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On the Efficiency of Internal and External Corporate Control Mechanisms

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Internal, organizationally based mechanisms of corporate control and external, market-based control mechanisms can be employed to help align the diverse interests of managers and shareholders. After reviewing the related work in organization theory and financial economics, this paper articulates the strengths and shortcomings of both types of control mechanisms; it also identifies a variety of managerial entrenchment practices that managers can use to compromise these mechanisms. A theoretical framework is developed next that explicates the interrelationships between and among these corporate control mechanisms. A number of research opportunities that span the disciplines of organization theory and financial economics are identified.

Managers of contemporary publicly held organizations typically are not the owners. Rather, a specialization of responsibilities has evolved whereby managers coordinate activities within the firm and position it appropriately in its competitive environment; the owners of the firm bear financial risk in the hope of retaining the difference between the firm's productive cash flows and the outflows of its promised payments (Fama & Jensen, 1983a, 1983b). Since the firm's owners would suffer tremendous financial losses if the firm failed, they tend to diversify their holdings across a variety of firms as a hedge against such a possibility. As a result, the individual owner has little interest in conducting, or even closely monitoring, the day-to-day activities in all of the firms in which he or she has a financial interest (Fama, 1980). The owners hire boards of directors who, in turn, hire managers to perform these duties.

A problem from the owners' point of view is that as their collective ownership of stock disperses, their incentive to exercise their ownership rights diminishes. The influence of the manager, however, increases concomitantly. In short, a conflict may emerge between the rights of ownership and the exercise of control (Berle & Means, 1932). These authors (1932, pp. 121–122) noted that the owners' interests are threefold: (a) to earn the maximum profit compatible with a reasonable degree of risk, (b) to distribute those profits generously and equitably among the owners, and (c) to maintain market conditions that are favorable to the investor. Managers, on the other hand, might be motivated by the pursuit of "prestige, power, or the gratification of professional zeal." Myers (1983, p. 55) labeled this phenomenon "top management featherbedding." Consequently, managers may be tempted to act according to their own interests rather than the owners' interests. The compelling issue, then, is how to mitigate this temptation in order to preserve the beneficial aspects of the separation of ownership and control.

Managerial self-interest may be reflected in the choices managers make regarding effort, risk exposure, and time horizons (Jensen & Smith, 1985). These choices may exert a negative impact on shareholder wealth. For example, although additional managerial effort could increase the value of the firm, managers might want to substitute leisure or overindulgence in company perquisites for that additional work effort (Jensen & Meckling, 1976). Second, in contrast to shareholders who can diversify their risk by holding a portfolio of stocks, the fortunes of top managers tend to be tied to the success of their companies (Fama, 1980). It may be in the interest of those managers, therefore, to take fewer investment risks than would be optimal for shareholders, even if in doing so they lower the aggregate market value of their company (Coffee, 1988; Morck, Shleifer, & Vishny, 1989). Third, even though the firm lives on, its managers do not. As a consequence, managers are most interested in firm performance for the time period in which they are compensated. They are likely, therefore, to have shorter time horizons than their shareholders, even if such time horizons lead to a present-value loss for the firm (Furubotn & Pejovich, 1973; Jensen & Meckling, 1979). The challenge for the firm's owners, of course, is to create incentives so that such self-serving investment decisions are not made. Given the asymmetry of information between owners and managers about the conduct of a firm's business, this is a daunting challenge.

Grounded in the work of Berle and Means (1932) and Coase (1937), agency theory has emerged as an important framework to help researchers to understand the nature of this conflict between owners and managers as well as its possible resolution. Jensen and Meckling (1976, p. 308) defined an agency relationship as "a contract under which one or more persons (the principal[s]) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent." They go on to argue that "since the relationship between the stockholders and manager of a corporation fits the definition of a pure agency relationship, it should be no surprise to discover that the issues associated with the 'separation of ownership and control' are intimately associated with the general problem of agency" (p. 309). (A detailed rendering of the agency theory can be found in Jensen and Meckling [1976], Fama [1980], Fama and Jensen [1983a, 1983b], and Jensen [1983]. Reviews of the theory are offered by Jensen and Smith [1985] in the economic literature and Barney and Ouchi [1986], Eisenhardt [1989], and Perrow [1986] in the organizational sciences literature.)

This paper develops a theoretical framework that illuminates the efficiencies and inefficiencies of various internal and external control mechanisms. Toward this end, we will (a) discuss the internal control options available to the board of directors (e.g., incentive contracts and management dismissal), (b) examine the external role of takeovers in aligning the interests of managers and shareholders, (c) articulate the frictions that keep both of these control mechanisms from operating efficiently (i.e., entrenchment practices), and (d) develop a research framework that explicates the time-dependent relationship between these various control mechanisms and entrenchment practices. In so doing, the importance of research that bridges the traditions of organization theory and financial economics should become evident.

It is important to recognize that our discussion is based upon a number of important assumptions. We believe that Bacharach's (1989) exhortation to be clear about the place of values in research is especially appropriate when two distinct research paradigms are mingled. In our view, the fields of financial economics and organization theory differ on three important issues: (a) the identification and rank ordering of a firm's claimants or stakeholders, (b) the implications of the theory of the firm for management activity, and (c) the appropriate measure of firm performance.

The characterization of management's objective function is relatively straightforward in the field of financial economics. The shareholder is viewed as the most important stakeholder (Jensen, 1986) so that management's responsibility is to maximize the market value of the claims held by shareholders. Although subject to certain limitations, the event-study methodology (Brown & Warner, 1980, 1985) has emerged as the dominant methodological tool for assessing the impact of various managerial decisions on the aggregate wealth of shareholders. (We should mention, however, that there are a number of ways to measure firm performance [e.g., event studies, accounting measures, outcome assessments, ex-post product-market performance indices, Tobin's Q ratio]. A survey of the strengths and limitations of each approach is beyond the scope of this paper. Nevertheless, when describing the event-study methodology, Caves [1989, p. 151] called it "a genuine innovation—theoretically well-grounded, cheap to execute, and able to evade the problem of holding constant other factors that plagues ex-post studies of mergers' effects. A better product, available at a lower price, naturally swept the intellectual marketplace." The measure is not without its limitations, however. It reflects a market estimate of subsequent performance based on publicly available information. As such, it is a measure of anticipated performance that can be compromised by an asymmetry of information. Moreover, it can be difficult to isolate the discrete effects of a single event, especially if information about that event leaks into the market over time [Ellwood, 1990].)

There is much less consensus about these issues within organization theory. Even though many members of this research community are comfortable with the assumptions of financial economics, many others are likely to endorse a stakeholder model of the firm (Freeman, 1984) wherein the interests of many claimants (e.g., capital contributors, suppliers, customers, employees, communities, government) are considered. While the interests of the shareholders are clearly acknowledged within the stakeholder view, the managers' responsibilities are seen as maximizing shareholder wealth subject to the constraint that the interests of the other claimants are reasonably met. (The conflict between shareholder and stakeholder models of the firm is due to the fact that some transactions can benefit one claimant group at the expense of others. Since transactions can transfer wealth between groups, the documentation of abnormal gains to shareholders need not necessarily arise from wealth-creating activities. Thus, firm value maximization and shareholder value maximization may not always be consistent objectives.) Not surprisingly, there is little consensus about how to measure organizational performance. Although various financial indices of firm performance are found in the literature (Lubatkin & Shrieves, 1986; Salancik & Pfeffer, 1980), so too are measures of employee turnover, absenteeism, and commitment (Mowday, Porter, & Steers, 1982), organizational alienation (Aiken & Hage, 1966), and the compilation of illegal acts (Kesner, Victor, & Lamont, 1986).

Our work will draw heavily on the assumptions of financial economics. We believe that this approach is warranted because it offers the greatest opportunity to bridge the current state of knowledge between financial economics and organization theory. Even though we recognize that value differences exist between these two fields, we cannot resolve them in this paper. Our decision to focus on the shareholders' interest should not necessarily be read as an endorsement of this perspective. Rather, it reflects our search for common ground.

Internal Control Mechanisms

Internal control mechanisms are designed to bring the interests of managers and shareholders into congruence. Required by law, the board of directors in a publicly held company is charged with the responsibility of developing and implementing these mechanisms. (The formal legal powers and responsibilities of the board of directors go far beyond the task of developing and implementing internal control mechanisms. For example, boards have the legal authority to make major business decisions and establish corporate strategy [Clark, 1986]. However, their actual role in the modern public corporation is much more modest. Clark argued that "it is still unrealistic to view directors as making any significant number of basic business policy decisions. Even with respect to the broadest business policies, it is the officers who generally initiate and shape the decisions. The directors simply approve them, and occasionally offer advice or raise questions" [p. 108].) As Fama (1980, p. 294) noted, the board's "most important role is to scrutinize the highest decision makers in the firm." It is in this light that Mizruchi (1983, p. 433) pronounced the board of directors to be "the ultimate center of control" in a publicly held organization. With the creation of a board, a division of labor emerges in the management and control of organizational decision making. The managers initiate and implement their decisions, while the board members ratify them and, in general, monitor the conduct of the firm's top managers (Fama & Jensen, 1983a, 1983b). A framework specifying the complexity and difficulty of their monitoring activities and the board actions that can follow from them will be developed in this section.

Boards of directors are becoming increasingly sensitive to their firms' performance in the stock market. Undervalued or poorly performing companies are now subject to intense scrutiny. The board needs to determine the origin of this suboptimal organizational performance, however, before it can act to redress the problems. As Wong and Weiner (1981) found, the very first question that must be answered when people ask such "why" questions about performance is whether or not the cause of the problem lies in the person or the situation. (At this point, we are implicitly assuming that suboptimal performance is directly related to the actions of management. An equally plausible perspective is to examine the actions taken by the board of directors. The board of directors' decisions and actions may also compromise firm performance. This alternative has received little attention in the literature, and thus represents an important topic for future research. We will return to this issue later in the paper.)

Unfortunately, by asking this question, the board discovers one of the central debates in organization theory. As Astley and Van de Ven (1983) observed, administrative scientists have spent years trying to determine the extent to which strategic choice (person) or environmental determinism (situation) shape organizational performance. Although some would argue that managers control their firms' destinies (Andrews, 1980), others point to the primacy of environmental forces (Hannan & Freeman, 1977). The current view is that both forces are operative; the magnitude of the effects is thought to vary by the particular nature of the situation (Hambrick & Finkelstein, 1987; Hrebiniak & Joyce, 1985). This leaves the board with the unenviable task of determining such an attribution of responsibility, a problem that has stymied a generation of scholars. In fairness, the board should strive not to penalize managers for outcomes truly outside of their control (Eisenhardt, 1985). As a consequence, the board must conduct both managerial and environmental assessments.

Managerial Assessment

Attribution theorists have argued that both the person's ability level and the amount of effort that was expended need to be assessed when determining a person's role in the success or failure of an achievement-related event (Weiner et al., 1972). As a consequence, the board of directors needs to assess both the ability and efforts of the top managers of their organization. As we will see, the results of this exercise hold distinct implications for the kinds of action the board might take to address a performance problem.

