The Power of Monitoring

*By Udo C. Brändle and Jürgen Noll**

A. Introduction

The corporation celebrates its 400th birthday. What Adam Smith treated skeptically concerning relative efficiency in 1776, has become the dominant organizational form, and not only in Smith's home country of Great Britain.

The main characteristic of corporations today, is the separation of ownership and control - a problem that was recognized by Smith, but only "rediscovered" in 1932 by Adolph Berle and Gardiner Means in their seminal book.[1] Berle and Means documented the extent to which control had shifted from shareholders to managers. This interaction of shareholders and managers leads to the "principal-agent" problem. The stockholders (principals) want their agents (managers) to maximize the value of the shares. But the manager may be better off pursuing some other strategy and therefore acting opportunistically. Writing a contract that strikes a balance between providing incentives for managers and guaranteeing a maximization of shareholder value is not an easy task. Even if this balance is successfully struck, it does not necessarily hinder the managers from finding new, more-or-less legal ways to increase their own benefit. Therefore, several institutions and mechanisms to control managers – all of which are very controversial – have come into existence. Such control mechanisms are meant to mitigate the inherent principal-agent problem which arises from the separation of ownership and control.[2] The

* Assistant Professors, Division for Industry, Energy and Environment Department of Business Studies, University of Vienna, Brünner Straße 72, A-1210 Vienna, Austria [udo.braendle@univie.ac.at].

1 ADOLPH BERLE & GARDINER MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

2 R. Chami & C. Fullenkamp, *Trust and efficiency*, 26 J. OF BANKING & FINANCE, 1785-1809 (2002).

https://doi.org/10.1017/S2071832200013274 Published online by Cambridge University Press

monitoring of boards of directors[3] by pension funds, venture capitalists, or by banks often entails a high degree of influencing the firm's course of action.[4]

In reviewing theoretical and empirical literature, this paper will focus on the often underestimated role performed by monitoring institutions and mechanisms. This paper adopts the regularly made distinction between external and internal monitoring actors and mechanisms. We argue that monitoring is essential to provide a solution to the inherent principal-agent situation between owners and managers of a firm. Our main contention is that because of the idiosyncratic strengths and weaknesses of different monitoring mechanisms, a need arises to strike a delicate balance between them. First, we start with a short historical survey in order to lay a basis for the necessity of monitoring (B). In the next step, we will analyze boards as internal institutions and mechanisms helping to control the managers (C). In this context we differentiate between the two-tier board system predominant in Civil Law countries and the one-tier board system, typical for Common Law countries. As soon as firms need to raise additional funds, external monitoring mechanisms come into play (D). Section (E) will provide a tentative conclusion.

B. The Corporation

The corporation, as we know it today is the product of a process that began in England as early as the 17th century.[5] In those days, ownership was divided among a few individuals who often also participated in management. At this time no organized markets existed for the transfer of ownership claims.[6] As a consequence, shares were only transferred to friends or relatives, and control was therefore characterized by "voice" rather than by "exit."[7]

---

3 E.J. Zajac & J.D. Westphal, *The Costs and Benefits of Managerial Incentives and Monitoring in Large U.S. Corporations: When Is More Not Better?*, 15 STRATEGIC MANAGEMENT J., 507-529 (1994); E.J. Zajac & J.D. Westphal, *Director reputation, CEO-Board Power, and the Dynamics of Board Interlocks*, 41 ADMINISTRATIVE SCIENCE QUARTERLY, 507-529 (1996).

4 J. Tirole, *Corporate Governance*, 69 ECONOMETRICA, 1-35 (2001).

5 D. MUELLER, THE CORPORATION - INVESTMENT, MERGERS, AND GROWTH(2003).

6 R. Larner, *Ownership and Control in the 200 Largest Nonfinancial Corporations, 1929 and 1963*, 56 AM. ECON. REV., 777-787 (1966).

7 A. Hirschman, *Exit, voice, and the State*, 31 WORLD POLITICS 90-107 (1978).

Toward the end of the 19th century, markets for the exchange of shares opened in New York and some European capital cities.[8] This development was connected with the huge capital demand of new giant firms, especially in the railroad industry.[9] The shareholders, as capital providers, increasingly relied on the exit option to express their pleasure or displeasure with "their" managers' decisions.

Legislators also began to take corporations into consideration: corporations were allowed to write broad charters.[10] Thus, considerable authority was granted to management.[11] Control *via* voice shifted to the boards of directors, which in turn were dominated by managers. In other words, at the end of the 19th century and beginning of the 20th century, control of corporations shifted into the hands of the managers and therefore, ownership and control separated. As the 20th century unfolded and corporations continued to grow while the descendants of the founding families increasingly reduced their share of the ownership, the extent of the separation of ownership from control - and therefore the agency problem - deepened.[12]

In this paradigm, the stockholders want their agent (manager) to maximize the value of their shares while the managers may be better off pursuing some other strategy. If we think about staff, sales, size of the firm, company car, etc. as (differently valued) input-vectors, we can assume that the vector that maximizes the profits of the firm, does not maximize the manager's wealth. Therefore the managers will choose the vector which maximizes their own wealth.

In a narrower sense, the principal-agent problem is an asymmetric information relationship, which could be solved by complete contracts. As such, a first-best contract often cannot be implemented.[13] Thus, the starting point will likely be the

---

8 K. Pistor & C. Xu, *Incomplete Law- A Conceptual and Analytical Framework- And its Application to the Evolution of Financial Market Regulation*, Columbia Law School Working Paper No. 204 (2002).

9 D. MUELLER, THE CORPORATION - INVESTMENT, MERGERS, AND GROWTH(2003). 9 D. MUELLER, THE CORPORATION - INVESTMENT, MERGERS, AND GROWTH(2003)

10 K. Hopt & P. Leyens, *Board Models in Europe. Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France, and Italy*, 18 ECGI Working Paper Series in Law, *at* http://www.ecgi.org (last visited 19 October 2004).

11 D. MUELLER, THE CORPORATION - INVESTMENT, MERGERS, AND GROWTH(2003).

12 S. J. PRAISE, THE EVOLUTION OF GIANT FIRMS IN BRITAIN: A STUDY OF THE GROWTH OF CONCENTRATION IN MANUFACTURING INDUSTRY IN BRITAIN, 1909-70 (1976).

