Monitoring Corporate Performance: The Role of Objectivity, Proximity and Adaptability in Corporate Governance

by

Arnoud W.A. Boot[*] and Jonathan R. Macey[**]

[*] University of Amsterdam, Faculty of Economics and Econometrics, Roetersstraat 11, 1018 WB, Amsterdam, The Netherlands, e-mail: awaboot@fee.uva.nl
[**] Cornell University School of Law, 306 Myron Taylor Hall, Ithaca, NY 14853-4901, U.S.A., e-mail: macey@law.mail.cornell.edu

Acknowledgements: The authors acknowledge the support of the Sloan Project on Corporate Governance at Columbia Law School. Arnoud Boot also acknowledges his stay as Olin Fellow at Cornell University. We thank Mark Roe, Eric Talley and seminar participants at Columbia, Michigan (Davidson Institute), Yale, HEC (Jouy-en-Josas Cedex), Bologna, Bruxelles (2002- CEPR meeting) and Amsterdam for their comments. The usual disclaimers apply.

Abstract

Objectivity, Proximity and Adaptability in Corporate Governance

In this paper, we identify what we regard as a fundamental tradeoff faced by individuals, firms and institutions that monitor the performance of corporate management. This tradeoff is between *objectivity* in monitoring and *proximity* in monitoring, which we regard as central to the corporate governance debate. Proximity exists where monitors are in close contact with management and participate in important decisions on a real-time basis. Objectivity exists when monitors such as hostile acquirers, analysts, credit rating agencies, accounting firms and outside lenders remain distant from management and make objective evaluations of management's performance.

A trade-off in these monitoring functions exists because monitors that obtain close proximity necessarily forego objectivity; while monitors that are objective must maintain sufficient distance from management, such that they lose the advantages of proximity. Thus each individual monitor of a firm must *choose* which of these characteristics they prefer because they can't have both. Theoretically, a firm could have some monitors that are proximate and others that are objective, however, in light of the fact that most countries' corporate governance laws encourage one extreme or the other, such "mixed monitoring" is somewhat unlikely.

Where neither proximity nor objectivity exists there can't be effective monitoring and disciplining of management. In this situation, outside investors will be reluctant to invest, and firms will be required to turn to internal sources of finance. We observe, however, that certain corporate governance systems feature *neither* attribute, and yet succeed nonetheless. Italy is one such a system. The example of Italy's system, which provides protection for workers who invest in firm specific assets, illustrates that corporate governance systems can be quite adaptable in contracting around the structural flaws that exist in their own governance systems. In Italy's case, the proliferation of (smaller) owner-managed firms is key to overcoming corporate governance failure. Moreover, providing protection for workers who invest in firm-specific assets is a distinct strength.

Finally, this paper argues that, notwithstanding current legal constraints to non-uniform systems of corporate governance within particular nations, that firms would be

best served by deciding and adapting between objectivity and proximity on an industry-wide rather than nation-wide level.

OBJECTIVITY, PROXIMITY AND ADAPTABILITY IN CORPORATE GOVERNANCE

Introduction

Monitors are crucial to effective corporate governance. Monitors come in a variety of forms, from directors, to auditors, credit rating agencies, stock market analysts, take-over firms, arbitrageurs, large shareholders and outside lenders. Even customers and suppliers can be viewed as monitors because of their ability to observe management quality and send effective signals to the market about management's performance.

In this paper, we identify what we regard as a fundamentally important tradeoff that must be faced when evaluating the ability of a monitor to succeed in improving a corporate governance system. This is the tradeoff between *objectivity* and *proximity*, which we regard as central to the corporate governance debate.

We posit a model of corporate governance in which there is a trade-off between proximity and objectivity. Each monitor within a corporate governance systems must *choose* whether they prefer a role that features one of these characteristics or the other because they can't have both. Theoretically, within a particular nation's system of corporate governance, a particular firm could have both proximate and objective monitors. However, in the interest of predictability and ease of application, many nations create and maintain corporate governance laws that facilitate uniform monitoring practices and discourage such "mixed monitoring". As such, in reality, either the feature of proximity or objectivity will likely dominate throughout successful corporate governance systems.

Nonetheless, we argue that certain corporate governance systems feature *neither* attribute, and yet succeed nonetheless. Where neither proximity nor objectivity exists to

permit the effective monitoring and discipline of management, investors will be reluctant to invest, and firms will be required to turn to internal sources of finance. While such a system has obvious costs, it has hidden virtues as well. In particular, such a system provides strong incentives for managers to make firm-specific human capital investments, which are necessary to develop specialized skills. Italy is one such a system.

Significantly, we lastly argue that the trade-off between proximity and objectivity and the adaptation between these two extremes would be ideally applied out on an industry-specific level rather than on nation-wide level. Notwithstanding the above-mentioned legal constraints that currently impede such non-uniformity within particular countries, data discussed in this paper bears out this suggestions.

Proximity

In systems like those that exist in Germany, the Netherlands and elsewhere, there is often intimate, sustained, intensive, and finely textured monitoring of management, either by large shareholders or by largely autonomous, entrenched, boards of directors (supervisory boards). These directors enjoy close proximity to the firms they are monitoring. They participate in decision-making, and monitor management's actions on a real-time basis. Inevitably, these monitors tend to become insiders and are captured by the firms they are monitoring. Their participation in the decision-making process not only requires that they have access to information more quickly than outside monitors, like takeover artists, arbitrageurs, credit rating agencies, and analysts, it also establishes the conditions by which capture of the monitors by incumbent management is most likely to occur. Capture means that the block shareholder or bank-board member who is the ostensible monitor adopts the perspective of the management team being supervised.

Consequently, the informational advantage enjoyed by the insiders in certain corporate governance systems is mitigated by the fact that these investors may gradually lose the ability to evaluate the performance of the firms by monitoring in an objective manner.

Objectivity

By contrast, in a corporate governance system like the one that exists in the U.S., far less monitoring comes from directors, large shareholders or others in close proximity to the firm's managers. Instead, a variety of outside forces and institutions, particularly the market for corporate control, but also credit rating agencies and investment banking analysts, serve as substitutes for direct shareholder involvement. In this system, considerable distance exists between monitors (investors) and management. The kind of "proximity" described above is impossible, and investors may thus face a significant problem in obtaining timely, reliable information about management.

This shortage of information could in theory negatively impact the effectiveness of corporate governance systems in regimes where monitors lack close proximity to management. In particular, monitoring in the U.S. generally is *ex post* and evaluative rather than *ex ante* and pro-active. However, there is a benefit to this lack of proximity. The distance that U.S. investors have from the firms in which they are investing brings with it a high degree of objectivity lacking in corporate governance systems where the proximity of monitoring subjects them to the risk of capture. This objectivity raises the probability that the outside monitors will impose sanctions on corrupt or under-performing managers when such corruption or poor performance is detected.

Adaptability

The purpose of our discussion about proximity and objectivity is to make three points. Our first point is that effective monitoring of corporate management cannot exist unless the monitors possess the characteristics of *either* proximity or objectivity. Our second point is that there is a trade-off between proximity and objectivity, and this trade-off makes it impossible for a *particular monitor within a* corporate governance system to provide monitoring that is both proximate and objective. Our third point is that corporate governance systems lacking one or both of these characteristics can succeed by adapting to compensate for weaknesses.

Where there is neither proximity nor objectivity on the part of monitors, investors will shy away because they know they will be unable to protect themselves from management opportunism. These sorts of pathological corporate governance systems must adapt to survive. Sometimes these adaptations, which generally involve using internal sources of finance, have benefits, such as encouraging firm and asset-specific capital investments that are not obvious at first glance.

This paper is organized as follows. In section I, we develop a theoretical framework highlighting the source of the corporate governance problem, the objectives of corporate governance and the importance of shareholders in corporate governance. Section II develops the point that systems differ in the proximity and objectivity of supervision and control. We illustrate that the optimal distance between management and monitor will be one of two extremes: *either* monitors should capitalize on the better information that comes with proximity *or* systems should seek to benefit optimally from the objectivity that comes with distance.

In Section III, we build on our point about adaptability. We discuss the issue of adaptability in the context of the corporate governance arrangements in the U.S. and Italy. The basic point here is Coasean in nature: firms in every country face legal constraints around which they must bargain in order to obtain the corporate governance regimes that meet their own, particularized contracting requirements[1].

Our conclusions about the nature of alternative corporate governance systems are interesting and important because they show the futility of efforts to design a perfect corporate governance system. Our analysis reveals that there is no clear answer to the question of which corporate governance system is best. It does however point at the desirability of industry-tailored corporate governance arrangements.

I. Corporate Governance: Theoretical Insights

A. The Corporate Governance Setting

On a theoretical level, the problems of corporate governance result from the existence of incomplete contracts. Governance is then desired to resolve the gaps left in these contracts in ways consistent with maximizing the value of the firm. The important contribution addressing this issue comes from Grossman and Hart.[2] They introduced the notion of residual rights of control that stresses the importance of allocating decisional power (control) when unspecified contingencies arise. Corporate governance could be narrowly defined as "the set of conditions that shape the ex post bargaining over the quasi-rents generated by a firm."[3] Under this definition, corporate governance fills in

[1] We ignore the impact of internal governance and product market competition on managerial agency problems. *See* S. Hirota and K. Kawamura, *What Makes Autonomous Management Do Well?: Corporate Governance without External Controls*, YALE ICF, Working paper no. 02-22 (2002).
[2] S. Grossman and O. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, JOURNAL OF POLITICAL ECONOMY, Vol. 94, 691-719 (1986).
[3] L. Zingales, *Corporate Governance in* THE PALGRAVE DICTIONARY OF ECONOMICS AND LAW (1997).

holes left in incomplete contracts. Corporate governance is irrelevant with complete contracts. Such contracts would fully specify the desired course of action, and provided that enforcement and time-inconsistency problems are not issues (and they are not in a world of complete contracting), such that no role would exist for corporate governance.

