Canadian Corporate Governance: The Challenge

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Introduction

No crystal ball is required to predict that, in the coming decades, the Canadian economy will be increasingly subjected to a phenomenon the popular press has labelled "globalization". Some key effects of globalization on Canada are already becoming evident. It brings consumers greater choice. Products from all over the world are available in Canada at affordable prices. Globalization constrains government in new ways. Investors, entrepreneurs and businesses who do not like Canadian government policy are free as never before to take their business elsewhere. The same process of globalization has both opened world markets to Canadian businesses and subjected Canadian companies to competition from parts of the world they had never heard of a decade ago. These effects have combined to force a rapid rationalization of the economy, which has disrupted the *status quo*. People of different ideological persuasions view these effects in different light, but that they are real is not in doubt.

Poor corporate governance practices, that might have been tolerable in previous years, are now untenable. The purpose of this volume is to examine corporate decision making in Canada, and to clarify the factors that, in the past, have sometimes led to suboptimal corporate governance. Our ultimate goal is to clarify government policy options that are both realistic in the new global economic environment, and likely to improve Canadian corporate governance.

The Economics Behind Globalization

In 1930, the Austrian economist Joseph Schumpeter proposed that a process he called *creative destruction* underlies the success of capitalism. Capitalism hugely, some would say obscenely, rewards people who *create* innovations that improve efficiency or better meet consumer demand. Capitalism also brutally *destroys* firms that fail in these dimensions. This creative destruction, Schumpeter argues, has led to unmatched improvements in both production efficiency and living standards. Mainstream economists are increasingly accepting Schumpeter's ideas, and it is now widely accepted that giving free reign to capitalist creativity is more important than avoiding transitory monopoly pricing or other economic distortions.

Over the last several decades, the role for markets has steadily increased in both the industrialized and developing world. In large part, this growth of markets' importance, and the consequent premium on competitiveness, is related to global integration of product, capital, and labour markets. This source of this integration have been thoroughly canvassed elsewhere, and is mainly the result of reductions in domestic trade protectionist barriers, technological innovation, and the liberalization of the command-based economies. The premium on international competitiveness has been felt more acutely in Canada than in other countries, owing to this country's relative openness to foreign competition. In comparison to other OECD countries, the Canadian economy exhibits high levels of export dependency and import penetration. The Canadian export sector, for instance, constitutes 25.2% of the domestic economy -- second only to Germany among the G7 countries in the importance of trade to the overall economy.[1] Likewise, Canada's import penetration rate was more than five times the United States' in 1970, and stood at three times the United States' rate in 1985.[2] Another indication of the Canada's dependence on external markets is the high level of foreign direct investment. In 1990 and 1991, for instance, Canada received 5% of the total foreign direct investment inflows to larger industrialized countries, whereas the United States, with an economy roughly ten times as large, received 29% and 14%, respectively.[3]

The increasing openness of industrialized economies to external market pressures has spawned a number of different effects. One of the most important is a sharp increase in the pace of innovation. In 1992, 187,200 patent applications were filed in the U.S, up from 105,300 in 1972 and 68,384 in 1952. There were 3,107 new product introductions in the U.S in 1992, up from 1,762 in 1982.[4] When less tangible innovations in areas like human resources management, marketing strategy, etc. are included, this acceleration of creativity may well be even greater. Continual innovation is expensive, so innovative firms need to be able to reach large numbers of customers quickly to earn maximum returns on their creativity. Access to global markets is essential, and that means granting foreign firms reciprocal access to Canada's markets.

This stepped up pace of innovation means firms that lag behind can be pushed into obsolescence, and their work forces left high and dry. An innovative new competitor from a remote corner of the world can grab market share with little warning. The bankruptcy rate tracks the downside of this creativity explosion. In 1993 in the U.S., 85,982 businesses failed. A comparable number for 1952 is 8,862 businesses.[5] Of course, bankruptcy laws and practices changed, as did the number of companies and their distribution across industries. Also, the employees of failed companies do not always lose their jobs. Often in bankruptcy, the creditors sell off the defunct firm's assets as a unit. The buyer often retains many or most of the predecessor firm's employees. Nonetheless, this increased pace of bankruptcy clearly does have social costs.

There would seem to be a clear national interest in fostering innovation, encouraging Canadian firms to get ahead and stay ahead, and cushioning firms that fall behind. Yet the globalization of the economy constrains government in new ways too.

Traditional government policies based on taxes and subsidies are in disrepute. Government subsidies and tax credits for R&D are perhaps more likely to foster innovative "mining" or the government than true innovation. Government industrial policies that sought to pick winners and subsidize their growth have seldom succeeded. Even the one previously notable exception, Japan, is now known to

[1] M. Porter, Canada At the Crossroads: The Reality of a New Competitive Environment (Ottawa: Business Council on National Issues/Supply and Services Canada, 1991) 10-12.

[2] T. Hatzichronoglou, "Indications of Industrial Competitiveness" Results and Limitations", in J. Niosi, ed., Technology and National Competitiveness (Montreal: McGill-Queen's Press, 1991) 191 (citing OECD data).

[3] Data from International Monetary Fund, reported in the Economist, World Economy Survey, September 19-25, 1992, at 17.

[4] Statistical Abstract of the United States, various years.

[5] Statistical Abstract of the United States, various years.

be no exception at all. Beason and Weinstein (1994) collect hard data on how much money the Japanese industrial policy directed at whom; and show convincingly that subsidies in that country where directed mainly at losers. The biggest recipients of subsidies in Japan were weak firms, and their performance actually declined subsequently . Indeed, taxing winners to subsidize losers, or even potential winners, seems especially unwise in a global economy where individual nations must compete for mobile capital and especially information (i.e. people with expertise). Capital and people can both go elsewhere if they are too heavily taxed. In this new environment, taxing winners heavily to cushion losers is likely to lead in short order to a country of losers.

In short, government itself has become a competitive business in new global economy. In the past, governments were monopolies. Businesses and people who didn't like the government of the day could work to change it, but could seldom simply take their business elsewhere. Now they can and do. Governments are therefore under pressure to themselves become "competitive". Competitive government is not necessarily small government. Rather it is government that provides services most people and businesses want at tax rates they are willing to pay. Selective subsidies financed by taxes on everyone else are understandably seldom in that category.

How then is government, robbed of its traditional policy tools, to promote the public interest in this new economic reality? We devote the final chapter of the volume to a list of viable options. A central thrust of our analysis is that governments should focus on framework policy. That is to say, the state should focus on providing the legal and institutional environment in which markets and firms are able to thrive. As Professor Michael Porter has observed[6]

[g]overnment's proper role is as a <u>pusher and challenger</u>. There is a vital role for pressure even adversity in the process of creating national competitive advantage ... Sound government policy seeks to provide the tools necessary to compete, through active efforts to bolster factor creation, while ensuring a certain discomfort and strong competitive pressure.

In our view, a core feature of an effective framework for competition is the nature and quality of the corporate governance system that obtains in a given country. Here, we refer to the legal and market institutions that make up a country's corporate governance system. Nevertheless, before we begin to think about the precise nature of an optimal corporate governance system, there is great need to sort out where exactly the public interest lies in issues of corporate governance.

Corporate Governance and the Public Interest

Canadians' standard of living depends critically on the success of Canadian business, which in turn depends on the decisions of top managers. Those decisions are heavily influenced by the legal and institutional settings in which directors and corporate officers function. How should corporations be run? If we are to propose ways in which government might improve their management, we must first consider how corporate decision making might go awry in the first place. This depends critically on the nature of the firm in question.

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[6] Michael Porter, <u>The Competitive Advantage of Nations</u> (New York: The Free Press, 1990) 681.

Why Care about Maximizing Shareholder Value?

A corporation is a legal fiction. It has the rights and responsibilities of a "legal person", yet it is owned by shareholders, and has complex contractual links to its employees, creditors, customers, suppliers and community - collectively called its "stakeholders". Often, the interests of a firm's shareholders and various stakeholders conflict with each other and with others' perceptions of the greater good. Whose interests should be paramount?

It is conventional wisdom, as well as economic theory, that those who bear the costs should have the decision-making responsibility. This is to avoid problems analogous to out-of-control medical bills that arise from giving physicians responsibility for ordering tests and taxpayers responsibility for paying bills.

