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From minimization to exploitation: re-conceptualizing the corporate governance problem

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Abstract: Over the past three decades, the topic of corporate governance has become an increasingly high profile aspect of social-scientific scholarship, both in the Anglo-Saxon world and continental Europe. To a significant extent, however, the conceptual boundaries of the corporate governance debate have been set narrowly in accordance with the logic and language of the dominant 'agency' paradigm of governance. According to agency theory, the central 'problem' of corporate governance is the question of how to minimize the (harmful) consequences of the separation of ownership and control within public companies first identified by Berle and Means (1932), by reference to competitive market pressures coupled with market-based incentive and disciplinary mechanisms. In this article, we present an alternative interpretation of the corporate governance 'problem' premised on the logic and language of institution rather than the market, which we argue is both more empirically relevant and conceptually defensible than the dominant agency paradigm. To this end, we rely on existing (US) corporate law doctrine in conjunction with recent developments in the economic theory of the firm. According to the proposed 'institutional' model of corporate governance, the central governance 'problem' is that of how to exploit, rather than minimize, the (beneficial) consequences of the separation of ownership and control, so as to engender the development of a more dynamic and sustainable system of governance than that emanating from the free interplay of (stock) market forces.

Key words: corporate governance; Berle & Means; agency theory; stock market efficiency; private equity; team production.

Introduction

As an area of social science, the topic known as 'corporate governance' is principally an enquiry into the causes and consequences of the allocation of *power* within large economic organizations. This endeavor can be regarded as socially important for two overarching reasons. First, in the course of their normal productive and administrative operations, economically significant business firms tend to produce a large quantity of norms and rules that affect their socio-economic environment. The informal assumption by corporations of such a quasi-regulatory function means that they acquire the status of intermediate actors situated between the two basic components of a liberal politico-economic system: the State and individuals. And, secondly, business firms are a peculiar institutional feature of a liberal political economy due to the further fact that they entail the limited usurpation of the basic principle of formal equality before the law. This is on account of the phenomenon of 'internal' power[1] within bureaucratic capitalistic organizations, as underpinned by the basic concept of employee subordination that remains intrinsic to the labour relation within both the Anglo-Saxon common law and the European continental civil law worlds (see Fox, 1974).

Although the term 'corporate governance' literally applies to any incorporated entity, corporate governance scholars tend to be primarily concerned with 'public' or listed corporate entities, whose securities are traded on regulated liquid investment markets and which, in consequence, exhibit the institutional characteristic known popularly as 'the separation of ownership and control'. Berle and Means (1932) were first to portray how the growing importance of listed companies leads to a concentration of quasi-governmental decision-making power within firms, as disparate securities holders sacrifice powers of direct control over professional (non-proprietary) managers in favour of gaining the practical benefits of liquidity. The separation of ownership and control has since become the focus for company law and corporate governance debates within the Anglo-Saxon world for the past seven decades.

In this article, we highlight the fact that, as a positive statement, the separation of ownership and control invites competing normative analyses. In particular, whereas standard economic logic advocates shareholder primacy and supports measures aimed at *minimizing* this separation – either through competitive (stock) market pressures or through effective 're-entrepreneurialization' of the firm *via* transition to private equity control – the managerialist viewpoint associated with Berle and Means contrarily proposes to *exploit* this separation in order to draw out the inherently public dimension to modern corporate capitalism. It has often been argued that Berle and Means, in reaching this normative conclusion, ignored some basic elements of theoretical economics (see Tsuk Mitchell, 2005, p.209). We argue on the contrary that recent empirical developments (e.g. high-profile corporate scandals such as Enron and the 2008 international banking crises) as well as evolutions in theoretical economics tend to weaken the validity of the standard economic doctrine of shareholder primacy, whilst at the same time providing fresh support to Berle and Means' original position.

The separation of ownership and control

In 1932, Adolf Berle and Gardner Means published what was to become one of the most influential and inspirational social-scientific works of the twentieth century. *The Modern Corporation and Private Property* was concerned with the then growing economic and political phenomenon known as the widely-held or 'public' company. Unlike smaller closely held or 'private' companies, these larger companies were capitalised by the investment of finances from the private wealth of members of the public at large. The extraordinary nature and potential of the public company resided in the fact that, theoretically at least, it exhibited a complete 'separation of ownership and control'. The controlling managers of such organisations in many cases held a small or even negligible ownership stake in the firm. Accordingly, they derived the main component of their income not from returns on company shares but rather from a fixed salary in essentially the same vein as any other officer or employee of the company. The ownership of these firms, meanwhile, was increasingly becoming vested in a multitude of small-scale individual investors, lacking both the resources and also the incentive to undertake effective control over the use to which management put their economic investment in the firm. On this basis, Berle and Means argued that "[t]he separation of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge, and where many of the checks which formerly operated to limit the use of power disappeared" (1932, p. 7). Berle and Means described corporate managers as "economic autocrats", whose ability in effect to perpetuate their own existence had promoted them to the position of "the new princes", assuming unchecked control over their "economic empires" (1932, p. 116).

Furthermore, as Galbraith (1973) later noted, even to the limited extent that any shareholder was sufficiently disposed to intervene from time to time in the operational affairs of the companies in which they were invested, any action that they took or demands that they made in this regard were inherently irrational, given the inability of these 'outsiders' to acquire sufficient expertise to be able to pass informed judgment on the merits of managers' strategic decisions. Not only were shareholders physically detached from the day-to-day affairs of the business, but they were also excluded from what Galbraith termed the corporate "technostructure": the collective body of corporate officers (including senior managers themselves) who command exclusive strategic control over the extensive base of scientific skills and expertise underpinning the firm's ongoing productive operations. Galbraith believed that, in the modern corporate economy, where operations were increasingly technical and specialised in nature, the real power within the large company rested with those that possessed the relevant *knowledge*, rather than the wealth, that comprised the business, thereby excluding shareholders from the realm of effective corporate control.

The shareholder primacy principle: how to minimize the separation

The agency perspective

The standard reaction to the aforementioned separation is to favour continuity between the ancient and the new economic orders, by advocating shareholder primacy: shareholders, because they provide financial capital without guarantee, should be the ultimate beneficiary of corporate conduct. From the end of the 1960s the contractarian theory of the firm, which considers the corporation as a self-determinative 'nexus of contracts' linking together various individual input-providers, has provided the doctrine of shareholder primacy with strong analytical support (Jensen & Meckling, 1976; Easterbrook & Fischel, 1991).[2]

The rejection of the concept of ownership, as applied to the business firm, is a standard assumption of this contractarian approach in law and economics (see, e.g., Fama, 1980). This rejection is bound to a vision of the firm as a nexus of contracts. By definition, one cannot possess a contract (or contracts) as one can possess a standard asset. The idea of shareholders as owners of the company is therefore replaced by the notion of an 'agency' relationship constituted in the shareholder's exclusive favour. Managers are considered to be the 'agents' of the shareholders, who are the 'principals': in other words, the managerial team has been 'hired' by the shareholders to best serve their interests.

