Corporate Governance and Economic Organization:

A Contractual and Organizational Perspective

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"Nothing but a serene and frank examination of the oligarchical dangers of …[organization] will enable us to minimize these dangers."

Robert Michels (1913)

Although corporate governance has been extensively "transformed in response to intellectual currents in finance and economics and new transactional developments" (Romano, 2005a, p. 359), a corporate governance consensus has yet to develop. Some of the disparities are due to explicit or implicit differences among conceptual setups.[1] The dialogue on corporate governance will benefit from bringing these differences up front.

The conceptual framework that I employ in this paper rests on three legs. The first is the use of the lens of contract/governance[2] to examine of the contractual relations between the firm and each of its constituencies, where the board of directors is interpreted as a contractual safeguard to the contract between the firm and its equity investors. The firm is then described as an adaptive system that works out of double feedback. Provision is thereafter made for intertemporal transformations within the firm, a key effect of which is to privilege the management of the firm in relation to the board of directors.

My focus is on corporate governance in the United States. Although some take this to be deeply problematic, I agree with the judgment of Andrei Shleifler and Robert Vishny that, as compared with extant and feasible alternatives, governance in the United

States (and in Germany and Japan) are "successful" systems (1997, p. 774).[3] If and as others agree, proposed corporate governance reforms should be mindful of this.

I begin, for purposes of perspective, with a sketch of "pragmatic methodology," which some may regard as a digression but which I believe provides a constructive framework for evaluating all would-be theories, corporate governance or otherwise. The lens of contract/governance approach to economic organization is described in Section 2. The resulting "simple contractual schema" is then applied to finance transactions in Section 3, where debt is a rules governed mode of finance and equity is a more discretionary form of governance. The board is thereafter interpreted as fulfilling the role of a monitor in a double-feedback model of the corporation. Boards in practice are described in Section 4 and the reasons why theory and practice differ are explored. Reform proposals are examined in Section 5. Conclusions follow.

1. A framework

Corporate governance is a vast subject to which business and legal practitioners, policy wonks, and all of the social sciences have contributed. Out of this vast buzzing, blooming confusion, where does the essence reside? How do we sort the sheep from the goats?

Because "any direction you proceed in has a very high a priori probability of being wrong" when studying poorly understood and complex phenomena, of which corporate governance is one, "it is good if other people are exploring in other directions" (Simon, 1992, p. 21). Pluralism does not, however, imply that anything goes: "science … advances primarily by unsuccessful experiments that clear the ground" (Friedman, 1997, p. 196). Sooner or later, all would-be theories need to stand up and be counted.

Describing himself as a native informant rather than as a certified methodologist, Robert Solow's "terse description of what one economist thinks he is doing" (2001,

p. 111) takes the form of three precepts: keep it simple; get it right; make it plausible.[4] Keeping it simple is accomplished by stripping away inessentials, thereby to focus on first order effects – the "main case," as it were – after which qualifications, refinements, and extensions can be introduced. Getting it right entails working out the logic. And making it plausible means to eschew fanciful constructions.

Solow observes with reference to the simplicity precept that "the very complexity of real life … [is what] makes simple models so necessary" (2001, p. 111). Inasmuch as "the social sciences … deal with phenomena of the greatest complexity" (Simon, 1957, p. 89), with which view E. O. Wilson concurs (1999, p. 183), there is no realistic prospect of explaining everything. But there is more to it than a concession to bounded rationality: "Most phenomena are driven by a very few central forces. What a good theory does is to simplify, it pulls out the central forces and gets rid of the rest" (Friedman, 1997, p. 196). The object is to uncover central features and key regularities by the application of a focused lens.

Getting it right "includes translating economic concepts into accurate mathematics (or diagrams, or words) and making sure that further logical operations are correctly performed and verified" (Solow, 2001, p. 112). Especially in the public policy arena (but also more generally), one of these further logical operations is to ascertain whether putative "inefficiencies" survive comparative institutional scrutiny. Because any display of inefficiency simultaneously represents an opportunity for mutual gain, the parties to such transactions have an incentive to relieve inefficiencies (in cost-effective degree). What are the obstacles? What is the best feasible result?

Plausible simple models of complex phenomena ought "to make sense for 'reasonable' or 'plausible' values of the important parameters" (Solow, 2001, p. 112). Also, because "not everything that is logically consistent is credulous" (Kreps, 1999, p. 125), fanciful constructions that lose contact with the phenomena are suspect −

especially if alternative and more veridical models yield refutable implications that are congruent with the data.

This last brings me to the fourth precept: derive refutable implications to which the relevant (often microanalytic) data are brought to bear. Nicholas Georgescu-Roegen had a felicitous way of putting it: “The purpose of science in general is not prediction, but knowledge for its own sake,” yet prediction is “the touchstone of scientific knowledge” (1971, p. 37).

Some scoff at prediction, evidently in the belief that prediction is easy. Also, since everyone knows that “it is easy to lie with statistics,” what useful purpose is served by empirical testing? My experience is that prediction is a demanding standard and that corroboration is not easy but difficult. A multiplicity of theories, some of which are vacuous, others of which are fanciful, and still others of which are contradicted by the evidence is an embarrassment to pragmatically oriented social scientists. Among this subset, insistence upon the injunction to derive refutable implications and submit these to the data has attractions.

To be sure, new theories rarely appear full blown but evolve through a progression during which the theory and evidence are interactive (Newell, 1990, p. 14):

> Theories cumulate. They are refined and reformulated, corrected and expanded. Thus, we are not living in the world of Popper … [Theories are not] shot down with a falsification bullet…. Theories are more like graduate students – once admitted you try hard to avoid flunking them out…. Theories are things to be nurtured and changed and built up.

Sooner or later, however, the time comes for the reckoning. All would be theories need to stand up and be counted.

2. The Lens of Contract[5]

James Buchanan distinguishes between the orthodox lens of choice and the emergent lens of contract and observes that the latter resonates with the proposition that "mutuality of advantage from voluntary exchange … is the most fundamental of all understandings in economics" (2001, p. 29). John R. Commons also gave prominence to mutuality, especially in relation to the continuity benefits that frequently attend exchange, whereupon he reformulated the problem of economic organization as follows: "the ultimate unit of activity … must contain in itself the three principles on conflict, mutuality and order. This unit is a transaction" (Commons, 1932, p. 4). Commons thereafter recommended that "theories of economics center on transactions and working rules, on problems of organization, and on the … [ways] the organization of activity is stabilized" (1950, p. 21).

The lens of contract takes the transaction to be the basic unit of analysis and defines governance as the means by which to infuse order, thereby to mitigate conflict and realize mutual gains. It furthermore holds that adaptation is the central problem of economic organization, of which two types are distinguished: autonomous adaptations in the market in response to changes in relative prices (Hayek, 1945) and coordinated adaptations of a "conscious, deliberate, purposeful kind" accomplished with the support of hierarchy (Barnard, 1938).

