# MONITORING CORPORATE PERFORMANCE: THE ROLE OF OBJECTIVITY, PROXIMITY, AND ADAPTABILITY IN CORPORATE GOVERNANCE

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## INTRODUCTION

This Article identifies the fundamental tradeoff faced by individuals, firms and institutions that monitor corporate management's performance. This tradeoff, between *objectivity* in monitoring and *proximity* in monitoring, is central to the corporate governance debate. Proximity exists when monitors maintain 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 evaluate management's performance without influence by management.

A tradeoff between monitoring functions exists because monitors that obtain close proximity necessarily forego objectivity, and objective monitors must maintain sufficient distance from management, which results in loss of the advantages of proximity. Thus, each individual firm's monitor must *choose* his or her preferred characteristic; proximity and objectivity cannot coexist. Although, theoretically, a firm could have both proximate and objective monitors, most countries' corporate governance laws encourage only one monitoring function, thus rendering such "mixed monitoring" somewhat unlikely.

Where neither proximity nor objectivity exists, it would appear that effective monitoring and discipline of management also cannot exist. In such a situation outside investors are reluctant to invest, so firms must turn to internal sources of finance. We observe, however, that certain corporate governance systems feature neither objectivity nor proximity. For example, we find one such system in Italy. The Italian system, which protects workers who invest in firm specific assets, ably contracts around the structural flaws in its corporate governance systems.[1] In Italy, the proliferation of smaller, owner-managed firms helps avoid corporate governance failure.[2]

This Article argues that, notwithstanding current legal constraints on nonuniform systems of corporate governance within particular nations, firms would benefit from deciding between and adapting to objectivity and proximity on an industry-wide rather than a nation-wide level.

Monitors are crucial to effective corporate governance and assume a variety of forms: directors, auditors, credit rating agencies, stock market analysts, takeover firms, arbitrageurs, large shareholders, and outside lenders. Even customers and suppliers act as monitors when they exercise their ability to observe management quality and to

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1 For an overview of the Italian corporate governance system, see generally Jonathan R. Macey, *Italian Corporate Governance: One American's Perspective*, 1998 COLUM. BUS. L. REV. 121.

2 *See id.* at 141–43.

send effective signals to the market about management's performance. This Article identifies a tradeoff which is fundamentally important to the corporate governance debate, that we must face when evaluating a monitor's ability to succeed in improving a corporate governance system. This is the *objectivity-proximity* tradeoff. The authors posit a corporate governance model, in which proximity and objectivity trade off. Each monitor within a corporate governance system must choose a role that features one of these characteristics or the other; a monitor cannot exhibit both proximity and objectivity. Theoretically, within a particular nation's system of corporate governance, a firm could have proximate and objective monitors operating simultaneously. 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 what we term "mixed monitoring." Therefore, either proximity or objectivity will necessarily dominate throughout successful corporate governance systems.

Nonetheless, certain corporate governance systems feature *neither* attribute and manage to succeed. Where neither proximity nor objectivity permits effective monitoring and management discipline, investors will still, albeit reluctantly, invest, and firms will turn to internal sources of finance. Although such a system has obvious costs, it also holds hidden virtues. For example, this type of system provides managers with strong incentives to make firm-specific human capital investments, which are necessary to develop specialized skills. Again, Italy's system provides apt illustration.[3]

The central argument of this Article is that the tradeoffs between proximity and objectivity are ideally applied on an industry-specific level rather than on a nation-wide level. Notwithstanding the legal constraints that currently impede nonuniformity within particular countries, and the fact that some countries have found success with corporate governance that feature neither objectivity nor proximity, data discussed in this Article supports this argument.

In Germany and the Netherlands, large shareholders or autonomous, entrenched boards of directors (supervisory boards) monitor management intimately and intensively.[4] These directors enjoy close proximity to the firms they monitor, participate in firm decisionmak-

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3 *See id.* at 142.

4 *See* Edward S. Adams, *Corporate Governance After Enron and Global Crossing: Comparative Lessons for Cross-National Improvement*, 78 IND. L.J. 723, 762 (2003); David Fairlamb & Kerry Capell, *The Netherlands: A Bog for Investors*, BUS. WK., May 19, 2003, at 54; *see also* BOB CHIRINKO ET AL., FIRM PERFORMANCE, FINANCIAL INSTITUTIONS AND CORPORATE GOVERNANCE IN THE NETHERLANDS 5–11 (Univ. of Munich Ctr. for Econ. Studies & IFO Inst. for Econ. Research, Working Paper No. 210, 1999), http://www.cesifo.de/pls/cesifo-app/CESifo FrameSet.SwitchFrame?factor=10&page=/link/cesifo-wps.htm.

ing, and monitor management's actions on a real-time basis.[5] This proximity inevitably results in these monitors becoming insiders, and subject to capture by the firms they monitor. Their participation in the decisionmaking process not only requires them to have faster access to information than takeover artists, arbitrageurs, credit rating agencies, and analysts have, but it also establishes the conditions by which incumbent management's capture of the monitors is most likely to occur.[6] Capture means that the block shareholder or bank board member—the ostensible monitor—adopts the perspective of the management team under supervision. When this occurs, outside investor monitors may gradually lose their ability to evaluate a firm's performance objectively, thereby offsetting the informational advantage that insiders enjoy in certain corporate governance systems.

In a corporate governance system such as the one in the United States, directors, large shareholders, or others in close proximity to the firm's managers, play a lesser role in monitoring management.[7] Instead, a variety of outside forces and institutions, particularly the market for corporate control, credit rating agencies, leveraged buyouts, and investment banking analysts, act as a substitute for direct shareholder involvement.[8] In this type of system, a considerable distance separates monitors (investors) and management. Thus, proximity is impossible, and investors face significant difficulty with respect to obtaining timely, reliable information about management.

This information shortage could, in theory, reduce the effectiveness of corporate governance systems in which monitors lack close proximity to management. For example, the effectiveness of the U.S. system might be affected by the fact that monitoring in the United States generally occurs ex post, rather than ex ante. It is, therefore, evaluative, not proactive. However, this lack of proximity may also be beneficial. In the United States, the distance between investors and firms provides the objectivity lacking in corporate governance systems in which more proximate monitoring subjects the monitors to the risk of capture. Objectivity increases the probability that the monitors will impose sanctions on corrupt or under-performing managers.

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5 *See* Adams, *supra* note 4, at 762.

6 *See id.* at 762–63; *see also* Benjamin E. Hermalin & Michael S. Weisbach, *Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature*, FED. RES. BOARD N.Y. ECON. POL'Y REV., Apr. 2003, at 7, 7.

7 *See* Adams, *supra* note 4, at 729–32.

8 *See* Jonathan R. Macey, *Efficient Capital Markets, Corporate Disclosure, and Enron*, 89 CORNELL L. REV. 394, 403–07 (2004) (discussing the market for corporate control, credit rating agencies, and analysts' role in corporate governance); Bengt Hölmstrom & Steven N. Kaplan, *The State of U.S. Corporate Governance: What's Right and What's Wrong?*, 15 J. APPLIED CORP. FIN. 8, 11 (2003) (discussing takeovers, junk bonds, and particularly LBOs).

Three important points about the objectivity-proximity tradeoff must be considered in order to understand the argument presented below. First, effective monitoring of corporate management cannot exist unless the monitors possess the characteristics of *either* proximity or objectivity. Second, there is a tradeoff between proximity and objectivity that makes it impossible for a particular monitor within a corporate governance system to provide both proximate and objective monitoring. Third, corporate governance systems lacking one or both of these characteristics can nonetheless succeed by adapting to compensate for weaknesses in monitoring capability. These pathological corporate governance systems simply must adapt to survive. Sometimes these adaptations, which generally involve turning to internal sources of finance, have benefits, such as encouraging firm and asset-specific capital investments, that are not obvious at first glance.

Section I of this Article develops a theoretical framework that highlights the source of the corporate governance problem, the objectives of corporate governance, and the importance of shareholders in corporate governance. Section II suggests that systems differ in the proximity and objectivity of supervision and control and that the optimal distance between management and monitor will be one of two extremes: either monitors should capitalize on the increased access to information that comes with proximity, *or* systems should seek optimal benefit from the objectivity that accompanies distance. Section III presents the issue of adaptability through review of American and continental European corporate governance arrangements and then we consider the rather special case of Italy. The basic point in this section is Coasean in nature: firms in every country face legal constraints around which they must bargain in order to obtain corporate governance regimes that meet their own, particularized contracting requirements.[9]

Conclusions reached below about the nature of alternative corporate governance systems show the futility of efforts to design a perfect corporate governance system. The following analysis reveals that no clear answer exists to the question of which corporate governance system is best. However, the analysis does point to the desirability of industry-tailored corporate governance arrangements.

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9 This Article will not consider the impact of internal governance and product market competition on managerial agency problems. For a discussion of these issues, see Shinichi Hirota & Kohei Kawamura, *What Makes Autonomous Management Do Well? Corporate Governance Without External Controls*, *in* ECGI WORKING PAPER SERIES IN FINANCE (European Corp. Governance Inst. No. W 2003), http://ssrn.com/abstract_id=379100.

## 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. Therefore, it is desirable for governance to resolve the gaps left in these contracts in a manner consistent with maximizing the value of the firm. In an important contribution to the analysis of this issue, Sanford Grossman and Oliver Hart introduced the notion of residual rights of control, which stresses the importance of allocating decisional power (control) when unspecified contingencies arise.[10] Grossman and Hart narrowly define corporate governance as the "complex set of constraints that shape the [ex post] bargaining over the quasi-rents generated [by a firm]."[11] As such, corporate governance fills in any holes left in incomplete contracts, but remains irrelevant for complete contracts. Complete contracts would fully specify the desired course of action, and provided that enforcement and time-inconsistency problems are not at issue (and they are not in a world of complete contracting), would leave no role for corporate governance.

