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Antoine Reberieux

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Maître de conférences
EconomiX, Université Paris X - Nanterre
Maison Max Weber, bât. K
200 avenue de la République
92 000 Nanterre, France
Email: antoine.reberieux@u-paris10.fr

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Shareholder primacy is increasingly considered as the most effective way to foster managerial (corporate) accountability. Contrary to this now standard argument, we consider that shareholder primacy, rather than gatekeeper failure, is directly responsible for the multiplication of accounting irregularities and the dramatic increase in executive compensations. To defend this thesis, we propose a new reading of Berle and Means (1932), Galbraith (1973) and Alchian and Demsetz (1972), stressing the logical failure of a control of the business firm provided for by stock markets: the implementation of shareholder primacy implies a partial disconnection between access to internal knowledge and empowerment. In turn, this disconnection favours deceptive behaviours on the part of corporate insiders. Empirical evidence mostly based on Enron-era financial scandals illustrates our argument.

Keywords: shareholder primacy; managerial accountability; theory of the firm

JEL classification: D23, G30, L20

Antoine Rebérioux
Maître de conférences
EconomiX, Université Paris X - Nanterre
Maison Max Weber, bât. K
200 avenue de la République
92 000 Nanterre, France

SHAREHOLDER PRIMACY AND MANAGERIAL ACCOUNTABILITY

Antoine Reberioux¹

I. INTRODUCTION

By the end of the year 2000, the doctrine of shareholder primacy seemed to be unchallengeable. It was winning ground in business circles, while most economic and legal scholars depicted it as an efficient corporate governance mode. Besides, the jurisdiction the most receptive to this model, the U.S.A., exhibited exceptional economic performances, at the peak of the so-called 'New Economy'. In continental Europe, the growing activity of financial markets together with the rise to power of foreign institutional investors were not favourable to the traditional model of the corporation, where shareholders' interest is only one among others. As Hansmann and Kraakman (2001) provocatively stated: 'Since the dominant corporate ideology of shareholder primacy is unlikely to be undone, its success represents the 'end of history' for corporate law' (p.89).

This doctrine is traditionally grounded in two different ways. From a legal point of view, it is possible to consider that stockholders are the owners of the corporation. In this case, shareholder primacy fully protects private ownership, the cornerstone of a free market economy. From an economic point of view, one may argue that shareholders, as residual claimants, are the only risk-bearers in the firm; therefore, they need to be in control (see e.g. Easterbrook and Fischel, 1993). Yet it is now

¹ University Paris X – Nanterre, EconomiX, 200 avenue de la République, 92001 Nanterre cedex, France ; 0033(1).40.97.71.83 ; antoine.reberioux@u-paris10.fr

widely recognized that none of these claims is convincing (Stout, 2002). Most corporate lawyers admit that shareholders in widely-held companies own their shares, which grants them numerous rights (for example, the right to vote in general assemblies on proposals included in the proxy statement). But they do not own the company, as a legal entity, nor the firm as an economic (productive) entity. Concerning the economic argument, Williamson (1985), Blair (1995) or Zingales (1998) convincingly stated that, when contracts are incomplete, non-shareholder constituencies—and in particular workers investing in specific human capital—do bear risk.

However, the proponents of shareholder primacy are increasingly putting forward a new justification: shareholder primacy is analysed as the most effective way to foster managerial (corporate) accountability. The main reason is that it assigns a clear objective to managers (the maximisation of the market price of shares), together with numerous disciplinary and incentive mechanisms. By contrast, a stakeholder approach would dilute managerial accountability and lead to a (sub-optimal) 'politicization' of the board of directors (see e.g. Bainbridge, 1993, Hansmann, 1996 and Tirole, 2001).

In that case, it is striking that the unprecedented series of accounting irregularities by leaders of U.S. and (to a lesser extent) European stock markets, following the Enron disaster in December 2001, did not result in a reconsideration of this argument. The standard thesis explaining this major confidence crisis in financial markets stresses the failure of the supervisory actors, both external (mainly the auditors and the securities analysts) and internal (the board of directors). This failure, in turn, is explained by the conflicts of interest in these professions, and so by an incentive argument. The present article challenges this thesis, by considering that the generalisation of shareholder primacy as a corporate governance mode is the main driving force behind the crisis. As a consequence, the accountability argument is reversed: shareholder primacy *weakens*, rather than strengthens, managerial accountability. The intuition behind this point is the

following: the implementation of shareholder primacy implies a partial disconnection between access to internal knowledge and empowerment. In turn, this disconnection favours erratic, deceptive behaviours on the part of corporate insiders. This ‘cognitive argument’ therefore completes the ‘incentive argument’ in explaining the financial crisis of the Enron-era.

The article is organized as follows. In section II, the core of the shareholder primacy doctrine is portrayed and the standard interpretation of the crisis is critically assessed. Section III offers a new reading of major authors—namely Berle and Means (1932), Galbraith (1973) and Alchian and Demsetz (1972)—who laid the theoretical foundations of our cognitive argument. Section IV provides empirical evidence in favour of this argument, stressing the limits of the supervision by financial market gatekeepers during the massive financial scandals of the Enron-era. These limits explain the *opportunity* for managers to extract quasi-rent under shareholder primacy. Section V then makes clear how deviant behaviours become *effective*, given the flawed incentives provided for by ‘Value Based Management’—the use of management tools to measure the creation of shareholder value. Section VI concludes.

