	
		Strategy S	Strategy L
Our Firm:	Strategy S	76	96
	Strategy L	70	90

The dominant strategy for the firm, indeed for all firms, is to adopt the short-term strategy. It is interesting to note that in equilibrium, with all firms adopting the short-term strategy, the market indeed values shares correctly. In equilibrium, the market is not being fooled. Yet even though the market is not being fooled, and cannot be fooled in the long term, managers still have the incentive to adopt short-term strategies. In this model, a market for corporate control would drive managers to make inefficient decisions.

As another example, consider a two-period model in which the present-value discounted revenues are as follows:

Strategy S (Short term): PV of Period 1 revs = 100, PV of Period 2 revs = 100

Strategy L (Long term): PV of Period 1 revs = 80, PV of Period 2 revs = 130

Suppose that labor costs in period 1 are fixed by contract at 50 but that the period 2 labor bill will be renegotiated. Suppose that bargaining strengths of labor and management are equal so that second period revenues will be equally split between labor and shareholders. Thus the return to shareholders of Strategy S is 50 in both periods or a total of 100. Returns to shareholders of Strategy L is 30 in the first period and 65 in the second or a total return of 95. Thus share price is maximized by S, even though L produces more value. In this case, even though Strategy S benefits shareholders, it is socially inefficient. Again, the market for corporate control drives managers to make inefficient decisions.

It should be noted that market-induced myopia, though theoretically possible, is difficult to identify empirically due to the difficulty in establishing a benchmark.

5.3 The Specification and Enforcement of Managerial Duties

Some scholars have viewed the establishment of managerial duties legislatively, administratively, judicially, or contractually, and then the establishment of an enforcement mechanism as a means of mitigating the costs associated with the separation of ownership and control (see, for example, Brudney, 1966).

We can divide enforcement regimes into two general categories. The first is enforcement through private rights of action. Typically, in such a system, attorneys are provided incentives, through attorneys' fees in derivative or class action suits, to prosecute cases in which directors violate their duties. Without the provision of attorneys' fees, individual shareholders have little incentive to prosecute such cases themselves since they would bear all of the costs but receive a very small fraction of the benefit. The provision of attorneys' fees solves this problem by creating large incentives for attorneys to prosecute these cases. In effect, such a system provides private attorneys general who operate to enforce managerial duties (see Romano, 1991). This system represents one in which someone other than shareholders (that is, attorneys) provides the enforcement mechanism (the shareholder is just a nominal presence). A number of duties are enforceable in this manner, such as, in the US, the duties of care and loyalty.

The second enforcement mechanism is direct enforcement by the government. In the US, a number of duties are enforceable in this manner, including many duties created through the securities acts. Many duties are enforceable through both private and public enforcement.

The following issues have occupied scholars who have studied this class of mechanisms. What is the optimal set of managerial duties? Should they be broad or narrow? To whom should duties be owed? Should duties be mandatory (state-imposed) or optional (contained in charter provisions)? Should enforcement be private (through derivative and class action suits) or public? Is enforcement effective? Who should be liable, managers, the corporation or both? As to private enforcement, what sort of incentives and disincentives should lawyers have to bring such suits? To what extent should managers be able to immunize themselves through insurance and indemnification? (In addition, there is a question as to the history and origins of the duties and whether the process of producing duties is a good one. I put this last question off to a later section since it relates to corporate law in general and not just to this particular mechanism.)

As to the issue of which duties are best privately enforced and which are best publicly enforced, there is a large literature which is not limited to corporate law. For example, Calabresi and Melamed (1972) and Cooter (1984) both discuss rationales for different enforcement regimes (see also *Boston University Law Review* (1996). In private enforcement, there exists a large literature on optimal incentives to sue which again is not limited to the corporate area (see, for example, Shavell, 1982). Specific to corporate law, there is much debate on whether private enforcement through derivative actions is effective (see, for example, Kraakman, Park and Shavell (1994).

An additional enforcement issue which has been treated by law and economics scholars is whether liability should run to organizations, natural persons or both (see, for example, Arlen, 1994; Arlen and Kraakman, 1997).

One important issue that has been addressed by law and economics scholars is whether duties should be mandatory or optional. Under an optional (opt-out) regime, the law would provide a standard set of duties that would be optimal for a large number of corporations. However, individual corporations would be allowed to opt out of these duties through provisions in the corporate charter. Under this view, the corporation is seen as a nexus of voluntary contracts designed to minimize agency costs. (This nexus of contracts view of the firm probably dates from Coase, 1937. See also Alchian and Demsetz, 1972; Jensen and Meckling, 1976; Klein, 1982; Cheung, 1983; Williamson, 1984; Butler, 1989; Butler and Ribstein, 1990; Easterbrook and Fischel, 1991).

