

A relational approach to Corporate Governance design

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Abstract

The paper outlines a new pluralistic method for analyzing, assessing and improving corporate governance structures in their traits relevant both for financial and for human capital providers. The framework seeks to enlarge the rather universalistic approach to governance structures ‘ranking’ used in the economic (principal-agent) approach, introducing sensitiveness to some relevant contingencies. Among the contingencies, task complexity and innovativeness is supposed to matter, as well as the configuration of motivations and preferences of capital providers – which are supposed not to be uniform but to be predictable in their main configurations. The framework is design-oriented and aimed at improving corporate governance configurations in a generative way, based on the discovery of superior matches between the preferences of different categories of capital providers over governance mechanisms (rather than focused, as usual, on the comparative assessment of discrete realized ‘models’). The approach is relational in two ways: it builds governance structures on pairwise analyses of effective matches among preference configurations; it builds governance structures as nexuses of complementary governance mechanisms (effective matches among mechanisms).

The three fundamental ‘factors’ of production and value generation – capital, land and labor – are not factors in the same sense. While capital and land are resources, assets, ‘potential energy’ for generating services and value, labor is itself a service. Therefore a different concept would be needed for representing the ‘potential’ for labor service generation, the stock of valuable knowledge and competences which are combined with other assets for value generation, a concept like those of ‘human capital’ or ‘human assets’, and ‘social capital’ that today have become of common use both in the sociology and economics of organization (Becker 1986; Williamson 1979; Burt 1997). The firms and sectors in which the provision of labor services involves more than the sale of those services, implying investments of critical human assets, are of growing importance in economic life, high tech and new economy sectors being examples. What do these investments in different types of assets imply for governance structures? To what extent the now popular yardstick of ‘shareholder value’ is adequate for regulating the behaviors of those firms? This paper aims at contributing to the debate on corporate governance structures by extending currently available governance design models to incorporate those concerns. It builds on advances both in theoretical and empirical research, and propose a new framework for designing those aspects of governance structures relevant for the ‘governance of agents’ who qualify as human capital providers.

Shareholders, stakeholders and ‘capital providers’ value

If the owner and providers of human capital put it at risk in association with other assets, it is both efficient and fair to allocate to them some rights on the results of the economic use of their assets (Hart and Moore 1986). It is not simply a case in generic ‘stakeholding’ - the bearing of relevant consequences from a firm’ activities – but it is a case in the direct investment of resources, which should be adequately attracted, rewarded and coordinated with other resources. In agency theory, the standard assumption is that the financial investments in a firm are the more specific, the most difficult to recover, the most critical for success, *then* financial capital providers should be considered the ‘principal’ in principal-agent analysis of governance structure (Shleifer, Vishny 1986). That assumption is not ubiquitously valid. There are situations in which human capital investments are very specific, difficult to recover and critical for success. This paper explores some substantive and methodological consequences of taking all capital providers ‘on board’ in the governance structure optimization problem. By the way, the approach enlarges the perspective even towards financial and technical capital providers – with respect to the usual shareholder value maximization approach – as not all those capital providers are shareholders.

When an ‘investment of human capital’ is in order rather than just the sale of a labor service? Typically when knowledge and competence (the capital) and tasks (the service) can not be easily

separated, when it is technically unfeasible that one actor possessing the relevant knowledge 'directs' another about what tasks to perform (Demsetz 1991); something that in turn tends to occur when knowledge is difficult to codify, sophisticated and diffused among different specialists. Second, human capital investments rather than labor service exchanges are likely when services are generated by the combined use of complementary human and technical knowledge – i.e. when there are tight 'complementarities' with other resources (Richardson 1972), that would be difficult to coordinate through exchange contracts.

Among the possible responses, advised in theory and partially diffused in practice, there is an allocation of the 'bundle of property rights', broadly intended, over the firm, diffused to all capital providers, including human capital providers. These rights include decision and control rights as well as rights to residual rewards and to partnership in ownership (Fama and Jensen 1983; Blair 1995, 1996). The forms and degrees of this diffused right allocation are debateable, however, in that they can have different incentive and risk-bearing properties, and they might need to be complemented by different corrective organizational mechanisms for being viable. This 'assessment' is addressed first here, in the format of a partial analysis of the properties of each mechanism; in order to be able to envisage and assess complementary and superior ways of combining them for solving governance problems.