Management researchers have conducted literally thousands of studies in an attempt to isolate the skills and abilities necessary to lead an organization. Beatty, Schneier, and McEvoy (1987) reviewed much of this work. They found that six broad competencies must undergird any executive development effort. Thus, a board of directors might assess their top managers' abilities in the following areas: (a) product, firm, and industry knowledge; (b) emotional maturity; (c) entrepreneurial abilities; (d) intellectual abilities; (e) interpersonal abilities; and (f) leadership skills. The board might also consider how well their organization's succession planning system identifies such high calibre management talent (Friedman, 1986; Vancil, 1987).

After reviewing the abilities of its top managers, the board must then assess how the amount and quality of the management's efforts may have led to the present organizational situation. This is very difficult for a board to assess. The problem is one of asymmetry of information. The board simply has very little information about how the firm's managers behave. It is in this light that Baysinger and Hoskisson (1990) argued that it is the inside director's responsibility to provide the board with such information. Nevertheless, there are problems associated with receiving a subordinate's unbiased assessment of a CEO's leadership in his or her presence at a board meeting. Moreover, it is difficult to know how to judge these reports when they are supplied. After all, a top manager's job is complex and ambiguous (Kotter, 1982; Mintzberg, 1973). It is difficult to specify appropriate managerial behaviors after the fact, well enough before. The time lag between managerial effort and a project's outcome, and the potential irreversibility of previous managers' decisions further complicate the board's judgment.

Although it often works with unreliable and impressionistic data, the board must draw inferences about the ability and effort levels of top management when faced with suboptimal organizational performance. Figure 1 illustrates four conclusions that the board can arrive at after

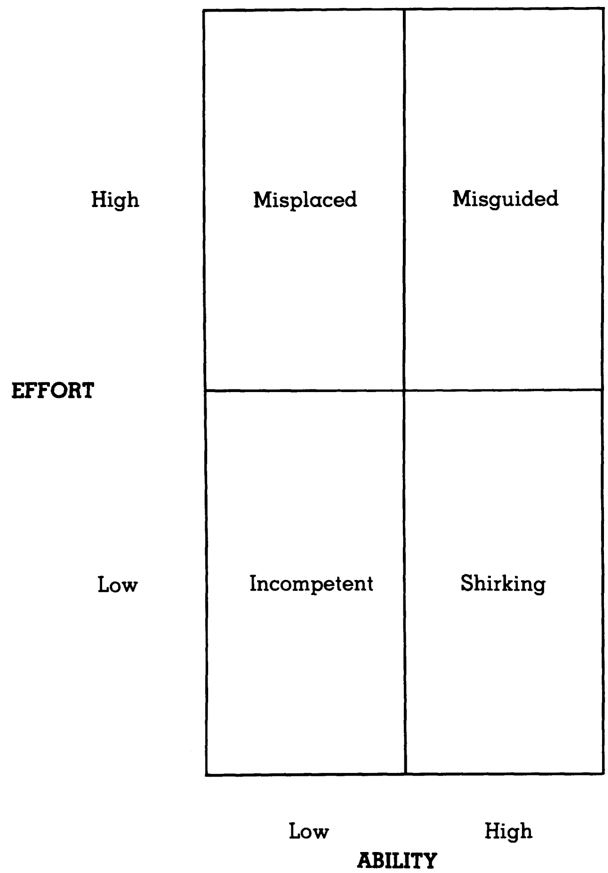

***Figure 1.* The board of directors' inferences about suboptimal top management performance.**

assessing its top managers. Perhaps the most common inference is that the high-ability managers just were not working hard enough; that is, they were shirking (Fama, 1980; Jensen & Meckling, 1976). Even though this may be a popular inference, Finkelstein and Hambrick (1988, p. 550) saw it as a "dubious" one in light of myriad pressures on an executive to perform well. Consequently, a CEO who works 65 hours per week may be accused of shirking for not working 80. The board also may conclude that hardworking, high-quality managers were simply misguided: They made a wrong decision at some point. It may even discover that the top managers have low ability. Such managers might be declared incompetent for not working very hard or misplaced if they are struggling to perform in a job that stretches their abilities too thin. As we will see, each inference carries with it a set of remedial actions.

Environmental Assessment

The board also needs to conduct an assessment of the environmental effects on organizational performance before taking any action regarding the management team. In Hrebiniak and Joyce's (1985) terms, they need to determine the magnitude of the environmental constraints facing the firm. Generally speaking, the most constraining environment is a perfectly competitive market. The least constraining is an environment with significant barriers to entry that are unlikely to fall with the passage of time. The board also might have a difficult time holding the manager responsible for poor organizational performance if its firm's product is a commodity sold in a low-growth market marked by stable demand. Moreover, if the firm operates in an oligopolistic market with quasi-legal constraints (i.e., regulation), the executive's discretion is even more limited (Hambrick & Finkelstein, 1987).

One alternative to conducting a direct investigation of environmental constraints is to compare the company's stock returns to other competitors' returns. Although this might appear to be a simple task, Lubatkin and Shrieves (1986) identified a number of factors that should be considered when attempting to compare returns across a sample of companies (e.g., establishing the referent companies, choosing the appropriate time frame and sampling frame, and controlling for spurious effects). Just as the assessment of executive ability and effort was a relatively subjective endeavor, so too is the assessment of environmental constraints. Nevertheless, the board must continuously monitor both, determine the responsibility for suboptimal performance, and take appropriate action.

In summary, then, our discussion of ability, effort, and environmental assessments portrays the difficulty of disentangling the effects of person and situation. This is the key problem to be overcome in the optimal construction of an internal corporate control mechanism.

The Attribution Decision

A number of factors conspire to place the manager at risk in this attribution decision process. Assuming that a board is independent, it is likely to attribute poor organizational performance to the manager for several reasons. First, the directors may reason that it is the manager's job to guide the firm to success in any environment, no matter how constraining or competitive. Second, the board itself is often composed so as to facilitate coordination in an uncertain and challenging environment (Burt, 1980; Mizruchi & Stearns, 1988; Palmer, 1983; Pennings, 1980; Richardson, 1987; Schoorman, Bazerman, & Atkins, 1981). The directors may observe the uncertainty-reducing and coordination-enhancing interlocks present on the board and conclude that a hostile environment has already been tamed. Third, the directors have the ability to make changes in the management team, even though altering a constraining environment, by definition, is very difficult. In essence, the managers may become scapegoats (Gamson & Scotch, 1964). Fourth, if the executive is not well connected in the nexus of interfirm social and business contacts (i.e., Useem's, 1984, notion of the *inner circle*), he or she may be dismissed with minimal damage to the corporation's reputation. Therefore, the board may focus on its managers simply because it can. It may make changes for symbolic reasons if nothing else (Pfeffer, 1981). Finally, if the organization's performance is particularly poor, the board members may invoke a defensive attribution (Burger, 1981) and hold the managers responsible for the firm's failures. Early on, Walster (1966, p. 74) argued that "as the magnitude of misfortune increases . . . it becomes more and more unpleasant to acknowledge that 'this is the kind of thing that could happen to anyone.' Such an admission implies a catastrophe of similar magnitude could happen to *you*." Since most board members are business executives, they are unlikely to acknowledge that an uncontrollable misfortune could happen to them. As such, they should be quick to attribute responsibility for poor organizational performance to the shortcomings of the management team. The following section describes the board's available control options when it considers how to motivate and discipline its managers.

Internal Control Options

The board of directors has two broad classes of internal control options available to it. It can either alter the incentives of its managerial team or it can dismiss them. The choice follows directly from the attributions of responsibility represented in Figure 1. Regardless of the managers' effort level, if the board determines that its executives have high ability, it is likely to adjust their incentive structure. On the other hand, if the board concludes that its executives have low ability, turnover becomes the favored option. The ability attribution is key because ability reflects a relatively stable contribution to performance (Weiner et al., 1972). Effort levels are much more amenable to change than ability. In fact, in an agency theory framework individuals are thought to respond directly to altered incentives. As a consequence, high-ability people are likely to have their incentive structures changed to increase or redirect their efforts; low-ability people are likely to be dismissed.

All things being equal, it is probable that the board will adjust a manager's incentives before dismissing him or her. Most fundamentally, by monitoring a manager's response to an altered incentive plan, the board creates an opportunity to assess his or her ability. Such action should clarify any lingering questions about the person's capabilities. Moreover, the board, no doubt, conducted a rigorous selection process to find the current manager. If for no other reason than to justify this selection process (Staw & Ross, 1987), the board is unlikely to pronounce its choice as "incompetent" or "misplaced." Consequently, the turnover option is likely to be invoked only after the executive has had a chance to respond to an altered compensation package. Of course, this presumes some degree of rational behavior on the part of the board. If a board chooses to make the manager a scapegoat (no matter how qualified or rigorous the selection process), these compensation adjustments would not be considered. The following sections detail the strengths and shortcomings of these two options.

Adjusting Incentive Contracts. The logic of Figure 1 suggests that two objectives might underlie the adjustment of incentive contracts. For managers who have been perceived by the board as shirking, the objective is to get them to work harder. This objective might be accomplished by increasing the magnitude of compensation or by tying compensation more directly to various performance measures. For managers who have been perceived as misguided, on the other hand, the objective is to get them to work smarter. To do so the board must examine a pay-for-performance program to determine if the performance benchmark has been improperly specified. Suboptimal performance in this instance may not be the manager's fault but rather the board's responsibility for not specifying the appropriate performance (Crystal & Hurwich, 1986). Such a view leads directly to the importance of answering the following questions: Does management respond inappropriately to correct incentives, or are the incentives themselves structured inappropriately? Clearly, this distinction holds important implications for the kinds of remedial action that can be taken regarding executives' compensation plans.

The subject of executive compensation has become increasingly controversial (Baker, Jensen, & Murphy, 1988; Finkelstein & Hambrick, 1988; Hoskisson, Hitt, Turk, & Tyler, 1989; Ungson & Steers, 1984, 1988). Critics question the size of the remuneration (both in absolute terms and relative to other employees in the company) and its equivocal link to organizational performance (Patton, 1985). Others marshal impressive evidence to argue that managers are worth every nickel they get (Murphy, 1986). Unquestioned is the desirability of linking pay to performance (Brickley, Bhagat, & Lease, 1985), although it is very difficult to specify the type of performance desired (Hurwich & Furmiss, 1985). We do know, however, that it has been argued that fixed salaries increase a manager's incentive to consume excessive perquisites on the job, reduce the firm's risk to suboptimal levels, and obstruct takeover attempts that would benefit shareholders (Hoskisson et al., 1989; Larcker, 1987; Walkling & Long, 1984).

Though the principle of tying pay to performance is sound, the empirical results of research investigating the efficacy of such plans have been mixed. Historically, Roberts (1959) and McGuire, Chiu, and Elbing (1962) found little relationship between the two, but later, Lewellen and Huntsman (1972) and Prasad (1974) did. More recently, sophisticated inquiries by Murphy (1985) and Coughlan and Schmidt (1985) concluded that such compensation plans are associated with increased shareholder wealth. Nevertheless, the debate continues. Kerr and Bettis (1987) found no such relationship. O'Reilly, Main, and Crystal (1988) found only a modest relationship. Interestingly, they found a strong relationship between CEO pay and the pay levels of the outside directors who set the compensation levels. In their study, compensation was determined more by the psychology of social comparison than by the economics of corporate performance.