I also make explicit provision for the attributes of human actors that bear on contracting. Specifically, all complex contracts are incomplete (by reason of bounded rationality), some contracts are subject to defection hazards (by reason of opportunism), and farsighted parties make efforts to mitigate contractual breakdowns by crafting credible commitments. Also, whereas the details of firm and market organization are scanted under lens of choice setups, firm and market are described as alternative modes of governance that differ in consequential ways when viewed through the lens of contract. Specifically, each generic mode of governance (market, hybrid, hierarchy) is

defined as a syndrome of attributes (which differ in incentive intensity, administrative control, and contract law respects) that give rise to distinctive strengths and weaknesses.

Of these attribute differences, I call attention here principally to the way in which contract law regimes vary across modes. By contrast with economic orthodoxy, which implicitly assumes that there is a single, all-purpose law of contract that is costlessly enforced by well-informed courts, the lens of contract treats court-ordering as a special case and gives prominence to private ordering, the mechanisms of which vary among alternative modes of governance.

To be sure, court ordering usefully describes the ideal transaction in law and economics: "sharp in by clear agreement; sharp out by clear performance" (Macneil, 1974, p. 738). Marc Galanter (1981, pp. 1-2) nevertheless observes that many disputes between firms that could under current rules be brought to a court are resolved instead by avoidance, self-help, and the like. That is because in "many instances the participants can devise more satisfactory solutions to their disputes than can professionals constrained to apply general rules on the basis of limited knowledge of the dispute" (1981, p. 4). Such a view is broadly consonant with the concept of "contract as framework" advanced by Karl Llewellyn (1931, pp. 736-737), which holds that the "major importance of legal contract is to provide…a framework which never accurately indicates real working relations, but which affords a rough indication around which such relations vary, an occasional guide in cases of doubt, and a norm of ultimate appeal when the relations cease in fact to work." This last is important, in that recourse to the courts for purposes of ultimate appeal serves to delimit threat positions. As compared with contract as legal rules, the more elastic concept of contract as framework facilitates cooperative adaptations across a wide range of contractual disturbances, which is important as continuity takes on added importance.

The cooperative adaptations to which Barnard referred are realized through administration. These entail taking transactions out of markets and organizing them internally – to which the contract law of internal organization applies. Except as "fraud, illegality or conflict of interest" are shown, courts will refuse to hear disputes that arise within firms − with respect, for example, to transfer pricing, overhead, accounting, the costs to be ascribed to intrafirm delays, failures of quality, and the like. In effect, the contract law of internal organization is that of forbearance, according to which the firm becomes its own court of ultimate appeal (Williamson, 1991). Firms for this reason are able to exercise fiat that markets cannot.[6]

Upon naming the transaction as the basic unit of analysis, the critical attributes of transactions (for governance structure purposes) are (1) the condition of asset specificity, in that such assets cannot be redeployed to alternative uses and users without loss of productive value, (2) the disturbances (uncertainty) to which contracts are subject, and (3) the frequency with which transactions recur. Differential contractual hazards are traced principally to variations in asset specificity in conjunction with disturbances for which adaptations are needed.

The predicted relation between transactions and modes of governance is derived from application of the discriminating alignment hypothesis – to wit, transactions, which differ in their attributes, are aligned with governance structures, which differ in their cost and competence, so as to effect a transaction cost economizing alignment. The paradigm transaction is vertical integration (or, in more mundane terms, the make-or-buy decision). Not only is vertical integration the obvious candidate transaction (Coase, 1937), but it is a fortuitous choice because transactions in the intermediate product market are less beset with asymmetries of information, budget, legal talent, risk aversion, and the like than are many other transactions. It is nevertheless gratifying that

the simple contractual schema applies both to intermediate product market transactions and (with variation) to the study of transactions more generally.

With reference to vertical integration, assume that a firm can make or buy a component and assume further that the component can be supplied by either a general purpose technology or a special purpose technology. Letting k be a measure of asset specificity, the transactions in Figure 1 that use the general purpose technology are ones for which $k = 0$. In this case, no specific assets are involved and the parties are essentially faceless. Transactions that use the special purpose technology are those for which $k > 0$. Such transactions give rise to bilateral dependencies, in that the parties have incentives to promote continuity, thereby to safeguard specific investments. Let s denote the magnitude of any such safeguards, which include penalties, information disclosure and verification procedures, specialized dispute resolution (such as arbitration) and, in the limit, integration of the two stages under unified ownership. An $s = 0$ condition is one for which no safeguards are provided; a decision to provide safeguards is reflected by an $s > 0$ result.

Node A in Figure 1 corresponds to the ideal transaction in law and economics: there being an absence of dependency, governance is accomplished through competition and, in the event of disputes, by court awarded damages. Node B poses unrelieved contractual hazards, in that specialized investments are exposed ($k > 0$) for which no safeguards ($s = 0$) have been provided. Such hazards will be recognized by farsighted players, who will price out the implied risks.

Added contractual supports ($s > 0$) are provided at nodes C and D. At Node C, these contractual supports take the form of interfirm contractual safeguards. Should, however, costly breakdowns continue in the face of best bilateral efforts to craft safeguards at Node C, the transaction may be taken out of the market and organized under unified ownership (vertical integration) instead. Because added bureaucratic

costs accrue upon taking a transaction out of the market and organizing it internally, internal organization is usefully thought of as the organization form of last resort: try markets, try hybrids, and have recourse to the firm only when all else fails. Node D, the unified firm, thus comes in only as higher degrees of asset specificity and added uncertainty pose greater needs for cooperative adaptation.

Note that the price that a supplier will bid to supply under Node C conditions will be less than the price that will be bid at Node B. That is because the added security features at Node C serve to reduce the contractual hazard, as compared with Node B, so the contractual hazard premium will be reduced. One implication is that <u>suppliers do not need to petition buyers to provide safeguards</u>. Because buyers will receive goods and services on better terms (lower price) when added security is provided, buyers have the incentive to offer credible commitments.

Not only, moreover, does the simple contractual schema inform make-or-buy decisions, the repeated application of which permits the boundary of the firm to be derived, but any issue that arises as or can be construed as a contracting problem can be examined to advantage in very similar efficient governance terms. To be sure, as discussed below, the efficacy of credible contracting is sometimes compromised by information asymmetries. These will temporarily be set aside. Consider therefore the application of the simple contractual schema to finance transactions.

3. Debt and Equity as Governance Structures

3.1 Discriminating alignment

The choice between debt and equity varies with the governance needs of the projects to be financed. Expressed in transaction cost economics terms, the basic regularity is this: debt is well-suited to finance generic assets that can be redeployed to alternative uses and users with little loss of productive value whereas equity is reserved

for financing specific assets for which continuity (in the same uses and by the same users) is valued.[7]

Arrayed by increasing degree of asset specificity, suppose that a firm is seeking to finance the following: general-purpose, mobile equipment; a general-purpose office building located in a population center; a general-purpose plant located in a manufacturing center; distribution facilities located somewhat more remotely; special-purpose equipment; market and product development expenses; and the like. Also assume that the governance structure for debt requires the debtor to observe the following rules: (1) stipulated interest payments will be made at regular intervals; (2) the business will continuously meet certain liquidity tests; (3) sinking funds will be set up and principal repaid at the loan-expiration date; and (4), in the event of default, the debt-holders will exercise pre-emptive claims against the assets in question. If everything goes well, interest and principal will be paid on schedule. But debt is unforgiving if things go poorly. Failure to make scheduled payments thus results in liquidation. The various debt-holders will then realize differential recovery in the degree to which the assets in question are redeployable.

