U.S.-style corporate governance may be a poor fit for the developing world.

Corporate Governance and Economic Development

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Policymakers can choose from two competing models of corporate governance. The first is a market-oriented model that relies on relatively little mandatory law to protect shareholders. Instead, it depends on a host of other formal and informal mechanisms, such as incentive-based compensation and hostile takeovers, to hold managers and directors accountable. The United States (or, more correctly, Delaware) embodies this approach, with its so-called "enabling" corporate law that parties can opt out of in crafting their governance structures. The second approach depends on a mandatory model of corporate law in which the state, as opposed to the marketplace, plays a central role in shoring up shareholder protections by fashioning mandatory rules that define shareholder property rights.

Which corporate governance model should developing countries follow? The stakes are high in answering this question correctly, as studies show a link between strong protections that shield shareholders from exploitation at the hands of insiders and the promotion of equity markets and economic growth. The basic intuition is that shareholders are more willing to invest when they are sufficiently confident that the system is not rigged against them.

If the goal is to protect shareholder interests from the abuses and mismanagement of directors and officers, and similarly to protect minority shareholders from the opportunism of controlling shareholders, developing countries generally should turn to a mandatory model of corporate law instead of a market-oriented corporate governance system.

U.S. Corporate Governance

Corporate law in Delaware allows directors, officers, and shareholders to order their affairs as they see fit. To be sure, the Delaware corporation code contains a number of important provisions, although most are default rules and few protect shareholders from insider abuses. It is not much of an overstatement to say that the Delaware corporation code is largely beside the point when it comes to protecting shareholders. In fact, the most important provision of the Delaware corporation code cuts against shareholder protection. Section 141(a) of the code provides that the "business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors." Section 141(a) grants expansive authority to the board and, in effect, to the officers to whom the board delegates managerial control. Thus, the section

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deprives shareholders of any legal control over day-to-day business affairs and overall corporate policy, although shareholders, particularly institutional investors, can and do involve themselves informally on those matters. The Sarbanes-Oxley reforms ushered in by Congress after the scandals at Enron and WorldCom have not upset this basic allocation of corporate authority.

FIDUCIARY DUTY To the extent that substantive corporate law matters in the United States, it is not the law on the books but the common law of fiduciary duties that judges craft. Fiduciary duties do not give shareholders any "positive" control over the firm but they do constrain management's and the board's exercise of their authority and thus are a sort of "negative" control right that shareholders hold.

In brief, the fiduciary duty of care requires directors and officers to run the company with reasonable care and spend the time and effort needed to make prudent business decisions. The duty of loyalty charges directors and officers with acting honestly and prohibits them from looting the company, engaging in self-dealing that is unfair to the corporation, or otherwise acting in their own self-interest. The concept of good faith is marbled into both the duty of care and the duty of loyalty, although a separate fiduciary duty of good faith is starting to take shape in Delaware.

An important benefit of policing management through fiduciary obligations is that it allows the Delaware judiciary to craft corporate law on a case-by-case basis. The result is what many believe to be a more efficient corporate law than a one-size-fits-all mandatory approach that is both fixed and universally applied.

The law of fiduciary duties consists of three additional important features. First, Delaware has a very well-developed body of case law that makes fiduciary obligations less open-ended than standards applied in other contexts. Second, a very sophisticated and experienced judiciary that is highly respected and active in legal and business circles administers the law of fiduciary duties. Third, the Delaware judiciary enforces fiduciary obligations against the background norm of shareholder primacy. The combination of those factors limits the range of likely outcomes in any given case and injects predictability into Delaware corporate law. The norm of shareholder primacy is especially important to shareholders if fiduciary duties are to protect them against insider abuses or, for that matter, against the interests of other constituencies, such as employees or creditors, that might conflict with shareholders' interests in maximizing firm value.

Fiduciary duties have limits, however. They do relatively little to protect shareholders, except in the most egregious cases. For example, courts are reluctant to second-guess business decisions and, under the business judgment rule, generally defer to managers and directors. Directors and officers will not be held liable under the duty of care unless they were grossly negligent, which in practice means an abdication of responsibility. Even the most lackadaisical board and management team rarely are that deficient. The courts do aggressively monitor the duty of loyalty, but the legal sanctions for disloyalty are relatively modest. Additionally, because of a number of procedural hurdles that shareholders must clear, it can be difficult even to bring a lawsuit for breach of fiduciary duty.