A normal, healthy corporation has well defined legally enforceable contractual commitments to its employees, creditors, customers, suppliers and community. If may not, in the normal course of business, default on wages, interest payments, promised shipments, promised payments, or taxes. However, the shareholders have no such contractual rights. Rather, they are the residual claimants. Whatever money the firm has left over after paying off its contractual obligations can be either paid out to shareholders as dividends or reinvested to generate capital gains for shareholders. The firm can freely alter its dividend payments and investment policies with few legal consequences. Thus, when unwise business decisions are made in the boardroom, it is the shareholders who pay the price. For this reason, economic theory dictates, corporations should be controlled by their shareholders.

Economic theory, like any theory, is a simplification of reality. When a firm does poorly, employees may be laid off without the firm actually going bankrupt. Some stakeholders may thus bear more of the costs of bad management than does the typical shareholder. But most stakeholders do not. Senior workers are usually well protected from layoffs. Of course, if a corporation is run extremely badly, it may default on its wages, interest payments, deliveries or bill payments too. But this will happen only when shareholder value sinks to zero and the firm is bankrupt. Under those circumstances, bankruptcy trustees must run the firm in the interests of the creditors and other former contractual claimants who have been made residual claimants. In any event, from a policy perspective, it is important to focus on those stakeholders who suffer from certain contracting disabilities, and are thus unlikely to have been able to anticipate and negotiate for effective protection from the firm (in the form of ex ante compensation or ex post severance benefits) for the risks of dislocation. For these stakeholders, strong policy arguments exist for some type of public intervention, although not through modifications to the traditional apparatus of corporate governance.[7]

Ultimately, the reason good corporate governance is important is that its absence would erode public confidence in Canada's financial markets and therefore depress share prices. Such a lack of confidence would make raising equity capital more difficult for Canadian companies, limiting their growth. This, in turn, would slow economic growth and thus exacerbate problems like

[7] R.J. Daniels, "Can Contractarianism be Compassionate?: Stakeholders and Takeovers", in University of Toronto Law Journal (1994).

unemployment and government deficits. Good corporate governance is unquestionably in the public interest.

Directors are Shareholders' Representatives

In practice it is difficult for all shareholders to be consulted on all business decisions in firms with many shareholders. The solution is the board of directors. Directors are elected by the shareholders and paid to represent the shareholders' interests in corporate decision making. To emphasize the ultimate purpose of the board, the law makes directors personally liable to lawsuits by shareholders if they fail in this duty. Officers of the corporation, the top managers such as the C.E.O., president and senior vice-presidents, are assigned a similar legal duty and liability. In the jargon of economics, this is a type of *principal-agent relationship*: the shareholders are the *principals* and the officers and directors are their *agents*. Corporate directors and officers are required to act in the best interests of the corporation, and that means the best interests of its legal owners, the shareholders.

Shareholders and Stakeholders: A Practical Compromise

To some, this seems like an excessively narrow doctrine. There are others besides shareholders whose fates are interwoven with the firm's: its employees, creditors, managers, customers, suppliers, and the communities that depend on it. These parties are called the firm's *stakeholders*.[8] Surely it would be better if top managers ran the firm in the best interests of society, or at least the community, or at a bare minimum the workers and shareholders together?

The economist's response is twofold. First, a proper legal system collapses all of these into the interests of shareholders alone. If a firm passes over top job applicants because of racial or gender prejudice, firm performance is suboptimal and the shareholders lose. If a firm pollutes the environment and is sued, the shareholders lose. If it mistreats its workers and is subjected to strikes or other labour unrest, share prices and dividends fall and again the shareholders lose. Second, managers can often point to some element of social good, benefits to workers, etc. in even the most foolish decisions. Assigning managers such a multidimensional responsibility risks effectively erasing all responsibility. Responsibility to all means responsibility to none at all.

The law has evolved a workable compromise. Managers owe principal duties to shareholders, but the legislature and the courts have developed a range of overriding duties and corresponding sanctions to ensure fidelity to broader social goals. As a consequence, a corporation cannot rely on devotion to shareholder interests to justify neglect of explicit occupational health and safety, environmental, or human rights obligations. Not only will a failure to meet these obligations subject the corporation's agents to individual sanctions, the law also imposes financial sanctions on the firm's shareholders in the form of penalties levied on the corporation. In this way, shareholders have powerful incentives to monitor and discipline corporate misconduct. This compromise has strong efficiency properties. But it also is deeply compatible with a thick conception of democratic theory. Instead of vesting an unelected and unrepresentative cadre of senior corporate managers with the task of determining how corporate resources should serve the public good, this model relies on accountable and elected

[8] The issue of the objective function of the firm is thoroughly canvassed in a symposium issue of the University of Toronto Law Journal devoted to Stakeholders and Corporate Governance, xx.

legislatures to pull that freight. Doing so, means that the decision as to when and how corporate externalities should be internalized are fully transparent and subject to full and proper public deliberation and accountability.

Myopia

Another widely repeated concern with focusing on shareholders' interests is that shareholders themselves are said to be myopic. They are, it is alleged, concerned mainly with short term performance, so excessive smarming to shareholders means forsaking long term investments. As the chapter by Giamarino convincingly explains, there is absolutely no credible evidence that this concern is real. Statistical analyses of large numbers of U.S. firms have shown that firms' share prices unambiguously rise when they announce long term investment projects or large R&D programs. The apparent conclusion is that long term investments please shareholders. This is supported by other studies that find a strong and sustained positive correlation between R&D spending and share value. If firms do have a short term bias, it seems the average shareholder would be pleased to see this change.

Principal-Agent Duties

A more legitimate concern is that managers can often ignore small, poorly informed shareholders. Thus, the board may toady to a single large active shareholder, while small investors, who collectively own most of the firm, are effectively disfranchised. In firms that lack any large shareholder, such as the large chartered banks, there is a danger that managers may ignore shareholders entirely and run their firms as personal fiefdoms. Shareholder rights activists allege that managers can then pursue pet projects, adopt biased hiring policies, and otherwise waste the shareholders' money. Such breakdowns of the principal-agent relationship are termed *agency problems*. Mainstream economics recognizes that various sorts of agency problems are pervasive throughout both the public and private sectors. It is alleged by some economists that they are the chief cause of economic inefficiency in modern capitalist economies.

Although agency cost nomenclature is new, the concept of accountability which underlies it is not. Since the early part of the century, corporate scholars have worried about the accountability problems set in train by delegations of authority required to realize gains from specialization in the modern corporation. Berle and Means' seminal study on the American corporation was focussed precisely on this issue. It was these scholars who coined the phrase "separation of ownership and control" to describe the American system of corporate governance. Berle and Means conceived Corporate America as being riven by pervasive accountability problems which emanated from scattered, small stakes shareholdings. With so many shareholders, there was no incentive on the part of any shareholder to assume responsibility for controlling the affairs of the corporation. The consequence was virtually unchecked power for American corporate managers and the resultant suppression of the profit motivation.

In retrospect, it is clear that the Berle and Means' account was too bleak. While it is undoubtedly true that small stakes shareholders do not exert any real direct control over directors and managers in large public corporations, it does not necessarily follow that managers are forever on a frolic of their own. As a number of law and economics scholars have demonstrated, a variety of legal and market devices work to align managerial and shareholder interests. Legal instruments ensure managerial accountability by imposing ex post costs on self-dealing managers. Market instruments (such as the takeover or the "corporate control" market, the market for managers, and the capital market) typically focus on less malign sources of managerial misconduct, and operate either directly (through the threat of displacement or debased reputation) or indirectly (through provision of information of managerial performance problems to parties capable of undertaking direct action). The existence of these various legal and market instruments does not mean that the problem of accountability is trivial in the modern corporation, some residual agency problems still remain. Rather, the claim is that the legal and market arrangements that comprise the system of corporate governance are fairly robust, and, thus, to the extent that improvements can be made to that system through institutional reconfiguration, these gains are on the margin.