The ability to exercise discretion with respect to incomplete contracts makes the allocation of residual rights of control important. In the incomplete contract context, management may have a substantial informational advantage that allows for certain residual rights of control. Therefore, more effective monitoring is necessary to level the playing field between investors and managers. Management accountability vis-à-vis stakeholders, and the governance or supervision provided by those stakeholders, is the primary focus here.

Ideally, who 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.[12] Dividends are paid at the discretion of a corporation's board of directors. Although dividends may not be withheld in bad faith, directors have wide discretion in determining how a corporation's free cash flow should be allocated, and can decide that the corporation is best served by reinvesting such

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10 *See* Sanford Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, J. Pol. Econ. 691, 692 (1986).

11 Luigi Zingales, *Corporate Governance*, *in* The New Palgrave Dictionary of Economics and the Law 497 (Peter Newman ed., 1997).

12 It is not feasible for shareholders to solve the agency problems between themselves and managers through the contracting process, because such contracts would have to be extremely elaborate. Fiduciary duties substitute for enforceable contract terms as a means for protecting managers. *See* Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law 92 (1991).

funds in internal corporate projects, rather than by paying them out in the forms of dividends.[13] These factors suggest that shareholders are the prime candidates for increased control rights.[14]

This raises a difficult question: how should the corporate governance system be arranged to best protect shareholder interests? The basic tradeoff between proximity and objectivity exists regardless of whether the monitors act on behalf of residual claimants or some other, more complex constellation of constituents. It is difficult for shareholders to observe and evaluate monitors' performance, particularly when the monitors are involved in complex tasks on behalf of a wide array of constituents with potentially conflicting objectives.

## B. Managerial Inefficiencies and Shareholder Involvement

The contracting problems that lie at the heart of corporate governance arise only when ownership is separate from control. When management is made up of shareholders, shareholders automatically possess control rights. But the exercise of these control rights is somewhat illusory, as they depend on annual meetings and other formal events. In fact, both law and custom severely limit direct shareholder involvement in corporate affairs.

These limitations become apparent when shareholders seek to exercise direct control over managers. The potentially insurmountable free-rider problems that result from the dispersion of ownership make this very difficult for shareholders.[15] Although the presence of some large shareholders may ameliorate the freerider problem,[16] the participation of large shareholders in management leads to other difficulties. Large shareholders may face conflicts of interest that undermine their incentives to maximize firm value.[17] For example, they

[13] Gottfried v. Gottfried, 73 N.Y.S. 2d 692 (1947).

[14] *See* Raghuram G. Rajan & Luigi Zingales, *Power in a Theory of the Firm*, 1998 Q. J. ECON. 387, 423–25. Rajan and Zingales discuss the question of whether stakeholders—employees, suppliers, or financers that make firm-specific investments—should have property rights in the firm. They suggest that stakeholders might actually have more incentive to invest if they are insecure investors. Conversely, shareholders are better able to "make decisions that are in the best interests of the firm," and thus could be a more effective choice for increased control rights. *Id.* at 424. Further, 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 decisionmaking, but receive control rights ex post. The suppliers of other inputs, including workers (labor), generally cannot distance themselves; they have a permanent effect on the quality and usage of their input. Therefore, granting them control rights might be suboptimal. *Id.* at 423–25.

[15] *See* Grossman & Hart, *supra* note 10, at 716–18.

[16] *See* Andrei Shleifer & Robert W. Vishny, *Large Shareholders and Corporate Control*, 94 J. POL. ECON. 461, 461–65 (1986).

[17] *See, e.g.*, Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 799–839 (1993) (discussing public pension fund conflicts of interest).

may enjoy private control benefits that distort decisionmaking. Alternatively, large shareholders such as public pension funds may be part of organizations that face their own governance problems.[18]

In the United States, share ownership dispersion mitigates direct shareholder involvement in corporate governance. This dispersion limits direct shareholder involvement to periodic interference via proxy fights, hostile takeovers, and other mechanisms of shareholder mobilization.[19]

In continental Europe, concentrated ownership prevails. However, this does not readily translate into increased shareholder control. In Germany, Korea, and Italy, for example, cross holdings and pyramid structures shield firms from shareholder control.[20] Also, nonexecutive directors (or supervisory boards in a two-tier system) may shield management from direct shareholder involvement.[21] This is particularly true in some continental European countries, such as the Netherlands and, to a lesser extent, Germany, where autonomous supervisory boards operate semiindependently from shareholders and effectively shield management from direct shareholder involvement.[22]

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18 *See id.* at 796–99.

19 In general, shareholders have stronger incentives to become involved when financial difficulties or managerial control prohlems emerge.

20 *See generally* Mark L. Loewenstein, *Stakeholder Protection in Germany and Japan*, 76 TUL. L. REV. 1673, 1675–83 (2002) (discussing the structure of corporate governance in Germany); Rohert Monks, Address at the Japan Investor Relations Association (Nov. 2, 1994), http://www.lens-library.com/info/viner.html (discussing similarities in the corporate governance structures of Korea, Italy, Germany, and other countries).

21 Corporate law imposes an important obligation on directors. Althougb the system of corporate law is endogenous and, in the end, creates a potentially optimal outcome in corporate governance, the specification of the law remains both of interest to and a determinant of corporate governance itself. For example, the fiduciary duty of managers and directors via-à-vis shareholders is deeply entrenched in U.S. law. Hamermesh formulates this duty 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." Lawrence A. Hamermesh, *The Shareholder Rights By-Law: Doubts from Delaware*, 5 CORP. GOVERNANCE ADVISOR 9, 9 (1997) (footnotes omitted). Similarly, U.S. courts have ruled that "[a] board may have regard for various constituencies in discharging its responsihilities, provided there are rationally related benefits accruing to the stockholders." *See, e.g.*, Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986). Blair and Stout take the controversial point of view that American corporate law should dictate that directors act in the firm's, as well as the shareholders', interest. This theory mimics the continental European corporate governance arrangement. For example, Dutch corporate law explicitly states that directors should serve the interests of the firm as an entity. *See* M.M. Blair & L. Stout, *A Theory of Corporation Law as a Response to Contracting Problems in Team Production*, Brookings Institute Working Paper (1997).

22 *See* Loewenstein, *supra* note 20, at 1676 (discussing Germany's system of supervisory boards); H. VAN EES & T. POSTMA, ON THE FUNCTIONS OF SUPERVISORY BOARDS IN THE NETHERLANDS (Univ. of Groningen, Research Inst. SOM (Systems, Orgs. & Mgmt.) Research Paper No. 00E50, 2000), http://ideas.repec.org/p/dgr/rugsom/00e50.html.

Therefore, as in the United States, direct shareholder control over management is limited.[23]

Sufficient shareholder control is necessary in order to overcome managerial inefficiencies, and important to address other objectives of corporate governance. Thus, a successful corporate governance system will seek to facilitate sufficient shareholder control, and a successful review of an already existing corporate governance system will focus on whether or not that system exhibits sufficient shareholder control.

### C. Objectives of Corporate Governance

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

Second, the relationship between investors and managers presents a straightforward agency problem related to the difficulties inherent in the separation of ownership and control. Because of this separation, measures to overcome potential managerial inefficiencies are important. As the main objective of corporate governance is managerial monitoring, corporate governance is critical to minimizing the effects of this agency problem.

Finally, the modern corporate enterprise requires a wide variety of firm-specific investments. An important, though frequently ignored, characteristic of a properly functioning corporate governance system is a mechanism that protects firm-specific investments made through contributions of 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. However, the presence of outside monitors may provide disincentives for managers to make firm-specific human capital investments that leave them subject to monitor exploitation.[24] Monitoring-based systems of corporate governance may not be appropriate where the goal is protection of asset-specific investments.

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23 Shareholders exert significant control where no separation exists between ownership and control, as might be the case in family businesses. Observe, however, that the corporate governance debate typically focuses on larger public firms characterized by a separation of ownership and control, rather than on these family owned businesses.

24 *See* Ernst Maug, *Board of Directors and Capital Structure: Alternative Forms of Corporate Restructuring*, 3 J. CORP. FIN. 113, 120–37 (1997).

Thus, the different objectives of corporate governance must trade off. Improving the performance of a corporate governance system along one vector may weaken that system's ability to perform along another vector. For example, it is well known that the Italian corporate governance system's weakness stems from its lack of useful background rules addressing the agency problems between investors and managers.[25] What is not well known, however, is that the Italian system also has strengths, as displayed by its ability to nurture.[26]

### D. Evaluating Corporate Governance Systems

How should we evaluate corporate governance arrangements, in light of the previous discussion regarding corporate governance objectives? One of the most striking features of the corporate governance debate is how divorced the rhetoric is from the reality. Many of the corporate governance systems characterized as defective in fact appear to produce impressive economic results. A number of countries, including Italy, France, and by some accounts the United States, categorized as deficient in corporate governance have produced superior results in terms of productivity.[27] It is difficult to understand how such "defective" systems are capable of generating so much wealth. For example, Italy, which appears by all accounts to have a completely dysfunctional corporate governance system, has a GDP per capita that is not significantly different from that of Britain, whose corporate governance system appears to be one of the best.[28]

In addition, two paradigmatic governance systems—the German model and the American model—are not really paradigms at all. In reality, these systems exist sui generis. The German system does not even serve as a model for other countries in Europe. For example, the co-determination of workers and shareholders, a key characteristic of the German model,[29] does not exist elsewhere. Countries such as

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25 *See* Macey, *supra* note 1, at 143.

