

# CORPORATE GOVERNANCE MECHANISMS FOR PUBLICLY-TRADED COMPANIES

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## Abstract

The resolution of conflicts between shareholders and managers, at minimal cost, is the goal of corporate governance. This paper discusses four mechanisms, two internal, two external, that attempt to ensure managers act in the best interests of shareholders: 1) the board of directors, 2) management compensation plans, 3) the market, and 4) takeovers. Theoretically, these four forms of corporate governance *should* ensure management maximizes shareholder value. But, agency costs are real for shareholders. In practice each the mechanisms may be severely limited in their ability to protect shareholders. The best protection is an independent, credible board of directors. Without good boards, shareholders are left to the mercy of the agents. In such cases, it is very difficult, and expensive, to discipline the senior managers of a publicly-traded company.

**Keywords:** agency costs, corporate governance, board of directors, management compensation plans, block shareholders, takeovers

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## 1. Introduction

According to finance theory, the principal financial goal of a publicly-traded company is to maximize shareholder value. For the modern corporation, however, the separation of ownership and control creates an agency problem. Professional managers act as agents for the owners (common shareholders) in running the corporation. The decisions made and actions taken by management impact shareholders and other stakeholders, but also the wealth, tenure, and reputation of management. Consequently, the senior managers of a company may pursue their own goals for personal gain. The resolution of the conflicts between the principals (common shareholders) and agents (managers), at minimal cost, is the goal of corporate governance.<sup>176</sup>

Corporate governance is the set of actions and procedures used to ensure a company is managed so shareholders receive a return on their investment in the company that is reasonable, given the risks involved. In many public companies, ownership is fragmented across many investors allowing management with no or a very small ownership

position full control of the company (the residual right of control). In such cases there can be significant agency problems and corporate governance is vital to ensure management's actions serve shareholders, not management. The objective of corporate governance is to ensure acceptable performance. For managers who are not creating shareholder wealth, who are behaving in their own interests, or who are simply incompetent, shareholder and market mechanisms should serve to check the inefficiency and penalize the outcome.

There are four approaches to corporate governance, four market and shareholder initiated mechanisms that shareholders rely upon to ensure managers do not act in their own self-interest at the expense of investors. These are: 1) the board of directors who monitor management, 2) management compensation plans, including options, 3) the mechanism of the market that both evaluates management's performance (through the market price of the common shares) and allows individual shareholders to become holders of large voting blocks of shares concentrating ownership and control, and 4) takeovers.<sup>177</sup> The first two are internal corporate governance mechanisms, the latter two external. Each are considered below.

<sup>176</sup> Agency theory analyzes the conflicts between the principals and agents. A selection of papers from the extensive literature that considers agency issues include Berle and Means (1932), Coase (1937) Donaldson (1963), Alchian and Demsetz (1972), Jensen and Meckling (1976), Fama (1980), Fama and Jensen (1983a, 1983b), Jensen (1986), and Shleifer and Vishny (1997). Berle and Means went so far as to claim the separation of ownership and control "threatens the very foundation on which the economic order of the past three centuries has rested."

<sup>177</sup> A fifth mechanism, not addressed in this paper, is the legal and regulatory systems as discussed in La Porta et al. (1999, 2000).

## 2. The Four Corporate Governance Mechanisms

An obvious form of corporate governance is the board of directors whose mandate is to monitor management on behalf of shareholders. Boards, a regulatory phenomenon, are prevalent around the world and across organization type. The board's role is to directly represent shareholders' interests to management and ensure that management acts in the owners' best interests. This implies the maximization of shareholder value, not of management's income or tenure in their jobs. If a company's financial performance is poor, the ultimate power of the board (shareholders) is to decrease manager's compensation or replace underperforming managers.

A second internal component of corporate governance is management compensation plans. Stock options are a part of the compensation package offered to the managers of most publicly-traded companies. The premise underlying this action is that tying compensation to the value of the company's common shares may align the interests of shareholders and management. Greater overlap between ownership and control reduces the conflicts between owners and managers. Too little ownership may lead to inefficient use of a company's free cash flow, or outright theft; too much, to management entrenchment and empire-building. Jensen and Warner (1988) suggest that there is some optimal level of ownership by management that fully aligns the interest of shareholders and managers.