II. SHAREHOLDER PRIMACY: FROM THEORY TO PRACTICE

A. THE BASIC FOUNDATIONS OF SHAREHOLDER PRIMACY

According to the proponents of shareholder primacy, corporate governance deals primarily, if not exclusively, with the relations between shareholders and managers, and these relations are conceived in a strictly hierarchical fashion. The emergence and expansion, since the 1960s, of the ‘contractarian’ approach to the firm, in economics as well as in legal (corporate law) studies (Cheffins, 2004), gave a formal shape to this idea. Prior to the 1970s, most economic scholars tended to consider the firm as a ‘black box’, a simple channel between different markets (labour,

capital and product markets). Pioneered by Coase (1937), the contractarian approach defends, on the contrary, the idea that market mechanisms (i.e. voluntary agreements between rational agents) are an essential part of intra-firm coordination. Describing the firm as 'a nexus of contracts', the contractarian approach emphasises the incentive (rather than cognitive) aspect of the coordination.² In this framework, managers are considered as the 'agents' of the shareholders, who are the 'principals'. More precisely, the concept of 'agency relationship' was introduced in corporate governance debates by the Positive Agency Theory (Jensen and Meckling, 1976; Fama, 1980; Fama and Jensen, 1983). Borrowed from legal analysis, 'the agency relation differs from other fiduciary relations in that it is the duty of the agent to respond to the desires of the principal' (Reuschlein and Gregory, 1979, p. 11). Qualifying the relationship between shareholders and managers as an agency relationship then entails the belief that it is the 'duty' of the latter 'to respond to the desires' of the former, in other words, that the managerial team has been 'hired' by the shareholders to best serve their interests.

Yet this doctrine has to cope with one essential characteristic of stock markets, at least in the U.S. (or in the U.K.): their liquidity. This liquidity induces a dispersion of stock ownership. In turn, direct monitoring by shareholders is impeded by the problem of collective action: for each shareholder possessing an insignificant fraction of the capital, the effort necessary to monitor managers is much greater than the expected gain, thus giving rise to free-riding. As Berle and Means (1932) long ago recognised, the managerial team enjoys great freedom and *de facto* power: '[the shareholder] power to participate in management has, in large measure, been lost to him, and has become vested in the 'control'' (p. 245).

² For a discussion on this point, see Langlois and Foss (1999).

Herein resides a tension, which constitutes the matrix of the shareholder primacy doctrine: stockholders are considered as the legitimate possessors of power within the firm, but this power is supposed to be wrested from them by the corporate executives, leading to 'agency costs'. In other words, shareholder primacy is rooted in a philosophy of *dispossession*. This situation has led to an exclusive focus on the question of control: how can the lost power be recovered? The answer is by encouraging managers (with their potential for misbehaviour) to act in the interests of the shareholders and by establishing safety mechanisms capable of detecting and curbing managerial misconduct.

The economic translation of this agency perspective is the following: the objective of the managers is reduced to maximising the utility of the pool of shareholders. Nevertheless, the hypothesis of opportunism, at the heart of the contractarian approach, requires analysts to acknowledge that managers will do everything in their power to divert value. Shareholders must therefore ensure that incentive contracts are signed, in order to reduce conflicts of interest to the lowest possible level. Let us denote V as the utility function of the group of shareholders, U the utility function of the manager, \bar{U} the manager's reserve utility, w his/her salary, and $e(w) = \{e^+; e^-\}$ his/her effort ($e^+ > e^-$), then the firm's programme can be written as follows:

$$\begin{aligned} & \underset{w}{\text{Max}} V(w) \\ & \text{subject to } U(w; e^+) \geq \bar{U} \quad \textit{participation constraint} \\ & \quad \quad \quad U(w; e^+) \geq U(w; e^-) \quad \textit{incentive constraint} \end{aligned}$$

In this model, the firm behaves in an optimal (second best) way when it maximizes the well-being of the shareholders. To simplify, the stock market price is often used to represent V , as it incorporates *expected* gains in capital and future distributions in dividends. Because share prices are primarily perceptions of value, managers accountable to shareholders should therefore first and foremost influence those perceptions.

In this framework, all the mechanisms which favour the alignment of managers' interests with those of the shareholders will improve the efficiency of the firm. Corporate executive behaviour should, as far as possible, be dependent on stock prices, that is to say on the selling and buying decisions of investors. Two mechanisms play a decisive role: hostile takeovers (Manne, 1965) and share option schemes. In both cases, depreciating share prices have damaging consequences for executives (either in terms of their careers or in terms of compensation). Yet these mechanisms are effective if and only if investors are properly informed about the quality of the management. A set of actors might help to reduce informational asymmetries between the investors and the insiders (the executives). Ultimately, the accuracy of the now standard defence of shareholder primacy—as a corporate accountability enhancing mechanism—crucially depends on the functioning of these actors. These latter may be distinguished according to their position *vis-à-vis* the business firm. The board of directors constitutes the main *internal* supervisory device. Following Fama and Jensen (1983), the board is depicted as an institution whose function is to reduce agency costs by monitoring and ratifying the actions of the managerial team on behalf of the shareholders.³ Thus, exclusive control of the board of directors by the stockholders constitutes an efficient arrangement. This conception emphasises the 'control' role of the board at the expense of its 'strategic' role, as an organ supporting executives in their choices (Roberts, McNulty and Stiles, 2005). This has a direct consequence: non-executive directors' independence from the management is recognised as a cardinal value, preventing conflicts of interest. *Outside* the firm, (external) auditors, securities analysts and ratings agencies (the so-called 'gatekeepers') are held responsible for verifying the honesty and relevance of financial statements as well as for using the information to give the best advice possible to investors.

³ See also Williamson (1984).

For the last twenty years, shareholder primacy has deeply influenced the evolution of corporate governance regulations and practices in the United States and, to a lesser extent, in the European Union. The rights of (minority) stockholders have got stronger everywhere, primarily through federal law in the U.S. and trans-national law in the E.U. (Cioffi and Cohen, 2000). In addition, the activism of institutional investors (mainly pension funds) has promoted best practices closely akin to shareholder primacy. The growing success of a shareholder value-oriented approach to managing a business can be observed on at least three levels. First, the presence of independent non-executive directors, mostly in the *ad hoc* committees (audit, nomination and remuneration), is now the rule rather than the exception: according to Finkelstein and Mooney (2003), outside directors accounted for 75 % of directors in 2003 on the average board of firms in the Standard and Poor's (S&P) 500. Second, stock options are increasingly used as a remuneration device for senior managers: while they accounted for less than 25% of the average S&P500 Chief Executive Officer (CEO) pay package at the beginning of the 1990s, this part has stabilized to around 50% since 1999 (Jensen and Murphy, 2004). Last but not least, 'Value-Based Management' is now a common practice for listed companies (Cooper, Crowther, Davies and Davis, 2000; Hossfeld and Klee, 2003). To conclude, for most of the commentators, at least before December 2001, 'managerial capitalism', as described by Williamson (1964) or Galbraith (1967), was over.