The presence of discretion in incomplete contracts makes the allocation of residual rights of control important. Management – in this incomplete contracting world – may have a substantial informational advantage that gives it certain residual rights of control. More effective monitoring can level the playing field between investors and managers. The accountability of management vis-à-vis stakeholders and the governance and/or supervision provided by those stakeholders occupies our primary focus.

The question thus becomes who *ideally* should be granted the residual rights of control? Shareholders lack protection in terms of enforceable contractual rights. They have no legal rights to dividends, capital appreciation or even a return on their initial investments. They also have weak bargaining power because their investment in the firm is sunk once it has been made. This view points at shareholders as the prime candidate for being allocated control rights.[4]

The difficult question at this point is how the corporate governance system should be arranged to protect the interests of shareholders. However, we also observe that the basic dichotomy between proximity and objectivity exists regardless of whether the monitors are acting on behalf of the residual claimants or on behalf of some other, more

[4] *See* R. Rajan & L. Zingalas, *Power in a Theory of the Firm*, QUARTERLY JOURNAL OF ECONOMICS, Vol. 113 (1), p. 387-432 (1998). Rajan and Zingales link the choice of residual claimants' incentive and abilities to choose the specificity of their contribution to the firm. Highly firm-specific contributions may limit ex post bargaining power. Shareholders, however, could part with their money and thus (partially) distance themselves from the direct decision-making but be granted control rights ex post. The suppliers of other inputs, including workers (labor), are generally not able to distance themselves. That is, they have a permanent effect on the quality and usage of their input. Granting them control rights may then be suboptimal: they would seek to affect or manipulate the firm-specificity of their contributions. *Id.*

complex constellation of constituents. Simply put, observing and evaluating the performance of the monitors themselves is not easy, and the task becomes even more difficult when the monitors are involved in complex tasks such as monitoring on behalf of a wide array of constituents with possibly conflicting objectives.

B. Managerial Inefficiencies and Shareholder Involvement

The contracting problems that lie at the heart of corporate governance arise only when ownership is separated from control. When management and shareholders are the same party, control rights are automatically in the hands of shareholders. But these control rights are highly attenuated, depending, as they do on annual meetings and other formal events. In fact, in the real world, direct shareholder involvement in corporate affairs generally is severely limited by law and custom.

These limitations become apparent when shareholders seek to exercise direct control over managers. Most notably, free-rider problems due to the dispersion of ownership may be insurmountable.[5] While having some very large shareholders may ameliorate the free rider problem,[6] other problems arise when large shareholders participate in management. Large shareholders may face conflicts of interest that undermine their incentives to maximize firm value. For example, they may enjoy private benefits of control that distort their decision-making. Alternatively, large shareholders may themselves be part of organizations that face governance problems (e.g. (public) pension funds).[7]

[5] *See* Grossman & Hart, *supra*, n. 2.
[6] *See* A. Schleifer and R.W. Vishny, *Large Shareholders and Corporate Control*, JOURNAL OF POLITICAL ECONOMY, Vol. 94, 461-88 (1986).
[7] *See* Roberta Ramano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795 (1993).

In the U.S. direct shareholder involvement is mitigated by the fact that share ownership is relatively dispersed. This dispersion limits direct shareholder involvement to periodical interference via proxy fights, hostile takeovers or other mechanisms that seek to mobilize shareholders.[8]

In the Continental European context concentrated ownership is more prevalent. However, this does not readily translate into more shareholder control. In some countries (Germany and countries in Southern Europe) cross holdings and pyramid structures shield firms from shareholders. Also, non-executive directors (or supervisory boards in a two tier system) may shield management from direct shareholder involvement.[9] This is particularly true in the context of some Continental European countries. In counties like the Netherlands and –to a lesser extent – Germany, rather autonomous supervisory boards operate semi-independently from shareholders and effectively shield management from

[8] In general, shareholder control becomes more powerful when financial difficulties and/or managerial control problems emerge. In those circumstances we often observe concentration of shareholdings.

[9] An important issue is the obligation that corporate law imposes on directors. While the system of corporate law is endogenous, and in the end potentially an outcome of the search for an optimal corporate governance, the specification of the law is still of interest and a determinant of corporate governance as well. In this context Shleifer and Vishny emphasize the fiduciary duty of managers and directors via-à-vis shareholders. This duty is deeply entrenched in U.S. law. *See* A. Shleifer and R.W. Vishny, *Large Shareholders and Corporate Control*, JOURNAL OF POLITICAL ECONOMY, Vol. 94, 461-88 (1997). Hamermesh formulates this as follows: "Delaware fully supports the proposition, dismissed in some quarters as myopic, that the business and affairs of a Delaware for profit stock corporation are to be managed so as to maximize the value of the investment of one group and one group only, its stockholders." *See* L.A. Hamermesh, *The Shareholder Rights By-Law: Doubts from Delaware*, CORPORATE GOVERNANCE ADVISOR 9, Vol. 5 (1997). Similarly, U.S. courts have ruled that "A board may have regard for various constituencies in discharging its responsibilities provided there are rationally related benefits accruing to the stockholders." *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc. 506 A.2d 619, 624 (Del. 1984). Blair and Stout take the controversial point of view that American corporate law should dictate directors to act in the interest of the firm, and not only those of shareholders. This focus mimics Continental European corporate governance arrangement, e.g. Dutch corporate law explicitly states that directors should serve the interests of the firm as an entity. *See* M.M. Blair and L. Stout, *A Theory of Corporation Law as a Response to Contracting Problems in Team Production*, Brookings Institute Working Paper (1997).

direct shareholder involvement. Therefore, as in the U.S., direct shareholder control over management is limited.[10]

The main issue in developing or assessing a corporate governance system, however, is how to facilitate sufficient shareholder control to overcome managerial inefficiencies and address the other objectives of corporate governance.

C. Objectives of Corporate Governance

Corporate governance is needed for three reasons. First, and foremost, as noted above, the necessarily incomplete nature of the corporate contract implies a need for background rules to supply solutions to the unforeseen contingencies that confront investors. To the extent that corporate law is enabling, rather than mandatory, problems of incomplete contracts can be resolved so long at there is an adequate mechanism for monitoring the behavior of managers, and so long as there is an honest judicial system capable of enforcing shareholders' contractual rights.

Second, the relationship between investors and managers presents a straightforward agency problem that must be addressed. This relates to the problems inherent in the separation of investment ("ownership") and management ("control"); in particular, measures to overcome potential managerial inefficiencies are important. The ability to monitor managers effectively is an important objective of corporate governance.

Finally, the modern corporate enterprise requires a wide variety of firm-specific investments. Thus, an important, though frequently ignored, characteristic of properly functioning corporate governance system is to protect the firm-specific investments made

[10] Shareholder control is very real in cases where no separation exists between ownership and control, which might be the case in family businesses. Observe, however, that the corporate governance debate typically does *not* focus on these businesses but rather focuses on large(r) public firms characterized by a separation of ownership and control.

by those contributing human capital to the firm. By protecting these asset-specific investments, corporate governance systems provide firms and individuals with the necessary incentives to make such investments. Here, monitoring may actually impede the ability of corporate governance systems to function efficiently, because the presence of outside monitors may provide disincentives for managers to make firm-specific human capital investments that leave them subject to exploitation by the monitors[11].

Thus, trade-offs between the different objectives of corporate governance must be made. Improving the performance of a corporate governance system along one vector may weaken the ability of that system to perform along another vector. For example, the weaknesses of the Italian corporate governance system in lacking useful background rules that address the agency problems that exist between investors and managers are well known.[12] However, the strength of the Italian system in nurturing and protecting firm-specific human capital investments is not widely recognized.[13]

D. Evaluating Corporate Governance Systems

The question remains how we should evaluate corporate governance arrangements. One of the most striking features of the corporate governance debate is how divorced the rhetoric is from the reality. This assertion is significant in two ways. First, the rhetoric or corporate governance is divorced from reality in that many of those corporate governance systems that are characterized as defective somehow appear to produce impressive economic results. Specifically, a number of countries, including France, Italy, and by some accounts even the U.S., which are categorized for various

[11] E. Maug, *Board of Directors and Capital Structure: Alternative Forms of Restructuring*, JOURNAL OF CORPORATE FINANCE, Vol. 3, p. 113-38 (1997).
[12] Jonathan R. Macey, *Corporate Governance in Italy: One American's Perspective"*, COLUM. BUS. L. REV. 121 (1998).
[13] *Id.*

reasons as having deficient corporate governance systems, over time have nevertheless produced superior results in terms of productivity.[14] How can it be that such "defective" systems are capable of generating so much wealth? Why for example does Italy, which appears by all accounts to have a completely dysfunctional corporate governance system, have a higher GDP per capital than Britain, whose corporate governance system appears, on the basis of existing theories to be among the best?

