

# **International Corporate Governance**

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### **Abstract**

We survey two generations of research on corporate governance systems around the world, concentrating on countries other than the United States. The first generation of international corporate governance research is patterned after the US research that precedes it. These studies examine individual governance mechanisms – particularly board composition and equity ownership – in individual countries. The second generation of international corporate governance research recognizes the fundamental impact of differing legal systems on the structure and effectiveness of corporate governance and compares systems across countries.

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# **International Corporate Governance: A Survey**

## **I. Introduction**

Jensen and Meckling (1976) apply agency theory to the modern corporation and model the agency costs of outside equity. In doing so, they formalize an idea that dates back at least as far as Adam Smith (1776): when ownership and control of corporations are not fully coincident, there is potential for conflicts of interest between owners and controllers. There are also benefits to separating ownership and control; otherwise such a structure is highly unlikely to have persisted.<sup>1</sup> The conflicts of interest, however, combined with the inability to costlessly write perfect contracts and/or monitor the controllers, ultimately reduce the value of the firm, *ceteris paribus*. These ideas form the basis for research on corporate governance. How do entrepreneurs, shareholders, and managers minimize the loss of value that results from the separation of ownership and control?

The publication of Jensen and Meckling's model spawned a voluminous body of research, both theoretical and empirical. Through the 1970s and 1980s, that research was largely focused on the governance of US corporations, and US-based corporate governance research continues to expand. By the early 1990s, however, research on governance in countries other than the US began to appear. In the beginning, that research focused primarily on other major world economies, primarily Japan, Germany, and the United Kingdom. More recent years, however, have witnessed an explosion of research on corporate governance around the world, for both developed and emerging markets. The result is an extensive and still growing body of research on international corporate governance. Our task here is to survey that body of literature.

We define corporate governance as the set of mechanisms – both institutional and market-based – that induce the self-interested controllers of a company (those that make

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<sup>1</sup> Individuals are not necessarily endowed with both managerial talent and financial capital. The ability to separate ownership and control allows the holder of either type of endowment to earn a return on it. In addition, the ability to raise capital from outside investors allows firms to take advantage of the benefits of size, despite managerial wealth constraints and/or managerial risk aversion.

decisions regarding how the company will be operated) to make decisions that maximize the value of the company to its owners (the suppliers of capital). Or, to put it another way: “Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment.” (Shleifer and Vishny (1997), p. 737).

The governance mechanisms that have been most extensively studied in the US can be broadly characterized as being either internal or external to the firm. The internal mechanisms of primary interest are the board of directors and the equity ownership structure of the firm. The primary external mechanisms are the external market for corporate control (the takeover market) and the legal/regulatory system.

## A. Internal Governance Mechanisms

### A.1 Boards of Directors

Corporations in most countries of the world have boards of directors. In the US, the board of directors is specifically charged with representing the interests of shareholders. The board exists primarily to hire, fire, monitor, and compensate management, all with an eye towards maximizing shareholder value. While the board is an effective corporate governance mechanism in theory, in practice its value is less clear. Boards of directors in the US include some of the very insiders who are to be monitored; in some cases they (or parties sympathetic to them) represent a majority of the board. In addition, it is not uncommon that the CEO is also the chairperson of the board. Finally, the nature of the selection process for board members is such that management often has a strong hand in determining who the other members will be. The primary board-related issues that have been studied in the US concern the size and structure of the board: the number of directors that comprise the board, the fraction of these directors that are outsiders, and whether the CEO and chairperson positions are held by the same individual.

## A.2 Ownership Structure

Ownership and control are rarely completely separated within any firm. The controllers frequently have some degree of ownership of the equity of the firms they control; while some owners, by virtue of the size of their equity positions, effectively have some control over the firms they own. Thus, ownership structure (i.e. the identities of a firm's equity holders and the sizes of their positions) is a potentially important element of corporate governance.

It is reasonable to presume that greater overlap between ownership and control should lead to a reduction in conflicts of interest and, therefore, to higher firm value. The relationships between ownership, control, and firm value are more complicated than that, however. Ownership by a company's management, for example, can serve to better align managers' interests with those of the company's shareholders. However, to the extent that managers' and shareholders' interests are not fully aligned, higher equity ownership can provide managers with greater freedom to pursue their own objectives without fear of reprisal; i.e. it can entrench managers. Thus, the ultimate effect of managerial ownership on firm value depends upon the trade-off between the alignment and entrenchment effects.

Shareholders other than management can potentially influence the actions taken by management. The problem in the typical US corporation, with its widely-dispersed share ownership, is that individual shareholders own very small fractions of an individual firm's shares and, therefore, have little or no incentive to expend significant resources to monitor managers or seek to influence decision-making within the firm. Moreover, the free-rider problem reduces the incentives for these disparate shareholders to act together. However, individual shareholders who have more significant ownership positions have greater incentives to expend the resources required to monitor and seek to influence managers.

As with ownership by managers, ownership by outside blockholders is not an unequivocally positive force from the perspective of the other shareholders. Blockholders can use their influence such that management is more likely to make decisions that increase overall shareholder value. These are the shared benefits of control; i.e. blockholders exercise them but all shareholders benefit from them. However,

there are private benefits of control as well – benefits available only to blockholders. These private benefits can be innocuous from the point of view of other shareholders; e.g. a blockholder may simply enjoy the access to powerful people that comes from being a major shareholder. However, if blockholders use their control to extract corporate resources, the private benefits they receive will lead to reductions in firm value. Thus, the ultimate effect of blockholder ownership on firm value depends upon the trade-off between the shared benefits of blockholder control and any private extraction of firm value by blockholders.

## B. External Governance Mechanisms

### B.1 The Takeover Market

When internal control mechanisms fail to a large enough degree – i.e. when the gap between the actual value of a firm and its potential value is sufficiently negative – there is incentive for outside parties to seek control of the firm. The market for corporate control in the US has been very active, as have researchers interested in this market. Changes in the control of firms virtually always occur at a premium, thereby creating value for the target firm's shareholders. Furthermore, the mere threat of a change in control can provide management with incentives to keep firm value high, so that the value gap is not large enough to warrant an attack from the outside. Thus, the takeover market has been an important governance mechanism in the US.

As with other potential corporate governance mechanisms, however, the takeover market also has its dark side for shareholders. In addition to being a potential solution to the manager/shareholder agency problem, it can be a manifestation of this problem. Managers interested in maximizing the size of their business empire can waste corporate resources by overpaying for acquisitions rather than returning cash to the shareholders.

### B.2 The Legal/Regulatory System

The literature that we term first-generation international corporate governance research, and which we survey in section II, is largely patterned after the existing US studies. Individual first-generation studies generally focus on board structure, equity ownership, and/or external control mechanisms. The typical individual study examines

one (or a small number) of non-US countries. This generation of international corporate governance research, and the US research on which it is patterned, is important and informative. However, it pays only scant attention to another external corporate governance mechanism, the legal/regulatory system. Jensen (1993) acknowledges the legal system as a corporate governance mechanism but characterizes it as being too blunt an instrument to deal effectively with the agency problems between managers and shareholders. Practically speaking, studies that examine evidence from a single country provide little scope for studying the effects of legal systems, as all of the firms in such a sample are subject to the same national legal regime.

LaPorta, Lopez-de-Silanes, Shleifer, and Vishny (1998) hypothesize that the legal system is a fundamentally important corporate governance mechanism. In particular, they argue that the extent to which a country's laws protect investor rights and the extent to which those laws are enforced are the most basic determinants of the ways in which corporate finance and corporate governance evolve in that country. This basic idea has spawned a growing body of research that examines differing legal regimes across countries. Such research allows for meaningful comparative studies of corporate governance. Given the interrelationships between the various corporate governance mechanisms, it also has the potential to provide a more complete understanding of the roles of firm-specific corporate governance mechanisms such as the board of directors and equity ownership. We term this line of research the second generation of international corporate governance research and survey it in section III.