26 *Id.* at 142–43.

27 For examples of Italian productivity, see Fabrizio Barca, *On Corporate Governance in Italy: Issues, Facts and Agency*, *in* BANK OF ITALY, ROME (1995) (unpublished manuscript, on file with author); *see also* Top 100 GDP (per capita), http://www.nationmaster.com/graph-T/eco_gdp_cap. For examples of French productivity, see *id.* For examples of American productivity, see Michael C. Jensen, *Eclipse of the Public Corporation*, HARV. BUS. REV., Sept.-Oct. 1989, at 61, 63–64; Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, 48 J. FIN. 831, 835–47 (1993); and Michael E. Porter, *Capital Disadvantage: America's Failing Capital Investment System*, HARV. BUS. REV., Sept.-Oct. 1992, at 65, 74–76.

28 *See* Kevin G. Lynch, Deputy Minister, Department of Industry, Canada, Building a Global, Knowledge-Based Economy/Society for the 21st Century, Address Before the SchoolNet National Advisory Board (Nov. 4, 1999); Top 100 GDP (per capita), http://www.nationmaster.com/graph-T/eco_gdp_cap (last visited Nov. 22, 2003).

29 Loewenstein, *supra* note 20, at 1675–83.

Italy and France, which are characterized by extensive cross holdings[30] and interference by the State,[31] and the Netherlands and Sweden, which are characterized by autonomous boards that may be insufficiently accountable to shareholders,[32] have corporate governance systems that scarcely resemble the German model. Similarly, the American system of corporate governance differs in important ways from the current governance systems in other common law countries, such as Great Britain and Canada.[33]

## II
## PROXIMITY AND OBJECTIVITY

### A. A Tradeoff: Shifting the Paradigm

Professors John Coffee, Jr. and Amar Bhide observe that share ownership in the United States is quite dispersed. Although this dispersion generally will not permit effective management discipline, it may promote liquidity.[34] This suggests that there is a tradeoff between liquidity and control. Some, however, including Erik Berglöf,[35] Patrick Bolton, and Ernst-Ludwig von Thadden,[36] challenge the suggested link between dispersed ownership and lack of control. Berglöf 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 "[i]nvestors and issuers have found a number of ways of keeping control concentrated while increasing liquidity and limiting the capital committed."[37] Bol-

30 *See* David Berger, 11 Nw. J. INT'L L. & BUS. 484, 504 (1991); Zohar Goshen, *The Efficiency of Controlling Corporate Self-Dealing: Theory Meets Reality*, 91 CAL. L. REV. 393, 435–36 (2003).

31 *See* Olivier Pastré, *Corporate Governance: The End of "L'Exception Française"?*, 1998 COLUM. BUS. L. REV. 79, 82–83; Lorenzo Stangnellini, *Corporate Governance in Italy: Strong Owners, Faithful Managers: An Assessment and a Proposal for Reform*, 6 IND. INT'L & COMP. L. REV. 91, 106–19 (1995).

32 *See* JONATHAN R. MACEY, SVENSK AKTIEBOLAGS RÄTT I OMVANDLING: EN RÄTTSEKONOMISK ANALYS (CORPORATE LAW AND CORPORATE GOVERNANCE IN SWEDEN: A LAW AND ECONOMICS PERSPECTIVE) 27–33 (1993); John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 YALE L.J. 1, 9–10 (2001); Macey, *supra* note 8.

33 *See* John Armour et al., *Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom*, 55 VAND. L. REV. 1699, 1714–20 (2002) (distinguishing between the American and British corporate governance systems).

34 *See* Amar Bhide, *The Hidden Costs of Stock Market Liquidity*, 34 J. FIN. ECON. 31, 41–45 (1993); John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1291–93 (1991).

35 Erik Berglöf, *Corporate Governance*, *in* THE EUROPEAN EQUITY MARKETS: THE STATE OF THE UNION AND AN AGENDA FOR THE MILLENIUM 147–84 (Ben Steil ed., 1996).

36 *See* Patrick Bolton & Ernst-Ludwig von Thadden, *Blocks, Liquidity, and Corporate Control*, 53 J. FIN. 1, 14–23 (1998).

37 Berglöf, *supra* note 35, at 157. Berglöf suggests that cross holdings and pyramidal structures could allow for disproportional voting rights considering the capital committed.

ton and von Thadden make a more subtle argument: although a large shareholder might be desirable, he may still desire an exit option.[38] Without sufficient liquidity in the market, exit is costly because an investor with a large ownership stake faces a considerable price impact in his trades. As this might result in investors refusing a large ownership stake, liquidity may be a precondition to the existence of large shareholders. Bolton and von Thadden's analysis, therefore, describes liquidity and the presence of large shareholders as complementary phenomena.

In addition to criticizing the claim that there is a tradeoff between liquidity and control, critics challenge the empirical observation that shareholders are very dispersed. The ownership structure in the United States is *not* as dispersed as some suggest. While a cross-country comparison indeed shows more dispersion in the United States than elsewhere, American share ownership has become more concentrated.[39] Much of this comes from the proliferation of pension funds, mutual funds, and other institutional investors.[40]

These observations are important because they qualify the tradeoff between liquidity and control. From our perspective, however, the questions of how control is exercised and what makes control effective are more important. Shareholders can exercise control through their impact on the board of directors and through interventions in the market for corporate control. As the liquidity-control tradeoff suggests, corporate governance systems worldwide may differ in effectiveness with respect to both of these channels. For example, the continental European model focuses primarily on the shareholders' impact on managerial decisionmaking via the board of directors, and includes only a marginal role for the market for corporate control.[41] The Anglo-Saxon model, in contrast, places more weight on the market for corporate control and other third-party monitoring mechanisms.[42]

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*See id.* Alternatively, Bengt Holmström and Jean Tirole argue that liquidity may facilitate more effective stock-based executive compensation schemes, and thereby improve managerial incentives. *See* Bengt Holmström & Jean Tirole, *Market Liquidity and Performance Monitoring*, 101 J. POL. ECON. 678, 707–08 (1993).

38 *See* Bolton & von Thadden, *supra* note 36, at 19.

39 *See* Bernard Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 521–24 (1990) (assumption of dispersed ownership becoming "increasingly obsolete."); Coffee, *supra* note 34, at 1290–1317; John C. Coffee Jr., *The SEC and the Institutional Investor: A Half-Time Report*, 15 CARDOZO L. REV. 837, 906–07 (1994).

40 *See* Coffee, *supra* note 34, at 1290–1317.

41 *See* Joseph A. McCahery & Erik P.M. Vermeulen, *The Evolution of Closely Held Business Forms in Europe*, 26 J. CORP. L. 855, 874–75 (2001); Scott Mitnick, *Cross-Border Mergers and Acquisitions in Europe: Reforming Barriers to Takeovers*, 2001 COLUM. BUS. L. REV. 683, 684.

42 *See* Thomas J. André, Jr., *Cultural Hegemony: The Exportation of Anglo-Saxon Corporate Governance Ideologies to Germany*, 73 TUL. L. REV. 69, 106 (1998).

Ultimately, we identify a fundamental tradeoff between *proximity* and *objectivity* in supervision and monitoring. Well informed and objective monitors—the board or shareholders—provide the most effective supervision and monitoring. However, monitoring and disciplining management are primary issues in the corporate governance debate, and this may require timely corrective action. The objectivity necessary for such timely corrections requires sufficient distance between management and monitor, but being well informed requires close and intrusive contact. Such analysis illustrates one aspect of the tradeoff between proximity and objectivity.

1. *Theoretical Underpinnings of the Objectivity-Proximity Tradeoff*

While it is obvious that close proximity will create increased levels of information, it is less clear why objectivity requires distance between management and monitor. Public choice and psychology research illustrates that boards with close proximity to management are likely to become captured by management. Psychologists, for example, have observed a "foot-in-the-door" phenomenon, which predicts that individuals will agree to a series of escalating commitments once they make an initial commitment.[43] Thus, earlier decisions, once made and defended, affect future decisions such that later decisions comport with earlier decisions. As applied to board members, this phenomenon suggests that board members begin to identify strongly with management after some agreement with management's decisions.[44] Studies of the decisionmaking process during the Vietnam War era reveal that this country's leaders paid more attention to new information compatible with their earlier decisions, and tended to ignore information that contradicted those earlier assumptions.[45] 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: "beliefs are like possessions" and "[w]hen someone challenges our beliefs, it is as if someone criticized our possessions."[46]

Furthermore, social psychologists have found that people tend to internalize their vocational roles. Occupational choices, such as the choice to accept employment as a corporate director, strongly influ-

43 *See* DAVID G. MYERS, SOCIAL PSYCHOLOGY 46–49 (1983).

44 *See id.*

45 *See* Ralph K. White, *Selective Inattention*, PSYCHOL. TODAY, Nov. 1971, at 47 (observing that "[t]here was a tendency, when actions were out of line with ideas, for decision-makers to align their ideas with their actions"); *see also id.* at 49.