13 *See* O. HART, FIRMS, CONTRACTS AND FINANCIAL STRUCTURE, (1995).

https://doi.org/10.1017/S2071832200013274 Published online by Cambridge University Press

second best solution. The starting point solution has associated agency costs. These costs can be reduced by effective monitoring, although one has to keep in mind that monitoring itself naturally entails costs. Nevertheless, monitoring can provide access to capital; capital that would not be accessible without the monitoring.[14] In the following sections, we analyze the institutions and mechanisms that can help control the managers. We distinguish between external and internal monitoring. External control mechanisms are capital markets with (hostile) takeovers, whereas internal control mechanisms are supervisory boards and their committees. With internal control mechanisms we can observe legal differences between Common and Civil Law. In general, Civil Law countries are characterized by a two-tier board system (with a supervisory- and management organ) whereas companies in Common Law countries normally have a one-tier board system (with an administrative organ).[15]

C. Internal Monitoring

Especially after recent financial scandals such as Enron, Worldcom or, in Europe, Arhold or Philipp Holzmann,[16] countries sought to create new governance rules. As a result, several corporate governance codes and laws were enacted.[17] Efficient

14 *See* Tirole's illustrative example of project financing: J. Tirole, *Corporate Governance*, 69 ECONOMETRICA 1-35 (2001).

15 For this characterization, *See* Hopt, *The German Two-Tier Board (Aufsichtsrat): A German View on Corporate Governance*, *in* COMPARATIVE CORPORATE GOVERNANCE, ESSAYS AND MATERIALS 3 (Hopt & Wymeersch eds., 1997); interestingly, the Statute of the Societas Europaea (SE) in the EU Directive 2157/2001 (Abl L 294/1) allows companies incorporating as a SE to choose between a two-tier and a one-tier organisational structure. The inclusion of this option is motivated by the existing differences between the national corporation laws that were largely responsible for the decade-long struggle over the SE; *See* Chrsitoph Teichmann, *The European Company - A Challenge to Academics, Legislatures and Practitioners*, 4 GERMAN L. J. No. 4, 1 April 2003, at 309-331, *at* http://www.germanlawjournal.com/article.php?id=259; *See also* U.C. Brändle & J. Noll, *Die Societas Europaea – Droht ein Wettbewerb der Führungssysteme?*, ÖSTERREICHISCHES ANWALTSBLATT, 442-447 (2004) (arguing that this option, resulting from a political compromise, resulted in increased discretion for the firm's management).

16 *See* Deakin & Konzelmann, 12 CORPORATE GOVERNANCE 134 (2004); Bratton, 76 TULANE L. REV. 1275 (2002); *See also* the commentary "Auf Wiedersehen, Germany Inc.," *at* http://www.businessweek.com/2000/00_08/b3669018.htm.

17 For example, *See* Sarbanes Oxley Act of 2002,H.R. 3763, 107th Cong. (2002); *See also* the KonTraG 1998 and TransPuG 2002 in Germany, all claiming for more transparency and disclosure; on the development in Germany, *See* Cioffi, *Restructuring "Germany Inc.": The Politics of Corporate Governance Reform in Germany and the European Union*, 24 LAW & POLICY 355 (2003); on Sarbanes-Oxley Act of 2002, *See* Gordon, *Governance Failures of the Enron Board and the New Information Order of Sarbanes-Oxley*, Harvard John M. Olin Center for Law, ECON., and Business, Discussion Paper No. 416 (April 2003).

internal management control has thereby been the center of the corporate governance debate since its beginning. In particular, boards are now in the spotlight as they link managers and investors, therefore being an effective instrument of "good governance." A board is seen as an economic institution that can help solve the agency problems inherent in managing an organization. But, the supervisory board itself poses many problems. Members of this board are also utility maximizers and therefore we cannot assume that they always represent the best interests of the shareholders. To underscore this observation, we start with a short overview on the differences between the one tier board, found in the Anglo-Saxon countries, and the two tier board structure common in continental Europe. Then we review empirical literature to cover some aspects of board's activities and their determinants.

I. One Tier- and Two Tier Boards

Continental European company laws traditionally rely upon statutory regulation with a two tier board model, often including co-determination, whereas the Anglo-Saxon corporation relies on a one tier board.

1. The "European" Way: Two Tier Boards

The two tier system is mandatory in Denmark, Finland, Germany, Sweden, Austria and large companies in the Netherlands. In France, Portugal, Switzerland and Spain the companies can choose between a one or two tier board.[18] But non-statutory rules became a supplementing regime soon after several corporate governance codes took effect.[19] The new codes follow the self-regulatory "comply-or-explain"-approach and distinguish between regulatory levels.[20] The central feature of internal corporate governance therefore lies in the organizational and personal division of management and control by a two tier structure.[21] Direction and control

18 See the overview, BERRAR, DIE ENTWICKLUNG DER CORPORATE GOVERNANCE IN DEUTSCHLAND IM INTERNATIONALEN VERGLEICH (2001).

19 For an example of the German and Austrian Corporate Governance Codes in 2002, *See* U.C. Brändle & J. Noll, *Die Societas Europaea – Droht ein Wettbewerb der Führungssysteme?*, ÖSTERREICHISCHES ANWALTSBLATT 2004, 442-447.

20 M. Becht, P. Bolton, & A. Roell, *Corporate Governance and Control*, ECGI Working Paper Series of Finance, *at* http://www.ecgi.org (last visited 19 October 2004).

21 K. Hopt & P. Leyens, *Board Models in Europe. Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France, and Italy*, 18 ECGI Working Paper Series in Law (2004), *at* http://www.ecgi.org.

of the company, for that reason, remain separated. Responsibilities and functions of the boards are theoretically quite obvious and clear which is practically not true as the system rests on partially wrong assumptions.

Running the business in the interest of the stakeholders could be one goal of the management board. This responsibility, to some extent, is contradictory - as maximizing the utility of totally different stakeholders always is. Essentially, this is the problem the principal-agent literature deals with in many variations.[22] However, the role of the supervisory board is even more difficult and often misunderstood, but, its legal functions are clear regarding the appointment, supervision, and removal of members of the management board.