Comparisons of differing systems of corporate governance inevitably lead to certain obvious questions. Is there one 'right' system of corporate governance? If so, what are the characteristics of that system and are we observing convergence towards it? If there is not one right system of governance, what characteristics of countries or companies determine the best systems for them? Several authors have tackled these important questions and we review their ideas and ours in section IV.

Some of the most dramatic changes in corporate governance mechanisms occur when previously state-owned firms are privatized. The privatization of a firm is a discrete event in which its equity ownership undergoes a relatively rapid transition from highly-concentrated ownership by the government to potentially more diffuse ownership

by private entities. Moreover, privatizations are often undertaken in tandem with major developments in private capital markets in the countries in which they occur. Thus, privatizations are potentially important natural experiments that can provide evidence on how corporate governance mechanisms evolve and interact and on how they affect firm value. Section V, which is not yet completed, will review the international literature on privatizations. Section VI concludes.

Having indicated what we do in this paper, it is only fair to point out what we do not do. Because numerous excellent surveys of the extensive US literature on corporate governance have been written over the years, we do not survey that literature here.<sup>2</sup> We do, however, briefly review certain papers and subject areas from the US literature to help us frame and interpret the international evidence that we present.

Equity holders, of course, are not the only suppliers of capital to corporations and Jensen and Meckling (1976) also model the agency conflicts between shareholders and debtholders. Other than to acknowledge its existence, we do not deal with that particular agency relationship in this survey.

Finally, the traditional caveat for survey papers applies to this one as well. It would not be possible to give due consideration to all of the many excellent papers that have been written in the area of international corporate governance. The global scope of the topic makes this more true than usual: there are undoubtedly good papers written in languages other than English and/or published in outlets with which we are not familiar. We apologize in advance to the authors of each paper omitted. We have tried, however, to cover the major papers and the major topics in a way that will provide a representative view of what the literature has to say about international corporate governance.

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<sup>2</sup> See, for example, Denis (2001) and Shleifer and Vishny (1997) on general corporate governance; Hermalin and Weisbach (2002) on boards of directors; Core, Guay, and Larcker (2001) and Murphy (1999) on executive compensation; Holderness (2002) on blockholders; Holmstrom and Kaplan (2001) on merger activity; and Karpoff (1998) on shareholder activism.

## **II. First Generation International Corporate Governance Research**

The international corporate governance research that we label first generation is largely patterned after a large body of US research. In this section, we review the international evidence on internal control mechanisms, in particular the board of directors and equity ownership structure, and on the external market for corporate control.

The first generation of research on corporate governance mechanisms generally concerns itself with two questions regarding a particular mechanism. First, does that mechanism affect firm performance, where performance is typically measured by profitability or relative market value? Second, does that mechanism affect the particular decisions made by firms; for example with respect to such issues as management turnover and replacement, investment policy, and reactions to outside offers for control?

### **A. Boards of Directors**

In the US, the board of directors is charged with representing shareholders' interests. As such, it is the official first line of defense against managers who would act contrary to shareholders' interests. A considerable body of evidence addresses the effectiveness with which US boards protect shareholders' interests. Hermalin and Weisbach (2001) review this literature.

The board characteristics that have been most extensively studied are the relative proportion of outside directors and the size of the board. Hermalin and Weisbach summarize the US evidence as follows: (1) Higher proportions of outside directors are not associated with superior firm performance but are associated with better decisions concerning such issues as acquisitions, executive compensation, and CEO turnover. (2) Board size is negatively related to both general firm performance and the quality of decision-making. (3) Poor firm performance, CEO turnover, and changes in ownership structure are often associated with changes in board members.

The earliest non-US evidence on boards of directors comes from Japan. Kaplan and Minton (1994) examine the effectiveness of boards of directors in the Japanese

system. In particular, they concentrate on the appointment of outside directors to Japanese boards, where outside directors are defined as individuals previously employed by banks or other nonfinancial corporations. They find that such appointments increase following poor stock performance and earnings losses, and that they are more likely in firms with significant bank borrowings, concentrated shareholders, and membership in a corporate group. As evidence that such outside directors are effective corporate governance mechanisms, Kaplan and Minton show that, on average, such appointments stabilize and modestly improve corporate performance, measured using stock returns, operating performance, and sales growth.

Wymeersch (1998) details extensively the makeup of European boards of directors. He reports that, in most European states, the role of the board of directors has not been prescribed in law. Thus, in many European countries shareholder wealth maximization has not been the only – or even necessarily the primary – goal of the board of directors. This varies across countries, with the British, Swiss, and Belgian systems being the most focused on shareholder welfare.

Boards of directors in Europe are most often unitary, as in the US. In some European countries, however, boards are two-tiered. A two-tiered structure is mandatory in some countries, e.g. Germany and Austria, and optional in others, e.g. France and Finland. Two-tier boards generally consist of a managing board, composed of executives of the firm, and a supervisory board. In Germany, representation of employees on the supervisory board, termed co-determination, is mandatory.

Until recently there have been few published papers that study the effectiveness of European boards of directors. Despite this lack of evidence, and despite the fact that the US evidence is somewhat open-ended regarding the effect of board characteristics on firm value, various European commissions have embraced the idea that appropriate board composition is important to good corporate governance. Codes of Best Practice have been issued in a number of European countries, starting with the UK in 1992. Common to most of these codes is a requirement for specified numbers and/or percentages of independent directors on the boards of firms in the country. The codes are typically voluntary in nature and the degree of compliance with them varies across countries. Wymeersch (1998) hypothesizes that compliance is more difficult on the continent than

in the UK, due to the greater presence there of controlling shareholders who do not wish to see their influence reduced by the addition of independent directors to their companies' boards.

Dahya, McConnell, and Travlos (2002) address the effect on board effectiveness of the UK Code of Best Practice, adopted based upon the recommendations of the Cadbury Committee. Among other things, the Code recommends that boards of UK corporations include at least three outside directors and that the positions of chairperson and CEO be held by different individuals. While the Code is voluntary (as of the writing of this paper), the London Stock Exchange does require that all listed companies explicitly indicate whether they are in compliance with the Code. If a company is not in compliance, an explanation is required as to why it is not.

Dahya, McConnell, and Travlos document that CEO turnover increased following issuance of the Code and that the sensitivity of turnover to performance is stronger following its issuance. These increases are concentrated among those firms that chose to adopt the Code. They further conclude that it is the increase in the fraction of outsiders on the board, rather than the separation of the Chairperson and CEO positions, that explains the turnovers. These results are consistent with the findings of Weisbach (1988) for US firms, but inconsistent with the evidence documented by Kang and Shivdasani (1995) for Japanese firms and Franks, Mayer, and Renneboog (2001) for UK firms. The latter two papers are unable to document a definitive relation between the presence of outside directors and the sensitivity of CEO turnover to performance.

Dahya and McConnell (2002) examine the effect of the UK's Code on appointments of new CEOs. They report that a firm's board is more likely to appoint an outside CEO after the firm has increased the representation of outside directors to comply with the Code. This result is consistent with the findings of Borokhovich, Parrino, and Trapani (1996) for the US. Based upon an event study of stock prices, Dahya and McConnell also report that appointment of an outside CEO is good news for shareholders.

As stated earlier, some Codes of Best Practice specify that the Chairperson and CEO positions should be held by different people. What evidence there is regarding the importance of such a separation to governance effectiveness generally indicates that

separating the two positions does not result in better firm performance or in better decision-making by firms. (See, for example, Brickley, Coles, and Jarrell (1999) for the US and Vafeas and Theodorou (1998) for the UK.)