Both managers and shareholders have incentives to avoid management ownership stakes that do not align the interests of the two parties. Third, the stock market provides a forum for corporate governance. It has been long argued that when investors can freely trade their shares in efficiently-operated markets, the mechanism of market pricing allows shareholders to "vote" on management actions thereby minimizing agency costs and ensuring acceptable performance. If a company's financial performance is poor, shareholder "voting" in the stock market will result in the common share price declining, leading the board to question the poor performance of the company. In addition, stock options provided to managers will lose value or become worthless. This external mechanism should lead to changes, either with the strategic direction of the company, the tactics the company is using to meet their goals, or with senior management. In addition, institutional investors own the majority of the common shares of many companies. These professional managers, who hold large blocks of shares, would be expected to actively monitor a company's performance. Poor financial results, leading to declining share values, may provoke these institutional investors to gain control of a company's board and replace under-performing managers.

In some cases, an institutional investor may hold a significant interest (between 5% and 10%) in a company for a long period of time. These

blockholders become "relational investors" and are expected to play an important role in ensuring acceptable firm performance.

Fourth, takeovers are believed to be a potent form of external corporate governance. Underperforming companies often attract the interest of others who feel they can run the company more efficiently and profitably. The underperforming company becomes the target of a takeover, usually with the intention of replacing current management. Shareholders benefit since the takeover price is generally at a significant premium to the market price prior to the takeover.

## 3. Do These Corporate Governance Mechanisms Work?

Theoretically, these four forms of corporate governance *should* ensure management maximizes shareholder value; there seems to be significant forces in place to effect this outcome. But beginning with Adam Smith in the late 18th century, expanded upon by Berle and Means (1932), and formalized by Jensen and Meckling (1976), an extensive literature has developed noting both the virtues and defects in the corporate governance process. Shleifer and Vishny (1997) and Denis and McConnell (2002) provide excellent reviews of this work. There are a number of conclusions that can be drawn from the significant body of research concerning the effectiveness of governance.

### 3.1 The Board

While it seems the board of directors *should* afford excellent protection for shareholders, whether this occurs is still an open question.<sup>178</sup> Perhaps the first person to recognize the agency problem and to draw attention to the problems of boards was Adam Smith in 1776. In his landmark book, *The Wealth of Nations*, Smith argued that directors are negligent and profuse, not as vigilant with other people's money as with their own. This comment could have been made today.

Recent antidotal evidence suggests that the boards of many companies around the world have done a poor job of protecting and creating firm value. Jensen's (1986) free cash flow theory contends that managers of companies with access to large cash reserves (either internal or external through unused borrowing capacity) are more likely to undertake low-benefit or value-destroying transactions. These transactions occur with either the explicit or implicit support of the board.

Another problem with boards is that they often include the very managers the board supposedly monitors. While these inside directors may be a minority on the board, their positions in and

<sup>178</sup> Hermalin and Weisbach (2003) review the literature concerning the effectiveness of boards.

knowledge of the company afford them powerful voices on the board. Furthermore, the outside or non-management board members are often selected by and are sympathetic (some suggest beholden) to management. Board compensation committees have been described as: "a close-knit fraternity of perhaps 100 peripatetic directors each serving on between five and 15 boards. It's still a fairly closed network, you might call it stacking the deck." (The National Post; May 22, 2001, C1, C6).

Board memberships are lucrative and membership is tied to the ability to work with the CEO. The CEO likely serves on other company's boards. It's a system where it is in everyone's interest to keep the board and senior management team together, and pay levels rising, regardless of actual company performance. An investor complains: "There is an element of the senior people helping each other to get cookies out of the jar."