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MARKET FORCES Thus, billions of shares change hands daily on the New York Stock Exchange and NASDAQ despite the lack of strong legal protections for shareholders in the United States. Why?

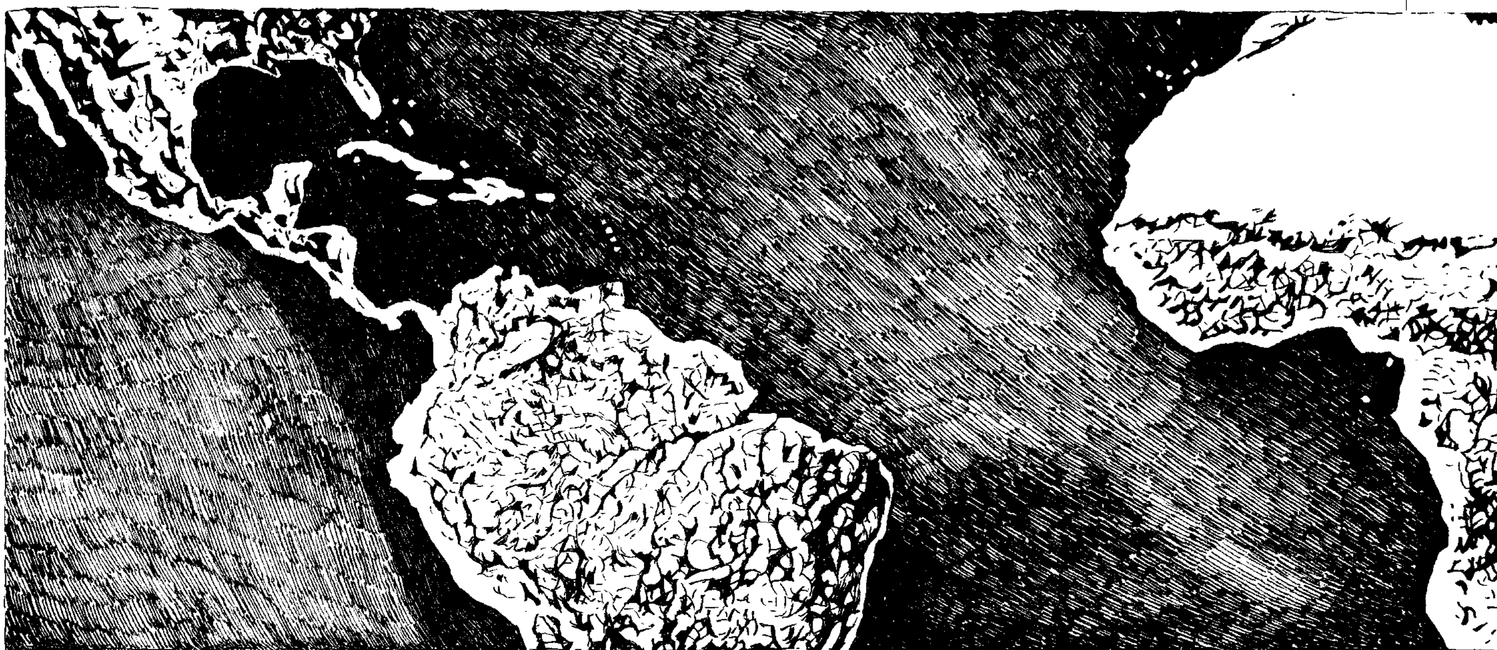
Shareholders are protected primarily by nonlegal mechanisms such as contracts, market forces, and norms of good practice that directors and officers follow. Incentive-based executive pay is an example of using contracts to control agency costs. A variety of well-known market forces—including product market competition, hostile takeovers, the market for managerial and directorial services, and capital markets—also protect shareholders by aligning the interests of managers and directors with shareholders' interests. Those market forces reduce agency problems by punishing managers and the boards that oversee them if shareholder value is not maximized. If a company underperforms, for example, its CEO might be removed, the board might be shaken up, the company's cost of capital will rise, the company might lose customers to competitors who provide better goods and services at lower cost, and the company risks becoming a takeover target. Analysts and investors today pay more attention to corporate governance, in addition to company fundamentals, than ever before, and studies show that companies with poor governance often perform less well and trade lower.