The second way that existing rhetoric about corporate governance appears to be divorced from reality is that two paradigmatic governance systems—the German model and the U.S model—are not really models at all. The reality is that these systems are *sui generis*. The German system is not even a model of the rest of Europe. Nowhere else, for example, exists the "co-determination" of workers and shareholders that is a key characteristic of the German model. Countries such as Italy and France on the one hand (extensive cross holdings and interference by the State), and the Netherlands and Sweden on the other hand (autonomous boards that may be insufficiently accountable to shareholders) have corporate governance systems that scarcely resemble the German model. Similarly, the U.S. system of corporate governance differs in important ways from the governance systems in place in other common law countries such as Britain and Canada.

[14] *See* A. Ostrand, *France is a Banana Republic: Corporate Governance is Changing in France…Slowly*, FINANCIAL WORLD, July/August, 1997 40-43. *and* J. FANTO, CORPORATE GOVERNANCE IN AMERICAN AND FRENCH LAW (1997) for France; *see* L. Zingales, *The Value of the Voting Right: A Study of the Milan Stock Exchange Experience*, REVIEW OF FINANCIAL STUDIES (1994) *and* F. Barca, *On Corporate Governance in Italy: Issues, Facts and Agency*, *in*, BANK OF ITALY, ROME (manuscript) (1995) for Italy; *see* M. Jensen, *Eclipse of the Public Corporation*, HARVARD BUSINESS REVIEW, Vol. 60, 67 (1989), M. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, JOURNAL OF FINANCE, Vol. 48, 830-881 (1993) and M. Porter, *Capital Disadvantage: America's Failing Capital Investment System*, HARVARD BUSINESS REVIEW, Sept-Oct., 65-83 (1992) for the U.S.

II. Proximity and Objectivity

A. A Tradeoff: Shifting the Paradigm

Coffee and Bhide observe that share ownership in the U.S. is very dispersed and may not permit effective discipline of management, but may promote liquidity. [15] This suggests a trade-off between liquidity and control. Some, however, including Berglof[16] and Bolton and Von Thadden, [17] have challenged the suggested link between dispersed ownership and lack of control. Berglof argues that a dispersed ownership of shares does not necessarily imply a lack of control. In particular, he states that "the link between liquidity and control is less direct than suggested…." and that "Investors and issuers have found a number of ways of keeping control concentrated while increasing liquidity and limiting the capital committed." [18] Bolton and Von Thadden make a more subtle argument.[19] They argue that a large shareholder might be very desirable, but may still desire an exit option. Without sufficient liquidity in the market, exit is costly. That is, an investor with a large ownership stake would face a considerable price-impact of his trades. He may then refuse to take a large ownership stake. Liquidity may thus be a pre-condition for having large shareholders. Bolton and Von Thadden's analysis, therefore, points at a *complementarity* between liquidity and the presence of large shareholders.

[15] *See* J.C. Coffee, *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, COLUM. L. REV. (1991) *and* A. Bhide, *The Hidden Costs of Stock Market Liquidity*, JOURNAL OF FINANCIAL ECONOMICS, Vol. 34 (1), 31-51 (1993).
[16] E. Berglof, *Corporate Governance*, in: *The European Equity Markets*, LONDON: THE ROYAL INSTITUTE OF INTERNATIONAL AFFAIRS, Chapter 5. 147-184 (1996).
[17] *See* P. Bolton and E.L. von Thadden, *Blocks, Liquidity and Corporate Control*, JOURNAL OF FINANCE, Vol. 53, 1-26 (1998).
[18] Berglof points at cross holdings and pyramidal structures in particular. These could allow for disproportional voting rights considering the capital committed. *See* E. Berglof, *Corporate Governance*, in: *The European Equity Markets*, LONDON: THE ROYAL INSTITUTE OF INTERNATIONAL AFFAIRS, Chapter 5. 147-184 (1996). Another argument could be based on the work of Holmstrom and Tirole who argue that liquidity may facilitate more effective stock-based executive compensation schemes, and thus improve managerial incentives. *See* B. Holmstrom & J. Tirole, *Market Liquidity and Performance Monitoring*, JOURNAL OF POLITICAL ECONOMY, Vol. 101, 678-709 (1993).
[19] *See* P. Bolton and E.L. von Thadden, *supra*, n. 17.

The empirical observation that shareholders are very dispersed has also been challenged. The ownership structure in the U.S. is *not* as dispersed as is sometimes suggested. While a cross-country comparison indeed shows more dispersion in the U.S. than elsewhere, ownership of shares has become more concentrated. Much of this comes from the proliferation of pension funds, mutual funds and other institutional investors.

These observations are important and qualify the trade-off between liquidity and control. From our perspective, however, the question of *how* control is exercised and what makes control effective are more important. Shareholders could exercise control through their impact via the board of directors and through interventions via the market for corporate control. As the liquidity/control trade-off suggests, corporate governance systems in the world may differ in the effectiveness of both of these channels. The Continental European model focuses primarily on the impact of shareholders on managerial decision making via the board of directors, with a marginal role for the market for corporate control. The Anglo-Saxon model differs in that it puts more weight on the market for corporate control and other third-party (i.e., outside the firm) monitoring mechanisms, and less on the board.

Thus we can identify a fundamental trade-off between *proximity* and *objectivity* in supervision and monitoring. Effective supervision and monitoring is best performed if the monitor (board or shareholders) is both well informed and objective. This assertion is apparent if one observes that monitoring and disciplining management are the primary issues in the corporate governance debate. Such monitoring and discipline may require timely corrective actions. However, the objectivity needed to bring about such timely corrections requires sufficient distance between management and monitor, while being

well informed is best accomplished by being close and thus intrusive. This analysis suggests a trade-off between proximity and objectivity.

1. Theoretical Underpinnings of the Objectivity/Proximity Trade-off

While it is obvious why being well informed is best accomplished by close proximity, it may be less clear why objectivity requires a sufficient distance between management and monitor. Research in public choice and psychology illustrates this point. There is ample evidence in social psychology literature to support the view that boards with close proximity to management are likely to become captured by management. For example, the "theory of escalating commitments" predicts that board members will come to identify strongly with management because they have begun a pattern of agreeing with management's decisions.[20] Those earlier decisions, once made and defended, will affect future decisions such that those later decisions will comport with earlier decision.[21] In line with this theory, studies of the decision making process that contributed to the escalation of the Vietnam War showed the leaders paid more attention to new information that was compatible with their earlier decision. They tended to ignore information that contradicted those earlier assumptions.[22] These studies suggest that once ideas and beliefs become ingrained in the mind of a board of directors, the possibility of altering those beliefs decreases substantially. As Tom Gilovich has argued, "beliefs are like possessions" and "when someone challenges our beliefs, it is as if someone criticized our possessions".[23]

[20] *See* D.G. Myers, SOCIAL PSYCHOLOGY, 46-47 (1983).
[21] *See Id*.
[22] *See* R. White, *Selective Inattention*, PSYCHOLOGY TODAY, 82, p. 47 (1971) (observing that "there was a tendency, when actions were out of line with ideas, for decision-makers to align their actions.").
[23] *See* T. Gilovich, *How We Know What Isn't SO: The Fallibility of Human Reason in Everyday Life*, p. 86 (1992).

Furthermore, social psychologists have shown that people tend to internalize their vocational roles. Occupational choices, such as the choice to accept a particular position as a corporate director, will have a strong influence on our attitudes and values.[24] In the context of boards of directors, this influence means that board members tend to internalize the perspective of management. This tendency causes them to lose objectivity.[25]

The analysis here is an application of what Kahneman and Lovallo (1993) described as a cognitive bias known as the "inside view." Like parents who often are unable to view their own children in an objective or detached manner, proximate monitors may reject statistical reality and view the firms with which they are associated as above average. Objective monitors, by contrast, are able to evaluate management decisions and make comparisons between incumbent management and rival management teams in a dispassionate way.

Similarly, proximate monitors may be afflicted with what is known as an "anchoring bias" which leads them to establish or 'anchor' their views and opinions of management when they establish their initial opinions. This generally will be during the time that a monitor is being retained or an outside director is being recruited (we regard outside directors as proximate monitors). Once a proximate monitor has developed a positive view of management, that opinion becomes "anchored" and does not change.

We can also support the notion that proximate boards lack objectivity from an economic perspective. Board supervision tends to make the board jointly responsible

[24] J. Bachman & P. O'Malley, *Self-Esteem in Young Men: A Longitudinal Analysis of the Impact of Educational and Occupational Attainment*, JOURNAL OF POLITICAL ECONOMY, Vol. 85 (1977).
[25] Observe that this problem does not arise with shareholders in public markets who have little or no contact with management.

with management for the state of the firm. The degree of joint responsibility depends on how much the board has been involved with the firm. The board may abstain from corrective action because of the "cognitive biases" as discussed, but also for related reputational reasons. Abstinence can then occur because taking corrective action may reveal that the board previously failed to take the proper course of action.[26] Boards may resist action for other reasons as well. They invest considerably in the information specific to the existing management. Changing management would then potentially dilute the value of this investment. Moreover, to a very large extent, boards of directors can be viewed as legislatures with essentially one interest group constituency: management. Management not only has the time and the resources to cultivate management, it is also the group that presents the board with the information it must have to make its decisions. Over a wide range of issues, all management must do is present information in a way that is likely to generate support for its perspectives; or in a way that is slightly slanted or selective, to achieve effective capture of the board. It is, therefore, not surprising that boards often lack objectivity.[27]

2. Tangible Examples of Objectivity and Proximity

Empirical evidence presented by Michaely and Womack (1999) illustrates our point about the difference between proximate and objective monitors in the corporate governance context. Michaely and Womack look at analysts' recommendations of

[26] In this interpretation, the board monitors management. In a two-tier system (e.g. the Netherlands and Germany), this is a clearly defined task for the supervisory board. In the case of a one-tier system (e.g. US and UK) non-executive directors have a role as monitors.