To apprehend the resulting problems, one has to know the interactions of the bodies of the companies and which are regulated within the company law.[23] In short, the general assembly that meets once a year, or extraordinarily in the case of emergency, relieves the management and supervisory board[24] and has the right to elect the latter.[25] The supervisory board in turn elects the management board,[26] concludes the contracts with each of the members of the management board[27] and controls them.[28] As the management board has the right to suggest part of the members for the supervisory board, this system is often criticized and can lead to collusion between these two bodies.[29]

Generally, the members of one board cannot act as members in the other board[30] and managerial functions cannot be delegated to the supervisory board.[31] The com-

22 *See* S. Grossman & O. Hart, *An Analysis of the Principal-Agent Problem*, 51 ECONOMETRICA, 7-46 (1983).

23 Austrian Stock Corporations Act (1965) (F.R.G.).

24 *Id.*, § 104.

25 *Id.*, § 87.

26 *Id.*, § 75

27 *Id.*, § 97.

28 *Id.*, § 95. 28 *Id.*, § 95.

29 M. Becht, P. Bolton, & A. Roell, Corporate Governance and Control, ECGI Working Paper Series of Finance (2002), available at http://www.ecgi.org (last visited 19 October 2004).

30 *See*, *supra*, note 23, § 90.

31 *Id.*, § 90.

position of the supervisory board reflects the stakeholder perspective in Germany and Austria, namely due to the high influence of labor representatives, especially since 1976 when the Co-determination Act was passed. Starting in 1976, it was obligatory that two members from the capital side (representing labor) delegate one board member.[32] Large blockholders (in Austria 33% of the capital) can also delegate supervisory board members.[33] In Germany, banks often hold large blocks of companies and they make up large parts of the boards and consequently, have strong influence in the general meetings. These German banks, in addition to the depository voting rights of their customers, hold power as external monitors. But banks do not necessarily represent the interests of the other shareholders.[34]

In corporations with concentrated ownership it is therefore quite impossible for the supervisory board to protect the interest of the minority shareholders against both managing board and blockholders. Committees, although legally permissible, are less common in two tier board systems than in the UK or US. However, a strong tendency towards nomination, remuneration, and audit committees can be observed, and the majority of the larger listed companies have already installed them.[35]

Apart from the strong position of banks in supervisory boards, one might also view interlocking directorships as a problem of the two-tier board system. These directorships are established if a member of one supervisory board is also a member of one or more other supervisory or management boards of another company.[36]

The strong emphasis on separation of management and control can lead to inefficiency as the two bodies of the company should work together. Each control method has a trade-off between a first-degree error where good management is qualified as insufficient, and a second degree error where bad management is not

32 The so-called one-third regime, *Cf.* § 106 ArbVG (Arbeitsverfassungsgesetz - Law concerning the representation of labor).

33 *See*, *supra*, note 23, § 88.

34 D. MUELLER, THE CORPORATION - INVESTMENT, MERGERS, AND GROWTH (2003).

35 COMPARATIVE CORPORATE GOVERNANCE. STATE OF THE ART AND EMERGING RESEARCH (K. Hopt ET AL. eds., 1998); M. Becht, P. Bolton, & A. Roell, *Corporate Governance and Control*, ECGI Working Paper Series of Finance (2002), *at* http://www.ecgi.org; BERRAR, DIE ENTWICKLUNG DER CORPORATE GOVERNANCE IN DEUTSCHLAND IM INTERNATIONALEN VERGLEICH (2001).

36 E. Boehmer, *Germany*, *in* CORPORATE GOVERNANCE AND ECON. PERFORMANCE, 96-120 (K. Gugler ed., 2001).

disciplined.[37] In this context, consequences like occasional scandals are inevitable if one wants to avoid a second degree error where efficient management would be hassled. This would harm the company, as managers tend to loose motivation and initiative if they are controlled continuously. Since the publication of corporate governance codes, the focus of the supervisory board's work within the two-tier board system has begun to shift more and more towards advising and counseling the management board designing itself to be a kind of continuous representative of the shareholders between their meetings.

2. The Anglo-Saxon Way: One Tier Boards

In contrast, the one tier board realizes management and control within one body, the board of directors, which is vested with universal powers.[38] To understand the control function, a pivotal distinction has to be made between executive directors who are employed as managers parallel to their directorate and non-executive directors who are not involved in the running of the day-to-day business of the company. As all directors have the same power, non-executive directors can also take the initiative in management decisions and they are not restricted to post-decision approval like the German supervisory board.

The board is elected in the annual general meeting, typically for one year term. Due to the dispersed ownership structure within Anglo-Saxon companies, a "free rider" problem for the shareholders manifests itself and the voting rights are therefore exercised by a proxy assigned to the management. The "free riding" occurs when shareholders only hold small fractions of shares and therefore do not have enough incentives to engage in looking for the best independent members. Consequently, the management safeguards its job in the end by choosing their favorite "supervisors." This resembles the problem of the two tier board in which the management board has the right of proposal for the members of the supervisory board.

Concerning the independence of non-executive directors, the Combined Code, which is part of the listing requirements at the London Stock Exchange, explicitly defines indicators where a director, in principle, should not be deemed independent. Examples of non-independence include: the existence of an employment contract with the company within the last five years, a material business relationship

---

37 U.C. Brändle & F. Wirl, *Corporate Governance Normen – Wege aus der Krise?*, WISU – DAS WIRTSCHAFTSSTUDIUM 7/04, 906-910 (2004).

38 *See* P. DAVIES, GOWER'S PRINCIPLES OF MODERN COMPANY LAW (7th ed., 2003).

within the last three years, additional remuneration apart from the director's fee, close family ties, cross directorships, representation of a significant shareholder, or a directorship for more than nine years.[39] According to the Combined Code, at least half of the board should be comprised of independent non-executive directors.[40] The rationale behind this regulation is that if directors are not dependent on the CEO in some way then they are more likely to defend shareholders' interests without fear of consequences such as budget reductions for their departments. But it is not difficult to find flaws in this logic. First, directors who are independent of the firm may lack the knowledge or information to be effective monitors. Second, even unrelated directors are still dependent on the CEO for reappointment.