Not only do managers and directors worry about retaining their positions, maximizing their compensation, and keeping their companies competitive, but they also worry about their reputations. They worry about the shame and embarrassment they might suffer if they are scorned in the *Wall Street Journal* or on CNBC for rejecting good corporate governance practices, allegedly looting the business through exorbitant executive pay packages, opposing a premium all-cash bid for the company, or simply taking the company in some ill-advised direction. Put differently, "shaming" complements other sanctions and monitoring devices that hold insiders accountable.

Directors and officers often seem "to do the right thing" by voluntarily taking steps to maximize firm value even when nobody is watching and there is little, if any, risk of legal, market, or reputational sanction. At least to some extent, the U.S. corporate governance system relies on insiders enforcing upon themselves norms of good corporate governance. As then–Delaware Supreme Court Chief Justice E. Norman Veasey put it:

> There is a significant self-governance aspect to the corporation law in that daily functions of the enterprise are based largely on norms . . . . Self-governance works for the most part because of the sensitivity of directors to do what is right, what is professional, what is honorable, and what is profitable.

To encourage innovation, entrepreneurship, and risk taking, U.S. corporate law errs on the side of allowing directors and officers discretion in running the business, leaving shareholder protection largely to nonlegal influences.



THE RELEVANCE OF U.S. CORPORATE GOVERNANCE

Is a market-based model of corporate governance feasible for developing countries? In my view, the answer is no, for several reasons.

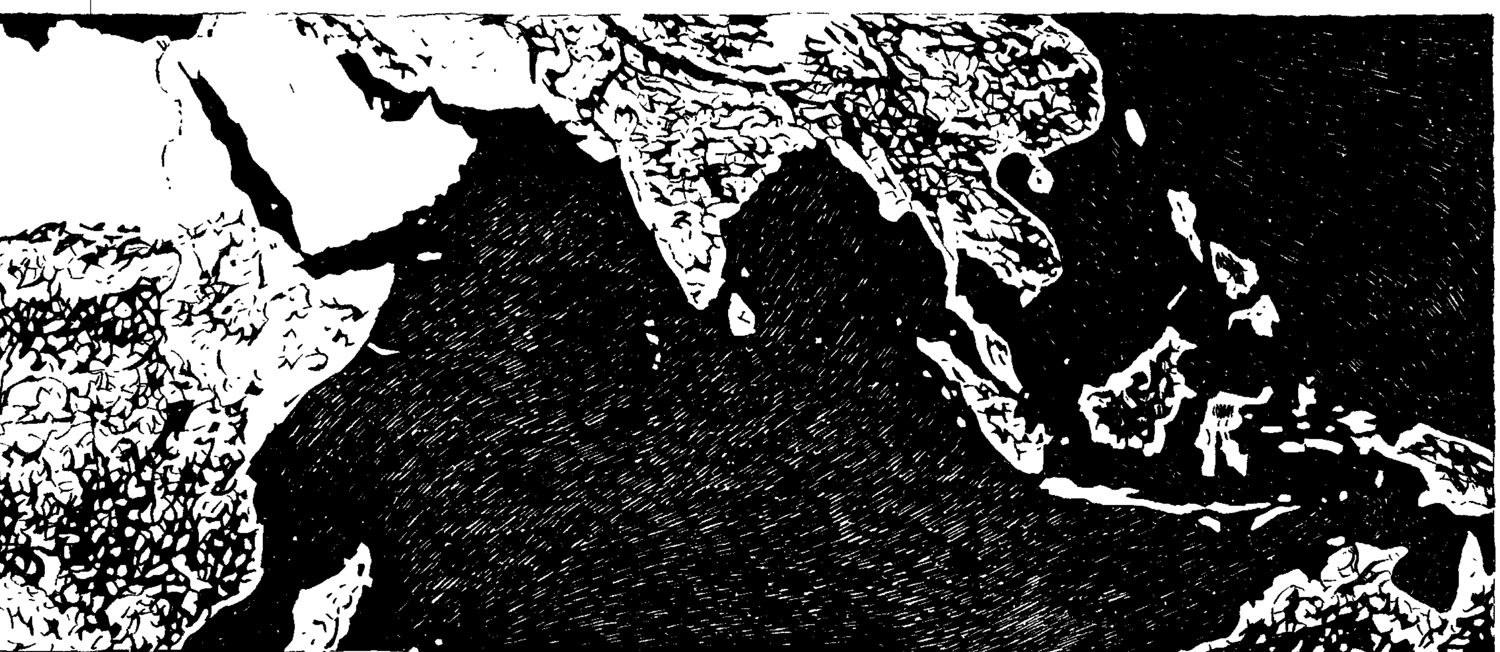
First, developing countries lack most of the formal and informal institutions that make workable a market-based corporate governance system characterized by an enabling corporate law with few mandatory shareholder protections. Put simply, developing countries lack the advanced markets that are essential for a market-based governance system to work. Indeed, the whole point of ongoing corporate governance reform efforts is to create securities markets. Developing economies also lack important second-order institutions (e.g., experienced investment bankers, lawyers, securities analysts, accountants, money managers) that enable markets to monitor. In fact, there might be few experienced managers to run companies, a fact that challenges a basic presupposition that it is efficient for ownership and control to separate with dispersed shareholders hiring expert managers.