In reaction to concerns regarding the effectiveness of boards, publicly-traded companies are being ranked based on the corporate governance procedures that are in place. In many countries, lists of the best and worst boards are being published and used by investors. One of the factors responsible for this trend is that some have questioned the competency and ethical standards of board members. With very few exceptions, however, the problem with boards is not corruption or ineptness. The members of most boards likely feel they are performing their duties to a high standard. Unfortunately, it is the few exceptions that make all the news. The board members of companies such as Tyco, Enron, ImClone, WorldCom, Adelphia Communications, HealthSouth, and Global Crossing, among others, exhibited questionable behaviour. Perhaps the example of Hollinger International best illustrates the problems that can occur with boards. Hollinger, the world's third-largest newspaper empire with more than 500 titles, was the subject of a 2004 report investigating claims of fraud and theft. Breeden (2004) reports that Hollinger's former CEO and other senior executives received more than US\$400 million from the company by siphoning off 95.2% of Hollinger's total adjusted net income during the 1997-2003 time period. Over this period Hollinger's stock price and operating performance were among the worst of the publicly-traded publishing companies.

The report stated that: "[Conrad] Black (the CEO) named every member of the board, and the board's membership was largely composed of individuals with whom Black had longstanding social, business or political ties. The board functioned more like a social club or public policy association than as the board of a major corporation, enjoying extremely short meetings followed by a good lunch and discussion of world affairs. Actual operating results or corporate performance were rarely discussed."

Discussing the performance of perhaps the most important board committee, Breeden states: "On balance, however, the Audit Committee's

ineffectiveness is primarily a consequence of its inexplicable and nearly complete lack of initiative, diligence or independent thought. The Audit Committee simply did not make the effort to put itself in a sufficient position to recognize untruthful or misleading information, or even to make informed decisions on the issues before it."

Some feel that structural limitations may result in the board being unable to monitor management's performance to ensure that the best job is being performed for shareholders. To improve board performance, it has been suggested that outside directors should hold a significant personal stake in the company through the ownership of shares purchased with their own money. Companies with such directors provide superior shareholder returns, and directors are much more attentive and engaged in monitoring management (Hambrick and Jackson, 2000). Is the board an effective governance mechanism? That is still an open question. More work is being done on modeling the relationship between the board, its membership, and actions to shareholder and firm value.

### 3.2 Compensation Plans

Since management's actions are "screened" from owners, tying their compensation to the value of the company's common shares should mitigate the problems associated with the managers having the residual right of control of a company. Shleifer and Vishny (1989) argue that in companies where managers do not have significant ownership stakes, corporate governance does not work. Managers pursue their own goals and destroy shareholder wealth. So, the thinking is, by giving senior managers an ownership position in the company, they will surely act to increase the value of the shares to their benefit, and the benefit of all shareholders.

But, there are three problems with this approach. First, one of the foundations of modern finance is diversification. It is good financial planning for managers to have no or a very small equity position in their employer. To ensure one holds a diversified basket of household wealth, it is sensible to separate human wealth (income from work) from financial wealth (holdings of financial assets). Therefore, managers would want to be paid in cash (not shares or options) so they could then invest in the equity of other companies. So, the incentives put in place to encourage managers to become owners work against managers' self-interest to maintain a diversified portfolio of total wealth.

A second problem with this mechanism is that the equity component of the compensation plan adopted by most publicly-traded companies uses share options, not common shares, as the equity payment. Furthermore, the share option component is often an additional part of the pay package, it does not replace the manager's salary. Compounding the problem is that the options are often exercisable in the short-run,

encouraging short-term, not long-term planning. This can result in management actions that seek to maximize short-term earnings at the expense of long-term performance. In addition, even for options that vest in the longer-run, there is no real cost to managers if the market price of the shares does not reach the exercise price; the managers received their salary anyway. This process is hardly making managers feel like owners. Compensation plans that pay all or a part of a manager's salary in shares, not cash, and that require managers to hold the shares for many years before being allowed to sell may be an effective corporate governance measure. Unfortunately, very few publicly-traded companies have adopted this compensation method.