The Role for Law

If firms are based on voluntary activity among well informed deliberative stakeholders, and if markets play an important supporting role in disciplining managerial misconduct, what role is there for law and legal institutions? As mentioned earlier, if it can be demonstrated that certain stakeholders lack access to adequate information, that their bargaining with the corporation is beset by severe asymmetries in power, or that they are coerced into certain commitments with the corporation, then a plausible case for government intervention of some sort can be made. Most commentators agree that, save for employees, claims of this sort are unpersuasive. Moreover, even where they do attract legitimacy, it is not clear that the best form of state intervention is through corporate law, which is usually viewed as being devoted to shareholder and, to a lesser extent, creditor interests. Policy makers ought to be careful about overloading a single regulatory instrument with multiple and often conflicting goals, such as would result were employees and other constituencies deserving of protection to find their interests protected through corporate law.

If corporate law is primarily about shareholder interests, what form should it take? While early corporate statutes contained several mandatory elements that indicated a highly interventionist role for the state in ordering private arrangements, the clear trend in corporate law is to an enabling type regime, which confers considerable latitude on parties to pick and choose among various background terms. The enabling role for corporate law is consistent with the belief that shareholder interactions with the corporation are largely voluntary in nature, and the law should, as much as possible, defer to the wishes of contracting parties. Viewed in these terms, the role for corporate law is clear: lawmakers should struggle to develop and maintain a corporate law regime that facilitates contracting by private parties. One way to do so is by supplying background legal terms that economize on the costs of repeated negotiation for private parties. Another way to facilitate private contracts is through the supply of certain terms that private parties are unable to generate on their own because of high investment costs and risks of appropriation (the public goods problem). The elaborate system of fiduciary duties developed under corporate law is an instance of such a public good.

IV. Corporate Governance Problems in Canada

The economics underlying these agency problems is different in different types of firms. We examine each of the most common types of corporation in turn.

Widely-held Firms: Other People's Money?

A firm is widely-held when it is owned by a large number of small shareholders, each of whom has no effective control over management decisions. Some of Canada's largest firms, and almost all large U.S. firms, fall into this category. All the major chartered banks are widely held. So are Bell Canada and Air Canada. Although some widely-held firms are prominent in Canada, this genre of ownership structure is not common here. Morck and Stangeland place only 16% of the largest 550 Canadian corporations in this category in 1989.

In widely-held firms, it is commonly alleged that managers too easily forget their duties as shareholders' agents, and govern their firms to benefit themselves. This agency problem both impoverishes shareholders and undermines the economic logic that links optimal corporate policy to the common good.

For example, suppose a manager declines to make a corporate decision that would benefit the firm $5,000,000 but would cost him intangible losses he values at $50,000. If he owns one half of one percent of the firm's outstanding shares, a situation not uncommon in many large widely-held firms, he will forego $25,000 of share value but keep $50,000 in intangible benefits. He thus comes out $25,000 ahead. The other shareholders lose the remaining $4,975,000, perhaps without ever realizing they might have had it.

Of course, most self-serving behaviour by managers is less transparent. It might involve a phenomenon economists have dubbed *managerialism*: corporate empire building through unprofitable takeover binges that enhance only the top managers' egos. Another possibility is ethnicity or gender biased hiring or promotion policies that keep things comfortable for the managers but cost shareholders the value the best candidates would have added to the firm. Yet another is funnelling shareholders' money into economically questionable pet projects like unviable subsidiaries in exotic places. Some managers find it so wrenching to pay out cash windfalls to shareholders through increased or extraordinary dividends that they invest in almost any project, no matter how unprofitable, to keep the money inside the firm and under their control. Unnecessary Lear jets and palatial head office buildings are almost a caricature of self-serving managerial behaviour.

Because widely-held firms are characteristic of corporate America, both the mass media and the academic research literature have dealt extensively with instances of self-serving management in widely-held firms. The hit movie "Other People's Money" and the high profile attention newspapers now give to poison pills, greenmail, and other instances of managerial misbehaviour testify to the extensive public awareness, if not always extensive understanding, of corporate governance issues in widely-held firms.

Closely-held firms: Entrenched Insiders?
As the chapter by Rao and Lee Sing shows, most large Canadian firms are not widely-held. In more than three quarters of the Canadian corporations they study, at least one large blockholder controls 20% or more of voting shares, and in over half of the firms a blockholder controls more than 50%. Large shareholdings by management often let them dominate shareholder meetings since most small shareholders do not attend. This lets them control director appointments and thus indirectly control corporate decisions. Under these circumstances, it is unlikely that senior managers would ever forget about dominant shareholders' interests for long. Given this, on might think Canadians would be rejoicing that most of our big firms are free of American style agency problems. Unfortunately, the ownership structure of Canadian firms does not wholly eliminate these problems, and brings with it a whole additional set of other agency problems.

In closely-held firms, the fear is that directors and officers might toady excessively to the dominant shareholder and ignore smaller investors. Consequently, their fiduciary duty to act in the interests of the corporation is interpreted to mean acting in the interests of *all* the shareholders. The agency problem here is the possible conflict of interest between the dominant shareholder (as well as the officers and directors he controls) and other shareholders.

There is considerable evidence from the U.S. that blockholders do extract private benefits from firms. Barclay and Holderness (1989, 1992) show that large blocks of stock are generally transferred at prices higher than those prevailing on the open market for the same shares. Presumably this is because large blocks of shares confer more benefits than small stakes. Barclay, Holderness and Pontiff (1993) make the further case that the prices of many closed end funds in the U.S. are depresses because controlling blockholders extract private benefits. There is no reason to expect Canadian blockholders to be more altruistic than their American peers.

Dominant shareholders are perhaps less likely to deliberately push the firm towards nonvalue-maximizing activities of the sort described in connection with widely-held firms. After all, the dominant shareholder pays a large fraction of the cost himself. However, it is not reasonable to entirely rule out such behaviour. Large blockholders can often dominate shareholder meetings with 20% of the stock or less. A decision that cost the firm $5,000,000 would not be in a 20% dominant blockholder's interests unless it also generated benefits he valued at more than 20% of $5,000,000 or $1,000,000. Certainly, such situations are not impossible.

The additional set of potential problems in closely-held firms involve what financial economists call *entrenchment*. A dominant blockholder who exerts a detrimental influence over corporate policy is almost impossible to remove. He is largely immune to takeovers, proxy challenges, and board rebellion. Dominant shareholders, who originally brought value to their companies, may continue to exercise control long after they should have retired.

There is substantial evidence that managerial entrenchment is common. Morck et al. (1988) show that in the U.S. firm performance rises with insider ownership for widely-held firms, but then falls as ownership levels rise above a threshold that permits entrenchment. Johnson *et al.* (1985) show that sudden deaths of C.E.O.s over the age of 70 cause their firms' share prices to rise on average. Often, the death of a firm's dominant blockholder leads to it becoming widely-held as the heirs cash out. However, the inheritance of dominant blocks of stock may also put less competent heirs into positions of power they have not earned. Morck and Stangeland (1994) find that Canadian firms whose dominant shareholders are their founders' heirs perform significantly worse than other firms of the same age and size in the same industries.

Firms with Dual Class Shares: The Worst of Both Worlds?
Canadian law and practice allow companies to freely issue multiple classes of shares with different voting rights. This, in theory, allows closely-held firms to grow without the dominant blockholder losing control. In practice, many fear that it also opens Canadian firms to the worst of both worlds. By issuing themselves stock with many votes per share others shares with few or no votes, dominant shareholders entrench themselves and yet own only a tiny fraction of the firm.

Dual class recapitalizations, transformations of one vote per share firms into firms with different classes of voting stock, can be coercive. For example, suppose small shareholders in a one vote per share firm are given two weeks to either convert there common stock into class B common stock that will have no votes but will pay an extraordinary dividend, or commit to retaining their existing common shares (renamed class A common) and votes. Each small shareholder knows that if all others convert and she retains her class A stock, she will miss out on the extraordinary dividend and be left with a vote that is essentially useless. Thus she should convert. On the other hand, if all the other shareholders retain their class A shares, her converting her share to class B will not allow management to become entrenched, so she might as well get the dividend. Thus, again she should convert. In essence, each small shareholder is enticed to convert her stock to nonvoting common, despite the fact that this entrenches management and reduces the value of the firm. Jarrell and Poulson (1988) show empirically that dual class recapitalizations likely to lead to entrenchment depress firm values.