Independence is also important for the composition of the board committees, which are very common in one tier boards. An audit committee is part of the listing requirements on most stock exchanges.[41] audit committee is to set the scope and review the results of the yearly audit.[42] It also reviews the financial relationship between the company and auditors. The importance of an audit committee has increased in the wake of the scandals of Enron, WorldCom, Parmalat, etc., where the independence of the auditor was not always clear.[43] Unlike the board of directors, which meet five to six times a year, committees meet, on average, three times a year.

Questions concerning human resources are the task of the nomination and compensation committee. The latter is responsible for the evaluation of the management, which is intimately connected with the appraisal of the adequacy of management's compensation.[44] The nomination committee deliberates on the planning of succession of the directors. These committees meet several times a year and can only pronounce suggestions to the board members who finally decide about the issues.

39 UK's Combined Code, 2003.

40 Combined Code 2003, Section C.3.

41 L. Braiotta, *The impact of U.S. requirements for audit committees on the structure and membership of non-U.S. audit committees*, 17 ADVANCES IN INT'L ACCOUNTING, 119-135 (2004); L. Spira, *Ceremonies of Governance: Perspectives on the Role of the Audit Committee*, 3 J. OF MANAGEMENT & GOVERNANCE, 231-260 (1999).

42 Combined Code 2003, Section D.3.

43 K. Palepu & P. Healy, *The Fall of Enron*, 17 J. OF ECON. PERSPECTIVES, 3-26 (2003).

44 H. L. Tosi & L.R. Gomez-Mejia, *CEO Compensation Monitoring and Firm Performance*, 37 ACADEMY OF MANAGEMENT J., 1002-1016 (1994); BERRAR, DIE ENTWICKLUNG DER CORPORATE GOVERNANCE IN DEUTSCHLAND IM INTERNATIONALEN VERGLEICH (2001); U. C. Brändle & J. Noll, *Enlarged EU – Enlarged Corporate Governance?, 6 Corporate Governance*: THE INT'L J. OF BUS. IN SOCIETY (forthcoming), (2006).

In sum, the separation of the positions of board chairman and chief executive officer (CEO), and the recommendation to compose at least half the board with independent non-executives can be seen as a functional distinction between management and control.

II. The Better Board System?

Now, of course, bearing in mind the specifics of the two types of board systems just described, the question arises whether one system can be seen as superior to the other. One might ask, "which is the better system?" This is problematic as normally every system has its strengths and weaknesses. The one-tier board has the advantage that the common responsibility of its members for management and control provides much more flexibility for board organization, as well as ensuring that the necessary information will be available to all its members. But it lacks independence of control, with board members too often dependent on the CEO. By contrast, the two-tier German system, theoretically and historically, is based on the idea of a separate outside board.[45] Since its introduction, the supervisory board has been implemented to control the management board (the other tier). The supervisory board has the right to approve certain categories of management decisions with far reaching consequences (for example major acquisitions). Day to day management is strictly reserved for the management board.[46] In practice, though, the supervisory board is also dependent on the management board. Former members of the management board often become ordinary members or even president of the supervisory board.[47] The supervisory board collects the necessary information from the management board, the body over which it should be exercising control.

But an assessment of the "better" system question is not necessary as we can observe a convergence of both board structures.[48] The revised Corporate Governance

45 K. Hopt & P. Leyens, *Board Models in Europe. Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France, and Italy*, 18 ECGI Working Paper Series in Law (2004), *at* http://www.ecgi.org.

46 See, *supra*, note23, § 95 (5).

47 There exists a current debate over possible ways of changing this practice, *See* BERRAR, DIE ENTWICKLUNG DER CORPORATE GOVERNANCE IN DEUTSCHLAND IM INTERNATIONALEN VERGLEICH (2001).

48 U. C. Brändle & J. Noll, *On the Convergence of National Corporate Governance Systems*, 16 J. OF INTERDISCIPLINARY ECON. (forthcoming), (2005).

Code in the UK (Combined Code)[49] and the Principles of Corporate Governance recently adopted in France,[50] strengthen the presence of independent directors on one-tier boards. Another advantage of the two tier board seems to be the separation of the positions of CEO and chairman of the board, which is nowadays a suggestion of all corporate governance codes. For the German two-tier structure, the strengthening of the strategic role of the supervisory board by the new German Corporate Governance Code[51] of 2002 means an attempt to incorporate a key advantage of the one-tier model.

Strengths Separation of direction and control Supervisory board can release the shareholders in the general meeting	***Weaknesses*** Scarcely involved in business activity Supervisory board is dependent on information from the managing board
Opportunities Supervisory board could be a strong agent of the shareholders	***Threats*** Incentives to represent shareholders' interests are questionable Direction and control can coincide

Table 1: SWOT-analysis of two-tier boards

49 UK's Combined Code, 2003.

50 Recommandations sur le gouvernement d'entreprise, 2002.

51 German Corporate Governance Code (2002) (F.R.G.), *at* http://www.corporate-governance-code.de/index-e.html (in German, English, French, Italian and Spanish).

Strengths Clearly defined management body Faster decision making Directors have direct access to information	***Weaknesses*** Dependent on CEO CEO "captures" the board
Opportunities Board members know day-to-day business	***Threats*** Representation of shareholders' interests is not guaranteed

Table 2: SWOT-analysis of one-tier boards

III. Studies on Boards of Directors

We can observe that the two board systems are getting closer to each other in some respects. On the one hand, we have many independent directors in one-tier boards and on the other hand, supervisory boards in two-tier systems are increasingly becoming consultants of the management rather than only monitors. Agency theory,[52] for example, addresses the need for the board as a monitoring mechanism where the CEO has incentives to "capture" the board to ensure that he can keep his job and increase managerial discretion. Outside directors have an incentive to maintain their independence, to monitor the CEO, and replace the latter if performance is poor. But this behavior of the directors is only permissible if we assume that they have incentives to build reputations as expert monitors.[53] However, a reputation as a director who does not cause trouble for CEOs is potentially valuable to the director as well.[54] Consequently, their incentives are yet not clear.