Specifically, debt works well for projects for which k=0 and rules-based governance applies. This corresponds to Node A in the simple contractual schema. As, however, the value of k increases, the value of liquidation claims declines and the terms of debt finance will be adjusted adversely (as at Node B). Confronted with the prospect that specialized investments will be financed on adverse terms, the firm might respond by sacrificing some of the specialized investment features in favor of greater redeployability. But this entails tradeoffs: production costs may increase or quality decrease as a result. Might it be possible to avoid these by inventing a new governance structure of a Node C kind to which mutual gains (added continuity and adaptability in exchange for added safeguards) can be projected? In the degree to which this is

feasible, the value-enhancing benefits of investments in specific assets could thereby be preserved.

Suppose that a financial instrument called equity is invented and assume that equity has the following governance properties: (1) it bears a residual-claimant status to the firm in both earnings and asset-liquidation respects; (2) it contracts for the duration of the life of the firm; and (3) a board of directors is created and awarded to equity that (a) is elected by the pro-rata votes of those who hold tradable shares, (b) has the power to replace the management, (c) decides on management compensation, (d) has access to internal performance measures on a timely basis, (e) can authorize audits in depth for special follow-up purposes, (f) is apprised of important investment and operating proposals before they are implemented, and (g) in other respects bears what Eugene Fama and Michael Jensen refer to as a decision-review and monitoring relation to the firm's management (1983).

The board of directors thus "evolves" as a way by which to reduce the cost of capital for projects that involve limited redeployability. Not only do the added controls to which equity has access have better assurance properties, but equity is more forgiving than debt. Efforts are therefore made to work things out and realize adaptive benefits that would otherwise be sacrificed when disturbances push the parties into a maladapted state of affairs.[8]

3.2 The board as monitor: double-feedback

Although the simple contractual schema (Figure 1) is instructive for interpreting how and why finance transactions differ in governance respects, there is a major missing piece: where does the board of directors fit within the overall organizational scheme of the modern cooperation?[9]

Taking adaptation to be the central purpose of economic organization, W. Ross Ashby's model of double-feedback (1960) and Herbert Simon's examination of the architecture of complexity (1962) are germane.[10] Ashby established that all adaptive systems that have a capacity to respond to a bimodal distribution of disturbances – some being disturbances in degree; others being disturbances in kind – will be characterized by double feedback. As shown in Figure 2, disturbances of both kinds originate in the environment (E) and the feedback divide is this: operating decisions are made and implemented in the primary feedback loop by the reacting part (R) with the benefit of extant decision rules whereas strategic decisions of a more consequential and longer run kind are processed through the essential variables (V) and the step functions (S) in the secondary feedback loop.

In effect, the reacting part (R) works out of the presumption that successive state realizations are draws from an unchanged probability distribution to which the application of extant routines will yield an efficacious response. Indeed, the routines employed by the operating part remain unchanged so long as performance falls within the control limits on the essential variables (V) in the secondary feedback loop. If and as, however, performance falls outside of these control limits, the secondary feedback loop interprets this as a disturbance in kind for which new routines (changes in parameter values or new rules) are needed to restore performance to acceptable levels. These changes are introduced into the reacting part as step functions (S). So described, the primary feedback loop is implementing extant decision rules in real time in a mechanical way whereas the secondary feedback loop is activated episodically by changes in kind (and possibly with reference to longer run (strategic) considerations). Evolutionary systems that are subject to such bimodal disturbances will, under natural selection, necessarily develop two readily distinguishable feedbacks (Ashby, 1960, p. 131).

Simon's discussion of the organizational division of decision-making labor in the firm is in the same spirit. From "the information processing point of view, division of labor means factoring the total system of decisions that need to be made into relatively independent subsystems, each one of which can be designed with only minimal concern for its interaction with the others" (Simon, 1973, p. 270). That is accomplished by grouping the operating parts into separable entities within which interactions are strong and between which they are weak and by making temporal distinctions of a strategic versus operating kind. Problems are thus factored in such a way that the higher-frequency (or short-run) dynamics are associated with the operating parts while the lower-frequency (or long-run) dynamics are associated with the strategic system (Simon, 1962, p. 477).

Where does the board of directors fit within such a concept of organization? My interpretation of the foregoing is that the primary feedback loop describes the behavior of the operating parts of the enterprise and the strategic feedback loop is where the team of monitors and managers in the firm is located. Thus whereas the reacting part (R) uses extant routines to respond to small and familiar disturbances in the environment (E) on a continuing basis, the secondary feedback loop deals with exceptions. Unless individual or successive disturbances push the essential variables (V) outside of their control limits, the strategic feedback loop merely registers assent. When, however, the essential variables are pushed outside of their control limits, the step functions (S) are activated. Parameter changes or new routines are then introduced into the reacting part with the purpose of restoring the essential variables to acceptable levels.

A simple interpretation of the secondary feedback loop is to view the board as the essential variables (V) and the management as the step functions (S). Accordingly, except as the essential variables are pushed outside of their control limits, the board remains in a passive mode of nodding approval and the management advises the

operating parts to continue business as usual. If and as disturbances push the essential variables outside their control limits, the board registers concern to which the management takes corrective action.[11]

Under this interpretation, the board takes performance meter readings at prescribed intervals but does not need to be deeply knowledgeable of the management of the firm in either operating or strategic respects. Indeed, this interpretation appears to implement the conception of the board of directors as monitor. Upon being apprised of the need to adapt, the management calls on its deep knowledge and expertise to reposition the firm. Once the essential variables have been brought within control limits, the board returns to its standby mode of nodding approval.

4. Boards in Practice

Examining corporate finance through the lens of contract yields the result that the main purpose served by the board of directors is to safeguard equity investments, thereby to reduce the cost of capital, which function is discharged by the board serving as monitor. This benign interpretation is, I submit, an instructive place to begin. But how does this square with boards in practice? What are the disparities between the ideal board and actual boards? Not only do we need to know how things work in practice, but we need to understand the obstacles, natural and contrived, that will block or undermine changes if we are to recommend feasible and effective reforms.[12]

4.1 What's going on here?

Myles Mace (1971) and Michael Jensen (1993) offer useful perspectives.

Mace's book, Directors: Myth and Reality, has the purpose of challenging the myths and telling the reality: "As a participant on, and observer of, boards of directors for over 25 years, I have developed a healthy skepticism about the prevailing [mythical]

concept of the board of directors. Specifically, it seemed important to ask what directors actually do in fulfillment of their responsibilities" (1971, p. 8; emphasis added).

