

Varieties of Governance

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1 Introduction

Like many topics in economics, that of corporate governance rests on axioms and assumptions that are rarely debated and that are not always even articulated. Arguably, the position with respect to corporate governance is more extreme than most because the relevant theory is often taken to be that of the nature and boundary of the firm, which is both fragmented and controversial (Winter 1993).

In this paper we are concerned with the relative merits of stakeholder or shareholder orientation and on what the literature has to say on this. In much of the economics literature there tends to be a default position of shareholder value. Nevertheless, optimal governance orientation can not easily be read off from a traditional theory of the firm (Blair 1995, Zingales 2000, Tirole 2001)¹. One objective of this paper is to review the theoretical rationale offered for different forms of governance and also to show how varieties of governance involve different trade-offs. Section 2 discusses governance systems from the perspective of the firm's *current performance*, while section 3 mirrors that comparison in relation to the firm's appetite for *forward commitments*. As far as governance is concerned, the latter issue has been the dog that didn't bark, but there is now renewed interest in the adequacy of innovation, infrastructure and other capital investments (Christensen *et al.*

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¹ For an overview of governance systems see Blair and Roe (eds 1999) and Kelly, Kelly and Gamble (eds 1997). The relation of governance to the varieties of capitalism debate is discussed in Hall and Soskice (1995); see also its critique by Pontusson (2005).

2008). Section 4 suggests that reforms to the US system of governance over the last few decades have been aimed mainly at current performance. Section 5 compares two rival systems of governance reform from the perspective of forward commitments. Section 6 concludes.

We begin with a methodological question. Suppose that we could represent models of governance that are more or less shareholder, or stakeholder oriented in the sense that control rights rest largely with one of these polarities; what criteria would be appropriate in choosing between them? The literature tends to focus on the efficiency and distribution properties of the systems. By “distribution” is meant, in the case of shareholder orientation, the issues concerned with danger of expropriation, conflict between minor and major shareholders, or between holders of debt and equity (See, for example Shleifer and Vishny 1997). For stakeholder models, the distribution interest is in how implicit contracts may be broken and weaker parties defrauded (Shleifer and Summers 1988). Nevertheless, no matter how important these distribution issues may be in their own right, they are generally subordinated in the literature to a consideration of efficiency. Thus, shareholder rights are seen as important to ensure finance on good terms; implicit contracts are important for ensuring stakeholder commitment etc. In our review of the literature we will capture the main debates by focusing on how efficiency is served by governance.

Governance influences costs and benefits that markets cannot mediate, partly because not all uncertain effects can be contracted for (incomplete contracts) and/or because information asymmetries create moral hazard or adverse selection. Governance thus corresponds to a broad system of incentive provision, that being interpreted to include arbitration procedures in respect of non-contracted claims and externalities. Incentives can be changed in a variety of ways, including full integration, profit sharing, and other forms of organisational design such as a change of arbitration rules. Importantly, incentives relate to both current performance and forward commitments. The former relates to questions of productive efficiency such as effort and compensation of employees (shirking, private benefits etc). The latter relates more to the split between dividends (or share buy backs) and internal investments (capital investment, training, marketing, innovation etc), with increasing commitment generally associated with higher total risk. We may characterise the existing discourses on these issues in the array shown in Table 1 where the cells are set up to represent an ordering in importance that is suggested by the weight of the associated literature.

How true is such a representation of ordering? The square bracketed numbers represent the number of articles recorded in a *Web of Science* topic search that arguably correspond to the cells, supporting the idea that shareholder oriented systems are viewed primarily as bearing on current performance; more so than stakeholder systems. Certainly the question of forward

Efficiency Objective	Shareholder orientation	Stakeholder orientation
Current performance	Important [662]	Important [621]
Forward commitments	Relatively unimportant [80]	Relatively important [214]

Table 1 : *Importance of efficiency objectives by governance type: the literature perspective*

commitments seems a relatively neglected topic in the shareholder oriented literature². In the following two sections we aim to collate the efficiency arguments supporting each of the governance forms in respect of current performance and forward commitment.

2 Current performance: the issues

Governance is often exemplified as a chosen level of integration for the firm e.g. a choice between organising production with employees or self-contracting suppliers, or some intermediate arrangement. The principles governing the choice of integration depend on what is held constant under integration. In some models the level of information is unchanged but implied incentives are changed because of different allocation of control rights (Hart 1993). Alternatively the level of integration might be chosen because it corresponds to an advantage in information or process (Williamson 1993). In any event, the decision is resolved by some trade-off between the potential deviations from first best that governance generally implies³. A number of theories show the advantages of designing organisational boundaries and routines to reflect the market failures and externalities that would otherwise affect performance more negatively. There is a large literature on all these questions, a good starting point being Holmstrom and Tirole (1989), Williamson and Winter (eds 1993), Holmstrom and Roberts (1998) and Roberts (2004).

The issue of integration and the boundary of the firm is sometimes seen as a parable for broader governance problems such as the rules for resolving ex-post conflict with suppliers of labour or finance (Williamson 2002, p.182). Seen in this broad perspective, shareholder and stakeholder governance forms may affect the firm's current performance differently. Some distinctions are summarised in Table 2 and discussed in the subsequent text.

² Clockwise from the top left the cells represent for the Web of Science search 1980-2008, the combinations (shareholder NOT stakeholder AND performance); (stakeholder NOT shareholder AND performance); (shareholder NOT stakeholder AND innovation); (stakeholder NOT shareholder AND innovation). Stakeholding and shareholding were also included as alternative terms in each case. The term innovation was chosen rather than investment because the latter may represent financial investment.

³ Hart (1993, section 4.1) provides an example where under asymmetric information with no externalities, the person who determines the profitability of an asset should fully own it, though the particular example is so stark that it allows a first best solution. Rajan and Zingales (1998) derive a variety of complex models with diverse results along the same lines.

Theoretical view:- Importance of Governance relates to:	Shareholder or Stakeholder orientation supported?
2.1 Principal-Agent theory with shirking under information asymmetry.	Hybrid case.
2.2 Adaptation to contingencies.	Depends on relative monitoring costs or relative coordination costs.