46 THOMAS GILOVICH, HOW WE KNOW WHAT ISN'T SO: THE FALLIBILITY OF HUMAN REASON IN EVERYDAY LIFE 86 (1991) (footnote omitted) (quoting Robert P. Abelson, *Beliefs Are Like Possessions*, 16 J. THEORY SOC. BEHAV. 222 (1986)).

ence our attitudes and values.[47] In the context of boards of directors, this internalization leads board members to be influenced by management's perspective. This in turn causes board members to lose their objectivity.[48]

This analysis applies what Daniel Kahneman and Dan Lovallo describe as a cognitive bias, or the "inside view."[49] Like parents unable to evaluate their children objectively, proximate monitors reject statistical reality and view their firms as above average. Objective monitors, by contrast, evaluate management decisions and compare incumbent management and rival management teams dispassionately.[50]

Similarly, proximate monitors may be afflicted with what is known as an "anchoring bias," which leads them to establish or anchor their initial views and opinions of management.[51] This generally occurs during the time that a firm retains a monitor or recruits an outside director. Once a proximate monitor develops a positive view of management, that opinion is anchored and does not change.[52]

In addition to psychological barriers to objectivity, proximate boards lack objectivity from an economic perspective. Board supervision generally means that the board is jointly responsible with management for the state of the firm. The degree of joint responsibility depends on the level of the board's involvement with the firm. Because of this joint responsibility, the board may abstain from corrective action based on reputational reasons as well as cognitive biases. The board might abstain, for example, because corrective action could reveal the board's failure to take the proper course of action.[53]

Boards may resist corrective action for other reasons as well. They invest considerably in the information specific to the existing management; changing management would thus potentially dilute the value of this investment. Moreover, to a large extent, boards of

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47 *Cf.* Jerald G. Bachman & Patrick M. O'Malley, *Self-Esteem in Young Men: A Longitudinal Analysis of the Impact of Educational and Occupational Attainment*, 35 J. PERSONALITY & SOC. PSYCHOL. 365, 370–76 (1977) (discussing the effect of vocational choices on self-esteem).

48 This problem would not arise with shareholders in public markets who have little or no contact with management.

49 *See* Daniel Kahneman & Dan Lovallo, *Timid Choices and Bold Forecasts: A Cognitive Perspective on Risk Taking*, 39 MGMT. SCI. 17, 24–27 (1993).

50 *Cf. id.* at 26–27 (noting that an insider's prediction will generally, but not invariably, result in optimistic forecasts).

51 *Cf.* Marcel Kahan & Michael Klausner, *Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases*, 74 WASH. U. L.Q. 347, 362–63 (discussing the anchoring bias and its effect on corporate contracting).

52 *Cf. id.* (noting that once anchors are established, adjustments to them are minimal).

53 This analysis assumes that the board monitors management. In a two-tier system (e.g., the Netherlands and Germany), this is clearly the supervisory board's task. Under a one-tier system (e.g., the United States and the United Kingdom), however, nonexecutive directors act as monitors.

directors resemble legislatures with essentially one interest group constituency: management. Management not only has the time and resources to cultivate the board, it also presents the board with the information necessary to make decisions. Over a wide range of issues, all management must do to sway the board's decision is present information in a manner likely to generate support or to achieve effective capture of the board. It is not surprising, therefore, that boards often lack objectivity.[54]

### 2. *Tangible Examples of Objectivity and Proximity*

Roni Michaely and Kent Womack illustrate the difference between proximate and objective monitors in the corporate governance context in a review of analysts' recommendations of companies that have been taken public by the broker-dealer firms for which they work.[55] They show that the stocks underwriter analysts recommend perform worse than stocks recommended by analysts who work for banks that did not participate in the underwriting.[56] The underwriter analysts' recommendations show significant elements of bias.[57] Michaely and Womack explain that the systematically over-optimistic predictions of analysts who are affiliated with underwriters, unlike independent, objective analysts, are the result of "cognitive biases," which lead them to "genuinely believe that the firms they underwrite are better than the firms underwritten by other investment banks."[58] Reality does not seem to change their prior opinions.

According to Michaely and Womack, the underwriter-affiliated analysts have more and better information than unaffiliated analysts, because the investment bankers participating in the underwriting have superior access to the information and management of the firms they have underwritten. This information access advantage comes from analyst participation in the due diligence and marketing of the new IPO. Thus, the comparison between underwriter analysts and unaffiliated analysts provides a concrete illustration of the tradeoff between proximity and objectivity in corporate governance. Michaely

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54 Stephen Bainbridge offers group decisionmaking as a solution to nonobjective boards. He emphasizes, however, not the effectiveness of monitoring the CEO, but rather the potential benefits of team decisionmaking versus individual decisionmaking. *See* Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1, 19–38 (2002). Bengt Holström defends the opposite view, however, and argues that group decisionmaking may undermine each individual's incentive to engage in monitoring. *See* Bengt Holmström, *Moral Hazard in Teams*, 13 BELL J. ECON. 324, 326–28, 334–39 (1982).

55 Roni Michaely & Kent L. Womack, *Conflict of Interest and the Credibility of Underwriter Analyst Recommendations*, 12 REV. FIN. STUD. 653, 660–80, 683 (1999).

56 *See id.* at 657, 680.

57 *See id.* at 677–80.

58 *Id.* at 680.

and Womack's results are consistent with and supportive of the view that an objective monitor performs better than a proximate monitor, despite the proximate monitor's clearly superior access to information. Notably, the analysts that Michaely and Womack studied were compensated in part by their perceived external reputation and in part by revenue generated by their firms' services for companies seeking to go public.[59] Thus, their compensation ultimately suffers when they make bad recommendations, because these recommendations hurt their external reputations. This exploitation of analysts' biases does not, however, require analysts to be dishonest. Although some commentators blame analyst dishonesty for over-optimistic predictions, our theory merely holds that analysts' ultimate involvement induces bias.

Cognitive bias affects not only analysts employed by underwriters, but all proximate monitors to some extent. For example, it is widely believed that when firms are forced to change accountants, the new accountants may be inclined to take large write-offs relative to their predecessors because they can get a fresh start and blame problems on the old auditor.[60] This fact, coupled with new legislation that requires firms to change auditors every five years,[61] suggests that accountants, like analysts, are vulnerable to capture. Arguably, new accountants are willing to take write-offs because they are not yet captured and are therefore more objective than their predecessors who were too intimately involved with management to audit the firm objectively. The accounting aspect of Enron's collapse exemplifies the extent to which accountants can become captured by the management of the firms that they audit. Enron could have avoided at least some of its troubles if it had hired new accountants periodically instead of maintaining its relationship with Arthur Anderson; this would have likely resulted in concomitantly more objective audits.[62] Similarly, if Arthur Andersen had better internal monitoring and control systems, then more objective, noncaptured supervisors could have resisted the

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59 *See id.* at 659–60.

60 *See Hearings Before the Subcomm. on Oversight and Investigations and the House Comm. on Energy and Commerce*, 99th Cong. 551 (1985) (statement of Rep. Richard Shelby) ("How can an auditing firm remain independent . . . when it has established long-term personal and professional relationships with a company by auditing the same client for many years, some 10, 20, or 30 years?").

61 *See* The Public Company Accounting Reform and Investor Protection Act of 2002 (Sarbanes-Oxley Act of 2002), Pub. L. No. 107-204, § 203, 116 Stat. 745 (codified as amended at 15 U.S.C. § 78j-l).

62 *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*, BOSTON GLOBE, Mar. 10, 2002, at C1 (quoting one source who stated that "taking such steps as changing accountants every five years and providing ample disclosure of the fees it pays firms" would "go a long way toward easing investor fears" in the post-Enron era).

more aggressive accounting techniques utilized by the (captured) Arthur Andersen accountants working on the Enron audit engagement team.

*Smith v. Van Gorkom*[63] provides another, now infamous, example of the potential proximate monitor cognitive bias. In *Van Gorkom*, the court held the entire Trans Union board of directors personally liable for failing to follow adequate procedures when considering (and approving) a tender offer unfavorable to shareholders.[64] In this case, which ultimately revolutionized the quality of corporate decisionmaking, Jerome W. Van Gorkom, a Trans Union board member and management team member, advocated an offer that was held to be flawed because it undervalued the firm's shares.[65] Notwithstanding Van Gorkom's suspect motivations—he was nearing retirement and probably engineered the merger agreement to serve his own interest in liquidating his shares of the company rather than to serve the shareholders' interest—the board of directors approved the deal with seemingly little thought.[66] Unquestionably, "[b]y today's standards, the board's procedures seem woefully inadequate."[67] Indeed, the Trans Union board "did not read the merger agreement, much less discuss and deliberate its contents in any detail."[68] The board inappropriately "delegated too much power to Van Gorkom in his negotiations" and did not "properly monitor [his] negotiations."[69] Not surprisingly, five of the Trans Union board members were inside directors who had each been with the company for an average of 23.2 years.[70] However, the board's decision in this case was not tainted by self-dealing, conflict of interest, ineptitude, laziness, or corruption.[71] This case illustrates that proximate monitors are susceptible to bias, and that boards of directors in particular may become too reliant on and captured by the judgment of the management of the firms they ostensibly oversee.

63 488 A.2d 858 (Del. 1985).

64 *Id.* at 871–72. *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, 607 (2002) (arguing that while the *Van Gorkom* decision "may have dramatically improved the quality of deliberations in corporate boardrooms, the imposition of liability on the defendants in the case seems profoundly unjust").

65 *See id.* at 610–11.

66 *See id.* at 609–10.

67 *Id.* at 607.

68 *Id.*

69 *Id.* at 609.

70 *Id.* at 608.

71 *Id.*

B. The Corporate Governance Structure

Three groups determine the corporate governance structure of a firm: management, the board, and the shareholders.[72] Management makes decisions regarding strategy or chooses to invest in a project, and the board acting alone or with the shareholders, monitors and possibly intervenes to correct managerial decisions.[73] This Article will focus on the board as monitor.