Shareholders are therefore not depicted as owners, but rather as 'principals'. The implications, as far as corporate governance is concerned, are basically the same: managers and directors should be accountable solely to shareholders. However, asymmetric information coupled with opportunism leads corporate executives to serve their own interests at shareholders' expense, which in turn gives rise to 'agency costs'. Various incentive and disciplinary mechanisms are then considered to help minimize the occurrence of agency costs, by aligning corporate insiders' (managers') interests with those of shareholders. These mechanisms generally fall into two main categories, which each attempt to solve the same basic governance problem but by taking fundamentally opposite approaches from one another. These two categories are, namely, (a) competitive markets; and (b) private equity. Each will now be considered in turn.

The role of competitive markets

Having identified the separation of ownership and control, and the resultant problem of managerial hegemony, Berle and Means (1932) believed that the solution to this problem was to use formal legal constraints as a means of controlling managers' decision-making power. In this regard, Berle and Means' views were to become a dominant strand in the subsequent thinking of many 20th century corporate lawyers. It has been forcefully argued, however, that by focusing exclusively on corporate law mechanisms as a perceived solution to the accountability deficit posed by the separation of ownership and control, Berle and Means ignored economic theory and the potential for re-invigoration of the competitive market as an effective managerial constraint.[3] One such notable critic of Berle and Means' disregard for the role of the market in corporate governance was Alchian (1969), who warned that "ignoring or denying the forces of open competitive market capitalization is…a fundamental error in the writing about ownership and control and about the modern corporate economy" (ed. 1974, p. 136).

A distinctive feature of the aforementioned 'agency' theory of corporate governance, in consequence, is its contrary emphasis on the role of competitive markets in solving the economic distortions which stem from the separation of ownership and control. According to agency theory, competitive market forces are capable of aligning the dual interests of managerial 'insiders' and shareholder 'outsiders' whilst, simultaneously, preserving the specialization of risk-bearing and entrepreneurial functions associated with the modern corporate form (Easterbrook & Fischel, 1991). The most obvious forms of market pressure acting on corporate managers at any point in time are competition on price and quality in the firm's primary market for goods and services, and also competition from potential substitutes on the managerial labour market (Fama, 1980).

According to agency theorists, though, the most powerful discipline over management stems not from those markets, but, rather, from the market for the financial stock of companies themselves (Alchian, 1969). Indeed, a liquid stock market is not only valuable as a medium through which firms must compete with one another to raise equity capital at low cost, but, more significantly, it is also a necessary prelude to the effective functioning of the market for corporate control and the associated disciplinary device of the hostile takeover (Manne, 1965). At the same time, managers' interests can be theoretically aligned with those of shareholders on an *ex ante* basis through the use of incentive-remuneration devices such as executive stock options.

Clearly, then, the doctrine of shareholder primacy relies for its effective realisation upon the functioning of a liquid and efficient stock market. It is at this point, though, that the agency perspective encounters a potential paradox. Within the contractarian theory of the firm, shareholders' exclusive entitlement to the company's residual wealth is ultimately justified on the basis of their unique capacity for diversification. This is made possible by the liquidity of their market equity investment and resultant detachment from micro-level governance of any particular firm(s). In turn, it is argued, shareholders are likely to support risky but potentially value-enhancing investment strategies, given their relatively low exposure to loss from individual firm failure. This is in contrast to other corporate participants such as employees, who are said to be 'over-invested' in any individual firm and thus incapable of bearing entrepreneurial risk at a socially efficient level (on this, see Kelly & Parkinson, 2000, pp. 114 – 119).

However, the fact that shareholder primacy is premised on the notion of supervisory *detachment* or *passivity* means that contractarianism must consequently provide an alternative explanation for how firm-specific information impacts on investor choices in the absence of any direct proprietary monitoring process. For this purpose, contractarianism relies heavily on the assumption that corporate share prices *in themselves* provide a credible and comprehensive reflection of the information that is relevant to the income-generating potential of any particular corporate investment. Or, at the very least, it assumes that prevailing prices will reflect all of the information that is currently *publicly* available in relation to any company, as stated by the semi-strong version of the efficient capital markets hypothesis (ECMH) in finance theory (Fama, 1970; Stout, 2003). However, this assertion is inherently circular absent any more thoroughgoing enquiry into the actual capital market pressures and institutions that effect the continuing production, dissemination and incorporation of information into securities prices.

From a more empirical or institutional point of view, contractarianism's underpinning doctrine of 'passive shareholder primacy' is therefore necessarily reliant for its effective realisation upon the existence of legal and other institutional mechanisms that enable the continual publication of credible information on firm performance for the benefit of investors. This ensures that relevant information is made accessible to distant investors. Moreover, those investors must be sufficiently rational so as to process this information effectively in making securities selection choices. Within a complete market-based corporate governance system, reliable information on the firm is obtained primarily through external 'gatekeepers', most notably financial auditors, securities analysts and ratings agencies. These gatekeepers are vested with the responsibility of verifying the honesty and relevance of financial information disclosed by the company's accounting reports, thereby reducing informational asymmetries between investors and insiders (agents in the company) so as to ensure the proper working of financial markets. On the basis of this information, investors (shareholders) buy and sell securities, thus generating stock price movements, which in turn trigger either or all of the above market-disciplinary mechanisms.

Moreover, once the relevance of stock prices is established, an important role is devoted to the board of directors. According to agency theory, the board should act as a supervisory panel situated between the shareholders' General Meeting and management team, thus providing an 'internal' point of surveillance over managers in the absence of direct shareholder monitoring. In particular, the board should make sure that corporate insiders act according to stock market signals (Gordon, 2007). Insofar as this primary monitoring function of the board is concerned, the most important quality required of directors is their independence, in the sense of the absence of any conflicts of interest on their part or other potential for collusion with management.[4] Board independence was first advocated at the beginning of the 1980s by activist shareholders in the United States. Across many national jurisdictions today, the presence of at least some independent directors on public company boards is now a standard expectation by virtue of corporate laws and/or stock market regulations. As a result board independence is now the "conventional wisdom" (Bhagat & Black, 1999), a view which is supported by the contractarian idea that directors are ultimately disciplined by the market for their specialist supervisory services, "which prices them according to their performance as referees" (Fama, 1980, p. 294).

Thus, even in the absence of a mandatory state-imposed system of corporate disclosure regulation, efficient market-induced mechanisms are likely to evolve so as to ensure that: (a) relevant information is inculcated rapidly into corporate securities prices; and (b) managers in turn respond quickly to stock market signals in a manner conducive to the continuing advancement of the general shareholder interest. Not only are these mechanisms believed to represent an adequate substitute for direct one-on-one supervision by investors of individual firms, but they moreover enhance the quality of corporate governance by substituting the cumulative allocative decisions of the capital market for the necessarily limited supervisory competences of the individual investor (Easterbrook & Fischel, 1991). It is accordingly through the above course of logic that the contractarian model of the corporation succeeds in establishing that shareholder passivity is to a significant extent compatible with an informationally efficient corporate securities market, in spite of the typically limited degree of direct communication that takes place between the financial-investment and corporate-managerial communities respectively on a day-to-day basis.