Table 2 : *Governance influences on Current Performance*

2.1 Principal Agent

Costly monitoring of behaviour by agents affects the alignment of reward with effort and thus effort itself. Agents (typically managers) engage in efforts that are difficult to evaluate due to stochastic environments and produce outputs that are unverifiable because of team production. If performance is very sensitive to one party's input and high monitoring cost makes opportunism pay, then one solution is for the monitored party to obtain ownership. It could be said that the stakeholder becomes a shareholder so that the system is hybrid. The solution is modified when objective characteristics (poor access to capital, say) limit such ownership change: it is then the capital structure that defines the governance form. A solution may also emerge where incentives are altered by ownership rights being transferred by the principal, as under profit sharing schemes.

2.2 Adaptation

The allocation of control rights does not always have to go with "ownership".⁴ This issue is addressed in "adaptation theory". The context is where the parties involved in joint enterprise e.g. workers and financiers agree ex-ante on decision rules for residual control. It is simple and instructive to formalise this. Following Simon (1951) and its development in Gibbons (2005) we write the expected total surplus (TS), where the decision rule is given to party i as:

$$TS_{d=d_i} = \underset{s}{E} \{ U_1(s, d_i(s)) + U_2(s, d_i(s)) \} \quad (1)$$

where s is the state of nature, d_i the decision of party i ; U is the pay-off to each player and E is the expectation operator.

⁴ For Hart (1995) the separation of residual control rights (the right to determine uncontracted decisions) and residual (i.e. non-contractual) income generates perverse incentive effects because the holder of control rights is then not incentivised to maximise income and thus it "... makes sense to allocate these rights to the same person" (p.65). This does not address the problem of multiple recipients of residual income.

The specification shows both how realised total surplus depend on the decision rule (allocation of residual control, the i in the d_i). This could occur because of different capabilities of the parties; because of objective circumstances such as coordination costs or monitoring costs that are implied by a particular party having control rights; or in a more complex setting where the incentives of a player to invest for the future depends on who holds decision rights (See Section 3).

The adaptation context can be illustrated where monitoring cost depends on the form of governance, making asymmetric information less problematic in some contexts. For example, monitoring costs might be low for a small number of cooperating agents whereas the reverse might apply for a principal and a large set of contracted employees, though there is no consensus on this dependence in the literature (Holmstrom and Tirole 1989, Holmstrom and Roberts 1998).

Besides differential monitoring costs, the *degree* of opportunism (and thus the need for monitoring) may perhaps be determined by the governance form and managerial culture (Kreps 1990, Stout and Blair 2001, Roberts 2004). The issue is complex because although control rights for stakeholders may reduce shirking it may also make it more feasible to misappropriate benefits (Hellwig 1998). Some argue that there is a hidden cost to insider (stakeholder) monitoring: "...the result could be a rent-dissipating struggle for stakeholders to "dispossess each other" (Rajan and Zingales 1998 p.424; see also Lazonick 1992, Hansmann 1996, and Jensen 2001). What seems clear from all this is that the organisational culture may change with a change in governance form and that this may be just as important as the direct effect of incentives.

2.3 Assessment regarding current performance

Summing up the arguments for shareholder or stakeholder orientation from the perspective of current performance it seems that many of the major issues are still to be resolved. The theories are complex and non-nested and the empirics are fragmented. Formal incentive theory has little to say about the stakeholder-shareholder orientation but may predict where profit-sharing is likely to be observed. In adaptation theory on the other hand, governance choice reduces to the question of who best exercises control rights. Hansmann (1996) provides a set of case studies where allocation of control rights to different groups may be efficient in different circumstances depending particularly on the cost of coordination. Rock and Wachter (1999) argue that workers and capitalists generally do both participate in governance according to their objective circumstances. What is missing is a programmatic empirical study of a dynamic nature that investigates what happens when governance changes⁵. That is particularly important because so much

⁵ See Blair and Roe (1999), Pendleton (2001), Michie and Sheehan (2001), Cook et al (2002) for some work along these lines.

of the disputed territory concerns what is appropriate to hold constant when comparing forms of governance. The answer may of course be elusive because governance change may be endogenous and depend on evolving characteristics such as technological regime and the importance of intangibles.

3 Forward commitments: the issues

Arguably, it is in relation to sustained performance – and the forward commitments that create the opportunities for this – that the sharpest differences arise between the shareholder and stakeholder views. We will summarise the results of some of the literature by annotating the results table below that shows the conditions under which different governance forms may be superior in creating incentives for forward commitments.

Theoretical view: Importance of Governance relates to:	Shareholder or Stakeholder orientation supported?
3.1 Asset specificity	Depends on whether the shareholder is a sole residual claimant bearing all risk.
3.2 Adaptation	Depends on who is best placed to bear risk, create reputations etc. Depends on bargaining strengths i.e. credible threats to withhold finance, human capital etc.
3.3 Biased time horizon for investments	Depends on liquidity preference of investors and on whether financial market arbitrage is strong enough to counter short-termism.

Table 3 : *Influences on forward commitments according to governance orientation in different theories*

3.1 Asset specificity

The first set of issues (top row of Table 3) originates in the property rights treatment of the boundary of the firm problem under incomplete contracts. Assuming that ownership implies control rights, a decision on the level of integration may permit the internalising of the incentive problem or “hold-up” caused by asset specificity (relational investment). For example, a firm may refuse to invest enough because the resultant sunk cost would make it vulnerable (Hart 1995). In that case, the coordination problem is potentially solvable by a change of ownership (merger) and thus bargaining power, so that the threatened underinvestment is avoided ⁶.

⁶ The relevance of the theory is controversial outside of the regulatory sphere. Holmstrom and Roberts (1998) say that “hold-up problems are of central concern to business people” (p.80) and the idea is central to much recent theory on incentives to innovate (Gambadella 2008). However, others argue that the focus

The basic argument can, however be remoulded in a surprising way by a consideration of human capital. Although residual income is often thought as accruing only to shareholders, this is not so if other parties receive a portion of remuneration in the form of non-contractual risk-based income. Since this is inevitably the case under limited liability (and where tax-payers, debt-holders, specialised suppliers, workers with firm-specific skills, and recipients of efficiency wages all tend to share in the risk of failure), it is arguable that control rights should also be shared on efficiency grounds. This is one basis for the *stakeholding* view (Blair 1995; Driver and Thompson 2002; Asher et al 2005). One of the implications of shareholder orientation in this way of thinking is that owners of human capital will have an incentive to bias their training towards generic skills so as to increase their outside option. A tendency towards underinvestment in firm-specific human capital is thus implied by shareholder orientation in the property rights view (Zingales 2000)⁷. It may be noted that the theory does not address generic skill formation but only firm-specific skill investments. Since much of that skill formation may be directed by the firm rather than a subject of individual choice, it is thus the unmonitored effort or commitment of energy and risk to the firm's projects that is in question. While it might be argued that such commitment could be ensured by appropriate incentives, the issue then shades into one of monitoring effort where communication and cooperation is central to the work process. The resolution of this may have less to do with asset specificity *per se*, than with the complexity of the environment, so that governance needs to be responsive to technological and organisational trajectories.