[27] Bainbridge argues in favor of group decision-making. His emphasis however is not so much on the effectiveness of monitoring the CEO, but rather on the potential benefits of team decision-making versus individual decision-making. *See*, S.M. Bainbridge, *Why a Board? Group Decision-making in Corporate Governance*, VANDERBILT LAW REVIEW, Vol. 55, 1-55 (2002). An opposite point of view could however also be defended. Group decision making may undermine each individual's incentive to engage in monitoring. *See* B. Holmstrom, *Moral Hazard in Teams*, BELL JOURNAL OF ECONOMICS, Vol. 13, p. 324-340 (1982).

companies that have been taken public by the broker-dealer firms for which they work. They show that stocks that underwriter analysts recommend perform more poorly than stocks recommended by analysts who work for banks that did not participate in the underwriting. They find that the recommendations by underwriter analysts show significant elements of bias. As Michaely and Womack observe, one possible explanation for the systematically over-optimistic predictions of analysts who are affiliated with underwriters is that these analysts, unlike independent, objective analysts, have "cognitive biases" such that they "genuinely believe that the firms they underwrite are better than the firms underwritten by other investment banks."[28] This results in a situation in which the reality is not likely to change their prior opinions.

What is strikingly relevant about the Michaely and Womack research is that the underwriter-affiliated analysts have more and better information than unaffiliated analysts because the investment bankers participating in the underwriting have access to superior information and better access to management in the firms they have underwritten. This information advantage and access comes from the analysts participation in the due diligence and marketing of the new IPO. Thus, the comparison between underwriter analysts and unaffiliated analysts is a very concrete illustration of the trade-off between proximity and objectivity in corporate governance. Michaely and Womack's results are consistent with the view that objective monitor can do a better job than the proximate monitor, despite the proximate monitor's clearly superior access to information. This result is particularly important in light of the fact that the analysts that Michaely and Womack are studying are compensated in part by the analysts' perceived external

[28] R. Michaely and K. Womack, *Conflict of Interest and the Credibility of Underwriter Analyst Recommendations*, THE REVIEW OF FINANCIAL STUDIES, Vol. 12 (4), p. 680 (1999).

reputation, in addition to their ability to generate revenue by marketing their firms' services to companies that want to go public. Thus, their compensation ultimately suffers when they make bad recommendations because these recommendations hurt their external reputations.[29] What is interesting as well is that this exploitation of analysts' biases does not require analysts to be dishonest. While the SEC (along with others) has pointed to analyst dishonesty, our theory merely observes that analysts' ultimate involvement induces biases.

We believe that this problem of cognitive bias affects not only analysts employed by underwriters, but all proximate monitors. For example, it is well known that when firms change accountants they tend to take large write-offs relative to their predecessors. This fact, coupled with proposed legislation that could require firms to change auditors periodically,[30] illustrates that accountants, like analysts, may well be vulnerable to 'capture.' Arguably new accountants are willing to take write-offs because they are not yet captured and are thus more objective, while their predecessors may have gotten too involved with managers to objectively audit the firm. The accounting aspect of Enron's collapse may be viewed as one example of the extent to which accountants can become captured by the management of the firms whose books they are engaged to audit. It appears that at least some of Enron's troubles could have been avoided had they gotten new accountants (and concomitantly more objective audits) periodically instead of maintaining their relationship with Arthur Anderson.[31] Similarly, if Arthur Andersen had

[29] What is interesting as well is that this explanation of analysts' biases does not require analysts to be dishonest. While this has been a key accusation by (among others) the SEC, our explanation only uses the observation that their intimate involvement induces biases.
[30] *See* Sarbanes Oxley Act (2002) and measures that might be introduced in the slipstream of this Act.
[31] *See* Beth Healy, *Under Scrutiny: It's March Madness for Accountants as Annual Meeting Season Begins and, in the Post-Enron Era, All Eyes are on the Books*, THE BOSTON GLOBE, Mar. 10, 2002, at C1 (quoting one source who stated that "taking such steps as changing accountants every five years and providing

better internal monitoring and control systems, then more objective, non-captured supervisors would have resisted the more aggressive accounting techniques utilized by the (captured) Arthur Andersen accountants working on the Enron audit engagement team.

One last example of the potential cognitive biases of proximate monitors is the now infamous *Smith v. Van Gorkom* case,[32] in which the entire board of directors for a company called Trans Union was held personally liable for failing to follow adequate procedures when considering (and approving) a tender offer that was not favorable to the shareholders.[33] In this case, which ultimately revolutionized the quality of deliberations in corporate boardrooms, Jerome Van Gorkom, a board member who was also part of Trans Union's management team, advocated an offer that was held to be flawed for its undervaluing of the firm's shares.[34] Notwithstanding the fact that many suspected that Jerome Van Gorkom who was nearing retirement engineered the merger agreement to serve his own interest in liquidating his shares of the company rather than to serve the interest of the shareholders, the board of directors approved the deal with seemingly little thought.[35] One scholar commented that "[b]y today's standards, the boards procedures seem woefully inadequate."[36] Indeed, the Trans Union board "did not read the merger agreement, much less discuss and deliberate in any detail."[37] Arguably, the board in this case in exhibiting an "inappropriate reliance on Van Gorkom's judgment and

ample disclosure of the fees it pays firms" would "go a long way toward easing investor fears" in the post-Enron era).
[32] 488 A.2d 858 (Del. 1985). *See supra*, n. 36.
[33] *See generally*, Jonathan R. Macey, *Smith v. Van Gorkom, Insights About C.E.O.s, Corporate Law Rules, and the Jurisdictional Competition for Corporate Charters*, 96 NW. U. L. REV. 607 (2002).
[34] *See Id.* at 607, 610.
[35] *See Id* at 610.
[36] *Id* at 607
[37] *Id.*

negotiating" did not do a sufficient job of overseeing managerial decision-making.[38] Toward that end, it has been argued that the board failed in "that it did not properly monitor Van Gorkom 's negotiations with the acquirer."[39] Not surprisingly, in light of our above discussion, five of the members of the Trans Union board were inside directors who had been with the company and average of 23.2 years.[40] Significantly, the board's decision in this case was not tainted by self-dealing or conflict-of interest, nor could the board be considered inept, lazy or corrupt.[41] Thus, like analysts who arguably can be biased without being dishonest, the board of directors in this case failed to adequately monitor notwithstanding that they were acting in good faith. This case is thus a particularly glaring example of the fact that proximate monitors may become biased and that boards of directors generally may become captured by and too reliant upon the judgment of the firms they are supposed to oversee.

B. A Framework and Illustration

There are three parties that determine the corporate governance structure of a firm: management, board and shareholders. Management makes decisions (e.g. decides on a strategy or chooses to invest in a project); while board and/or shareholders can monitor and possibly intervene to correct managerial decisions. For our purposes, we will focus upon the board as monitors.

After management makes a decision, monitors can act immediately, *if* they have *timely* information that allows them to assess the quality of the project endorsed by management, or alternatively they might intervene at a later point, when it becomes

[38] *Id* at 609.
[39] *Id*.
[40] *Id* at 608.
[41] *Id.*

readily apparent to them whether the project is good or bad. The likelihood of immediate monitoring depends on the distance between the board and the management. The smaller the distance the higher the probability that information will be received in time for the monitor to act.

However, even when timely information is received, monitoring will not always be successful. Success depends in part on the *quality* of the monitor, as well as the timing of the receipt of information by the monitor.

Also, if the monitor does not correct managerial failure immediately, it can always intervene late regardless of the cause of the monitoring failure (i.e. regardless of whether the monitor monitored unsuccessfully or simply did not receive timely information). From a firm value maximization point of view, early correction via monitoring is preferred to late intervention. This preference exists because late intervention is more costly ("losses have accumulated") than early intervention. Abstaining from intervention in the case of managerial failure is the most costly alternative of all because it will lead to continued value dissipation.

The effectiveness of late intervention is important because early monitoring may not be effective for two reasons. First, the monitor may not obtain timely information on managerial failure and may not, therefore, be able to correct managerial failure early. Second, the monitor may fail in its monitoring (again early correction will not materialize).

However, the monitor may well choose to distort his/her late intervention decision. This may occur for reputational reasons: late intervention might point at a failure of early monitoring and indirectly signal a lack of monitoring ability. Thus the monitor may

observe that a bad decision has been made, but choose to abstain from late intervention for private reasons.

C. Information Structure, Remuneration and Objectives

An examination of the information structure within systems of corporate governance is helpful to understanding how and why intervention decisions are made. Outsiders (including shareholders) can generally observe the intervention decision of the monitor. This late intervention is a drastic action. Before this time, no information becomes available to outsiders. And abstaining from late intervention may, at least for some time, hide the (negative) information on project quality to outsiders, and indirectly also hide the monitor's failure in (early) monitoring.

When a monitor enjoys close proximity, late intervention is informative to outsiders because it indicates that the monitor may well have done a bad job initially. Late intervention by a proximate monitor reveals that the monitor may have failed to recognize initially that a bad decision was being made and block it. The ability of the manager plays a crucial role; good monitors are more successful in monitoring and hence will not be required to intervene as often as bad monitors.

