Introduction: The Study of Corporate Governance

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Corporate governance refers to the ways in which suppliers of capital seek to ensure that their capital is wisely managed. As such, it is the backbone of a modern capitalist economy: absent high-quality corporate governance, no one would invest in a firm if she or he was vulnerable to losing her or his investment—or realizing an inadequate return—due to mismanagement, misallocation, or even misappropriation. But what constitutes high-quality governance? And is high-quality governance the same for every firm or does it vary depending on circumstances? Moreover, even a casual reader of the financial news knows that firms can suffer breakdowns in their governance, sometimes even fatal ones. How is it that some firms have better governance than others? Further, presumably governance plays a role in how firms make strategic choices; but how and in what ways? These are all questions of first-order importance; their answers critical to understanding the functioning of corporations.[1]

Given the importance of corporate governance, there is, not surprisingly, a large body of research on it; indeed, a body that has been growing rapidly as the importance of governance has become increasingly evident over time. However, the complex nature of corporate governance means that there is no single paradigm or research method that alone is suited to its study. In particular, it is a topic that has drawn considerable attention from sociologists and organizational behavior scholars, in addition to economists and others who employ similar methods (*i.e.*, finance and accounting scholars). It would be difficult to do justice to such a broad spectrum of

[1] In both this introduction and throughout the volume, much of the focus is on the governance of for-profit corporations. At the same time, many of the insights and models have applications more broadly to a variety of organizations. For instance, even in a state-run firm or governmental agency, the state faces issues of ensuring appropriate use of state resources. Similarly, appropriate use of resources is critical in non-profit organizations, such as colleges and universities. Indeed, there is a non-trivial literature on the governance of institutions of higher education (see, e.g., Ehrenberg, 2004).

approaches in a single volume and, consequently, this volume limits attention to those approaches that fall within the scope of economics, broadly considered.

Even within economics, corporate governance has been approached from a variety of angles and perspectives, with a correspondingly wide array of methods brought to bear. As Benjamin Hermalin observes in the next Chapter, there is a way in which the study of corporate governance, even within economics, is reminiscent of the parable of the blind men and the elephant.[2] Like the blind men struggling to synthesize their different impressions of the elephant, this multitude of research approaches can make it difficult to have a clear view of governance. Yet, at the same time, there is no question that a variety of approaches are required—no more than one could have an impression of an elephant without considering its trunk, its ears, its legs, etc., one cannot understand governance without, for instance, considering issues of incentives, or assessment of managerial ability, or understanding the roles of various institutions, like boards of directors. Consequently, this volume surveys a variety of questions that have been studied using a variety of economic tools, both theoretical and empirical. The goal of this volume is to provide the reader, whether a student new to the area or a researcher in the area looking for insights about the "other parts of the elephant," a broad sense of the economic literature on corporate governance. Ideally, it should also spur her or him to think of new questions and issues to explore.

[2] Briefly, the parable considers a group of blind men who encounter an elephant for the first time. Each feels a different part of the elephant and, thus, draws a different impression of what an elephant is (*e.g.*, the man who feels a thick sturdy leg, believes the elephant to be like a tree; the one who feels the trunk thinks an elephant is like a giant snake; and so forth).

1. Theoretical Underpinnings

Although there are a variety of approaches and issues even within the economic study of governance, there is a common element: governance matters are complex typically because there is some underlying market imperfection, at least from an Arrow-Debreu perspective. If there were perfect markets, wholly rational actors, complete and symmetric information (not only between investors and their managers, but also with those who enforce the contracts between investors and managers), capacity for perfect commitment, and a strong and efficient legal and regulatory systems, then governance would be little more than the design of optimal contracts to achieve first-best solutions. This is not to say there would not be some challenges (*e.g.*, determining optimal risk sharing), but, overall, issues would be straightforward.

It follows, therefore, that much of what makes governance interesting is that those ideal conditions fail to hold in practice. Markets, including capital markets, are not perfect; real-life actors are not the totally rational economic persons of traditional economic models; information is both incomplete and asymmetric; and all legal and regulatory systems have weaknesses (some more pronounced than others). Moreover, what makes the study of governance complex is that *all* those failings are prevalent, whereas much of our economic toolkit permits us to focus on the consequences of only one failing at a time.

