A Survey of Corporate Governance

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ABSTRACT

This article surveys research on corporate governance, with special attention to the importance of legal protection of investors and of ownership concentration in corporate governance systems around the world.

CORPORATE GOVERNANCE DEALS WITH the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment. How do the suppliers of finance get managers to return some of the profits to them? How do they make sure that managers do not steal the capital they supply or invest it in bad projects? How do suppliers of finance control managers?

At first glance, it is not entirely obvious why the suppliers of capital get anything back. After all, they part with their money, and have little to contribute to the enterprise afterward. The professional managers or entrepreneurs who run the firms might as well abscond with the money. Although they sometimes do, usually they do not. Most advanced market economies have solved the problem of corporate governance at least reasonably well, in that they have assured the flows of enormous amounts of capital to firms, and actual repatriation of profits to the providers of finance. But this does not imply that they have solved the corporate governance problem perfectly, or that the corporate governance mechanisms cannot be improved.

In fact, the subject of corporate governance is of enormous practical importance. Even in advanced market economies, there is a great deal of disagreement on how good or bad the existing governance mechanisms are. For example, Easterbrook and Fischel (1991) and Romano (1993a) make a very optimistic assessment of the United States corporate governance system, whereas Jensen (1989a, 1993) believes that it is deeply flawed and that a major move from the current corporate form to much more highly leveraged organizations, similar to LBOs, is in order. There is also constant talk of replacing the Anglo-Saxon corporate governance systems with those patterned after Germany and Japan (see, for example, Roe (1993) and Charkham (1994)). But the United States, Germany, Japan, and the United Kingdom have some of the best corporate governance systems in the world, and the differences between

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them are probably small relative to their differences from other countries. According to Barca (1995) and Pagano, Panetta, and Zingales (1995), Italian corporate governance mechanisms are so undeveloped as to substantially retard the flow of external capital to firms. In less developed countries, including some of the transition economies, corporate governance mechanisms are practically nonexistent. In Russia the weakness of corporate governance mechanisms leads to substantial diversion of assets by managers of many privatized firms, and the virtual nonexistence of external capital supply to firms (Boycko, Shleifer, and Vishny (1995)). Understanding corporate governance not only enlightens the discussion of perhaps marginal improvements in rich economies, but can also stimulate major institutional changes in places where they need to be made.

Corporate governance mechanisms are economic and legal institutions that can be altered through the political process—sometimes for the better. One could take a view that we should not worry about governance reform, since, in the long run, product market competition would force firms to minimize costs, and as part of this cost minimization to adopt rules, including corporate governance mechanisms, enabling them to raise external capital at the lowest cost. On this evolutionary theory of economic change (Alchian (1950), Stigler (1958)), competition would take care of corporate governance.

While we agree that product market competition is probably the most powerful force toward economic efficiency in the world, we are skeptical that it alone can solve the problem of corporate governance. One could imagine a scenario in which entrepreneurs rent labor and capital on the spot market every minute at a competitive price, and hence have no resources left over to divert to their own use. But in actual practice, production capital is highly specific and sunk, and entrepreneurs cannot rent it every minute. As a result, the people who sink the capital need to be assured that they get back the return on this capital. The corporate governance mechanisms provide this assurance. Product market competition may reduce the returns on capital and hence cut the amount that managers can possibly expropriate, but it does not prevent the managers from expropriating the competitive return after the capital is sunk. Solving that problem requires something more than competition, as we show in this survey.

Our perspective on corporate governance is a straightforward agency perspective, sometimes referred to as separation of ownership and control. We want to know how investors get the managers to give them back their money. To begin, Section I outlines the nature of the agency problem, and discusses some standard models of agency. It also focuses on incentive contracts as a possible solution to the agency problem. Finally, Section I summarizes some evidence pointing to the large magnitude of this problem even in advanced market economies.