His "final summary" of directors in large and medium sized firms where the CEO and board members own only a few shares of stock are these (Mace, 1971, pp. 205-206):[13]

1. [CEOs] with de facto powers of control select the members of the boards.
2. [CEOs] determine what boards do and do not do.
3. Directors selected are usually heads of equally prestigious organizations with primary responsibilities of their own.
4. Heads of businesses and financial, legal, and educational organizations are extremely busy [people] with limited motivation and time to serve as directors of other organizations.
5. Most boards of directors serve as advisors and counselors to the [CEOs].
6. Most boards of directors serve as some sort of discipline for the organization – as a corporate conscience.
7. Most boards of directors are available to and do make decisions in the event of a crisis.
8. A few boards of directors establish company objectives, strategies, and broad policies. Most do not.
9. A few boards of directors ask discerning questions. Most do not.
10. A few boards evaluate and measure the performance of the president and select and de-select the president. Most do not.

Pertaining to item 3 on this list, Mace quotes from one executive as follows (1971, p. 90):

> The board is part of the image of the company. The caliber and stature of the outside board members, both just as names and as people circulating

> in the business community, contributes to the image of the company. When I look at a company, I look at who is on the board … . The type of people on a board does, in a series of informal and intangible ways, have a good deal to do with what the character of a company is. Is it a respectable and conservative company, or is it highly speculative? The investing public, you know, really care who is on the board.

Also, Mace observes that one of the functions played by the board with respect to discipline and corporate conscience (item 6) is that the CEO and his subordinates "know that periodically they must appear … before a board of directors consisting of respected, able people of stature [who], no matter how friendly, cause the company organization to do a better job of thinking through their problems and of being prepared with solutions, explanations, or rationales" (1971, p. 180).

Such effects notwithstanding, Mace concludes that the role of the board as a corporate conscience is mixed (1971, p. 181):

> Usually the symbols of corporate conscience are more apparent than real, and [CEOs] with complete powers of control make the compensation policies and decisions. The compensation committee, and the board which approves the recommendations of the compensation committee, are not in most cases decision-making bodies. These decisions are made by the [CEO] and in most situations the committee and board approval is perfunctory. The [CEO] has de factor powers of control, and in most cases he is the decision maker. The board does, I believe, tend to temper the inclinations of [CEOs] with de facto control, and it does contribute to the avoidance of excesses. Thus it serves the important role of a corporate conscience.

With reference to item 10, Mace identifies “two crisis situations where the role of the board of directors is more than advisory.” One is if the CEO were to die or become incapacitated; the second is if performance is “so unsatisfactory that a change must be made” (1971, p. 182) – which recalls Oswald Knauth’s view that “the degree of success that management must produce to remain in office is surprisingly small. Indeed, management must fail obviously and even ignominiously before the dispersed forces of criticism become mobilized for action” (1948, p. 45). To be sure, hostile takeovers have since changed that somewhat – although CEOs and their boards have also devised protective responses, of which staggered boards and poison pills are two.

Jensen opens his section on “The Failure of Corporate Internal Control Systems” with the observation that “By nature, organizations abhor control systems, and ineffective governance is a major part of the problem with internal control mechanisms. They seldom respond in the absence of a crisis” (1993, p. 852). He thereafter makes a series of observations about boards in practice and recommends how boards should be reformed. I take up the latter in Section 6.

Jensen’s main observations about boards in practice are these: (1) board culture typically emphasizes “politeness and courtesy at the expense of truth and frankness” (p. 863); (2) the board has a serious information deficit and lacks financial expertise (p. 864); (3) legal liability encourages risk averse behavior by boards (p. 864);[14] (4) neither managers nor non-manager members of the board own substantial fractions of their firm’s equity (p. 864); and (5) the board in a well-functioning organization will normally be inactive and exhibit little conflict. Jensen concludes that “bad systems or rules, not bad people, underlie the general failings of boards of directors” (p. 863) and that the board “becomes important primarily when the rest of the internal control system is failing” (p. 866).

Taken together, Mace and Jensen describe the board of directors in the large corporation as follows: (1) the CEO is in de facto control of the operation and composition of the board; (2) outside members of the board are at an enormous information and expertise disadvantage to the management; (3) most boards most of the time are responding with nodding approval; (4) boards can and often do move into a more active mode when the corporation experiences adversity and, albeit unmentioned, (5) the very existence of the board affords an opportunity for shareholders to "vote the rascals out."

4.2 interpretation

The disparities between boards in theory (Section 3) and boards in practice appear to be substantial. It is nonetheless noteworthy that theory and practice seem to be in agreement in the following respects: the board (1) is a safeguard for equity investors that (2) serves as a monitor that mainly nods approval but is activated by exceptions, and (3) the relation between the board and management is rarely adversarial but is more accurately described as a team. De facto, however, the board is a submissive partner. How does this come about? I contend that there are both natural and contrived origins.

Natural: As Philip Selznick observes, "The important point about organizations is that, though they are tools, each nevertheless has a life of its own" (1966, p. 10). Among the intertemporal features that are of special importance to corporate governance are the oligarchical advantages that accrue naturally to the leadership by reason of its strategic position in the organization.

Robert Michel's famous Iron Law of Oligarchy speaks to the transformation of organizations as follows: "It is organization which gives birth to the dominion of the elected over the electors, of the mandatories over the mandators, of the delegates over

the delegators. Who says organization, says oligarchy" (1962, p. 365). In any large organization whatsoever (private, public, and eleemosynary), the leadership enjoys informational and strategic advantages over both the operating parts of the enterprise and the "trustees."

In the context of the modern corporation, I will take it as standard practice that the board (1) is made up of part-time monitors, (2) takes readings on the essential variables periodically rather than continuously, and (3) has little or no direct staff support. By contrast, the officers of the firm (1) are full-time, (2) are continuously involved in the management of the firm, and (3) have extensive staffs that provide them with economic, technical, and legal expertise. Moreover, the incentive system within the firm (promotions and compensation) is also under the purview of the management. Given these differences, a natural asymmetry of information develops whereby the management has a deeper and more nuanced understanding of what has transpired and what is in prospect than does the board.

Ideally, the management relates to the needs of the board in a wholly constructive way – by revealing all pertinent information that the board can productively use and by interpreting this information for the board objectively. That, however, asks a lot. At a minimum, the management can be expected to release information selectively and interpret it in ways that favor its purposes. But much the more serious are the contrived advantages that accrue to the management in relation to the board, the exercise of which permits the management to extend its control over the mechanisms of governance.

Contrived Extensions: Instruments by which the management can extend its control include: (1) gaining control over nominations to the board; (2) essential variable control; (3) agenda control; and (4) entrenchment.

An obvious composition of the board concern is with the ratio of officers to independent board members, but the qualifications and predilections of independent board members are also pertinent. With respect to qualifications, independent board members who possess financial or business expertise are, in principle, better able to relate and have more to offer by way of sound judgment and informed critique than do those who are lacking in these respects. The objectivity of such "independent" board members can nevertheless be compromised if they are part of what Bang Nguyen-Dang refers to as "corporate elite's small world … [of] cross-directorships" (2005, p. 6), an illustration of which is executive compensation at Verizon, where "Verizon's compensation committee … consists of … [four] chief executives or former chief executives," three of whom sit on other boards with the Verizon CEO (Morgenson, 2006, p. A16). This is by no means an isolated example (Bebchuk and Fried, 2004, Chap. 2), moreover. Outside CEO directors who possess the requisite expertise but lack objectivity – because they and the officers are "in this together" – compromise the board.