B. THE GATEKEEPERS' FAILURE THESIS

On 2 December 2001, Enron was placed under bankruptcy protection according to Chapter 11 of the Bankruptcy Code. With \$63 billion in assets, this has been the largest bankruptcy in U.S. history. The various investigations will show that accounting

irregularities were systematic:⁴ heavy recourse to off-balance-sheet accounting and creative accounting on the income statement contributed to the misuse of value for the benefit of a few executives. Astonishing as it sounds, this was not an isolated case. In the months that followed Enron's collapse, massive scandals of listed companies in the U.S. succeeded each other. The telecommunications sector was hit especially hard by the bankruptcies of Qwest, Global Crossing and WorldCom. WorldCom's June 2002 bankruptcy even surpassed Enron's in scale (\$104 billion in assets, \$41 billion in liabilities). But all sectors were involved. According to a report published by the General Accounting Office in October 2002, between January 1997 and June 2002, nearly 10% of listed companies in the U.S. restated their earnings at least once due to accounting irregularities. Moreover, a study conducted by the Huron group demonstrates that earnings restatements following financial irregularities are on the upswing:⁵ they reached a peak in 2004, with a total number of 414. Ultimately, the 1990s and the first half of the 2000s witnessed a dramatic increase in financial irregularities.

Recent decades have also witnessed a huge rise in executive compensation. According to Holmström and Kaplan (2003), overall CEO compensation increased by a factor of six during the 1980s and the 1990s. Most of this increase took the form of incentive pay—primarily stock options. This process has resulted in a deepening of intra-firm inequalities, of which the *Business Week* executive pay survey, regularly carried out, gives an idea: in 1980, the average income of CEOs of the largest firms in the U.S. was 40 times the average salary of a worker. In 1990, it was 85 times higher, and in 2003, it jumped to 400 times higher. From a strict economic standpoint, such an increase raises serious concerns: it is hard to explain on the basis of incentive factors alone, despite

⁴ The Powers Report (2002) remains the authoritative reference. See also Bratton (2002).

⁵ Cited by Coffee (2005).

the effort made by some authors (see in particular Jensen and Murphy, 2004). Rather, a process of rent extraction by corporate managers seems to be at work here (Bebchuk and Fried, 2004; Bratton, 2005). As such, this process can be considered alongside the wave of financial scandals and accounting irregularities. Both are the most visible marks of a structural phenomenon: a decline in corporate management accountability.

The standard explanation of this phenomenon (at least of corporate scandals) points to the responsibility of the 'gatekeepers'. Coffee (2002) provides the most convincing outline of this thesis. The (external) auditors, who verify and certify companies' accounts, and the financial analysts, who compile information in order to make buy-and-sell recommendations on securities, are those whose responsibility has been the most emphasised. This failure of auditors and analysts is explained, for a large part, by the conflicts of interest in these professions. For the auditors, the conflicts arose over the course of the 1990s as audit firms began to provide consulting services to their clients (other than auditing). Conflicts of interest are also presented as the mainspring of analysts' misconduct: securities analysts most often work for investment banks offering advisory services to the corporations they analyse.

Besides the gatekeepers' dysfunctions, Enron-era scandals also revealed the weaknesses of the board of directors, as some commentators judiciously noted (see for example Gordon 2002). In the Enron case, independence did not prevent misbehaviour: at the end of 2001, Enron's board included 12 'independent' directors out of a total of 14.

The Sarbanes-Oxley Act (SOA), promulgated in July 2002, was the explicit response to the loss of confidence in U.S. security markets. This text addresses two main issues. First, the SOA tightens the regulation of gatekeepers in order to limit conflicts of

interest. In particular, audit firms are forbidden from providing certain services to the companies they audit.⁶ Second, the SOA reaffirms the disciplinary role of the board of directors. The most significant rule concerns the audit committee. The Securities Exchange Commission is authorized to strike a company off the exchange if its audit committee is not *entirely* composed of independent members.⁷

Despite increasingly virulent criticism, the subject of stock options is not even broached. In short, the SOA can be summed up as follows: shareholder primacy is good, but its monitoring system failed, mostly for incentive reasons. As a consequence, control mechanisms accountable to the shareholders must be strengthened. Yet this account might appear somewhat paradoxical. Indeed, it is incongruous that the governance model in the U.S.A., focused entirely on stacking up mechanisms of control for the last twenty years, failed so spectacularly in controlling corporate actors. This paradox might be expressed in more general terms: never have managers been as powerful, or at least as well-remunerated, as they have been since the alleged return in force of the shareholders.

III. THE COGNITIVE ARGUMENT: SOME THEORY

In this section, we offer a solution to the previous paradox by casting doubt on the effectiveness of shareholder primacy as an accountability-enhancing mechanism. To do so, we choose to rely

⁶ Despite their ineffectiveness as gatekeepers from 1997 to 2001, securities analysts are the objects of fairly inconsequential clauses aimed principally at preventing conflicts of interest.

⁷ Even if the text does not specifically anticipate the obligation to put an audit committee into place, it does specify that in the absence of such a committee, all clauses dealing with this committee (notably the independence of its members) must be applied to the board of directors as a whole. The constrictive character of this clause leads one to conclude that the majority of listed companies will create an audit committee.

on three major theoretical contributions that join to stress the intrinsic limits of an external control on the business company, mostly for cognitive reasons. It is our argument that this idea may be found in the institutional perspectives of Berle and Means (1932) and Galbraith (1973) on one side and Alchian and Demsetz (1972) on the other side—beyond their yawning analytical divergences.