For example, suppose there are perfect markets, rational actors, perfect commitment, and an idealized legal system, but that there is asymmetric information between investors (principals) and managers (agents). In particular, suppose that the managers come to have superior information either about what they've done (*i.e.*, they can take actions hidden from investors) or about payoff-relevant states (*e.g.,* they alone learn about important aspects of their firms' prospects). As discussed in depth in the next chapter, as well as in Chapters 3, 6, and 7, such asymmetries of information require those designing the governance relation (the *agency contract*) to make various tradeoffs. For example, when managers privately learn about payoff-relevant states (*hidden-information agency*), they are in a position to earn rents from that information.

Because the rents in hidden-information agency come at the investors' expense, the investors will wish to limit those rents. Limiting them, however, typically means having their managers take actions that are not first-best efficient; that is, there is a rents-efficiency tradeoff.

When managers' actions are hidden from investors (*hidden-action agency*), then investors face a challenge in incentivizing managers to take the actions that investors favor rather than the actions that managers favor. Typically, such incentives are provided by tying managerial compensation to a noisy signal (performance measure) of the action taken. Because the signal is noisy, such a compensation scheme imposes risk on the manager, for which she or he will need to be compensated. The need to compensate the manager for the risk associated with an uncertain payment raises the cost of providing incentives, which in turn can lead investors to incentivize managers to take actions other than those that are first-best efficient. In other words, there is a tradeoff between insuring managers against shocks out of their control and providing them with incentives. The way in which these tradeoffs are managed, what factors influence how they are managed, what institutional responses might they generate, and how their resolution may vary across firms (even in the same industry) are topics of considerable importance both for understanding governance and thinking about how governance mechanisms are best designed. Not surprisingly, they have generated considerable research, both theoretical and empirical, as discussed in depth in Chapters 2 and 7.

Moreover, as discussed in those and other chapters, were one to deviate, say, from the assumption of perfect commitment (which, among other implications, means allowing for contract renegotiation), then managing those tradeoffs can become even more complex. Sometimes commitment can be recovered via repeated interaction, but repetition raises its own set of issues and complexities. For example, sometimes, especially when investors and managers observe the same information, but cannot verify it in court, repeated interaction can permit outcomes that are superior to what is achievable via formal contracts. Moreover, and perversely, sometimes the better the formal contracts the parties could write, the worse the parties can do via repeated interaction—the parties can, in certain circumstances, be made worse off if the formal-contracting technology gets better.[3] Chapter 2 discusses these and other issues relevant to the study of agency problems in the context of corporate governance.

In addition to agency problems between shareholders and managers, another issue that affects governance is that, sometimes, it is unclear *how* a firm should maximize profits. In particular, firms do not know for sure which strategies it should employ to develop, produce, and market its products, or which managers it should appoint. For these types of questions, the usual approach is to utilize a learning or assessment model. Chapter 3 of this volume discusses the application of this type of model to corporate governance.

Suppose, for example, that one wanted to model the process by which firms replace managers, a learning model would be a useful approach.[4] If investors and managers could write complete contracts to which they were fully committed, then the utilization of new information would be effectively a stochastic optimal control problem; perhaps challenging computationally, but not necessarily as a matter of economics. However, for many reasons, it is impossible to

[3] There is a literature on the tension and relations between formal and informal contracting. See Baker et al. (1994), Schmidt and Schnitzer (1995), Hermalin et al. (2007), and Hermalin et al. (2013).
[4] See Chapter 3 for an example of such a model.

write such contracts.[5] Once we are in a world of *incomplete* contracting, then learning and assessment become more challenging economic issues. Assessment itself generates incentives; for example, knowing one will be assessed will affect one's behavior (sometimes positively so, sometimes negatively so). Additionally, assessment generates incentives with regard to who one might wish to hire initially and incentives to try to influence how assessment is done (*e.g.*, by seeking to create some level of commitment via the structure of the organization, such as the composition of the board of directors).

Consequently, there are ways, then, in which learning and assessment, while essential to dealing with a critical aspect of governance—*does the firm have the right managers*—can *create* agency problems. Hence, as with other aspects of governance, learning and assessment generate their own set of tradeoffs with corresponding consequences and questions around their optimal operation, the factors that influence how they are managed, the institutional responses they generate, and how their resolution may vary across firms, both cross-sectionally and temporally.