Weaknesses in the market-based model of corporate governance

Over recent years a number of empirical factors have conspired to undermine public and academic confidence in the reliability and efficacy of market-based mechanisms of corporate governance. First, there have been a series of well-publicised corporate scandals such as the Enron and Worldcom collapses at the turn of the 21st century (see Aglietta & Rebérioux, 2005; Armour & McCahery, 2006; Bratton, 2002; Deakin & Konzelmann, 2004) and, more recently, the sub-prime mortgage crisis (see Langley, 2008) and ensuing implosion of major Anglo-American financial institutions such as Bear Sterns, Lehman Brothers, AIG and Northern Rock. Such high profile episodes have together served to undermine the perceived ability of informational gatekeepers to ensure the effective functioning of stock market-based managerial monitoring devices: the former catastrophes in respect mainly of auditors and securities analysts, and the latter in regard to ratings agencies.

Secondly, a number of questions have been raised as to the effectiveness of independent directors, especially in the wake of the above scandals. Empirical (econometric) evidence has cast doubt on the proposition that independent directors are prone to occasion improvements in firm performance (as measured by stock market value or productivity)[5]. Numerous explanations have been put forward to account for this disappointing result. In particular, it has been widely suggested that independent directors have a cognitive disadvantage in relation to non-independent board members, insofar as the former group lack relevant firm-specific knowledge. This disadvantage, in turn, is likely to impede the ability of independent directors to supervise corporate actors in those instances where market signals alone are insufficient as a means of gauging corporate performance (Baysinger & Hoskisson, 1990, p.74; Hillman & Dalziel, 2003 ; Osterloh & Frey, 2006).

Thirdly, the increased dependence of both US and European companies on intangible assets such as trust-based employment practices and internal 'know-how' sources highlights a further weakness in agency theory's market-based model of control[6]. By definition, intangible assets are non-physical (in that they lack any 'hard' material existence), non-financial (in that they do not provide any legally-constituted revenue streams), and promise uncertain future benefits. Further, knowledge-based intangibles involve strong complementarities (see, e.g., Antonelli, 2001; OECD, 2006). Complementarities occur when the combination of two different resources (or inputs) yields a greater overall output than the sum of the respective outputs resulting from the separate use of these inputs individually[7]. This means that, for a given resource, the value of individual contribution (the cash flows directly attributable to it) is impossible to deduce from the observation of the joint output. On the (standard) assumption that the market value of a resource equals the properly discounted sum of its expected cash flows, then complementarities can be said to impede the emergence of any reliable market value for that asset. For this reason, intangibles typically do not have any readily identifiable market value, rendering them impossible to price on an objective 'arm's length' basis.

More generally, every productive process involving complementarities between resources raises specific problems of separability, measurement and marketability. This point was emphatically recognized in the seminal paper by Alchian and Demsetz (1972), with particular reference to the case of human resources. Alchian and Demsetz explained how "team production" occurs whenever overall output is greater than the sum of individual worker contributions. In such instances, reliable metering and monitoring of individual contributions cannot be performed on an *ex post* basis (*via* observation of the output) but, rather, only from an *ex ante* perspective (*via* direct observation of the productive process and individual workers' behaviour). This *ex ante* observation obviously implies a particular position 'inside' the business firm as a going concern and productive entity. For this reason, Alchian and Demsetz suggest having a supervisor within the firm, in the sense of a member of the team who can monitor individual contributions 'from the inside'.

Whenever complementarities occur, the inherent difficulty of evaluating resources from an external perspective also lends credence to Galbraith's famous argument (see part 1, *supra*) that, in complex corporate organisations, the inevitably superior knowledge of the (managerial) 'insiders' places them in a natural position of power *vis-a-vis* the relatively uninformed (shareholder) 'outsiders'. In a nutshell, the ability of outsiders (independent board members, distant shareholders, securities analysts, etc.) to value properly an intangible-driven business model is put into question, thereby undermining the alleged superiority of market-based mechanisms of control.

Overall, the disappointing evidence on the performance of external gatekeepers and independent directors casts doubt on the capacity of market-based mechanisms to ensure the production and public disclosure of reliable information for the benefit of actual and potential financial investors, especially when intangibles are the main driver of value. Further, regardless of the quality of the information set used by investors in assessing relative firm performance and making subsequent securities selection decisions, the ability of the stock market to provide efficient pricing in the sense depicted by the ECMH is open to debate (Stout, 2005). Indeed, the ECMH has been the subject of increasing academic criticism over recent decades, most notably as a result of developments in behavioural finance. If investors habitually operate under conditions of bounded rationality, then the prevailing market prices of corporate securities cannot be relied upon to reflect accurately even that amount of information as is publicly available in relation to any particular firm (Shiller, 2000). Likewise, the capacity of informed professional investors to 'correct' the otherwise irrational activities of speculative 'noise' traders is open to question. Borrowing from the insights of Keynes (1936), writers such as Orléan (1999) and Gilson & Kraakman (2003) have demonstrated that, even where professional investors possess negative information in respect of any particular company, it may still be individually rational for such investors to trade 'with the market' where there is growing (irrational) demand for the relevant firm's over-priced securities. Such practices, far from correcting securities mis-pricing, serve only to exacerbate the formation of speculative bubbles in stock markets, resulting in the breakdown of the share price mechanism as an effective managerial disciplinary mechanism. The dot.com and international banking crises at, respectively, the beginning and end of the 2000s arguably serve to confirm this pessimistic diagnosis of the informational efficiency of stock markets.

In summary, the intrinsic limitations on the ability of gatekeepers and independent board members to provide reliable information to the market, as well as the subsequent failure of the market to process this information efficiently, strongly suggests that stock prices may have limited, and also somewhat misleading, informational content. In turn, agency theory's claim as to the alleged superiority of market-based mechanisms for controlling managerial decision-making at the individual firm level can be said to lack empirical and analytical foundations, thus building a negative case for the promotion of non-market, law-driven or firm-specific control devices within mainstream corporate governance scholarship.

In these conditions, moreover, the utility of stock options as a managerial remuneration scheme is unsurprisingly open to debate. An increasingly prominent view is that such devices have served primarily to benefit corporate insiders, in the absence of (or, worse still, to the positive *detriment* of) other corporate participant groups such as employees or even minority shareholders themselves. Not only have stock options been found to enable covert forms of managerial rent extraction by means of back-dated, 'in-the-money' or non-index-linked schemes (see Bebchuk & Fried, 2005; Bechuk, Fried & Walker, 2001), but they have also been regarded as a significant cause of moral hazard in limited liability companies given the absence of balancing 'downside' risks for unscrupulous or reckless executives (see Skeel, 2005; as arguably exemplified by the conduct of listed investment banking firms prefacing the 2008 sub-prime mortgage crisis). Concerning the market for corporate control, meanwhile, the empirical evidence is rather inconclusive: the extensive literature on the effects of takeovers, whilst pointing to the (positive) short-term implications of takeover bids in terms of market value, suggests that those operations do not have, on average, any positive effect on either market value or operating performance over the long run. Indeed, an extensive series of empirical studies actually suggests that takeover bids have an overall *negative* impact in the above respects (see, e.g., Burkart & Panunzi, 2006; Martynova & Renneboog, 2007).