*A. BERLE AND MEANS (1932) AND GALBRAITH (1973):
CORPORATE POWER AND KNOWLEDGE*

Few books have caused as much stir as *The Modern Corporation and Private Property*, written in 1932 by Berle and Means. These authors examined the way in which the rise to power of the stock company had affected private property, the main driving force of U.S. economic dynamics in the nineteenth century. From a survey of the 200 largest, non-financial corporations in the U.S. (presented in Book I), the two authors noted the following empirical fact: 44% of firms were under managerial control. The ‘liberal conception of ownership’ (Honoré, 1961)—where the owner is both the beneficiary of the wealth created by the object owned and the sole person capable of transforming its substance—no longer applied to the real situation of shareholders. According to Berle and Means, shareholders of public corporations were just owners of an equity stake in a company. This ownership gave them certain rights, but it was no longer sufficient to provide shareholders with control of the company. In practical terms, therefore, the shareholders were no longer owners of firms.

Book II was devoted to an analysis of the jurisprudence of the time. This analysis demonstrated that U.S. jurisprudence did not apprehend the full measure of the transformations presented in Book I. Thus, the U.S. judicial system continued to cling to the liberal, classical concept of ownership. The legal order therefore reaffirmed shareholder primacy. This revealed a certain lag in the legal order in relation to the social and economic reality, as well as underscoring the failure of the legal order to discipline corporate managers. Indeed, detailed analysis of the jurisprudence showed

that the stacking of legal measures, with the aim of ensuring shareholder control despite the dispersion of equity capital, was totally insufficient for restoring shareholder power:

As the power of the corporate management has increased, and as the control of the individual has sunk into the background, the tendency of the law has been to stiffen its assertion of the rights of security holder. The thing that it has not been able to stiffen has been its regulation of the conduct of the business by the corporate management. And this omission has resulted, not from lack of logical justification, but from lack of ability to handle the problems involved. The management of an enterprise is, by nature, a task which courts can not assume; and the various devices by which management and control have absorbed a portion of the profit-stream have been so intimately related to the business conduct of an enterprise, that the courts seem to have felt not only reluctant to interfere, but positively afraid to do so (Berle and Means, 1932, p. 296).

This quotation clarifies the reasons behind the legal system's incapacity effectively to control the misappropriation of corporate wealth by managers: these misappropriations proceed, for the most part, from the very process of management itself. It is, for example, by choosing to take over a given firm or to invest in a given market that the executives increase their wealth and power at the expense of shareholders. Managers can always justify their choices by invoking industrial strategy, a justification that is practically impossible for the law to contest. And the reason is simple: courts are *exterior* to the firm as much as the shareholders concerned with preserving the liquidity of their shares. Ultimately, cases of pure embezzlement, objectively perceptible by the law (insider trading, for example, or misuse of corporate property), are relatively rare. This fact is at the root of the so-called 'business judgement rule', according to which U.S. courts give managers broad discretion.

This analysis of the courts' structural inability to discipline managers did not attract much attention from subsequent

commentators, as compared to the free riding problem stemming from the dispersion of ownership. And yet it has profound insights for current debates on corporate governance. Not only did Berle and Means (1932) emphasise the difficulty for 'liquid' shareholders to control corporate executives; they also underlined the intrinsic limits of purely *external* control. Courts have the (legal) power to discipline corporate executives, but they lack reliable information to do so in a rational, effective manner. Because they are remote from day-to-day business conduct, courts lack the knowledge of business conduct, of the firm as a productive entity, necessary to monitor managerial behaviour. *In fine*, Berle and Means (1932) shed light on the cognitive limitations of courts as a corporate management control mechanism.

This insight has been further developed by Galbraith (1973),⁸ who forcefully argues that the power of corporate insiders derives from, and is justified by, the informational advantage that they enjoy over liquid shareholders. Even to the limited extent that any shareholder or financial institution were sufficiently disposed to intervene from time to time in the operational affairs of the companies, any action that they took or demands that they made in this regard would be inherently irrational, given the inability of these 'outsiders' to acquire sufficient information or expertise to be able accurately to pass judgement on the merits of managers' strategic decisions. According to Galbraith (1973), not only were shareholders physically detached from the day-to-day affairs of the business, but they were also excluded from the corporate 'technostructure'. The technostructure is defined as the collective body of corporate officers who, by virtue of the supremacy that they enjoyed over the base of scientific and technical skills, knowledge and expertise upon which the company's operations were dependent, enjoyed the exclusive capacity to command strategic control over all business affairs. In other words, Galbraith believed that, in the modern corporate economy, where operations

⁸ I would like to thank Marc Moore for this reference.

were increasingly technical and specialised in nature, the 'real' power within the large company rested with those that possessed the relevant *knowledge*, rather than the wealth, that comprised the business, thereby excluding shareholders from the realm of effective corporate control.

B. ALCHIAN AND DEMSETZ (1972): TEAM PRODUCTION AND LIQUID SHAREHOLDERS

The parallel between Berle and Means and Galbraith is hardly a surprise, given the intellectual proximity between them. However, it is probably more unusual to bring together Alchian and Demsetz (1972) with the authors of *The Modern Corporation*. Indeed Alchian and Demsetz laid down the basic foundations of the contractarian approach, which was later to constitute the main critic of the stakeholder approach to corporate governance, often associated with Berle and Means. However, and somewhat paradoxically, Alchian and Demsetz's argument is at odds with the principle of shareholder primacy. The originality of their contribution, inside the contractarian approach, is related to their specific focus on the productive dimension of intra-firm coordination.