Proponents of the opt-out regime point out that the same set of provisions is unlikely to be optimal for every corporation. They also assert that the existence of relatively efficient markets for securities will create incentives for corporations to adopt provisions that are efficient. Those corporations with inefficient provisions will have depressed share prices and will invite takeovers. As such, the adoption of managerial duties by a corporation is similar to any other managerial decision. (For examples of analyses in support of an opt-out regime, see, Winter, 1977; Carlton and Fischel, 1983; Easterbrook and Fischel, 1982; Macey, 1984; Easterbrook, 1984, among others.)

Proponents of mandatory managerial duties point to market failure. Consider the case for the mandatory provision of information. One argument is that efficient markets depend on the availability of information. Without a duty to disclose there will be an inadequate provision of information. Efficient charter provisions, including efficient disclosure provisions, are unlikely to be produced if the market for securities is inefficient. Thus efficient disclosure provisions are unlikely to be produced in an inefficient market and an efficient market is unlikely to develop absent efficient disclosure provisions (Joseph Heller referred to this type of situation as a Catch-22). Thus, the argument goes, mandatory disclosure provisions are necessary.

A similar argument could be made for provisions (such as poison-pill provisions) that insulate management from the market. Again, efficient take-over provisions are unlikely to be produced in an inefficient market and an efficient market is unlikely to develop absent efficient take-over provisions.

Even if markets are relatively efficient, market forces may provide inadequate incentives. For example, Bebchuk (1989) argues that a charter amendment that redistributes corporate money to management would affect the probability of a takeover only marginally given that such transfers are probably small relative to corporate assets though large relative to individual assets.

Other market failure critiques point to the public-goods nature of managerial duties. This argument asserts that a change in duties could have a large negative impact on the corporation. However, the impact on individual shareholders could be small due to small individual share holdings and thus it would not be worth the cost of resistance. For example, imagine a relaxation of the duty of loyalty. Such a change could result in large benefits for the manager by allowing the manager to expropriate a percentage of corporate wealth. Since the change is small to individual shareholders, such shareholders would not bother to resist. Share price could fall representing the amount that managers have taken. Such an expropriation could not be remedied through the market for corporate control since corporate wealth has already been removed from the corporation.

Yet other critiques point to the lack of sophistication of shareholders. The previous story is enhanced, for example, if the change in the charter is relatively complex. An unsophisticated shareholder would then have to invest more heavily in order to understand and resist such a change. Another critique of the opt-out duties, attacks the wealth-maximization criterion. Under this critique, even if opt-out duties did result in efficiency, mandatory duties would be necessary to accomplish other societal goals such as distributive goals. Several empirical studies have attempted to determine whether corporate decisions to opt out of managerial duties are efficient. (For analyses in support of a mandatory regime see Bebchuk, 1989; Brudney, 1985, and Coffee, 1988, among others.)

5.4. Corporate Governance Structure and Oversight

Under this rubric I include policies directed at the structure and procedures of the board of directors. Some important questions are: How should the board be selected? Who should be on the board of directors? Who should the board represent? What should be the goal of the board? How should the board be compensated?

Boards of directors in US corporations are typically elected by shareholders. In Europe, there has been some experience with boards that represent other constituencies, such as labor. In addition, large share-holdings by banks in countries such as Germany and Japan have provided oversight by lenders. A body of literature examines the costs and benefits of these various representational schemes (see, for example, Aoki, 1984; Jensen and Meckling, 1979; Summers, 1980, and Williamson, 1984). Additionally there exists literature as to whether boards, however chosen, have responsibilities narrowly to shareholders or broadly to the society as a whole. For example, Dodd (1932) has argued that managers have responsibilities to the community and not just to shareholders. Friedman (1970), on the other hand, has argued that the manager has a duty to maximize shareholder value subject only to legal and ethical constraints. Recently, the debate has been reenergized by the passage in several states of ‘other-constituency’ statutes. Proponents view these statutes as providing boards with the right to consider other constituencies, such as labor. Opponents view these statutes as merely providing cover for managerial entrenchment.