A second class of board members are those who, though lacking in expertise, possess "gravitas." Such board members can be expected to be more compliant (1) as the ratio of board payments to their other income is higher, and (2) their susceptibility to indirect rewards – such as "contributions" to the board member's place of employment (as with eleemosynary institutions), or to favored charities, or out of the prospect of reciprocity (e.g., procurement) from the board member's place of employment (Bebchuk and Fried, 2004, pp. 27-28) – is higher. University faculty and administrators are often vulnerable in both of these respects (Schevitz and Wallack, 2006).[15]

The common attribute of both of these groups is that they are predisposed to support the management. Indeed, if board and management are thought of as constituting a team, such support is altogether to be expected. Chester Barnard's remarks about "compatibility" are apposite (1938, p. 224):

> The general method of maintaining an informal executive organization is so to operate and select and promote executives that a general condition of compatibility of personnel is maintained. Perhaps often and certainly occasionally, men cannot be promoted or selected, or even must be relieved, because they cannot function, because they "do not fit," where there is no question of formal competence.

If the CEO is in effective control of the membership of the board, little wonder that he gives consideration to whether, as members of the team, they will fit. The possibility that insecure CEOs will cross the line from constructive support to use obeisance as a selection criterion is where the problem resides.

Agenda Control: I concur with Jensen's recommendations that the CEO should not chair the board but that an independent board member (possibly elected by the independent board members) should both chair the board and (in consultation with the CEO) set the agenda and select new members for election to the board. (This will be difficult to test empirically if few boards are currently organized in this way.)

Measures of performance at the essential variables can be compromised by a failure to choose the relevant measures (by reason of omission of appropriate measures or inclusion of misleading measures) or a failure to report accurately and intelligibly on the readings that are taken. In principle, accountants and auditors who subscribe to and live up to high standards of professional ethics will relieve such concerns. But by the same token, the integrity of the performance measures will be compromised if these professional toady to the management.

Jensen's concerns with agenda control are reflected in recommendations that the CEO should not chair the board but that an independent board member (possibly elected by the independent board members) should both chair the board and (in

consultation with the CEO) set the agenda and select new members for election to the board.

Individually and collectively, management control over and strategic deployment of all of the above instruments can be used to undermine effective oversight and thereby to entrench it. But the management is also susceptible to the "market for corporate control" (Manne, 1965), whereby persistent failures of performance elicit takeover efforts. Inasmuch as the optimum premium that must be paid to displace an incumbent management is not zero (Hahn and Riyanto, 2006), the question is what degree of protection is warranted. This will vary with the circumstances, but most students of corporate governance would agree that for successful hostile bidders to "pay an average premium of 40% … has … left managers with considerable autonomy" (Bebchuk and Fried, 2004, p. 55) and is explained by the creation of takeover obstacles.

Staggered boards and poison pills are commonly introduced at the behest of the management but require board approval. Lucian Bebchuk's evidence on the unwillingness of boards to implement precatory resolutions passed by the majority of the shareholders to repeal staggered boards (2005, pp. 852-856) reinforces the concern that compliant boards are operating in the service of the management. The burden of justifying such a degree of protection by staggered boards and poison pills falls heavily on those who support the such practices.

4.3 A puzzle: the failure of mutual gain

As discussed in Section 2, suppliers in the intermediate product market who make specialized investments in support of the buyers do not need to petition buyers to provide credible commitments. That is because both parties recognize that the hazards will be priced out and that mutual gains accrue by locating at Node C (with credible commitments) than at Node B (unrelieved hazards). The general principle is this:

inefficiencies invite their own demise – both in a zero transaction cost (Coase Theorem) world and more generally.

Applied to equity, the argument is this: a board that is compromised in its capacity to serve as a monitor locates the parties at Node B, as a consequence of which the cost of capital will be higher than it would be if the integrity of the board were restored, thereby to locate the parties at Node C. Since mutual gains would accrue from restoring integrity, why do we not observe this result?

One response would be to insist that what we observe is efficient and that complaints to the contrary are wrong-headed. Indeed, if the cost of capital gains of moving to Node C are large enough, efforts to displace the incumbent management and board should presumably be forthcoming – as with proxy contests or takeover. Because, however, such efforts are costly and, if most firms most of the time do not exceed the threshold, then Node B may remain viable.

But then what explains why Node B is non-viable for intermediate product market transactions yet is viable for equity? A significant contributing factor, I submit, is that the intermediate product market transaction is between two firms, both of which are roughly on a parity in knowledge and expertise respects and can bargain easily to an efficient result, whereas equity ownership is dispersed among many parties, few of whom can be presumed to be knowledgeable, and works through collective action mechanisms. Bargaining to an efficient result is thus made much more difficult – and not merely because the collective action machinery is more cumbersome. Additional complications arise if (1) the management, over the course of time, has gained significant control over the collective action machinery (board nominations, procedures, operations, information) through which equity operates, (2) reforms that are immune to being reversed by the insidious creep of oligarchy are well nigh impossible, and (3) the very act of proposing such a reform puts an incumbent management at risk of being denounced for having

compromised the interests of the equity, whereupon they will be punished by indignant owners of equity (with the support of public outcry) rather than be rewarded by sharing in the benefits of Node C status (to which the aforementioned mutual gains would accrue).

5. What to Do?

Michels advises us that “a severe and frank examination of the oligarchical dangers of …[organization] will permit as to minimize these dangers” (1962, p. 375). If private ordering fails, what are the other alternatives?

5.1 Stakeholder proposals

Stakeholder proposals of two kinds have been proposed. One is to include many constituencies on the board. The second is to treat the board as a mediating court of ultimate appeal.

The first of these advances the proposition that constituencies that have a stake in the corporation should be represented on the board. Why should the holders of equity, the stockholders, be privileged? Why not apportion equal representation on the board of directors to those with equal stakes?

My position is that the contractual relation between the firm and each constituency should be worked out with reference to the distinctive needs of each: at each contractual interface, craft transaction specific credible commitments in cost-effective degree.

With respect to labor, for example, generic labor ($k=0$) is a Node A transaction, hence does not pose credible contracting issues, whereas workers who acquire firm-specific skills ($k>0$) are ones for which continuity is valued by both firm and worker. Since individual workers are often too numerous, too uninformed, and too lacking in contract negotiation skills, collective organization has much to recommend it in these

circumstances. Thus although labor unions are typically thought of as instruments of monopoly, that is too narrow a construction. Labor unions can and often do have efficiency purposes. (Note, moreover, that, by contrast with equity, managements rarely capture the collective action machinery of workers.)

Specifically, in circumstances where $k>0$, unions can and do serve as a contractual safeguard, the effect of which is to move transactions from inefficient Node B (unrelieved hazards) to credible commitment status at Node C. Security interests are better protected if and as (1) union leadership and supporting staff are more informed and contractually sophisticated, (2) the design of specialized dispute settlement mechanisms (such as grievance procedures and arbitration mechanisms) permits disputes to be settled in a more well-informed way on the merits, and (3) premature termination by either party is deterred by the use of disincentives (e.g., non-vested benefits and severance packages). Thus although the state can confer monopoly powers on unions whatever the value of k, the design and deployment of credible commitment mechanisms is a private ordering, bilateral response that is conditional on the attributes of the labor market transaction. Specifically, added security is awarded to workers who acquire firm specific skills ($k>0$) but will not equally be conferred on those with easily redeployable skills ($k=0$). That is a refutable implication.