As a control device, pay-for-performance plans have a number of weaknesses. First, bonus plans that link compensation to accounting rates of return are thought to be very susceptible to managerial manipulation (Healy, 1985; March, 1984). Managers might be tempted to employ some accounting legerdemain to ensure their bonus at shareholder expense. Second, even though linking compensation to strict market measures of performance obviates the problem of manipulation, it may err by tying rewards to a performance measure that is subject to too many forces beyond a manager's control. The motivational potential of rewards (no matter how large) diminishes if the goal they are tied to is viewed as impossible to achieve (Locke, Shaw, Saari, & Latham, 1981). Finally, the most fundamental limitation in employing an incentive plan to achieve control is that it only focuses on outcomes and, indeed, monetary outcomes. Pay-for-performance plans specify desired ends but say little about the appropriate means to achieve those ends (Eisenhardt, 1985). Although as was noted, it is very difficult before the fact to specify the appropriate job behaviors for top executives, we know that the capacity to perform a specific task is as much a part of motivation as making sure that an appropriate reward system is in place to reinforce such performance (Vroom, 1964). Moreover, the exclusive focus on monetary outcomes seems premised on a utility-maximizing model of human behavior that is at odds both with research about the managerial utility of financial incentives (Lawler, 1971) and research testifying to the validity of the theory of utility maximization (Kahneman & Tversky, 1979; March, 1978; Simon, 1978). Nevertheless, until such time that boards can specify a top manager's motivations and appropriate actions with the precision that would enable effective behavioral control, they must live with the imprecise outcome controls that yield the kinds of equivocal ties to performance that we have seen in the literature for the past 30 years (Ouchi, 1979). The only control the board has over the exercise of managerial effort and ability is a crude one. It may determine after the fact that the incumbent manager was unable to perform appropriately and, consequently, dismiss him or her. We will now review the board's options for control in this area.

Management Turnover. If incentive adjustments do not provide the desired performance improvement and the board has decided that its top managers are incompetent or misplaced (see Figure 1), then the directors have little option but to dismiss them. As James and Soref (1981, p. 16) noted in their discussion of company presidents, "dismissal is the ultimate sanction which conditions their behavior." There is some evidence that misplaced executives can be demoted or reassigned rather than fired (Mahajan & Lummer, 1988), but senior managers are typically dismissed in these circumstances. Two points are relatively clear about the workings of this internal control mechanism. First, top management turnover generally follows periods of poor organizational performance, and second, the ultimate utility of this action is by no means clear.

The performance/turnover finding is robust across a variety of operational measures of performance. Investigations of profitability using accounting-based measures of performance (Friedman & Singh, 1989; James & Soref, 1981; Osborn, Jauch, Martin, & Glueck, 1981; Salancik & Pfeffer, 1980), investigations employing stock market measures of performance (Bonnier & Bruner, 1989; Coughlan & Schmidt, 1985; Warner, Watts, & Wruck, 1988; Weisbach, 1988), and investigations employing both measures (Dalton & Kesner, 1985) all concluded that poor firm performance predicts executive turnover. Even studies of firms slipping into bankruptcy find that boards dismiss their top managers in an attempt to correct this slide (Gilson, 1989; Schwartz & Menon, 1985). Morck, Shleifer, and Vishny's (1988) research provided the strongest evidence in support of our attribution theory approach to the problem of internal corporate control. They found that a board will dismiss its top managers if its firm is performing poorly compared to other firms in the industry. If the entire industry is in trouble, however, the top managers are not fired for poor performance. With respect to our theory, the attribution to the person is straightforward in the first case. In the latter case, the board is faced with some compelling evidence of an environmental constraint; therefore, it does not act. We should note we are presuming that this management turnover following poor performance represents *involuntary* turnover. It is very difficult to disentangle voluntary from involuntary turnover at the highest level in an organization. Executive departures are typically choreographed to preserve the integrity of both the firm and the departing executive. In fact, Warner et al. (1988) examined the stated reasons in *The Wall Street Journal* for 230 of their top management turnover events. Only one person was reported to have been fired! James and Soref (1981), however, looked directly at firings and, indeed, found that drops in profitability predicted such dismissals.

We should emphasize that the magnitude of this performance/turnover relationship is not always strong. Both Osborn et al. (1981) and Warner et al. (1988) found weak relationships in their two different approaches to the measurement of performance. At least two factors may contribute to these weak effects. First, senior managers leave their positions for a variety of reasons besides poor performance (e.g., a better job opportunity, retirement, death). Consequently, we should not expect organizational performance to explain all of the variance in turnover. Second, even if the company is performing poorly, Fredrickson, Hambrick, and Baumrin (1988) noted that a tight executive labor market might leave boards little option but to keep their ineffective executives. As a result, the efficiency of management turnover as an internal control mechanism is sometimes compromised.

A second broad point about the utility of this control mechanism is that turnover in itself will never improve organization performance: The successor's skills and abilities are needed to meet that objective. Indeed, Carroll (1984) found that firms have a particularly difficult time finding successors to their founders. Organizational death rates are at their peak at this moment in an organization's history. The board of directors' ability to identify and hire high-quality top management talent thus becomes a crucial aspect of internal control (Lubatkin, Chung, Rogers, & Owers, 1989; Pfeffer & Davis-Blake, 1986). The difficulties inherent in this task are apparent from the equivocal results of studies that attempted to assess the consequences of top management succession. Relying upon stock market assessments, Furtado and Rozeff (1987) and Weisbach (1988) both found a positive share price response to succession events; Reinganum (1985), Worrell, Davidson, Garrison, and Chandy, (1986), and Warner, Watts, and Wruck (1988), however, found no response; and Beatty and Zajac (1987) found a negative response. Friedman and Singh (1989) found all three types of stockholder reactions in their study. Interestingly, stockholder reaction was most positive when a board initiated a CEO succession event after a period of poor performance. Although the problems boards face in their attempts to monitor and control top management are evident in these equivocal research results, Friedman and Singh's (1989) results suggest that the board is capable of exercising control, albeit imperfect control.

In summary, the board of directors' task in monitoring and controlling the behavior of the firm's top managers is not an easy one. Under the best of circumstances, the attribution of responsibility for corporate performance is difficult to make (i.e., disentangling managerial and environmental origins of performance). Time pressures, unreliable data, and unsophisticated analytic approaches no doubt undermine the board's decision processes. Further, having decided that a manager is culpable and his or her behavior must be controlled, the board is limited to the use of relatively crude outcome control mechanisms (e.g., incentive adjustments and turnover). In short, internal control mechanisms are not fully efficient.

The board's monitoring and control effort is also costly, both for the directors and for the firm. Most directors are very busy people. Board membership is a part-time job for them. While they are compensated handsomely for their time, neither their incentive structure nor their time commitments allow them to devote their energies fully to these monitoring activities. Although the import and complexity of their task might demand such a commitment (Worthy & Neuschel, 1984), directors are usually forced to scale back their involvement. The organizational costs of large compensation packages (Loomis, 1982) and disruptive management succession events (Brady & Helmich, 1984) are evident to all. As a consequence, the board will monitor and control the behavior of top managers only to the point where the marginal cost of this activity equals the perceived marginal return on the organizational efficiency to be gained by it (Jensen & Smith, 1985). Interestingly, such behavior may leave the board members vulnerable to shareholder liability suits (Galen, 1989). These monitoring costs further compromise the efficiency of internal control mechanisms.

Our discussion so far has only considered the monitoring inefficiencies that result from the complexity of the task itself and the limitations of available control options. We have assumed that the managers conduct themselves in a relatively straightforward, task-oriented manner, that is, that their focus is on managing their firms, not on impressing the boards of directors. Clearly, this may be an unreasonable assumption. Managers may take steps to increase the costs of board monitoring and control even beyond the already high levels. Thus, the preceding discussion represented a "pure type" argument by assuming openness on the part of the manager and rationality on the part of the board. We will now add some realism to the discussion by considering how managers can work to entrench themselves in their firms. In this way, our argument parallels Hirsch, Michaels, and Friedman's (1987) discussion of the relationship between the clean models of economics and the more complicating perspective of sociology.

Internal Entrenchment Practices

Top managers are well aware of their precarious employment situations. Consistent with the evidence in the turnover literature, they know that they are at risk of being dismissed for suboptimal organizational performance, even if they did not contribute to the problem (or worse, even if they kept the problem from becoming as bad as it could have been). Valuing their position, many executives work to ensure their own job security. Toward that end, they have no choice but to tamper with the board's ability to monitor and control their performance. Indeed, a great many authors have questioned the (too) close ties that often emerge between top managers and boards of directors (Fredrickson et al., 1988; Herman, 1981; Kimberly & Zajac, 1988; Mace, 1971; Pfeffer, 1972; Vance, 1983). The framework presented in Figure 1 provides a new perspective on management-board relations. Our discussion of the challenges that face the board in the attribution of responsibility for suboptimal firm performance suggests four broad classes of managerial entrenchment practices. Each serves to reduce the efficiency of the internal corporate control mechanisms.

Alter Person Assessments. As indicated in Figure 1, the only relatively "safe" inference (from the point of view of the manager) that can be drawn about a manager is that he or she was misguided. In this instance, the board may take responsibility for the performance problems or, more likely, it will be willing to entertain notions of environmental determinism. Accordingly, managers may strive to make sure that the board sees them as high-effort/high-ability people. Two broad approaches are possible. First, managers can strive to demonstrate and promote their positive qualities. By employing institutionally "correct" strategy-making procedures (Meyer & Rowan, 1977) that are affirmed by a team of consultants and attested to by the inside board members, top managers may influence the board to believe that they followed correct decision-making procedures and, hence, should not be subject to disciplinary action. As March (1984, p. 58) observed, "If one can claim to have done the things a good manager should do, bad outcomes can be seen as irrelevant to evaluation."

Alternatively, the manager may hide or obscure his or her negative attributes. By controlling the board's agenda (Alderfer, 1986) or holding infrequent, ceremonial meetings, the manager may avoid scrutiny by the board. Coughlan and Schmidt (1985, p. 45) observed, for example, that "managers may withhold some relevant information from compensation committees when that information would attribute poor firm performance to bad management."

Managers also may try to set a norm whereby it would be inappropriate to ask challenging questions. In his classic study, Mace (1971, p. 80) found that "those members of the board who elected to challenge the presidents' powers of control were advised . . . that such conduct was inappropriate or they were asked to resign." Mueller (1979), another keen observer of board members' behavior, concluded that boards develop a "concinnity bias." That is, "many boards tend to develop a clubbable, if elusive, characteristic of organizations which place internal harmony and fitness before such attributes as objectivity and independent judgment" (p. 106). Top managers in such companies can expect to avoid scrutiny and the discipline it engenders.

If by chance a manager is being blamed for poor performance, he or she can employ a counterdefensive attribution (Bradley, 1978) and work to foster an "illusion of control." Salancik and Meindl (1984) found that when top executives take responsibility for a failure, acknowledge that they now know how and why they failed, and present a turnaround strategy, they often get a chance to correct past misfortunes. In this instance, the manager is able to deflect the disciplinary action that typically follows a person attribution.