Private equity and leveraged buyouts (LBOs)

Doubts as to the ability of stock market-based mechanisms to ensure proper control over public corporations have led some law and finance scholars to consider an opposite form of governance, namely joint ownership and control by means of private equity (see Jensen, 1989 & 2007; Jensen *et al*, 2006; Baker & Smith, 1998; Shleifer and Vishny, 1990).[8] In its literal sense, the term 'private equity' refers to any investment in the equity of a business where the stake of equity purchased is relatively large and illiquid and hence not easily tradable on a public investment market. The most famous sense in which private equity is known today, however, is in regard to leveraged buyout (or 'LBO') transactions, which typically entail the acquisition of control by one or more specialist financial firms over a formerly listed corporation, by means of intensive recourse to borrowed funds (UK Treasury Committee, 2007). From a corporate governance perspective, LBOs entail directly re-connecting the dual ownership and control dimensions of the (formerly) public corporation, whilst, at the same time, preserving one important benefit of the public corporation: the specialization between risk-bearing and management. However, in a private equity-controlled company, risk bearing does not operate through the dispersion of equity capital (in the form of liquid minority shareholdings) but, contrarily, through the concentration of equity capital in illiquid blocks coupled with the wide dispersion of liquid securitized debt (i.e. bonds) on the public market.

The LBO expanded in popularity and significance throughout the 1980s to become a relatively mainstream practice of US corporate finance and governance (on this, see Baker & Smith, 1998, ch. 1). The initial LBO movement of the 1980s reached its zenith in 1988 following KKR's then-record-breaking $25 billion acquisition of the Atlanta tobacco and foods conglomerate RJR Nabisco (see Burrough & Helyar, 1990), although the ensuing collapse of the market for cheap low-quality debt securities (known as 'junk bonds') prefaced a marked reduction in large-scale buyout activity in the 1990s. However, the first decade of the 21st century witnessed the onset of a larger-scale and more globalised LBO movement, against the background of buoyant equity markets and a (temporary) revival in the international junk bond market (Kaplan, 2007; UK FSA, 2006). Over 2006 and 2007 alone, the world buyout record was broken three times in succession after the respective acquisitions by leading LBO specialists of Hospital Corporation of America (HCA), Equity Office Properties (EOP) and the Texan power generator and distributor TXU for the sums of $33 bn, $39 bn and $45 bn respectively.

Typically, an LBO will be conducted by a specially constituted 'LBO partnership', which will take the legal form of a limited partnership[9]. As such, it will comprise one or more general partners (GPs) together with a relatively small number of limited partners (LPs). The GP will be a specialist private equity (LBO) firm, such as KKR, Blackstone, Texas Pacific Group, CVC Capital or Permira. The LPs will usually be large institutional investors such as public or private sector pension funds, insurance companies, unit trusts or university endowments. As the general partner, the LBO firm will usually have exclusive authority to manage the business of the partnership (i.e. the corporate buyouts) and will also be wholly liable for any debts incurred by the partnership. The limited partners, on the other hand (as their name suggests), are exempt from responsibility for the partnership's debts beyond the extent of their initial investment in its 'buyout fund': this is a pool of equity capital advanced by the various LPs, which will be used to support a number of corporate buyouts over the life of the LBO partnership.

The GP will typically identify a company that has a strong asset base and/or which generates high and stable cash flows, but whose widely-held ownership (and governance) structure gives the incumbent managers inadequate incentives to apply the extra level of effort necessary to maximise value. In any event, the GP will be aware that, if the LBO partnership successfully acquires a controlling stake in the company, it will be in a direct position to take whatever steps it deems necessary in order to improve the operating performance of the business and, in turn, the ultimate value of the firm's equity when it is returned to the public market (or else sold on to another private buyer) following its reorganisation[10].

Once the GP has selected a suitable buyout target, it will then initiate its bid for control of that company. A proportion of the LBO partnership's buyout fund will be allocated as the equity component of the bid finance. This sum will then be 'leveraged' by extensive recourse to bank borrowings. Normally at least 70% of a target company's purchase price will be financed in the form of debt from third parties, with at most only 30% of that figure comprising equity from the buyout fund itself (Froud & Williams, 2007). As collateral for the loan(s), the GP will pledge the assets and/or future cash flows of the target company's business(es), which the lender(s) will subsequently acquire rights of security over in the event that the acquisition of the target is successfully completed. Lending banks will thereafter typically 'spread' their risk exposure amongst the investing public by issuing a large number of liquid asset-backed securities (ASBs) on the international debt markets.

Following successful completion of the LBO, the acquired corporation will typically be de-listed from the relevant public equity market and re-registered as a private company. The typical board of a private equity-controlled company will be relatively small and comprised mainly of representatives of the GP together with, in some cases, representatives of the largest LPs (i.e. the institutional investors to the buyout fund), both of whom will work closely with the firm's management team on an ongoing basis (Jensen *et al*, 2006). In a sense then, the archetypal director in a private equity-controlled company is the exact opposite of the 'independent' board member in a public company, whose inevitable lack of direct connection with the firm arguably reduces his ability to monitor corporate executives robustly. In a private equity-controlled company, meanwhile, board meetings will almost always be presided over by an executive chairman, who will typically be either a senior officer or appointee of the GP itself. The presence of significant proprietary interests on the board theoretically makes for a more motivated and strategically focussed discursive form (Jensen, 2007; Jensen *et al*, 2006). In this way, the decision-making process at board level is redesigned specifically for the purpose of resolving 'internal' strategic problems rather than on ensuring perfunctory 'external' accountability to financial-market actors.

Academic advocates of LBOs argue that such (market-driven) devices are a crucial antidote to the aforementioned 'agency problem' that is endemic to the structure of public corporations. In providing what is arguably the most well known academic justification of LBOs, the financial economist Michael Jensen argued that:

> "By resolving the central weakness of the large public corporation – the conflict between owners and managers over the control and use of corporate resources – these new organizations are making remarkable gains in operating efficiency, employee productivity, and shareholder value." (Jensen, 1989, p.2)

Yet LBOs raise serious concerns that cast doubt on the pretension of private equity to constitute a coherent, alternative model of corporate governance for large business firms.