To be sure, best constituency specific responses may be judged sometimes to be inadequate. Awarding added security in the form of board membership might therefore be considered. Whether or not that should be done should await a showing that real gains are in prospect that are not more than offset by the costs (of politicizing the board and further devaluing the safeguard to equity). Note, moreover, that there is no case whatsoever for awarding board membership to constituencies for which contractual hazards are nil ($k=0$); and conferring stakeholder status on a constituency for which negligible relief is thereby realized is likewise dubious.

Margaret Blair and Lynn Stout have a different view of stakeholders. They recommend that public corporations be interpreted (or reshaped as) mediating hierarchies with the board of directors at the apex (Blair and Stout, 1999, pp. 276-287). Their core concept is this (p. 278):

> [The] public corporation is a team of people who enter into a complex agreement to work together for their mutual gain. Participants – including shareholders, employees, and perhaps other stakeholders such as creditors or the local community – enter into a [pact] … under which they yield control over outputs and key inputs (time, intellectual skills, or financial capital) to the hierarchy…. They … agree not to specific terms or outcomes (as in a traditional "contract"), but to participation in a process of internal goal setting and dispute resolution. Hence the mediating hierarchy of a corporation can be viewed as a substitute for explicit contracting that is especially useful in situations where team production requires several different team members to make various kinds of enterprise-specific investments in projects that are complex, ongoing, and unpredictable.

Key concepts from the lens of governance setup to which they appeal include asset specificity, incomplete contracting, and dispute resolution.

Their use of these concepts and mine, however, are different. With respect to asset specificity, for example, they never discuss participants who have negligible asset specificity (k=0) at risk. Instead, all of the named participants to which they refer (from which list consumers are conspicuously omitted) have a stake. The agreements to which they refer, moreover, do not seem to be incomplete contracts so much as internal goal setting and dispute resolution agreements – presumably of a multilateral rather than

bilateral kind, but the mechanics are vague. Their use of the concept of forbearance law is similarly of an all-purpose rather than transaction-specific kind.

Thus although Blair and Stout appeal to my concept of forbearance law to describe dispute settlement in the firm, their dispute settlement mechanisms and mine are very different. My view is that forbearance law applies principally (1) to dispute settlement for intermediate product market transactions for which the firm has decided to make rather than buy the good or service and (2) to business judgment decisions made by the management and board of directors. Disputes between successive stages of production that cannot be settled by the parties are ones that courts will refuse to hear. These are appealed instead to the boss to which the two stages report. And decisions by the management or board of directors are likewise ones that the courts will refuse to hear unless issues of fraud are posed. The courts, however, do enforce debt-related disputes. Arbitration is used to settle labor disputes. More generally, as heretofore stated, the mechanisms of dispute settlement are worked out with reference to the needs of each class of transactions at the contractual interface where firm and each constituency are joined.

Blair and Stout, by contrast, stipulate that "the relevant hierarch (the 'boss') has the authority to resolve disputes among members at lower levels" and that contested decisions are appealed up, where the "peak of the pyramid is occupied by … a board of directors whose job includes serving as a final arbiter in disputes that cannot be resolved at lower levels" (1999, p. 279).

One of the problems with this option to appeal disputes up <u>across successive levels of the hierarchy</u> is that it introduces a means by which disaffected parties can threaten to impair the adaptive efficacy of the firm by using their entitlements to appeal strategically – an extreme example of which would be to enter fabricated complaints. A

related concern is that no board (of workable size) can be expected to possess the requisite expertise to deal with the vast panoply of disparate disputes that would arise.

5.2 Activate investors: Jensen

Although Jensen makes a series of specific recommendations for reforming the board, his main recommendation is to resurrect active investors by taking leveraged buyout associations as the model (p. 869):

> LBO associations and venture capital funds provide a blueprint for managers and boards who wish to revamp their top-level control systems to make them more efficient. LBOs and venture capital funds are, of course, the preeminent examples of active investors in recent U.S. history, and they serve as excellent models that can be emulated in part or in total by virtually any corporation. The two have similar governance structures, and have been successful in resolving the governance problems of both slow growth or declining firms (LBO associations) and high growth entrepreneurial firms (venture capital funds).

I submit that LBOs and venture capital firms are evanescent forms of organization that possess properties that are non-replicable in the ongoing modern corporation. Both feature concentrated ownership and high-powered incentives that cannot be sustained once the project succeeds (or fails, as the case may be). LBOs and startups are both variants upon Rudolf Spreckels' remark that "When I see something badly done, or not done at all, I see an opportunity to make a fortune."

The LBO sees something badly done, mobilizes financing, pays the requisite premium to gain control of the firm, replaces the incumbent management, and reshapes the firm and its financing. Thus debt is substituted for equity, thereby to restore a more efficient mix of debt and equity in relation to the firm's assets,[16] and unrelated or

underperforming parts are sold or spun off. The big reward comes when the firm is taken public again. In the interim, the new management and the banks, insurance companies, and investment bankers that package the deal are actively involved in the management and reshaping of the corporation. Once the firm goes public, the high-powered incentives and the priority of real-time responsiveness give way to a steady state modern corporation with managers (rather than financial entrepreneurs) at the helm, lower powered incentives, and diffuse ownership. In the fullness of time, many of the benefits of LBOs are undone as oligarchy sets in, but this will not be done without interim gains.

Start-up firms, especially of a high technology kind, may also be aimed at improvements on something badly done but more often arise out of perceived opportunities to provide something altogether new. Whatever, these are high risk undertakings that combine venture capitalists with entrepreneurial, technical, and legal talent in a race to be first. High powered incentives and real-time involvement by all of the critical actors (as managers or directors) are practiced.[17] If and as the start-up succeeds, the big rewards are realized when the firm goes public. Albeit gradually, the firm gradually takes on the characteristics of a business-as-usual enterprise, as more of the action devolves to the primary feedback loop where routines set in.[18]

5.3 Activate investors: Bebchuk

Of his many influential contributions to corporate governance, I focus on his recent paper, “The Case for Increasing Shareholder Power” (2005). His basic argument is that shareholders should be given the power “to initiate and vote to adopt changes in the company’s basic corporate governance arrangements … [to] include the power to adopt provisions that would allow shareholders, down the road, to initiate and vote on proposals regarding specific corporate decisions” (2005, p. 836; emphasis added). It is

his view that increasing shareholder power to intervene in this way will “improve corporate governance and enhance shareholder value” (2005, p. 836).

Although Bebchuk makes a thoughtful and interesting argument in support if this recommendation, other students of corporate governance have vigorously contested it.[19] The three issues that I examine are these: How should the board be described? Will the proposal have the intended activation effects? And how radical is it?