Sections II through IV outline, in broad terms, the various ways in which firms can attract capital despite the agency problem. Section II briefly examines how firms can raise money without giving suppliers of capital any real
power. Specifically, we consider reputation-building in the capital market and excessive investor optimism, and conclude that these are unlikely to be the only reasons why investors entrust capital to firms.

Sections III and IV then turn to the two most common approaches to corporate governance, both of which rely on giving investors some power. The first approach is to give investors power through legal protection from expropriation by managers. Protection of minority rights and legal prohibitions against managerial self-dealing are examples of such mechanisms. The second major approach is ownership by large investors (concentrated ownership): matching significant control rights with significant cash flow rights. Most corporate governance mechanisms used in the world—including large shareholdings, relationship banking, and even takeovers—can be viewed as examples of large investors exercising their power. We discuss how large investors reduce agency costs. While large investors still rely on the legal system, they do not need as many rights as the small investors do to protect their interests. For this reason, corporate governance is typically exercised by large investors.

Despite its common use, concentrated ownership has its costs as well, which can be best described as potential expropriation by large investors of other investors and stakeholders in the firm. In Section V, we focus on these potential costs of ownership by large investors.

In Section VI, we turn to several specific examples of widely used corporate governance mechanisms, which illustrate the roles of legal protection and concentrated ownership in corporate governance. We begin by discussing debt governance and equity governance as alternative approaches to addressing the agency problem. We then turn to a brief discussion of a hybrid form—the leveraged buy out—which reveals both the benefits and the costs of concentrated ownership. Finally, we look at state enterprises as a manifestation of a radical failure of corporate governance.

In Section VII, we bring sections III through VI together by asking: which system is the best? We argue that a good corporate governance system should combine some type of large investors with legal protection of both their rights and those of small investors. Indeed, corporations in successful market economies, such as the United States, Germany, and Japan, are governed through somewhat different combinations of legal protection and concentrated ownership. Because all these economies have the essential elements of a good governance system, the available evidence does not tell us which one of their governance systems is the best. In contrast, corporate governance systems in most other countries, ranging from poor developing countries, to transition economies, to some rich European countries such as Italy, lack some essential elements of a good system. In most cases, in fact, they lack mechanisms for legal protection of investors. Our analysis suggests that the principal practical question in designing a corporate governance system is not whether to emulate the United States, Germany, or Japan, but rather how to introduce significant legal protection of at least some investors so that mechanisms of extensive outside financing can develop.
Finally, in Section VIII, we summarize our argument and present what we take to be some of the major unresolved puzzles in the analysis of corporate governance.

Before proceeding, we should mention several important topics closely related to corporate governance that our article does not deal with, as well as some of the references on these topics. Our article does not deal with foundations of contract theory; for that, see Hart and Holmstrom (1987), Hart (1995, part I), and Tirole (1994). Second, we do not deal with some of the basic elements of the theory of the firm, such as the make or buy decision (vertical integration). On this topic, see Williamson (1985), Holmstrom and Tirole (1989), and Hart (1995, part I). Third, while we pay some attention to cooperatives, we do not focus on a broad variety of noncapitalist ownership patterns, such as worker ownership or nonprofit organizations. A major new treatise on this subject is Hansmann (1996). Finally, although we talk about the role of financial intermediaries in governance, we ignore their function as collectors of savings from the public. For recent overviews of intermediation, see Allen and Gale (1994), Dewatripont and Tirole (1995) and Hellwig (1994). In sum, this survey deals with the separation of financing and management of firms, and tries to discuss how this separation is dealt with in theory and in practice.

The last preliminary point is on the selection of countries we talk about. Most of the available empirical evidence in the English language comes from the United States, which therefore receives the most attention in this article. More recently, there has been a great surge of work on Japan, and to a lesser extent on Germany, Italy, and Sweden. In addition, we frequently refer to the recent experience of privatized firms in Russia, with which we are familiar from our advisory work, even though there is little systematic research on Russia’s corporate governance. Unfortunately, except for the countries just mentioned, there has been extremely little research done on corporate governance around the world, and this dearth of research is reflected in our survey.