As noted, Chapter 3 presents a formal treatment of the basic learning model. Further, in that Chapter, we consider the implications for learning on managerial incentives. Sometimes these incentives are positive, sometimes negative (*e.g.*, incentivizing managers toward shorter-term rather than higher-value longer-term investments). As we further show, these models have implications for how vacant slots on the board of directors are filled. This chapter also summarizes a growing empirical literature that estimates learning-based incentives for some industries, and shows how learning about managerial ability can affect stock volatility and a firm's cost of debt. It concludes with a speculative discussion of the way that behavioral considerations—to wit the fact that most people are non-Bayesian in how they incorporate new

[5] In part because sometimes, as in the managerial myopia model of Stein (1989), such contracting would also need be done with *future* investors.

information, often overweighting the most recent information—could affect governance. As we suggest there, such biases can enhance the effects of learning and assessment, thus making learning models perhaps more important to governance then their rational-actor versions might suggest.

2. Legal and Market-wide Factors

Agency and learning models have become an important part of the economics literature. This is reflected in the Nobel Prizes recently awarded to Oliver Williamson, Jean Tirole, Oliver Hart, and Bengt Holmstrom, all of whom have made seminal contributions to issues of governance and control. Much of their work has considered issues of what parties can accomplish via contracts between them and what might be some of the limits on their ability to write formal contracts. A key factor is the strength of the underlying legal system, both the statutory law on contracts and property, but also the reality of their enforcement. Crucial work by Shleifer and Vishny (1997) and La Porta, Lopez de Silanes, Shleifer and Vishny (1998), among others, has persuasively argued that any corporate governance system is only as good as the laws that enforce claimholders' property rights. Since this work appeared, the way in which different legal structures enforce property rights has become an important part of the corporate law literature. The corporate governance literature has demonstrated the first-order importance of these issues, since better enforcement of claimholder property rights means better corporate governance and ultimately better economic performance.

In Chapter 4, Robert Bartlett and Eric Talley survey key aspects of the legal institutions pertaining to corporate governance. As with many topics in this volume, theirs is one that could fill an entire book; hence, their chapter is "meant to serve as a handy reference point and summary of legal dimensions of corporate governance." The chapter begins by reminding the reader that a corporation is a legal entity, distinct from other types of firms (*e.g.*, partnerships), for which many aspects of its governance are dictated by the very law, both statute and precedent, under which it is created. In other words, to form a corporation is effectively to choose a particular governance structure.[6] As Bartlett and Talley further remind the reader, "choose" truly means choice insofar, in addition to choosing a corporate form for the firm over a non-corporate form, there also choices as to what type of corporation (some of which are afforded by deciding in which jurisdiction to incorporate). For example, the law distinguishes between publicly traded (held) and privately held corporations; a crucial distinction with important implications for governance, as Bartlett and Talley discuss.

A further issue is that while the law can stipulate obligations, such as fiduciary duty, to which actors (*e.g.*, directors) must adhere, there are questions as to the mechanisms by which these obligations are enforced; further, there is the subtle question of toward what objective(s) are the actors are obliged to work? A key section of Chapter 4 is, therefore, taken up with how the law perceives the *appropriate* objectives of the corporation and, hence, how it judges whether the relevant actors are or are not meeting their obligations.[7]

Although Chapter 4 is a survey, it does take a reasonably "deep dive" into some specific laws and regulations pertaining to governance, such as those pertaining to shareholder oversight and voting; differences between privately held and publicly traded corporations; and some emerging trends and challenges in how the law (*e.g.*, the courts) have been treating governance disputes. Among the issues considered is that the default legal structure for corporations provides

[6] Although, in some aspects this structure is a *default* structure and the parties can "contract around" certain aspects of that structure. It is also important to keep in mind that there is also considerable degree of discretion of how governance functions within that structure.

[7] Some of these issues are also taken up in Chapter 9 of this volume and the reader is referred there as well as to further discussion of this topic *infra* in this chapter.

for shareholder voting and oversight are surprisingly limited and that there are interesting convergences in the legal treatment of private and publicly held corporations.

In addition to legal factors, corporate governance is affected by the existence of active takeover markets. Early modeling by Grossman and Hart (1980), Shleifer and Vishny (1986), and Stein (1988), as well as others, has explored the various ways in which the threat of takeovers creates positive (and as well as negative) incentives for managers and otherwise affects governance.

Chapter 5 of this volume, by Harold Mulherin, Jeffry Netter, and Annette Poulsen, surveys the empirical literature on mergers and acquisitions. Since the literature already contains several surveys of mergers and acquisitions, the authors of this chapter concentrated on more recent contributions, principally work that have been published since 2011.[8] Nonetheless, mergers and acquisitions is a sufficiently large area of research that Mulherin, Netter, and Poulsen are able to provide detailed summaries of over 115 articles that were published between 2011 and 2017.