The negative signal associated with late intervention may cause monitors to distort their intervention decisions. Since outsiders (sometimes) cannot observe the success or failure of early monitoring, monitors may choose not to intervene in order to mask their own failure as monitors.

The ability of the monitor to shapes its intervention decision to avoid contradicting its external image as a good monitor is particularly significant given that a

monitor's remuneration is linked to his reputation. Arguably, the monitor thus seeks to maximize its reputation when it decides whether it should intervene late.

A monitor's late intervention decision is also influenced by the probability that the monitor will receive timely information. This probability crucially depends on the proximity of the monitor. Thus, a distant monitor is less likely to have the necessary information to correct managerial decisions early. Since the corporate governance system in place dictates the "distance" and is public information, the distant monitor's decision to intervene carries less reputational stigma. Figure 1 depicts a time line summarizing the key events and decisions.

t=0	**t=1**
• management chooses project • proximate monitor does (with high probability) receive timely information about the quality of the project • proximate monitor does/does not correct managerial failure • distant monitor unaware	• monitor observes quality of the project • objective (distant) monitor intervenes, proximate monitor may not • reputation/remuneration of monitors determined

Figure 1: Key events and decisions

Signaling concerns are crucial to the monitor's late intervention decision. Because the objective of the monitor is to maximize its reputation, its choice of action will depend on the publicly known distance between monitor and management and on the observed quality of the project, which may point at an earlier monitoring failure. Of course, where the monitor observing management is an outside (distant) monitor with no connection of any kind to the earlier decision (and no possibility of having received timely information), the late intervention cannot harm the monitor's reputation.

D. The Analysis

As discussed above, by not intervening, a monitor may be able to avoid having its reputation downgraded. Thus, some monitors might decide not to intervene. An important exception arises in the case where an inside monitor can show that it was defrauded or somehow otherwise did not receive timely information and hence could not be expected to have monitored successfully. This is most plausible for a distant monitor. Under such circumstances, all monitors would be willing to intervene when appropriate. Thus, only in the extreme case where early monitoring could *never* be expected to be effective (i.e. when nobody receives timely information) are monitors willing to intervene efficiently.

At issue at this point is whether monitoring efficiency would improve if we increased the distance between monitor and management in order to obtain greater objectivity on the part of the monitors.

The cost of increasing the distance between monitors and management is that such distance prevents the monitor from receiving timely information, and thus allows

more bad projects to escape early correction because timely information did not become available. The benefit however is that the intervention policy will become tougher; late intervention stigmatizes less. That is, where the monitors have sufficient distance from the original decision, they will not hesitate to intervene later on. Thus the question becomes whether this negative "*volume* effect" (more bad projects "survive" early monitoring) would be offset by a positive "*behavioral* effect" in the form of a tougher intervention policy later on.

These considerations suggest a trade-off between proximity and objectivity. Objectivity comes with distance and may improve behavior, while proximity brings more timely information (a higher probability that the monitor will receive such) and early monitoring.

Intervention is likely to be more prevalent when monitors have distance for two reasons. First, distant monitors can more objectively evaluate the quality of management's decision, because such monitors have not become co-opted by their participation in the decision-making process into thinking that the original decision was a good one. Once a monitor has committed itself to a decision, it becomes more difficult to switch gears and decide that the decision was flawed.

Second, even after the closely proximate monitor recognizes that the decision was a bad one, it may be reluctant to intervene because such intervention reveals that the monitors' earlier acquiescence in the original decision occurred as a result of bad judgment. Distance then helps because the stigma of intervention would be strictly lower.

However, increasing the distance between the monitors and management will only increase efficiency if the tougher intervention policy that we expect from outside,

independent monitors (the behavioral effect) can discipline management at a rate effective enough to compensate for the fact that outside monitors are unable to stop bad projects in as timely a fashion as inside monitors (the volume effect). In other words, it might be the case that increasing the distance between a monitor and management will reduce monitoring efficiency so severely that more bad projects ultimately slip through, despite the tougher intervention policy. Thus what we need is that the behavioral effect overcomes the negative volume effect. That is, distance lets more bad projects initially continue, but the behavioral improvement via tougher intervention could lead to fewer bad projects ultimately continuing. On top of this, the behavioral improvement should outweigh the volume effect sufficiently to overcome the additional cost of – on average – later intervention.

Put simply, when establishing systems and institutions for monitoring, we must choose whether the monitor will be objective or proximate. If we choose a close, proximate monitor, we get the benefits of early correction (bad projects are nixed before they are begun), but we must bear the costs of capture and the concomitant risks that when poor decisions are made, they will not be recognized in a timely fashion because the monitor is worried about its reputation. If we choose a distant, objective monitor, we get the benefits of bold, consistent intervention without the risks of capture or worries about the effects on the monitor's reputation, but we must bear the cost that poor decisions will not be avoided early.

The analysis to this point points at an additional flaw -- besides the danger of capture discussed above -- associated with monitoring by monitors such as boards of directors who are closely involved in management's decision-making processes. This

additional flaw is the risk that monitors will fail to punish bad managers, *even after managers' decisions have been revealed as flawed*, for fear that their own reputations will suffer.

As we emphasize in related work[42], a key parameter dictating the choice between proximity and objectivity might be the irreversibility of investments. As is the case in traditional manufacturing, investments are *sunk*, timely correction is crucially important. Late intervention is not very valuable because these types of investments are lost (dissipated) once made. Facilitating early correction is then paramount.

Since the type of investments is industry specific, key then is that firm or industry characteristics dictate what corporate governance system is optimal.

III. Adaptability

A. Role of Adaptability

Our analysis and interpretation has so far focused exclusively on a one dimensional interpretation of proximity and objectivity; that is, we let the distance between monitor and management directly translate in the monitor's willingness to intervene. Obviously this is a simplification. The objectivity of the monitor and the willingness to engage in corrective action is undoubtedly affected by many other factors.

We also want to point out that the various issues that have become important in corporate governance recently all can be viewed in the context of the proximity-objectivity trade-off that we have identified. Factors that have become important to the

[42] A.W.A. Boot and J. Macey, *The Trade-off between Objectivity and Proximity in Corporate Governance*, UNIVERSITY OF AMSTERDAM, WORKING PAPER (2003).

corporate governance debate can roughly be put into four categories:[43] (1) measures to ensure the proper functioning of non-executive directors (to achieve greater objectivity); (2) the need for shareholders' rights (to achieve more effective intervention by an objective (distant) monitor); (3) ownership structure issues (e.g. concentration of share holdings); and, (4) the need for disclosure and transparency requirements (to increase the efficacy of a distant monitor).

The first group of issues includes the appointment process of (non-executive) directors, the remuneration of those directors, the desirability of a two-tier board structure (e.g. should the non-executive supervisory board be separated from the CEO/management board?) and the personal liability of directors. The main question underlying this group of issues is whether non-executive directors can be made sufficiently accountable to preserve their independence and thus overcome the problems of proximity. The assumption is that they can; however, we think that our analysis raises considerable doubt about this.

The second group of issues addresses the rights of shareholders. In particular, how can information problems (due to distance) and free-rider problems be resolved to facilitate monitoring and prompt corrective actions by shareholders? In this context, for example, the desirability of proxy voting and the presence of anti-takeover measures are being discussed. Also, the protection of minority shareholder belongs to this group's issues.

The third and fourth groups of issues address the ownership structure and transparency and disclosure. Ownership structure is directly related to the role and

[43] *See, e.g.* the Cadburry Report in England, the Hemple Report in the U.S., and the Vienot Report in France.

effectiveness of shareholders. Are large shareholders needed to facilitate shareholder activism? Are cross holdings helpful? Is a stable core shareholder base desirable? Transparency and disclosure requirements among other things may help to overcome the information gap between (distant) shareholders and management.

At their core, all of these issues also relate to the adaptability of corporate governance arrangements. These issues might be important considering the suggested "*either/or*" solutions to the optimal governance regime described above. In particular, the "*either/or*" type solution to the optimal structure of corporate governance may go hand in hand with other features that may mitigate the disadvantages of proximity-based and objectivity-based systems. More specifically, a proximity-based system with, for example, a finely textured involvement of a board may benefit from shareholder activism. Shareholders could possibly align the board's incentives with their own, or at the very least mitigate capture by management. The reputational distortions rooted in proximity may then be partially mitigated and the board may choose to intervene more.

These observations suggest a potential *complementarity* between the monitoring provided by boards and the market for corporate control. If the board knows that it will be ousted following a successful disciplinary takeover, the board may become more vigilant to preempt the need for corrective takeovers. A takeover threat may then not only discipline management, but also discipline the (non) monitoring board.

The importance of adaptability is now easy to see. The issues of ownership structure, shareholders rights and disclosure and transparency may all play a key role in facilitating shareholder activism. These issues may help to discipline management and (supervisory) board in both proximity- and objectivity-based systems. Similarly, in both

types of systems we see the introduction of measures to facilitate the proper functioning of non-executive (or supervisory) directors. In the context of the Anglo-Saxon one-tier system these measures could be interpreted as an attempt to add some benefits of proximity to this objectivity-based system.

B. Application to U.S. and Italy

In this section we show how corporate governance systems can be evaluated on the basis of how well they fill gaps in contingent contracts, resolve agency problems, and promote investments in human capital. This discussion will allow us to focus on the adaptability of those systems. In particular, by understanding the strengths and weaknesses of each system we can understand how these systems adapt to overcome their weaknesses.