Currently, there are a variety of ways in which corporate and securities law constrain the scope for opportunistic recapitalizations. First, it is open to shareholders to commence a derivation action or seek an oppression remedy on the grounds that such conduct is motivated by an improper purpose. This claim would be most salient in the context of share recapitalizations effected in the context of a hostile takeover bid. Second, both corporate law (provisions respecting fundamental changes) and securities law (e.g., Ontario Securities Policy 1.3) require special shareholder votes when dual class share structures are created. These votes enable dissident shareholders to object to opportunistic dual class recapitalizations.

Firms with Takeover Defences: Protecting Shareholders from the Temptations of Wealth?
Hostile corporate takeovers are events that often pit incumbent managers and workers against shareholders. Takeover bids are always good for shareholders. Tender offers to buy control are generally made at premia of more than 30% above previous stock market prices, and can be much

higher. It is hard to see why shareholders need to be protected from selling their stock on such favourable terms. Indeed, shareholder rights activists argue that takeover defences exist primarily to entrench top managers who have established comfortable positions for themselves.

This view may be excessive. In some circumstances it is in shareholders' interests to have a takeover delayed so alternate buyers can be found. If an bidding war can be started, the ultimate takeover price might be increased even more. With this justification, many large Canadian firms have constructed defences against hostile takeovers. These include:

Poison Pills

These are amendments to corporate charters that penalize shareholders who acquire more than a certain amount of stock. For example, a flip-in poison pill might declare anyone who buys more than 15% of outstanding voting stock an "acquiring person", and then go on to say that in the event anyone becomes an "acquiring person", all other shareholders except the "acquiring person" receive 10 free shares. This both reduces both the value of the acquiror's position and its voting strength by 90%. The acquiror is almost back where he started.

In Canada, shareholders must vote in poison pills, however in some cases the vote has been tied to other issues, like increased dividends, casting doubt on the voluntariness of shareholder approval. Nevertheless, the Canadian strain of poison pills is much less virulent than their American counterpart, which suggests that shareholder approval has limited somewhat the scope for opportunism. Even more significantly, there have been several setbacks for poison pills in Canadian courts and securities commissions.[9] The general thrust of these decisions is that poison pills can buy time for managers to conjure up another offer for shareholders, but ultimately shareholders will be given the opportunity to decide on whether they want to tender their shares to an offer or not.

Voting Caps

Many corporations that are established by acts of parliament, such as chartered banks and privatized crown corporations like Air Canada and PWA Corp. have legislative voting caps. These conditions, laid out in the statutes that created these firms, make it illegal for any shareholder to own more than minimal amounts of the firms' shares. In the case of Air Canada, the limit is 4%. For the banks, the limit is 10%. Voting caps are merely extreme forms of poison pills.

Takeover Rules of the Road

Under Canadian securities laws, a takeover bid is defined as any offer to acquire an issuer's equity that would confer more than 20% ownership of a single class of shares on the offeror. Once a takeover is deemed to have occurred, the acquiror must comply with certain rules of the road, including pro rata take up of shares, minimum bid periods, information disclosure obligations, and so on. For purchases of control from dispersed shareholders, the rules in Canadian securities law do not

[9] 347883 Alberta Ltd. v. Producers Pipelines Ltd. (1991), 80 D.L.R. (4th) 359 (Sask. C.A.); Remington Energy Ltd. v. Joss Energy Ltd., unreported, Alberta Court of Queen's Bench, per Fraser J., Dec. 17, 1993; Re MDC Corporation and Regal Greetings & Gifts Inc. (1994) 17 OSCB 4971; and Re Lac Minerals Ltd. and Royal Oak Mines Inc. (1994) 17 OSCB 4963.

operate very differently from the United States. The crucial difference arises in the context of sales of control by an existing control holder. Whereas these transactions are subject to only selective ex post review for substantive fairness in the United States, in Canada, the takeover regime applies to these transactions, thereby entitling all shareholders to participate pro rata in the transaction. The effect of this rule is to raise the costs of a change in control transaction for an interested acquiror. Because an existing control block holder is unlikely to want to part with only part of her holdings (minority status is an unattractive prospect for a controlling shareholder), the acquiror is forced to bid for 100% of the company's shares.

Do takeover defences ultimately benefit shareholders? The answer appears to be no. Empirical evidence suggests that takeover defences do have an entrenchment component on average. Stangeland (1994) finds that firms with poison pills have performance below that of industry rivals without such antitakeover defences. Other recent studies also find that adoptions of poison pills and other takeover defences are correlated with reduced share value.

Firms with Free Cash Flow

Harvard Business School professor Michael Jensen (1986) has suggested that financial policy is closely related to corporate governance issues. He theorizes that in mature industries, firms existing operations produce substantially more cash flow than is needed for profitable capital investments. This excess he calls *free cash flow*. Firms should use cash flows they cannot profitably use internally to pay increased dividends. In firms with inadequate corporate governance, managers may seek to retain control over their firm's free cash flow by retaining it for suboptimal investments. According to Jensen, a low dividend rate in a mature industry is strong evidence of poor corporate governance. He suggests that, to prevent managers from misinvesting funds, firms in cash rich, mature industries should also be more highly levered. Thus, cash rich firms with low debt are probably also subject to poor corporate governance.

The chapter in this volume by Gagnon and St. Pierre takes a preliminary cut at Canadian data and finds no evidence of a systematic link between leverage or dividend policy and performance. More specific empirical tests, analogous to those done in the U.S., have not yet been performed for Canada.

Conglomerates: A Shells Game?

In Canada, as in continental Europe, Korea and Japan, much corporate activity is undertaken by conglomerates consisting of numerous related firms that collectively own controlling blocks of each others' stock. Public shareholders own the remainders of shares at each level.

There are many valid reasons in economic theory for the existence of conglomerates. It is costly for firms to raise external capital. Financing investment projects is simpler and cheaper if it can be done using internal funds. Conglomerates can serve as a sort of internal capital market for member firms. Excess cash from one firm can be invested in another if the return their is higher. The argument is that because conglomerates are run by managers who can understand and control all its diverse parts, it should make considerable economic sense.

However, the performance of conglomerates in general has not lived up to such expectations. Lang and Stulz (1992) show that conglomerates' performance lags behind that of focused firms. Also, the collapses of conglomerates like Argus, Olympia and York and the Hees-Edper group of firms have added to investors doubts about the real economic value of conglomerates. In the U.S., conglomerates have made up a disproportionate share of hostile takeover targets. Raiders there have found that conglomerates share prices are so depressed,
money can be made by buying the whole conglomerate, busting it up, and then selling all its parts separately. In these cases, at least, the whole is worth considerably less than the parts.

The underlying problem with conglomerates is widely perceived to be that they are much more difficult to manage than focused corporations. It is hard, if not impossible, for the head office managers in a conglomerate to understand each component business deeply enough to formulate strategies as effective as those of its more focused rivals. This undercuts the main advantage of a conglomerate, the alleged allocation of the group's capital to where it earns the highest return. However, it is not clear all the large conglomerates that have risen and fallen in Canadian corporate history served useful economic purposes.

But more than that, conglomerates open up a whole new type of agency problem. By controlling interfirm dividends, having companies within the conglomerate group lend to each other at nonmarket interest rates, organizing intercorporate billing for goods or services at artificial prices, or transferring assets at synthetic prices, a conglomerates managers can reduce profits in one firm and increase them in another. The fear is that profits in firms where insiders own relatively less stock might be diverted to firms where they own most or all of the stock - a kind of corporate shell game. In this case, the agency problem is the plural version of that in a closely-held firm: that the insider shareholders in control of the conglomerate might enrich themselves at the expense of the public shareholders in all its firms.
An analogous problem arises for tax authorities in other countries when money flows from profitable, and therefore taxable, firms to loss making firms within a conglomerate. This is not a problem in Canada because tax-free payment of dividends within a corporate group are completely legal here.

In fact, as the chapter by Daniels *et al*. points out, there are numerous other features of the Canadian legal and institutional environment that also facilitate conglomerate formation. Canada's *Investment Companies Act* is a less effective barrier to establishing conglomerates with large numbers of partially owned subsidiaries than is *Investment Company Act of 1940,* and can be easily avoided through provincial reincorporation. More liberal interest deductions in Canada subsidize debt, which provides favourable financing for acquisitions. The lack of a vigorous, privately enforced securities disclosure regime in Canada reduces the transparency of internal corporate transactions, and heightens the attractiveness of the conglomerate form of organization to opportunistic corporate insiders. Similarly, the lack of a clearly articulated corporate law fiduciary duty from majority to minority shareholders in Canada helps explain, at least historically, the attraction of conglomerates to opportunistic controlling shareholders. The absence of such duties allows controlling shareholders greater scope for unfair self-dealing transactions than would be possible in the United States.