I. The Agency Problem

A. Contracts

The agency problem is an essential element of the so-called contractual view of the firm, developed by Coase (1937), Jensen and Meckling (1976), and Fama and Jensen (1983a,b). The essence of the agency problem is the separation of management and finance, or—in more standard terminology—of ownership and control. An entrepreneur, or a manager, raises funds from investors either to put them to productive use or to cash out his holdings in the firm. The financiers need the manager’s specialized human capital to generate returns on their funds. The manager needs the financiers’ funds, since he either does not have enough capital of his own to invest or else wants to cash out his holdings. But how can financiers be sure that, once they sink their funds, they
get anything but a worthless piece of paper back from the manager? The agency problem in this context refers to the difficulties financiers have in assuring that their funds are not expropriated or wasted on unattractive projects.

In most general terms, the financiers and the manager sign a contract that specifies what the manager does with the funds, and how the returns are divided between him and the financiers. Ideally, they would sign a complete contract, that specifies exactly what the manager does in all states of the world, and how the profits are allocated. The trouble is, most future contingencies are hard to describe and foresee, and as a result, complete contracts are technologically infeasible. This problem would not be avoided even if the manager is motivated to raise as much funds as he can, and so tries hard to accommodate the financiers by developing a complete contract. Because of these problems in designing their contract, the manager and the financier have to allocate residual control rights—i.e., the rights to make decisions in circumstances not fully foreseen by the contract (Grossman and Hart (1986), Hart and Moore (1990)). The theory of ownership addresses the question of how these residual control rights are allocated efficiently.

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.

In practice, the situation is more complicated. First, the contracts that the managers and investors sign cannot require too much interpretation if they are to be enforced by outside courts. In the United States, the role of courts is more extensive than anywhere else in the world, but even there the so-called business judgment rule keeps the courts out of the affairs of companies. In much of the rest of the world, courts only get involved in massive violations by managers of investors' rights (e.g., erasing shareholders' names from the register). Second, in the cases where financing requires collection of funds from many investors, these investors themselves are often small and too poorly informed to exercise even the control rights that they actually have. The free rider problem faced by individual investors makes it uninteresting for them to learn about the firms they have financed, or even to participate in the governance, just as it may not pay citizens to get informed about political candidates and vote (Downs (1957)). As a result, the effective control rights of the managers—and hence the room they have for discretionary allocation of funds—end up being much more extensive than they would have been if courts or providers of finance became actively involved in detailed contract enforcement.
B. Management Discretion

The upshot of this is that managers end up with significant control rights (discretion) over how to allocate investors' funds. To begin, they can expropriate them. In many pyramid schemes, for example, the organizers end up absconding with the money. Managerial expropriation of funds can also take more elaborate forms than just taking the cash out, such as transfer pricing. For example, managers can set up independent companies that they own personally, and sell the output of the main company they run to the independent firms at below market prices. In the Russian oil industry, such sales of oil to manager-owned trading companies (which often do not even pay for the oil) are evidently common. An even more dramatic alternative is to sell the assets, and not just the output, of the company to other manager-owned businesses at below market prices. For example, the Economist (June 1995) reports that Korean chaebol sometimes sell their subsidiaries to the relatives of the chaebol founder at low prices. Zingales (1994) describes an episode in which one state-controlled Italian firm sold some assets to another at an excessively high price. The buying firm, unlike the selling firm, had a large number of minority shareholders, and these shareholders got significantly diluted by the transaction. In short, straight-out expropriation is a frequent manifestation of the agency problem that financiers need to address. Finally, before the reader dismisses the importance of such expropriation, we point out that much of the corporate law development in the 18th and 19th centuries in Britain, Continental Europe, and Russia focused precisely on addressing the problem of managerial theft rather than that of shirking or even empire-building (Hunt (1936), Owen (1991)).