After management endorses a project, monitors will act immediately *if* they have *timely* information that allows them to assess the quality of the project. Alternatively, monitors might intervene at a later point if the project's advantages or disadvantages become readily apparent to them. The likelihood of immediate monitoring depends on the distance between the board and management.[74] The smaller the distance between these groups, the higher the probability that monitors will receive information immediately.[75]

However, even if monitors receive timely information, monitoring will not always be successful.[76] Success depends on the quality of the monitor, as well as on the timing of the monitor's receipt of information.[77] Also, if the monitor does not correct managerial failure immediately, it can always intervene later regardless of the cause of the initial monitoring failure (i.e., regardless of whether the monitoring was unsuccessful or the monitor simply did not receive timely information). From a firm value-maximization viewpoint, early correction is preferable to late intervention. By the time a late intervention occurs, losses will have already accumulated. Abstaining from intervention in the case of managerial failure is the most costly alternative of all because abstinence will lead to continued value dissipation. Regardless of its increased costs, however, the effectiveness of late intervention is important because early monitoring may not always be effective. Early monitoring will fail when the monitor does not obtain timely information on managerial failure and cannot, therefore, correct managerial failure early, or when the monitor fails in its monitoring.

One difficulty of relying on late intervention is that a monitor may choose to forego the late intervention decision for reputational reasons. As late intervention might higblight an early monitoring failure and indirectly signal monitoring inability, the monitor may

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72 *See* JESSE H. CHOPER ET AL., CASES AND MATERIALS ON CORPORATIONS 5 (5th ed. 2000).

73 *See id.* at 5–12.

74 *See* discussion *supra* Part II.A.1.

75 *See id.*

76 *See* discussion *supra* Part II.A.2.

77 *See* discussion *supra* Part II.A.1–2.

choose to abstain from late intervention even if he realizes that a bad decision has been made.[78]

### C. Information Structure, Remuneration and Objectives

An examination of the information structure within systems of corporate governance aids in understanding how and why intervention decisions are made. Outsiders (including shareholders) are generally able to observe the monitor's intervention decision. Thus, late intervention is a drastic action. Before a late intervention, outsiders do not have access to information. This creates motivation to abstain from late intervention because at least for some time abstention might hide the negative information on project quality from outsiders and indirectly might also hide the monitor's early monitoring failure.

When a monitor enjoys close proximity, late intervention is informative to outsiders because it indicates that the monitor initially failed to monitor effectively. Late intervention by a proximate monitor reveals the monitor's failure to recognize and block a bad decision. Good managers do not require intervention as often as bad managers, however, so lack of intervention may simply indicate the presence of high quality managers. The negative signal associated with late intervention may cause monitors to distort their intervention decisions.[79] As outsiders often cannot observe the success or failure of early monitoring, monitors may choose not to intervene in order to mask their own failure.[80]

The monitor's ability to shape its intervention decision to avoid tainting its image as a good monitor is particularly significant because remuneration is linked to reputation. Arguably, the monitor thus seeks to maximize its reputation in any decision to intervene late.

The probability that the monitor will receive timely information influences whether or not the monitor will be forced to intervene late. This probability necessarily depends on the monitor's proximity; a distant monitor is less likely to have the necessary information to correct managerial decisions early. Since the corporate governance system publicly dictates this distance, the distant monitor's decision to intervene carries less reputational stigma than does a proximate monitor's decision to intervene. Figure 1 summarizes the key events and decisions for proximate and distant monitors.

Signaling concerns are crucial to the monitor's late intervention decision. Because the monitor's objective is to maximize its reputation, its choice of action depends on the publicly known distance be-

78 *See* discussion *supra* Part II.A.1.

79 *See* discussion *supra* Parts II.A.1, II.B.

80 *See* discussion *supra* Part II.B.

| t=0 | t=1 |
|---|---|
| • Management chooses project<br>• Proximate monitor (with high probability) receives timely information about the project's quality<br>• Proximate monitor does or does not correct managerial failure<br>• Distant monitor as yet unaware of managerial failure | • Monitor observes quality of the project<br>• Objective (distant) monitor intervenes, but proximate monitor may not<br>• Monitor's reputation or remuneration determined |

tween the monitor and management and on the observed quality of the project, which may point to an earlier monitoring failure. Of course, where the monitor is an outside (distant) monitor, without connection to the earlier decision or access to timely information, late intervention will not harm the monitor's reputation and may very well enhance it.

## D. The Analysis

As discussed above, sometimes a proximate monitor may attempt to avoid reputation downgrade by not intervening. Thus, proximate monitors might decide not to intervene, regardless of whether a management decision requires correction. An important exception arises in the case where an inside monitor can prove that management defrauded or somehow deprived it of timely information, thereby making it impossible for the monitor to operate successfully. Distant monitors, who are always deprived of timely information, have an easier time making this claim. Where inside monitors are involved, there will always be some doubt about whether they could have discovered a problem if they had been either more attentive, more able, or both. Regardless of this always existing doubt, all monitors would be willing to intervene if this exception applied. Thus, in the extreme case where early monitoring could *never* be expected to be effective because nobody receives timely information, monitors will intervene efficiently.

Accordingly, monitoring efficiency may improve if corporate governance systems increase the distance between the monitor and management in an effort to obtain greater monitor objectivity. This solution is somewhat problematic, however, because increased distance prevents the monitor from receiving timely information and allows bad projects to escape early correction. The solution does offer a countervailing benefit; intervention policy becomes tougher and late intervention less stigmatizing. Where the monitors have sufficient distance from the original decision, they will not hesitate to intervene later. Thus, the question becomes whether this negative *volume* effect (more bad projects "survive" early monitoring) would be offset by a positive *behavioral* effect (intervention policy would become tougher).

These considerations provide further support for a tradeoff between proximity and objectivity. Objectivity accompanies distance and may improve behavior, while proximity brings more timely information and early intervention. Two considerations suggest that intervention is likely to be more prevalent when monitors have distance. First, distant monitors can evaluate the quality of management's decision more objectively, because such monitors are not co-opted by their participation in the decisionmaking process into believing the original decision to be 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.[81] Second, even after the closely proximate monitor recognizes a poor decision, it may be reluctant to intervene because such intervention reveals that the monitor's earlier acquiescence in the original decision resulted from bad judgment. Distance may help resolve this problem because the stigma of intervention is less likely to attach to a proximate monitor.

Although increasing the distance between the monitors and management may increase efficiency, it can only do so if the tougher intervention policy expected 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 are able to stop them (the volume effect). It may be that increasing the distance between the monitor and management reduces monitoring efficiency so severely that more bad projects ultimately slip through, despite the tougher intervention that occurs when such projects are discovered. Thus, the behavioral effect must overcome the negative volume effect in order for distance to increase efficiency. Efficiency results even if distance will allow bad projects to continue unchecked, if the behavioral improvement decreases the number of bad projects ultimately approved. Moreover, the behavioral improvement must sufficiently outweigh the volume effect if it is to overcome the additional cost of later intervention.

Simply put, when establishing systems and institutions for monitoring, firms must choose whether the monitor will be objective or proximate. If the firm chooses a close, proximate monitor, it will benefit from early correction (a proximate monitor may be able to reject bad projects sometimes even before they are begun). However, the firm must bear the costs of capture and the concomitant risks that when poor decisions are made, they will not be corrected in a timely

81 *See supra* Part II.A.1.

fasbion because the monitor is worried about its reputation. If a firm chooses a distant, objective monitor, it will get the benefits of bold, consistent intervention without the risks of capture or worries about the effects on the monitor's reputation. However, the firm must then bear the cost that poor decisions will not be avoided or corrected early. This analysis highlights an additional flaw associated with monitoring by boards of directors who are closely involved in management's decisionmaking processes: the risk that monitors will fail to punish bad managers, *even after managers' decisions are revealed as flawed*, for fear that their own reputations will suffer.

As we emphasize in a related work,[82] the irreversibility of investment dictates the choice between proximity and objectivity. Similar to traditional manufacturing, when investments are *sunk*, timely correction is crucially important. Late intervention ceases to be valuable, irreversible investments that dissipate once made. Early correction is therefore paramount. Because the type of investment is industry specific, firm or industry characteristics dictate the optimal corporate governance system.

## III
## ADAPTABILITY

### A. Role of Adaptability

The analysis has, thus far, focused exclusively on a one dimensional interpretation of proximity and objectivity; that is, it was assumed that the distance between monitor and management directly translates into the monitor's willingness to intervene. Obviously, this oversimplifies the matter. The monitor's willingness to engage in corrective action is undoubtedly affected by many other factors.

Various recently surfaced corporate governance issues may be viewed in the context of the proximity-objectivity tradeoff. For example, four groups of measures, which are newly cited as important to improving corporate governance,[83] can all be connected to the objectivity-proximity debate: (1) measures aimed at ensuring that nonexecutive directors are more independent and professional that will achieve greater objectivity; (2) measures increasing shareholders' rights that will tend towards more effective intervention by an objec-

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82 Arnoud W. A. Boot & Jonathan R. Macey, The Trade-off Between Objectivity and Proximity in Corporate Governance (Nov. 2002) (unpublished manuscript, on file with the University of Amsterdam).