First, there is the significant concentration of power that private equity governance necessarily entails (UK Treasury Committee, 2007). Although the same charge of concentrated power could be levelled at the hegemonic managerialist corporation, the fact that residual 'ownership' rights in public companies are spread amongst a multitude of minority shareholders vests the process of public company governance with a formally (if not substantively) pluralist character. In contrast, within private equity-controlled companies there occurs an amalgamation of both managerial and proprietary governance rights. Whilst rendering corporate decision-making more akin to orthodox entrepreneurial activity in terms of its underlying proprietary motivation, such a re-alignment of ownership and control nevertheless threatens the basic notion of 'checks and balances' that lies at the heart of a liberal democratic political economy by engendering a uniquely autonomous form of decision-making power in respect of large-scale corporate organisations.[11] If corporate governance is concerned primarily with the proper way to mitigate the concentration of power within public (widely-held) companies, it may well be the case that, as a medicine to cure this concentration, LBOs are often worst that the putative disease.

Secondly, there is the issue of private equity's lack of transparency, at least in relation to the alternative option of public company governance. By virtue of their de-listed status, private equity-controlled firms are exempt from the standard public company practice of preparing statutory accounts and reports, together with quarterly earnings reports, for the benefit of (current and potential) investors and the general public. This has bred concern as to a possible 'accountability deficit' within the private equity sector, whereby the activities of firms with high socio-economic impact can be effectively 'veiled' from public inspection simply by means of removing their securities from the investment marketplace (Thornton, 2007; Walker Working Group, 2007; UK Treasury Committee, 2007). In particular, worker unions worry about the implications of LBO operations in terms of employee security and welfare, such as where the UK motor services firm AA reportedly saw approximately one-third of its workforce made redundant as part of a wide-scale restructuring drive initiated following the company's acquisition in 2004 by Permira and CVC Capital (Lemkin, 2007; Thornton, 2007).

Finally, the fact that LBOs are by definition heavily dependent on debt 'leverage' renders their continuing operation and success contingent to a significant extent on the maintenance of favourable macro-conditions and, in particular, the preservation of low interest rates (Cheffins & Armour, 2007; UK FSA, 2006). It is therefore unsurprising to witness a sharp contraction in large-scale public-to-private LBO activity as a result of the recent sub-prime mortgage crisis and ensuing 'credit crunch' on the international debt markets.

Summary

In this part we have critically assessed two distinctive modes of governance for large business firms, which enable them to raise funds on a significant scale from the investing public. These two modes are clearly contrasting as to the role played by competitive (stock) markets in the control of firms, but they share one common attribute: shareholder sovereignty. In the next part, we consider an alternative mode of governance, grounded on the normative perspective envisaged by Berle and Means (1932).

The institutional nature of the public company: how to *exploit* the separation

Berle and Means' new corporate order

The final Book (IV) of Berle and Means' *Modern Corporation* begins with the following passage:

> "The shifting relationships of property and enterprise in American industry…raise in sharp relief certain legal, economic, and social questions which must now be squarely faced. Of these the greatest is the question in whose interests should the great quasi-public corporations…be operated." (Berle and Means, 1932, p. 294)

Berle and Means (1932) identified two alternative answers to this question, corresponding to two different doctrines: on the one hand, the doctrine of managerial sovereignty; and, on the other, that of shareholder sovereignty. The managerial sovereignty doctrine recognizes the concentration of power in the hands of managers, observing that it is the result of a strictly contractual process: the shareholders have accepted loss of control over the company in exchange for greater liquidity (Berle & Means, 1932, p. 251). Consequently, the shareholders can no longer legitimately demand control over the company, so that ultimate power of direction over the firm rests with managers. Berle and Means (1932) expressed concern about this approach on the basis that it gives almost dictatorial power to the managers, whom they described as "the new princes" (see *supra*). This concentration of power, we have argued, also raises serious concerns as to the attractiveness of private equity governance by LBO partnerships, albeit for somewhat different reasons (on which, see *supra*).

Although Berle and Means regarded the shareholder sovereignty doctrine to be a better (or, at the very least, *a less worse*) solution, they were not especially enthused by it either, on the basis that it refuses to acknowledge the trade-off between control and liquidity. In addition, they cast doubt on the possibility that distant and passive owners might be capable of exercising a sufficient degree of control over hegemonic managers. As Tsuk Mitchell (2005, p.188) notes: "Berle and Means feared that such rules would have 'the bulk of American industry operated by trustees for the sole benefit of inactive and irresponsible security owners.'"

Berle and Means' position concerning the accountability of corporate managers is briefly presented in the very last chapter. This chapter begins with a long quotation from Rathenau, industrialist, statesman in the Weimar Republic and social theorist, describing the German conception of the public limited company in the following terms: "The depersonalization of ownership, the objectification of enterprise, the detachment of property from possessor, leads to a point where the enterprise becomes transformed into an institution which resembles the state in character" (Berle & Means, 1932, p. 309). Likewise, in the new introduction to the 1967 edition of the *Modern Corporation and Private Property*, Berle wrote: "There is an increasingly recognition of the fact that collective operations, and those predominantly conducted by large corporations, are like operations carried on by the state itself. Corporations are essentially political constructs" (Berle and Means, 1932, p. xxvi).

Both quotations shed light on the distinction between two antagonistic logics. According to the logic of *ownership*, the (legal) world is divided between owners (legal persons, whether human or non-human) and objects of ownership. The owner of an object has 'subjective' power over that object, which means that he has the right (the power) to do whatever he wants with it under the law (Robé, 1999). Note that shareholder sovereignty and managerial sovereignty both analyse the corporation through this logic: the company is an object of ownership. The difference is the identity of the owners. According to the doctrine of shareholder sovereignty, the only legitimate owners are the shareholders. Of course, as discussed above, within contractarian logic shareholders are, strictly speaking, 'principals' of their managerial 'agents' rather than owners of the corporation itself. However, this conceptual technicality does not alter the ultimate positive outcome: both proprietary and agency rationality confers upon shareholders subjective power over the corporation in the sense of the legal entitlement to demand managerial deference to their subjective interest, even if this subjective power is *de facto* limited by the opportunism of corporate executives. The substance of the agency model is similarly unambiguous from a normative standpoint: an efficient corporation is a corporation where shareholders are able, through a diversity of mechanisms, to impose their subjective interests on managers.

According to the managerial sovereignty thesis, on the other hand, shareholders' ownership powers have been traded off in favour of liquidity, so that managers assume the effective status of corporate 'owners' in the sense of having untrammelled discretion over the direction of the company's business and the allocation of its assets and cash flows. On a normative level, meanwhile, this arrangement is viewed to be legitimate insofar as managers can be trusted to exercise their 'unchecked' decision-making power in accordance with the general socio-economic 'good' as expressed *via* received public opinion (Dodd, 1932; Berle, 1960).