A basic and important finding in the early mergers and acquisitions (M&A) literature is that, on average, M&A transactions create wealth, where wealth gains are determined by the total stock price gains to bidders and targets. Recent work attempts to determine the source of these gains. To that end, researchers have examined the processes used for transactions; how the involved parties interact; the motivations for M&A; the sources for synergies and post-transaction changes in the merged firms; as well as methodological issues in measuring returns. Much of the historical and current research uses stock price reactions as a way of studying the effects of various factors influencing M&A for firms. In addition, there is also an extensive

[8] See Jensen and Ruback (1983), Jarrell, Brickley, and Netter (1988), Andrade, Mitchell and Stafford (2001), Eckbo (2009) and Mulherin (2012) for earlier surveys of the mergers and acquisitions literature.

literature that looks at cross-sectional and time-series differences in M&A-related factors to better understand the underlying motivations and impact of these transactions.

Mulherin, Netter, and Poulsen summarize the literature in terms of the questions the papers ask. They group the papers as addressing the following questions: What attributes of acquiring firms, their chief executive officers (CEOs) and their boards are associated with better acquisitions? Do financial advisors or institutional investors know more about potential deals? What are some of the characteristics of *target* firms and how do those characteristics affect the consequences for *acquirers*? Are acquiring firms characterized by overvaluation or overconfidence? What determines the stock price gains to targets and joint returns to targets and acquirers. Do stock price reactions measure the value increases in mergers correctly? How important are networks and relationships among the relevant actors in acquisition decisions? What are the consequences of financial constraints and capital structure on M&A decisions? How are M&A deals structured and what might be the consequences of how such deals can be structured on M&A activity? How and why do firms use antitakeover strategies? What are the consequences of merger on market competitiveness? Are advertised synergies realized? What causes merger waves and how do such waves relate to the state of the macro-economy? What factors lead to international (cross-border) M&A? These are the key questions; hence, even though there is already a large literature addressing them, M&A will be continue to be a fruitful area of research in years to come.

3. Governance Components

Governance has many components, among these are a board of directors, managerial incentive compensation plans, and, in many instances, an ownership structure in which large blockholders monitor management. Each of these components has spawned a literature of its own. Chapters 6, 7, and 8 of this Volume discuss these important governance components.

Chapter 6, by Renée Adams, surveys the literature on boards of directors and updates prior surveys by Hermalin and Weisbach (2003) and Adams, Hermalin, and Weisbach (2010) on this topic. Adams starts from the observation that having a board of directors is one of the legal requirements for incorporation, and, additionally, many non-incorporated entities also have a governing board of some sort (e.g., a university's board of regents).[9] Adams surveys the research on boards of directors in the economics and finance literatures. In the early days of the corporation, boards had a managerial role, which is sometimes still true of small start-ups. Recently, however, boards' role has increasingly come to be seen as a supervisory one: they are the means by which a diffused ownership can oversee management. On the other hand, because boards do not typically consist of large shareholders, there is often an agency relation between shareholders and their board of directors.

Adams argues that the two main reasons why boards have become a central element of corporate governance is that they help to solve agency problems between shareholders and top management, and they provide a valuable source of advice for top management. Within the boardroom, the major conflict of interest is between the chief executive officer (CEO) and the directors. The CEO has incentives to "capture" the board, so as to limit how vigilantly directors monitor her or him (in particular, how prone it might be to replace her or him in response to poor performance). For a variety of reasons, directors have at least some incentives to monitor the CEO and to replace her or him if his performance is poor. Boards evolve over time depending on the bargaining power of the board on the one hand and the CEO on the other.

[9] Although it should also be noted that many non-state-supported colleges and universities are incorporated entities and, so, obligated to have boards. Indeed, some colonial-era colleges, such as Harvard, are among the oldest corporations in the United States.

Research on boards has tended to focus on one of three questions:

1) How do board characteristics such as composition or size affect profitability?

2) How do board characteristics affect the observable actions of the board?

3) What factors affect the makeup of boards and how they evolve over time?