52 E. Fama & Jensen, *Separation of Ownership and Control*, 26 J. OF L. & ECON., 301-325 (1983).

53 E. Fama, *Agency Problems and the Theory of the Firm*, 88 J. OF POLITICAL ECON., 288-307 (1980).

54 B. Holmstrom, *Managerial Incentive Problems: A Dynamic Perspective*, 66 REV. OF ECON. STUDIES, 169-182 (1999).

Up to now, there has been a strong need to rely on the extensively available empirical literature to assess the propositions in academic literature on the topic.[55] Yet, determining how board characteristics such as composition or size affect the company's performance, or how they affect actions of the board, remains difficult. Almost all interests appear both a result of the actions of previous directors and of the influences of subsequent directors. Moreover, many empirical results can be interpreted either as describing equilibrium or out-of-equilibrium phenomena.[56] It is very difficult to distinguish between the two interpretations in a given study but they often have quite different implications for policy. The subsequent sections are used to convey a picture of existing studies, both analytical and empirical, on a number of essential board related topics.

1. Why Boards Exist At All

While we have, to some extent, analyzed what boards are doing, we still have not provided an answer to why boards exist at all. On the one hand, we find much critique of boards for being insufficient guardians of other people's money and being too much in management's hands.[57] On the other hand, boards have existed for a long time and if they were really so inefficient we could have expected the market to improve or even replace them. In other words, pointing out that an institution is not first-best efficient does not necessarily mean that we need another regulation. A reasonable alternative is that boards are second-best solutions to the agency problems confronting a company with large divergence in interests among its members.[58]

Therefore the potential answer that boards just exist as a product of regulation is not far-reaching enough because if they existed just for that reason, they would represent deadweight costs to firms in which subsequent lobbying would have eliminated, at least somewhere in the world. So, if boards resembled deadweight

---

55 *See*, *e.g.*, J. Byrd & K. Hickman, *Do Outside Directors Monitor Managers? Evidence from Tender Offer Bids*, 32 J. OF FINANCIAL ECON., 195-221 (1992); H. Mehran, *Executive Compensation Structure, Ownership, and Firm Performance*, 38 J. OF FINANCIAL ECON., 163-184 (1995); *See*, *infra*, note 56.

56 B. Hermalin & M. Weisbach, *Boards of Directors as an Endogenously Determined Institution: A Survey of the ECON. Literature*, FRBNY ECON. POL. REV., 7-26 (2003).

57 *See*, M. Lipton & J. Lorsch, *A Modest Proposal for Improved Corporate Governance*, 48 BUSINESS LAWYER, 59-77 (1992).

58 B. Hermalin & Katz, *Judicial Modification of Contracts between Sophisticated Parties: A More Complete View of Incomplete Contracts and Their Breach*, 9 J. OF L., ECON., AND ORGANIZATION, 230-255 (1993).

https://doi.org/10.1017/S2071832200013274 Published online by Cambridge University Press

costs to the companies we should expect them all to be minimum size. But to the contrary, boards are much larger in practice than required by law. Hence, the literature defines boards of directors as part of the market solution to the contracting problems inside most organizations as the shareholders are too diffuse, rationally plugged by free-riding and often too uninformed to control managers and tie their compensation packages.

2. The Board's Role – Theoretical Contribution

As mentioned above, formal analysis of the role of boards of directors and how they should be regulated is rare and hard to find, but there is a small number of laudable exceptions.

Hermalin and Weisbach consider a model where the firm's performance, together with monitoring by the board, reveals information - over time - about the ability of the CEO.[59] In this model the extent of monitoring by the board is a function of the board's independence as measured by the directors' financial incentives as well as their distaste for confronting management, and therefore an endogenous variable. As a result, CEOs tend to be less closely monitored the longer they have been on the job. This gradual erosion of the effectiveness of boards over time is an important insight in the course of our investigation.[60] It suggests that regulatory responses should be targeted more directly at the selection process of directors and their financial incentives to monitor management.

For example, Warther allows for the dismissal of minority directors who oppose management but newly selected members are assumed to act in the interest of shareholders.[61] His model thus predicts that directors, who are assumed to prefer staying on the board, will be reluctant to vote against management unless the evidence of mismanagement is so strong that they can be confident enough that a majority against management will form. Thus, boards are active only in crises situation.

59 B. Hermalin & M. Weisbach, *Endogenously Chosen Boards of Directors and Their Monitoring of the CEO*, 88 AM. ECON. REV., 96-118 (1998).

60 M. Becht et al., *Corporate Governance and Control,* ECGI Working Paper Series of Finance (2002), *at* http://www.ecgi.org (last visited 19 October 2004).

61 V. Warther, *Board Effectiveness and Board Dissent: A Model of Board's Relationship to Management and Shareholders*, 4 J. OF CORPORATE FINANCE, 53-70 (1998).

Rajeha takes the proportion of independent directors as a control variable.[62] He derives the board composition and size that best elicits insider information and shows how it may vary with underlying firm characteristics. According to Hirshleifer and Thakor,[63] takeover threats have a disciplining effect both on management and boards.[64]

3. *The Empirical Contribution*

The bulk of empirical literature deals with board composition and independence and their effect on corporate performance. The results presented in this section are from the US. Unfortunately, the international evidence on the role of boards in corporate governance and their impact on corporate performance is sketchy, or relevant studies are not easily accessible, with the exception of the UK. Here, a number of studies have broadly confirmed the findings for the US.[65]

Some evidence suggests that there is no significant relation between firm performance and board composition.[66] But according to Byrd and Hickman, outside boards are more likely to remove CEOs as a result of poor company performance.[67] Another approach, suggested by Morck et al.,[68] is to use Tobin's Q as a performance measure, the idea being that it reflects the "value added" of intangible factors such as governance. Bhagat and Black use this approach but find that there is no rela-

62 C. Rajeha, *The Interaction of Insiders and Outsiders in Monitoring: A Theory of Corporate Boards*, Vanderbilt University Working Paper No 25 (2001), *at* http://www2.owen.vanderbilt.edu/fmrc/pdf/wp2001-25.pdf (last visited 27 October 2004).