These approaches either work to ensure that the board does not attribute poor organizational performance to the manager (promoting positive qualities, obscuring negative attributes) or act on this attribution (creating illusions of control). A companion approach is to ensure that the board recognizes the primacy of environmental determinism.

Alter Situation Assessments. As we noted, the board may tend to ignore the potent role that the firm's environment can play in determining performance. A manager, intent on entrenchment, will consistently point out the environmental influences that shape his or her firm's performance. Although self-serving, this attribution strategy does have a basis in fact (Lieberson & O'Connor, 1972; Salancik & Pfeffer, 1977). Bettman and Weitz (1983) and Staw, McKechnie, and Puffer (1983) both found that top managers routinely employ this line of reasoning. If the board accepts it, the manager will prevail through periods of organizational decline.

Alter Performance Assessments. In his investigation of the origins of causal reasoning, Hastie (1984) found that unexpected events trigger the causal attribution process. Following these results, managers can entrench themselves by ensuring that the board does not monitor them too closely. One way to do this is to work to define low organizational performance expectations. By setting mediocre performance expectations, the board should not be surprised to discover that these modest objectives were met. In such circumstances, the manager would have succeeded in shutting down the causal attribution process.

Top managers also may entrench themselves by working to redefine the appropriate organizational performance metric. In fact, there has been a strident academic debate about this very issue (Jensen, 1984, pp. 110–111). A manager of a company in financial distress could be expected to articulate a multiple constituencies (Connolly, Conlon, & Deutsch, 1980) or stakeholder (Freeman, 1984) model of organizational effectiveness; that is, he or she might argue that although the company has not benefitted the shareholders recently, the firm's employees and community are thriving. Again, if successful, the manager would have redefined the nature of corporate performance to his or her advantage.

Neutralize Internal Control Mechanisms. The previous three entrenchment strategies focus on compromising the board's ability to attribute responsibility for poor performance to the top manager. Having eluded the board's monitoring, the manager thereby escapes the board's control. A complementary entrenchment strategy is to neutralize the control mechanisms themselves. Both the incentive and turnover controls can be rendered impotent.

The key to neutralizing the incentive controls is to avoid pay-for-performance plans that tie company performance to the stock market. As we noted above, fixed salaries are the most vulnerable to managerial abuse. If a manager, set on entrenchment, can co-opt a board of directors in the way Mace (1971) described, the first action he or she might take is to engineer a large fixed salary for himself or herself. If such an action fails, a bonus system tied to accounting-based performance measures still allows the manager some degree of discretion (Healy, 1985).

Shleifer and Vishny (1988) discussed how to neutralize the turnover control mechanism. They argued that entrenched managers strive to raise their value to shareholders relative to other managers in the labor market. In essence, entrenched managers become nonsubstitutable. They do this by embarking on a corporate strategy that capitalizes on their own unique skills and abilities, by establishing implicit contracts with employees and suppliers that are bonded only by their word and reputation, and by designing their organizational control systems in such a way that they are the dominant integration mechanism in a finely differentiated structure. All we would add to this list is the recent practice of top managers working to link their personas with their companies in the public eye. Lee Iacocca, Ted Turner, and Bill Marriott, for example, are all top managers of publicly held corporations. Many people drive Chrysler automobiles to Marriott Hotels and watch the Cable News Network because they trust these three men to deliver a quality product. The boards of directors of their firms will think twice before firing these men.

Addressing Internal Control Mechanism Inefficiencies

We have seen that the efficiency of board monitoring and control can be compromised by the difficulty of the task itself, the directors' motivations to perform their duties, suboptimal outcome-oriented control mechanisms, and a variety of managerial entrenchment practices. Some of these inefficiencies are intractable, whereas others may be addressed. Two remedial approaches have been considered in the literature. One focuses on the composition of the board and the other examines various firm ownership arrangements. Each has its limitations.

The typical prescription has been to argue for more independent outside representation on boards of directors (Eisenberg, 1976). Some evidence suggests that the presence of such people can improve corporate governance. Baysinger and Butler (1989), for example, discovered a lagged relationship between the proportion of outside directors and an accounting-based measure of firm performance. Kosnik (1987) found that independent boards resisted paying greenmail to corporate raiders. Indeed, boards themselves seem to recognize the importance of independent outsiders. Hermalin and Weisbach (1988) found that inside directors are likely to leave a board and outside directors are likely to join it after a period of poor firm performance. Similarly, Mizruchi and Stearns (1988) found that representatives of financial institutions are added to boards after a period of declining profitability and increasing insolvency. And, finally, in a study of CEO turnover, Weisbach (1988) found a much stronger association between poor stock price performance and turnover in companies with outsider-dominated boards than in companies with insider-dominated boards. Kesner, Victor, and Lamont (1986), however, provided evidence that the proportion of insider/outsider board composition was unrelated to the commission of illegal corporate acts. This last result would not surprise Brudney (1982). In his review of the utility of outside directors, the noted legal scholar concluded that "the ambiguity of the standards of fairness, the difficulty in ascertaining and weighing the relevant facts, the psychological and social pressures on independent directors, and the limited incentives and weak sanctions available suggest that to elicit disapproval from outside directors would take a transaction so grossly overreaching as not often to be proposed by management" (p. 616). The simple presence of outsiders on a board, then, may not guarantee effective monitoring.

Second, there has been an increasing amount of theory and research on the control implications of diffuse and concentrated equity ownership structures. The basic idea is that concentrated ownership is thought to bring with it an incentive to closely monitor managers. Shleifer and Vishny (1986) argued that only large shareholders have the economic justification to monitor management. Indeed, the Council on Institutional Investors was created by an activist group of large shareholders with this purpose in mind (Oviatt, 1988).

We are just beginning to see research that tests the veracity of this idea about concentrated ownership. Holderness and Sheehan (1988) analyzed the performance of large firms with majority shareholders (i.e., ownership percentage greater than 50 percent but less than 100 percent). They also compared the performance of their sample against that of a control group of diffusely held firms (i.e., largest shareholder holds less than 5 percent ownership). Their results revealed that large shareholders usually were directly involved in firm management rather than serving a purely monitoring role. Two compensation studies corroborated this finding about large shareholder activism. Gomez-Meija, Tosi, and Hinkin (1987) found that pay-for-performance relationships were much stronger in companies with concentrated, as opposed to diffused, ownership profiles. Moreover, a survey of chief compensation officers revealed that monitoring and incentive alignment were perceived to be more effective in concentrated rather than dispersely owned firms (Tosi & Gomez-Meija, 1989). Holderness and Sheehan (1988) also found that large shareholders did not expropriate wealth for themselves. Their surprising result, however, was that the performance characteristics of the majority-held and diffusely owned firms were similar. All things being equal, the increased vigilance associated with concentrated ownership does not seem to improve firm performance. A related line of reasoning, however, suggests that management ownership in the firm should decrease agency costs.

The problem of agency was initially thought to disappear when a manager was made an owner. A management ownership stake was thought to align the potentially divergent interests of outside shareholders and management (Jensen & Meckling, 1976). More recently, however, some theorists have argued that increasing managerial ownership stakes may not increase aggregate shareholder wealth. Fama and Jensen (1983a, 1983b), for example, argued that managers could increase their ownership percentage to a degree that allows them to dominate the board of directors, thereby insulating their interests from any attempts at internal or external control. This, in turn, allows the majority stakeholders to use their voting power to expropriate or consume substantial amounts of corporate wealth. In a related article, Stulz (1989) suggested that large management ownership stakes make it easier for managers to keep their jobs, or entrench themselves (see also Shleifer & Vishny, 1988). These theorists, then, suggest that increased ownership concentration by management leads to a direct reduction in firm value. An empirical test of these conflicting ideas provides support for both of these divergent perspectives. Morck, Shleifer, and Vishny (1988) discovered that managerial ownership and firm performance are not monotonically related. They found that firm performance actually increases as insider ownership increased up to 5 percent, and then again above 25 percent. Firm performance, however, decreased when managerial ownership was in the 5 to 25 percent range. They suggested that the self-serving benefits of management entrenchment in this range of ownership exceed the firm performance incentive effects created by the managers' larger equity stake.

In summary, there does not yet seem to be consensus support (either theoretically or empirically) for the conventional wisdom that either an increased presence of outsiders on the board of directors or the increased ownership stakes by any shareholder group (including management) necessarily improve corporate performance by reducing the agency costs of the management-shareholder conflict. This analysis suggests, then, that every organization is at risk from abuse by top managers intent on self-aggrandizement at shareholder expense. As we have seen, the adjustment of incentive contracts to bond a manager's welfare to a firm's welfare can be an effective disciplinary device, as can be turnover when a competent successor is found to assume a leadership role. We have also seen that managers set on entrenchment can find a variety of ways to escape these internal controls. The costs of internal monitoring and control can become so high that no effective managerial control exists. In such cases, the value of the company would diminish accordingly. The probability of bankruptcy and firm failure becomes very high. Fortunately, external control mechanisms exist to check this downward spiral. Thus, one basic tenet of this article is that the failure of the internal control mechanism triggers the activation of the external control mechanism.

External Control Mechanisms

The market for corporate control serves as a discipline of last resort (Fama, 1980). It should operate when internal control efforts have failed. In keeping with Berle and Means (1932), the theory of the market for corporate control was suggested by Manne (1965) and then refined in a series of articles by Jensen and Meckling (1976), Fama (1980), and Fama and Jensen (1983a, 1983b). According to this theory, as top managers engage in self-interested behavior, their company's performance is likely to increasingly diverge from its maximum potential. This underperformance is reflected in the value of the company's stock. Under such circumstances, other management teams are likely to offer themselves to the shareholders as alternatives to the incumbent management. The "market for corporate control," then, is the competition among these management teams for the rights to manage corporate resources. As Lowenstein (1983, p. 272) noted, the acquiring company's expected gain resides "almost entirely in the expectation that [it] will be able to root out deadwood inefficiencies and put a target's assets to better use." Thus, the market for corporate control provides an external control mechanism whereby the shareholders' interests can be served in the event of the breakdown of the internal control mechanism.

The Market for Corporate Control: Empirical Evidence

Three types of studies have been conducted to determine the efficiency of this external control mechanism. At the broadest level, investigators have tried to determine if the market for corporate control serves to create shareholder wealth. Others have tried to determine the efficiency of the market for corporate control by assessing the theoretical factors that might actually explain the sources of the documented wealth gains. Finally, some investigators are beginning to conduct direct tests of the external control market's ability to redress internal control market inefficiencies. Each set of studies will be reviewed.