Perhaps the single most important institution in the U.S. system is the Delaware judiciary. Developing countries often lack an effective judicial system, let alone a highly regarded expert judiciary like the Delaware courts. More fundamentally, judges in civil law countries may be reluctant to exercise the kind of discretion required to apply fiduciary duties. The law of fiduciary duties is ineffectual if judges are not willing to exercise their discretion or if judges are not respected enough for their decisions to have legitimacy.

Second, private ordering is not easy. One cannot simply turn an economy loose and instruct the parties to organize their affairs as they see fit, even if the formal corporate law provides a general governance framework. Rather, successful private ordering depends on a variety of important preconditions that, for the most part, do not exist in developing economies. The parties need to know how to organize a corporation's internal affairs, how to implement a governance structure, and how to evaluate various governance practices. The parties need a textured understanding of the issues as well as insight into what a reasonable allocation of rights, duties, and risks might be for a particular company given its management team, financing needs, operating history, financial condition, future prospects, and capital structure.

Formal training is not enough. Bankers, lawyers, investors, and other market players need the kind of sophistication and experience that only come from on-the-job training. In a market-based system, it is important that market actors draw from a similar set of experiences and a shared mental model of business dealings and corporate governance because this reduces transaction costs by ensuring that everybody is "on the same page" with common understandings and similar expectations.

Third, for a model of corporate governance that depends on relatively few legal mandates to work well, the future has to matter. That is, the long-term payoff for insiders of cooperating and refraining from exploiting shareholders must exceed the short-term payoff insiders receive when they act opportunistically. The future matters more when a person expects to engage in a series of repeated transactions for which his reputation for cooperation and honest dealing is essential. The social, political, and economic instability found in many developing countries means that future prospects are heavily discounted and are worth less than the immediate benefits of shirking, looting, self-dealing, and other disloyal behavior. Further, it is hard for those who are "cooperators" to commit credibly by contract or otherwise to cooperate if courts and other enforcement institutions are not well-established.



MORGAN BALLARD

A COMPETING MODEL

A market-based corporate governance regime cannot be achieved overnight. As Nobel laureate Douglass North put it, institutions are the "product of a long gestation" and the "process of [institutional] change is overwhelmingly incremental." Policymakers find it difficult to nurture institutions or to accelerate their development because the process of institutional change and development is uncertain, particularly when one is trying to institutionalize customs, norms, and cooperation.

If markets and other nonlegal modes of corporate governance are inadequate to protect shareholders, developing countries should adopt a more mandatory model of corporate law that utilizes bright-line, clear-cut rules around which parties generally cannot contract. The regime should be both more proscriptive and prescriptive in nature than the U.S. approach, placing further restrictions and imposing additional requirements on directors and officers, giving shareholders a greater role in corporate governance, and affording minority shareholders greater protections against the power and influence of controlling shareholders.

Bright-line rules, simply by being bright line, contribute to a more effective corporate governance regime. First, bright-line rules generally are more straightforward and clearer than standards and are therefore more predictable. Legal certainty is a valuable asset that facilitates business and investing. As Justice Antonin Scalia explained in a 1989 *University of Chicago Law Review* article, "There are times when even a bad rule is better than no rule at all."