More precisely, Alchian and Demsetz (1972) argue that much of the productive process involves 'team production': by definition, team production occurs whenever overall output (y) is greater than the sum of individual contributions or investments (e_i , $i=1, \dots, n$), due to the complementarities of human assets. The production function is then nonseparable:

$$y = y(e_1, \dots, e_n), \text{ with } \frac{\partial^2 y}{\partial e_i \partial e_j} > 0, j \neq i$$

Team production has two major implications. On the one hand, it implies that the individuals involved in the team produce "organizational" rent, as a result of a specific combination of assets (here, mainly human assets). On the other hand, it is hard to attribute any particular portion of the gains to any particular

member's contribution. Yet in a standard, neo-classical framework, allocative efficiency recommends that individual retribution should equal individual marginal productivity: otherwise, free riding occurs. The crux of the problem is then the following: how can one profit from the synergy gains made possible by team production when individual contributions cannot easily be inferred from the output? Alchian and Demsetz (1972) add a crucial assumption: individual productivity may be inferred not from the observation of output (that is from outside), but from the observation of individual behaviour (that is from inside). And this inference is made easier for an individual who has, prior to the production process, assigned and dictated jobs.

In these conditions, the solution put forward by Alchian and Demsetz is to select a supervision (monitoring) specialist at the head of the team. The specialist's role is to oversee how the individuals perform (right 1) in order to come to a precise evaluation of their marginal productivity and thus to adapt their remuneration accordingly. To ease this supervision function, the right to assign and dictate jobs to the other members of the team is given to the monitor (right 2). If this latter performs his or her task well, each of the members will be rewarded for their marginal productivity and an efficient allocation attained. The appropriate incentive measure in this case is to make the monitor the residual beneficiary of the team (right 3). Beyond the right to supervise (1), to assign tasks and to organise production (2), and to obtain the residual gains (3), Alchian and Demsetz grant the specialist the right to resell the preceding rights (right 4). Finally, Alchian and Demsetz stress the exact correspondence between their central agent and the owner of the capitalist firm as the latter is traditionally defined. And this is precisely how they demonstrate the efficiency of the capitalist firm, born from the desire to profit from the synergy gains of team production, all the while avoiding the incentive problems raised by this type of activity.

Yet we would argue that the very structure of their model is in contradiction to the principle of shareholder primacy. To see this, one should note that authority (i.e. the right to assign tasks and to

organise production) and residual claim are allocated to the central agent *because he is the supervisor*. It is because he is in charge of supervising (right 1) that he is granted the power to decide who should do what (right 2) and the residual income (right 3). This is exactly the opposite of the traditional economic argument (see *supra*), where the ultimate authority is given to the stakeholders who bear the risk (namely the stockholders). In Alchian and Demsetz, risk-bearing is backed onto control and supervision. The crucial point is that the supervising function cannot be exercised, by definition, outside the team (the firm). Being part of the team (an insider) induces a specific knowledge about the origin of profit (organizational rent), and this knowledge lies at the very foundation of authority and power. Any attempt to empower liquid shareholders therefore comes up against this cognitive issue: authority should, by definition, be located inside the firm as a productive entity.

In sum, focusing on team production leads to reservations—to say the least—about shareholder primacy, an original standpoint within the contractarian paradigm.⁹ The following quotation, where Alchian and Demsetz tend to minimise the role of shareholders, should not come as a surprise:

Instead of thinking of shareholders as joint owners, we can think of them as investors, like bondholders, except that the stockholders are more optimistic than bondholders about the enterprise prospects. [...] The residual claim on earnings enjoyed by shareholders does not serve the function of enhancing their efficiency as monitors in the general situation. The stockholders are ‘merely’ the less risk-averse or the more optimistic members of the group that finances the firm. [...] [So] why should stockholders be regarded as ‘owners’ in any

⁹ But note that Blair and Stout (1999) or Kaufman and Englander (2005) develop a similar argument.

sense distinct from the other financial investors? The entrepreneur-organizer, who let us assume is the chief operating officer and sole repository of control of the corporation, does not find his authority residing in common stockholders (except in the case of a take over). [...] In sum, is it the case that the stockholder [...] relationship is one emanating from the division of ownership among several people, or is it that the collection of investment funds from people of varying anticipations is the underlying factor? If the latter, why should any of them be thought of as the owners in whom voting rights, whatever they may signify or however exercisable, should reside in order to enhance efficiency? (Alchian and Demsetz, 1972, p. 789)

In this section, we have sought to show that Berle and Means (1932), Galbraith (1973) and Alchian and Demsetz (1972) share a common argument, despite their obvious methodological and theoretical divergences: they all stress the specificity of the productive activity—the source of corporate profit as an organizational quasi-rent—and the intrinsic limitations on the evaluation of this activity by outsiders. In this context, shareholder primacy attempts to empower those stakeholders whose firm-specific knowledge is the least developed. As such, the implementation of shareholder primacy implies a partial disconnection between access to internal knowledge and empowerment. This disconnection raises serious concern: those vested with ultimate control rights and whose interests are supposed to be served (shareholders) are intrinsically limited in their ability to assess corporate activity. Control of managerial accountability is fully exteriorized, increasing the opportunity for fraudulent behaviour. The next section provides empirical evidence to support this argument, taken from the massive post-bubble corporate financial scandals: in particular, we illustrate the limits of the monitoring devices upon which a shareholder-oriented model relies.

IV. THE COGNITIVE ARGUMENT: SOME EVIDENCE

In this section, we successively consider the case of the two sets of supervisory actors who are, in a shareholder-oriented model of corporate governance, in charge of reducing informational asymmetries between insiders and shareholders: directors and external gatekeepers.