The second part of the paper addresses the possibility that the different possible ways of allocating rights may be ranked in different ways by the different categories of capital providers, in particular by financial capital providers and human capital providers. These differences may generate a first type of 'governance gap': a gap between solutions preferred by providers of different types of capital (a 'negotiation gap'). A negotiation analysis of superior governance structures is accordingly called for, and addressed in the second section of the paper.¹

The third section offers a discussion of a second type of 'governance gap' (an 'efficiency gap'): a gap between the existing (hence the usually studied) governance and organization arrangements and potentially superior combinations of mechanisms. Under this aspect, the paper contributes in the recent debate on 'corporate disaggregation' (Zenger and Hesterley 1997; Williamson 1991), by proposing to disaggregate our concept of governance structures into the mechanisms which contribute to define them. In that way, we might be able to see more clearly how current combinations of governance mechanisms are just particular combinations; and how new combinations are possible, without necessarily conceiving those new forms as a result of reciprocal 'infusions' of existing forms (typically, 'infusions' of market into hierarchies and vice-versa). Finally, the method is empirically grounded. In fact, the set of undominated governance arrangements, only on the basis of technical feasibility and economic return, would be pretty large if 'assumptions' were not made on preferences – and in fact those assumptions are usually made for making assessment exercises (e.g. random distribution of preferences in Williamson 1981; disutility of effort in agency models, Levinthal 1988). The approach to preferences developed here rests on two different methodological options: a) preferences should be empirically elicited, not 'assumed' in any governance problem; b) we should advance testable hypotheses on the possible configurations of preferences, in order to be able to evaluate efficient solutions in a generalizable way (Grandori 1991).

Mechanism assessment

¹ The two methodological options applied here – the search for complementary combinations of coordination mechanisms (rather than the comparative assessment of given governance forms packaging them in historically predefined ways); and the negotiation analysis of the so generated governance and organization forms with respect to the preferences of the relevant stakeholders – have been developed in previous works and exposed systematically in Grandori (2001).

Pay for performance. Both theoretically and empirically there has been a recent plea and trend toward the variabilization of reward. It responded to a pressure by financial capital providers towards making their agent-managers more accountable (Useem 1996). However, even if we consider managers just agents of financial investors, and even using standard agency theory, maximizing the sensitiveness of managers' rewards to variations in shareholders wealth does not follow. The mechanism of incentivating performance with contingent pay entails growing marginal costs and decreasing marginal benefits determining an 'optimal incentive' intensity which is lower the more uncertain the activities are (due to exogenous variance), the less measurable performance outcomes are, and the less performance is attributable to agents' actions (due to low discretion or interdependence with other actions) (Milgrom and Roberts 1992). Therefore, we may hypothesize that the incidence of pay for performance, should not be extremely high in the governance of human capital investments in risky and complex activities; while it should be high wherever activities stay in known causal relations with clear outcomes, but activities are poorly observable and relevant information and discretion stay with the agent.

Own capital: shareholding and partnership. Rather than linking incentives to individual or small group performance, human capital providers' objectives can be 'realigned' with those of other assets providers through property rights over the firm. In fact, this solution is widely used in human capital intensive firms, such as in the cases of professional partnerships, and in science-based and high tech firms through extensive shareholding by scientists (Lacetera 2001).

The limits of those solutions stem mainly from risk aversion. Human capital investments are poorly diversifiable, therefore it is likely that human capital providers are, or easily become, risk averse (Jensen and Meckling 1976; Milgrom and Roberts 1992). Additional investments in financial capital into the same firm, therefore seems to worsen the situation in risk-bearing respects. In fact, the diffused mechanism of 'stock options' can be seen as a partial solution to this problem. Being a right to buy stock at a pre-defined price, whenever the market value of firm shares is higher, stock options may involve limited risk transfer to the agents.

As long as these property sharing mechanisms determine significant shareholding by human capital providers, it can be claimed that shareholder value maximization becomes a more encompassing and valid indicator of firm performance. Even in that case, however, it is unlikely that it can be valid as a single parameter. In fact, as known, that index is very volatile and sensitive to many other factors beyond management performance, and can distort investment decisions toward financial 'short-termism' and band-wagon behaviors. In addition, as for any performance indicator, its design and use involves a validity problem and not only a motivational problem: is the relevant dimensions of performance adequately 'operationalized' and measured by the indicator? Is share-based value a 'sufficient statistic' of the value a firm creates, even for owners? Even more: can significant shares of property be allocated to critical human capital providers – as it should be efficient and fair in incentive respects – without running into inefficiencies in risk allocation respects – having these actors bearing excessive risk. Moderating complementary mechanisms should then be devised and expected, especially in high risk, human capital intensive settings.