In many countries today, the law protects investors better than it does in Russia, Korea, or Italy. In the United States, for example, courts try to control managerial diversion of company assets to themselves, although even in the United States there are cases of executive compensation or transfer pricing that have a bad smell. For example, Victor Posner, a Miami financier, received in 1985 over $8 million in salary from DWG, a public company he controlled, at the time the company was losing money (New York Times, June 23, 1986). Because such expropriation of investors by managers is generally kept down by the courts in the United States, more typically managers use their discretion to allocate investors' funds for less direct personal benefits. The least costly of this is probably consumption of perquisites, such as plush carpets and company airplanes (Burrough and Helyar 1990). Greater costs are incurred when managers have an interest in expanding the firm beyond what is rational, reinvesting the free cash, pursuing pet projects, and so on. A vast managerialist literature explains how managers use their effective control rights to pursue projects that benefit them rather than investors (Baumol (1959), Marris (1964), Williamson (1964), Jensen (1986), etc.). Grossman and Hart (1988) aptly describe these benefits as the private benefits of control.

Finally, and perhaps most important, managers can expropriate shareholders by entrenching themselves and staying on the job even if they are no longer
competent or qualified to run the firm (Shleifer and Vishny (1989)). As argued in Jensen and Ruback (1983), poor managers who resist being replaced might be the costliest manifestation of the agency problem.

Managerial opportunism, whether in the form of expropriation of investors or of misallocation of company funds, reduces the amount of resources that investors are willing to put up ex ante to finance the firm (Williamson (1985), Grossman and Hart (1986)). Much of the subject of corporate governance deals with constraints that managers put on themselves, or that investors put on managers, to reduce the ex post misallocation and thus to induce investors to provide more funds ex ante. Even with these constraints, the outcome is in general less efficient than would occur if the manager financed the firm with his own funds.

An equally interesting problem concerns the efficiency of the ex post resource allocation, after investors have put up their funds. Suppose that the manager of a firm cannot expropriate resources outright, but has some freedom not to return the money to investors. The manager contemplates going ahead with an investment project that will give him $10 of personal benefits, but will cost his investors $20 in foregone wealth. Suppose for simplicity that the manager owns no equity in the firm. Then, as argued by Jensen and Meckling (1976), the manager will undertake the project, resulting in an ex post inefficiency (and of course an ex ante inefficiency as investors cut down finance to such a firm).

The Jensen-Meckling scenario raises the obvious point: why don’t investors try to bribe the manager with cash, say $11, not to undertake the inefficient project? This would be what the Coase (1960) Theorem predicts should happen, and what Grossman and Hart (1986) presume actually happens ex post. In some cases, such as golden parachutes that convince managers to accept hostile takeover bids, we actually observe these bribes (Walkling and Long (1984), Lambert and Larcker (1985)). More commonly, investors do not pay managers for individual actions and therefore do not seem to arrive at efficient outcomes ex post. The Jensen-Meckling view is empirically accurate and the Coase Theorem does not seem to apply. Moreover, the traditional reason for the failure of the Coase Theorem, namely that numerous investors need to agree in order to bribe the manager, does not seem relevant, since the manager needs only to agree on his bribe with a small board of directors.

The reason we do not observe managers threatening shareholders and being bribed not to take inefficient actions is that such threats would violate the managers’ legal “duty of loyalty” to shareholders. While it is difficult to describe exactly what this duty obligates the managers to do (Clark (1985)), threats to take value-reducing actions unless one is paid off would surely violate this duty. But this only raises the question of why this legal duty exists at all if it prevents efficient ex post bargaining between managers and shareholders. The reason for introducing the duty of loyalty is probably to avoid the situation in which managers constantly threaten shareholders, in circumstances that have not been specified in the contract, to take ever less efficient actions unless they are bribed not to. It is better for shareholders to avoid
bargaining altogether than to expose themselves to constant threats. This argument is similar to that of why corruption in general is not legal, even if ex post it improves the resource allocation: the public does not want to give the bureaucrats incentives to come up with ever increasing obstacles to private activity solely to create corruption opportunities (Shleifer and Vishny (1993)). But the consequence is that, with limited corruption, not all the efficient bargains are actually realized ex post. Similarly, if the duty of loyalty to shareholders prevents the managers from being paid off for not taking self-interested actions, then such actions will be taken even when they benefit managers less than they cost shareholders.