Bebchuk uses the term “management” to describe “the team of directors and officers who shape board decisions,” the reason being that he wants to focus on “the allocation of decision-making power between the team of directors and officers as a whole – that is, between management as I define it – and shareholders” (2005, p. 842). Inasmuch as part-time monitors and full-time managers are in fact very different, conflating the two under the term management seems to me potentially misleading. As discussed in Section 3, however, treating the officers and the directors as a team is, I think, instructive.

Indeed, although some might describe the ideal relation between the directors and the officers as being guarded or even adversarial, that seems to me to be a prescription for frustrating the firm in adaptive, sequential decision making respects. A better description is that the board should relate to the management in a constructive and objective manner – where by constructive I mean that the board is normally supportive of the management, intervenes only for good cause, and then mainly so as to effect corrective actions (rather than seek blame for which heads must roll); and by objective I mean that it is provided with accurate and relevant performance measures in a timely way. So described, the monitors and managers form a team “which enhances shareholder and firm value,” which Bebchuk takes to be the objective underlying his analysis (2005, p. 842).

To be sure, as described in Section 4, the actual relation between the board and the management may be compromised. Evidence that Bebchuk takes to be supportive of this is his observation that boards of directors frequently disregard shareholder resolutions that have widespread support. Thus although shareholders can, under existing securities laws, initiate resolutions for a "charter amendment, reincorporation, or to urge the management to adopt a particular policy or course of action, … these resolutions are not binding: under state corporate law, directors have discretion whether to follow precatory proposals that receive substantial or majority support, and director's freedom to disregard such resolutions is protected under the business judgment rule" (Bebchuk, 2005, p. 846). Such disregard for shareholder resolutions is not merely hypothetical, moreover – as witness the evidence presented by Bebchuk that shareholder support for precatory resolutions to repeal staggered boards is so often ignored (2005, pp. 852-856). Presumably because he regards the board as a hopelessly compliant instrument of the management, Bebchuk proposes not to reform the board but to go around the team instead.

Would, however, his board activation proposal have the intended effect? Might it instead have the main effect of activating institutional investors – to which Roberta Romano's examination of the evidence of the evidence on activism by institutions is pertinent: "very few studies find evidence of a positive impact, and some even find a significant negative stock market price effect from activism" (2001, p. 177). Such negative effects could be because those "institutions most inclined to be activist investors are associated with state governments and labor unions" (Strine, 2006, p. 10), which is also Stephen Bainbridge's view: "state and local public employee and union pension funds … are precisely the classes most likely to misuse … [the] powers" that Bebchuk would confer (2006, p. 28). At the very least, a systematic examination of the

unintended and, especially, downside consequences of Bebchuk's shareholder activation proposal warrants scrutiny in these and other respects.

Vigorous opposition notwithstanding, is the Bebchuk proposal really very radical after all? For example, if the team of officers and outside directors were confronted with the choice between Bebchuk's proposal and the alternative of giving the shareholders (and the shareholders only) the responsibility to name to nominees to the board, how would they come out?

My conjecture is that both the independent directors and the officers would prefer Bebchuk's proposal. Outside nominations would be vigorously opposed by the independent directors, who will project that they will not be nominated to jobs that currently confer personal net benefits; and the officers will regard the outside nomination procedure as alien to the team relationship. Thus although Bebchuk's proposal has the appearance of being radical, reform by indirection (going around the team) may not be so bad after all.

5.4 Other

One possibility would be to reshape the board by making a series of specific changes, possibly along the lines that Jensen suggests (1993, pp. 861-866): keep the board small (seven or eight members); there should be only one inside member, namely the CEO; the chair of the board should not be the CEO; the chair should initiate board appointments and make board committee assignments; outside board members should invest in the stock of the company with personal funds of $100,000 or more; and some outside board members should possess financial expertise. The qualifications and susceptibility of outside board members to be compliant could also be brought under systematic scrutiny. More generally, the board might be reformed along the lines of the

1992 Cadbury Report in the UK, with special emphasis on the auditing function (which is also emphasized by Sarbannes-Oxley).

An obvious problem is that such reforms will be ineffectual because it is so easy to comply with the letter with little change to the substance. A second and related concern is that there is too much emphasis in the corporate governance literature on proposals that are long on good intentions but have no empirical basis.[20] Indeed, one of the lessons of Roberta Romano's research is that corporate governance will benefit from requiring the recommendations of "policy entrepreneurs" to be confronted with the data (2005b).

6. Conclusions

The three legs upon which my argument works are these: (1) the logic of corporate governance turns on applications of the lens of contract to the finance transaction and to other constituencies for which contract-specific credible safeguards are provided; (2) the corporation is interpreted as an adaptive system that employs double feedback; and (3) organizations undergo oligarchical transformations.

With respect to finance transactions, debt is well suited to finance generic assets (k=0) to which rules based safeguards apply. Equity is used to finance non-redeployable investments (k>0) for which a board of directors is created and awarded to equity as a safeguard. Other constituencies are likewise examined with respect to contractual hazards for which transaction specific safeguards are crafted if and as needed (k>0). Equity excepted, there is no general case for including any other constituency on the board of directors. Mutual gains are nevertheless realized by providing each constituency that experiences contractual hazards with cost-effective credible commitments.[21]

With respect to double feedback, the board of directors is located at the essential variables in the secondary feedback loop. So construed, the function of the board is to ascertain when performance drops below acceptable levels and to activate the management to take remedial action. In a effect, this is a management by exception setup, in that the board gives nodding approval most of the time and the management is advised to make discrete structural changes only as the essential variables fall outside their control limits.

Provision, moreover, is made for the fact that organization has a life of its own, of which oligarchy is one. Specifically, the leadership (full-time management) of the firm is, by reason of its deep knowledge, expertise, and strategic location, able to release information, control the agenda, make appointments, acquire resources, give direction, and ensconce itself securely in relation to control efforts. Although these advantages accrue naturally, they can also be augmented by calculated efforts of a strategic kind. This is a matter of special concern in relation to the controls exercised by the board of directors, the efficacy of which is compromised by managements that arrogate the prerogatives of control to themselves. What is furthermore noteworthy is that once de facto control of the board has passed to the management, it may be impossible to restore the board to Node C (credible commitment) status.

The marvel of it all is that, widespread loss of control notwithstanding, corporate governance in the U.S. works as well as it does. To be sure, this is measured not in relation to the normative ideal (as set out in Section 3) but rather as compared with corporate governance around the world. The checks brought to bear from competition in the product market and competition in the capital market in combination with the benefits that accrue to organizational innovations and “The Genius of American Corporate Law” to which Roberta Romano (1993) refers are presumably contributing factors.

The upshot is that, although the study of corporate governance has come a long ways in the past 30 years (Romano, 2005a), it is still confronted with serious gaps and puzzles. Part of the reason, I submit, is that the new economic reasoning needs to be complemented by a greater awareness and deeper understanding of the intertemporal regularities to which economic organization is subject. Thus although organization theory is an inherently "messier" subject than economics, it deals with many important issues that have been too long ignored or suppressed. If and as the regularities that organization theory brings to our attention can be interpreted and the ramifications worked out by applications of the lens of contract, more headway with the study of corporate governance (and more generally) is in prospect.