Risk-free rent sharing. Agents investing both human and financial capital in one firm, especially if its value is contingent to the success of innovative ventures, bear substantial risk and may demand a insurance premium as part of their compensation package. This can be provided by the distribution of risk-free uncontingent shares of a firm rent. Marshall already noticed that a firm's income can be seen as a composite quasi-rent, generated by the association of specific resources, over which all of these resource providers have a claim (Aoki 1984).

To the extent that human capital investments are firm-specific, their continued association with other firm resources generate a surplus with respect to possible alternative combinations that can be distributed to resource providers. If distributed, surplus shares should make the reward of specific human capital providers higher than in the next best employment of those resources. Therefore, we

conjecture that when human capital investments are put at risk, a fixed (non contingent) component of reward, that makes it neatly superior to what is perceived as the average alternative obtainable reward should appear. Empirically, there are initial data that support this conjecture, which, by the way, modifies if not reverses the conventional recepies about the should-be diffusion of contingent rewards in risky and innovative sectors (Grandori et al. 2001; Bloom, Milkovich 1998).

Decision rights sharing and monitoring. Organization science has consistently shown that the more complex the tasks are, the more distributed the relevant knowledge and information is, the more decentralized the effective and effiicient allocations of decision rights are . In addition to individual autonomy and discretion, interdependence among competencies in the solution of complex problems makes teaming an effective mode of cordination: both for knowledge sharing and integration purposes, for problem solving purposes, and for risk sharing purposes (Grandori 2001). The decentralization of decision rights, on the other side, generate risks of uncoordinated behavior of a firm system as a whole (Radner 1997). Investments in monitoring, to accrue the difficulties, are not likely to be very efficient for complex activities, in which both behaviors and results may not be easily and timely observable (Shapira 2000). ‘High powered incentives’ have also limits, we argued. How then would relevant actors – the providers of different types of capital in the present discussion – control each other and ensure a reasonably consistent firm behavior?

Corporate governance literature, as well as governance practices in non economic realms, where the lack of clear performance measures and clear outcomes is most common, provide suggestions. Institutional ‘bodies’ and ‘chambres’, able to represent key actors, and at the same time to separate decision and control, and to set up a system fo multiple ‘checks and balances’ seems to be a solution. One currently praised solution is the independence of members of those board who decide on management reward. But it is unlikely that the composition of one single board can solve all problems. In fact empirical evidence on the relation between boards composition and type and consistency of managerial reward packagees is quite unconvulsive (Daily et al. 1998).The composition of governance bodies may be differentiated according to the problem at hand (e.g. firm strategy, reward allocation, auditing); but the ‘internal legal system’ of the firm should be prepared to deal with misapplications and grievances. Therefore - drawing here on the insights provided by ‘organizational justice’ studies (Folger, Greenberg 1985) and drawing a prescriptive implication from management studies on the processes of corporate governance (Pettigrew 1992, Huse 2000; Zajac and Westphal 1996) - *procedural* mechanisms should be as important as structural mechanism in favouring correct governance – e.g. ethic codes, procedural justice codes, fair voice giving procedures and independent arbitration procedures .

Ownership concentration. A likely impediment to delegation, to high managerial discretion and to autonomy and transparent decision making is the concentration of ownership into one dominant block. The issue of the ‘optimal’ degree of concentration is core and hot in the corporate governance debate, given the divergence between the Anglo-American and the European reality in this respect. High levels of concentration are seen as possibly detrimental with respect towards minority investors and the public interest, but are seen as providing more incentives and possibilities for owners to control managers, thereby reducing agency costs. This last hypothesis neglects the possibility, actually the likelihood, that in addition to reducing agency costs, concentrated ownership reduce agency all together, compressing the ‘delegation of power’ on which agency relations themselves are built. Given those trade-offs, it seems that intermediate and hybrid ownership structures should rank higher, all considered, than extreme diffusion and extreme concentration models. Therefore, rather than concentrating our research efforts on establishing which of those two ‘models’ – that also happen to be those relatively more diffused, in US and Europe respectively – is superior, or which one converges toward the other, it may be more useful to devise interesting ‘mixed’ models, featuring capabilities of monitoring managers while credibly

delegating them power, and of repaying the conferments and giving voice to minority investors. One can even hypothesize that the interests of human capital providers and of minority (typically institutional) investors may be in many respects convergent, in calling for infusing in corporate governance structures those elements that are known to sustain economic and organizational democracy in general: balanced representation of all categories of capital providers in Boards (thereby also increasing the variety of points of views which typically nurtures good group decision making), intermediate organizations – e.g. associations - giving voice to dispersed ownership (rather than just individual legal protections rights which are seldom exercised), a multiplicity of large blockholders (if any) rather than one.