3.2 Adaptation

As seen in Section 2, adaptation theory places more emphasis on the outcome of incomplete contracts being resolved by authority than bargaining (Williamson 2002, p.188). Indeed, this might thought to be logical since the uncertainty associated with incomplete contracts may imply bounded ratio-

on hold-up may be at the expense of more important aspects of coordination (Foss 2000) and indeed Hart also seems to accept this (Hart 1995 p.88). Lyons (1996) is one of very few empirical studies of the effect of hold-up on investment, finding just a small difference in the responses of firms who would use a first-best specialised asset under long-term contracts as compared to those who were currently using it with short-term contracts. More disturbingly, it now appears that the eponymous Fisher-GM case was based on a misreading of the facts. In a savage indictment of theoretical economics, Ronald Coase (2006) excoriates those who disregarded inconvenient facts to push a false account of the incentive problem faced by Fisher bodies in choosing plant locations. Williamson (2002) is surely wrong to argue that the anecdote was simply pedagogical. As Coase shows, the facts support the prevalence of trust relationships rather than opportunism in that case.

⁷ Zingales (2000) notes that while the property rights view of corporate governance appears "logically to imply a Marxian position of worker control", he is "not aware of any corporate governance paper arguing along these lines" (p.1639). See, however Blair (1995); Hart (1996); Becht et al (2003); and Asher et al (2005) where the point is acknowledged in various ways.

nality which is at variance with much of the property rights literature. Whereas the logical sequence in the property rights view is *governance* → *anticipated bargaining strength* → *incentives*, the adaptation sequence is *structural characteristics* → *governance* → *incentives*. Structural characteristics relate to the objective position of the parties (including bargaining strengths) that determine their suitability for governance. The important question is then in which party should authority be vested for good governance? Here we are asking this question from the standpoint of forward commitments.

Table 3, row 2 notes that one criterion may be related to who is best placed to bear risk. An argument along these lines in support of shareholder orientation is due to Rajan and Zingales (1998). Here the focus is on whether a manager has an incentive to increase the extent of specialisation, and thus incur more risk. In contrast to the apparent implications of the property rights approach, as interpreted by stakeholder theorists such as Blair (1995), residual rights of control should, according to this argument, belong to agents who *have little control* over the extent of specialisation because specialisation is held to reduce the value of the asset in alternative use. This is said to support shareholder control on the grounds that shareholders have nothing to lose by specialisation⁸. Were residual control rights to be granted to managers (solving one incentive problem), it would *reduce* their incentive to further specialise the firm because, should they quit the firm, their specialised human capital would lose value. It could be said that Rajan and Zingales have discovered independently the argument in Hart (1993), echoed in Gibbons (2005), that the solution to every hold-up problem creates another.

This, then, is an important argument that concerns the limits to risk-bearing by managers and other employees. While they are obliged to share some risk they can offset it by diversifying their human capital investments and by containing the firm's overall risk exposure. It is plausible that senior managers and employees may have already concentrated their assets in the firm and to commit further investment to the firm rather than raise payouts may be unattractive due to risk aversion. Shareholders having more diversified wealth may be less concerned with this, so that the constraint on investment is internal rather than external and the risk profile of the firm is biased away from a first best case. It is of course hard to prove this, though a necessary condition is that risk-taking increases with shareholder orientation and there is some evidence for that. Following demutualisation of the UK building societies in the 1980s, investor-owned funds made riskier,

⁸ These authors argue that human and non-human capital can be considered as a source of power and thus that the property rights view of the firm needs to be replaced for high human capital firms by a theory of "access" to complementary factors. While the theory challenges the case for stakeholder control it is not an argument for a shareholder value theory of the firm because the authors note that residual income accrues to stakeholders.

higher-return investments than the mutuals (Cook et al 2002). Also, hostile takeovers have been found to be related to the degree to which shareholder rights take precedence in the prevailing legal and institutional framework, i.e. insiders tend to oppose such moves (Schnepper and Guillen 2004). However while risk-taking may rise under shareholder orientation, that does not mean that it is optimal. Nor does it even imply that the risk-return trade-off becomes more attractive, because cooperative risk-sharing and the quality of information flows may also be affected by the form of governance. The available evidence appears to suggest that insider systems such as in Germany facilitate better inter-firm cooperation and information sharing than shareholder-oriented systems and that may lead to a spreading of risk (Love and Roper 2004)⁹.

We turn next to the issue of reputation and to the question of which party is best placed to hold title to this. Adaptation theory is intimately related to "implicit contracts" that can be thought of as contingent payments that are offered in normal circumstances but which can be suspended, at some cost in reputation, by the exercise of authority (Demsetz 1993). Examples are work-place norms in relation to work-intensity or the degree of protection for a firm's pension fund. These relational contracts are in effect informal allocations of residual income (generally to employees) in exchange for residual control rights (generally to owners). They require a dynamic analysis because the strength of the informal contract depends on trust or reputation built up over time.¹⁰ (Kreps 1990, Baker et al 2004).

In regard to the specific question of how reputation relates to the form of governance, Holmstrom and Tirole (1989) comment that parties with significant interest invested in acquiring a reputation should typically be given residual decision rights. This will ensure that "the potential loss of reputation will assure a more efficient and fair adjudication process in the event of the unforeseen" (p.77). The argument may, however, be circular since reputation is achieved through not abusing control rights and invested interest in it is, therefore, potentially endogenous to the consideration of who should hold such rights.

Finally, the bargaining strengths of the parties is another element in the adaptation theory argument (Table 2 row 2). The form of governance may depend on bargaining power because the exercise of governance requires

⁹ Extending the above argument it is sometimes argued that governance involves a "horses for courses" approach to risk with insider systems more appropriate where cooperative incremental innovation is the norm and shareholder control when the environment is rapidly changing with radical uncertainty (Hall and Soskice 2001). Some have argued that stakeholder economies such as Germany have trouble in diversifying into radical new areas such as biotechnology (Casper 1999; see also Carlin and Mayer 2003, p193-4). But the result is contested in Kaiser and Prange (2004). For further discussion see Ramirez and Tylecote (2004) and Tylecote 2007.