Wealth Effects. A large number of event studies have been conducted that examine the returns to both the acquiring and acquired firms' shareholders following a merger or acquisition announcement (see Halpern, 1983; Jarrell, Brickley, & Netter, 1988; Jensen & Ruback, 1983; Roll, 1987, for reviews). A consistent pattern emerges from all of these studies. Acquired company shareholders earn sizable premiums following a merger or acquisition announcement, while the announcement has an equivocal impact on the acquiring company shareholders' wealth. Jarrell et al. (1988) cited evidence that suggests target company shareholders earned premiums of 19 percent in the 1960s, 35 percent in the 1970s, and 30 percent between 1980 and 1985. On the other hand, acquiring company shareholders earned slightly more than a 4 percent return in the 1960s and a 1 percent return in the 1970s. In the 1980s, however, bidding companies lost slightly more than 1 percent. We should point out, however, that many of the existing empirical studies disagree on the issue of whether acquiring firm shareholders gain or lose in these transactions, especially in the case of mergers (Asquith, 1983; Dodd, 1980; Jarrell & Poulsen, 1987). Consequently, researchers are attempting to identify and correct the various measurement problems that have complicated the process of estimating a bidding firm's return (Dennis & McConnell, 1986; Malatesta, 1983; Schipper & Thompson, 1983). Finally, unsuccessful tender offers and merger bids provide further insights about shareholder welfare in these transactions. The positive abnormal returns that accrue to the target company during the contest period are completely dissipated upon termination of the transaction if no further bidders emerge (Asquith, 1983; Bradley, Desai, & Kim, 1984; Dodd, 1980). This result suggests that the economic benefits of corporate control can be achieved only when the contested resources are transferred to the bidding firm's management.

In sum, these investigations revealed that large gains accrue to the acquired company shareholders following an acquisition announcement. This gain, however, is not offset by a loss of similar magnitude to the acquiring company's shareholders, although they seem to realize fewer gains. No shareholder apparently loses (or loses much) by this activity. On balance, the shareholder wealth results are interpreted as evidence that takeovers are beneficial to the economy (Jensen, 1988a, 1988b).

Sources of Takeover Gains. A number of seemingly plausible theories have been put forth to explain the size and allocation of gains generated by the workings of the takeover market. Jensen and Ruback (1983), Jarrell, Brickley, and Netter (1988), Ravenscraft (1987), and Roll (1987) provided succinct summaries of these theories and their empirical evidence. The following sources of gains might arise in these organizational combinations:

Synergies

Tax savings

Wealth transfers (from bondholders and labor)

Hubris

Elimination of inefficient management

The evidence about the first four sources is either nonexistent, inconclusive, or nonsupportive of the proposition.

Briefly, the evidence regarding synergy as a source of gain is inconclusive. Using accounting-based measures of firm performance, Rumelt (1974) and Bettis (1981) found that related diversification strategies outperformed unrelated ones. More recently, however, researchers employing market-based measures of performance found equivocal results. Some found that related mergers created more shareholder value than unrelated mergers (Shelton, 1988; Singh & Montgomery, 1987), whereas others found unrelated mergers to perform at least as well (Chatterjee, 1986; Eckbo, 1983; Elgers & Clark, 1980; Lubatkin, 1987; Stillman, 1983).

The available evidence seems to indicate that tax savings do not represent a significant motivation for acquisition activity (Auerbach & Reishus, 1988). Ravenscraft (1987) and Gilson, Scholes, and Wolfson (1988) concluded that any tax advantage that may be obtained in a corporate control contest often can be obtained elsewhere. Tax considerations seem to primarily affect the timing and structure of the deal.

The expropriation of wealth from bondholders and labor has often been argued to fuel the magnitude of the shareholder wealth effects generated by takeover activity. The available evidence does not seem to support these two motives. Although bondholders do suffer periodic losses in these transactions, the overall magnitude is not sufficiently large to explain the size of the shareholder gains (Asquith & Kim, 1982; Dennis & McConnell, 1986). Shleifer and Summers (1988) made the strongest case that breaches of labor contracts and employee dismissals pay for the gains. Studies of plant closings and job loss associated with takeovers, however, found little association between them (Blackwell, Marr, & Spivey, 1989; Brown & Medoff, 1988; Yago & Stevenson, 1986). Yago and Stevenson (1986), for example, reviewed the mergers and acquisitions activity in New Jersey and New York from 1978 to 1985. They found that less than 2 percent of the total job loss in New Jersey in that period could be traced in any way to acquisition activity. They also found, for 1,083 plant closings and 370 plant contractions in New York, "no statistically significant association between closing events and M&A activity" (p. 17). In a study of Michigan's unemployment insurance records from 1978 to 1984, Brown and Medoff (1988) found that there were only small (and occasionally positive) changes in wages and employment following acquisitions.

Roll's (1986) hubris hypothesis is based on the notion that corporate managers overestimate their abilities to enhance the value of target companies and, hence, overpay to acquire them. Even though this hypothesis questions an acquiring management team's ability to combat a target company's inefficient internal control mechanism, no formal test of the hypothesis has yet been reported.

As we will see, there have been a few very recent attempts to directly assess the elimination of inefficient management hypothesis. Nevertheless, absent any direct support, this hypothesis has enjoyed wide currency in the academic community (Varian, 1988). The presence of the demonstrated shareholder wealth effects, an elegant theory of the market for corporate control, and a lack of compelling support for any of the rival hypotheses seem to satisfy many. We would agree with Ravenscraft (1987, p. 21), however, when he concluded that a theoretical "elimination process is not the most persuasive approach [to hypothesis testing]."

Direct Tests of the Inefficient Management Hypothesis. Manne (1965, p. 120) argued that a "possible approach to proof in this area is to determine if actual changes in the management personnel ultimately follow the merger." Walsh (1988, 1989) documented that top management turnover following mergers and acquisitions is significantly higher than "normal" turnover (absent any merger or acquisition activity). Without measures of preacquisition company performance, however, we cannot determine if this turnover represents an amelioration of internal control inefficiencies or some other antecedent.

Martin and McConnell (1989) found that companies with higher levels of postacquisition turnover of senior management exhibited poorer preacquisition performance. The results of their study are consistent with the hypothesis that successful changes in corporate control are followed by changes in the composition of the top management team. However, their study is limited because they did not examine the performance-turnover relationships for the acquiring companies, nor for a matched set of control companies. Moreover, they assumed that all management turnover was involuntary and driven by disciplinary motives.

Walsh and Ellwood (1989) examined the relationship between a company's performance history and its subsequent top management turnover for a sample of target companies, their acquirers, and a control group of companies not involved in merger and acquisition activity. Their results revealed that although top management turnover can be explained by prior company performance levels in both the parent and control companies, the predicted relationship between previous target company performance and its subsequent top management turnover rate was nonexistent. However, they did find relationships between turnover and the acquiring company's performance history. They concluded that much of the early postacquisition turnover may be voluntary. Talented top managers who do not wish to be a part of a poorly performing company, and those who have employment opportunities elsewhere, may depart. A limitation of their study, however, is that their sample included both mergers and tender offers. A better test might be to examine only a sample composed of hostile tender offers.

The dismissal of an acquired company's top management is only one of the control options available to an acquiring management group. To date, no one has investigated the use of revised incentive contracts as a less drastic approach to correcting control inefficiencies. Based on our analysis of the internal control mechanism, we might expect turnover to occur if the managers are completely entrenched; however, in less extreme circumstances, a more incremental incentive-based approach might be warranted. Quite obviously, this is an important area for research. Similar to the internal control process, the external control process does not operate in an entirely straightforward manner. The next section articulates a number of entrenchment practices that managers might engage in to compromise the efficiency of the external corporate control mechanism.

External Entrenchment Practices

The evolution of an active market for corporate control has been accompanied by an increase in the sophistication and variety of managerial defense tactics against hostile suitors. Managers may entrench themselves even beyond the level set by their internal entrenchment practices. They can attempt to subvert the external control mechanisms. For our purposes, we can distinguish between operating and nonoperating defensive measures of entrenchment. An operating measure would involve a decision in which management implements an actual change in corporate assets and/or financial structure. Any change in this category would have a direct impact on the company's balance sheet. For example, the target firm may implement its own acquisition or divestiture program in order to defend against a hostile takeover. A nonoperating measure would not necessarily involve a direct change in the firm's existing asset and/or financial structure, but would nevertheless affect the probability of a successful takeover attempt. For example, management might take actions to change the legal environment or the rules of the voting process.

A second important distinguishing characteristic of managerial defensive tactics is to determine if the measures require shareholder approval or not (Jarrell et al., 1988). This distinction is important because it provides additional insights about the actions of target management in an environment that poses an obvious conflict of interest. Theoretically, defensive actions taken by management that do not require shareholder approval may be particularly damaging to shareholder interests. Figure 2 presents examples of common defensive measures that fall into these categories. As illustrated, target management can choose from among a wide variety of defensive tactics.

Each of these practices has the potential to thwart a takeover bid. A number of empirical investigations have been conducted to determine if their implementation negatively affects shareholder wealth. If the capital market recognizes these entrenchment practices as protecting the self-serving interests of management,

	Operating	**Nonoperating**
Shareholder Approval Required	**1** 1. Dual-Class recapitalization 2. Certain acquisitions and divestitures (e.g., Pac-Man defense)	**3** 1. Supermajority amendments 2. Fair price amendments 3. Changes in state of incorporation 4. Reduction in cumulative voting rights
No Shareholder Approval Required	**2** 1. Targeted large block share repurchase (greenmail) 2. Poison pills 3. New security issuance placement 4. Certain acquisitions and divestitures (e.g., spin-offs, sell-offs)	**4** 1. Litigation by target management 2. Standstill agreements 3. State antitakeover amendments 4. Golden parachutes

Figure 2. **External entrenchment practices.**

we would expect the firm's value to be diminished. In general, the evidence seems to suggest that negative shareholder returns are associated with managerial actions intended to eliminate a takeover bid or cause a takeover failure (Jensen & Ruback, 1983). Furthermore, the statistical evidence seems to indicate that shareholders are usually harmed more by operating than by nonoperating defensive measures. Perhaps this is due to the latter's being likely to be less costly to reverse if circumstances warrant. We should also note that certain company-specific characteristics influence the point at which these classifications become operative. Bond covenants, corporate charter, and state incorporation laws may affect their implementation. The following provides a brief review of the empirical evidence advanced in support of these conclusions.

Cell 1. In a dual-class recapitalization, corporate management creates a new class of common stock with limited voting rights, which is then exchanged for a certain number of old common shares. DeAngelo and DeAngelo (1985) found that one common effect of these transactions is to significantly increase management ownership concentration in the superior-vote class of stock. Such moves can cripple external control efforts and negatively affect stock prices (Jarrell & Poulsen, 1988; Partch, 1987), especially since the New York Stock Exchange relaxed its listing restrictions on limited-voting shares.

Dann and DeAngelo (1988) studied the wealth effects of defensive changes in asset and ownership structure (e.g., private block placement of securities, self-tender share repurchases). Their evidence showed that actual implementation of these defensive restructurings makes the acquisition of the target by the hostile bidder virtually impossible. In our view, this represents the most extreme form of entrenchment. It is no surprise to discover that target shareholders experienced significant wealth losses at the announcement of such defensive restructurings (Dann & DeAngelo, 1988).

Cell 2. Managers also can defend themselves against external control by repurchasing large blocks of shares from potential acquirers without shareholder approval. Investigations by Dann and DeAngelo (1983) and Bradley and Wakeman (1983) found that such greenmail payments were associated with significantly negative abnormal stock returns for shareholders of the repurchasing firm. In contrast to the evidence regarding nonexclusionary share repurchases (Dann, 1981; Vermaelen, 1981), this form of exclusionary share repurchase reduces the wealth of nonparticipating shareholders. Mikkelson and Ruback (1985), however, found that even though the greenmail transaction itself does harm shareholders, the net returns to shareholders resulting from the initial repurchase announcement (and extending over a longer time period to incorporate the effect of related events) are positive. This latter result led Jarrell et al. (1987) to conclude that it is not necessarily in the interest of shareholders to abolish greenmail payments. Although we know that the payment of greenmail will halt a particular takeover attempt, the effect of this action on shareholder wealth is equivocal.