Evidence regarding the effectiveness of boards of directors elsewhere in the world is scattered. Blasi and Shleifer (1996) examine board structure in Russia in 1992/1993 and then again in 1994. They report that most firms are majority-owned by insiders and employees and that the boards are solidly controlled by insiders. Most managers indicate resistance to outsiders on the board. Those board members that are outsiders are typically blockholders. Blasi and Shleifer note that a government decree urging that boards be composed of no more than 1/3 insiders has been ignored by all but a very few small Russian companies.

Hossain, Prevost, and Rao (2001) examine the relation between firm performance and the presence of outside directors in New Zealand firms both before and after the 1994 Companies Act. This Act was issued in 1994 with the intention of enhancing the performance of New Zealand firms through better monitoring by boards. Hossain, Prevost, and Rao find a positive relation; i.e. a higher fraction of outside directors leads to better performance. However, they find no evidence that the strength of that relation was affected by the Companies Act. Rodriguez and Anson (2001) examine the market reaction to announcements by Spanish firms that they will comply with the Spanish Code of Best Practice, which contains 23 recommendations that aim to strengthen the supervisory role of Spanish boards of directors. Rodriguez and Anson report that the market reacts positively to announcements of compliance when such announcements imply a major restructuring of the board; this reaction is stronger for firms that have been performing poorly.

Consistent with the findings for the US, there is some evidence that outside directors in other countries are more likely to dismiss top management. Suchard, Singh, and Barr (2001) find that the incidence of top management turnover in Australia is positively related to the presence of non-executive directors on the board. Renneboog (2000) documents a similar result for firms listed on the Brussels Stock Exchange.

Overall, the empirical evidence on board structure around the world supports the more extensive US evidence. The presence of outsiders on boards of directors does not

alter the ongoing performance of the firm, on average, but does sometimes affect decisions about important issues. Codes of Best Practice that have been issued in many countries around the world generally seek to move boards towards greater representation by non-executive directors. The evidence to date on the effects of compliance with these Codes tentatively hints that having more outside directors alters board decisions within some, but not all, countries studied. Whether better decisions are being made is still largely an open question.

To our knowledge, other aspects of board structure that have been studied in the US – e.g. board size and whether the Chairperson and CEO positions are held by one person – have not been studied in other countries. For many countries in the world there is little or no empirical evidence regarding any issues related to the effectiveness of boards of directors. These are useful avenues for further research. In addition, boards of directors cannot be viewed in isolation. The interrelationship between board composition and other corporate governance mechanisms remains a fruitful area for research worldwide.

## B. Ownership and Control

Early corporate governance research in the US centered on large corporations with diverse shareholders and professional managers who owned little or none of the equity of the firms they managed. Beginning in the late 1980s, however, research emerged that recognized that many US corporations do, in fact, have significant equity ownership by insiders and/or shareholders that own significant blocks of equity. Holderness (2002) surveys the US evidence on equity ownership by insiders and blockholders, where insiders are defined as the officers and directors of a firm and a blockholder is any entity that owns at least 5% of the firm's equity. He reports that average inside ownership in publicly-traded US corporations is approximately 20%, varying from almost none in some firms to majority ownership by insiders in others. Mehran (1995) reports that 56% of the firms in a sample of randomly selected manufacturing firms have outside blockholders.

Holderness (2002) also surveys the US literature that examines the effects of insider and blockholder equity ownership on corporate decisions and on firm value. Recall from the introduction that there are opposing hypotheses about these effects. Equity ownership by insiders can align insiders' interests with those of the shareholders, thereby leading to better decisions and/or higher firm value. However, higher ownership by insiders results in a greater degree of managerial control, potentially entrenching managers. Similarly, the greater control that blockholders have by virtue of their equity ownership positions can lead them to take actions that increase the market value of the firm's shares, benefiting all shareholders. However, that same control can provide blockholders with private benefits, i.e., benefits that are not available to other shareholders. The private benefits enjoyed by blockholders potentially reduce firm value.

The US evidence regarding the effects of ownership structure on corporate decisions and on firm value is mixed. Morck, Shleifer, and Vishny (1988) and McConnell and Servaes (1990) find that the alignment effects of inside ownership dominate the entrenchment effects over some ranges of managerial ownership. However, as inside ownership increases beyond some level, the entrenchment effects of inside ownership dominate and higher inside ownership is associated with lower firm value. Himmelberg, Hubbard, and Palia (1999), however, use panel data and conclude that changes in managerial ownership do not affect either firm decisions or firm performance.

Holderness (2002) indicates that there have been few direct attempts to separately measure the impact of outside (i.e. non-management) blockholders on firm value. Mehran (1995) finds no significant relations between firm performance and the holdings of a variety of different types of blockholders, including individuals, institutions, and corporations. There is, however, some evidence that the formation of a new block or the trade of an existing block are met with abnormal stock price increases. (See Mikkelson and Ruback (1985) and Barclay and Holderness (1991, 1992).) Overall, Holderness (2002) concludes that the body of evidence on the relation between blockholders and firm value in the US indicates that the relation is sometimes negative, sometimes positive, and never very pronounced.

While there is little strong evidence that blockholders affect the market value of firms, the US evidence does indicate that blockholders enjoy significant private benefits

of control. A number of studies document that block trades are typically priced at a premium to the exchange price, consistent with blockholders expecting benefits that are not available to other shareholders. (See Barclay and Holderness (1989), Mikkelson and Regassa (1991), and Chang and Mayers (1995).) The extent to which such private benefits lead to reductions in firm value remains an open question.

### B.1. Ownership Concentration Around the World

Of all of the corporate governance mechanisms that have been studied in the US, ownership structure is the mechanism that has been studied most extensively in the rest of the world. As with other aspects of corporate governance, the early non-US evidence on ownership focused on Japan, Germany, and the UK.

Equity ownership in the UK has historically been much like that in the US: large numbers of publicly-traded firms, most of which are relatively widely-held. Equity ownership in Germany and Japan has historically been more concentrated than in the US. In addition, banks play more important governance roles in Germany and Japan. These distinctions led researchers to distinguish between market-centered economies (US and UK) and bank-centered economies (Germany and Japan).

Despite both being considered bank-centered economies, there are differences between the structure of equity ownership in Germany and Japan. Prowse (1992) indicates that financial institutions are the most important blockholders in Japan. It has been a common perception that the same is true in Germany; however, Franks and Mayer (2001) find that other companies are the most prevalent blockholders in Germany, followed by families. German banks do, however, have more voting power than their equity ownership would suggest by virtue of the fact that they vote the proxies of many individual shareholders. Thus, financial institutions have significant amounts of control over firms in both Germany and Japan.

Beginning in the mid-1990s, studies of equity ownership concentration spread to countries others than the ‘big four’. This body of evidence reveals that the more concentrated ownership structures observed in Germany and Japan are more typical of ownership structures around the world than are the relatively diffuse structures observed in large, publicly-traded US and UK firms. This generalization, however, masks

important differences across countries with respect to the degree of ownership concentration and the identities of the blockholders.

Faccio and Lang (2002) examine western European countries and conclude that listed firms are generally either widely-held, which is more common in the UK and Ireland, or family-owned, which is more common in continental Europe. Blass, Yafeh, and Yosha (1998) document high ownership concentration in Israel, with banks and affiliated institutional investors as the most significant non-insider holders. Xu and Wang (1997) document high ownership concentration in China, with ownership split relatively equally between the government, institutions, and domestic individuals. Valadares and Leal (2000) document high ownership concentration in Brazil; with the majority of blockholders being corporations or individuals.