A. *THE CASE OF THE BOARD OF DIRECTORS*

According to institutional investors as well as proponents of shareholder primacy, the *raison d'être* of this internal organ is to control the managerial team on behalf of distant stockholders. Following this line, independence—as a way to prevent collusion between the controllers (board members) and the controlled (managers)—came to be a cornerstone of corporate governance reforms. The difficulty is that it is hard to give a precise content to the concept of independence. Yet institutional investors need clear signs, visible from a distance. Among these signs, the absence of relationships with management is favoured. But as Roberts, McNulty and Stiles (2005) note, such an approach to independence tends to limit the involvement and commitment of non-executive directors in corporate affairs. In turn, this means a rather weak knowledge of the firm and of its productive and commercial dynamics. The assessment of the board of directors offered by the doctrine of shareholder primacy is therefore paradoxical in that it advocates an increasing *exteriority* for this *internal* mode of control. As argued before, this exteriority reduces the effectiveness of the board as a control mechanism. But it is even more damaging for its strategic role, which remains—contrary to the claim of the agency theorists—an essential part of the job.¹⁰

¹⁰ For a critique of this exclusive focus on the control role of the board, and more broadly of the agency approach to the board, see the special issue of the *British Journal of Management*, vol. 16 and, in particular, Roberts, McNulty and Stiles (2005) and Huse (2005).

The in-depth study conducted by Roberts *et al.* (2005) demonstrates that if independence is a crucial feature for non-executive directors, it should be understood as a 'willingness to exercise independence of mind in relation to executive strategy and performance' (p. 19). And this willingness is only possible if the directors' knowledge about the company and its management is strong enough. Accordingly, as Roberts *et al.* (2005) logically conclude: '[...] the advocacy by institutional investors, policy advisors and the business media of greater non-executive independence may be too crude or even counter-productive' (p. 19).

Consequently, it should come as no surprise that performance studies have failed to reveal any relationship between board composition and firm performance. Worse, some studies suggest that there may be a *damaging* influence of independent directors: Fernandes (2005), for example, finds for listed Portuguese companies that executive compensation increases with the number of independent directors and that the relationship between this compensation and firm performance is stronger in firms with no independent board members.

Considering the case of the high profile corporate scandals, we find clear evidence that the lack of reliable knowledge by independent directors was one of the driving forces behind control failure. As already mentioned, Enron's board contained 12 independent directors out of a total of 14, in the last months. Their incompetence appears to be more striking than their dishonesty. The case of the LJM's (LJM1 and LJM2)—private investment funds created at the instigation of Enron's executives—and the Raptors is a conspicuous example. The objective of the four Raptor operations, initiated in June 2000, was to hide losses related to depreciated investments. Approximately \$1 billion in losses was transferred in this way. A Special Purpose Entity (SPE), intended to receive the assets that Enron wanted to hedge, was created for each operation (Raptor I, II, III and IV). Each time, funding of the SPE came from two sources: a contribution from Enron in the form of pledges of Enron stock and call options, and \$30 million in liquid assets from LJM2. LJM2's investment was nevertheless

accompanied by a commitment to repay within six months with a premium of \$11 million (to make a total reimbursement of \$41 million). Consequently, Enron stock was the only tangible capital that the Raptors had for hedging Enron assets. In short, Enron 'hedged' itself, counter to all financial logic. The board of directors was informed of all these transactions. But instead of worrying, the board appeared to be quite enthusiastic. Thus, we learn in the Report of the U.S. Senate on "The role of the board of directors in Enron's collapse" (2002) that one of the board members suggested that Enron's Chief Financial Officer (CFO) file "a patent" on the accounting techniques used in the Raptor operations (p.21, note 47). Later, in his hearing with the Senate Committee, this director would qualify the Raptor operation as 'leading hedge accounting' (p. 20). All in all, LJM2's first six months of business brought Enron a profit of \$200 million. As the US Senate Report notes, '...[no] Directors asked how LJM was able to produce such huge funds flow with such minimal effort by [Enron's CFO]' (p. 33).

This lack of understanding of what was going on inside the firm by non-executive board members might be contrasted with the reaction of Enron's employees. Employees, by definition, have access to specific and tacit knowledge, the foundation of effective monitoring. In particular, one employee, Sherron Watkins—vice president of corporate development—was aware of the extent of fraudulent behaviour. However, she did not have any formal right to express her concerns publicly. She feared for her job and so decided to write an anonymous letter to Kenneth Lay (Enron CEO), concluding: 'We're such a crooked company'. This story reveals an important aspect of the internal balance of power in US corporations, and in the shareholder-friendly model in general (Windolf, 2004): the lack of internal countervailing powers. The US model of corporate governance does not grant any rights to sustain the voice of non-shareholder constituencies, and in particular the workers. This marks a major difference with the European continental model, characterized by worker involvement in corporate governance (Rebérioux 2002): as a constituent element, workers have the right to be informed and consulted about the main issues in the functioning of the firm. Possibly,

they may be granted a power of co-determination on a more or less wide range of subjects, through elected representatives. Through these rights, managers are induced (or forced) to take the interests of employees into account when making their decisions. Corporate governance is directly affected: these rights to information, consultation and co-determination contribute, when they exist, to the definition of a specific aim for the exercise of power within companies, in which the maximization of the well-being of shareholders is not taken to be the required norm. But there is more: worker involvement provides at least some internal countervailing powers. This is evident in the case of codetermination in the form of board-level participation (on the supervisory board, as in Germany, or on the board of directors, as in Sweden). But it is true for the information and consultation rights granted to works councils. From this point of view, France is a good example. Article L.431 of the Labour Code, for example, requires the employer to provide the works council with the information it may wish to obtain on the general functioning of the company. This information plays an important role in the *ex post* control, conducted by judges, of the legal validity of economic lay-offs. Another important right is the possibility for the works council to call in an expert accountant, in order to obtain a counter-valuation of the information communicated by the employer. As Grumbach (1995) notes, this right challenges the 'employer's monopoly on legitimate expertise'.¹¹

B. THE CASE OF EXTERNAL GATEKEEPERS

It is now widely accepted that conflicts of interest—in particular for external auditors and securities analysts—did play a role in the failure of gatekeepers during the Enron-era financial scandals.