Human capital mobility. A way of reducing the risk of firm-specific human capital investments, and actually a way of diversifying, at least over time, those investments is to shorten the investment time horizon and to maximize the re-saleability of experience into new ventures and new positions. This contributes in explaining the shortening of the length of stay in single positions and firms. However, a countervailing force, encouraging the longevity of relations, is represented by investments in the development of competences specific to the firm, the tasks, the co-workers. As these countervailing forces affect a single variable, job tenure, we expect that the variable will assume values that are approximately equal to the technically minimum period required to construct and use profitably firm-specific competencies.

The contrasting needs posed by the investments in firm-specific human asset and the realization of returns on human capital investments (through re-selling of experience), is likely to affect also the modes of regulating mobility and not only its speed. In an exploratory study on governance mechanisms of human and social capital in the new economy (Grandori et al. 2001) have hypothesized and found that *both* ‘free’ market-like human-capital mobility across firms, *and* internal labor markets, should be less efficient than competence-based professional networks (appropriately brokered) in innovative risky ventures for which evaluating human resource potential is quite difficult ex-ante.

Expected possibility set of effective governance mechanisms

In sum, it is possible to specify an expected set of mechanisms effective for governing the continued association of critical human capital with other assets. By ‘critical’ we have meant specific human capital that is contributing significantly to surplus value generation, and that is put at risk together with other firm-specific assets. Task complexity/innovativeness should matter for distinguishing effective combinations within the feasible set of mechanisms/dimensions. In highly innovative and complex activities, it is likely that a larger set of mechanisms’ combinations is to be ruled out as dominated or ‘failing’ (Grandori 2001).

- High discretion of agents (diffusion of decision rights to managers) seems to be a universal requirement (irrespective of industry or other contingency) for governing critical human capital investments.
- ‘High-powered incentives’ and pay for performance can be expected to be less universally efficient. There are trade-offs. The relative incidence of pay for performance should vary with the riskiness and complexity of activities. In highly risky ventures and complex activities (in which performance is not easily and short-term measurable) we expect a fairly consistent amount of risk-free rent sharing.
- Individual ‘entrepreneurship’ and accountability, and pay for performance is likely to be complementary with the use of teaming, the more task complexity and task interdependence obtains.
- The degree of mobility and positional tenure is expected to assume intermediate values, in order to ‘optimize’ the trade-off between resaleability of experiences and career speed on one side and the investment in firm-specific competences and partner-specific confidence.

- Multi-lateral monitoring seems to have better chances of success than any form of unilateral monitoring. Effective coordination and control can be sustained by carefully ‘weighted’ bodies for ‘checks and balances’: pluralistic composition of Boards of Directors (representative of control and minority investors, of managers, independent); separation of powers in different bodies and organs.
- Pluralistic ownership (different types of investors) may be expected to be superior to homogeneous categories of investors (no matter of who they are – inside or outside financiers, concentrated or dispersed).²

The space of possibilities as to effective governance mechanisms, defined by the above hypotheses, can be operationalized into a web of dimensions. A framework operationalizing eight dimensions is outlined in the next paragraph. That ‘governance web’ is proposed as a useful analytical tool for measuring, comparing and designing governance solutions, on the basis of different inputs. The first input is the theoretical space of effective mechanisms, discussed above. Actually observable effective solutions can be located or ranked with respect to those predictions. A further input are the (eventually different) preferred combinations of those mechanisms by the providers of different sorts of capital, namely financial and human. Preference gaps on the ‘governance-web’ may be minimized to support the design of maximum joint utility structures. It is to this task that we turn now.

A conceptual premise for that exercise is still on the ground of predicting possibility sets of effective mechanisms. In fact, any ‘possibility theorem’ in this respect should include the detection of actual ‘zones of agreement’ given some likely configurations of parties’ preferences. Therefore, also on the basis of initial empirical evidence, we advance the following hypotheses.