Poison pills provide target shareholders with the rights to either purchase additional shares or sell shares to the bidder at prices substantially different from market value. Studies by Malatesta and Walking (1988) and Ryngaert (1988) support the hypothesis that a target's management utilizes poison pills to entrench themselves. Firms perceived as takeover targets experience statistically significant shareholder wealth reductions upon the announcement of a poison pill adoption, while share prices increased significantly if the firms abandoned plans to adopt a poison pill.

Dann and DeAngelo (1988) described the use of new security issues as a defensive mechanism. Target management can place securities privately in order to establish a friendly consolidated voting block of shares. This can be accomplished by issuing new securities to parties who are friendly to management, to management-allied employee stock ownership plans (ESOPs), or to the current incumbent management group itself. Alternatively, target management could publicly issue new equity claims in order to dilute the vote percentage held by a hostile bidder. In each case, the share price response to the announcement of the transaction is significantly negative.

Among the variety of defensive mechanisms available to corporate managers, spin-offs and sell-offs would seem to stand alone as transactions that create significant positive increments to shareholder wealth (Dann & DeAngelo, 1988). Thus, while these transactions are partially successful in protecting target management, they do so only at the expense of transferring control of some of their assets to a different management team. Conditional on a corporate control challenge, these restructuring transactions suggest that target management can respond appropriately in reducing their inefficient utilization of some assets (perhaps irrespective of their intentions).

(Corporate restructuring can be viewed in our framework as a rational response by an organization to the breakdown of its own internal control mechanisms. [Sometimes, of course, corporate restructuring can also be precipitated by the announcement of an external control contest.] Our framework suggests that corporate restructuring becomes necessary when the board is unable to construct a set of internal control mechanisms that efficiently optimizes firm performance. For example, consider a firm that consists of multiple, unrelated operating divisions. It is entirely possible that the distinct nature of these divisions precludes a common set of monitoring and incentives. In this case, separate governance structures could be more suitable for ensuring operational efficiency. In this environment, transactions such as an asset sale or a spin-off would facilitate the separation of, and changes in, the appropriate corporate governance structures. Indeed, our framework suggests that these transactions provide an important area for further investigation of optimal internal control mechanisms.)

Cell 3. Supermajority voting provisions increase the percentage of shareholder votes that must approve a transaction before a change in control can occur. These amendments generally supercede the minimum requirements set forth by state corporation laws. These provisions often contain waivers that facilitate friendly combinations. Jarrell and Poulsen (1987) found that significantly negative wealth effects were associated with the introduction of these amendments. Interestingly, these amendments were, on average, introduced in firms with relatively low institutional holdings and high insider ownership.

The fair price amendment is a specific type of supermajority amendment that has become very popular. This amendment applies to situations where bidders attempt to utilize nonuniform, two-tier takeover bids in order to acquire control of a target firm. Jarrell and Poulsen (1987) found a statistically insignificant share price response to the announcement of such amendments. In theory, a change in the state of incorporation can affect both the likelihood and the outcome of a corporate control contest. The state of incorporation imposes restrictions and limitations on stakeholder contractual obligations through its corporate statutes. Dodd and Leftwich (1980), however, found that there was no decline in stockholder wealth at times when a firm's state of incorporation was changed.

Cumulative voting allows stockholders to vote jointly on candidates for the board of directors, so that a shareholder can allocate all available votes for just one candidate. This differs from the usual corporate voting system, which is based on the simple majority system. Cumulative voting rights make it easier for minority groups of shareholders (e.g., management critics) to elect a board member to represent their interests. Bhagat and Brickley (1984) examined the share price reaction to management-sponsored amendments that either reduced or eliminated cumulative voting. They found that statistically negative wealth effects were associated with these amendments. This effect is consistent with the theory that the capital market recognized instances when managers seek to entrench themselves at shareholder expense.

Cell 4. Jarrell (1985) examined the impact of litigation against hostile bidders by target company management. These activities seem to produce two common results. First, litigation usually extends the time period of the control contest, and second, target firms usually end up being sold via auction (which normally produces additional shareholder premiums above the initial bid price). Thus, this evidence seems to support the view that litigation by target management improves shareholder wealth by enhancing management's negotiating position. In this case, managerial entrenchment motives may work to serve their shareholders' interests.

A standstill agreement generally limits a shareholder's ownership percentage to less than a controlling interest for a specific period of time. Often these agreements are executed in conjunction with targeted share repurchase programs. Dann and DeAngelo (1983) found a statistically significant negative share price reaction to the announcement of such agreements. They also found that the negative reaction is larger for firms that simultaneously executed standstill and repurchase agreements than for the firms that enacted standstill agreements alone. They interpreted their results as support for the managerial entrenchment hypothesis.

Jarrell et al. (1988) described the evidence on wealth effects of state antitakeover amendments. These laws are ostensibly adopted to protect state employment and tax revenues. However, they appear to harm shareholders because stock prices decline at the announcement of the passage of these laws.

Golden parachutes are a form of compensation that awards large termination payments to a target's management if they are dismissed in a successful corporate control contest. In contrast to the view that managers negotiate such incentive contracts out of an abiding sense of greed, Lambert and Larcker (1985) found that the adoption of golden parachutes is associated with a positive security market reaction. This suggests, then, that the capital market believes such contracts serve to align the diverse interests of shareholders and management in corporate control contests (i.e., financially secure executives will not obstruct an external control contest). In this light, the recent evidence that links outsider presence on a board of directors to the adoption of golden parachutes (Singh & Harianto, 1989; Wade, O'Reilly, & Chandratat, 1989) supports Eisenberg's (1976) argument for such outside representation.

In summary, each of these entrenchment practices may serve to decrease the efficiency of the external control mechanism to the point where the cost of a takeover is prohibitive. When successful, self-interested managers become immune to external control. Our review of the wealth effects of such practices indicated that, in general, the capital market is able to recognize management practices that are not in the shareholders' interest. Stock prices typically drop following their implementation. We found some irony in a few of these actions, however. On occasion, external entrenchment practices may actually lead to increased shareholder wealth. Management-initiated corporate restructurings (spin-offs and sell-offs) often serve to improve the functioning of the organization to the benefit of all, and antitakeover litigation by top management often precipitates a wealth-enhancing auction for the firm. The next section places our discussion of the external control mechanism, as well as the internal control mechanism, in the context of overall firm performance. We will continue with an examination of the theoretical links between both sets of mechanisms.

Research Implications

Throughout this article, we have examined a number of variations on a basic theme: How can the self-interests of professional managers be controlled in order to preserve the beneficial aspects of the separation of ownership and control? We have documented the existing evidence on the efficiency of two general categories of management control (i.e., internal and external mechanisms). In a well-functioning market, it should be less costly to implement control changes internally rather than through external corporate control contests. If this is true, we wonder why we observe so many corporate control contests. Our thesis here is that there are costly imperfections in the internal control market that can inhibit the efficient operation of these mechanisms (e.g., attribution problems created by observability problems and a variety of managerial entrenchment practices). If the costs are large enough, it becomes less costly to implement the necessary changes through the external control market.

Several research implications can be derived from our argument. In this section we will explicate the theoretical relationships between these internal and external control mechanisms. After examining a broad research agenda suggested by this view, we will identify a number of discrete studies that should be conducted. We will pay particular attention to developing a better understanding of internal and external managerial entrenchment practices. A consideration of board or management culpability in the breakdown of internal control and its relationship to external control contests also will be investigated. We will close with a look at corporate governance in the international arena.

Internal and External Control and Firm Performance

Ultimately, firm performance is crucially dependent on the efficient operation of internal and external corporate control mechanisms. Figure 3 illustrates the hypothesized relationships between the various internal and external corporate control mechanisms and firm performance. Two control cycles are posited. The internal control cycle captures the activities of a firm as its board of directors attempts to monitor and control the activities of its top managers, occasionally in the face of the various entrenchment practices identified previously. The external control cycle reflects the market for corporate control.

An internal control mechanism is designed to ensure optimal firm performance. Such performance is dependent upon the efficiency of that mechanism and the presence or absence of internal entrenchment practices. A well-entrenched management team can drive a firm to failure. The normal conduct of business affairs then is based upon a continuous cycle of a board's assessment of firm performance; its attributions of the cause of that performance; the implementation of various internal controls, occasional corporate restructurings, and, hopefully, improved firm performance. At this point, the entire cycle repeats itself. Internal entrenchment practices may or may not make the board's task even more difficult than it is.

If managers in a poorly performing firm anticipate an external control contest, they may engage in the kind of external entrenchment practices identified in Figure 2 that protect them and further harm shareholder value. Moreover, by preventing a takeover, such entrenched managers may also bring a firm to failure. The external control cycle represents the acquiring firm's control tasks. If a takeover deal is consummated, the new owners must pay the costs associated with the prior managers' external entrenchment practices, as well as the costs associated with imperfect internal controls and internal entrenchment practices. Once a deal is agreed upon, the "external firm" becomes an "internal firm." At that point, the internal control cycle begins anew. Of course, our model points out that another external control contest is always possible. In this way, the theory complements Hirsch's (1986) observation that takeovers are now a routine business practice. In our view, takeovers (and, indeed, even multiple

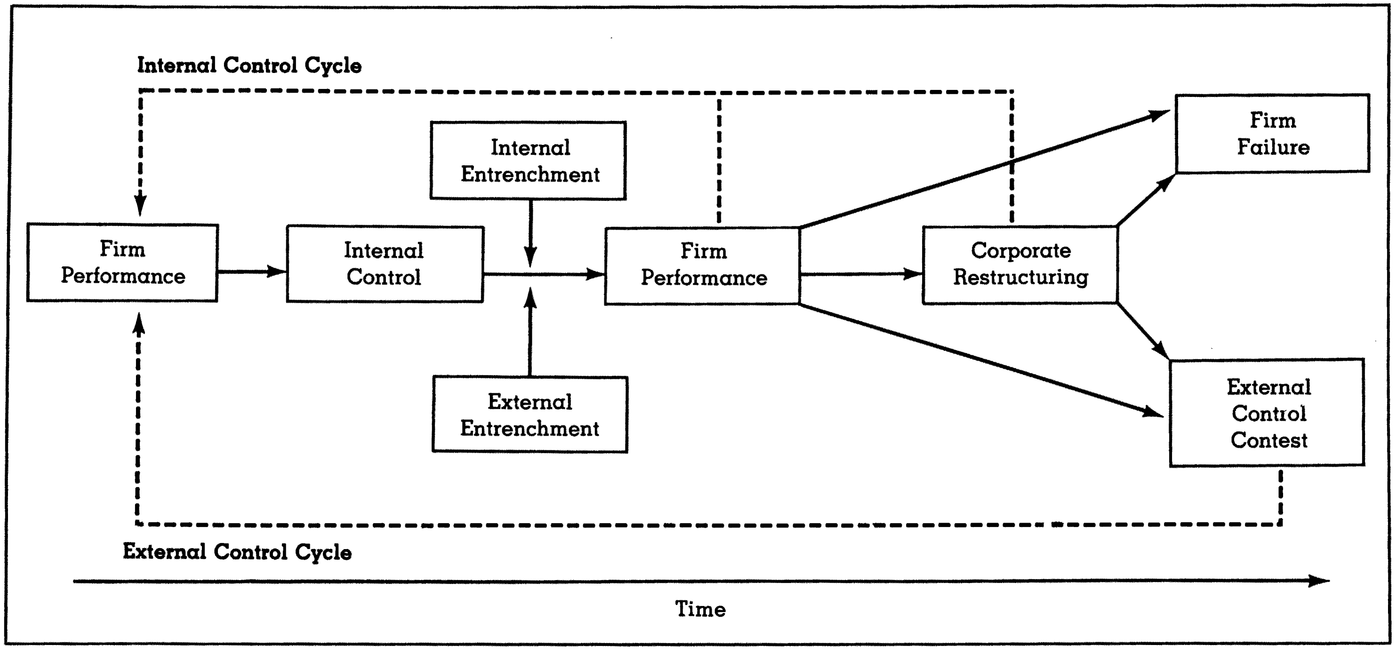

Figure 3. **The relationship between internal and external corporate control mechanisms.**

takeovers) represent a perfectly normal and theoretically sound mechanism of ensuring optimal firm performance when a firm's internal control mechanism has been compromised. A firm continually moves through these control cycles in its attempt to avoid becoming a failure statistic.