Firms that operate within competitive product, labor and capital markets face strong incentives to innovate around any defects that may exist within the framework of any particular set of corporate governance rules. Such innovation reflects the notion of adaptability. In this context, we discuss the tradeoff between the value of objectivity that comes with distance, and the value of information that comes with proximity.

The U.S. could fit our example of a corporate governance system in which the entities that provide monitoring and discipline may lack information but enjoy objectivity. Italy provides an example of a country with, what appears to be, a defective corporate governance structure. The Italian corporate governance structure permits neither the separation of ownership and control, which brings the "distance" that produces objectivity (e.g. as in the U.S.), nor the continuous and textured monitoring and discipline by institutions or supervisory boards that potentially provide monitors with real-time

information about corporate performance (e.g. Germany and the Netherlands). While it is possible to identify corporate governance systems that lack both objectivity and proximity (Italy), it is virtually impossible to identify systems that feature both traits.

2. U.S. Corporate Governance

The U.S. system of corporate governance gets high marks for its ability to fill in gaps in contingent contracts, mediocre marks for its ability to resolve agency problems, and poor marks for its ability to promote human capital investments. With regard to filling in gaps in contingent contracts, the U.S. system, while far from perfect, does a good job of policing efforts by management to divert corporate assets to their own uses. U.S. law has rules that protect minority shareholders from exploitation,[44] including those who invest in subsidiaries of firms that are part of larger corporate groups.[45] U.S. law also polices rather vigorously against director conflict of interest transactions.[46] More importantly, U.S. directors owe a fiduciary duty of undivided loyalty to their shareholders under basic U.S. Corporate governance principles.[47] In addition to these protections for

[44] *See, e.g.*, Katzowitz v. Sidler, 24 N.Y. 512 (1969) (holding that the majority shareholders breached a fiduciary duty to the minority shareholders by offering them additional shares, notwithstanding that the minority shareholders held a right of first refusal, because the sole reason for the issuance of new stock was to freeze out one of the shareholders, and there was no legitimate business purpose for the issuance), *Cf.* Nixon v. Blackwell, 626A.2d 1366 (Del. 1993) (holding that majority shareholders did not breach their fiduciary duty to the minority by establishing an insurance and retirement plan that gave certain benefits to employees who happened to be majority shareholders, even though these plans afforded the majority more liquidity than that available to the minority because fair treatment of the minority does not necessarily require equal treatment). *See also* Grace Bros. V. Uniholding Corporation, 2000 Del. Ch. Lexis 101 (2000) and Orsi v. Sunshine Art Studios, 974 F. Supp 471 (1995).

[45] *See* Sinclair v. Levien, 280 A.2d (Del 1971) (holding that a parent corporation owes a fiduciary duty to its subsidiary when there are parent-subsidiary dealings and remanding the case for determination of whether the parent's making a self-dealing contract with their subsidiary and then causing the subsidiary not to comply with the contract constituted a breach of that duty).

[46] *See, e.g.*, Subchapter F (sections 8.60-8.63) of the Model Business Corporation Act. *See also*, American Law Institute Principles of Corporate Governance Analysis and Recommendations, §1.23 and §5.02.

[47] *See* Kenneth E. Scott, *Corporation Law and the American Law Institute Corporate Governance Project* 35 STAN. L. REV. 927, 932-25 (1983); *See also* Robotham v. Prudential Ins. Co. of America, 62 N.J. Eq. 673 (1903) (granting an injunction against the merger negotiated by the directors of Prudential whereby so that both Prudential and its counter-party would be insulated from hostile-takeover because the court held that where all directors have a direct interest in a transactions—i.e. where there is a potential breach of the

shareholders,[48] a critical element of U.S. corporate law is that most of its provisions are enabling rather than mandatory: investors can customize their own arrangements with the firms in which they have invested in order to tailor these arrangements to correspond to their own particular needs.

While it is true that U.S. law does a good job of dealing with crude efforts by managers to abscond with corporate assets, in recent years, the U.S. system has not dealt as well with other, more subtle aspects of the agency problem investors in public companies, such as managerial entrenchment in the face of hostile take over bids or excessive managerial compensation. It is well known that the U.S. system of corporate governance is categorized by a degree of separation between ownership and capital that is pronounced relative to that in other countries. The U.S. depends more on capital markets and less on banks and large shareholders than other countries.[49] As a consequence of this historical phenomenon, which is at least partially attributable to political causes,[50] the performance of the American system of corporate governance hinges in part on its ability to resolve agency problems that result from the separation of ownership and management, which uniquely characterize the U.S. public corporation.

duty of loyalty -- the shareholders can compel them to prove the transaction is advantageous to the corporation) *and* Globe Woolen Co. v. Utica Gas & Elec. Co. 224 N.Y. 483 (1918) (holding that a chairman of the board of directors breached his duty of loyalty to shareholders when he caused the corporation to contract with another company of which he was chairman of the board, even though he disclosed his affiliation with the latter, because he failed to disclose the known pitfalls of the contract to the board of the former).

[48] Note that American shareholders are also protected in that they are owed a duty of care. *See e.g.* Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985), a very famous case in which a board of directors was held to have breached their duty of care to shareholders in that they did not engage in a sufficiently long or thorough review of a takeover bid. This holding arose, notwithstanding that the price offered for the company's shares was well above the firm's market price, because the court held that the stock of the company was historically overvalued and that the company should've gone to greater lengths to discern the stock's actual value.

[49] *See* A. Murray, *New Economic Models Fail While America, Inc. Keeps Rolling: Why?* THE WALL STREET JOURNAL, Dec. 8, 1997, A2, col. 1.

[50] *See* M. Roe, *Strong Managers, Weak Owners, The Political Roots of American Corporate Finance*, PRINCETON UNIVERSITY PRESS (1994).

The way that the U.S. system has historically confronted agency problems is though takeovers. A wealth of theoretical arguments and empirical evidence supports the proposition that takeovers address corporate governance problems, in particular, by controlling managerial discretion. Shleifer and Vishny[51] have observed that "takeovers are widely interpreted as the critical corporate governance mechanism in the United States, without which managerial discretion cannot be effectively controlled.[52]

Several political developments may have weakened the effectiveness of the market for corporate control. In particular, the collapse of Drexel, Burnham Lambert contributed to the end of the 1980 takeover wave by depriving bidders of ready access to the significant capital needed to finance a hostile acquisition.[53] Also, state legislatures and state judiciaries in virtually all important U.S. jurisdictions have succumbed to political pressure to impose legal curbs on the market for corporate control.

These events, however, posed only temporary problems. Takeover entrepreneurs—and their legal and financial strategists – are much more dynamic and inventive than many suppose. Following the demise of Drexel, the junk bond market collapsed, but only for a time. Soon, not only were high-yield bonds back, but their role in financing takeovers was supplemented by the growth of hedge funds, and by the increased availability of commercial bank financing. The total capital available to finance arbitrage and other takeover related activities is greater today than it was in the 1980s. More importantly, institutional shareholders have become more activist in recent years. They also use their political leverage to try to insure that the balance of power in

[51] *See* Shleifer, A. and R.W. Vishny, *A Survey of Corporate* Governance, JOURNAL OF POLITICAL ECONOMY, Vol. 52, p. 337-57 (1997).

[52] *Id.*

[53] *See* Bailey Morris, *Drexel Case Renew Fears Over 'Junk Bond' Market*, THE TIMES, Sept. 10, 1988.

the market for corporate control does not tip too far in favor of incumbent management.[54] Together with the effective bundling of hostile bids with consent solicitation and proxy fights, hostile takeovers, which had virtually disappeared as a corporate governance device at the start of the 1990s, but which reappeared around 1995, continue to play an important role in mitigating managerial agency problems.[55] Nevertheless, managerial entrenchment problems have far from disappeared. The various highly publicized corporate scandals (Enron, WorldCom, etc.) indicate that there is substantial scope for improvement.

As noted at the outset, corporate governance systems work to reassure suppliers of capital. Among the more important and illustrative sorts of capital is firm-specific human capital. It is here that the vaunted U.S. system of corporate governance reveals its deepest flaws. A distinguishing feature of the U.S. system is its reliance on capital markets. These markets place pressure on corporate managers to deliver profits. A defining attribute of this system is its objectivity. Another distinguishing feature of the U.S. system is its dynamism and flexibility. In particular, participants at all levels of U.S.

[54] *See* J.E. Fisch, *Relationship Investing: Will it Happen? Will it Work?*, OHIO STATE L. J. (1994)

[55] Perhaps, most significantly, takeover entrepreneurs and arbitrageurs have introduced an innovation, the shareholder rights by-law, that is likely to do even more to invigorate the market for corporate control by eliminating the ability of target company boards of directors to keep the poison pill defensive devices in place once an outside bid has been made. (The new technique is simple. A shareholder proposes an amendment to his firm's bylaws requiring the company's poison pill (and other defensive measures) to expire automatically whenever the firm receives an all cash offer for 100 percent of the firm's stock at a price at least 25 percent above the market. The only way the firm can keep its poison pill is if the shareholders vote to keep the pill within 90 days of receiving the offer.) The Securities and Exchange Commission is requiring firms to include these shareholder rights by-laws in their proxy solicitation materials at their own expense under SEC Rule 14a-8. By refusing to permit companies to exclude shareholder proposals from their proxy solicitations, the SEC has set the stage for a major legal battle. This battle will come when shareholders approve a proposed shareholder rights-by-law, and directors claiming to that their right to run the company was wrongfully usurped then challenge the by-law in court. If Delaware judges refuse to respect the rights of the shareholders by upholding the legality of rights by-laws, institutional investors may start demanding that their firms reincorporate to jurisdictions that provide more rigorous protection for shareholders. However, even if the Delaware judiciary is not persuaded by legal arguments, pressure by institutional investors to find a jurisdiction hospitable to these arrangements may well insure their long-term viability even if Delaware's judges are reluctant to enforce them.

labor markets are highly mobile. Hiring and firing workers is far easier in the U.S. than in Europe or Japan. These features have been heralded as causing the low rates of unemployment that the U.S. enjoyed in the late 1990s. These advantages are offset, to some extent, by costs, which result from the fact that employees, including high-level managers, cannot make credible, long-term commitments to their firms. This reduces the incentives of both firms and managers to make firm-specific investments in employment relationships. Thus, the unstable nature of these employment relationships has distinct costs as well as distinct benefits.

