15. The Institutions of Corporate Governance

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Introduction and Scope: The Organization at the Top of the Large Business Firm

I outline here the institutions of decision-making in the large public firm in the wealthy West, emphasizing those that try to thwart decision-making from going awry.

By corporate governance, I mean the relationships at the top of the firm—the board of directors, the senior managers, and the stockholders. By institutions I mean those repeated mechanisms that allocate authority among the three and that affect, modulate and control the decisions made at the top of the firm.

By taking governance to mean the relationships among the triumvirate at the top—and not taking it to mean their relations with, say, the firm's employees or its labor unions—I right away give the analysis an American cast, not a European one. Although my primary focus here is on American corporate governance institutions, I look at other nations' corporate governance institutions primarily by way of contrast (as opposed to, say, finding the deep functions that all corporate systems must have). Thus, I focus on the division of authority between the board and the CEO on one hand, and the shareholders on the other, with the primary task of the institutions of corporate governance being to make managers inside the firm run that firm well and to make them loyal to shareholders. At the end of this paper, I look at how these relationships relate to basic institutions of contract and political organization in Europe and the United States.

I focus on features that are at the heart of recent academic legal inquiry. Others could, and would, emphasize other governance features: an organizational theorist might look to how a leader motivates the people in a large organization. A psychologist or a sociologist might emphasize how discussion in the boardroom is vibrant, supportive, and inquiring, instead of being stale, formal, and useless. A technology theorist might emphasize the mechanisms by which the firm innovates. Another might emphasize how ideas are transformed into products. One type of economist might relentlessly analyze what goes on inside the firm (and thereby is "governed" within) and what goes on outside it (and is thereby "governed" by contract). These are all worthwhile modes of inquiry. But they are not mine, at least not here.

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In Part 1, I sort out the central problems of corporate governance. In Part 2, I catalog the basic institutions of corporate governance, from markets to organization to contract. In Part 3, I consider contract law as corporate law's "primitive" building-block. In Part 4, I briefly examine issues of corporate legitimacy that could, and do, affect corporate governance. The institutions of corporate governance are usually seen as separated from the institutions of political organization. But they should not be. In Part 5, I re-examine corporate governance in terms of economies of scale, contract, markets, and property rights. And then I summarize and conclude.

1. The Core Problems of Corporate Governance

The corporate governance triumvirate—the board, the managers, and the stockholders—has a vertical and a horizontal dimension. The vertical dimension is between senior managers and distant shareholders (see Figure 1). The focus there is on keeping the CEO and the top people (the board and the senior officers) loyal to shareholders, and competent for the task of managing the firm. It's this vertical dimension that's especially relevant in the United States.

The horizontal dimension is between dominant stockholders and dispersed stockholders (see Figure 2). The horizontal focus is on preventing or minimizing the shifts in value from dispersed outsiders to controlling inside stockholders. That dimension of inquiry is paler in the United States than it is in Europe, perhaps because controller machinations are resolved well in the United States, or because other forces keep more American firms with dispersed ownership. Lacking a single shareholder-controller, the typical American firm has fewer horizontal problems, but more vertical problems: dispersed ownership fades the horizontal dimension but brings to the forefront the firm's vertical weaknesses. Foreign nations also have legitimacy as a core problem of corporate governance, a muted issue in the United States.

These two corporate governance problems are similar in one dimension—in each a controller extracts rents or private benefits—but less so in other, perhaps more critical dimensions. First, the centrality of each differs around the world—horizontal issues dominate in most of the world, vertical issues in the United States. Second, the means by which the controller extracts benefits differ between the two. And, third, the means to mitigate the costs of each differ. These distinctions are not always made, but should be.

A. Vertical Corporate Governance: Managerial Agency Costs

Public firms with full ownership separation have no dominant shareholder. With shareholders dispersed, the task of keeping managers working primarily in shareholders' interests becomes critical. And ownership in the largest American firms is dispersed: Bill Gates' ownership of Microsoft is an exception; General Motors', without a dominant stockholder, is the norm. This diffused