Expected preferences

There are reasons to expect that financial and human capital providers will rank some of the listed attributes in different ways according to preference. In spite of the common interest in not applying technically unefficient mechanisms (e.g. unable to convey complex information where needed, board too large to take any decisions etc.), there might be distributive issues on rights and resource allocation grounds.

Preferences should be empirically assessed rather than assumed, we have said. As for any descriptive empirical endeavor, however, hypotheses on expected configurations will strengthen the interpretation of results. Where do we expect convergence and where divergence, and in what direction, on the various dimensions?

On some aspects, complementary preferences can be expected, thanks to the quasi-indifference of some parties. It is unlikely however that quasi-indifference regards the content of activities on the part of those who provide work - as in classical employment contracts (Simon 1955). Rather, the reverse is more likely to be true – human capital providers are extremely concerned with the content of their work, while financial capital providers may be quasi-indifferent with the nature of performed tasks (the classical configuration is reversed).

On other aspects we can expect diverging preferences and a need for compromise. These include: representation in boards of direction and residual control (involves some zero-sum elements on the available ‘places’, controls are generally more beneficial to the controller than the controlled), incidence of contingent pay (more praised by risk transferers, i.e. financial investors), incidence of rent sharing (more in the interest of human capital providers), interfirm mobility (more in the interest of human capital providers).

Converging rankings may be expected on still other matters, such as the intensity of use of stock options, the types of mechanisms governing human capital mobility, the distributions of investment

² Jensen and Meckling seminal article (1976) actually set out the basic trade-off according to which intermediate arrangements between inside and outside financing should be generally superior to extreme ones.

in human capital (through various forms of training) as there should be configurations that are superior for everybody.

‘Governance gaps’ analysis.

Both the currently employed governance mechanisms and their ranking according to preference can be elicited by using a set of dimensions expressing and operationalizing the discussed issues. They are listed in Table 1 .

The analysis of ‘governance gaps’ involves gathering data both on current and desired arrangements and the preferences of different categories of actors. Therefore we envisage a two-tiered procedure. A first step should ask to the respondents to select which values on the scales best represent the actual solution implemented in their firms. Respondents should include at least the two groups of human capital and of financial capital providers. A second step should ask the respondent to rank the possible values of the various dimensions according to preference and to assign importance weights to the dimensions themselves.

Table 1. Operationalizing corporate governance mechanisms relevant for human capital providers

<i>Governance mechanisms</i>	<i>Scale</i>
1.Incidence of contingent compensation	Incidence of individual and group pay for performance, incidence of stock options
2. Length of firm tenure	Average stay in each firm in years
3. Autonomy	Autonomy in work, location of work, incidence of teamwork
4. Mode of interfirm mobility	from market-like circulation to tightly networked
5.Work effort pressure	work vs free time per day, pressure of external requests on work
6. Work content	Relative importance of professional interest, social relations, power/prestige, innovativeness
7. Corporate governance	Board structure, representative structure, ownership structure
8. Investments in human capital	Relative investment by individuals and by firms

The distributions of responses on actual and desired solutions, and the distances between the configurations of responses of different groups, will allow to measure the ‘governance gaps’ we are interested in. These gaps , in turn, should allow to provide some responses to some important open questions in the corporate governance debate :

- Which configurations of governance mechanisms minimize the distances between capital providers’ preferences? The expectation is to find more than one ‘superior’ configuration, depending especially on the degree of riskiness and task complexity of activities.

- Which of the currently adopted governance arrangements get closer to the Pareto-efficient frontier defined by actors' preferences combinations? The expectation is that the currently diffused structures in large firms are not particularly well suited for attracting and retaining highly valuable human capital providers. This may also have been true in the past, but the new outburst of entrepreneurial activity and new firm foundations (in the so called 'new economy' and more generally in knowledge intensive sectors), providing attractive alternatives, is likely to raise the expectations of human capital providers towards higher/different standards. Are firm's owner, if different from managers, willing to meet these demands?
- Do the commonly recommended corporate governance 'best practices', drawn from the Anglo-Saxon model (which some regulators in Europe are trying to reproduce) actually rank high in the utility of any of the relevant actors? Do the 'gap analysis' reveal superior configurations with respect to that model? Which ones? Are they close to the mixed or hybrid combinations that we have suggested in our analysis?

The next step in this research programme is the actual conduct of empirical research on the configuration of preferences over governance mechanisms and on the correlation between governance mechanisms combinations and economic performance, meant to contribute further indications on how to up-grade governance forms towards superior configurations.

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