¹⁰ Treatments of reputation typically employ repeated game theory to show that reputation is valuable for improving performance. The result is similar to oligopoly "tit for tat" models where the extreme conclusions of the prisoners' dilemma game are modified in repeated play (Kreps 1990).

authority. Whereas in the property rights approach, bargaining power is endogenous, here it is taken to be characteristic of the supplier of factors. A formal justification of shareholder orientation along these lines is the “pledgeable income theory” due to Tirole (2001)¹¹. This theory, elaborated in the Appendix, is a Rawls -type argument that an ex-ante agreement, that includes a probability of a reneged implicit contract, is better than no contract at all. Specifically, suppliers of finance need to be confident that they will be allowed to pursue non-pareto optimal actions to secure their own interests, because otherwise they will at the margin provide less finance¹². This argument is said to justify residual control rights for shareholders.

3.3 Biased time horizons and the incentive to commit

In the presence of asymmetric information it is difficult to frame incentives for forward commitments to ensure that expected returns are equal to the marginal cost of funds. The design of optimal investment rules such as company or division hurdle rates under imperfect information often implies a second-best solution (Holmstrom and Tirole 1989, Taggart 1987, Harris and Raviv 1996, Wulf 2002). Given such difficulties, a number of models predict capital rationing either inside the firm among its divisions or, in a principal-agent context where owners do the rationing as they cannot verify why managers are seeking funds. (Holmstrom and Roberts 1998).

A related but distinct problem is *short-termism* which again can be manifested within the firm or by the providers of finance. The latter problem arises partly due to the need to monitor fund managers, whose performance is evaluated often on a quarterly basis. Within the firm, short-termism can be caused by behavioural bias such as that arising from managerial game playing, especially in the context of short job tenures. A combination of heightened incentives and increased managerial turnover may induce managerial short-termism as rational response (Palley 1997).

While many second-best outcomes are *inevitable* corollaries of imperfect information, the incidence of short-termism arguably relates more directly to the form of governance. Dispersed ownership is attractive to owners due to

¹¹ Tirole takes seriously the derivation of first-principle arguments for the allocation of control rights. Recognising the problematic interpretation of ownership, he argues for a broad definition of governance as the “design of institutions that induce or force management to internalise the welfare of stakeholders” (p.4). Contrast with the more neutral definition in Zingales (1998) given as “the complex set of constraints that shape the ex post bargaining over the quasi rents generated by a firm” (p.498) which is nevertheless broader than some definitions which see corporate governance as merely a principal-agent problem.

¹² Earlier justifications for shareholder control rights include the idea that the objective position of this party is different due to information concerns: shareholder assets are “most susceptible to misappropriation” and may therefore be undersupplied so that “capital should hold title to the residual return stream” Holmstrom and Tirole (1989p.73). A parallel argument is that, although shareholders rewards (such as dividends) are generally transparent, it is easier to disguise other distributions such as worker rents and customer sweeteners (Tirole, p.28).

enhanced liquidity of shareholdings. The downside is the mirror image of liquidity viz. a lack of commitment on behalf of the owner who can sell up at short notice. This may create a “free-rider” problem where there is less monitoring than under insider governance. It may also bias commitments towards those with fastest paybacks (Miles 1993, Peck and Temple 1999, Gracia 2004) .

3.4 Assessment: Future Commitments

In section 3.1. we reviewed the position of Blair (1995) who argues for a stakeholder perspective as the logical corollary to the property rights view of governance. This argument is an important corrective to those who take shareholder rights as axiomatic. However, in my view, this argument offers only partial support for a stakeholder framework because the property rights approach in general may not be robust and as we have seen it is not the only defence of a shareholder orientation.

In Section 3.2 we considered the adaptation view and here there is scope for serious comparison between the shareholder and stakeholder models. Adaptation theory needs to explain *why* the allocation of control rights to one or other party might indeed maximise total surplus or utility. A separate set of literature has sought to answer this in a number of distinct ways that variously support either the shareholder or stakeholder perspective.

In reviewing the adaptation theory arguments we have noted potential effects from risk position, reputation and bargaining power. An important argument was that an aversion to risk on behalf of (undiversified) workers and managers may limit the appeal of stakeholding, though that could be countered to some extent by the role of cooperation in mediating risk¹³. Ambivalence extends to the other issues. The question as to which party should have responsibility for the firm’s reputation is not resolved. Finally, in terms of bargaining power, Tirole’s “pledgeable income” argument would not appear be general. Rather, this argument depends on the existence of “finance gaps” making its scope contingent on details such as size, country and sector¹⁴.

Summarising the more robust arguments from adaptation theory we can say that a shareholder orientation is supported when equity finance constraints exist and where managers’ risk-aversion creates constraints on

¹³ We have not sought to complicate the matter further by considering the effect of different capital structures, implied by difference governance forms, on risk-taking, but if total risk matters that would be relevant.

¹⁴ US equity capital raised has actually been negative for nearly 30 years (Clark ed. 2004). Indeed it has been shown for the US that share buy back announcements increase a company’s share price, suggesting an absence of financial constraint (Frank and Goyal 2005). Thus, if there is a constraint on innovation and investment it would appear to be internal rather than external. Overall, the situation is complex because recourse to equity may be endogenous under asymmetric information (Greenwald, Stiglitz and Weiss, 1984).

investment. A stakeholder orientation may be supported where cooperation and good internal information mediates risk ¹⁵.

In section 3.3 we reviewed the issues of imperfect information that results in both internal capital rationing and short-termism in response to outside pressure. While second-best outcomes are often implied by imperfect information – irrespective of the type of governance – the intensity of short-termism is also arguably contingent on the form of governance. Short-termism can be considered a design fault of dispersed ownership because in that system liquidity is considered important to attract funds. The result is a free-rider problem in regard to monitoring agents' behaviour as well as a predisposition to neglect long-term commitments. Empirical work has shown that short-run efficiency improvements are often made at the expense of growth (AT Kearney 1999; Mackenzie and Hodgson 2005) and that the vast majority of firms are prepared to sacrifice value to smooth short-term earnings (Graham *et al.* 2005) ¹⁶.