Second, bright-line rules are also easier for judges and regulators to interpret and apply. As Judge Richard Posner noted in a *World Bank Research Observer* article, "determining whether [rules] have been violated is a relatively mechanical, cut-and-dried process rather than one requiring the exercise of discretion and the determination of numerous facts." A key benefit of standards—that they are more efficient than mandatory rules because they can be tailored to fit each particular case—is not useful in developing countries because judges and regulators typically lack the understanding and experience needed to apply corporate law standards in a textured, fact-specific way.

Third, bright-line rules make it easier to monitor and control agency problems and corruption. Bright-line rules facilitate market enforcement of corporate law because defections (i.e., the failure of insiders to comply with legal mandates) are more easily detected. The lack of regulatory and judicial discretion also allows directors, officers, shareholders, and others more easily to police the application of the law by regulators and the courts.

Critics of such proposals for state involvement in corporate governance worry that the state will intervene in the economy too much, undermining the private sector. That is a risk. However, mandatory corporate law, as I envision it, is about shifting greater control to shareholders, and possibly other stakeholders. It is not a call for the state to substitute its business judgment for the marketplace, and it is important that the state's more visible hand in corporate governance does not morph into a form of industrial policy or crony capitalism. While strong legal protections should shield shareholders from insider abuses, shareholders should not be shielded from business risks. Companies should be allowed to fail and investors should be allowed to lose money.

SPECIFIC PROPOSALS Let us consider some concrete provisions. At a minimum, a developing country's corporation code could simply prohibit self-dealing transactions. Although transactions between a corporation and an insider can sometimes be in a corporation's best interests, interested-party transactions pose a serious risk of abuse. A flat prohibition on self-dealing avoids the complexity of the U.S. approach, which permits such a transaction if it is ratified by an informed vote of a corporation's disinterested directors or shareholders, or if the deal is otherwise fair to the corporation. If a flat bar is too restrictive, the code could allow for certain *de minimis* exceptions from the prohibition or could allow approval by both disinterested directors and disinterested shareholders, not just one or the other.

Other provisions that could stem insider disloyalty include capping executive compensation, or at least giving shareholders a right to vote on executive pay; prohibiting cash-out mergers by which controlling shareholders squeeze out the minority, or at least fixing a minimum premium that a controlling shareholder must pay the minority; and banning insider trading, including the possibility of limiting the number of shares that an insider can buy or sell during some period, such as every three months, whether or not the insider is in possession of inside information at the time. To the extent insiders do buy or sell, they could be required to disclose their planned trades before they are made.

To make it easier for shareholders to elect their preferred representatives to the board, shareholders could be allowed to nominate directors, an idea that has been very controversial in the United States. A more far-reaching provision would require that shareholder nominees actually fill a minimum number of board seats. To ensure that a controlling shareholder, if one exists, does not elect the entire board, the corporation code could require that minority shareholders have the right to elect one or two directors. Cumulative voting, which allows a shareholder to aggregate his votes by multiplying the number of directors to be elected by the number of such shareholder's shares and cast the total number of votes for one or more directors, is a more conventional way of ensuring minority board representation. One option, then, is to make cumulative voting mandatory.

Instead of relying on the board to represent their interests, shareholders in developing economies could be given more direct say over the enterprise, and not be limited to voting on mergers and sales of substantially all of the company's assets as they are in the United States. For example, shareholders could have the right to demand a dividend, perhaps subject to a cap; to approve the sale of key assets or the sale of any assets with an aggregate value above some threshold amount; and to block a major acquisition by the company.

In terms of financings, the corporation code could require shareholder approval before a corporation pledges a substantial portion of its assets or incurs material obligations, such as if a new line of credit or a new debt issuance would cause the company's debt-to-equity ratio or debt–to–total assets ratio to exceed some threshold. Shareholders could also have the right to block the issuance of additional shares of stock.

Finally, there is the option of a "catch-all"—a provision that states that any shareholder proposal receiving the affirmative vote of, say, 60 percent of the outstanding shares is binding on the board and management.