A key issue in the empirical research addressing these questions is how to find measures that proxy for the board's degree of independence from the CEO. Much of this work starts from the often implicit assumption that observable board characteristics, such as size or composition, are correlated with this level of independence. Adams challenges this assumption and argues that the differences between directors are much subtler, and cannot be captured using traditional measures of independence. For example, the chapter (and a good amount of her own work) focuses on the role of director gender as a factor that could potentially affect directors' actions.

Adams emphasizes the methodological difficulties involved in studying boards of directors throughout her chapter. Boards of directors are chosen endogenously through a complicated process involving the CEO and existing directors, so observed boards are likely to be substantially different from the boards that we would observe if boards were chosen randomly from a pool of potential directors. Moreover, it is not clear how useful laboratory experiments would be to study professionally chosen directors, nor are there many natural experiments that scholars can rely on to identify their equations. These issues have made doing empirical work on boards more difficult than one might expect *ex ante*; and responding to this challenge has been one factor spurring the enormous growth in research on boards.

In addition to the "stick" that monitoring by boards represents,[10] another way to motivate top management is "carrots" contained in the compensation system. The more the compensation

[10] Although a board that is a better monitor may also be capable of utilizing implicit or relational incentive contracting with the CEO. See the discussion in Chapter 2, as well as in Cebon and Hermalin (2015).

system aligns management interests with those of their shareholders, the more optimal managerial actions are from the shareholders' perspective. With this idea in mind, the famous Jensen and Murphy (1990) paper argues that shareholders should effectively "sell" their firms to the top managers through a system that allows them to keep a high proportion of the wealth they create through their actions. While the extent to which actual practice is or is not optimal has been questioned (see Haubrich, 1994, for example, as well as related discussion in Chapter 2), the Jensen and Murphy paper as well as some of the original hidden-action agency papers (e.g., Holmstrom, 1979; Shavell, 1979; and Grossman and Hart, 1983) have sparked an enormous academic literature on executive compensation. In addition, executive compensation has become a high-profile topic of discussion in the public square, where CEOs who earn high salaries are often criticized for earning many times what workers in their companies do.

Chapter 7, by Alex Edmans, Xavier Gabaix, and Dirk Jenter, synthesizes this literature. Their discussion of executive compensation in a sense parallels the overall issues in corporate governance, where the big issue is not the way any particular model fits the data, but rather the right conceptual framework underlying the model. Traditionally, economists have taken the view emphasized by Jensen and Murphy (1990), that executive compensation plans should be thought of as a partial solution to the agency problem between the owners (shareholders) and the managers of a corporation.

However, an alternative view, most commonly attributed to Bebchuk and Fried (2004), is that rather that being a solution to the agency problem between managers and shareholders, executive compensation *is itself* a large part of the agency problem. Bebchuk and Fried argue that the correct formulation of the economic problem that determines the executive compensation is not to choose a compensation policy that motivates managers to maximize the value of the firm subject to the usual constraints in a principal-agent problem. Instead, they argue that because managers effectively control the process of setting their compensation, the problem is to maximize the wealth transferred from shareholders to managers. In this formulation, what limits the magnitude of executive compensation is an amorphous "constraint" that Bebchuk and Fried refer to as an "outrage constraint," the idea being that if compensation plans are too high, public outrage will lead to adverse consequences for the firm.

Much of the Edmans, Gabaix, and Jenter chapter focuses on these two perspectives on executive compensation, as well as a third, which is that executive pay is also shaped by institutional forces, such as regulation, tax, and accounting policies. They conclude that "No one perspective can explain all of the evidence, and a narrow attachment to one perspective will distort rather than inform our view of executive pay."[11] It appears that the process determining executive compensation process contains multiple elements: sometimes boards structure compensation plans that provide incentives to maximize wealth and other times the managers are able to influence boards to increase the level of pay without strong links to performance.

In addition to evaluating the relative merits of the "shareholder value" and "rent extraction" views of executive compensation, Edmans, Gabaix, and Jenter includes a number of elements that should prove useful to students of corporate governance. They present a number of stylized facts on executive pay, using U.S. data on public firms going back to 1936. While the level of pay has generally increased over time, this trend has been neither constant nor uniform, contrary to popular belief. They decompose total pay into its components, illustrating in particular the rise and fall of option pay, and discuss the increasing use or disclosure of other forms of pay, such as perquisites, pensions, severance pay, performance-based equity,

[11] Weisbach (2007) reaches a similar conclusion in his review of Bebchuk and Fried (2004).

and (multi-year) bonus plans. Edmans, Gabaix, and Jenter also present evidence on the level and composition of pay in ten non-U.S. countries, as well as in U.S. privately held firms. Overall, this chapter provides a thorough summary of the governance literature as well as a perspective on the overall approach one should take while studying corporate governance.