63 D. Hirshleifer & A. Thakor, *Managerial Performance, Boards of Directors, and Takeover Bidding*, 1 J. OF CORPORATE FINANCE, 63-90 (1994).

64 *See*, D. Scharfstein, *The Disciplinary Role of Takeovers*, 55 REV. OF ECON. STUDIES, 185-199 (1988); M. Becht et al., *Corporate Governance and Control,* ECGI Working Paper Series of Finance (2002), *at* http://www.ecgi.org.

65 J. Franks et al., *Who Disciplines Management in Poorly Performing Companies?*, 10 J. OF FINANCIAL INTERMEDIATION, 209-248 (2001).

66 *See*, B. Hermalin & M. Weisbach, *The Effects of Board Composition and Direct Incentives on Firm Performance*, 20 FINANCIAL MANAGEMENT, 101-112 (1991); *See*, *infra*, note 67; H. Mehran, *Executive Compensation Structure, Ownership, and Firm Performance*, 38 J. OF FINANCIAL ECON., 163-184 (1995); *See*, *supra*, note 56.

67 J. Byrd & K. Hickman, *Do Outside Directors Monitor Managers? Evidence from Tender Offer Bids*, 32 J. OF FINANCIAL ECON., 195-221 (1992).

68 R. Morck et al., *Management Ownership and Market Valuation: An Empirical Analysis*, 20 J. OF FINANCIAL ECON., 293-315 (1988).

tionship between the proportion of outside directors and Tobin's Q.[69] The authors also do not find any relationship between board composition and firm performance if they examine the effect of board composition on long term stock market and performance. Summed up, the evidence from the US suggests that board composition and corporate performance are "not related,"[70] the relationship is "uncertain"[71] or is "at best ambiguous."[72] Only MacAvoy and Millstein find evidence that the board procedures grading by the "California Public Employees' Retirement System" (CalPERS) - presumably, in part, a proxy for independence - is positively correlated with accounting based measures of performance.[73]

Further empirical results come from Yermack[74] and Eisenberg et al.[75] who find a significant negative relationship between board size and Tobin's Q, which confirms the results that market participants seem to think that small boards do a better job of monitoring management than do large boards.[76] Core et al. study the relationship among board composition, ownership structure and CEO pay.[77] Their results suggest that firms with weaker governance structures tend to pay their CEOs more. CEO pay rises with variables likely to indicate a lack of board involvement such as board size, the number of directors over age sixty-nine, and the number of directors holding more directorships.

---

69 S. Bhagat & B. Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUSINESS LAWYER, 921-963 (2000).

70 B. Hermalin & M. Weisbach, *Boards of Directors as an Endogenously Determined Institution: A Survey of the ECON. Literature*, FRBNY ECON. POLICY REV., 7-26 (2003).

71 *See*, *supra*, note 69.

72 R. Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE LAW J., 2359-2430 (1998).

73 P. MacAvoy & I. Millstein, *The Active Board of Directors and Its Effect on the Performance of the Large Publicly Traded Corporation*, 11 J. OF APPLIED CORPORATE FINANCE, 8-20 (1999).

74 D. Yermak, *Higher Market Valuation of Companies with a Small Board of Directors*, 40 J. OF FINANCIAL ECON., 185-212 (1996).

75 T. Eisenberg et al., *Larger Board Size and Decreasing Firm Value in Small Firms*, 48 J. OF FINACIAL ECON., 35-54 (1998).

76 R. Gertner & S. Kaplan, *The Value-Maximizing Board*, University of Chicago Working Paper Through SSRN (1996), *at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=10975 (last visited 23 October 2004).

77 J. Core et al., *Corporate Governance, Chief Executive Officer Compensation, and Firm Performance*, 51 J. OF FINANCIAL ECON., 371-406 (1999).

Some evidence supporting the hypothesis that independent directors improve board performance is available. There is a higher likelihood that an independent board will dismiss the CEO following poor performance[78] as they are not captured or beholden by the CEO. There is evidence of positive stock price reaction to news of the appointment of an outside director[79] which seems to confirm that shareholders feel better represented by independent directors.

Hallock examines board interlocks, which occur when one firm's employee sits on another board and that firm's employee sits on the first firm's board.[80] Given this type of relationship, the potential for collusive or quid pro quo behavior on part of the "interlocked" directors is particularly high.

Shivdasani and Yermak examine the extent to which the CEO is involved in the board-selection process.[81] This is interesting as the theoretical work of Hermalin and Weisbach implies that the role of the CEO in choosing directors have an impact on the board's effectiveness.[82] The authors find that this measure of CEO involvement decreases the firm's subsequent number of independent directors. This is consistent with the view that the CEO is able to use his control over the selection process to decrease the board's independence.

All in all, it seems that there is substantial evidence that the size and the degree of independence of boards affect corporate performance, at least in the US.

D. External Monitoring

Now we will concentrate on another form of monitoring: in particular we will analyze external monitoring mechanisms. They commonly come into play as soon as firms need to raise additional funds.

78 M. Weisbach, *Outside Directors and CEO Turnover*, 20 J. OF FINANCIAL ECON., 431-460 (1988).

79 S. Rosenstein & J. Wyatt, *Outside Directors, Board Independence, and Shareholder Wealth*, 26 J. OF FINANCIAL ECON., 175-191 (1990).

80 K. Hallok, *Reciprocally Interlocking Boards of Directors and Executive Compensation*, 32 J. OF FINANCIAL AND QUANTITATIVE ANALYSIS, 331-334 (1997).

81 A. Shivdasani & D. Yermak, *CEO Involvement in the Selection of New Board Members; An Empirical Analysis*, 54 J. OF FINANCE, 1829-1854 (1999).

82 B. Hermalin & M. Weisbach, *Endogenously Chosen Boards of Directors and Their Monitoring of the CEO*, 88 AMERICAN ECON. REV., 96-118 (1998).