Numerous international studies address the relation between ownership structure and firm performance. Kang and Shivdasani (1995) find that Japanese firms with blockholders restructure more quickly following performance declines than do Japanese firms without blockholders. They point out, however, that the response comes less quickly in Japan than in the US. Gorton and Schmid (2000) find that firm performance in Germany is positively related to concentrated equity ownership. Kaplan (1994), however, finds no relation between ownership structure and management turnover in Germany. Claessens and Djankov (1999) study Czech firms and find that firm profitability and labor productivity are both positively related to ownership concentration.

There are numerous potential types of large shareholders – other corporations, institutions, families, and government – and the evidence implies that the relation between large shareholders and value often depends on who the large shareholders are. Claessens, Djankov, Fan, and Lang (1998), for example, examine firms in nine East Asian countries and find that the impact of ownership varies according to the identity of the blockholder. Ownership by corporations is negatively related to performance, while ownership by the government is positively associated with performance. They find no relation between institutional ownership and firm performance.

The effects on value of ownership by management have been of particular interest in international research. With respect to inside ownership in the UK, Short and Keasey (1999) document that the entrenchment effects of managerial ownership begin to

dominate the alignment effects when management ownership is 12%. Because Morck, Shleifer, and Vishny (1988) find that entrenchment dominates alignment beginning at 5% managerial ownership, Short and Keasey conclude that managers become entrenched at higher levels of equity ownership in the UK than in the US. They attribute this to better coordination of monitoring by UK institutions and less ability of UK managers to mount takeover defenses. Miguel, Pindado, and de la Torre (2001) document a similar nonlinear relation between inside ownership and firm value in Spain. Djankov and Claessens (1998) find for Czech firms that managerial equity holdings have no effect on performance. However, they do show that firm performance improves with the appointment of new managers, particularly if the managers are chosen by private owners rather than by the government. Craswell, Taylor, and Saywell (1997) document only a weak curvilinear relation between inside ownership and performance in Australia; the relation is unstable across time and inconsistent over firm-size groups.

Less direct evidence on the relation between inside ownership and firm performance comes from studies of diversified firms. A large body of US evidence documents a diversification discount; i.e. diversified firms are worth less than the sum of the stand-alone value of the separate pieces of the firm. (See, for example, Lang and Stulz (1995), Berger and Ofek (1995), and Servaes (1996).)<sup>3</sup> Lins and Servaes (1999) measure the relation between concentrated ownership in the hands of insiders and the value of diversification for firms in Germany, Japan, and the UK. They find that inside owners have a positive effect on the value of diversification in Germany, but not in the UK or Japan. Chen and Ho (2000) study firms in Singapore and document that diversification has a negative effect on value only in firms with low managerial ownership.<sup>4</sup>

We indicated earlier that some governance researchers dichotomize economies into those that are market-centered and those that are bank-centered. Numerous studies

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<sup>3</sup> Several recent studies question whether the diversification discount is caused by diversification per se. (See, for example, Campa and Kedia (2002), Chevalier (2000), Graham, Lemmon, and Wolf (2001), Maksimovic and Phillips (2002), and Whited (2001).) There is, however, little disagreement about the fact that the average diversified firm is valued less than a similar group of stand-alone firms.

<sup>4</sup> These results contrast somewhat with those of Denis, Denis, and Sarin (1997) for the US. Denis, Denis, and Sarin do find that firms with high inside ownership are less likely to diversify. Conditional on diversifying, however, the valuation effects of diversification are unrelated to inside ownership.

address the impact of bank involvement on firm value. Morck, Nakamura, and Shivdasani (2000) find that the relation between bank ownership and firm performance in Japan varies over the ownership spectrum; in particular, the relation is more positive when ownership is high. Gorton and Schmid (2000) report that the positive relation between ownership concentration and firm value for German firms is particularly strong where there is block ownership by banks. Xu and Wang (1997) document an overall positive relation between ownership concentration and profitability in Chinese firms; this relation is stronger when blockholders are financial institutions than when it is the state that is the primary blockholder. Sarkar and Sarkar (2000) find that block equity ownership by lending institutions tends to be good for firm performance in India. Blass, Yafeh, and Yosha (1998) report that banks are significant blockholders in Israel. They conclude, however, that the benefits that the powerful role of banks have for shareholders are outweighed by the costs, e.g. the lack of an external control market.

The evidence from around the world indicates that the relation between ownership structure and firm performance varies – both by country and by blockholder identity. Overall, however, this body of evidence suggests that there is a more significant relation between ownership structure and firm performance in non-US firms than there is in US firms. Ownership concentration most often has a positive effect on firm value. The important role that banks play in governance is particularly interesting given that US banks are prohibited from playing a large role in governing US firms. Do such prohibitions interfere with optimal governance for US firms – or do other aspects of US governance reduce the potential value of bank involvement?

## B.2. The Private Benefits of Control

Equity ownership provides holders with certain rights to the cash flows of the firm. To the extent that large shareholders have both the incentive to monitor management and enough control to influence management such that cash flow is increased, all shareholders of the firm benefit. These are the shared benefits of control. In examining the relation between equity ownership by blockholders and firm performance, we are effectively measuring whether there are any shared benefits

associated with having large shareholders. However, there are potential private benefits of control as well, private in that they are available only to those shareholders who have a meaningful degree of control over the firm.

To the extent that control has value beyond any cash flow rights associated with equity ownership, there is incentive to seek to hold disproportionate amounts of control. There are a number of ways in which shareholders can achieve control rights that exceed cash flow rights in a given firm. In the US, this is most typically accomplished through ownership of shares of common stock that carry disproportionately high numbers of votes. Several studies examine firms that deviate from one share-one vote in the US and find that superior voting shares trade at a small premium to inferior voting shares (See Lease, McConnell, and Mikkelson (1983, 1984), DeAngelo and DeAngelo (1985), Zingales (1995).) Such evidence is consistent with there being private benefits of control. Studies of voting share premiums around the world confirm the US evidence. The premium is larger in all other countries that have been studied than in the US, ranging from a low of 6.5% in Sweden (Rydkvist (1987)) to a high in Italy of 82% (Zingales (1994)).

Control in excess of proportional ownership can also be achieved through pyramid structures or by cross-holdings. In a pyramid structure, one firm owns 51% (for example) of a second firm, which owns 51% of a third firm, and so on. The owner at the top of the pyramid thereby has effective control of all of the firms in the pyramid, with an increasingly small investment in each firm down the line. Cross-holdings exist when a group of companies maintain interlocking ownership positions in each other. To the extent that the interlocking nature of their ownership positions makes group members inclined to support each other, voting coalitions are formed.

Consolidation of control via dual share classes, pyramids, and cross-holdings are common around the world. Claessens, Djankow, and Lang (2000) examine firms in nine East Asian countries and find that voting rights frequently exceed cash flow rights, typically via pyramid structures and cross-holdings. The result is that in over 2/3 of the firms in these countries there is a single shareholder that has effective control over the firm. Faccio and Lang (2002) report that the use of dual class shares and pyramids to enhance the control of the largest shareholders is common in western Europe, though the

resulting discrepancy between ownership and control is significant in only a few countries. For Brazilian companies, Valadares and Leal (2000) find that the vast majority of firms they study have some non-voting shares; pyramiding is not common in Brazil, however.

Group ownership structures are common in a number of countries. In Japan they are termed keiretsu, in Korea chaebols, and in Russia Financial-Industrial Groups. Groups are also common in India, Italy, and Brazil. Kantor (1998) reports that South Africa is dominated by five large groups – three of which are controlled by founders or their families. These groups have control despite having made only minority cash flow investments.