83 *See, e.g.*, ASS'N FRANCAISE DES ENTREPRISES PRIVEES AFEP, RECOMMENDATIONS OF THE COMMITTEE ON CORPORATE GOVERNANCE 3–9 (1999), *available at* http://www.ecgi.org/codes/country_documents/france/vienot2_en.pdf [hereinafter VIENOT REPORT]; COMM. ON THE FIN. ASPECTS OF CORPORATE GOVERNANCE, REPORT OF THE COMMITTEE ON FINANCIAL ASPECTS OF CORPORATE GOVERNANCE ¶¶ 1.6–1.11 (1992), *available at* http://www.worldbank.org/html/fpd/privatesector/cg/docs/cadbury.pdf [hereinafter CADBURY REPORT].

tive, distant monitor; (3) measures improving disclosure and transparency requirements that will increase the efficacy of distant monitors; and (4) ownership structure issues, such as concentration of shareholdings, which relate to the ability of shareholders to act as effective outside monitors.

The first group includes the appointment process of nonexecutive directors, the remuneration of those directors, the desirability of a two-tier board structure (e.g., whether tbe nonexecutive supervisory board should be separated from the CEO and the management board), and the personal liability of directors. The main question concerns whether nonexecutive directors can be incentivized to be sufficiently accountable, so that they may preserve their independence and overcome problems of proximity. The authors assume that they can but this analysis raises considerable doubt.

The second group addresses shareholder rights, resolving whether information problems (due to distance) and free-rider problems can be resolved to facilitate monitoring and prompt corrective action. The desirability of proxy voting, the presence of antitakeover measures, and the protection of the minority shareholder also belong in this group.

The third and fourth groups address ownership structure, transparency, and disclosure. Ownership structure directly relates to the role and effectiveness of shareholders. Are large shareholders necessary 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 shareholders and management.

At the core, all of these issues relate to the adaptability of corporate governance arrangements, and they might be particularly important considering the suggested "*either-or*" solutions to the optimal governance regime described above.[84] The either-or solution to the optimal structure of corporate governance may go hand-in-hand with other features that mitigate the disadvantages of proximity-based and objectivity-based systems. For example, a proximity-based system with finely textured board involvement may benefit from shareholder activism. Shareholders might succeed in aligning the board's incentives with their own or, at the very least, mitigating capture by management. Reputation distortions may then be partially diminished, and the board may choose to intervene more frequently.

These observations suggest that board monitoring and the market for corporate control are potentially complementary. If the board knows that it will be ousted following a successful disciplinary take-

84 *See supra* Part II.A.

over, it may become a more vigilant monitor. Thus, a takeover threat may not only discipline management; it may also discipline an unsuccessful monitoring board.

Clearly, adaptability is crucial. The issues of ownership structure, shareholder rights, disclosure, and transparency all play a key role in facilitating shareholder activism. Measures addressing these issues may help to discipline management and the board in both proximity- and objectivity-based systems. Similarly, in both types of systems, measures to facilitate the proper functioning of nonexecutive (or supervisory) directors are conceivable.[85]

### B. Analysis Application: The United States, Continental Europe, and Italy

This section evaluates corporate governance systems by how well they fill gaps in contingent contracts, resolve agency problems, and promote investments in human capital. The discussion focuses on the adaptability of those systems. By understanding the strengths and weaknesses of each system, it is possible to 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 any particular set of corporate governance rules. Such innovation reflects the notion of adaptability. The following discussion will consider the interplay between the objectivity-proximity tradeoff and adaptability.

The United States is an example of a corporate governance system in which the entities that monitor and discipline may lack information, but enjoy objectivity.[86] Italy provides an example of a defective or failed corporate governance system.[87] The Italian system permits neither the separation of ownership and control, which brings distance and produces objectivity, nor the continuous and textured monitoring of institutions or supervisory boards that potentially provide monitors with real-time information about corporate perform-

85 For example, although the Anglo-Saxon one-tier system is objectivity-based, it includes measures that may provide proximity benefits. For example, the practice that some companies employ of splitting the roles of Chief Executive Officer (CEO) and Chairman of the Board between an inside officer and an outside, independent director, is designed to achieve objectivity benefits, while the practice employed by other companies in the Anglo-Saxon system of combining the two roles in a single individual, is presumably designed to capture certain proximity benefits. *See* Ben White, *Save the Chair for the Chief?; There's Concern but No Consensus About CEOs Leading Boards*, WASH. POST, Feb. 7, 2003, at E1, *available at* http://www.compensationresources.com/press_room/SavetheChairfortheChief.html.

86 *See* Macey, *supra* note 1, at 136; *supra* note 19 and accompanying text.

87 *See supra* notes 1–2 and accompanying text.

ance.[88] Although it is possible to identify corporate governance systems that lack both objectivity and proximity (i.e., Italy), it is virtually impossible to identify systems that feature both traits simultaneously.

### 1. *Corporate Governance in the United States*

The American system of corporate governance receives 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 gaps in contingent contracts, the American system, while far from perfect, does a good job of policing management efforts to divert corporate assets to their own uses. American law assiduously protects minority shareholders from exploitation,[89] including those shareholders who invest in subsidiaries of firms that are part of larger corporate groups.[90] U.S. law also vigorously polices against director conflict of interest transactions.[91] Most importantly, with respect to shareholder protection, U.S. directors owe a fiduciary duty of undivided loyalty to their shareholders under basic American corporate governance prin-

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88 Both Germany and the Netherlands utilize a supervisory board, two-tier corporate governance system. *See supra* notes 20–22.

89 *See* Anupam Chandler, *Minorities, Shareholder and Otherwise*, 113 YALE L.J. 119 (2003). *See also* Katzowitz v. Sidler, 249 N.E.2d 359 (N.Y. 1969) (holding that the majority shareholders breacbed a fiduciary duty to the minority shareholders by offering them additional shares, notwithstanding the minority shareholders' 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); *see also* Grace Bros., Ltd. v. Uniholding Corp., 2000 Del. Cb. LEXIS 101 (2000) (holding that minority shareholder's complaint, alleging that majority sharebolder allowed its wholly-owned subsidiary to assume control over tbe corporation's largest asset in an attempt to gain the benefits of a squeeze out merger without having to ensure that it was fair to minority shareholders, stated a valid claim for breacb of fiduciary duty); Orsi v. Sunshine Art Studios, Inc., 874 F. Supp. 471 (D. Mass. 1995) (stating that if a freeze out is unfair to a minority shareholder, because of usurpation of corporate opportunity or self-dealing, the minority sharebolder is entitled to relief from the majority shareholders for breacb of their fiduciary duty); *cf.* Nixon v. Blackwell, 626 A.2d 1366 (Del. 1993) (holding that majority shareholders did not breach their fiduciary duty to the minority sbareholders by establishing an insurance and retirement plan that gave certain benefits to majority shareholders, even though these plans afforded the majority shareholders more liquidity).

90 *See* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720, 722–23 (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 self-dealing contract witb their subsidiary and responsibility for the subsidiary's noncompliance with the contract constituted a breach of fiduciary duty).

91 Mark Roe, *Corporate Law's Limits*, 31 J. LEGAL STUD. 233 (2002). *See, e.g.*, MODEL BUS. CORP. ACT § 8.60–8.63 (1999); *see also* AM. L. INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS §§1.23, 5.02.

ciples.[92] In addition to these shareholder protections,[93] a critical element of U.S. corporate law is that most of its provisions enable rather than mandate. In other words, investors can customize their own arrangements with the firms in which they have invested and tailor these arrangements to correspond to their particular needs.[94]

Generally, U.S. law deals well with crude efforts by managers to abscond with corporate assets. But in recent years, the U.S. system has not dealt as well with other, more subtle aspects of the agency problem faced by investors in public companies, such as managerial entrenchment amidst hostile takeover bids or excessive managerial compensation. The U.S. system of corporate governance separates ownership and capital to a larger extent than do systems in other countries.[95] Furthermore, the United States also depends more on capital markets and less on banks or large shareholders.[96] As a consequence of this historical phenomenon, which is at least partially attributable to political causes,[97] American corporate governance performance hinges in part on its ability to resolve agency problems that result from the separation of ownership and management. These agency problems are a unique characteristic of the U.S. public corporation.

The U.S. system has traditionally confronted agency problems through takeovers. A wealth of theoretical arguments and empirical evidence supports the proposition that takeovers effectively address corporate governance problems, particularly by controlling manage-

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92 *See* Kenneth E. Scott, *Corporation Law and the American Law Institute Corporate Governance Project*, 35 STAN. L. REV. 927, 937–46 (1983); *see also* Robotham v. Prudential Ins. Co. of Am., 53 A. 842, 857–58 (N.J. Ch. 1903) (granting an injunction against the merger negotiated by Prudential's directors whereby both Prudential and its counter-party would be insulated from hostile takeover); Globe Woolen Co. v. Utica Gas & Elec. Co., 121 N.E. 378, 380–81 (N.Y. 1918) (holding that a chairman of the executive committee breacbed his duty of loyalty to sbareholders when he caused the corporation to contract with another company of which he was president, 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 corporation).

93 Note that American shareholders are also owed a duty of care. In *Van Gorkom*, for example, the board of directors breached their duty of care to shareholders by failing to engage in a sufficiently long or thorough review of a takeover bid. *See* 488 A.2d 858, 869, 873 (Del. 1985). The court came to this holding notwithstanding the fact that the price offered for the company's shares far exceeded the firm's market price, because the court found that the stock of the company was historically overvalued and that the company should have gone to greater lengths to discern the stock's actual value. *Id.* at 876.

94 Frank H. Easterbrook & Daniel R. Fischel, *The Structure of Corporation Laws*, 89 COLUM. L. REV. 1416, 1416 (1989).

95 *See* JAMES A. FANTO, CORPORATE GOVERNANCE IN AMERICAN AND FRENCH LAW 18 (1997).