An additional component of the corporate governance system is involvement by blockholders, who are shareholders that hold a large percentage of the company's equity. Blockholders' importance in corporate governance has been recognized at least since the seminal work of Grossman and Hart (1980) and Shleifer and Vishny (1986). Grossman and Hart (1980) shows that, in the *absence* of large shareholders, governance will be suboptimal since diffuse shareholders will free ride and will not exert sufficient effort to help firms improve their operations. Shleifer and Vishny (1986) extend this analysis by showing how the existence of a large shareholder can mitigate this problem in a number of ways: a blockholder will actively search for potential improvements, can facilitate control changes if there is a potential to improve value, and can influence existing management through "jawboning." Subsequent to these two papers, a literature has developed that explores these ideas both theoretically and empirically.

Chapter 8 of this volume, by Alex Edmans and Clifford Holderness, surveys this literature and summarizes the evidence on large blockholders and their role in corporate governance. Edmans and Holderness first present a unifying model of blockholders that characterizes the way that blockholders can influence the firm's operations directly through their "voice," and also indirectly through the threat of exit.

Edmans and Holderness then document a number of empirical regularities about blockholders. In particular, they show that blockholders appear to be ubiquitous; they are in virtually every company is every country in the world. However, there is no universally accepted definition of a blockholder. Most existing research uses 5% of equity value as a threshold for no particular theoretical reason; however, Edmans and Holderness argue that blocks smaller than 5% can also meaningfully affect corporate governance, so they should be studied more in future work.

Most research focuses on percentage blocks, but Edmans and Holderness argue that their dollar value is also relevant and should be studied as well. The existence of a blockholder is endogenous, so its effect on governance is difficult to measure, especially since there are no known instruments valid for blockholder ownership. In addition, blockholders are heterogeneous and interact with one another, which further complicates empirical work studying them. Overall, the extent to which blockholders evolve and interact with governance appears to be an important area of research.

4. External Constituents

Economic theory has long considered the privately and socially desirable goal of the corporation to be profit maximization (see, e.g., Friedman 1962, 1970). This implies that the objective of corporate governance is to facilitate profit maximization.[12] Further, given that the value of the firm equals the present value of expected economic profits, it follows that, accounting for intertemporal considerations, the objective of corporate governance is to maximize firm value.

This view has been challenged recently by some scholars, most notably Stout (2012) and Hart and Zingales (2017). Moreover, the law and public policy are sometimes at odds with an objective of firm value-maximization (the reader is here referred back to Chapter 4 of this

[12] The reader should, however, note that this need not be consistent with the law and public policy on appropriate objectives. See, in particular, Chapters 4 and 9 of this volume.

volume). German and Austrian firms' supervisory boards, for example, are required to balance the interests of all *stakeholders* (shareholders, creditors, employees, retired employees, suppliers, customers, host communities, governments, the environment, and anyone else with economic claims, actual or potential, to the firm's assets or income). Canadian boards act in the interests of the corporation, rather than its shareholders or other stakeholders. Finally, the various states within the U.S. differ with respect to the extent they mandate shareholder value maximization.

These tensions are focal in Chapter 9 by Vikas Mehrotra and Randall Morck, which concerns the role of stakeholders in corporate governance. Merhrotra and Morck ask why public policy toward corporate governance diverges from the consensus of economists with respect to what the appropriate objective is.

The authors first consider the question theoretically. Mehrotra and Morck argue that: "normative arguments for shareholder valuation maximization rely on simplifying assumptions that may be 'too simple' to guide public policy. Simply put, this argument holds that all other stakeholders must be paid first, before shareholders can receive any dividends. Maximizing the value of shareholders' claims (rational investors' expected present value of future dividends) therefore maximizes the probability that other stakeholders are paid and the efficiency of resource allocation within the firm. This arguably oversimplifies the nature of stakeholders' claims and the economic contribution of firms to the economy. Second, broader political economy considerations may overwhelm arguments based on firm-level economic efficiency. Firms' undertakings can have economically important externalities, motivating public policy that recognizes affected parties as stakeholders."