In general, the international evidence indicates that the accumulation of control rights in excess of cash flow rights reduces the observed market value of firms. Lins (2002) examines 22 emerging market countries and documents that the uncoupling of control rights from cash flow rights is common and value-reducing. Volpin (2002) reports that the sensitivity of top management turnover to performance in Italy is lower when controlling shareholders own less than 50% of the cash flow rights. Nicodano (1998) finds that the voting premium in Italy is higher when there are business groups involved. Lins and Servaes (1999) find that the diversification discount in Japan is concentrated in firms that are part of industrial groups. Lins and Servaes (2002) examine publicly-traded firms in seven emerging market countries and observe a diversification discount only when firms belong to industrial groups or when management ownership is in the 10-30% range. The discount is most severe when management control rights substantially exceed their cash flow rights. Joh (2000) shows for Korean firms that controlling blockholders in Korean firms are more effective when they also have high cash flow ownership. He finds that firms associated with business groups are less profitable overall. Gorton and Schmid (2000) reveal that bank control in Germany that stems from bank ownership has a positive effect on firm performance, measured as return on assets, while bank control that stems from banks' voting of other shareholders' proxies has no impact on firm performance.

Several studies address the effect of membership in a group on investment policies in companies within the group. In general, they find that investment is less

sensitive to cash flow for firms that belong to groups than for firms in the same country that do not. Hoshi, Kashyap, and Scharfstein (1991) find that Japanese firms with ties to large banks have lower sensitivity of investment to liquidity. Shin and Park (1999) show that investment by firms in Korean chaebols is less sensitive to firm cash flow than is investment by non-chaebol Korean firms. Perotti and Gelfer (1999) document the same for Russian firms that belong to Financial-Investment Groups, particularly those led by banks. While reliance on internal capital markets is not necessarily value-reducing, evidence from the US implies that it more often is. Scharfstein (1998), Rajan, Servaes, and Zingales (2000), and Ahn and Denis (2002) present evidence consistent with the hypothesis that diversified firms invest inefficiently, investing too much in some business units and/or too little in others.

On a more positive note for group membership, Hoshi, Kashyap, and Scharfstein (1990) present evidence showing that keiretsu membership in Japan reduces the costs of financial distress by mitigating the free-rider and information asymmetry problems that make renegotiation with creditors difficult. Firms that belong to keiretsu, as well as non-keiretsu firms that have a strong tie to a main bank, invest more in productive assets and sell more product in financial distress than do other Japanese firms.

A number of conclusions can be drawn from the international literature on the ownership of publicly-traded firms. First, ownership is, on average, significantly more concentrated in non-US countries than it is in the US. Second, ownership structure appears to matter more in non-US countries than it does in the US – i.e. it has a greater impact on firm performance. Overall, ownership concentration appears to have a positive effect on firm value. Third, there are significant private benefits of control around the world, and they are more significant for most non-US countries than they are for the US. Structures that allow for control rights in excess of cash flow rights are common, and generally value-reducing.

### C. The External Control Market

A vast literature on the takeover market in the US indicates that it is an important corporate governance mechanism, a ‘court of last resort’ for assets that are not being

utilized to their full potential. Holmstrom and Kaplan (2001) review this literature. Several stylized facts stand out. Average announcement abnormal returns to target firm shareholders are positive, while average abnormal returns to acquiring firm shareholders are, at best insignificantly different from zero and are, in most studies, significantly negative. The combined abnormal returns to a target and acquiring firm pair are relatively small, but significantly positive. Poorly-performing firms are more likely to be targets of takeover attempts and the managers of poorly-performing firms are more likely to be fired.

The takeover market in the UK is also active. Franks and Mayer (1996) examine UK hostile takeovers and find that they are followed by high turnover among members of the board of directors and significant restructuring. Target firms do not appear to be performing poorly before the acquisition bids, however. Short and Keasey (1999) suggest that managers are less able to avoid being taken over in the UK than in the US due to the inability of UK managers to mount takeover defenses.

Firth (1997) reports that New Zealand's takeover market is relatively unregulated and that there are a high number of takeovers relative to the size of the economy. The evidence is largely consistent with that for the US: average positive returns to target firm shareholders, average negative returns to acquiring firm shareholders, and an overall gain for the combined firms. He also documents a positive relation between returns and the equity ownership of the acquiring firm's directors.

Hostile takeover attempts in Germany have been rare, due presumably to the significant ownership concentration that characterizes the equity market. However, a number of authors present evidence that a German control market does exist, albeit one that is different in form than that of the US and the UK. Jenkinson and Ljungqvist (1997) assert that outsiders attempt to take control by seeking to acquire one or more blocks from existing blockholders. Franks and Mayer (2001) confirm these findings. Other evidence indicates that such changes in blockholder identity, and the turnover in board members that typically accompany them, are more likely following poor performance. (See Kaplan (1994), Franks and Mayer (2001), and Koke (2001).) Koke (2001) finds that changes in the blockholders of German firms are followed by increased

restructuring activity, particularly management turnover, asset divestitures, and employee layoffs.

In general, takeover activity does not appear to be an important governance mechanism around the world. Kabir, Cantrijn, and Jeunink (1997), for example, find that hostile takeovers are relatively rare in the Netherlands, while Blass, Yafeh, and Yosha (1998) indicate that there is only a very thin takeover market in Israel. Xu and Wang (1997) indicate that there is no active takeover market in China. This general lack of importance of takeovers is perhaps not surprising given the generally significant ownership concentration in most other countries.

The first generation of international corporate governance research provides an interesting look at governance in individual countries around the world. Some more recent work on international corporate governance is aimed more at comparing governance systems across countries. The authors of these comparative governance studies examine numerous countries in a unified framework, seeking to understand the factors that explain differences in corporate governance around the world. We review this literature in the following section.

### **III. Second Generation International Corporate Governance Research**

The evidence discussed in section II indicates that large shareholders are more common in most other countries of the world than in the US. In addition, the presence of large shareholders is more likely to have a statistically significant effect on firm performance in countries other than the U.S. In general, the first generation of international corporate governance research does not directly address the reasons for the increased prevalence and impact of large shareholders outside of the US. There are, however, some hints. For example, Zingales (1994) hypothesizes that the premium on voting shares in Italy is so much larger than in other countries of the world because the law does not adequately protect the rights of minority shareholders, giving whoever controls a company greater scope to dilute minority shareholder rights.

Legal and regulatory issues play a relatively small role in the first generation of international corporate governance research. U.S research involving these issues consists primarily of studies involving some specific legal issues, e.g. state of incorporation and state anti-takeover statutes. The effects of the more general underlying system of corporate laws and regulations on corporate governance and firm value are not generally considered. This is perhaps not surprising, given that there can be little variability in such factors in a sample made up entirely of US firms. In addition, some researchers downplay the legal system as an effective means of corporate governance. Jensen, for example, characterizes it as being “. . . far too blunt an instrument to handle the problems of wasteful managerial behavior effectively.” (Jensen (1993), p. 850.)

As discussed above, the first generation of non-US corporate governance research is largely patterned after US research, both in terms of the issues studied and because the samples tend to be drawn from a single country. Thus, as in the US, the impact of underlying legal and regulatory system on corporate governance and firm value is not generally addressed.