Shareholder orientation may also encourage short-termism by facilitating a market in corporate control. The effects on forward commitments of such a market will depend on the balance between the incentives that are implied for managers. The available evidence suggests that hostile takeovers are not targeted at poorly performing firms (Franks and Mayer 1997), so it is unclear that they play an allocative efficiency role. The main role then of hostile takeovers may well be the behaviour that they induce in firms that are *not* taken over. Hostile takeovers are relatively rare even when they are in fashion (Becht *et al.* 2003). Accordingly, it may not be the reality but the fear of takeovers that changes behaviour. It is this feature that explains why a serious role for takeovers in governance may imply short-term orientation by management, with forward commitments such as training and R&D sacrificed so as to maintain the current share prices (Bushee 1998, Peck and Temple 1999, Roberts 2001, Gracia 2004).

4 Recent trends in governance: the case of the US

In sections 2 and 3 we reviewed how specific circumstances would favour shareholder or stakeholder orientations in respect of current performance and forward commitments. However, it is difficult to relate this theoretical account to the history and evolution of governance since there is no reason

¹⁵ Faced with the choice, Tirole (2001) opts for a shareholder approach balanced by safeguards which include (i) circumscribing actions with strong negative externalities, presumably by legislation (ii) encouraging short-term or convertible debt to constrain shareholders from excessive risk-taking (iii) encouraging flexible labour markets to increase exit options for labour. These seem weak conclusions since some of the proposed actions eliminate other options. For example, flexible labour markets are associated with lower incentives for the provision of company training, and debt discipline may prevent company managers from pursuing growth options.

¹⁶ It might be thought that arbitrage should make short-termism irrelevant. However, theoretical work has shown how a short-term bias can persist without being countered by arbitraging investors (Morris 1998, Peck and Temple 1999, Krafft and Ravix 2005).

to believe in optimal evolutionary responses. Here we simply review the developments in governance in the major shareholder economy, the US, over recent decades in an attempt to interpret it in relation to the split between current performance and forward commitments illustrated in Table 1. The account will show how the US strengthened its orientation towards shareholder value throughout, in successive experimental episodes, influenced largely by a Principal-Agent view and the ideas in Section 2.1. A brief description of these episodes is followed by an assessment of effectiveness.

4.1 Periodisation of shareholder value regimes

In the US a decisive shift away from managerial capitalism – where managers had a great deal of autonomy – occurred as US global economic advantage waned under a new wave of globalisation in the 1970s (Chandler 1977). Financialisation, whereby financial institutions were de-regulated and acquired greater powers accelerated this process. But the increased influence for dispersed owners – that managerial capitalism had resolved by usurpation – raised again the principal-agent problems that had been analysed in the 1930s (Berle 1965) and which remained to be dealt with under the new shareholder orientation. Several experiments followed and it is possible to identify at least three distinct shareholder value regimes over the last four decades.

(i) Leveraged takeovers

The first period, which roughly fits between the mid 1970s and late 1980s, saw an increase in hostile debt-financed takeover activity in the US due in part to the relaxation of legal constraints on institutional investment and to a benign view of debt as a discipline on opportunistic managers (Greenwald *et al.* 1984, Jensen 1986, 1993; Blair 1995).

(ii) Incentives and alignment

The second period (roughly the 1990s) was characterised by renewed pressure on managers, with performance related CEO turnover rising five times between 1995 and 2000 (Gracia 2004). At the same time, shareholder value orientation was supported by designing incentives to align directly the interests of managers with those of owners, something made possible by organisations shedding layers of managers and concentrating power in the hands of a smaller managerial elite.

(iii) Concentrated holdings

This “post-Enron” period is one where legal requirements, such as auditor independence, were introduced at the same time as many companies paid more attention to board-room practices and design. This period is in many ways a continuum from the preceding one but now with increasing emphasis

on incentives for boards of directors rather than managers, on concentrated or block ownership and, as an extreme example of the latter, private equity¹⁷. Put differently, this period is not only shareholder oriented but, at least to some extent, concerned with direct shareholder control or greater ease of indirect control via the election of directors. We consider a version of concentrated shareholder control as one way of reforming governance in Section 5.1

4.2 Impact of shareholder value regimes

Each of these regimes, while aiming to fix one problem, ended up exacerbating others. In the first regime, the problem addressed was current performance in the form of shirking by managers or workers. But fixing this with the sticks of a takeover threat or indebtedness focused attention away from investing for the future. By the end of this period questions were being asked about the international competitiveness of US firms as import penetration increased from coordinated market economies that were devoting more resources to long-term investment and R&D. US Treasury Secretary Brady remarked that the takeover phenomenon had produced the opposite result to that intended by stoking a preoccupation with the short-term (*Financial Times* 14/05/90). Subsequent to a spate of bankruptcies that ended this period, there followed a set of legal judgements and reform of US corporate law that made hostile takeovers more difficult, arguably amounting to a partial retreat from shareholder orientation (Blair 1995).

The second period swapped the stick for the carrot of formal incentives so as to align the interests of managers and shareholders. In theory this should have aligned both performance and investment incentives. However, the stock option form that was generally adopted over-incentivised managers to perform in a way that inflated asset values. The result was complicated in terms of future commitments. On the one hand a real investment bubble was probably created in parallel with the dot-com boom, as with the earlier bubble in Japan (Chirinko and Schaller 2001). On the other hand intangible future investments may have suffered in the downturn due to the breaking of implicit contracts, erosion of trust, proliferation of fraud, and the neglect of poorly valued investments necessary for future value creation. Overall the current verdict in the literature appears to be that incentives regime was not effective¹⁸.

¹⁷ A greater reliance on voice rather than exit has been proposed in corporate governance literature for some time (Black 1997). The problem for regulators is to judge the extent to which concentrated holdings reduces the attractiveness of investment for more dispersed owners. In the UK where, in comparison with the US, more companies have one or more significant shareholders, the information disclosure requirements to all parties is stronger than in the US.

¹⁸ A meta picture is evaluated by Becht et al (2003) who conclude that "... it has become difficult to maintain the view...that US pay practices provide ...incentives for aligning the interest of managers with those of shareholders" (p.79). Some evidence is contradictory. Wulf and Lerner (2006) found that incentives increased innovation performance for firms with centralised R&D but not for those with decentralised R&D while noting that their research could not capture the effect of groundbreaking R&D which would take longer to show up as important.