In contrast to the above ownership rationality, the logic of *institution* dictates that the holder of power should not be free to exercise it in his interest (subjectively), but, rather, in the interests of those affected by it. The reference to the State in Rathenau's and Berle's quotations is significant on this level: the distinctive feature of a non-totalitarian State resides in the fact that the concentration of power within the State apparatus, necessary for its efficiency, is counterbalanced by limits placed on that power. The exercise of power is subjected, by means of various procedures, to the will of the people. Hence, the idea defended by Berle and Means is that the liquidity of stock markets calls for a rethinking of the nature of power within large companies. The firm is no longer an object of property, but an *institution* that must be governed as such. If the corporation is an institution -

meaning that subjective interest should not be a guideline for the exercise of power - then it is necessary to set limits on managerial power to ensure that it is exercised on behalf of the company's constituents: shareholders, certainly, but also workers and, even further, the communities in which these companies thrive. *The Modern Corporation* therefore ends with a plea for management that would be a “purely neutral technocracy” (p. 312). Ultimately, whereas the agency perspective seeks to *minimize* the separation of ownership and control, Berle and Means propose to *exploit* it in order to enhance the role of public concern in capitalism through an extended accountability for the managers of (American) society’s most powerful economic entities

The institutional basis of the corporate enterprise within existing (US) legal doctrine

It is a widely accepted truism that, whilst continental European jurisdictions do not provide any direct support to the shareholder sovereignty model (see, e.g., Jackson and Höpner, 2002 for the German case; Aglietta and Rebérioux, 2005, for the French case), within Anglo-Saxon legal environments the shareholder primacy norm contrarily represents an intrinsic and centrifugal norm of corporate governance law and practice (Clark, 1986; Keay, 2007).[12] On this basis it is commonly concluded that, in those instances where the pursuit of ‘shareholder value’ produces negative externalities, ‘corrections’ should be made not by reforming the structure of corporate law itself but, instead, by triggering alternative regulatory mechanisms from areas such as labour, tort and environmental law (on this, see Clark (1986), p. 20; Parkinson (1993), pp. 41-42). If indeed true this statement suggests that, in spite of the profound influence of their insights on a conceptual level, Berle and Means did not actually succeed in either rationalising or influencing the practical evolution of (US) corporate law. The present section argues, successively, that: (i) US legal doctrine is, as a matter of fact, more closely connected with the institutional perspective portrayed by Berle and Means (1932) than the aforementioned ‘agency’ paradigm; and (ii) that new developments in the economic theory of the firm may help to rationalize this arrangement normatively.

The term ‘shareholder value’ usually denotes, in essence, the corporate managerial norm of generating an optimal (or at least relatively high) financial return or profit from a company’s business for the benefit of its equity-holders. So pervasive is this yardstick as a perceived goal of the Anglo-American corporation today that one would be forgiven for regarding the maximisation of shareholder value as being a legally sanctioned norm of managerial conduct. However, at no point in history in the US (or, for that matter, the UK) have corporate managers been under any legal fiduciary duty to generate, on a continuous basis, high financial returns for shareholders. If anything, in fact, the dominant strand of common law reasoning on the relationship between corporate shareholders and the board would appear to operate firmly against any such suggestion.

The idea that a company’s board of directors is subject to any sort of direct ‘agency’ relationship with that firm’s shareholders, requiring ongoing subservience to the latter’s expressed interests, was dispelled in a line of cases decided by the New York courts over a century ago. In one of the earliest and also most emphatic refutations of the so-called ‘principal-agent’ model of corporate governance within the United States, Comstock J of the Court of Appeals of New York stressed the fundamental corporate law tenet that:

> “[t]he board of directors of a corporation do not stand in the same relation to the corporate body which a private agent holds toward his principal. In the strict relation of principal and agent, all the authority of the latter is derived by legislation from the former,…[b]ut in corporate bodies the powers of the board of directors are, in a very important sense, original and undelegated… in the sense of being received from the State in the act of incorporation.”

Moreover, according to Comstock J:

> “The recognition of this principle is absolutely necessary in the affairs of every corporation whose powers are vested in a board of directors. Without it the most ordinary business could not be carried on, and the corporate powers could not be

executed." (*Hoyt v Thompson's Executor*, (1859) 19 N.Y. 207 (Court of Appeals of New York), p. 216) [13]

Over half a century later Chase J of the same Court reiterated this basic line of reasoning, expressing the principle that "the individual directors making up the board are not mere employees, but a part of an elected body of officers constituting the executive agents of the corporation." Setting out the parameters of what is today known in corporate law jurisprudence as the business judgement rule, Chase J explained that directors "hold such office charged with the duty to act for the corporation according to their best judgment, and in so doing they cannot be controlled in the reasonable exercise and performance of such duty" (*People ex rel. Manice v Powell*, (1911) 201 N.Y. 194 (Court of Appeals of New York), p. 201).

Underlying all of the above propositions of law is a judicial adherence to the so-called 'concession' theory of corporate law (on this generally, see Bratton, 1989; Parkinson, 1993, pp. 25-32). According to this view, a company's charter is vested with the force of law by virtue of the act of incorporation alone, with the effect that the particular division of decision-making powers established in the charter is regarded as emanating directly from the state as the formal grantor of corporate status. It follows that, insofar as a company's charter vests executive authority for the running of the business in the hands of that firm's board of directors (as opposed to its shareholders), then the board's discretion over strategic and operational affairs can be regarded as sovereign and absolute, subject only to compliance with minimal standards of loyalty (i.e. anti-self-dealing) and decision-making rationality (on this doctrine of US corporate law, see Bainbridge, 2003).

Shareholders consequently have no legal power under US (Delaware and New York) corporate law to remove directors before expiration of office. Nor do they have the right to give any specific or general directions to the board regarding the running of the company, or to initiate constitutional amendments aimed at increasing their structural influence over managerial affairs (see Bebchuk, 2005). This is because, in the words of Chase J again, “[t]he board of directors [and not the general body of shareholders] represent the corporate body”, so that “recommendations by a body of stockholders can only be enforced through the board of directors [itself], and indirectly by the authority of the stockholders to change the personnel of the directors at a meeting for the election of directors” (*Continental Securities Co. v Belmont* (1912) 206 N.Y. 7 (Court of Appeals of New York), p. 16). For these reasons the US legal model of the corporation has recently been described by one scholar in terms of “a purely representative democracy” (Bebchuk, 2005, p. 850), in the sense that shareholders, just like the citizens of a democratic state, generally have no direct say in the governance of the organisation other than the collective right to dismiss those individuals in power (i.e. the board of directors or appointed head of state) at the end of the latter’s agreed period of office.

Such an institution- (as opposed to market-) based model of the corporation finds support not only in (US) legal doctrine, but also from recent developments in the theory of the firm which highlight the economic benefits of a model of corporate governance centred on the role and rights of the ‘internal’ board rather than ‘external’ shareholder. The ‘Team Production’ model of corporate law developed by Blair and Stout (1999) is a notable example of this analytical stance, relying in particular on advances in human capital theory and incomplete contract (see also Gelter, 2008). The argument runs as follows: when contracts are incomplete, protection of specific, non-redeployable investments cannot be achieved beforehand by the establishment of a contract providing for every possible contingency. Consequently, the parties to the contract are led to establish extra-contractual mechanisms which enable them to appropriate a share of the organizational quasi-rent as a return on their investment (Williamson, 1985). Further, it is increasingly recognized that the quasi-rent created by the firm derives from the pooling of complementary resources in the form of tangible, and also intangible, human and financial capital. ‘Team production’ is thus no longer limited just to human resources as portrayed in Alchian and Demsetz’s (1972) seminal model (see *supra*, p. __). Rather, it concerns the whole set of productive resources used by the firm including, in particular, its important body of ‘intangibles’. Coupled with contractual incompleteness, team production accordingly raises an economically crucial question: how can corporate law provide the requisite organizational incentives to encourage input providers to specialize their respective resources in line with the firm’s peculiar production needs?