An additional issue concerns the role of boards in active management and oversight. Some scholars have examined the separation of roles between the chairman of the board (oversight) and the chief executive officer (management). Others have examined the division between outside directors (oversight) and inside directors (management). In the US, boards are typically composed of inside and outside directors. Inside directors manage the day-to-day operations of the corporation. Outside directors provide oversight. Ideally, monitoring by outside directors could mitigate problems of moral hazard and adverse selection (see, for example, Weisbach, (1988).

The reward structure for inside and outside directors differ markedly. For example, in the takeover context, both inside and outside directors stand to lose their jobs. However, whereas for the insider directors this loss is potentially great, including loss of a large income, important responsibilities, prestige and the like, for the outside director this involves the loss of a very part-time job and a very part-time salary. Thus the outside director has diminished incentives to oppose the takeover for personal reasons.

Although outside directors may be more likely to act in the interests of the corporation, the position of outside directors is weakened, however, by the fact that such directors are typically chosen by inside directors and that their continued employment depends on getting along with the insiders. In addition, inside directors and outside directors often find their positions reversed with respect to other corporations. There is thus an incentive for mutual back-scratching. In addition, insider directors typically control the flow of information. This has led some commentators to be skeptical over the efficacy of this mechanism.

Scholars and investors (particularly institutional investors) have made proposals for corporate governance reform that are designed to increase the independence and influence of outside directors. Plans for reform often include one or more of the following proposals: (1) increase the number of outside directors relative to inside directors (most proposals specify that outside directors should be in the majority); (2) remove inside directors from the process of nominating new directors; (3) remove inside directors from the process of setting directorial compensation; (4) set a mandatory retirement age or term limits for directors; (5) prohibit interlocking directorship (where inside directors of one company are outside directors of another and vice versa, and (6) require that directors own stock in the company. (For additional analysis, see, among others, Mace, 1971; Jensen, 1993, and Lin, 1996.)

5.5 The Alignment of Direct Managerial Financial Incentives

Through derivative financial instruments, particularly warrants, it may be possible to give managers greater incentives to maximize share value. To the extent that share price maximization is desirable this mechanism may reduce the costs associated with the separation of ownership and control. Note, however, that compensatory incentive mechanisms address primarily the problem of moral hazard, not adverse selection.

Imagine, for example, a corporation whose shares are currently trading for $100. Suppose that at-the-money warrants are trading at $1. Now imagine the following compensation schemes. Scheme 1 pays the manager $200,000 cash per year. Scheme 2 pays the manager $100,000 cash plus $100,000 worth of restricted shares (that is, 1000 shares). The restricted shares cannot be traded for five years. Scheme 3 pays the manager $100,000 cash plus $100,000 worth of warrants (that is, 100,000 warrants). The warrants would be exercisable in five years. Each scheme provides the same value of compensation. However, the incentive effects are quite different. Under scheme 1, the manager is not required to take an equity interest in the corporation. Under scheme 2, the manager will have accumulated 5000 shares after five years. Under scheme 3, the manager will possess 500,000 warrants after five years. Imagine now that a takeover offer for the corporation develops involving a 100 percent premium. Under scheme 1, the manager has an incentive to resist the takeover even if the price is a good one since the manager will likely lose his or her job. Under scheme 2, the manager has something of an incentive to consider the opportunity of a good price since the manager will receive $500,000 in increased value for selling into the offer as opposed to resisting it. Under scheme 3, the share price is likely to dominate the managers thinking since the premium represents $50,000,000 to the manager. (Assume that the manager may exercise the warrants in a takeover situation.) To the extent that maximization of share price is a desired outcome this mechanism creates stronger incentives for managers than might otherwise exist.

The warrant mechanism could be combined with corporate governance structures in order to create even stronger incentives. For example, one could imagine governance structures in which outside directors constituted a majority and in which outside directors were compensated exclusively through warrants. In such a case, outside directors would have small adverse incentives (since the salary is small) and significant correct incentives since their compensation would depend almost exclusive on share price performance.

One should note that warrants create asymmetric incentives. That is, they pay if share price is above the exercise price. However, the payoffs are the same (that is, zero) for all prices below the exercise price. Thus warrants could create incentives for inefficient risk-taking. Nevertheless, since cash compensation creates incentives for inefficiently risk-averse behavior it is not clear what the net effect of warrants would be (see, among others, Jensen and Murphy, 1990; Gilson, 1992; Milgrom and Roberts, 1992).

5.6 Shareholder Empowerment

A number of scholars have made proposals to increase the power of shareholders over management. Shareholder empowerment as a mechanism for managerial control has a different emphasis from the previously discussed mechanisms in that those mechanisms relied on actors other than shareholders to restrain management. Those mechanisms sought to maintain the advantages of the separation of ownership and control while mitigating the costs. By contrast, shareholder empowerment reduces the separation and gives shareholders more say in management. Thus some of the critiques of these proposals point to the compromising of centralized management and reduction of the benefits that flow therefrom (see, for example, Boyer, 1993).