Daniels *et al*. also argue that the mercantilistic industrial policies of successive Canadian governments encouraged conglomerate formation. Restrictions foreign investment by Canadians, such as the *Income Tax Act*'s foreign property rule, reduce Canadian shareholders' investment opportunities. When they disagree with the policies of corporate managers, shareholders here have fewer alternative places to put their money than would be the case if they could freely invest abroad. This may have allows inefficient conglomerate holding structures to survive, and may have thereby prolonged wealth reducing redistribution from investors to Canadian corporate insiders. Trade protectionism and favourable tax treatment of certain types of domestic equity investments also contribute to an inward looking industrial economy. Canadian corporations focused on producing a broad range of goods and services for the protected Canadian market rather a narrow range of competitive products for the global market. In this setting, the diversified conglomerate served as a natural vehicle for achieving corporate growth. Further supporting the formation of the conglomerate was, in sharp contrast to the United States, a more congenial political environment for the concentration of economic power. Whereas American political traditions embody a deep and abiding mistrust of concentrated economic power, the Canadian political environment is more sanguine. Here, the development and preservation of a fragile national identity easily trumped concerns over concentrated power. So to the extent that economic concentration was the inexorable result of nationalism, Canadian political leaders regarded it as a price worth paying to promote collectivist goals.

Multinationals: A Global Shells Game?

Multinational corporations are multi-firm organizations akin to conglomerates, but with a more convincing economic rational. All the subsidiaries of a multinational are usually in the same line of business, so it is easier for head office management to run than is a cross-industry conglomerate. Moreover, multinationals have immediate access to markets in many countries. This can be critical in quickly earning a high return on expensive investments like R&D. For investment in innovation, production and marketing costs are often minimal compared to upfront R&D costs. Thus, the larger the firm's market for its new product, the higher the return on the original R&D. For firms in R&D intensive industries like pharmaceuticals, computers, telecommunications equipment, home electronics, etc. a multinational structure is almost essential. Foreign partners are often avoided in these industries because of a fear of reverse engineering or other theft of proprietary information. The same situation holds in other industries with high up front fixed promotion costs like music recording or films, though foreign partners are a more practical alternative there. Morck and Yeung (1991, 1992) present empirical evidence that foreign subsidiaries do, in fact, add value only for firms with high R&D spending or advertising spending.

There is, however, another reason for a multinational structure: tax avoidance. By shifting profits between subsidiaries using the same methods used by conglomerates, multinationals can control which subsidiaries are the most profitable and hence the most taxable. Harris et al. (1993) provide empirical evidence that U.S. multinationals shift income from highly taxed to less taxed subsidiaries. Canada has higher taxes than many of the other countries multinationals operate in. Given higher domestic tax rates, multinationals operating in the Canadian environment have strong incentives to systematically shift profits out of Canada through manipulation of transfer pricing schemes. Not only does such behaviour reduce the revenues flowing to the Canadian fisc, but it also reduces the wealth of Canadian investors holding minority stakes in the multinationals' subsidiaries. This phenomenon illustrates poignantly the law of unintended consequences; the creation of partially owned foreign subsidiaries was encouraged by Canadian tax and foreign investment policy.[10]

Cooperatives: The Members' Money?

A number of industries, that in other countries are made up of corporations, in Canada contain cooperatives. These organizations are owned by members and controlled by professional managers. Thus, in theory, they might share many of the problems of lack of managerial accountability that afflict widely-held firms and firms with entrenched management. Empirical studies of mutually owned banks in the U.S. show that conversion to joint stock companies

Crown Corporations: Taxpayers' Money?

Despite a series of privatizations in the 1980's, crown corporations are still very much a part of Canadian business. Corporations like the C.B.C., Alberta Treasury Branches, Ontario Hydro, and B.C.Tel. are unlikely to face privatization anytime soon. Given the agency problems that pervert decisions in the private sector, is not public sector ownership an attractive alternative?

The answer is an emphatic no. Megginson, Nash, and Van Randenborgh (1994) have show that the performance of state-controlled enterprises, including those only partially owned by the state, is unambiguously worse than that of similar private sector firms. Why?

The reason seems to be that state-owned enterprises have their own set of agency problems that are, in many ways, more intractable than those of private-sector firms. In principle, crown corporations are supposed to be run in the public interest. In practice, this often means they are run in the interests of politicians and senior bureaucrats who pay none of the costs of poor investments, empire building, etc., rather than only a small fraction of them as the managers and dominant shareholders of private-sector firms do. The critical agency problem in public-sector firms is that politicians and bureaucrats can lose sight of their duty to the public. Moreover, dysfunctional corporate governance in private-sector companies is ultimately constrained by the firm's bottom line and the bankruptcy that its violation triggers. State-owned enterprises have what economists call soft budget constraints. That means their deficits are picked up by the taxpayers. State-owned enterprises can thus tolerate worse governance than their private-sector counterparts can. Furthermore, those mechanisms that limit agency problems in private firms, such as shareholder votes, takeovers, project based capital market scrutiny etc., are not features of the governance of state-owned enterprises. The only lever the public

[10] Several examples can be cited. The tax incentives contained in the 1963 federal budget which lowered withholding taxes on dividends from 15% to 10% for companies beneficially owned by Canadians to the extent of at least 25% of their voting stock, and also where the parent company and its associates held no more than 75% of the voting shares and the stock of the subsidiary was listed on a Canadian exchange; the establishment of the Foreign Investment Review Agency in 1974 and its attention to Canadian share ownership as one of the criteria necessary for entry into Canada; and the incentives set out in the Trudeau government's National Energy Program for Canadian ownership.

holds is the threat of electing politicians who will privatize, and this is being exercised increasingly often.

Other Nonprofit Enterprises: Donors' Money?

The largest charitable organizations can be as big and complex as large corporations. Their top executives have responsibilities on a par with those of corporate executives, and make decisions involving as much money. Yet charitable organizations have nothing analogous to shareholder votes, annual reports, etc. To provide accountability, director liability rules do extend to charities, even small local organizations. Is this the best way of making sure the managers of the charity act as their donors expect?

The Contributions in this Volume

In this volume, Industry Canada and the Financial Research Foundation have gathered together the thoughts of leading Canadian business and legal academics on topics related to corporate governance in this country.

Problems and Potential In the Governance of Canadian Corporations

In the chapter entitled "The Degree of Association between Corporate Governance Structure, Corporate Decision Making and Firm Performance in North America", P. Someshwar Rao and Clifton Lee-Sing of Industry Canada present a thorough and exhaustive statistical analysis of this topic using several hundred firms from each of the U.S. and Canada. They essentially correlate various indicators of corporate strategy, such as leverage, capital intensity, R&D spending, and foreign market penetration with indicators of corporate governance such as whether a company is widely or closely-held and how its board is structured. All of these variables are measured relative to benchmarks for firms in a given size range and in a specific industry. They then perform a similar analysis correlating standard accounting performance measures such as return on equity, return on assets, and various growth and productivity measures, again measured relative to size and industry benchmarks.

Their results are quite interesting. They find no consistent effect of institutional (i.e. pension fund, etc.) ownership on either corporate strategy or performance in Canada, but find positive effects on both in the U.S. This begs questions about why Canadian institutional investors might be more shy about pushing for better corporate governance than their American peers, which later chapters try to answer. They find little difference in either strategy or performance between widely and closely-held Canadian firms, but find positive effects of heightened insider ownership and negative effects of highly concentrated ownership for U.S. firms.

These findings are consistent with, and add to, other studies of both countries. Morck and Stangeland (1995) find that the critical difference in Canada is between subclasses of closely-held firms. Closely-held firms controlled by entrepreneurs outperform widely-held firms, while closely-held firms controlled by heirs lag them. Several studies of U.S. data, including Morck *et al*.(1988), McConnell and Servaes(1993), and others, find that increased insider ownership improves corporate performance up to a point and beyond that, highly concentrated ownership is associated with poorer performance.