96 *See* Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 754 (1997).

97 *See* MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE 19–50(1994).

rial discretion.[98] Andrei Shleifer and Robert Vishny observe that "[t]akeovers are widely interpreted as the critical corporate governance mechanism in the United States, without which managerial discretion cannot be effectively controlled."[99]

Several political developments may have weakened the effectiveness of the market for corporate control. Specifically, the collapse of Drexel Burnham Lambert contributed to the end of the 1980s takeover wave by depriving bidders of ready access to tbe significant capital necessary to finance a hostile acquisition.[100] Also, state legislators responded to political pressure to impose legal curbs on the market for corporate control by passing antitakeover legislation.[101] State courts responded by ruling against takeovers.[102]

These events, however, posed only temporary problems. Takeover entrepreneurs—and their legal and financial strategists—are much more dynamic and inventive than most people suppose. The junk bond market collapsed in the late 1980s, but only for a short time.[103] Soon, not only were high-yield bonds back, but hedge fund growth supplemented their role in financing takeovers, as did the increased availability of commercial bank financing.[104] The total capital available to finance arbitrage and other takeover related activities is greater today than it was in the 1980s.[105] More importantly, institutional shareholders have the potential to become more activist.[106] In particular, they can use their leverage to try to ensure that the balance of power in the market for corporate control does not tip too far in favor of incumbent management.[107] With the effective bundling of hostile bids, consent solicitation, and proxy fights, hostile takeovers, which had virtually disappeared as a corporate governance device at the start of the 1990s, continue to mitigate managerial agency problems.[108] Nevertheless, managerial entrenchment problems have

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98 *See, e.g.*, Shleifer & Vishny, *supra* note 96, at 756–57.

99 *Id.* at 756 (citations omitted).

100 *See* Bailey Morris, *Drexel Case Renews Fears over 'Junk Bond' Market*, TIMES (London), Sept. 10, 1988, at 21.

101 *See* Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, 48 J. FIN. 831, 832 (1993).

102 *Id.*

103 *See id.* at 838–39.

104 *See id.*

105 *See id.* at 836–39.

106 *See* Jill E. Fisch, *Relationship Investing: Will it Happen? Will it Work?*, 55 OHIO ST. L.J. 1009, 1031–32 (1994).

107 *See id.* at 1032 & n.77.

108 *See* LUCIAN BEBCHUK & OLIVER HART, TAKEOVER BIDS VS. PROXY FIGHTS IN CONTESTS FOR CORPORATE CONTROL (European Corp. Governance Inst. ECGI Working Paper Series in Finance, Working Paper No. 04, 2002). Takeover entrepreneurs and arbitrageurs have also introduced an innovation, the shareholder rights bylaw, that is likely to further invigorate the market for corporate control by eliminating the ability of a target company's board to keep poison pill defensive devices in place once an outside bid has been made.

far from disappeared. The various highly publicized corporate scandals such as Enron and WorldCom indicate that there is substantial room for improvement.

As noted at the outset, corporate governance systems work to reassure suppliers of capital.[109] Firm-specific human capital is one of the more important and illustrative types of capital. Lack of such capital is where the vaunted U.S. system of corporate governance reveals its deepest flaws. The U.S. system relies on capital markets, which pressure corporate managers to deliver profits. This structure makes the system notable for its objectivity, dynamism, and flexibility. In particular, participants at all levels of U.S. labor markets are highly mobile. Hiring and firing workers is generally easier in the U.S. than in Europe or Japan.[110] These features may have caused the relatively low rates of unemployment in the United States during the late 1990s.[111] The advantage of flexibility is offset, to some extent, by the costs that result from the fact that employees, including high-level managers, cannot make credible, long-term commitments to their firms. This reduces both the incentives of managers to make firm-specific investments in employment relationships, and the incentives of firms to seek such investments.

Another weak aspect of the U.S. corporate governance system is rooted in the fact that U.S. investors are not relationship investors: they typically move in and out of their investor status though arms-

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Jonathan R. Macey, *The Legality and Utility of the Shareholder Rights Bylaw*, 26 HOFSTRA L. REV. 835, 835 (1993). 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 twenty-five percent above market. The firm can retain its poison pill only if the shareholders vote to retain it within 90 days of receiving such an offer. *Id.* at 861. The Securities and Exchange Commission (SEC) currently requires firms to include these shareholder proposals in their proxy solicitation materials, at their own expense, under SEC Rule 14a-8. *See* 17 C.F.R. § 240.14a–8 (2003). By refusing to permit companies to exclude shareholder proposals from their proxy solicitations, the SEC has set the stage for a major legal battle that will ensue when shareholders propose and approve a proposed shareholder rights bylaw, and directors, claiming that the shareholders wrongfully usurped their right to run the company, challenge the bylaw in court. If Delaware judges fail to respect shareholder rights by refusing to uphold rights bylaws, institutional investors may start demanding that their firms reincorporate in jurisdictions which provide more rigorous protection for shareholders. However, even if legal arguments do not persuade the Delaware judiciary, pressure by institutional investors to find a jurisdiction hospitable to these arrangements may well ensure this long-term viability.

109 *See supra* Part I.C.

110 *See G7 Jobs Summit*, THE JOBS LETTER, Apr. 19, 1996, at 1, 1; *see also* Stewart J. Schwah, *The United States*, *in* CORPORATE RESTRUCTURING: THE ROLE OF LABOUR LAW (Robert Blan-Pain ed., 2003).

111 *See* Constance Sorrentino & Joyanna Moy, *U.S. Labor Market Performance in International Perspective*, MONTHLY LAB. REV., June 2002, at 15, 17.

length market transactions.[112] As such, American investors depend on publicly available information that is inevitably incomplete, crude, and outdated upon receipt. U.S. investors generally do not receive the same privileged, detailed information about firms in which they have invested that institutional investors in other countries may enjoy. The answers to this deficiency under U.S. law are complex and extensive disclosure requirements.[113] 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.

### 2. *Continental Europe*

As was argued in Section II, continental European systems with large shareholders and direct control by supervisory boards or banks allow not only for finer information partitioning, and thus for more informed monitoring, but also for investor participation in decisions *before* they are made.[114]

A further advantage of this system of finely textured monitoring is that monitoring takes place on an outgoing basis, rather than episodically, in situations that are perceived as crises.[115] This sort of monitoring permits not only more informed monitoring, but also pre-emptive intervention in corporate decisions that more distant monitors are unable to effectuate.

The principle problem with the continental European system is that an element of capture may prevent effective governance.[116] Because the monitoring of corporate action is accomplished primarily by proximate monitors, such as large block-holders, these monitors may be both unable to objectively evaluate management proposals and un-

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112 This practice is so widespread that it has become known as the "Wall Street Rule," according to which, dissatisfied investors simply sell their stock, rather than attempt to influence management. Alfred Conrad, *Beyond Managerialism: Investor Capitalism?*, 22 U. MICH. J.L. REFORM 117, 144–45 ("[T]he Wall Street Rule fits the typical individual investor.").

113 *See generally* SEC. & EXCH. COMM'N, DISCLOSURE TO INVESTORS: A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS: THE WHEAT REPORT (1969) (discussing the registration requirements under the '33 and '34 Acts); Jason Michael Craft, Note and Comment, *What's all the Commotion?: An Examination of the Securities and Exchange Commission's Regulation FD*, 14 DEPAUL BUS. L.J. 119, 121–23 (2001); Caroline F. Hayday, Note, *Shedding Light on Wall Street: Why Reg. F.D. Is Appropriate in the Information Age*, 81 B.U. L. REV. 843, 844, 849–50 (2001).

114 *See supra* Parts I.B, II.A.1.

115 MARCO BECHT ET AL., CORPORATE GOVERNANCE AND CONTROL 37 (European Corp. Governance Inst. Working Paper Series in Finance, Working Paper No. 02, 2002); *see also* Ian Ayres & Peter Cramton, *Relational Investing and Agency Theory*, 15 CARDOZO L. REV. 1033 (1994) (arguing that large shareholder structures permit better monitoring and less myopia (short-term decision-making) than U.S.-style governance systems).

116 *See supra* Part II.A.1.

willing to intervene in a timely fashion when it becomes known that management decisions have turned out badly.[117]

While proximate monitors such as large block-holders with representatives on boards of directors have superior and more timely access to information than outside, objective monitors, they still have less information than insiders such as CEOs. This gives the CEOs an advantage even over proximate boards in influencing corporate decision-making. This advantage is exacerbated by the fact that CEOs have considerable, though waning, influence over the choice of who serves on boards of directors.[118] As Becht, Bolton and Röell have observed, "[e]ven when boards have achieved independence from management they are often not as effective as they could be because directors prefer to play a less confrontational 'advisory' role than a more critical monitoring role."[119] However, this problem is likely to be less acute where large stakeholders such as banks sit on boards, since they have such a significant financial stake in the corporation.

Formal economic analysis of the role of boards of directors reveals that the effectiveness of boards of directors erodes gradually over time.[120] However, on the plus side, the long run nature of relationships between the multiple constituencies in European and Japanese corporations is thought to promote human capital investment. Similarly, the fiduciary rules in the U.S. are designed to promote shareholder value, while the German rules are designed to balance the interests of shareholders and employees.[121]

Thus, we given the continental European system of corporate governance low marks for its ability to fill in gaps in contingent contracts, mediocre marks for its ability to resolve agency problems, and good marks for its propensity to promote human capital investments. In sum, notwithstanding the benefits afforded by the more proximate monitoring that characterizes the European system (like the U.S. system), the European system may fail to adequately address subtle agency problems.