C. Incentive Contracts

In the previous section, we discussed the agency problem when complete, contingent contracts are infeasible. When contracts are incomplete and managers possess more expertise than shareholders, managers typically end up with the residual rights of control, giving them enormous latitude for self-interested behavior. In some cases, this results in managers taking highly inefficient actions, which cost investors far more than the personal benefits to the managers. Moreover, the managers' fiduciary duty to shareholders makes it difficult to contract around this inefficiency ex post.

A better solution is to grant a manager a highly contingent, long term incentive contract ex ante to align his interests with those of investors. While in some future contingencies the marginal value of the personal benefits of control may exceed the marginal value of the manager's contingent compensation, such instances will be relatively rare if the incentive component of pay is substantial. In this way, incentive contracts can induce the manager to act in investors' interest without encouraging blackmail, although such contracts may be expensive if the personal benefits of control are high and there is a lower bound on the manager's compensation in the bad states of the world. Typically, to make such contracts feasible, some measure of performance that is highly correlated with the quality of the manager's decision must be verifiable in court. In some cases, the credibility of an implicit threat or promise from the investors to take action based on an observable, but not verifiable, signal may also suffice. Incentive contracts can take a variety of forms, including share ownership, stock options, or a threat of dismissal if income is low (Jensen and Meckling (1976), Fama (1980)). The optimal incentive contract is determined by the manager's risk aversion, the importance of his decisions, and his ability to pay for the cash flow ownership up front (Ross (1973), Stiglitz (1975), Mirrlees (1976), Holmstrom (1979, 1982)).

Incentive contracts are indeed common in practice. A vast empirical literature on incentive contracts in general and management ownership in particular dates back at least to Berle and Means (1932), who argue that management ownership in large firms is too small to make managers interested in
profit maximization. Some of the early studies take issue with Berle and Means by documenting a positive relationship between pay and performance, and thus rejecting the extreme hypothesis of complete separation of ownership and control (Murphy (1985), Coughlan and Schmidt (1985), Benston (1985)). More recently, Jensen and Murphy (1990) look at the sensitivity of pay of American executives to performance. In addition to looking at salary and bonuses, Jensen and Murphy also examine stock options and the effects on pay of potential dismissal after poor performance. Jensen and Murphy arrive at a striking number that executive pay rises (and falls) by about $3 per every $1000 change in the wealth of a firm's shareholders. Similarly to Berle and Means, Jensen and Murphy interpret their findings as evidence of inefficient compensation arrangements, although in their view these arrangements are driven by politically motivated restrictions on extremely high levels of pay.

Kaplan (1994a,b) shows that the sensitivity of pay (and dismissal) to performance is similar in the United States, Germany, and Japan, although average levels of pay are the highest in the United States. The question is whether there is a similar failure to pay for performance in all countries, or, alternatively, the results found by Jensen and Murphy are not so counterintuitive. In particular, even the sensitivity of pay to performance that Jensen and Murphy find would generate enormous swings in executive wealth, which require considerable risk tolerance. More sensitivity may not be efficient for risk-averse executives (Haubrich (1994)).

The more serious problem with high powered incentive contracts is that they create enormous opportunities for self-dealing for the managers, especially if these contracts are negotiated with poorly motivated boards of directors rather than with large investors. Managers may negotiate for themselves such contracts when they know that earnings or stock price are likely to rise, or even manipulate accounting numbers and investment policy to increase their pay. For example, Yermack (1997) finds that managers receive stock option grants shortly before good news announcements and delay such grants until after bad news announcements. His results suggest that options are often not so much an incentive device as a somewhat covert mechanism of self-dealing.