A third problem with this approach is if management is convinced (or bribed through the payment of shares or options) to assume a significant ownership stake in the company, an opposite incentive is created: develop a big enough stake to effectively control the company and become entrenched. Indeed, Holderness et al. (1999) report that the average percentage of shares held by company senior management and board rose from 13% in 1935 to 21% in 1995. Mikkelsen and Partch (1989) report that for 27% of the firms in their sample, insiders control 30% or more of the votes. This may explain why so few management teams are replaced, even for underperforming companies. Perhaps this second approach to corporate governance is doomed to failure due to the conflicts in positions between managers and shareholders.

Morck et al. (1988) provide evidence to support these views. They find that firm value increases as management's ownership position increases to 5%, but then decreases as the level of ownership increases from 5% to 25%. Value then slightly increases as ownership increases beyond 25%. An interpretation of this "sickle-shaped" relationship between firm value and insider ownership is that increases in managerial ownership from very low levels help align the interests of managers and shareholders. At higher levels of ownership, however, additional control by insiders leads to entrenchment. Jensen and Warner's (1988) optimal level of managerial ownership may be about 5%.

In summary, the two internal corporate governance mechanisms may not be as effective as theory might suggest. Indeed, Jensen (1993) suggests that internal control systems react too late, and take too long to effect major change. He believed that external corporate governance mechanisms were more likely to be effective and timely alternatives to discipline management.

### 3.3 The Market

While good and bad company performance is reflected in the market price of a company's common shares, the external mechanism of market pricing itself is ill-suited to corporate governance. A falling share price,

on its own, does not discipline managers; shareholders and others must act. For companies with holders of large blocks of shares or those where institutional shareholders own the majority of shares, there seem to be major incentives to act. A shareholder with a large block of shares (a minority position of say 10%) has significant incentive to monitor management's performance and act when performance lags. Shleifer and Vishny (1986) consider large shareholders "monitors" who can discipline managers and, if necessary, facilitate the replacement of poorly performing management through the voting of their shares.

But, the findings in the literature are mixed. Bethel et al. (1998) report that purchases of large blocks of shares by activist investors lead to superior firm and share price performance. Jarrell and Poulsen (1987) and Brickley et al. (1988) report that institutional ownership is associated with a higher probability of dissidents winning proxy contests and with fewer adoptions of antitakeover proposals. On the other hand, Black (1998), in a review of the literature concerning institutional investors, reports that institutional activism has little bearing on firm performance or actions. Holderness and Sheehan (1988) and Mehran (1995) find no significant relationship between firm value or performance, and the outside blockholdings of individual, institutional, or corporate investors. Hennessey (2005) reports that when a group of institutional shareholders each hold a sizeable but minor stake in a company (1% to 5%), there is little benefit in terms of superior company performance.

An explanation for these contradictory findings may relate to the fact that few institutional investors hold more than 10% of a company's common shares. This is due to the reporting requirements that are activated once this threshold ownership level is reached. For institutional shareholders who hold minor stakes, the incentives to act are reduced. This hesitancy on the part of institutional investors to take action to try to improve company performance may be a combination of three factors. First, given the low level of ownership, these investors may feel that any action taken will not have a significant impact on the return of the institution's overall portfolio. Second, these investors may believe that any increased return from action would not be worth the time invested. Finally, the free-rider problem may result in each of the institutions holding shares delaying action in anticipation that another party will do it.

### 3.4 Takeovers

Jensen (1993), and others, suggests that the market for corporate control is the most effective and timely method to discipline poor management.<sup>179</sup> The threat

<sup>179</sup> For examples, see Jensen (1986 and 1993), Martin and McConnell (1991), Mikkelsen and Partch (1997), and Kini et al. (2004). Much of this research reports that the takeover market acts

of takeovers can be viewed as a feedback mechanism between management and the stock market. Declining market prices lead to further share sales and further price declines. This increases the probability of takeover. To counter this threat, management must improve returns to capital and not make poor investment decisions. This logic implies that a takeover occurs when a company's share price is falling due to poor management.