The research that we term second generation effectively begins with the work of LaPorta, Lopez-de-Silanes, Shleifer, and Vishny (LLSV). In “Law and Finance” (1998) they hypothesize that the extent to which a country’s laws protect investor rights – and the extent to which those laws are enforced - are fundamental determinants of the ways in which corporate finance and corporate governance evolve in that country. Their empirical evidence indicates that there are significant differences across countries in the degree of investor protection, and that countries with low investor protection are generally characterized by high concentration of equity ownership within firms and a lack of significant public equity markets. LLSV measure ownership concentration in each country by computing the total percentage equity ownership of the three largest shareholders for each of the ten largest domestic, non-financial firms in the country. The median figure for the 49 countries in the sample is 45%. The US figure of 20% is the lowest in the sample; only six countries are under 30%. LLSV assign each of the 49 countries to one of four general groups: common law countries, French civil law countries, German civil law countries, and Scandinavian civil law countries. They find that the laws in common law countries provide the strongest degree of protection for

shareholders, while the laws in French civil law countries provide the least protection. Enforcement of the laws is stronger in the German and Scandinavian law countries than in the common law countries, with the weakest enforcement observed in French civil law countries.

Concentrated ownership may be a reasonable response to a lack of investor protection. If the law does not protect the owners from the controllers, then the owners will seek to be controllers. LaPorta, Lopez-de-Silanes, Shleifer, and Vishny (1998) point out that, in this situation, the agency conflict between managers and shareholders – the primary conflict around which most of the US corporate governance research has revolved - is not meaningful because large shareholders have both the incentive and the ability to control management. LLSV suggest, however, that highly concentrated ownership leads to an alternative equity agency conflict, which is between dominant shareholders and minority shareholders.

In addition to their important insight about the agency problems between large and small shareholders, LLSV provide international corporate governance researchers with important data by developing objective measures of investor protection for each of the 49 countries in their samples. These overall scores are made up of variables related to specific shareholder and creditor rights, which measure the protection afforded by the law, and variables related to the rule of law, which measure the degree to which the existing laws are enforced. The variability in legal structures around the world – and the ability to measure it – provide greater opportunities for comparative corporate governance studies.

## A. Legal Protection and Economic Growth

One branch of the existing literature on the effects of legal systems on economies and on the firms within them is concerned with their effects on the availability of external finance and, therefore, on economic growth. Rajan and Zingales (1998) hypothesize that financial development facilitates economic growth. Consistent with this, they find that industrial sectors that need more external finance develop disproportionately faster in countries that have more developed financial markets. Wurgler (2000) examines

investment by firms in 65 countries. Using the size of stock and credit markets relative to GDP as a proxy for financial development, he finds that firms in countries with developed financial sectors increase investment more in growing industries and decrease it more in declining industries.

LaPorta, Lopez-de-Silanes, Shleifer, and Vishny (1997) hypothesize that better legal protection leads investors to demand lower rates of return and that companies, in turn, are more likely to use external finance when rates are lower. They compute three aggregate measures of the use of external finance and find that all three measures are highest in common law countries, where investor protection is greatest, and lowest in French civil law countries, where investor protection is weakest. Regression analysis indicates that the use of equity finance is positively related to shareholder rights.

Himmelberg, Hubbard, and Love (2002) hypothesize that lack of investor protection forces company insiders to hold higher fractions of the equity of the firms they manage. These high holdings subject insiders to high levels of idiosyncratic risk, which, in turn, increases the risk premium and, therefore, the marginal cost of capital. Himmelberg, Hubbard, and Love find results consistent with their hypotheses for firms in 38 countries. They document a negative relation between the degree of investor protection and the fraction of equity held by insiders, and a positive correlation between inside equity ownership and the marginal return to capital.

The results detailed in the previous three paragraphs imply that strong economic growth requires developed financial markets and that strong investor protection is necessary if strong financial markets are to develop. Thus, studies indicate that investor protection laws and the degree to which they are enforced affect the size and extent of countries' capital markets and, with them, the level of economic growth.

Johnson, Boone, Breach, and Friedman (2000) provide evidence that the degree of investor protection in a country also affects the way in which that economy's capital markets respond to adversity. They examine 25 countries during the Asian crisis of 1997-1998 and find that the magnitude of decline in the stock market and the degree of depreciation of the exchange rate are negatively related to the degree of investor protection.

The positive effects of investor protection on economies are echoed for the individual firms within them. LaPorta, Lopez-de-Silanes, Shleifer, and Vishny (2000) find that firms in common law countries where investor protection is stronger make higher dividend payouts when firm reinvestment opportunities are poor than do firms in countries with weak legal protection. Dittmar, Mahrt-Smith, and Servaes (2002) report that firms in countries with strong legal protection are less likely to maintain excess cash balances. They reject the possibility that their results are driven by the difficulty of raising needed external capital for firms in countries where investor protection is weak. Thus, the agency costs associated with free cash flow appear to be lower in countries with stronger investor protection. LaPorta, Lopez-de-Silanes, Shleifer, and Vishny (2002) find that firms in countries with better investor protection have higher Tobin's Q ratios. Gul and Qiu (2002) relate LLSV's legal protection measures to information asymmetry for 22 emerging market countries, measuring information asymmetry based on the degree of importance that investors place on current versus future earnings. Their results indicate that greater legal protection is associated with lower levels of information asymmetry and, therefore, with less serious agency problems.

Market forces may lead individual firms within an economy to structure their own governance to overcome the deleterious effects that the lack of investor protection in their economy has on their ability to raise external capital. Durnev and Kim (2002) examine the quality of individual firm governance for firms in 26 countries, using corporate governance scores compiled by *Credit Lyonnais Securities Asia* and *Standard and Poor's*. These scores are assigned based on a wide variety of firm characteristics, including characteristics related to disclosure, board structure, ownership structure, and accountability. Durnev and Kim find that the quality of governance in individual firms varies greatly within countries; in particular, firms with better investment opportunities and firms that rely more on external finance have higher governance scores. Durnev and Kim also find that these firms are valued more highly.

Without underlying legal protection, individual company governance structures put into place when capital is needed to take advantage of investment opportunities do not necessarily survive when such opportunities disappear. Lemmon and Lins (2001) examine the response of firms in eight East Asian countries to the Asian financial crisis.

They find that Tobin's Q falls more and stock price performance is worse for those firms in which minority shareholders are potentially more subject to expropriation. They conclude that ownership structure may be especially important in times of declining investment opportunities.

The first generation of international corporate governance reviewed in section II establishes that equity ownership within firms is much more concentrated in most countries of the world than it is in the US, and that this ownership concentration tends to have a positive effect on firm value. The results above offer an explanation for both findings – concentrated ownership is a rational and valuable response to a system that does not protect minority investors. LaPorta, Lopez-de-Silanes, Shleifer, and Vishny (1998), however, point out that there are costs to concentrated ownership as well; namely the potential agency conflicts between large shareholders and those minority investors that do exist.

## B. Control vs. Ownership: The Private Benefits of Control

If large shareholders benefit only from proportionate cash dividends and appreciation in the market value of their shares there is no conflict between large shareholders and minority shareholders. The evidence in section II, however, establishes that there can also be private benefits of control. Furthermore, the existence of such benefits leads investors in many countries to seek control rights that exceed their cash flow rights. While concentrated ownership is more often associated with increased value, control rights in excess of cash flow rights tend to be value-reducing.

Dyck and Zingales (2002) measure the private benefits of control using the differences between the premiums for voting and non-voting shares for control transactions in 39 countries. Like previous researchers, they find that private benefits vary greatly around the world and that they are quite significant in some countries. More importantly, they find that the individual voting premiums are negatively related to the degree of investor protection; i.e. in countries where investors are less well protected by law, controlling shareholders can and do extract larger private benefits of control.

The second generation international corporate governance literature puts forth at least two important ways in which controlling shareholders extract value from the firm. The first is termed tunnelling, defined by Johnson, LaPorta, Lopez-de-Silanes, and Shleifer (2000) as transfers of assets and profits out of firms for the benefit of those who control them. They suggest that there are numerous ways in which tunneling can occur, that it happens even in developed economies, and that it is more common in civil law countries than in common law countries.