The third episode involved increased recourse to block-holding and should in theory have injected a long-term focus¹⁹. However, active hedge funds generally buy to trade rather than hold. Such activities may weaken the credit rating of the companies they invest in with problems for long-term investments. It is true that some private equity investments, in particular those held directly by institutions may be aimed at providing long-term finance to firms with high growth prospects (Nielsen 2006) but this does not appear to be general²⁰.

What stands out in the above characterisation of US governance over the recent past is how difficult it is for a shareholder oriented economy to adopt a culture of investing for the long run. The challenge for those who see the answer to good governance in the voice of institutional shareholders is to show that such governance can work to a horizon long enough to build trust, reputation and other strategic assets. These issues are discussed in the following section where two varieties of reform are contrasted based on some of the discriminators identified in Table 3²¹.

5 Future perspectives

The pre-Enron reforms in the US are generally regarded to have failed while the post-Enron reforms are seen as fire-fighting that might not have prevented the problems (Gillan and Martin 2007). This section is concerned with policy proposals for the future, drawing where relevant on the theory surveyed in earlier sections. To contain the discussion we consider here just two alternatives to the dispersed shareholder system that prevails in Anglo-American economies. Each alternative is associated with a representative actor: the committed shareholder and the trustee manager. As the names imply the governance systems are located differently on the shareholder-stakeholder spectrum. A brief pen-portrait of each follows.

5.1 The committed (long-run) shareholder

As noted earlier, the post-Enron period has been marked by greater calls for “relational” or committed shareholdings whereby voice complements exit

¹⁹ Overall, the verdict on block-holding seems mixed. Share value appears to increase with insider concentrated ownership, though liquidity may fall (Becht et al 2003 p.63). Some commentators have argued that the advantages of concentrated holdings for performance are industry-specific (Carlin and Mayer pp.193, 218) and the effects may also be non-linear.

²⁰ Indeed, even rating agency Moody's has argued that private equity horizons are shorter than public companies (*Financial Times*, 9 July 2007).

²¹ Far from being resolved, the problem of short-termism is arguably increasing in importance in Anglo American economies, as suggested in recent comments and reports by the president of the UK employers' organisation (CBI) and two US business groups: the Aspen group and the Donaldson group. See various issues of the *Financial Times* dated June 18; June 27 and additional comments in Stefan Stern's column, FT March 28 2007.

in the governance of firms. One idea is for a small number of block shareholdings to constitute up to a third of the share value, thus “holding managers feet to the fire” (Elson 2007; see also Black 1997).

It is, however, important not to equate block-holding with long-term pro-active investment strategies. At present these tend to be the preserve of individual contrarian investors, a small number of pension funds that emulate them, and possibly some sovereign funds. Proposals for extending the set of committed investors nearly always imply a reorientation of institutional investors towards long-term commitment and involvement. Tylecote *et al.* (2002) identify different current modes of institutional investor activity including (i) passive and opportunistic trading and (ii) active involvement which may be pro-active or reactive (reversing the fortunes of a failing company where selling shares is difficult)²². The proactive mode takes “a view of personnel and strategy long before outsiders are in a position to do so and acts accordingly”.

The case for proactive institutional involvement has been made by Hawley and Williams (2000, 2005), Aglietta and Rebérioux (2005) and Aglietta (2007). The argument is that pension funds and other institutional investors have two distinct characteristics. The size of their holdings makes exit difficult while simultaneously internalising externalities that smaller holdings could avoid. Put differently because they are “owners of small parts of global capital” they have a need to “induce efficiency in the real economy” (Aglietta 2007 p.14). In the UK active institutional investment has been cautiously encouraged in a series of government reports (Myners 2001; see also Aguilera *et al.* 2006, Mallin *et al.* 2005).

There is as yet, no convincing evidence that activism by institutional investors such as pension funds seem to make a difference either to the economy or to private investors. Arguably the former failure is because a small part of global capital is not large enough to internalise externalities. And perhaps both failures are an indication that these funds themselves are poorly governed (Becht *et al.* 2003 pp.64,69); indeed institutional investors are usually left outside the scope of corporate governance codes (Hertig 2005 p.273). Furthermore, they often farm out the management of their funds to agents with short-term incentives so that any specific advantage of concentrated holdings would not always be expected to occur. It should not be forgotten either that it was the rise of the institutional investor that sparked concern with short-termism in the UK in the 1980s (Walker 1985),

²² More accurately, these authors suggest three separate modes including a distinct one where investors deal on the basis of fundamental analysis holding significant shares, but in large firms, so they are protected from lock-in; they do not seek control but simply to benefit from their superior information and analysis. The reactive active investor may have begun in this way but then left it too late to exit. An emergent fourth mode is also suggested with more briefing for institutional investors but with the latter still able to trade given that the information can be argued to be public, or where the analysis and trading functions of the investor unit are isolated from each other.

nor that they pioneered stock-option incentives in the US. Furthermore, the average holding period for US institutional funds is only ten months (Christenson *et al.* 2008).

The “committed investor” reform therefore involves a complete transformation of institutional routines of decisionmaking. It is probably correct that any serious role for active institutional investors would have to be legislated for, given that an individual activist bears costs for gains that cannot be fully appropriated (Monks and Sykes 2002).

5.2 The trustee manager

This representative agent is concerned to implement a form of managerial capitalism. Managerial capitalism is often seen as a bench-mark for long-run strategy. Alfred Chandler’s historical work cited earlier was later built on by scholars of the “resource based” theory of management strategy, to pursue the argument that capabilities matter. These capabilities built up over many years are distinct and non-reproducible and as such confer power and effectiveness on firms that markets (or collections of less integrated firms) cannot replicate. The matching of these inherited characteristics (intellectual property and its protection; complementary assets; brands and marketing strength; managerial routines; control of materials; reputation; and global reach) to the current environment becomes the object of strategy, so that strategy and structure co-evolve²³. Because of its inherited capabilities, the firm is valued more than the sum of its assets, and it is hard to value how much the firm’s intangibles are worth. Managers, however have tacit knowledge that is neither codifiable nor fully communicable. A shareholder-oriented approach is thus unreliable and is likely to neglect valid opportunities that are known but not credibly signalled by managers. Giving power and autonomy to managers is a controversial alternative that needs an understanding of managerial motivation (Hertig 2005, Crouch 2006). The trustee manager model has been made increasingly problematic, however, as a slimmed-down layer of senior executives have effectively relinquished autonomy over decision-making in exchange for a remuneration system biased in their favour.