Arguably corporate governance and, in particular, the board of directors might be analyzed as a specific mechanism designed to provide such an incentive: thus the board should act as an independent third party, whose objective is to serve the collective interest of the corporate ‘team’ as a whole. The directors are no longer simply the agents of the shareholders; their fiduciary duties must be exercised, and discretion resolved, in favour of the overall corporate entity. The productive resources of the firm must be managed *in the interest of the firm itself*. Accordingly, ‘neutral’ board governance might be considered the most appropriate institutional means of protecting (and, moreover, enhancing) the firm’s overall wealth-generating capacity, at least in those instances where value creation is dependent on the efficient combination of specialist, non-redeployable productive resources.

In summary US corporate law, based as it is upon a conception of the corporation and its board as a mere representative channel for shareholders’ democratically and intermittently determined will, effectively relegates shareholders to the status of being *subject to* the corporation and the governing mandate of its board of directors. As such, US corporate law is squarely at odds with the doctrine of shareholder primacy, which in contrast depends on an assumption of shareholder sovereignty in the determination and appropriation of the corporation’s economic output on an ongoing basis. This suggests that, if the norm of shareholder primacy is indeed prevalent within Anglo-American corporate governance, it has become so *in spite of*, rather than because of, the surrounding corporate law framework. The logical deduction is that (stock) market pressures, rather than legal norms, are responsible for the promotion of the shareholder to the status of *de facto* primary beneficiary of the corporate production process[14], thus negatively confirming agency theory’s correctness on a positive level. From a normative standpoint, however, the above analysis demonstrates that the principal-agent model, on account of its narrow shareholder centricity, largely fails to account for the complex and variable nature of economic input provision within dynamic 21st century industries. On the contrary, it has been argued – following Blair and Stout (1999) – that complementary and non-redeployable investments of non-financial capital can only be effectively protected today under a board-centric governance regime based on the principle of managerial neutrality. Interestingly, though, this principle lies at the heart of the traditional US model of corporate governance as enshrined in formal legal doctrine.

Re-equilibrating managerial neutrality

The above insights establish that the institutional conception of corporate enterprise is already inherent in the (US) law as it stands. At the same time, though, managers are encouraged by (stock) market-based mechanisms and, in particular, equity-based remuneration devices (e.g. stock options), to adopt the 'external' (market-determined) yardstick of shareholder value rather than the 'internal' (technocratically-determined) criterion of enterprise value as the primary determinant of corporate success. Consequently, the doctrine of shareholder primacy is informally promoted to the status of central managerial norm, and managers are vested with the status of *de facto* 'agents' of shareholders, despite the apparent politico-economic 'colourness' of management within the corporation's formal legal decision-making framework.

Whilst the phenomenon of stock market control theoretically resolves the problem of managerial hegemony within the public corporation by substituting indirect market control for direct entrepreneurial oversight, it in practice has often exacerbate the unaccountability of key decision-makers by provide covert opportunities for excessive risk-taking and rent extraction based on the constantly shifting value of the firm's liquid equities (on this problem generally, see Rebérioux, 2007). And, although the market-based institution of private equity offers a potential solution to such problems *via* 're-entrepreneurialization' of the firm's ownership and governance structure, as explained above the permanence of large-scale LBOs within the corporate governance landscape is significantly inhibited by inert problems of socio-economic power concentration and over-dependence on favourable macro-economic conditions.

There is consequently a lack of any continuous and reliable market-based mechanism for 'internalizing' the investment horizons of corporate equity investors (and, in turn, managers) in line with the productive parameters of the business enterprise rather than the financial parameters of the liquid stock market. This highlights the need for regulatory measures aimed at re-allocating power within the firm's decision-making structures to those groups with a more continuous and intimate relationship with the corporate productive enterprise. The motivating aim of such a process of legal reform should not be that of reducing the shareholder's hierarchical status *vis-a-vis* other corporate participants (which is already largely achieved by company law doctrine), but, rather, of directly empowering non-shareholder groups within the firm's decision-making structures so as to re-equilibrate the doctrine of managerial neutrality in the face of shareholders' strong (stock) market-base influence over corporate decision-making processes. In this way, Berle and Means' conception of the company as a publicly orientated institution might be effectively implemented within the present-day corporate governance system.

Of course, the most obvious potential means of restoring managerial neutrality within the (financialized) public corporation is through removal of the main legal-institutional bases of shareholder primacy, namely executive stock options and shareholders' exclusive periodic rights of appointment over corporate directors. The danger with such a proposed reform, though, is that any gains to be made in terms of improved managerial responsiveness to enterprise- (as opposed to market-) level considerations may be negated by the increased accountability problems which would likely result from rendering corporate managers in effect answerable to no particular corporate constituency whatsoever (on this general problem, see Berle, 1932).

As a more effective and also practicable alternative policy, one may consider the re-allocation of a proportion of decision-making power to those corporate constituents who are most directly affected by the firm's activities, namely its workforce (Hill, 2003). Not only are the company's employees the only group of participants who are subject to the firm's authority structure as a matter of both economic fact (see Coase, 1937) *and* formal (labour) law (see *supra*, p. __); but also they are generally the only group whose 'investment' in the firm takes a relatively long-term relational form in the sense that open-ended undertakings of fidelity, obedience and care are substituted for promises to supply specific and defined economic 'inputs' (Macneil, 1978; Fox, 1974).[15] Consequently, the ongoing economic welfare of a company's workforce is to a considerable extent aligned inextricably with the continuing stability and success of the individual firm, thus vesting the employment relationship with a uniquely 'internal' constitutional quality that is generally lacking in other 'stakeholder' relations and, above all, in the corporate-shareholder relation. This is especially so in those cases where employees have made unique and non-redeployable investments in acquiring skills, experience or social familiarity within the peculiar context of an individual corporate enterprise, meaning that their continuing ability to generate income in excess of the opportunity cost of their labour varies directly and intrinsically with that firm's overall enterprise value (on this, see Blair, 1995; Blair & Stout, 1999; Kelly & Parkinson, 2000).