For the shareholder vote to be meaningful at all, shareholders need to be able to exercise it in practice. To that end, shareholders could be given liberal rights to act by written consent, to vote confidentially, to inspect corporate books and records, and to call special meetings at any time. Dual-class voting structures particularly prejudice minority shareholders, even with the other protections in place; minority shareholders simply do not have the votes to enact particular outcomes when facing a shareholder or shareholder group with super–voting rights. Accordingly, the code could prohibit dual-class voting structures by mandating one share/one vote or could at least cap a shareholder's voting interest at some multiple of the shareholder's economic interest in the company, such as three-to-one.

An active market for corporate control is also central to effective corporate governance. Shareholders in developing economies could be allowed greater discretion than their U.S. counterparts to sell the company to an unsolicited bidder. The corporation code could limit the defensive tactics a target board can adopt to fend off a bidder. Certain defensive tactics, such as poison pills, could be banned or, at a minimum, defensive tactics could require express shareholder approval. A more aggressive stance would require a target board to run a fair auction for the company once a bid is made, in which case the code could provide minimum steps that a board must take in running the auction to maximize the bid price.

Even when there is no control-related transaction, shareholders still might need more exit options than simply the ability to sell their shares in the market. Accordingly, shareholders could be given the right, without a board vote, to liquidate the company if, for example, the company's market-to-book value or the value of shareholders' equity drops below some threshold.

Developing economies cannot leapfrog the process of development to reach the finish line of a developed equities market. Because a market-based approach like the United States' is off the table for most countries, the remaining best option is a mandatory model of corporate law.

VENTURE CAPITAL Academics, as well as policymakers, have promoted the virtues of thick equity markets in developing economies. But the most pressing concern in many developing countries may not be public offerings and dispersed share ownership. The pressing concern in developing economies very well might be how to encourage venture capital markets as a first step before focusing on dispersed share ownership. The following are some of the keys to a thriving venture capital market.

First, venture capital arrangements are contractual. A complex agreement sets out the relationship between the fund manager (i.e., the general partner in what is usually a limited partnership, at least in the United States) and the fund investors (i.e., the limited partners). A number of complicated agreements also define the relationship between the venture capital fund and the company in which it is investing. Venture capital depends on private contracting. Private contracting, in turn, depends on parties' having clearly defined property rights that are enforceable and exchangeable. Yet, the requisite property law and contract law regimes for such transacting are often lacking in developing countries.

Second, as much as venture capital depends on extensive formal contracting, it also depends to an equal, if not greater, extent on relationships. In particular, venture capital depends on the willingness of parties to refrain from enforcing their formal rights in favor of working cooperatively if challenges and unforeseen events arise. Reworking the deal in this way takes business and legal sophistication and experience—assets that are often lacking in developing economies. Each party cannot simply hope that the other will rework the deal instead of strictly enforcing the parties' formal contract. Rather, the contracting parties must be able to commit credibly to cooperate, at least until problems become irreparable. The lesson for policymakers is that developing venture capital markets requires institutions that enable parties to commit credibly to cooperate in the future. In the United States, and presumably elsewhere, repeat play and reputational sanctions are central to disciplining venture capital market principals (i.e., fund managers, limited partners, and entrepreneurs) to work together.

Third, a new business should have a fair shot at succeeding if its product is good relative to its competitors' products. In a number of countries, though, building a better mousetrap is not the principal basis upon which competition takes place. Rather, the principal playing field is for control of legislative and regulatory bodies, as well as the executive branch and the courts. It is unlikely that a startup business, unless backed by very influential players, will win the game of regulatory capture. Put differently, corruption is an entry barrier that blocks business opportunities for entrepreneurs, which then undercuts the demand for venture capital.

Finally, crony capitalism and various forms of industrial policy and protectionism, even if they do not rise to the level of corruption as such, have a similar effect on the demand for venture capital. Whenever the state favors certain businesses, opportunities for competitors are crimped, discouraging entrepreneurship.

CONCLUSION

A market-based model of corporate governance, such as the United States enjoys, is a bad fit for most developing countries. Those countries lack the institutions and structures on which such a system depends. Rather, developing countries should adopt more stringent mandatory corporate law regimes in order to shore up shareholder rights. Indeed, the United States itself used to have a much more restrictive corporate law regime than it has today.

Why do shareholder rights matter anyway? Because shareholder protections encourage investment, the development of capital markets, and, ultimately, economic growth. R

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