5.3 choosing between the long term investor and the trustee manager

To what extent does the theory of governance for the long run, discussed in section 3 permit us to discriminate between the merits of the committed

²³ Chandler’s account, while more descriptive than theoretical, has now been developed and adopted as mainstream in business strategy education. See, for example, Nelson and Winter (1982); Kay (1995); Hodgson (1998); Teece (2006). Williamson (1999, p.1094) characterises the “competence” perspective as fire-fighting trial and error rather than strategy but this seems a misrepresentation. Big bets and shaping strategies are part of the toolkit in this approach.

investor and trustee manager models? The discussion here is analysed through the lens of forward commitments and ordered under two sets of familiar topics, discussed earlier.

i) Risk and Information

Risk and information considerations were treated as interacting elements in the adaptation view in the discussion of Table 3. Shareholders are argued to be best placed for residual control because managers' wealth is not sufficiently diversified to allow appropriate levels of risk-taking. Against that, stakeholder systems may lower vulnerability to risk due to cooperation and greater internal informational content. Thus, although much of the formal theory of governance suggests that it is insider systems of governance that discourage risk-taking, much of the informal literature argues to the contrary? For example, managerial stakeholding is supported in Lazonick (1992) and O' Sullivan (2000, 2004) because it is said to facilitate innovation:

"...corporate governance must be concerned not only with allocating returns to those participants in the enterprise who are engaged in cumulative learning, but also with ensuring that, in the form of committed finance, control over returns devolves to strategic decision makers who are and remain integrated into the processes of organizational learning." (Lazonick 1992 p.41, our emphasis).

A similar case for the manager, as steward or trustee, has been made by proponents of the resource view of management such as Kay and Silberston (1995)²⁴. What these accounts bring to the table is a characterisation of the firm as a repository of knowledge, both technical and strategic, which is not always codifiable or communicable beyond an inside group of involved agents.

Much of the discussion of "good governance" thinks that this knowledge is codifiable in the sense of being transmitted easily to the Board, or used as a basis for monitoring by the Board in its discussions of strategy. It is often supposed that by having independent or non-executive directors on the board, monitoring will help align incentives. But this leaves out of account the quality of the information that board members receive. While information deficiency is sometimes overstated e.g. the claim that intangibles are not represented in stock-market values (see Hall 1993, Tidd *et al.* 1996, Smit and Trigeorgis 2004) it is nevertheless correct that intangibles and options tend to be measured with a large margin of error. An important research question is whether information deficiencies create an advantage for the "trustee manager" model over the "committed investor" in respect of risk-taking and decisionmaking.

²⁴ In the approach of Kay and Silberston (1995), CEOs would be appointed for a four year period with total salary fixed in advance. As observed by Conyon and Peck (1998) the autonomy of the CEO would thus be greatly enhanced as hostile takeover would no longer result in a change in executive management.

To some extent the information problem between shareholder representatives and managers might be resolved by new forms of social and environmental reporting (Roberts 2001). Furthermore, established managerial techniques such as the Balanced Scorecard (Kaplan and Norton 1996) or the lifecycle track record approach (Madden 2007) can provide orderly information to Board members and monitoring committees, such as the audit committee. Madden argues that short-termism would decrease and boards would compete in professionally monitoring all aspects of management performance if new metrics were developed that were capable of conveying genuine information on long-term value. He suggests that embryonic versions of these metrics are already contained in what security analysts do.

Perhaps so, but even analysts' information is poor compared with that of most corporate strategy units. And while contrarian investors can perhaps afford to play a close monitoring game, the (private) advantage of this would be diluted if it became general. Metrics may be useful if board members (especially institutional ones) have the aptitude and inclination to study metrics but it should be understood how much of a revolutionary change this would be in terms of time and commitment. Expert advice may be adequate for ex-post monitoring but it hardly squares with a role for *strategic* initiatives and forward planning (Donaldson 1997)²⁵.

It should also be borne in mind what the likely effect would be on executive management of control through targets and metrics. The implications of this are captured in the study by Roberts *et al.* (2006) on the routines followed by executives in preparing for Board meetings. The executives:

"...come to transform themselves, their understanding and their actions in the images of the investor's desires...Autonomy is realised not against but through meeting the demand for shareholder value" (Roberts *et al.* 2006, p.287).²⁶

Thus, the "committed investor" model, even if could be established through legislation, would probably reduce managerial autonomy and have perverse effects on performance given the information gaps noted earlier.

(ii)incentives for forward commitment

In sections 3 and 4 it was suggested that short-termism was an inevitable product of the demand for liquidity that is part of shareholder orientation. This claim is often offset against the charge that stakeholder capitalism squanders resources for potential development due to rent seeking.

²⁵ It is not always recognised, even among economists, how far from the text-book model is the process of estimating the cost of capital and of planning investment and other forward commitments under uncertainty. See for example the critiques of capital budgeting in Jagannathan and Meier (2002) and the discrepancy between realized and theoretical outcomes (Driver *et al.* 2005).

²⁶ Perhaps this is one answer to "the problem of corporate governance" advanced by Lanonick (1992) as to why today's managers lack "necessary incentive and ability" (p.32).

In consequence, the market is starved of new resources that could be channelled to emergent start ups. There does seem to be some support for the overinvestment hypothesis for the US primary manufacturing sector (petrol refining and heavy metals) in the period before the hostile takeover boom of the 1980s. This sector experienced a subsequent sharp increase in capacity utilisation that may have indicated inefficiencies in production and rent-seeking (Driver and Shepherd 2005). Despite this, it does not appear that investment hurdle rates generally were kept low simply because of market power (Poterba and Summers 1995; Driver and Temple 2007). Thus, the evidence that managerial capitalism involves unacceptable levels of rent-seeking is at best unproven.

To judge the extent to which capital allocation should be internal or external goes to the heart of corporate governance debate. The “pledgeable income” argument discussed in section 3 argued that shareholder control would facilitate finance. Against that it can be argued that financial allocation does not need to be done through a market in funds but can be managed internally. Roberts (2004) notes that UK firms have tended to become more diversified in recent years and that this does not appear to represent empire building. Other work suggests that hurdle rates below the cost of capital are no more likely for divisions within diversified companies as in free-standing ones, suggesting that cross-subsidisation, where it occurs, is not due to rent-seeking (Chevalier 2004)²⁷. There is thus little reason to favour external over internal transfer of resources. Indeed, internal reallocation, in the trustee manager mode, has the added benefits of internalising externalities and avoiding at least some transactions costs.