Companies often don't have enough inside equity to finance costly projects. Therefore most firms require outside financing. In this context, we differ between "market finance" and "intermediated finance." Whereas market finance refers to issues of securities such as commercial paper and corporate bonds issued to a dispersed set of investors, intermediated finance involves financing by large investors like banks, large shareholders, and institutional investors. Investors want a high rate of return on their investment. Especially large investors have the power to monitor the companies in which they invest. Intermediated finance is more expensive than market finance as monitoring is costly and must be paid for. But as many companies, for various reasons, don't have access to market finance they have to borrow from intermediates.[83]

Monitoring is an attempt to reduce or to limit agency costs stemming from the fact that optimal contracting or the construction of incentive mechanisms is not feasible. These external monitors build a group, which can intensify external pressure on a firm's managerial decision in order to protect their interests.[84] These interests are not necessarily aligned with the interests of the other shareholders nor with the intentions and expectations of the management, which in turn acts opportunistically.[85]

In the following sections we want to describe some important external monitors like institutional investors, banks and other blockholders, like families or the state. As single, large outside shareholder monopolizing monitoring activities are not typical in modern corporations (although especially the ownership structure of many companies in continental Europe resemble this image),[86] we analyze active monitoring by numerous moderate-size blockholders which has attracted growing attention in the finance literature.[87]

---

83 J. Tirole, *Corporate Governance*, 69 ECONOMETRICA 1-35 (2001).

84 P. Wright, M. Kroll, *Executive Discretion and Corporate Performance as Determinants of CEO Compensation, Contingent on External Monitoring Activities*, 6 (3) J. OF MANAGEMENT AND GOVERNANCE 186-214 (2002).

85 D. MUELLER, THE CORPORATION - INVESTMENT, MERGERS, AND GROWTH(2003).

86 E. BOEHMER, *Germany*, in CORPORATE GOVERNANCE AND ECON. PERFORMANCE 96-120 (K. Gugler ed.,. Oxford 2001).

87 *See* D. Strickland et al., *A requiem for the USA: Is small shareholder monitoring effective?,* 40 J. OF FINANCIAL ECON. 319-338 (1996).

I. Institutional Investors

The premise that institutional investors may be highly effective external monitors is intuitively appealing, especially in the US and UK. They are large blockholders and their fraction of all shares of listed companies increased in Germany from 4% in the year 1990 to nearly 13% in 1998.[88] Starting from 1987, in the US, institutional investors- pension funds in particular- deviated from their prior role as passive investors by submitting proxy proposals focusing largely on corporate governance issues and therefore the decision when to reorganize a company. Between 1950 and 1994 the fraction of shares held by institutional portfolio holders in the US increased from 10% to over 50%.[89] In Japan, institutional investors hold about 45% of the listed shares,[90] and in the UK, the percentage has grown from 29% in 1963 to 60% in 1994.[91] The proposals of the institutional investor, CalPERS, shows how this influence can be used. Their message is clear: Companies wanting CalPERS to invest in them have to fulfill certain standards with respect to corporate governance organization. CalPERS, with over $100 billion invested in equities, is frequently mentioned in the shareholder activism literature.[92]

The beneficial role that institutional investors play as external monitors has been documented in various empirical studies.[93] The implications of these authors are that higher levels of investments by institutional investors suggest more effective monitoring. Chung et al. find that institutional investors with a large percentage of a company's shares have the incentive and motivation to monitor management's action and the power to change corporate actions and decisions.[94] Tirole's analysis

88 H. SCHMIDT & J. DRUKARCZYK, CORPORATE GOVERNANCE IN GERMANY (1997).

89 B. Friedman, *ECON. Implications of Changing Share Ownership*, 2 J. OF PORTFOLIO MANAGEMENT 59-70 (1996).

90 H. Kanda, *Trends in Japanese Corporate Governance,* in COMPARATIVE CORPORATE GOVERNANCE 185 (K. Hopt, E. Wymeersch eds., 1997).

91 P. Davies, *Institutional Investors as Corporate Monitors in the UK*, in COMPARATIVE CORPORATE GOVERNANCE 74 (K. Hopt, E. Wymeersch eds., 1997).

92 M. Smith, *Shareholder Activism by Institutional Investors: Evidence from CalPERS*, 51 J. OF FINANCE 227-252 (1996).

93 See G. Hansen & C. Hill, *Are Institutional Investors Myopic? A Time-series Study of Four Technology-driven Industries*, 12 STRATEGIC MANAGEMENT J. 1-16 (1991); J. McConnell & H. Servaes, Additional *Evidence on Equity Ownership and Corporate Value*, 27 J. OF FINANCIAL ECON. 595-612 (1990).

94 R. Chung et al., *Earnings Management, Surplus Free Cash Flow, and External Monitoring*, J. OF BUSINESS RESEARCH (forthcoming 2004).

shows that institutional investors can effectively and profitably monitor management even when monitoring is costly.[95] So, although institutional investors are often characterized as preferring exit in the classical dilemma of "exit" and "voice," this situation has changed, and they are now often seen as strong monitors who are interested in the processes of the companies and voicing their opinion.

II. Banks

The issue of external monitoring has been analyzed mainly in the context of bank monitoring. The theoretical literature on bank monitoring shows that monitoring by banks can be an efficient form of corporate governance, as it offers one way of resolving collective action problems among multiple investors. Especially in control-oriented jurisdictions in continental Europe, banks have developed and retained, over time, strong links with major industrial and commercial enterprises.[96] Therefore banks often own a block of shares in a company and act as a proxy for other investors at the shareholder meetings.[97]

Especially if firms are performing poorly (which is often the case before filing because healthy firms normally do not file a petition for reorganization or liquidation), control rights are swiftly transferred to the bank, which as a primary lender, organizes an informal restructuring or forces the company to file according to chapter 11.[98] Banks therefore often play an important role in the event of a crisis. This is particularly true for countries with underdeveloped capital markets, but even within the UK and US, this is an observable phenomenon. According to aggregate financial data in these two "market-oriented" countries, debt is a more important source of corporate funding than is the issuance of shares.[99] According to Byrd and

95 J. Tirole, *Corporate Governance*, 69 ECONOMETRICA, 1-35 (2001).

96 P. Moerland, *Alternative Disciplinary Mechanisms in Different Corporate Systems*, 26 J. OF ECON. BEHAVIOUR AND ORGANIZATION 17-34 (1995); SCOTT, CORPORATE BUSINESS AND CAPITALIST CLASSES (Oxford 1997).