Rao and Lee-Sing's results for their board structure variables are also interesting. They find that in Canada big boards are associated with less R&D, and poorer overall performance and productivity, whereas in the U.S. big boards seem to have little effect, either positive or negative. The find that foreign directors are associated have weak positive effects on Canadian firms, as does having a C.E.O. who is also chairman of the board. In the U.S. they find no real effect on performance for the average firm. This is consistent with other U.S. studies, eg. Weisbach (1988) and Morck et al. (1989), and Hermalin and Weisbach (1990), that find board structure seems unimportant for typical firms, but matters when performance is poor. Outsiders on the board is correlated with poorer performance in both countries.

It is important to emphasize the limitations of statistical evidence. First, statistical correlation does not usually imply causation. For example, a correlation between insiders on the board and good performance could be due to either outside directors causing poor management or poor management causing shareholders to demand more outside directors. Statistical evidence of the sort in this volume can be consistent or inconsistent with a given conclusion, it can never provide definitive proof. Second, the results in this chapter are from a type of statistical analysis called multiple regression, which looks for effects of one variable above and beyond the effects of the other variables. Thus, that inside directors is positively correlated with performance while inside ownership is not, means that inside ownership is not related to performance among firms that have the same proportion of inside directors. If you get lots of inside directors by having large blocks of insider ownership, obviously insider ownership is still important.

In the chapter entitled "Control and Performance: Evidence from the TSE 300", Vijay Jog, a distinguished business scholar at Carleton University, and Ajit Tulpule of PC Edge Inc., show that the percentage returns closely-held and widely-held Canadian firms have provided their shareholders between 1977 and 1991 are similar. Jog and Tulpule's results do not prove that ownership structure has no effect on share prices. Their result is consistent with the share prices of, say, widely-held firms being depressed relative to shares of closely-held firms by the same amount throughout the time period they examine. However, their results do show that intensified competition due to freer international trade has neither helped nor harmed closely and widely-held Canadian firms differently. Jog and Tulpule also present comparisons of various accounting performance measures for closely and widely-held firms, and report that there is again no difference. Note that this analyses is not strictly comparable to that of Rao and Lee-Sing since they use performance measures relative to size and industry benchmarks, while the accounting performance measures here are unadjusted.

Giovanni Barone-Adesi, the Peter Pocklington Professor of Free Enterprise at the University of Alberta, comments that he is not surprised that results found in the U.S. do not hold up in Canada. There are numerous institutional differences between the two countries. Canadian managers are free of class action suits by shareholders, can use dual class shares to retain control despite issuing large amounts of equity, are at less risk of hostile takeovers because of coattail provisions, etc. Because of these differences, he argues that most Canadian managers are well protected from shareholders regardless of the structure of their boards or the distribution of their companies' shares. Barone-Adesi argues that legal making class action suits by shareholders easier would help remedy this. He also points out that France assigns special legal duties to dominant shareholders, and argues that this might be appropriate for Canada as well.

David Stangeland of the University of Manitoba's Drake School of Management comments that Jog and Tulpule make an important contribution by emphasizing that relationships between corporate governance characteristics of firms and their performance may change over time as institutions evolve and as competitive pressures change. He also points out that ownership structure and other corporate governance related firm characteristics are very different in different industries, and argues that studies in this area must measure these features relative to industry norms.

The Board of Directors

As mentioned earlier, the principal goal of any corporate governance system is to solve the problem of delegated power from shareholders to directors and managers. One of the striking features of the recent debate over corporate governance is the extent to which it has focussed narrowly on the board of directors at the expense of other instruments. While the board of directors is the legal command centre of the corporation, it is clear that there are a variety of other organizational and market mechanisms that can attenuate agency problems in the modern corporation. For instance, commencing with Henry Manne, there has been a growing recognition of the capacity of the market for corporate control to monitor and discipline managers in widely held corporations. More recently, corporate scholars have looked to nuanced executive compensation arrangements and selective intervention by institutional investors as means for aligning shareholder and managerial interests.

The chapter by Jean-Marie Gagnon, of Universite de Laval, and Josee St-Pierre, Universite du Quebec, "Alternative Mechanisms for Corporate Governance and Board Composition", adopts a holistic view of the system of corporate control. The article invokes a cost-benefit analysis to evaluate the efficacy of alternative mechanisms for ensuring accountability, and then develops a taxonomy which links alternative systems of control with different underlying corporate structures. Motivating the analysis is the belief that shareholders will, within bounds, seek to adopt the most efficient basket of instruments to control managerial behaviour. The results of Gagnon and St-Pierre's analysis show that the distribution of voting rights in the corporation does affect the precise basket of instruments selected for control. In particular, they find that in widely held corporations, the ratio of outside to inside board members increases with the stock holdings of important outside shareholders (suggesting directorial appointments as a means to monitor performance) and decreases with the holdings of inside directors (suggesting entrenchment).

One of the key implications of the Gagnon and St-Pierre study is to remind us that markets, albeit not always unerringly, are capable of devising systems of control that support a multitude of corporate activities, without having to rely on external governmental intervention. In other words, so long as shareholders are able to access timely and accurate information about corporate structure and performance, they should be able to pressure managers and controlling shareholders to offer governance arrangements that are welfare enhancing, thereby reducing the need for potentially destabilizing government intervention. The propensity of markets to solve a lot of governance problems is instructive, and worth bearing in mind when the nature and scope for legislation in this area is contemplated.

The chapter, "Executive Compensation and Firm Value in Canada" by University of Toronto management professors Ramy Elitzur and Paul Halpern involves a systematic investigation of the compensation practices of public Canadian companies, that draws on data generated pursuant to the recently enacted amendments to the Regulations under the Ontario Securities Act. Elitzur and Halpern cite data from the United States which shows the existence of a positive relationship between the introduction of incentive based compensation arrangements (both short and long term) and share price increases (Bhagat et al (1985), Brickley et al (1985), Larcker (1983), and Tehranian and Waegelin (1986). They also discuss studies that track a broader range of firm performance measures after the introduction of incentive based compensation arrangements and find that a link between these schemes and firm performance improvements exists (Abowd , 1990). Nevertheless, the researchers note the existence of managerial earnings manipulation in cases where accounting rather than market-based financial criteria are used to undergird compensation schemes.

Elitzur and Halpern's empirical study focusses on the executive compensation practices of a sample of 180 companies from the TSE 300 index. The researchers' focus is on the difference in compensation practices between closely held and widely held Canadian firms. In the case of a closely held firm, where management already has a significant equity stake in the firm, conditioning compensation on share price changes would be superfluous, and may even subject managers to excessive levels of risk. However, the case for performance-based compensation is stronger where the manager holds less stock, for instance, where the company is widely held or where it is closely held but control is secured by a dual class share structure.

Elitzur and Halpern find that, regardless of ownership concentration, salary and total compensation are positively related to firm size. However, in contrast to earlier studies, they find that performance measured either by accounting, cash flow, or market based variables has no effect on the level of bonus, salary or total compensation for both closely and widely held firms. Further, the researchers did not find any relationship between the percentage change in compensation and firm performance variables, although they did find that compensation was positively influenced by the existence of a poison pill. This latter effect seems to be stronger in the case of closely held corporations, and suggests entrenchment. One final important difference between closely and widely held firms is the extent to which compensation levels persist despite a change in performance; the persistence effect is greater in the closely held firms.

The chapter entitled "High Gear: A Case Study of the Hees-Edper Firms" is by Ron Daniels of the University of Toronto Law School, Randall Morck of the University of Alberta Business School, and David Stangeland of the University of Manitoba's Management School. They point out that a conglomerate structure allows profitable subsidiaries to bail out troubled ones, and so makes higher risk business strategies viable. They find that, while Hees-Edper companies performed no better than independent firms of similar size in the same industries, they did have much higher risk. They find that this is due to both higher leverage and higher risk business strategies. Higher leverage is desirable for a firm because interest payments are tax deductible while dividend payments are not, but may serve little social purpose. Higher risk business strategies may serve the national interest if, as many critics argue, Canadian business is overly conservative. They argue that Canadian public policy should not aim to discourage the formation of conglomerates.