Key to this analysis is the idea that, when different groups of constituents lobby the government for different treatment, the groups that will be most successful are those best able to avoid free riding among their members. Although models of team production are ambiguous as to what parameters most limit group effectiveness, there are reasons to suspect that small groups—in part because intra-group monitoring and pressure limit free riding—can generate more resources *ceteris paribus;* that is, interest groups with fewer members will tend to be more effective lobbyists all else equal. Additionally, groups that have ways of readily organizing themselves (*e.g.*, as mandatory labor union membership can provide) should be effective lobbyists. Shareholders, typically being many and without an easy way to organize, should thus be less effective lobbyists than other groups. Consequently, shareholders, as a political class, could have relatively less political power than other stakeholders, which may help explain the evolution of social policy on corporate governance. Mehrotra and Morck argue that, with the rise of institutional ownership, this deficiency could be changing, and we could see a transition to more shareholder-oriented corporate governance policies in the future (the diminished power of private-sector unions in the U.S. could also be causing such changes).

5. International and Intertemporal Issues

An important point to understand about corporate governance is that it changes over time. Firms generally follow a life-cycle: they often start as private family or entrepreneurial firms, over time sometimes become publicly-traded and professionally managed, and can live indefinitely, liquidate, or be purchased by another firm. Firms' ownership structures and governance generally change over time as they evolve and as founding families or entrepreneurs exit. Theories of governance such as Hermalin and Weisbach (1998) imply that over time the power of top management relative to their boards can change substantially over time. Moreover, as just noted, corporate governance is highly dependent on country-specific institutional factors such as culture, the legal system, the extent to which individuals trust one another, and the development of the country's financial markets. All of these factors change over time as well, implying that there are many reasons why governance should evolve over time in a country-specific manner.

With these considerations and others in mind, Julian Franks and Colin Mayer, often working with a variety of coauthors, have published a remarkable series of papers, each of which traces the evolution of ownership and governance in a particular country over a long period of time, generally from the beginning of the 20^{th} century to the present. In Chapter 10 of this volume, Franks and Mayer synthesize these studies and present results from each. In addition, they include data from U.S. corporations as well.

The major conclusions Franks and Mayer draw are that the dispersion of ownership in the early part of the 20^{th} century happened in the absence of formal systems of legal protection, highlighting the importance of institutional developments that facilitated the building of trust between investors and firms. Franks and Mayer consider the way concentrated ownership affected equity markets, and argue that concentrated ownership played an important role in promoting relations between investors and firms that were central to the development of these markets. They also discuss the change in the role of the family firm and of private equity in restructuring public firms.

The Franks and Mayer studies highlight the importance of long time series and attention to institutional detail in studies of corporate governance. Another recent study that takes advantage of a long time series on corporate governance is Graham, Kim, and Leary (2017), who analyze the way boards of U.S. public corporations change over a long period of time. Ultimately, given the statistical issues associated with studying endogenously determined governance systems, the use of long time series to study the factors that lead to changes in governance seems like a potentially useful approach.

6. Some Additional Thoughts

Although the chapters that follow survey literally hundreds of articles and books on corporate governance, a theme that carries across these chapters is that our understanding of each of the topics covered remains incomplete. In addition, there are a number of important topics in corporate governance which we could not cover in much detail; these topics in general have some research but less than the topics for which we devoted a chapter. For example, the governance of startups, of family firms, and of nonprofits are all extremely important areas on which there is some, but not nearly enough good research. Moreover, as we discuss at the end of Chapter 3, most of the work in the discussion presumes rationality on the part of participants, yet there are good reasons to believe that behavioral considerations influence corporate governance as much as they do other aspects of human behavior.

Consequently, there is much more work that remains to be done on corporate governance. Partially this reflects the challenges in synthesizing the many perspectives on corporate governance and understanding the choices between alternative frameworks one could use to understand it. Partially this reflects the current limitations of economic theory. Partially this reflects ever increasing access to richer data sets and improved econometric techniques. But perhaps most critically it reflects that governance is not a static concept: as emphasized by Professors Franks and Mayer in Chapter 10, corporate governance in 2017 is far different than it was in 1917 (or even 1967) and radically different than in 1776 when Adam Smith offered one of the earliest (if not the earliest) critiques of corporate governance in the *Wealth of Nations*. A scholar of corporate governance is pursuing a moving quarry.

It is very much our hope that this volume not only acquaints the reader with the vast amount of scholarship already achieved in this field and convinces her or him of the importance of this research, but that it also motivates her or him to join the hunt to improve further our understanding of corporate governance.

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