3. *Corporate Governance in Italy*

The Italian system of corporate governance is a virtual mirror image of the U.S. system; it receives low marks for its ability to fill gaps in contingent contracts, due to its insufficient legal system and the absence of investor protection.[122] Italian corporate governance also per-

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117 *Id.*

118 BECHT ET AL., *supra* note 115, at 41.

119 *Id.*

120 *Id.* at 43; *see also* Benjamin Hermalin & Michael Weisbach, *Endogenously Chosen Boards of Directors and Their Monitoring of CEOs*, 88 ECON. REV. 96 (1998).

121 BECHT ET AL., *supra* note 115, at 17.

122 Macey, *supra* note 1, at 129, 134.

forms poorly in terms of its ability to resolve agency problems,[123] as illustrated by the fact that the duty of loyalty does not operate in Italy.[124] This absence exists for several reasons, not the least of which is that the Italian courts have no expertise or inclination to protect non-controlling investors.[125] Two features of the Italian corporate governance system—political involvement and small firms that finance themselves internally[126]—substitute for the lack of market-based control systems that cbaracterize U.S. corporate governance.

The State historically 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."[127] This element of State control in the Italian corporate governance system is hardly salutary. The politicization of capital investment decisions inevitably results in sub-optimal decisions about capital allocation.[128] In addition to State ownership, the Italian corporate governance system is characterized by complicated cross and pyramidal ownership structures.[129] This system of shareholdings possibly entrenches management, disadvantages minority shareholders, prevents capital market discipline, and stifles the development of a corporate control market.[130] 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 any information, including confidential corporate information, that it desires. Thus, tbe control group has 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.[131] Also, such investor proximity to management leads to joint responsibility (by implication) and a lack of objectivity that weakens the investors monitoring role.[132] Further, legal protection for shareholders in Italy is so insufficient that external financing is barely feasible for investors who do not receive control rights.[133]

The U.S. corporate governance system is flawed because takeovers are so expensive that it is only cost-effective to address large-

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123 *See id.* at 135–37.
124 *See id.* at 140.
125 *See* ROBERTO WEIGMANN, RESPONSABILITA' E POTERE LEGITTIMO DELGI AMMINISTRATORI 104–13 (1974); Barca, *supra* note 27; Macey, *supra* note 1, at 134–35.
126 *See* Macey, *supra* note 1, at 138, 143.
127 Barca, *supra* note 27.
128 *See Macey, supra* note 1, at 138.
129 *See id.* at 136.
130 *See id.*
131 *See id.*
132 *See supra* Part II.
133 *See* Macey, *supra* note 1, at 129–35.

scale managerial failures. In contrast, the controlling shareholders managing the Italian corporate governance system are able to make changes at a much lower cost because they are already in control. However, because of their personal involvement with management and their involvement in complicated ownership structures, these controlling investors are likely to lack the objectivity necessary to make the difficult decisions required to control agents' behavior.

As noted previously, the Italian economy has not suffered as a result of the failings of the Italian corporate governance system. 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 well.[134] An astonishing 98% of Italian firms employ fewer than twenty workers.[135] These firms solve corporate governance problems in the simplest way possible: they lack the separation between ownership and management that generates agency problems in more complex systems. Thus, "[c]orporate governance [does not] matter very much in Italy because there are so few large and medium sized firms."[136] Complex solutions to corporate governance problems are not necessary in these small firms because they are financed and managed by individual entrepreneurs and their families, who already have both the incentives and the ability to monitor and control their firm.[137]

The rigid, inflexible industrial structure of the Italian corporate governance system creates strong incentives for managers to make firm-specific human capital investments.[138] 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 employees that, in turn, provide the employees with incentives to make such firm-specific capital investments."[139] In Italy, even relatively large firms are influenced by family groups. For example, Francesca Visintin reports that almost 40% of businesses with less than 200 employees are controlled by families.[140]

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134 *See id.* at 141–43.

135 *See id.* at 141.

136 *See id.* at 140. *See also* Mark J. Roe, *Corporate Law's Limits*, 31 J. LEGAL STUD. 233 (2002) (discussing the meaning and effect of degrees of separation of ownership and control in various nations, including Italy). Roe argues that a nation's corporate law, even if "perfect" cannot fully contain managerial agency costs; thus, ownership structure may have to take this into account. *See* Roe, *supra*, at 233.

137 Macey, *supra* note 1, at 142.

138 *See id.* at 142.

139 Barca, *supra* note 27, at 7.

140 *See* FRANCESCA VISINTIN, CORPORATE GOVERNANCE AND PRODUCT INNOVATION: AN ATTEMPTED EXPLANATION OF THE ITALIAN INDUSTRIAL SPECIALISATION 9–10 (Università degli Studi di Udine Dipartimento di Scienze Echonomiche, Working Paper No. MOS. 03-01, Nov. 2002).

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 gaps in contingent contracts, or reduce agency costs. Therefore, it is not surprising that Italy has weak capital markets and virtually no venture capital. However, Italy has flourished because investors and entrepreneurs innovate around the system's deficiencies and utilize the closely held corporation form.[141] These small, often family-centered businesses obviate the need for mechanisms that reduce agency cost problems by eliminating the agency relationship altogether. Although it is often overlooked, this system provides strong incentives for managers to make the firm-specific human capital investments necessary to develop specialized skills.[142] Managers within these intimate firms can make investments with the knowledge that they will not be exploited. Italy's innovations illustrate how adaptability fosters successful corporate governance, notwithstanding the lack of an objective corporate governance system.

## IV
## FINAL OBSERVATIONS

The core problem in developed corporate governance systems is the inevitable tradeoff between proximity and objectivity among monitors of corporate agents. Both objectivity and proximity have distinct costs and benefits. Objectivity-based corporate governance systems result in distance, potentially less information, and less timely intervention in management's decisions. Proximity-based corporate governance systems are more informative and provide more timely intervention, facilitating not only prompt, but preemptive corrective action.

Ideally, governance arrangements should be tailored to fit the desired governance needs of a particular firm or industry. In some firms or industries the disadvantages of proximity might dominate, while in others the lack of information because of distance and objectivity might be prohibitively costly. For example, the irreversibility of investments is a potentially important determinant of the need for proximity, rather than objectivity.[143] Issues of adaptability play a role in this determination as well. For example, stricter disclosure requirements may overcome some information shortages and may facilitate more distance, both of which would lead to increased objectivity. Since

141 *See id.* at 140–43.

142 Macey, *supra* note 1, at 142.

143 This suggests that offering a choice among different charters or jurisdictions could enhance value because, ideally, corporate governance arrangements should be tailored to a particular industry. *See* LUCIAN BEBCHUK & ALMA COHEN, FIRMS' DECISIONS WHERE TO INCORPORATE (Nat'l Bureau of Econ. Research, Working Paper No. 9107, 2002).

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, nationwide corporate governance decisions doubtless provide predictability and ease of application, this Article suggests that greater benefits could be garnered via industry-specific governance decisions.

Observed nation-wide corporate governance arrangements—be they proximate or objective—do not deal satisfactorily with subtle agency problems, either because of lack of information, as in the objective U.S. system, or capture, as in the intrusive continental European system. The U.S. model is superior with regard to contingent contract gap filling, and thus has lower contracting costs, but it is inferior in generating high quality information and in protecting human capital and relationship-specific investments.[144] The continental European model provides less satisfactory solutions to contingent contract gap filling, but generates high quality information and is superior in protecting specific human capital investments.[145] The latter holds particularly true in a malfunctioning corporate governance system, i.e., the Italian system.[146]

In closing, while this Article emphasized the adaptability and resilience of different arrangements, it seems that corporate governance systems are converging along certain specific dimensions.[147] In continental Europe, where ownership stakes have traditionally concentrated, substantial pressure has recently come about to improve the liquidity of stock markets. The ownership of shares of the general public has grown substantially and this growth has led to increased dispersion. In the United States, we observe more concentration and increased institutional investor involvement. Observing the U.S. and continental European trends, convergence of stock ownership patterns seems underway, as concentrated and dispersed ownership meet. Corporate governance systems also seem to be converging in

144 Observe that the contracting environment in an objective system like that of the U.S. depends on enforceable contracts. In a proximity-based system, the legal regime could possibly allow contracting parties more discretion because the parties are close and could immediately respond to gaps.

145 *See supra* Part III.B.2.

146 *See id.* Observe that in Italy, as we have discussed, existing solutions to the problem of contingent contracts are totally inadequate. Moreover, Italy addresses subtle agency problems poorly.

147 *See, e.g.*, Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 AM. J. COMP. L. 329 (2001) (discussing the recent shift toward convergence and hypothesizing on reasons for this shift); *cf.* Lucian Arye Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127 (1999) (discussing structural and rule-driven forces that induce path dependence and delay convergence).

other ways. Boards of directors in two-tier systems and nonexecutive directors income tier systems have become more and more accountable to shareholders, which has required both groups to divorce themselves from management. Cozy arrangements between directors and management have thus become less acceptable.

Nonetheless, as corporate governance systems continue to converge, it is increasingly important to consider the impact of the tradeoff between objectivity and proximity and of the role of adaptability in shaping optimal corporate governance systems. Indeed, the above analysis makes clear that the tradeoff exists, that adaptability plays something of a mitigating factor, and that most nations maintain systems which feature either objectivity, or proximity, but not both. Thus, nations should seriously consider the potential value of combining these considerations with a move toward industry-specific governance structures.

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