97 J. CHARKMAN, KEEPING GOOD COMPANY; A STUDY OF CORPORATE GOVERNANCE IN FIVE COUNTRIES (Oxford 1994); K. Hopt, *Common Principles of Corporate Governance in Europe*, in THE CLIFFORD CHANCE MILLENIUM LECTURES: THE COMING TOGETHER OF THE COMMON LAW AND THE CIVIL LAW, 105-132 (B.S. Markesinis ed., Oxford, 2002).

98 CHARKMAN, KEEPING GOOD COMPANY; A STUDY OF CORPORATE GOVERNANCE IN FIVE COUNTRIES (Oxford 1994); *for Japan:* M. Hanazaki & A. Horiuchi, *Is Japan's Financial System Efficient?*,16 OXFORD REVIEW OF ECONOMIC POLICY, 61-73 (2000)

99 S. Prowse, *Corporate Governance in an International Perspective: A Survey of Corporate Control Mechanisms Among Large Firms in the US, UK, Japan and Germany*, 4 FINANCIAL MARKETS, INSTITUTIONS AND

Mizruchi,[100] banks can provide expertise and certification for distressed firms while exercising a monitoring role for non-distressed firms.

III. Other External Monitors

Families can act as external monitors, and not only in Italy, where on average the largest shareholder holds just over 50% of the shares, and a family is the most important blockholder in one third of such firms.[101] This is even true for the US if we consider more than just the largest firms. With the larger sample in view, family holdings turn out to be the most important investors and therefore often a strong monitor.[102]

Another institution, which does not directly hold shares but nevertheless provides monitoring, is security analysts. In their seminal work, Jensen and Meckling argued that security analysts can reduce agency costs.[103] Since analysts examine managerial decisions and forecast firm performance, they can detect flaws within a company and therefore "enforce" the management to prefer filing instead of waiting patiently for the doom of the company to arrive.

IV. The SWOT-analysis of the Monitoring Mechanisms

With the help of another SWOT-analysis we want to sum up the paper and give a brief overview of the different monitoring mechanisms concerning their strengths, weaknesses, opportunities and threats. Table 1 concerns the internal monitors whereas table 2 describes the external monitors.

INSTRUMENTS, 1-63 (1995); E. Bergloef, *A Note on the Typology of Financial Systems*, in COMPARATIVE CORPORATE GOVERNANCE, 151 (K. Hopt, E. Wymeersch, eds., 1997).

100 D. Byrd & M. Mizruchi, *Bankers on the Board and the Debt Ratio of Firms*, J. OF CORPORATE FINANCE (forthcoming 2004).

101 M. Bianchi, Pyramidal Groups and the Separation of Ownership and Control in Italy, in The CONTROL OF CORPORATE EUROPE, (F. Barca, and M. Becht eds. 2002)

102 K. Gugler, et al., Corporate Governance, Capital Market Discipline and Returns on Investment (University of Vienna Working Paper, available through SSRN at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=299520)

103 M. Jensen & W. Meckling, *The Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. OF FINANCIAL ECON., 305-360 (1976).

Strengths	*Weaknesses*
Averts managerial discretion Shareholder's organ Involved in strategic decisions of the company	Board interlocks Dependent on CEO and his/her information CEO "captures" the board
Opportunities Link between managers and investors Increase firm performance	*Threats* Board members maximize their utility and might therefore be interested in a quite life and re-election. Combination of CEO and Chairman of the Board Lobbying

Table 3: SWOT-analysis of internal monitors

Strengths	*Weaknesses*
Averts managerial discretion Facilitate outside financing Reduce collective action problem	Represents their own interests which are not necessarily congruent with the ones of the shareholders Does not know the internal structure as well as "insiders"
Opportunities Increase firm performance Power to change corporate action Reduce agency costs	*Threats* Short term profit maximization without long-term planning "exit" instead of "voice"

Table 4: SWOT-analysis of external monitors

E. Conclusion

We reviewed selected theoretical and empirical literature concerning internal and external monitoring devices and found that in both legal traditions monitoring systems are established to align the managers' interests with those of the external capital providers. These monitoring systems can be classified as internal and external. The literature assigns to both, the board of directors as an internal monitor as well as the capital market with its investors as external monitors, their idiosyncratic strengths but highlights that neither system is perfect.

In this contribution we argued that monitoring turns out to be essential to provide a second-best solution to the inherent principal-agent situation between owners and managers of a firm. Because of the specific strengths and weaknesses of different monitoring mechanisms we recommend that one has to strike a delicate balance between them.

Concerning boards as internal monitors we differentiated between the two-tier board system predominant in Civil Law countries and the one-tier board system typical for Common Law countries. Both systems have respective advantages which should be kept in mind, especially when thinking about incorporating in the new legal form of the *Societas Europaea* which allows a corporation to choose between these two board systems. Two-tier boards ensure a clear separation of direction and control. Therefore, in theory, it better represents the shareholders' interests. In practice, the incentives to do so are questionable as supervisory board members are no altruists. One-tier boards stand for faster decision making and flexibility as they are characterized by a clearly defined management body. On the downside, there is a greater risk of board capture, i.e. the members are heavily influenced by the CEO.

External monitoring, however, commonly comes into play as soon as firms need to raise additional funds. As we live in a time where companies often don't have enough inside equity to finance costly projects, most firms require outside financing. Monitoring by large investors, such as banks and institutional investors, is an attempt to reduce or to limit agency costs stemming from the fact that optimal contracting or the construction of incentive mechanisms isn't feasible. External monitors build a group which can intensify pressure on a firm's managerial decision in order to protect their interests. On the negative side, institutional investors often only care about short-term return on investment instead of long-term company success.

Our discussion has shown the necessity and power of monitoring while making clear that there is no one "magic bullet" to overcome the problems arising from the separation of ownership and control completely. Therefore the mentioned strengths and weaknesses of different monitoring mechanisms have to be kept in mind when dealing with such situations. This perception becomes especially important thinking about such ongoing debates like the question whether one board system is superior to the other and which monitoring devices should be called for in Corporate Governance Codes.