¹¹ On some aspects, the information rights enjoyed by the work council are even greater than those of shareholders: for example, managers must inform worker representatives (and not the shareholders) whenever the trade of a block holding is expected.

However, it is part of our argument that the failure of these gatekeepers cannot be reduced solely to this dimension. Even when it is carefully performed, gatekeeper control cannot supervise the whole process of profit formation inside the firm. This argument is clear-cut in the case of rating agencies and financial analysts, who rely mainly on publicly available information. It is their processing of this information that proves useful for investors. But this can hardly be enough to define them as watchdogs of corporate activity¹². The following quotation by Leo C. O'Neill, President of Standard and Poor's illustrates this point:

Obviously S&P and the other rating agencies were evaluating Enron, so it was fair enough to include us. My view is that the [Senate Governmental Affairs Committee's] report ascribed a watchdog role to S&P that no one, including us, ever intended S&P to have. That's not our job. We are recipients of the information that is generated by the companies, approved by their auditors, and sanctioned by their legal counsel. We believe we have every right to rely on the disclosures they make to the SEC. We also, as you know, meet with companies and ask them a lot of questions. But quite honestly, they have absolutely no obligation to disclose to us. And we have no right to impose any kind of sanctions or legal constraints [to make them disclose]' (CFO Magazine January 1, 2003).

The same comment might apply to securities analysts. The cognitive limitations of these actors—combined with their influence on stock price determination—form the basis of the assumption of a 'cognitive bias'. Moreton and Zenger (2004) have

¹² For a radical academic view, see Partnoy (2001), who considers that "*credit ratings are of scant informational value*" (p.1). I would like to thank Ludovic Moreau for this reference.

set up this hypothesis in the case of securities analysts. Specifically, they test the proposition that analysts discount 'unfamiliar (corporate) strategies', which combine assets from *a priori* unrelated business. These cross-sector strategies are, by definition, difficult for analysts to understand. Accordingly, the more diversified a firm is, the less it will be covered by analysts. In turn, one may argue that stock price evaluation is positively correlated with the number of analysts covering the firm. The conclusion is that securities analysts tend to restrain managerial strategy, in favour of 'familiar' strategies... that are not necessarily profit-maximizing. Indeed, it is a persistent message of organisational theory and resource-based theory of the firm that the production and preservation of organizational rent are closely related to business models favouring the original combination of assets. As a general principle, the growing role of knowledge and intangible assets in rent production widens the gap between the gatekeepers' evaluation and the reality of the business firm, leading to a deepening of cognitive bias.

Even in the case of auditors, more closely connected to the firm than rating agencies and financial analysts, we may cast doubt on the proposition that their failure is solely due to (remediable) conflicts of interest. For sure, the auditors' assessment is partly based on private information and on-going relations with executive officers. For this reason, rating agencies and analysts regularly complain that they are at the end of the 'informational chain', laying responsibility for the high-profile corporate scandals mainly at the door of the auditors. However, the power of auditors, their ability to monitor corporate managers and to detect deviant behaviour, should not be over-estimated. The following extract, by Mary Locatelli—former executive vice president and director of audit at American Savings Bank—is instructive: 'External auditors focus after the fact on a distinct event (a set of financial statements) and ask the question 'What, if anything, went wrong?'' (CPA Journal, October 2002). Thus, audit firms provide for an *ex post*, rather than *ex ante*, monitoring activity. This is to be contrasted with internal auditors, who 'focus on an ongoing process and assess risks and controls to answer the question 'What

could go wrong?’ Locatelli then concludes: ‘Outsiders are not insiders [...]. A lack of appreciation and understanding leads companies to leave controls to outside experts’.

To conclude, the information used by stock markets to evaluate business conduct and performance is produced by actors that are, by their very nature, at a distance from the productive process. As such, they suffer from intrinsic cognitive limitations. Reliable knowledge about the business firm is to be acquired, in a large part, inside the firm as a productive entity combining specific competences and tacit knowledge. By trying to empower liquid investors, shareholder primacy contributes to ‘externalize’ the sources of information about and control of business conduct. As such, it undermines its effectiveness as an accountability-enhancing arrangement.

V. MANAGERIAL BEHAVIOUR UNDER SHAREHOLDER PRIMACY

The argument developed so far helps to explain the *opportunity* for fraudulent behaviours under shareholder primacy. However, to understand how those behaviours become effective, we need to appreciate more clearly the constraint imposed on business conduct through the stock markets. Essentially, the power of financial markets is expressed by the imposition of constraining criteria of financial returns. The competition among investment funds to attract collective savings is transferred onto the companies, which are judged by these funds on the basis of their ability to meet the financial demands imposed on them. This power is conferred by stock market liquidity, which allows a continuous process of public evaluation of companies (Orléan, 1999; Deakin, 2005).

An analysis of the implications of the most popular ‘Value-Based Management’ tool—Economic Value Added (EVA)—may prove to be particularly useful: indeed, this metric condenses the logic of (stock) market control over listed companies. The first function of EVA is *informational*: it is considered to be the most relevant

criterion for the prediction of stock market prices. The second function is *operational*: EVA is set down as the management criterion for executives, who must seek to maximize the difference between financial profitability (the return on equity) and the cost of capital (see *infra*). The latter is no longer considered as a consequence of the firm's productive and commercial operations, determined *ex post*. Rather, the cost of capital is considered as a benchmark in itself, determined *ex ante*. The use of benchmarking thus provides financial investors with the ability to undertake a continuous and generalised comparison between listed companies.

The assumption that there are no tax deductions or exceptional results simplifies the calculation, so that the current result merges with the net result. Let us denote R_o the operating result, D the book value of debts, r their average costs, EC the book value of equity capital, k the equilibrium return on equity capital as determined by the Capital Asset Pricing Model (CAPM)¹³ and K the total book value of the assets ($D + EC$). Then it is possible to obtain the following expressions for the net result (R) and the weighted average capital cost ($WACC$):

$$R = R_o - r.D \quad (1)$$

$$WACC = k. EC / K + r. D / K = k - (k - r).D/K \quad (2)$$

The simplest expression of a company's EVA is then the following:

$$EVA = R - k.EC \quad (3)$$

MVA is defined as the discounted total (using the $WACC$) of expected EVA. By denoting ROE the return on equity (R / EC) and

¹³ The CAPM, developed in the 1960s (Sharpe, 1964; Lintner, 1965), permits the calculation of the premium which rational investors expect for holding risky assets (with high volatility).