Shareholder empowerment proposals seek to give public shareholders a greater voice in management by endowing them with greater rights to manage and by reducing the costs of involvement. An important subset of this research notes the increasing prominence of institutional investors in the securities markets and evaluates the costs and benefits of legal changes that would encourage greater activism by institutional investors.

Current proxy regulation in the United States gives incumbent management a tremendous advantage over challengers to their authority. Very few matters are required to be put to the vote of shareholders. Managers can fund proxy battles out of the corporate treasury while challengers must incur the high costs themselves unless they ultimately prove successful. In addition, corporations have the ability to restrict voting rights in certain classes of shares (see, for example, Seligman, 1986). This system, combined with collective action problems (see Section 2 above), discourages challenges even where the total benefit of the challenge to the corporation is great compared to the costs. Some proposals for corporate reform would alter proxy rules to put more decisions in the hands of shareholders (that is, to provide for binding shareholder resolutions) and to change the cost structure to make challenges significantly cheaper, for example, by putting some of the resources of the corporation into the hands of shareholder challengers (see, among others, Bernstein and Fischer, 1940; Caplin, 1953; Eisenberg, 1970; Dent, 1989; Goforth, 1994; Smith, 1996). Evaluation of such proposals must trade the gains of greater managerial accountability against both the costs of increased use of corporate funds for such purposes and the cost of decreased centralization of management decisionmaking.

In the US, equity securities are held increasingly by institutions, i.e., pension funds, insurance funds and investment funds. Although any individual fund holds a small percentage of the shares of any given corporation, the holdings are significant enough to encourage some monitoring. In addition, a small number of funds could control enough of a corporation to possess significant voting power if their actions are coordinated (see, among others, Gilson and Kraakman, 1991, 1993a; Black, 1992a, 1992b; and Maug, 1997). In the US, laws exist which work to discourage cooperation among funds to exercise voting control. Some proposals have suggested reducing these barriers to cooperation in order to allow funds to exert control over management and thus to reduce the separation of ownership and control and thereby reduce the costs associated with the separation of ownership and control. Some of this scholarship has been comparative in nature, focusing on institutional ownership by banks in countries such as Germany and Japan (see, among others, Gilson and Roe, 1993).

Skeptics of institutional monitoring point to a number of costs associated with institutional investor oversight. Fund managers are themselves agents whose interests are not aligned with their own investors. In addition, managers represent only some of the shareholders. Control and access to information may lead to insider trading and other abuses *vis-à-vis* other shareholders. Although fund managers may have incentives to cooperate with other fund managers in order to exercise control, they are also in competition. Strategic behavior may result in inefficient control. Some managers, particularly managers of government pension funds, may be susceptible to political influence. Debates over institutional investor voice involve assessing these costs (see, among others, Garten, 1992; Romano, 1993; Calio and Zahralddin, 1994; Bainbridge, 1993, 1995; Fisch, 1994; Utset, 1995).

6. Origins of the Mechanisms for Mitigating the Costs of the Separation of Ownership and Control

In the United States, most of the mechanisms for mitigating the costs of ownership and control are regulated by state law. Some commentators have suggested that the optimal development of mechanisms has been impeded through the process of state competition for corporate charters. This has become known as the 'race-to-the-bottom' thesis. This has led some commentators to support a federal (that is, national) chartering of corporations and the development of a federal corporate law. Other commentators argue that jurisdictions that compete for charters will offer efficient corporate laws. Yet other scholars have applied public choice tools to explain the development of corporate law as the result of the interest group interaction (see Cary, 1974;

Dodd and Leftwich, 1980; Romano, 1985, 1994; Hovenkamp, 1988; Macey and Miller, 1987; Bebchuk, 1992; Bratton, 1994; and Ayres, 1995).

7. Summary

Many of the issues in corporate law can be traced to the separation of ownership and control. This separation has made viable large, centrally-managed firms with diversified and liquid investors. It has provided the means for the efficient mobilization of large amounts of private capital towards productive uses. The same separation of ownership and control has created potential costs. Much of corporate law can be explained as mechanisms designed to mitigate these costs. Economic analysis of law, with its emphasis on incentive effects and on the costs and benefits that flow therefrom, provides an important tool for the analysis of corporate law and policy.

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