Another weak aspect of the U.S. corporate governance system is rooted in the fact that U.S. investors are not relationship investors: they move in and out of their investor status though arms-length market transactions. As such, in the U.S. investors depend on publicly available information that is inevitably incomplete, crude and backward looking. U.S. investors generally lack the same privileged, detailed information about firms they have invested in that institutional investors in other countries may enjoy. U.S. law has attempted to compensate for this deficiency by creating complex and extensive disclosure requirements.[56] While these mandatory disclosure rules may have improved the quality of the information received by investors, they do not change the fact that information is received only after critical decisions are made. As we argued in Section II, Continental European systems with large shareholders or direct control by supervisory boards and/or banks allow not only a finer information partitioning, and thus more informed monitoring, but also permit investors to participate in decisions *before* they are made. However, an

[56] *See e.g.*, Regulation FD, *Disclosure to Investors—A Reappraisal of Federal Administrative Policies under the '33 and '34 Acts* (S.E.C. 1969); Jason Michael Craft, *Notes and Comments: What's all the Commotion?: An Examination of the Securities and Exchange Commission's Regulation FD*, 14 DEPAUL BUS. L.J. 119 (2001); Caroline F. Hayday, *Note: Shedding Light on Wall Street: Why Reg. F.D. is Appropriate in the Information Age* (2001).

element of capture may enter that prevents effective governance. Thus, notwithstanding the benefits the U.S. systems reaps due to the benefits afforded by its objectivity, it seems the US model, like Continental European models, may fail to adequately address subtler agency problems.

3. Corporate Governance in Italy

The Italian system of corporate governance is a virtual mirror image of the U.S. system. The Italian system gets low marks for its ability to fill in gaps in contingent contracts, due to its poor legal system and absence of protections for investors' rights. Italian corporate governance also performs poorly in terms of its ability to resolve agency problems. The fact that the duty of loyalty is not an operating concept in Italy illustrates this weakness. The absence of this doctrine exists for several reasons, not the least of which is that courts have no expertise or inclination to provide protections for non-controlling investors.[57] Two features of the Italian corporate governance system-- politics and small firms that finance themselves internally-- substitute for the lack of market-based control systems that characterize the U.S. corporate governance.

The State historically has controlled the nation's banks and large companies, and has "constantly made up for failures in the governance environment of private companies by providing them with a steady flow of resources."[58] The role of the State in Italian corporate governance is hardly salutary. The politicization of capital investment decisions inevitably results in sub-optimal decisions about capital allocation. In addition

[57] *See* R. Weignmann, *Responsibilitiá e potere legittimo delgi amministratori* , 104-13 (1974), F. Barca, *On Corporate Governance in Italy: Issues, Facts and Agency*, BANK OF ITALY, ROME, manuscript (1995), Jonathan R. Macey, *Corporate Governance in Italy: One American's Perspective* 1998 COLUM. BUS. L. REV. 121.
[58] F. Barca, *On Corporate Governance in Italy: Issues, Facts and Agency*, BANK OF ITALY, ROME (manuscript) (1995).

to State ownership, the Italian corporate governance system is characterized by complicated cross and pyramidal ownership structures. This system of shareholdings possibly entrenches management, disadvantages minority shareholders, prevents capital market discipline and stifles the development of a market for corporate control. However, these ownership structures do result in the emergence of a clearly identified, highly stable, controlling coalition. This control group has close ties to management and timely access to whatever information, including confidential corporate information that it wants. These factors affords the control group a highly textured involvement that includes the ability to make instantaneous changes whenever necessary. The complicated and pyramidal ownership structures do, however, distort and confuse incentives. Also, the proximity of investors to management leads to "joint responsibility" and a lack of objectivity that weakens the monitoring role of investors.[59] Moreover, legal protection for shareholders in Italy is so poor that external financing is barely feasible for investors who do not receive control rights.

In essence, the U.S. corporate governance system is flawed in that takeovers are so expensive that it is only cost-effective to address large-scale managerial failures. By contrast, the controlling shareholders who manage the Italian corporate governance system can make changes at a far lower cost, since they are already in control. However, because of their personal involvement in the management of the firm and the complicated ownership structures, these investors are likely to lack the objectivity necessary to make the hard decisions required to control agents' behavior.

The success of the Italian economy is due, in large part, to the fact that the country has a disproportionately large number of small firms that perform exceedingly

[59] *See* Section II.

well. An astonishing 98% of Italian firms have fewer than 20 workers.[60] These firms solve corporate governance problems in the simplest way possible: they lack the separation of ownership and management that generates the agency problems that define the corporate governance puzzle in more complex systems. In other words, "corporate governance doesn't matter very much in Italy because there are so few large and medium sized firm."[61] Complex solutions to corporate governance problems are not necessary in these small firms because individual entrepreneurs and their families in Italy both finance and manage these small family firms, and they have both the incentives and the ability to monitor and control shirking.

The rigid, inflexible industrial structure of the Italian corporate governance system does create strong incentives for managers to make firm-specific human capital investments. This is true in small Italian firms because these firms "are often staffed with family members or close friends of the owner, who can make credible, long-term commitments to the employees that, in turn, provide the employees with incentives to make such firm-specific capital investments." [62]

In essence, the Italian system of corporate governance does not compare favorably with the U.S. system in terms of its ability to protect minority investments, fill in gaps in contingent contracts, or reduce agency costs. Therefore, it is not surprising that Italy has weak capital markets and virtually no venture capital. But Italy has flourished because investors and entrepreneurs have innovated around the deficiencies in its

[60] *See* Jonathan R. Macey, *Corporate Governance in Italy: One American's Perspective* 1998 Colum. Bus. L. Rev. 121.
[61] *See Id* at 140. *See* also M. Roe, *Corporate Law's Limits*, JOURNAL OF LEGAL STUDIES, Vol. 31 (2), (2002). Roe argues that corporate law, even if "perfect", cannot (fully) contain managerial agency costs, and ownership structure may have to take this into account.
[62] F. Barca, *On Corporate Governance in Italy: Issues, Facts and Agency*, Bank of Italy, Rome (manuscript) at 7 (1995).

corporate governance system by utilizing the closely held corporation. These small, often family-centered businesses have obviated the need for mechanisms that reduce agency cost problems by eliminating the agency relationship. An often overlooked virtue of this system is that it provides strong incentives for managers to make the firm-specific human capital investments necessary to develop specialized skills. Managers in these intimate firms can make these investments in the knowledge that they won't be exploited. Italy's innovations illustrate how adaptability can foster successful corporate governance notwithstanding a lack of objectivity or proximity.

IV. Final Observations

We have postulated the corporate governance problem in developed corporate governance systems as a trade-off between proximity and objectivity. Both objectivity and proximity have distinct costs and benefits. Objectivity goes hand in hand with distance and potentially less information and less timely intervention in management's decisions. Proximity-based corporate governance systems are more informative; and provide more timely intervention, and this facilitates not only prompt, but pre-emptive corrective action.

Ideally, governance arrangements should probably be tailored made to fit the desired governance needs of particular firms or industries. In some firms or industries the disadvantages of proximity might dominate, while in others the lack of information in case of distance and objectivity might be prohibitively costly. We have identified the irreversibility of investments as a potentially important determinant[63]. Issues of adaptability play a role as well. For example, stronger disclosure requirements may

[63] This would suggest that offering a choice among different charters and/or jurisdictions could be value enhancing because ideally corporate governance arrangements should be tailored to the particular industry. *See* L.A. Bebchuk and A. Cohen, *Firms' Decisions where to Incorporate*, NBER, Working paper, (2002).

overcome some of the information shortages and facilitate more distance and thus more objectivity. Since practical legal constraints currently impede such industry-specific choices, however, many nations will need to take significant steps to facilitate this superior means of constructing corporate governance systems. Indeed, while uniform nation-wide corporate governance decisions doubtless provide predictability and ease of application, the analysis in this paper suggests that greater benefits could be garnered via industry-specific governance decisions.