Tunnelling is common in firms in which excess control rights are achieved by pyramid ownership structures. LaPorta, Lopez-de-Silanes, Shleifer, and Vishny (1999) examine 27 wealthy economies and find that pyramids are the most common method by which controlling shareholders achieve control rights that exceed their cash flow rights. Recall that in a pyramid structure, one entity owns a controlling interest in a chain of firms in such a way that the controlling shareholder of the firm at the top of the pyramid achieves effective control of all of the subsidiaries down the line, while actually owning an ever smaller portion of each firm. The controlling shareholder can extract value from the firms that are farther down the line by transferring resources of those lower-level companies to the firms that are higher in the pyramid. This can be done in a variety of ways; e.g. by selling goods from higher-level firms to lower-level firms at inflated prices, or by selling goods from lower-level firms to higher-level firms at below-market prices.

Control of a firm also allows the controller to install whoever he/she wishes as managers. Burkhart, Panunzi, and Shleifer (2002) develop a model in which they assume that a professional manager is better than an heir. Their model predicts that the equilibrium in legal regimes that protect minority investors will be widely-held firms managed by professional managers, while weak-protection regimes will tend to have family ownership with heir management. Several authors present evidence that controlling shareholders – or their family members - often manage the firms they control. Claessens, Djankow, and Lang (2000) find this to be true for nine East Asian countries, while Lins (2002) documents the same in his sample of firms from 22 emerging market countries. LaPorta, Lopez-de-Silanes, Shleifer, and Vishny (1999) find for 27 wealthy economies that controlling shareholders usually participate in management.

Of course, installing family members as managers is not harmful to minority shareholders if the managers installed are the best possible people to operate the firm. What evidence exists, however, demonstrates that this is not the case. The evidence in a number of US studies indicates that CEOs that are family members are more entrenched and more likely to detract from performance. For example, Johnson, Magee, Nagarajan, and Newman (1985) document a positive stock price response to the sudden deaths of founding chief executives; this result does not hold for non-founder chief executives. Morck, Shleifer, and Vishny (1988) find that among older firms Tobin's Q is lower when firms are managed by members of the founding family than when they are managed by unrelated officers. Volpin (2002) finds that the sensitivity of top management turnover to Tobin's Q in Italy is lowest when controlling shareholders are the managers, when control is fully in the hands of one shareholder, and when controlling shareholders own less than 50% of the cash flow rights.

There is currently conflicting evidence on whether the problems associated with the presence of a controlling shareholder are alleviated by also having a large non-management shareholder. LLSV (1999) indicate that it does not help for their sample of firms from 27 wealthy countries. Lins (2002), however, finds that outside blockholders reduce the valuation discount associated with managerial agency problems for firms from 22 emerging market countries.

Based upon currently existing second generation research, legal structure – in particular the degree to which investors rights are protected – is important to the development of financial markets and to the structure of governance within firms around the world. The evidence discussed in section II suggests that equity ownership structure has a stronger relation to performance and value in many countries than it does in the U.S. The results presented in this section offer a possible interpretation of this. Demsetz and Lehn (1985) hypothesize that ownership is endogenous; i.e. firms will adopt the ownership structure that is most appropriate given the characteristics of the firm. If this is true, the general lack of relation between ownership and performance in the US may not suggest that ownership does not matter – only that different ownership structures are most appropriate for different firms. Under this view, the more significant relation between ownership and performance in some other countries in the world may stem from

their weaker legal systems. In other words, without strong protection of investor rights, firms do not have the luxury of developing optimal firm-specific governance systems. Concentrated ownership is a necessity, despite the fact that it creates its own set of problems. Consistent with this, Lins (2000) finds stronger positive relations between ownership and performance in countries with less legal protection and Durnev and Kim (2002) find that relations between governance quality scores and Tobin's Q are stronger in countries that are less investor friendly.

Do these results suggest that concentrated ownership is suboptimal in an overall sense, that its incidence would be greatly reduced if legal systems the world over provided strong protection of investors? Would corporate governance systems converge in such an environment? Are they converging in the current environment – and, if so, towards what are they converging? We turn to these questions in the following section.

#### **IV. Convergence in Corporate Governance Systems**

For as long as we have had evidence that there are fundamental differences in corporate governance systems across countries, there has been debate about which system is 'best.' Because the earliest non-US evidence was from Germany, Japan, and the UK, the early debate centered around these countries and compared the bank-centered governance systems of Germany and Japan to the market-centered governance systems of the US and the UK. During the 1990s, the system of governance in Japan was compared favorably to that of the US. While the US system was heavily market-based, the Japanese system was more relationship-based. Proponents of the Japanese system characterized it as a superior substitute for the external control market, one in which managers were less subject to short-term pressures from the market. Critics, however, argued that the system entrenched managers, potentially protecting them from the value-increasing discipline of the market.

Shleifer and Vishny (1997) assert that good corporate governance systems are rooted in an appropriate combination of legal protection of investors and some form of concentrated ownership. The US and UK systems rely somewhat more heavily on

stronger legal protection, while the German and Japanese systems are characterized by weaker legal protection but more concentrated equity ownership. Shleifer and Vishny downplay the debate about the corporate governance systems of these particular countries and characterize all four of them as having good corporate governance systems.

As the evidence on corporate governance systems has grown to encompass countries other than the 'big four,' the debate has expanded as well. Shleifer and Vishny (1997) argue that other countries of the world lack the necessary legal protection to develop good corporate governance systems. In other words, while there is some room for variation in legal protection, there is a reservation level of legal protection that is required if an economy is to have an effective corporate governance system – and this reservation level is not met in many of the world's economies. Rajan and Zingales (2000) hypothesize that, while a relationship-based system of corporate governance can overcome some of the problems associated with the lack of investor protection, the long-run ability of firms to raise capital and allocate it efficiently will be better served by a market-based system. They emphasize that a market-based system can only be effective with transparency and strong legal protection of investors.

It is likely that an evolution towards stronger legal protection for investors in many countries would lead to improved corporate governance systems and greater economic development. What is less clear is the likelihood of such an evolution occurring. The equilibrium response to lack of investor protection around the world has been concentrated equity ownership, often accompanied by control rights that exceed cash flow rights. LaPorta, Lopez-de-Silanes, Shleifer, and Vishny (1999) and Bebchuk and Roe (1999) both conjecture that the controlling shareholders of the world will fight to protect their private benefits of control. Attempts to improve laws protecting minority shareholders clearly threaten those private benefits of control. To the extent that controlling shareholders are influential people within economies, convergence to legal systems that are more protective of minority investor rights will be difficult. Stronger laws will expropriate value from controlling shareholders; thus, controlling shareholders will demand to be compensated for their losses.

LaPorta, Lopez-de-Silanes, Shleifer, and Vishny (2000) distinguish between legal and functional convergence. Functional convergence occurs when individual investors

and/or firms adapt in ways that create stronger governance, despite a lack of appropriate legal structure. Because the large number of changes in laws that are needed to bring about legal convergence are likely to be politically difficult, LLSV put more store in functional convergence. For example, investors can opt to invest their money in firms that are in more investor-friendly regimes. Firms in less protective regimes can bond themselves to practice better corporate governance by listing on exchanges in more protective regimes or by being acquired by firms in more protective regimes. Reese and Weisbach (2001) present evidence indicating that foreign firms that list in the US do so to protect shareholder rights. Doidge, Karolyi, and Stulz (2001) examine firms at year-end 1997 and find that foreign companies listed in the US have greater Tobin's Q ratios than do firms from the same countries that are not listed in the US. They hypothesize that the firms that list in the US are better able to take advantage of growth opportunities and that their controlling shareholders cannot extract as many private benefits of control.