The prognosis for firm success or even survival is not good. Few firms are destined to last forever. Birch (1987) tracked the history of 12 million U.S. business establishments between 1969 and 1986. He found that "for every group of companies that opened their doors, approximately half will last five years, 38 percent will be around after 10 years, and 31 percent will survive 15 years" (p. 18). In their study of the Argentinian and Irish newspaper industries, Carroll and Delacroix (1982) found that 92 percent of all Argentinian newspapers died during the 60-year observation period, whereas 88 percent of all Irish newspapers perished during a 150-year observation period. Finally, Newcomb (1987) traced membership in the *Forbes* list of the top 100 American businesses over the period 1917–1987. He found that only 22 companies survived the 70-year period. We believe that the inefficiencies in the internal and external control mechanisms, and the high costs of coping with internal and external entrenchment practices, contribute in large part to the likelihood of firm failure. (We should note that these statistics may overestimate the threat of failure, however. All of the authors counted a firm that had been merged or acquired as a mortality statistic. Of course, we consider such firms to be subjected to the external control mechanism. At minimum, then, these statistics reflect breakdowns of internal control. Counts of firms that do not emerge from bankruptcy proceedings would constitute a more accurate compilation of firm failure.)

Firm failure results from the breakdown of both the internal and external control mechanisms. If a firm's managers entrench themselves with the sole objective of ensuring their own power, prestige, and perquisites, the organization is likely to lose sight of its competitive environmental position and will fail (Antonio, 1979; Gray & Ariss, 1985; Mintzberg, 1984). Indeed, Hambrick and D'Aveni (1989) found that in the four years preceding a bankruptcy, the outside directors tended to leave the board (not to be replaced) and the chief executive officer tended to increase his or her autocratic control of the company. We argue that in such failing firms, the shareholders have lost any ability to monitor their top managers. The firms went bankrupt either because no external firm believed they were attractive turnaround candidates or because the managers put external entrenchment mechanisms in place to thwart an external control attempt. In either event, by losing control of the internal monitoring mechanisms, the shareholders ultimately lost their ownership investment. Some firms do emerge from bankruptcy proceedings, however. We would expect that a successful resurrection from the brink of failure would follow an overhaul of the firm's internal control mechanism (perhaps under a bank's guidance). (This view suggests that additional theoretical and empirical study is necessary to identify the conditions under which costly formal bankruptcy proceedings will be preferred to the normal operation of internal and external corporate control mechanisms. Why is it that some firms then emerge successfully from such proceedings, and how have the firm's internal control mechanisms been attuned to accommodate this emergence?)

External control efforts also may fail. Acquiring companies have the ability to break many of the attribution biases and implicit contracts associated with internal entrenchment (Shleifer & Summers, 1988). Nevertheless, they must also bear the normal costs of the inefficient control mechanisms that were identified previously; the additional costs of managing the integration of strategy, structure, systems, and people between the two firms (Schweiger & Walsh, 1990); and the cost of dealing with any external entrenchment hurdles the acquired firm's management has put in place. The cost of redesigning an organization (Welsh & Slusher, 1986), coping with the aftermath of layoffs (Brockner, 1988), and managing the relationships established by severed implicit contracts (Morck, Shleifer, & Vishny, 1988) can be very high indeed. As such, there are no guarantees that an external control effort will succeed. The integration imperatives may strain an acquiring firm's capability to provide the needed control.

No one has yet chronicled the incidence of firm mortality following a takeover, but we suspect that a number of acquiring companies may find the monitoring and control costs to be very high. Indeed, researchers using accounting-based measures of performance to assess the postacquisition performance of the four waves of mergers and acquisitions evidence since the turn of the century were unanimous in their conclusions that acquiring companies typically suffer postacquisition profitability declines and efficiency losses (Herman & Lowenstein, 1988; Mueller, 1977; Ravenscraft & Scherer, 1987). Recent evidence of the long-term stock price performance of acquiring companies seems to corroborate this rather gloomy view (Magenheim & Mueller, 1988).

Given the sobering organizational mortality rates we identified, it would be presumptuous of us to offer a blanket prescription for organizational survival. We would just note that our analysis suggests that the probability of achieving optimal firm performance will certainly be improved when steps are taken to ensure that board members overcome their attributional blinders and when both internal and external managerial entrenchment practices are recognized and kept to a minimum. Moreover, organizational success may very well result from a number of passes through both the internal and external control cycles identified in Figure 3. To survive and be successful, a firm may need to endure a number of external control contests.

Internal and External Control Cycles

Internal and external control mechanisms represent complementary ways to direct the behavior of management. As such, they should be viewed as different response alternatives to a similar problem. From a research standpoint, this suggests that these mechanisms and the various managerial entrenchment practices designed to compromise them should be studied concurrently, not separately, as has been the custom. Researchers in both the administrative sciences and financial economics have tended to study management compensation (e.g., Murphy, 1985; O'Reilly et al., 1988), turnover (e.g., Brady & Helmich, 1984; Warner et al., 1988), behavior of board members (e.g., Hermalin & Weisbach, 1988; Zahra & Pearce, 1989), and external entrenchment practices (e.g., Jarrell & Poulsen, 1987; Singh & Harianto, 1989) as discrete topics worthy of independent investigation. Often, but not always, each aspect of corporate control is tied to only one firm performance measure rather than to the complex web of control mechanisms identified here. Our view is that all of these control mechanisms are inextricably linked and should be studied as such. In particular, we believe that much can be learned about internal control mechanisms when they are investigated in and around external control activity. Therefore, a complete time-series analysis of the relationship between the internal and external control cycles identified in Figure 3 should be conducted on a population of firms. This analysis would require a prodigious effort, but the payoff would be a greater understanding of the full complexity of corporate control. A number of more circumscribed and still important projects could be completed while this broader effort is being conducted. Research aimed at understanding the origins and consequences of the various managerial entrenchment practices is especially needed.

Internal Entrenchment. A number of hypotheses about the relationship among the various internal entrenchment practices, firm performance, and the probability of firm failure or takeover await examination. Our attribution theory perspective on a board's judgment process provides an important new way of identifying internal entrenchment practices. The three practices that work to subvert the board's attribution judgments (altering person, situation assessments, and performance assessments) will be particularly difficult to investigate, however. To date, our evidence concerning board behavior has been derived from reflections (Mueller, 1979), ethnographies (Mace, 1971), and archival records (Baysinger & Butler, 1989). It will be difficult to gain access to board members to conduct psychological experiments on their judgment and inference processes. Until such a time, we will need to be creative and examine directors' letters (Salancik & Meindl, 1984) or speeches (Stubbart & Ramaprasad, 1988) for such evidence. A study of how managers neutralize the board's control options, however, may be more promising. Following Shleifer and Vishny (1988), the idea that firms targeted for external control are marked by a differentiated organizational structure with few integration mechanisms other than a small group of top managers is amenable to an empirical test. Such research would draw attention to many other largely overlooked ideas about the relationship between organizational design and governance (Scott, Mitchell, & Peery, 1981).

External Entrenchment. The study of external entrenchment practices should also be placed in the broader context suggested by our framework. As we saw, most investigators of defensive tactics focused on their wealth effects. There is now a great opportunity to examine the antecedents of the use of these tactics (i.e., links to various aspects of internal control and entrenchment), the adoption of such defensive tactics, their subsequent effects on the likelihood of a takeover, and future firm performance. The short history of work on greenmail payments illustrates how investigators have been guided, perhaps unknowingly, by the logic of Figure 3. Initially, three teams of researchers examined the wealth effects of the payment of greenmail (Bradley & Wakeman, 1983; Dann & DeAngelo, 1983; Mikkelson & Ruback, 1985). Since that time, investigators have begun to examine the governance implications of this activity. Kosnik (1987) examined a number of board attributes in an attempt to predict the kinds of companies that would pay greenmail, whereas Klein and Rosenfield (1988) examined management turnover following a greenmail payment. Of course, this is only a beginning. Additional research efforts should examine the other relationships specified in our framework, as well as their relationship with other types of external entrenchment practices. In short, research that examines the internal and external control implications of the various entrenchment practices is sorely needed.

Internal Control Failure: Culpability and External Control

Historically, interest in understanding agency costs and their possible resolution has focused on the motives and behavior of top management. Indeed, agency theory suggests that it is their self-interest or perhaps incompetence that may contribute to the generation of suboptimal shareholder wealth (Jensen & Smith, 1985). Of course, this view assumes that firm performance is not entirely determined by environmental factors. Our discussion of top management effort and ability, coupled with our consideration of a variety of internal and external entrenchment practices, illustrated managers' potential shortcomings.

With the possible exception of the work on the composition of boards of directors that we discussed previously, no one has seriously examined the board's role in failures of internal control. It is quite possible that the board, rather than the top managers, should be held accountable for suboptimal firm performance. In the language of Figure 1, the board may be responsible for selecting the problematic "incompetent" or "misplaced" manager. Their failings may also include the abrogation of a responsibility to offer their managers substantive guidance and support in difficult times. Moreover, the board may not be able to design the appropriate incentive contracts to properly motivate and direct their top managers' efforts. Therefore, any consideration of internal corporate control failures should examine the potential culpability of both the firm's management and the board of directors.

Consistent with our basic theme of understanding the interrelationships between internal and external control, Figure 4 represents our hypotheses about how these relationships may be seen as contingent upon the possible shortcomings of either managers or the board of directors. The typology represents both the conditions necessary for effective internal control and the source of different kinds of internal control inefficiencies. The insight that the type of external control contest should be predicated on the source of the internal control failure represents a novel strength of our approach. In contrast to previous work, the board's role in the resolution of the agency costs that derive from the separation of ownership and control is highlighted.