The chapter by Professors Paul Halpern and Vijay Jog, "Bell Canada Enterprise: Wealth Creation or Destruction" tracks the performance of BCE, Canada's largest conglomerate, since its establishment in 1983. In particular, the researchers focus on BCE's growth and strategic direction and its value creation performance. This inquiry is salient; BCE is insulated from the discipline of the takeover market by virtue of its sheer size (it had $37 billion in assets in 1993) and certain regulatory impediments which limit foreign ownership, and it is important to determine whether and how shareholders have controlled managerial accountability problems in the conglomerate, especially given the company's dispersed shareholdings. As mentioned earlier, there is an extensive body of literature that argues that financial diversification motivations for the conglomerate structure are suspect from a social welfare perspective, and simply reflect entrenched management's desire to diversify their human capital against firm specific risks, even though this is not valued by shareholders.

As measured by a variety of criteria, Halpern and Jog find that BCE has demonstrated marginal performance over the period since its inception. During the first six years, BCE operated like a large conglomerate, purchasing and establishing companies, many of which were in areas unrelated to its core activities. The source of financing for these transactions was the firm's steady supply of cash, secured through mature product lines and a highly regulated telecommunications' franchise. These results seem to confirm the existence of entrenchment behaviour. Halpern and Job do find, however, that its performance in the post-1989 period has improved (involving a return to more focussed corporate growth), and seems to have attracted some modest recognition by shareholders. Nevertheless, shareholder support for the conglomerate is not as great as it could be, and the researchers argue that this discount reflects the market's concern that management will repeat the mistakes of the past, namely by diverting free cash flows (kicked off by the regulated telecommunications monopoly) to investments in wholly owned or portfolio companies in related and semi-related businesses across the world. Further exacerbating the company's problems is its strategic commitment to management of assets, not businesses.

Clifford Holderness of Boston College, a leading expert on closely-held firms in the U.S., comments that closely-held firms are more important in the United States than is commonly realized, though they are not nearly as pervasive as in Canada. He argues that dominant shareholders can and do extract private benefits from firms they control, but there must be constraints on this. Otherwise, closely-held firms would eventually disappear, and this is not happening, even in the United States. Vikos Mehrotra of the University of Alberta argues that sole federal jurisdiction in areas related to corporate governance is needed to prevent managers reincorporating their firms in provinces that provide comfortable protection for insiders. He advances the argument that disputes between dominant shareholders and small shareholders are the central issue in Canadian corporate governance.

Institutional Investors

One of the most important changes to Canadian capital markets, and one which was frequently discussed during the conference, was the growing significance of institutional owners. Spurred on by the retirement needs of an aging population, large institutional investors (public and private pension funds, mutual funds, insurance companies and banks) are blessed with ample pools of capital that they have directed to investment in Canadian corporate equity. For many Canadian and American commentators, the growth of institutional ownership has profound implications for the control of managerial behaviour in both widely and closely held corporations. The claim is simple. By virtue of their size, sophistication, and staying power, institutional investors are capable of monitoring and disciplining both managers and controlling shareholders. Nevertheless, the claim for institutional ownership is not without its detractors. Many have argued that the scope for vigorous institutional activism is hobbled by a range of legal, organizational and cultural barriers (see, for instance, Coffee, Rock).

The studies commissioned for this volume address the scope for, and prospects of, institutional activism from a range of different perspectives. The chapter by Professor Jeffrey MacIntosh of the Faculty of Law, University of Toronto and Lawrence Schwartz, a private consulting economist, addresses the impact of both institutional and controlling shareholders on corporate value. In the case of the former, the researchers posit that institutional shareholders will increase corporate value, although they concede the possibility that institutional clout may be co-opted into being an unwitting ally of opportunistic management. In the case of the latter, the researchers are more agnostic; they predict that controlling shareholders will engage in both more effective monitoring of managers than non-control shareholders, and redistributive transactions that shift wealth from non-controllers to controllers. Given the prospects of controlling shareholder opportunism in the form of wealth re-distributive transactions, MacIntosh and Schwartz predict that institutional investors will make controlling shareholders, not just management, a target of their monitoring.

To test their hypotheses, MacIntosh and Schwartz examined several different performance measures for TSE 300 firms, which were correlated with data on Canadian patterns of institutional ownership. The researchers found a positive and statistically significant relationship between both return on assets and return on equity and institutional holdings. They also found some support for the hypothesis that institutional monitoring tends to mitigate the danger of redistributive transactions engineered by controlling interests. While the presence of institutional investors was correlated with increased corporate value, the relationship between controlling shareholders and corporate value was more ambiguous. MacIntosh and Schwartz find that although firms with controlling shareholders generate higher profits, these profits are siphoned off by controlling shareholders.

The chapter by Professor Steven Foerster of the Western Business School considers the desirability of importing into Canada the highly interventionist pattern of shareholder activism used by the California Public Employees' Retirement System (CalPERS) in the United States. CalPERS is not only the largest public pension fund in the United States (assets of $US 80 billion), but also the most activist. Over the last several years, CalPERS has trained its sites on the most poorly performing corporations in the United States. Each year, the fund identifies performance laggards, and subjects management of these firms to increasing pressure (ranging from quiet behind the scenes diplomacy to more public and stinging forms of intervention, such as "Just Vote `No'" proxy campaigns). Foerster cites a recent study by Nesbitt (1994) that found that although the targets of CalPERS activism underperformed the S&P Index by 60% prior to CalPERS' involvement, post-intervention returns jumped dramatically (outperformed the index by 40%).

Given the returns alleged to derive from CalPERS' activism, Foerster investigates why Canadian investors have yet to embrace this model of intervention. On the basis of extensive interviews conducted with Canadian public fund managers, Foerster traces the lack of enthusiasm for CalPERS' style intervention to differences in "style", rather than to any fundamental difference in the underlying regulatory structure of the two countries. That is, Canadian institutional investors systematically favour a less confrontational style of dealing with performance problems than is manifest in the United States. Another interesting point Foerster raises is that CalPERS systematically avoids closely-held firms. Since most Canadian firms fall into this category, it may be that CalPERS' style of intervention is not well suited to dealing with managers who are also dominant shareholders. It is important not to overstate the commitment to tacit pressure and activism; even Foerster acknowledges the activism of Canadian institutions (spearheaded by Fairvest) in responding to unfair management initiated transactions.

The chapter entitled "Monitoring Incentives Facing Institutional Investors" by Michel Patry of the École des Hautes Études Commerciales and Michel Patry of the Université de Montréal analyze the governance of institutional investors themselves. They point out that employees usually have little influence on how their pension money is invested. They point out that in defined benefit pension funds, the sponsoring organization has an incentive to maximize the fund's return. However, that sponsor is often a corporation with its own governance problems. Where the sponsor is not a corporation, it is usually a government and therefore subject to the political favour trading that plagues the public sector in Canada.

Various studies in the U.S. agree that corporate pension funds' portfolios perform surprisingly poorly compared to both broad market indices and mutual funds. Public pension funds' portfolio performance is even worse.

Corporate treasurers, usually responsible for managing corporate pension funds, are likely to favour hiring outside portfolio managers rather than indexing. Hiring outside managers gives them someone to blame for poor performance, but still provides work for the corporate treasurer's department. Outside managers must be evaluated, hired and fired. Indexing would be too easy a way of earning higher returns, and would not justify a large bureaucracy in the corporate treasurer's office. Since neither plan beneficiaries nor public shareholders have any input, the interests of corporate treasurers take precedence.

In public sector funds a similar situation occurs, with neither beneficiaries nor taxpayers having any serious input into how their plans are managed. Hiring, firing, and evaluating outside managers gives inside managers the same advantages as in corporate pension funds. However, the additional complication of pressure to put money into politically favoured investments may reduce performance even further among public sector funds.

Outside portfolio managers for pension funds are usually compensated with a management fee similar to that charged by mutual funds. Thus their incentive it to acquire and keep a large portfolio to manage, increasing its value is less important to them.

There is evidence that corporate treasurers use quarterly performance to evaluate outside portfolio managers' performance. However, stock prices are known to exhibit mean reversion, that is, unusually low stocks tend to go up and unusually high stocks tend to go down. Thus, corporate treasurers are systematically buying high and selling low. Also, there is evidence that portfolio managers systematically sell dog stocks and replace them with high flying stocks at quarterly reporting times. Having a few good stocks in one's portfolio apparently impresses sponsors. Again, buying high and selling low is not a recommended formula for financial success. Overall, this poor governance within pension funds results in sponsors reallocating their funds' assets among portfolio managers too often, in portfolio managers trading too often, and in poor overall returns.