Footnotes

1. Other factors include lack of agreement on how to interpret the data and the differing ideological predilections of “political entrepreneurs” (Romano, 2003).

2. As I discuss elsewhere, the lens of contract approach to economic organization divides into an incentive branch and a governance branch (Williamson, 2003). This paper works out of the lens of contract/governance branch. All mention hereafter of the lens of contract should be understood to mean the lens of contract/governance.

3. As Bengt Holmstrom and Steven Kaplan put it (2003):

    > Despite the alleged flaws in its governance system, the U.S. economy has performed very well, both on an absolute basis and particularly relative to other countries. U.S. productivity gains in the past decade have been exceptional, and the U.S. stock market has consistently outperformed other world indices over the last two decades, including the period since the scandals broke. In other words, the broad evidence is not consistent with a failed U.S. system. If anything, it suggests a system that is well above average.

4. As developed herein, I begin my examination of corporate governance by applying the focused lens of contract. Simplicity is accomplished by taking adaptation to be the chief purpose of economic organization, in relation to which the economizing alignment of transactions with governance structures is taken to be the main case. The logic of efficient alignment is then worked up with reference to the paradigm transaction (vertical integration) and then more generally, with special emphasis on equity finance and the governance thereof. Plausibility considerations are discussed in the context of boards in practice.

5. This section draws upon my paper, “The Theory of the Firm as Governance Structure: From Choice to Contract” (2002).

6. Timely adaptation is facilitated by an understanding that orders that are ambiguous with respect to or even exceed the scope of authority are to be fulfilled first and disputed later (Summers, 1969, pp. 538, 573).

7. The remainder of this subsection is based on Williamson (1988, pp. 579-580). For a related paper that examines debt financing for different assets, see Andrei Shleifler and Robert Vishny (1992). Note that a governance interpretation of corporate finance provides yet another challenge to the Modigliani-Miller theorem that the cost of capital in a firm is independent of the mode of finance.

8. Shleifler and Vishny (1992) also emphasize that maladaptation is the main disability of non-redeployable assets.

9. Jensen locates the board “at the apex of the internal control system” (1992, p. 862), but where in the scheme of things is this?

10. The next two paragraphs and Figure 2 are from Williamson (1985, pp. 282-283).

11. Note that the board does not itself “decide what to do.” As Shleifler and Vishny put (1997, p. 741):

> In principle, one could imagine a contract in which the financiers give funds to the manager on the condition that they retain all the residual control rights. Any time something unexpected happens, they get to decide what to do. But this does not quite work, for the simple reason that the financiers are not qualified or informed enough to decide what to do – the very reason they hired the manager in the first place. As a consequence, the manager ends up with substantial residual control rights and therefore discretion to allocate funds as he chooses. There may be limits on this discretion specified in the

contract – and much of corporate governance deals with these limits, but the fact is that managers do have most of the residual control rights.

12. What I have referred to as the remediableness criterion is pertinent, which criterion eschews the usual comparison of an actual condition with a hypothetical ideal − it being elementary that all extant modes of organization are inferior to a hypothetical ideal. The remediableness criterion counsels that an extant mode of organization for which no superior feasible mode can be described and implemented with expected net gains is presumed to be efficient (Williamson, 1995; 1996). For earlier discussions that prefigure remediableness, see Coase (1962) and Demsetz (1967). Also see Dixit (1966) for related discussion.

13. Mace wrote in 1971, but I believe that his observations (with small changes in nomenclature – e.g., substituting CEO for president) are applicable today. Some, however, contend that things have changed significantly. Thus Stephen Bainbridge describes the current state of affairs as follows (2003):

> The board capture phenomenon seems less valid today … than it once was. During the 1980s and 1990s, several trends coalesced to encourage more active and effective board oversight. Much director compensation is now paid in stock, for example, which helps align director and shareholder interests. Courts have made clear that effective board processes and oversight are essential if board decisions are to receive the deference traditionally accorded to them under the business judgment rule, especially insofar as structural decisions are concerned (such as those relating to management buy-outs). Third, director conduct is constrained by an active market for corporate control, ever-rising rates of shareholder litigation, and some say, activist shareholders.

Others, like Michael Jensen and myself, are less sanguine.

14. Bernard Black, Brian Cheffins, and Michael Klausner contend otherwise: given the "safeguards for directors built into the rules setting out the duties of directors, ample scope for indemnification by companies, and a congenial legal environment for D&O insurance, … directors [are] essentially unexposed [to liability] unless they engage in self-dealing or consciously disregard their obligations" (2006, p. 6).

15. Expertise considerations also arise in this connection. Thus a justification for board participation that was advanced on behalf of one university administrator was that board service would benefit the university because the administrator would learn "different styles of leadership, governance, planning and finance, and best practices from the corporate world" (Schevitz and Wallack, 2006). For a board member with so much to learn, where is the benefit to the corporation? (The benefit to the management is presumably compliance.)

16. Thus, suppose that over the course of time that the efficient debt to equity ratio undergoes a transformation. Specifically (Williamson, 1988, p. 585):

> Suppose … that a firm is originally financed along lines that are consistent with the debt and equity financing principles set out [in Section 3] above. Suppose further that the firm is successful and grows through retained earnings. The initial debt-equity ratio thus progressively falls. And suppose finally that many of the assets in this now-expanded enterprise are of a kind that could have been financed by debt.
>
> Added value, in such a firm, can be realized by substituting debt for equity. This argument applies, however, selectively. It only applies to firms where the efficient mix of debt and equity has gotten seriously out of

alignment. These will be firms that combine (1) a very high ratio of equity to debt with (2) a very high ratio of redeployable to nonredeployable assets.

Interestingly, many of the large leveraged buyouts in the 1980s displayed precisely these qualities.

17. As Jensen observes, "the close relationship between the LBO partners or venture fund partners and the operating companies facilitates the infusion of expertise from the board during times of crisis. It is not unusual for a partner to join the management team, even as CEO, to help an organization through such emergencies" (1993, p. 870).

18. Henry Hausmann contrasts the use of special charter provisions by venture capital start-up firms that have a relatively short expected life with publicly traded firms that consistently defer to the default terms provided by corporate law (2006, p. 9). The former are intended to elicit high-powered incentives. The later are more well-suited to business-as-usual.

19. See the exchange between Stephen Bainbridge (2006), Leo Strine (2006), and Lucian Bebchuk (2006).

20. For example, Romano's empirical examination (2005b) of the auditing recommendations of Sarbannes-Oxley shows that there is no empirical basis for introducing these rules; and the study by Guner, Malmendier, and Tate (2005) on the influence of financial experts finds that "financial experts on boards do have a significant impact on board decisions, but not necessarily in the interest of shareholders."

21. In the degree to which the merits of credible contracting are not understood by many members of the board, board members should be educated to understand that credible contracting is practiced throughout the corporation. Not only should the board members understand that they are the credible commitment instrument

for safeguarding equity investors, but the board should also appreciate that the appropriate commitment device for each constituency (stakeholder) is primarily worked out at its respective contractual interface with the corporation.