ROA the return on assets (R / K), expression (3) can be rewritten as:

$$EVA = (ROE - k).EC = (ROA - WACC).K \quad (4)$$

Equation (3) brings out the specific nature of EVA: while the wealth going to shareholders is normally measured by net return (R , that is the profit once the employees have been paid and the debts serviced), the EVA indicator is based on the idea that the value actually created for shareholders is anything in excess of the profitability demanded by the capital market ($k.EC$). In other words, if the effective return on investment (the *ROE*) is the rate k , which corresponds to the equilibrium market return for that class of risk, then the EVA model considers that no value has been created (see 4). Likewise, if the investment is ultimately remunerated at a rate n with $0 < n < k$, then there is destruction of value: there is some return on investment, but less than the market has the right to expect. The difference is identified as a loss, even if shareholders are paid for their investment. The market return at equilibrium (k) becomes a *minimal* return or an opportunity cost, 'always to be exceeded' (Batsch, 1999, p. 36). This has two far-reaching consequences.

On the one hand, the systematization of the EVA model results in a profound modification of the status of shareholders. As Lordon (2000) notes, creation of value means that shareholders are paid *twice*: once at the opportunity cost k and again at the EVA. Through the EVA, residual creditors therefore become privileged creditors, as if they were lenders. They acquire guarantees of returns on their investments (k) and although these guarantees are not contractual, they do constrain managerial strategies¹⁴. This

¹⁴ On this point, see for more details Froud, Haslam, Johal and Williams (2000).

change, it should be noted, further undermines the traditional economic justification for shareholder sovereignty: risk-taking¹⁵.

On the other hand, the creation of shareholder value originates in a logic of imbalance transformed into a permanent objective. The macro-economic inconsistency of this principle is obvious: not all the (listed) companies can create value for their shareholders, whatever the quality of their management. At the micro-economic level, methods for doping financial returns beyond what the companies' economic potential would permit are sustained by elevated stock-exchange prices. These methods combine the increase of the debt-to-equity ratio (financial leverage), the asset-light strategy and the repurchase of shares. If the interest rate r is below k , an increase in the debt-to-equity ratio reduces the WACC (see equation 2) and thus raises the EVA (see 4). The asset light strategy ($\Delta K < 0$) automatically raises the return on assets (ROA), while the repurchase of shares increases the return on equity (ROE). Both result in a rise in the EVA (see equation 4). All of these methods were extensively used by Enron's officers. Clearly, none of them are sustainable over the medium-to-long term. These are short-term strategies with the aim of generating financial returns beyond the market equilibrium. As such, they are highly risky and encourage bold innovations flaunting acceptable standards of caution.

Let us sum up our main argument. If capital markets have increased their ability to obtain results (in terms of financial return), they are limited in their ability to appreciate the way in which these requirements are met. This contributes to making managerial power *less* accountable: financial irregularities multiply and executive remunerations explode. Shareholder

¹⁵In the introduction, we emphasised a complementary argument, implying that shareholders are not the unique risk-bearer in the firm: the growth of human capital specificity in a context of contractual incompleteness.

primacy fails exactly where it strives to succeed: it reinforces the discretionary power of managers rather than limiting it.

VI. CONCLUSION

Share prices are fundamentally perceptions of value. The primary concern of managers accountable solely to the shareholders is therefore to influence these perceptions. Accordingly, the crucial question is the information upon which these perceptions are formed. We have argued that in a market-based model of corporate governance, this information is essentially produced by outsiders. In the context of a liquid stock market, monitoring by investors through long-term block holding is not feasible. In addition, and by definition, workers are out of the game: it is hard to ask them to monitor managers to ensure the latter create value for shareholders. Yet it is a relentless message of organizational theory that the wealth creation process and corporate profits are part of a complex cognitive dynamics hardly observable at a distance—an insight we can trace back to Berle and Means (1932), Alchian and Demsetz (1972) or Galbraith (1973). The revival of non-contractarian, cognitive-based theories of the firm—with the resource-based approach or evolutionary theory—should reinforce the scepticism towards shareholder primacy (see for example O’Sullivan, 2000A and 2000B; Grandori, 2004; Aglietta and Rebérioux, 2005). Indeed, cognitive approaches explore the way in which the firm constructs, maintains and develops tacit and collective productive knowledge. The competitiveness of the firm then depends on the quality of this ‘cognitive’ process, that is to say a process of collective (organizational) learning. The fact that such an approach leads to a rejection of shareholder primacy should come as no surprise.

Besides the intrinsic limitations of shareholder primacy in generating an effective supervising environment, we have stressed another crucial feature of finance-led capitalism: the power of capital markets is expressed through the definition of *ex ante* financial requirements, which lead corporate executives to pursue highly risky strategies. Weak control on one side and strong

pressure on the other: taken together, these features create a highly favourable configuration for fraudulent behaviours. Hence the paradox: the greater the implementation of shareholder sovereignty, the less corporate executives are effectively accountable. In other words, it is our argument that instability is an inherent defect of shareholder primacy.

Some perennial questions in the field of corporate governance and corporate law are observable. Managerial accountability is one of these—if not the most important. As Cheffins (2004) notes, there is something cyclical about this issue, which casts doubts on the idea that corporate law and, more broadly, the theory of the firm is on a constant progressive trend. From this point of view, new developments in the theory of the firm, together with the current evolution in corporate practices and business conduct, may well deeply influence the way corporate accountability is understood—after long domination by the shareholder primacy principle.

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