Given the self-dealing opportunities in high powered incentive contracts, it is not surprising that courts and regulators have looked at them with suspicion. After all, the business judgment rule that governs the attitude of American courts toward agency problems keeps the courts out of corporate decisions except in the matters of executive pay and self-dealing. These legal and political factors, which appear to be common in other countries as well as in the United States, have probably played an important role in keeping down the sensitivity of executive pay to performance (Shleifer and Vishny (1988), Jensen and Murphy (1990)). While it is a mistake to jump from this evidence to the conclusion that managers do not care about performance at all, it is equally problematic to argue that incentive contracts completely solve the agency problem.
D. Evidence on Agency Costs

In the last ten years, a considerable amount of evidence has documented the prevalence of managerial behavior that does not serve the interests of investors, particularly shareholders. Most of this evidence comes from the capital market in the form of “event” studies. The idea is that if the stock price falls when managers announce a particular action, then this action must serve the interests of managers rather than those of the shareholders. While in some circumstances this inference is not justified because the managerial action, while serving the interests of shareholders, inadvertently conveys to the market some unrelated bad news about the firm (Shleifer and Vishny (1986a)), in general such event study analysis is fairly compelling. It has surely become the most common empirical methodology of corporate governance and finance (see Fama, Fisher, Jensen, and Roll (1969) for the first event study).

We have pointed out above that managerial investment decisions may reflect their personal interests rather than those of the investors. In his free cash flow theory, Jensen (1986) argues that managers choose to reinvest the free cash rather than return it to investors. Jensen uses the example of the oil industry, where in the mid-1980s integrated oil producers spent roughly $20 per barrel to explore for new oil reserves (and thus maintain their large oil exploration activities), rather than return their profits to shareholders or even buy proven oil reserves that sold in the marketplace for around $6 per barrel. McConnell and Muscarella (1986) look more generally at announcement effects of investment projects of oil and other firms, and find negative returns on such announcements in the oil industry, although not in others. The study of investment announcements is complicated by the fact that managers in general are not obligated to make such announcements, and hence those that they do make are likely to be better news than the average one. Still, the managers in the oil industry announce even the bad news.

The announcement selection problem does not arise in the case of a particular kind of investment, namely acquisitions, since almost all acquisitions of public companies are publicly announced. Some of the clearest evidence on agency problems therefore comes from acquisition announcements. Many studies show that bidder returns on the announcement of acquisitions are often negative (Roll (1986) surveys this evidence). Lewellen, Loderer, and Rosenfeld (1985) find that negative returns are most common for bidders in which their managers hold little equity, suggesting that agency problems can be ameliorated with incentives. Morck, Shleifer, and Vishny (1990) find that bidder returns tend to be the lowest when bidders diversify or when they buy rapidly growing firms. Bhagat, Shleifer, and Vishny (1990), Lang and Stulz (1994), and Comment and Jarrell (1995) find related evidence of adverse effects of diversification on company valuation. Diversification and growth are among the most commonly cited managerial, as opposed to shareholder, objectives. Kaplan and Weisbach (1992) document the poor history of diversification by the U.S. firms and the common incidence of subsequent divestitures. Finally, Lang, Stulz, and Walkling (1991) find that bidder returns are the
lowest among firms with low Tobin’s Qs and high cash flows. Their result supports Jensen’s (1986) version of agency theory, in which the worst agency problems occur in firms with poor investment opportunities and excess cash. In sum, quite a bit of evidence points to the dominance of managerial rather than shareholder motives in firms’ acquisition decisions.

Even clearer evidence of agency problems is revealed by the studies that focus on managers directly threatened with the loss of private benefits of control. These are the studies of management resistance to takeovers, which are now too numerous to survey completely. Walkling and Long (1984) find that managerial resistance to value-increasing takeovers is less likely when top managers have a direct financial interest in the deal going through via share ownership or golden parachutes, or when top managers are more likely to keep their jobs. Another set of studies finds that, when managers take anti-takeover actions, shareholders lose. For example, DeAngelo and Rice (1983) and Jarrell and Poulsen (1986a) find that public announcements of certain anti-takeover amendments to corporate charters, such as super-majority provisions requiring more than 50 percent of the votes to change corporate boards, reduce shareholder wealth. Ryngaert (1988) and Malatesta and Walkling (1988) find that, for firms who have experienced challenges to management control, the adoption of poison pills—which are devices to make takeovers extremely costly without target management’s consent—also reduce shareholder wealth. Comment and Schwert (1995), however, question the event study evidence given the higher frequency of takeovers among firms with poison pills in place. Taken as a whole, the evidence suggests that managers resist takeovers to protect their private benefits of control rather than to serve shareholders.