Hansmann and Kraakman (2000) argue that there is a strong likelihood of convergence towards a single governance model. They assert that the basic corporate form has already achieved a great deal of uniformity; i.e. that economies are approaching a world-wide consensus that managers should act in the interests of shareholders and that this should include all shareholders, whether controlling or non-controlling. They believe that there are three principal factors driving economies towards consensus: the failure of alternative models (e.g. manager-oriented, labor-oriented, and state-oriented models of corporate law), the competitive pressures of global commerce, and the shift of interest group influence in favor of an emerging shareholder class. They acknowledge that convergence in corporate law proceeds more slowly than convergence in governance practices; however they expect that the pressure for convergence in law will be strong and ultimately successful.

What about convergence in corporate governance mechanisms other than the legal system? There is evidence of convergence in a number of areas. Shleifer and Vishny (1997) and Hansmann and Kraakman (2000) both report that governance systems in Germany, Japan, and the US show signs of convergence towards each other. Large shareholders are on the increase in US firms, while board structure in Germany and Japan are moving more toward the US model of a single-tier board that is relatively small and

has both insiders and a meaningful number of outsiders. Wojcik (2001) examines changes in ownership structure in German firms over the period from 1997 through 2001. He finds that the level of ownership concentration fell significantly over this period, that cross-holdings started to dissolve, and that financial sector institutions declined in importance as blockholders. He concludes that German firms are, on average, moving towards the Anglo-Saxon system.

Codes of Best Practice around the world are consistent with convergence towards an Anglo-Saxon governance structure. As discussed earlier, Dahya, McConnell, and Travlos (2002) and Dahya and McConnell (2002) report evidence of significant changes in board structure in the UK following code adoption there. However, evidence from some other countries is less favorable. Bianchi and Enriques (1999) claim that the Italian environment is still not favorable for institutional activism, despite government attempts to increase protection of minority shareholders. DeJong, DeJong, Mertens, and Wasley (2001) study firms in the Netherlands following a private sector initiative to promote change in the balance of power between management and investors. They find no substantive effect on corporate governance characteristics or on the relations of these characteristics with value.

Liu (2001) reports that securities laws in Taiwan and China are increasingly influenced by the American common law model. In China such laws are meant to reduce asset stripping by directors and managers of state-owned companies, while in Taiwan it is minority expropriation by founders of family-controlled listed companies that the government wishes to curb.

In a more comprehensive study, Khanna, Kogan, and Palepu (2002) analyze 37 countries to determine whether globalization is leading firms to adopt a common set of the most efficient governance practices. They find *de jure* convergence – i.e. convergence in law - at the country level. Rather than converging towards any single system, however, they find convergence between various pairs of economically interdependent countries. They find no evidence of *de facto* convergence – i.e. convergence in practice. They conclude that while globalization has induced adoption of some common corporate governance recommendations, these recommendations do not yet appear to be being implemented.

Time will tell what the bottom line on the convergence of corporate governance systems around the world will be. Presumably market forces will affect the extent to which convergence occurs; however market forces are not allowed to operate unimpeded throughout the world. Convergence towards stronger legal protection of investors is likely to result in increased investment and growth; however, it is not clear whether or how quickly such convergence will occur. Convergence in other aspects of corporate governance – such as board composition and ownership structure – are evident in some places. Broad convergence may be hampered by the fact that there is not yet agreement on the factors that determine the optimal structures for individual firms.

## **V. Privatizations**

[To be completed.]

## **VI. Conclusion and Directions for Future Research**

The literature on international corporate governance tells us much about corporate governance but the message in the information is far from clear or complete. Much more work remains to be done. Our understanding of the relationship between systems of governance and the value of economies and the firms within them is of increasing importance as emerging markets around the world look to the developed markets to decide how to set up their own economic and corporate governance systems.

In this paper we review existing international corporate governance research. The first generation of this research is broadly patterned after the large body of evidence on governance mechanisms in US firms. These first generation studies examine governance mechanisms that have been studied in the US – particularly board composition and ownership structure – for one or more non-US countries.

The first generation of international corporate governance research examines individual countries in depth and establishes that there are important differences in governance systems across economies. Early international research focused primarily on Germany, Japan, and the UK. Even across these very developed economies, significant differences in ownership and board structure were observed. As international research expanded into other countries, the differences in corporate governance systems mounted. Of particular note are the very distinct differences in ownership structure across countries. The typical large US corporation, with its diffuse equity ownership structure and its professional manager, appears to be typical only of the US and the UK. Ownership concentration in virtually every other country in the world is higher than it is in these two countries. In many countries, majority ownership by a single shareholder is common.

It is also common in many countries that major shareholders' control rights exceed their cash flow rights. The realities of ownership and control are such that the primary agency conflict in the US – that between professional managers and their widely dispersed shareholders – is relatively unimportant in many other countries. In its place, however, there is a different agency conflict, that between controlling shareholders and minority shareholders. Evidence suggests that the private benefits of control of companies can be significant and that they are value-reducing.

The typical first-generation international corporate governance study examines one particular country. Taken together, these studies reveal differences in governance systems across countries. Such a fragmented approach, however, does not yield much understanding of why we observe the differences we do. To be able to explain these differences, examination of many countries in a unified framework is required. This task is taken up in the second generation of international corporate governance research.

An important insight generated from the second generation research is that a country's legal system – in particular, the extent to which it protects investor rights – has a fundamental effect on the structure of markets in that country, on the governance structures that are adopted by companies in that country, and on the effectiveness of those governance systems. This insight, along with newly-developed measures of the strength

of countries' legal protection of investors, will continue to generate a rich body of comparative corporate governance studies.

Strong legal protection for shareholders appears to be a necessary condition for diffuse equity investment. The relatively diverse ownership of US firms can be attributed, at least in part to the relatively strong legal protection available to potential investors in the US. The general lack of a relationship between ownership structure and firm value could simply mean that the strong legal protection in the US allows US firms to pick and choose among a menu of potential governance mechanisms to achieve optimal structures. In countries with weak protection, however, it appears that only ownership concentration can overcome the lack of protection.

While there is a large body of evidence on individual corporate governance mechanisms in the US, there is much less published evidence addressing the interrelationships among them and the factors that determine the optimal governance structure for a particular firm. In addition, the recent evidence on the importance of legal structure poses new questions even for the US. LaPorta, Lopez-de-Silanes, Shleifer, and Vishny (1998) argue that, while protection of shareholder rights in the US is the strongest in the world, such protection is not particularly strong anywhere. Would greater protection in the US improve corporate governance, and with it firm values? Clearly there are limits to the value of protection. For example, a system in which shareholders have the right to approve or disapprove every decision made by managers would be neither practical nor valuable. But what are these limits? Does the US have an optimal level of shareholder protection, or is there room for improvement?

Governance structures around the world are evolving, as governments, private parties, and markets seek to strengthen their economies and firms. Such evolution will provide opportunities for rich new data. For many countries in the world, there is relatively little empirical evidence on governance mechanisms other than legal protection and ownership structure. Such issues as board structure, compensation, and changes in control have been extensively studied in the US but have been studied much less – if at all – for many other world economies. This may reflect the dominant role of ownership structure in these economies, a dominance that appears to be driven by weaknesses in legal systems. Evolutions in legal structure provide for natural corporate governance

experiments. What aspects of legal systems evolve? What are the effects of such changes on the role of other firm-specific governance mechanisms? What, ultimately, are the effects of such changes on the strength of economies and on the actions and value of companies within them? Answers to these questions will increase our understanding of the role of corporate governance throughout the world.

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