But, there is some question whether takeovers truly address corporate governance problems. Research on takeovers suggest that while the excess returns to the shareholders of target firms are positive, the returns to acquiring firm's shareholders are, at best, zero, but are often negative (see Morck et al., 1990). In addition, takeovers are an extreme and expensive corporate governance mechanism that require access to large amounts of capital and are open to political interference.

Takeovers can create agency problems for the bidding firm's shareholders when empire-building is the motivation and the acquirer overpays. Roll (1986) suggests that takeovers are not successful because senior managers are subject to hubris, are too optimistic about their abilities to select and value targets, and overpay for the target. This may happen because many takeovers occur when the target's share price is rising, not falling. In such cases, a takeover cannot be viewed as a corporate governance mechanism. Recent research and observation tends to support this view.

For example, Moeller et al. (2005) report that acquiring firm shareholders lost \$120 per \$1,000 spent on takeovers for a total loss of \$240 billion during the stock market bubble of 1998 to 2001. The major destruction of shareholder wealth was due to the overestimation of expected synergy gains. In addition, the management of firms that believe they may be subject to a takeover may react negatively by implementing costly defensive strategies such as golden parachutes or poison pills and by seeking legal protection from takeovers. These actions are very costly to shareholders as their implementation often results in declining share prices and court cases.

Overall, whether takeovers are an effective external corporate governance mechanism is still an open question. While a company may be acquired, that doesn't mean the company's shareholders received a fair price for their shares. For an acquisition to make sense to an acquiring company, a less than full price has to be paid. By implication, the target company's shareholders may not receive full value. In addition, why should shareholders have to rely on another company's management to discipline the management of their company?

This form of corporate governance is costly and extreme, and should only be relied upon as a last

resort. As such it should not be a widely used mechanism. The decrease in hostile or unsolicited takeovers since 1990 may be a sign that this is being recognized by the market. The other three forms of governance should work well before a takeover is required, if the reason for the takeover is the poor company performance. This argument particularly applies to the board of directors. The board of a poorly performing company should act well before another company's management recognizes that major problems exist.

#### **4. Conclusion**

Finance theory suggests that for publicly-traded companies, market and shareholder initiated actions will encourage superior performance. But, agency costs are real for shareholders. The goals of management may be in conflict with and even supercede those of shareholders. In practice, corporate governance that attempts to mitigate this problem can be severely limited. Managerial entrenchment is a powerful motivating force that any approach to governance may not resolve. When managers hold little equity in the firm and shareholders are too dispersed or uninterested to enforce value maximization, corporate assets may be deployed to benefit managers rather than shareholders. There are numerous examples, from around the world, that illustrate the deficiencies of corporate governance. Theoretically, in the vast majority of these cases, the governance measures in place should have resulted in acceptable company performance. But they did not. Management did not act in the interests of shareholders or other stakeholders. The dollar amount of wealth destroyed in these cases ranges into many billions of dollars.

Does corporate governance work? The vast majority of publicly-traded companies around the world employ ethical, hard-working senior managers who try to look after the interests of all stakeholders. In this sense, corporate governance is very successful. But what happens when a company employees senior managers whose main goal is to get themselves rich, who use the company as their own personal bank, or who are simply incompetent?

The shareholders of both well and poorly managed companies must be able to rely on their representatives, the board of directors. For a board to be effective, the roles of CEO and chair must be split. Board members must be independent and financially literate. They must have a broad understanding of the economic and industrial environment, and the business. They must understand and be able to contribute to the strategic direction of the business, ask questions, and act if management is not achieving specified targets. They must have the ability to absorb and process complex information with integrity and discipline. They must feel free to offer differing points of view.

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as a disciplining force only when the internal control mechanisms are ineffective or have failed.

They must hold an equity position in the company purchased with their own money. In short, all board members must be viewed by management and stakeholders as credible representatives of shareholders. If not, shareholders will be left to the mercy of the agents. Companies with good managers need good boards. The shareholders and stakeholders of companies with poor managers need better boards.

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