At this stage, we can conclude that observed nation-wide corporate governance arrangements—be they intrusive or objective—do not deal satisfactorily with subtle agency problems, either because of lack of information (the "objective" U.S. system) or capture (the "intrusive" Continental European model). The U.S. model is superior in filling in gaps in contingent contracts, thereby lowering contracting costs, but inferior in generating high quality information and in protecting human capital and relationship specific investments.[64] The Continental European model provides less satisfactory solutions to contingent contracts, but generates high quality information and is superior in protecting specific human capital investments. The latter holds particularly in malfunctioning corporate governance system like that of Italy.[65]

In closing, while we have emphasized the adaptability and resilience of different arrangements, we do believe that corporate governance systems are converging along some dimensions.[66] In Continental Europe, where ownership stakes have traditionally

[64] Observe that the contracting environment in an "objective type system like the U.S. depends on having enforceable contracts. With proximity, more discretion could possibly be allowed in contracts because the parties to the contracts are "close" and could immediately respond to the gaps in the contract.
[65] Observe that in the case of Italy– as we have discussed– solutions to the problem of contingent contracts are totally inadequate and also subtle agency problems are addressed poorly.
[66] *See* Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 Am. J. Comp. L. 329 (discussing the recent shift toward convergence and hypothesizing on the reasons behind this

been concentrated, substantial pressure has recently come about to improve the liquidity of stock markets. The ownership of shares of the general public has thus grown substantially. This growth has increased dispersion. In the U.S, we observe more concentration and an increase in institutional investor involvement. Observing the U.S. and Continental European trends, convergence of stock ownership patterns seems underway since concentrated ownership goes hand in hand with dispersed ownership. Corporate governance systems are also converging in other ways. Boards of directors in two-tier systems and non-executive directors have become more and more accountable vis-à-vis shareholders, and are forced to divorce themselves from management. Cozy arrangements between directors and management, have thus become less and less acceptable.

Nonetheless, as corporate governance systems continue to converge, it is increasingly important to consider the impact of the trade-off between objectivity and proximity and the role of adaptability in shaping optimal corporate governance systems. Indeed, the above analysis makes clear that this tradeoff between proximity and objectivity exists, adaptability is a somewhat mitigating factor, and that most nations maintain systems that feature one or the other (or neither) of these features. Thus, nations should seriously consider the potential value of combining these considerations with a move toward industry-specific governance structures.

shift). L.A. Bebchuk and M.J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, STANFORD LAW REVIEW, Vol. 52 (1), 127-170, (1999), discuss structural and rule driven forces that induce pathdependence and delay convergence.

REFERENCES

Acemoglu, D., 1995, "Corporate Control and Balance of Powers," mimeo.

Aghion, P. and J. Tirole, 1997, "Real and Formal Authority in Organizations," *Journal of Political Economy*, Vol. 105, p. 473-94.

Bebchuk, L.A. and A. Cohen, 2002, " Firms' Decisions where to Incorporate," NBER, Working paper.

Bebchuk, L.A. and M.J. Roe, 1999, "A Theory of Path Dependence in Corporate Ownership and Governance," *Stanford Law Review*, Vol. 52 (1), p. 127-170.

Bainbridge, S.M., 2002, "Why a Board? Group Decision-making in Corporate Governance," *Vanderbilt Law Review*, Vol. 55, p. 1-55.

Backman, J. and P. O'Malley, 1977, "Self Esteem in Young Men: A Longitudinal Analysis of the Impact of Education and Occupational Attainment," *Journal of Personality and Social Psychology*, Vol. 35, p. 365-84.

Barca, F., 1995, "On Corporate Governance in Italy: Issues, Facts and Agency," Bank of Italy, Rome, manuscript.

Berglof, E., 1996, "Corporate Governance," in: B. Steil (ed.), *The European Equity Markets*, London: The Royal Institute of International Affairs, Chapter 5, p. 147-184.

Bhide, A., 1993, "The Hidden Costs of Stock Market Liquidity," *Journal of Financial Economics*, Vol. 34 (1), p. 31-51.

Blair, M.M. and L. Stout, 1997, "A Theory of Corporation Law as a Response to Contracting Problems in Team Production," Brookings Institution, Working paper.

Bolton, P. and E.L. von Thadden, 1995, "Blocks, Liquidity and Corporate Control," Working paper.

Boot, A.W.A and J. Macey, 2003, "The Trade-off between Objectivity and Proximity in Corporate Governance", University of Amsterdam, Working paper.

Burkart, M., D. Gromb and F. Panunzi, 1997, "Large Shareholders, Monitoring, and the Value of the Firm," *Quarterly Journal of Economics*, Vol. 112, p. 693-728.

Coffee, J.C., 1991, "Liquidity Versus Control: The Institutional Investor as Corporate Monitor," *Columbia Law Review* .

Cremer, J., 1995, "Arm's Length Relationships," *Quarterly Journal of Economics*, Vol. 110, p. 275-95.

Fanto, J., 1997, "Corporate Governance in American and French Law."

Fisch, J.E., 1994, "Relationship Investing: Will it Happen? Will it work?," *Ohio State Law Journal*, Vol. 55 (5), p. 1009-1048.

Fischel, D.R., (1995), Payback.

Fritsch, P., 1997, "Pennzoil Holder Proposes Limiting 'Poison Pill" Use," *The Wall Street Journal*, November 19, B5.

Gilovich, T., 1992, "How We Know What Isn't So: The Fallability of Human Reason in Everyday Life," p. 86.

Grossman, S. and O. Hart, 1986, "The Costs and the Benefits of Ownership: A Theory of Vertical and Lateral Integration," *Journal of Political Economy*, Vol. 94, p. 691-719.

Hamermesh, L.A., 1997, "The Shareholder Rights By-Law: Doubts from Delaware," *Corporate Governor Adviser* 9, Vol. 5.

Hirota, S. and K. Kawamura, 2002, "What Makes Autonomous Management Do Well?: Corporate Governance without External Controls," Yale ICF, Working paper no. 02-22.

Holmstrom, B. and J. Tirole, 1993, "Market Liquidity and Performance Monitoring," *Journal of Political Economy*, Vol. 101, p. 678-709.

Holmstrom, B., 1982, "Moral Hazard in Teams," *Bell Journal of Economics*, Vol. 13, p. 324-340.

Jensen, M., 1989, "Eclipse of the Public Corporation," *Harvard Business Review* , Vol. 60, p. 67.

Jensen, M., 1993, "The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems," *Journal of Finance*, Vol. 48, p. 830-881.

Kahneman, D. and D. Lovallo, 1993, "Timid Choices and Bold Forecasts: A Cognitive Perspective on Risk Taking," *Management Science*, Vol. 39, pp. 17-31.

Macey, J.R., 1998, "Italian Corporate Governance: One American's Perspective," *Columbia Business Law Review*, Vol. 1998, pp. 121-144.

Maug, E., 1997, "Board of Directors and Capital Structure: Alternative Forms of

Restructuring," *Journal of Corporate Finance*, Vol. 3, p. 113-38.

Mayer, C., 1997, "Financial Systems and Corporate Governance: A Review of the International Evidence," University of Oxford, Working paper.

Michaely, Roni, and Womack, Kent, 1999, "Conflict of Interest and the Credibility of Underwriter Analyst Recommendations," *The Review of Financial Studies*, Vol. 12 (4), pp. 653-686.

Milbourn, T., 1997, "Comment on Mayer's Financial Systems and Corporate Governance," London Business School, Working paper.

Murray, A., 1997, "New Economic Models Fail While America, Inc. Keeps Rolling; Why?," *The Wall Street Journal*, Monday, December 8, p. A2, Col. 1.

Myers, D.G., 1983, *Social Psychology*, p. 46-47.

Osterland, A., 1997, "France is a Banana Republic: Corporate Governance is Changing in France.... Slowly," *Financial World*, July/August, p. 40-43.

Pagano, M. and Volpin, P, 2001, "The Political Economy of Finance," *Oxford Review of Economic Policy*, vol. 17 (4), 502-519.

Porter, M., 1992, "Capital Disadvantage: America's Failing Capital Investment System," *Harvard Business Review*, Sept. - Oct., p. 65-83.

Rabin, M., 1998, "Psychology and economics," *Journal of Economic Literature*, Vol. 34, (1), p. 11-46.

Rajan, R. and L. Zingales, 1998, "Power in a Theory of the Firm," *Quarterly Journal of Economics*, May, pp. 387-432

Roe, M., 2002, "Corporate Law's Limits," *Journal of Legal Studies*, Vol. 31 (2), p. 233-271.

Roe, M., 1994, "Strong Managers, Weak Owners, The Political Roots of American Corporate Finance," *Princeton University Press*.

Romano, R., 1993, "Public Pension Fund Activism in Corporate Governance Reconsidered," *Columbia Law Review*, p. 795-85.

Scott, Kl, 1983, "corporation Law and The American Law Institute Corporate Governance Project," 35 *Stanford Law Review*, p. 935-37.

Shleifer, A. and R.W. Vishny, 1986, "Large Shareholders and Corporate Control," *Journal of Political Economy*, Vol. 94, p. 461-88.

Shleifer, A. and R.W. Vishny, 1997, "A Survey of Corporate Governance," *Journal of Finance*, Vol. 52, p. 737-81.

Strausz, R., 1997, "Delegation of Monitoring in a Principal -Agent Relationship," *Review of Economic Studies*, Vol. 64, p. 337-57.

Warther, V.A., 1994, "Board Effectiveness and Board Dissent: A Model of the Board's Relationship to Management and Shareholders,"mimeo.

Weigmann, R., 1974, "Responsibilita'e potere legittimo degli amministratori," p. 104-13.

White, R., 1971, "Selective Inattention," *Psychology Today*, November, p. 47, 82.

Yafeh, Y. and O. Yosha, 2001, "Large Shareholders and Banks: Who Monitors and How?," forthcoming in the *Economic Journal*.

Zingales, L., 1994, "The Value of the Voting Right: A Study of the Milan Stock Exchange Experience," *Review of Financial Studies*, Vol. 7, p. 125-148.

Zingales, L., 1997, "Corporate Governance," forthcoming in *The New Palgrave Dictionary of Economics and Law*.