Moreover, in contrast to market equity investors (shareholders), an employee's investment is by definition illiquid and hence provides minimal 'exit' protection against the downside risk of lost earnings-potential in an insolvent or financially unstable corporation. This suggests that employee representatives are prone to engender the formation of more stable and sustainable strategic policies on an individual firm basis, thereby counteracting shareholders' inclination to promote continual innovation and restructuring aimed at exceeding (on an intra-firm level) the variable opportunity cost of their rate of return on equity at macro (stock market-wide) level. And, finally, the representation of workers on the board should increase the knowledge used to monitor managers and to inform external stakeholders (including shareholders), especially where intangibles are a decisive driver of value. This point is supported by empirical evidence provided by Fauver and

Fuerst (2006), who show that the inclusion of worker representatives on the (supervisory) boards of German firms is positively correlated (up to a certain point) with the performance of those firms.

To this end, the participation of employees in corporate decision-making *via* formal rights to information, consultation and (to a limited extent) representation on the board of directors itself might be considered, principally as a means of 'constitutionalizing' the workforce as a locus of countervailing decision-making power *vis-à-vis* shareholders and (equity-remunerated) managers. The evolving 'European model' of corporate governance provides a vivid example of such an arrangement[16], and demonstrates the potential for effective (albeit artificial) regulatory re-equilibration of managerial autonomy within a modern environment of strong (stock) market-based controls otherwise favouring resolution of managerial discretion exclusively in the shareholder interest.

Conclusion

The recent series of international financial crises have strengthened the perceived importance of ensuring that key corporate decision-makers are held accountable for the socio-economic consequences of their actions. Moreover, within a liberal democratic system this is not only an economic problem but also one of politics, insofar as the aggregation of quasi-governmental power within the private sector threatens the practical capacity of citizens to govern themselves in accordance with the rule of law.

The foregoing analysis has highlighted the limitations of standard economic attempts to 'explain away' managers' decision-making power in accordance with a market-based 'agency' model of corporate governance, whereby the externally-imposed imperative of deferring to the general shareholder interest serves to minimise managers' scope for abuse of office. Not only are stock markets considerably limited as a medium for transmitting reliable firm-specific information from 'insider' managers to 'outsider' shareholders, but also detached public shareholders' face problems in designing effective institutional mechanisms for protection and promotion of their interest *vis-a-vis* hegemonic managers on an ongoing basis. And, whilst the market-induced institution of private equity promises an effective opposite response to the accountability deficit by means of re-entrepreneurialization of the public company, the influence of LBOs is in reality heavily curtailed by a combination of macro-economic factors and public-accountability concerns.

Accordingly, this article's central claim is that, rather than continuing the search for effective methods of minimizing the separation of ownership and control within public companies, the energies of corporate governance scholars might be better invested in the converse quest of finding ways to *exploit* this separation in order to engender the development of an alternative, more effective governance paradigm. In particular, it is submitted that the logic of institution embedded in existing legal doctrine and economic theory presents a more appropriate conceptual basis on which to elicit future governance reforms than the standard economic logic of the competitive market. This is true not only from the progressive viewpoint of encouraging more dynamic and sustainable modes of governance at the individual firm level, but also in terms of the more conventional challenge of ensuring the effective accountability of the corporate-managerial sector in general. For this reason, our proposed institutional model of corporate governance can be regarded as a 'new-age' solution to an 'age-old' dilemna.

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[1] On the difference between external and internal power, see Tsuk Mitchell (2005), p.187.

[2] For more details, see Cheffins, 2004.

[3] For this criticism, see e.g. the special issue (vol.26) of the *Journal of Law and Economics*, published in 1983. More recently, see e.g. Meese (2002). For more details on this issue, see Tsuk Mitchell (2005, p.212).

[4] Directorial independence is usually deemed to have been compromised if the director of a company (i) is, or has been, a corporate executive of that company or any of its affiliates, (ii) is, or has been, employed by that company or any of its affiliates, (iii) is employed as an executive of another company where any of that company's executives sit on the board, (iv) is a large blockholder of that company, and/or (v) has a significant business relationship with that company or any of its affiliates.

[5] See, e.g., the conclusion from the survey carried out by Bhagat & Black (1999): "*Most studies find little correlation, but a number of recent studies report evidence of a negative correlation between the proportion of independent directors and firm performance – the exact opposite of conventional wisdom*" (p.942). See also the meta-analysis conducted by Dalton, Daily, Ellstrand & Johnson (1998).

[6] Measurements on US data suggest that private investment in intangibles roughly equaled investment in tangibles, representing around 10% of domestic output (Nakamura, 2003; Corrado, Hulten & Sichel, 2006). Intangibles refer here to spending on information and communication technologies (ICT), spending on R&D and patents, spending on

development of brands and spending on workforce training in firm-specific capabilities and improvements in labor organization.

[7] Empirical literature provides for numerous examples of complementarities in the case of intangible resources. Regarding ICT and new work practices for example, Breshnahan, Brynjolfsson & Hitt (2002) observe that ICT have a stronger impact on productivity in firms that adopt decentralized labor organization at the same time. Regarding training and new work practices, different studies also provide evidence of a correlation between training efforts and labor reorganization, suggesting that their joint combination does improve performance (see e.g. Lynch & Black, 1998).

[8] On this topic generally, see the special issue (vol.18(3)) of the *Journal of Applied Corporate Finance*, published in Summer 2006.

[9] For a detailed explanation of the structure and functioning of LBOs, see Cheffins and Armour (2007); UK Treasury Committee (2007).

[10] Moreover, the GP will usually be placed to enjoy indirectly a significant proportion of any increase in the company's equity value by virtue of the 'carried interest' provision that is commonplace in LBO partnership agreements, whereby the GP will receive 20% of the total capital gains on investments made by each of their buyout funds every year.

[11] On the intrinsic importance of effective corporate accountability mechanisms within the framework of a liberal-democratic political economy, see Stokes (1994) ; Parkinson (1993).

[12] For example, in what is arguably the leading modern account of the US corporate law system, Harvard Law School's Robert Clark explains that, since "it is the shareholders who have the claim on the residual value of the enterprise, that is, what's left after all definite obligations are satisfied", it follows that "the managers have an affirmative open-ended obligation to increase this residual value." (1986, pp. 17-18). A recent academic account of the legal features of UK corporate governance, meanwhile, proceeds on the premise that "[g]enerally speaking, Anglo-American corporate law embraces a principle that has been expressed in one of the following ways: shareholder primacy, shareholder wealth maximisation or shareholder value." (Keay, 2007, p. 656)

[13] See also *Olcott v Tioga R.R. Co.*, (1863) 27 N.Y. 546 (Court of Appeals of New York); *Charleston Boot & Shoe Co. v Dunsmore*, (1880) 60 N.H. 85 (New Hampshire Supreme Court).

[14] On this point, see Lazonick & O'Sullivan (2000).

[15] On this legal quality of the Anglo-Saxon employment relation generally (as discussed within a UK context), see Deakin & Morris (2005), p. 121.

[16] Worker board-level participation in listed companies is provided for by (company or labour) law in almost half of the European Union member states (Germany, Austria, Nordic countries and most of the eastern countries), *via* representation on either a unitary board of directors (e.g. Sweden) or 'upper-tier' supervisory board (e.g. Germany).