6 Conclusions

All systems of governance are likely to be flawed in some respect. Governance implies that non-market forms of coordination are pressed into action to replace market forms that have failed (Williamson 1999). And, as Gibbons (1999) puts it “Why should firms be oblivious to conditions that wreck markets?”(p.145). Any governance solution is likely to be best second-best and there will be trade-offs between them (Carlin and Mayer 2003).

In this paper we have surveyed mechanisms by which governance might affect both current performance and forward commitments. The theory of the firm as currently expounded does not offer clear guidance on these issues. The most difficult issue to resolve when comparing forms of governance is what can or can not be taken as constant when comparing

²⁷ See also conflicting claims on rent-seeking and empire benefits in Hennessy and Levy (2002) and Aggarwal and Samwick (2006).

the systems. We therefore argued for a research programme on the dynamic effects of changes in governance form.

When comparing the effects of governance systems on forward commitments, we found two useful ways of understanding the arguments for a stakeholder or shareholder perspective. First, adaptation theory, introduced by Simon over half a century ago, asks where power should lie in a Rawlsian perspective? Second, the idea that governance influences the time-horizon for decisionmaking has underpinned much of the comment. In our review of recent US governance reforms we showed how they left untouched the problem of short-termism, which is a consequence of investors need for liquidity and imperfect signalling by management.

If the traditional shareholder orientation is problematic, is it best reformed by more voice for institutional committed shareholders? The difficulties with this, highlighted in our discussion on risk in section 5, is the quality of information. While some theories show that shareholder orientation is best for risk-taking, the deterioration in information quality that accompanies a locus of power from insiders to outsiders may degrade the decision-making process. The information deficit of non-executive investors or board members is a formidable objection to reforms aimed at better governance though committed investment. The model of the "committed investor" thus seems to require two conditions that are currently lacking: non-opportunistic behaviour by fund boards – which, given the free-rider problem may need to be legislated for – and codifiable strategic information.

The alternative reform – regression to managerial capitalism – is subject to separate critiques. Even if it were established that the appetite for forward commitments is enhanced in this mode, there remains the problem of opportunism that may have been increased by the recent focus on pecuniary incentives, targets, and executive tenure (Roberts 2001). Arguably, the extent of managerial opportunism is an *outcome* of processes and practices of accountability within the organisation that then influences the climate of trust or distrust that prevails. This again raises the question of what is held constant as the form of governance changes.

It may be that a restoration of responsible managerial autonomy may best be achieved by supporting an increased monitoring role for investors as an ex-post process (Krafft and Ravix 2005). Information is easier to assess in retrospect; managers could be judged on the basis of a broad analysis of historical performance. Perhaps, this retrospective review process might create as a by-product a greater respect for the role of executive managers as creative strategists, thus reinforcing anew a tradition of the trustee manager. This could be allied with other reforms to enhance the value of managerial reputation and to protect weaker stakeholders from arbitrary power, though the process is not simple (Kreps 1990). Arguably the process would require a reversal in the concentration of executive management power in a top hierarchy and a radical spreading of power downward in the organisation.

While it is tempting to conclude that governance reform can thus take the best from both the system of “committed investor” and “trustee manager”, this may turn out to be a mirage. Some aspects of the former model – such as short term arbitrary targets linked to high-level pecuniary incentives – are seriously inimical to a creation of trust and autonomy. Only if institutional voice is restricted to ex-post monitoring offering a retrospective view over a reasonable time span is there likely to be a possible synthesis.

Finally it may be of interest to finish this complex discussion with a short list of research questions.

First, in contrasting the role of governance for current performance and forward commitments, which role is more important? And is there a trade-off?

Second, which aspects of behaviour tend to hold constant when governance forms change? And which are most subject to change?

Third, and related to the second, of the many reasons why different parties are best placed to exercise residual control rights in an adaptation perspective, which ones matter most?

Fourth, how much are hurdle rates for forward commitments (tangible or intangible) biased by governance orientation?

Fifth, What is new theoretically, and what is unchanged, about referring the level of governance up one level to governance of the institutional investors themselves?

Sixth, what variation is currently observed in managerial autonomy? In what pockets of the economy has it survived best and why?

Seventh, and related to the sixth, how much of the firm’s strategic assets, position, and plans are codifiable in the sense of being packaged as metrics or forecasts?

If, at the end of this paper, the rationale for these questions are clearer than at the outset, it will have served its purpose.

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APPENDIX 1

A simple model of the firm is proposed in Tirole (2001). If the manager foregoes private benefits B , revenue R is generated with probability p_h and revenue 0 with probability $(1 - p_h)$. Similarly, the manager receives formal compensation w in the case of success (probability p_h) and zero for failure. Managers who decide to receive private benefits B , generate R (and receive w) with a lower probability of p_l . Since the manager trades off the loss of private benefit B with the differential probability times w , it must be the case that $w > B/(p_h - p_l)$ to provide incentives for managers. It follows that the maximum amount of available surplus (pledgeable income) is $p_h(R - B/(p_h - p_l))$ which must be greater than the cost of the project if the enterprise is raising all the capital. Under direct monitoring at cost c the private benefits are reduced to b and so the pledgeable income becomes $p_h(R - b/(p_h - p_l)) - c$. The result is that some positive NPV projects may not be funded, though that is less likely with low monitoring costs.

An interesting elaboration then follows that allows managers to take profit enhancing actions that increases the probability of success by a flat increment τ for both the low probability regime and the high probability regime so that $(p_h - p_l)$ is unaffected. Assume that the profit enhancing action (e.g. firing workers) is indeed welfare *reducing* with the private cost for the entrepreneur/other insiders higher than the gain in profits. If the entrepreneur retains control, the profit enhancing action is not taken and the pledgeable income remains constant at $p_h(R - B/(p_h - p_l))$. With relinquished control, the new pledgeable income is now $(p_h + \tau)(R - B/(p_h - p_l))$ which is bigger than before. This provides a potential argument for control rights to rest with the provider of finance, even though the result of the action is welfare reducing. Indeed, Tirole writes that this reasoning “provides us with a first argument in favour of shareholder value” (p.16).