The "effective governance" condition characterizes the situation when the internal control cycle is working efficiently. Talented managers respond to the guidance and appropriately set incentive structures offered by the board of directors. Changes in the managers' compensation structure and even in the composition of the team itself (Gupta, 1986) may occur as the firm adapts to changing circumstances. In this situation, an external control contest is unnecessary.

The notion of "managerial deadwood" may capture agency theorists' most common assessment of the origins of suboptimal firm performance. In this case, poor performance is attributed to poor management. Accordingly, we should observe periodic changes in the firm's compensation contracts here as the board of directors tries to improve firm performance. However, firm performance continues to be poor because management is unable to translate these incentives into improved firm performance. If management has not entrenched itself, management turnover would ultimately occur. If such turnover does not occur, we should see an

Board of Directors	Top Management: Good	Top Management: Bad
Good	***Effective Governance*** **Internal:** Incentives are designed appropriately and management responds correctly. **External:** No external control is necessary.	***Managerial Deadwood*** **Internal:** Incentives are designed appropriately but management is unwilling or unable to respond in kind. **External:** Tender offer.
Bad	***Board Obstruction*** **Internal:** Incentives are inappropriately designed and good managers are scapegoated. **External:** Going-private transactions (LBOs or MBOs) or a merger.	***Governance Failure*** **Internal:** Managers exhibit poor ability and/or low effort in the presence of inappropriate incentives and capricious dismissals. **External:** Proxy contest or a hostile tender offer.

Figure 4. **Internal and external control cycles: Management versus board culpability.**

external control effort that will facilitate the removal of such poor management. Because tender offers bypass the current management group, shareholders can vote directly on the competing management groups by responding to the tender offer. The tender offer will be opposed by management, but eventually it should be supported by the competent board of directors.

A second way a firm's internal control mechanisms may fail is by what we call *board obstruction*. In this case, talented managers labor under ill-conceived board actions. These boards may have structured the managers' incentives inappropriately. Moreover, such boards may be quick to use managers as scapegoats for suboptimal firm performance. We would expect managers in this situation to try to co-opt the board in the way Mace (1971) described. In this case, the benefits of a competent board would be lost as an incompetent one is rendered impotent. An external control effort, however, would facilitate the removal of the target firm's board of directors. With the help of outside institutional investors, the incumbent managers may take the firm private in a leveraged or management buyout. A management-negotiated merger also may achieve this same control objective. Such buyouts and mergers are means to remove incompetent boards of directors.

A "governance failure" occurs when neither the board of directors nor the top management team is sufficiently qualified to conduct the firm's business. Although seemingly random attempts may be taken to adjust incentive contracts or dismiss top managers, the internal control mechanism has virtually no chance of optimizing firm performance. In this instance, only an external control effort can save the firm. A suitor for the shareholders' votes would likely bypass the current board and management completely. As such, an external control contest would take the form of a proxy contest or a hostile tender offer.

In summary, the logic of Figure 4 extends our basic theme about the interrelatedness of a firm's internal and external control mechanisms to argue that the type of external control mechanism is directly tied to the source of failure in the target firm's internal control mechanism. Considerable insights about the efficiency of these control mechanisms can be gained by examining how a firm's internal control mechanism is affected by external control contests. We will illustrate this potential by suggesting a few specific research opportunities that can be derived from the perspective.

Illustrated Research Opportunities. Our goal in this section is not to develop an elaborate research design to test the entire logic of Figure 4. Rather, we will provide a sketch of the logic for two possible empirical studies that could shed light on the relationship between these corporate control mechanisms. We should emphasize that these are only two of a number of possible research opportunities. Since the notion of board culpability in control failures is novel, we will begin by taking a closer look at what we called *board obstruction*. An interested researcher would start by constructing both a sample of firms that had gone private and a matched sample of firms that had performed well in the same industry. We would expect to find that (a) there was relatively little change in the target managers' compensation contracts prior to the transaction, (b) these target managers' contracts were substantively different from those of their peers in the high-performing firms, (c) a substantial amount of turnover in the board of directors followed the completion of the going-private transaction, and (d) a shift occurred in the structure of the target managers' incentive contracts toward that of their peers in the high-performing firm.

A study of tender offers could further our understanding of the role of the board of directors in corporate control contests. Specifically, the distinction between control contests motivated by managerial deadwood and those motivated by governance failures should be examined. A researcher would begin by constructing a data base of tender offers and, again, a matched sample of firms that are industry leaders. The logic of Figure 4 suggests that (a) the target management turnover rate will be much higher than the "normal" rate established in the matched sample, (b) a comparison of the structure of the incentive contracts between the target and their industry leader will distinguish managerial deadwood from governance failure targets (no significant difference is predicted in the former case), and (c) postacquisition turnover among the boards of directors will be higher in the firms with governance failure than in the firms with managerial deadwood.

An International Perspective on Corporate Control

Our discussion of the evidence regarding internal and external corporate control mechanisms has focused exclusively on the experience of firms operating in the United States. We believe that new, further insights regarding the efficiency of internal and external control mechanisms can be gained by investigating corporate governance structures and monitoring across national boundaries (Seward, 1990). These control mechanisms differ significantly across national boundaries. These differences offer the opportunity to evaluate distinctive patterns of managerial control. To the extent that such mechanisms exert complementary modes of control, it suggests one of two possibilities. First, there may be many combinations of these various control mechanisms that are equally efficient in equilibrium. Alternatively, if there exist more efficient combinations of these control mechanisms, competition should ensure that it is the most efficient structure that eventually survives. Cross-national investigations of governance arrangements should provide important, new evidence about the effects corporate financial and governance structures have on the productive decisions of corporate managers and, hence, on aggregate firm value.

In the case of Japan, for example, the structure and allocation of ownership (e.g., debt and equity claims) are quite different from the observed patterns in the United States. Typically, Japanese corporations are characterized by (a) comparatively high degrees of financial leverage; (b) the predominance of bank loans for external financing choices; (c) large cross-holdings of equity shares between corporations, (d) large equity shareholdings by financial institutions (e.g., banks, insurance companies); (e) heavy reliance on a main bank as a lender, as a financial advisor, and for management skills (Hodder & Tschoegl, 1985). Even though the evolution of this Japanese system has been quite complex, the result has been an arrangement that arguably reduces the agency costs associated with outside equity and debt financing. This arrangement offers an interesting perspective on the well-documented success of Japanese companies in an increasingly competitive global marketplace.

These differences may help explain how, from the perspective of the U.S. corporation, Japanese firms can survive and excel in an environment in which internal and external corporate control mechanisms appear very weak. For example, there is virtually no external corporate control market in Japan (Sheard, 1989). Furthermore, the managerial labor market is typified by the lifetime employment contracts in most corporations, thereby dramatically reducing the role of turnover as a disciplining mechanism. Viewed together, these patterns seem to suggest that Japanese managers can operate virtually independent of the interests of their shareholder groups.

It is interesting to discover, then, that the monitoring and control of management comes from alternative mechanisms in Japan. Debt sources of capital are provided primarily through banks, which then have an appropriate incentive to monitor the decisions and performance of management (Hoshi, Kashyap, & Scharfstein, 1989a, 1989b). Furthermore, the board of directors consists of capital claimants (e.g., cross-holdings, financial institutions) who have large vested monetary interest in the firm's success (Sheard, 1989). Japanese banks and boards of directors, then, play a much more active role in controlling top management than they do in the United States. Thus, the Japanese governance system reflects its unique pattern of capital acquisition. The managerial labor market and corporate control contests apparently play a minor role. The apparent utility of Japan's interorganizational monitoring network suggests that Pfeffer's (1987) call to move beyond a methodological individualism is quite valid. The Japanese example illustrates that any investigators of the governance and control of the modern corporation must be alert to more subtle aspects of interorganizational monitoring and control than the hostile tender offer.

The Japanese example illustrates how capital acquisition patterns may affect the workings of corporate control mechanisms. The unique governance structure in Japan seems to have obviated the need for external corporate control contests. To fully understand corporate control, we must look beyond the complementary relationships between the internal and external control mechanisms within the governance system of the United States. The study of governance structures in other nations provides for the necessary variance to truly understand both the role of internal and external corporate control mechanisms in aligning management and shareholder interests and the pivotal role capital markets play in this process.

Conclusion

Our discussion of the efficiencies of internal and external corporate control mechanisms represents the kind of work that can extend both organization theory and financial economics. Organization theorists have held a longstanding interest in the role played by the dominant coalition (Thompson, 1967) or upper echelon (Hambrick & Mason, 1984) in the conduct of organizational affairs. Typically, this work has been placed within a strategic choice paradigm (Child, 1972) that defines the important role top managers play in achieving successful performance. Even though this paradigm has been challenged (Astley & Van de Ven, 1983), more recent investigators conclude that managers, in fact, do make a difference to organizational performance (Hambrick, 1987; Thomas, 1988). The ideas in this article provide organization theorists with a middle-range theory about how these top managers may have such an impact.

Financial economists have offered an important theoretical framework within which to consider this impact. Jensen and Meckling (1976), Fama (1980), and Fama and Jensen (1983a, 1983b) articulated the costs to a firm's shareholders that can accrue because of the separation of ownership and control. Their theory focused attention on the nearly 75,000 mergers and acquisitions that have been completed during the past 25 years (Grimm & Company, 1989). They raised for consideration the possibility that this activity may have served as an external control mechanism to discipline a firm's entrenched and inefficient managers. In this way, the agency theorists take exception with Berle and Means's (1932) pessimism about the likelihood that managers' and shareholders' interests can be coaligned. Agency theorists are optimistic about this question.

Organization theorists have been most interested in understanding internal corporate control through the study of the conduct of top management, the behavior of board members, executive compensation, and top management turnover. They have not, however, seen these studies as a part of an internal control process that takes place within the context set by potential external control contests. By and large, this work has been phenomenon-centered, focusing on each topic as a discrete subject worthy of independent investigation. The links among these studies, various entrenchment practices, and external control have not been fully considered. Financial economists, on the other hand, have mainly examined external control options, and a number of external entrenchment practices (neither group has particularly examined internal entrenchment practices). Their focus, however, has been on determining the wealth effects of these very specific, discrete events highlighted by the theory. They, too, have not fully considered the interrelationships among all of these practices nor how external control both influences and is influenced by internal control practices.

This article articulated this problem of the separation of ownership and control and identified a host of internal and external mechanisms that can be employed to ameliorate it. We developed a framework that identifies how managers may actively work to subvert such approaches to control. Our approach has been to emphasize the theoretical links among all control issues. When building this framework, we discovered that both organization theorists and financial economists have been interested in these issues for years. Unfortunately, they have been mainly unaware of the interconnectedness of their work both within and across their disciplines. By positing the relationships between and among all the various control approaches, our aim has been to provide researchers in both fields with a more integrated theoretical framework and research agenda. We hope that by bridging the two disciplines, we have enriched the theoretical context in which the financial economists' event studies are placed and provided organization theorists with a productive new focus. Our understanding of corporate control is still in its adolescence. An innovative research synthesis between organization theory and financial economics should bring this understanding to maturity.

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