Some of the evidence on the importance of agency costs is less direct, but perhaps as compelling. In one of the most macabre event studies ever performed, Johnson, Magee, Nagarajan, and Newman (1985) find that sudden executive deaths—in plane crashes or from heart attacks—are often accompanied by increases in share prices of the companies these executives managed. The price increases are the largest for some major conglomerates, whose founders built vast empires without returning much to investors. A plausible interpretation of this evidence is that the flow of benefits of control diminishes after the deaths of powerful managers.

There is also a great deal of evidence that control is valued, which would not be the case if controlling managers (or shareholders) received the same benefits as the other investors. Barclay and Holderness (1989, 1992) find that, in the United States, large blocks of equity trade at a substantial premium to the posttrade price of minority shares, indicating that the buyers of the blocks that may have a controlling influence receive special benefits. Several studies compare the prices of shares with identical dividend rights, but differential voting rights. Lease, McConnell, and Mikkelson (1983, 1984), DeAngelo and DeAngelo (1985), and Zingales (1995) all show that, in the United States, shares with superior voting rights trade at a premium. On average, this premium is very small, but Zingales (1995) shows that it rises sharply in
situations where control over firms is contested, indicating yet again that controlling management teams earn benefits that are not available to minority investors.

Even more dramatic evidence comes from other countries. Levy (1982) finds the average voting premium of 45.5 percent in Israel, Rydqvist (1987) reports 6.5 percent for Sweden, Horner (1988) shows about 20 percent for Switzerland, and, most recently, Zingales (1994) reports the 82 percent voting premium on the Milan Stock Exchange. Zingales (1994) and Barca (1995) suggest that managers in Italy have significant opportunities to divert profits to themselves and not share them with nonvoting shareholders.

The evidence on the voting premium in Israel and Italy suggests that agency costs may be very large in some countries. But how large can they get? Some evidence from Russia offers a hint. Boycko, Shleifer, and Vishny (1993) calculate that, in privatization, manufacturing firms in Russia sold for about $100 per employee, compared to market valuations of about $100,000 per employee for Western firms. The one thousandfold difference cannot be explained by a difference in living standards, which in Russia are about one tenth of those in the West. Even controlling for this difference, the Russian assets sold at a 99 percent discount. Very similar evidence comes from the oil industry, where Russian companies were valued at under 5 cents per barrel of proven reserves, compared to typical $4 to $5 per barrel valuations for Western oil firms. An important element of this 99 percent discount is surely the reality of government expropriation, regulation, and taxation. Poor management is probably also a part of the story. But equally important seems to be the ability of managers of Russian firms to divert both profits and assets to themselves. The Russian evidence suggests that an upper bound on agency costs in the regime of minimal protection of investors is 99 percent of value.

II. Financing Without Governance

The previous section raised the main question of corporate governance: why do investors part with their money, and give it to managers, when both the theory and the evidence suggests that managers have enormous discretion about what is done with that money, often to the point of being able to expropriate much of it? The question is particularly intriguing in the case of investors because, unlike highly trained employees and managers, the initial investors have no special ability to help the firm once they have parted with their money. Their investment is sunk and nobody—especially the managers—needs them. Yet despite all these problems, outside finance occurs in almost all market economies, and on an enormous scale in the developed ones. How does this happen?

In this section, we begin to discuss the various answers to the puzzle of outside finance by first focusing on two explanations that do not rely on governance proper: the idea that firms and managers have reputations and the idea that investors are gullible and get taken. Both of these approaches have