Patry and Poitevin suggest that few institutional investors have the expertise necessary to intervene in the management of firms whose shares they own. They also argue that the governance problems within pension funds must be cleaned up before pension funds can be expected to improve the governance of corporations.

Patry and Poitevin feel the current provision in the Income Tax Act that restricts pension funds to investing no more than 20% of their portfolios abroad probably does not lead to better corporate governance. A main effect of this rule is to prevent pension funds from selling out of poorly performing Canadian firms for lack of alternative better investments. Although this might force the funds to voice their concerns to the managers of such firms, it also reduces pension funds power to affect such firms by dumping their stock. Patry and Poitevin also suggest that pension fund managers' compensation be disclosed, and call for firms to disclose a greater range of economically relevant data to make monitoring their decisions easier,

Brian Smith and Ben Amoako-Adu of Wilfred Laurier University, contribute the chapter entitle "Outside Financial Directors and Corporate Governance." They find no consistent pattern relating Canadian firms' performance to the presence on their boards of directors affiliated with financial institutions. Their chapter is actually wider ranging than its title suggests. They also examine insider ownership. Perhaps because of the paucity of widely-held Canadian firms and the limited disclosure of their owners stakes, they find no statistically discernable pattern in the data for firms with insider ownership below 20%. Among firms with more than 20% managerial ownership, they find a positive relationship with share value similar to that found by Morck *et al.* (1988) in U.S. data. They also find no statistically discernable relation between the fraction of outsiders on the board and firm performance. However, they advance the important point that Canadian disclosure rules fail to establish who really is an outsider. A firm's lawyers, executives of its advertizing firm, and executives of companies that do business with it are not really outsiders, yet are so classified when they sit on its board. Their fear of losing business with the firm may deter them from challenging the C.E.O. Perhaps the rules defining outside directors should be more stringent.

Mark Huson's comments at the end of this section are perceptive. He points out that the defining theme of corporate governance in Canada is controlling shareholders, not unsupervised managers as in the U.S. Huson suggests that Amoaku-Adu and Smith do not distinguish which directors are controlled by management and which are really independent. Because of such problems in most studies of outside directors, he argues that government ought to hold off from mandating certain numbers of outsiders on boards.

He adds, though, that Amoaku-Adu and Smith's results are consistent with dominant shareholders extracting disproportionate income from firms they control. Can institutional investors limit this? Huson points out some econometric problems in Foerster's analysis relating to the use of returns excluding dividends. He argues that MacIntosh and Schwartz analysis does not distinguish between the possibility that institutional investors improve share values and the possibility that improved share values attract institutions. But despite these problems, he feels institutional investors do improve corporate governance in Canada. He does not support Patry and Poitevin's idea of flip taxes to reduce churning in pension funds. He feels funds should be free to divest themselves of investments in poorly run firms, and that the thinness of Canadian markets already constitutes a barrier to this.

Huson advocates instead measures to reduce pension funds costs in confronting corporate governance problems. He proposes that pension funds be allowed to communicate among themselves on corporate governance issues, that institutional investors not be classified as controlling shareholders, that valuation techniques in shareholder appraisal rights take into account value lost due to things like poison pill adoptions, that outside board members' pay be linked to share prices, and that pension funds be allowed to invest abroad with no restrictions.

Michael Weisbach of the University of Arizona, one of the foremost experts on boards of directors in the United States, suggests that Canadians should not be too quick to imitate practices south of the boarder. He argues that the current rule forcing Canadian pension funds to invest in Canada prevents them from diversifying as much as they should. Weisbach also suggests that activist U.S. pension funds like Cal.P.E.R.S. are overrated, and argues that their apparent success may be due to mean reversion in stock prices rather than any real effect on corporate governance. He points out that studies finding a statistical link between good company performance and institutional investors as shareholders may not indicate a beneficial effect of these investors on corporate governance. Rather, they may just be detecting fund managers rushing to buy winners so their quarterly portfolio reports look good. He supports Patry and Poitevin's call for increased indexing of pension funds' portfolios, though he stops short of calling for mandatory indexing.

International Aspects of Corporate Governance

The chapter entitled Globalization, Multinationals and Corporate Governance by Randall Morck of the University of Alberta and Bernanrd Yeung of the University of Michigan argues for a minimalist approach to corporate governance legislation. Globalization is fast making heavy-handed legislation of business impractical. Canada is in competition with other countries for capital, knowledgeable workers, and high-value added operations of multinationals. If the Canadian government passes onerous laws, we will simply lose out to more friendly jurisdictions. For this reason, there should be no special corporate governance rules for foreign multinationals' Canadian subsidiaries. In particular, there should be no requirement that a majority of the directors be Canadian. Multinationals should be treated like any other Canadian company with a dominant shareholder.

The same globalization process means that Canadian companies will be exposed to more bracing competition from abroad in coming years, and poor corporate governance will therefore be more costly. Rather than attempt to micromanage boards of directors, the emphasis should be on empowering small shareholders. Increasing shareholder power is a more flexible and more effective way of improve corporate governance and thereby making Canadian firms globally competitive.

The corporate governance issue to be addresses is the fair treatment of minority shareholders by the dominant shareholder, in this case, the foreign parent company. One way of doing this is to require that the boards of all closely-held firms, including foreign controlled subsidiaries, have conduct committees charged with monitoring non-arms-length transactions. These committees must have a majority of outside directors. If there is a political necessity, they could also have to be Canadian citizens, though there is little economic rational for this. It would also make sense for all closely-held firms, including partially-owned subsidiaries, to have to disclose the details of all their non-arms-length transactions, and for their small shareholders to have the right to launch class action suits against the dominant shareholder in cases of oppression.

The chapter by Professors Lewis Johnson and Ted Neave of Queen's University, "Governance and Financial System Supervision", systematically links the governance structures of financial and market intermediaries with the asset and liability mix of various institutions. The researchers do so by drawing on a transaction cost framework developed by Oliver Williamson. They demonstrate a linkage between the nature of assets and liabilities of market and the complexity and transparency of the monitoring arrangements that obtain across different financial and market intermediaries. To strengthen the performance of intermediaries, Johnson and Neave recommend greater reliance on mandatory production of information where asset valuations, liability valuations, or contingent risks are now opaque. Furthermore, the researchers endorse the value of continuing information release, rather than sudden announcements of dramatic change.

"Canadian Banks and Corporate Governance", by Randall Morck of the University of Alberta and Masao Nakamura of the University of British Columbia, describes the somewhat checkered history of the German and Japanese banking systems. They argue that the alleged benefits of banks as major shareholders are unlikely to materialize in Canada, indeed, that they are far from clear in Germany and Japan. They recommend no move towards increasing Canadian banks' role in the corporate governance of nonfinancial firms.

Roberta Romano, a professor at Yale Law School, comments that individuals have been remarkably creative throughout history in structuring institutions to evade regulations. Although she is concerned about the distribution effects of subsidies to higher education and university research, which mainly benefit the upper middle class, she agrees with Morck and Yeung that excessive regulation is to be avoided, especially in an increasingly global economy. She points to the beginnings of the Eurobond market is an example. The U.S. imposed taxes on foreign bonds in the early 1960's, and the market simply moved abroad. Overly heavy handed corporate governance regulations would simply fuel the search for administrative and legal structures that evade them. She agrees with Morck and Nakamura that the Japanese and German banking systems are probably not to be imitated. She points out that these systems were in place long before the rapid post-war growth of these two countries, and argues that a late comer advantage (learning from others' mistakes), and perhaps things like good education and a high savings rate were more important than corporate governance to that growth. She argues that German banking was more an effect than a cause of that country's rapid growth. Germany industrialized late, when the logistics of large scale manufacturing had been worked out by others. The optimal scale for German industry was therefore larger than it had been during England's or Frances industrialization. The need for large block s of capital may have built the banks, and not the reverse. She points out that codetermination in Germany assigns half the seats on a firm's supervisory board or *Aufsichtsrat* to labour representatives. With half the board definitely not representing shareholders and the other half doing so weakly at best, widely-held ownership is unlikely to be optimal in Germany, so another system had to be developed. This, she argues, shows that corporate governance must be thought of in the context of a country's overall economic system. German and Japanese style banking makes little sense here given the rest of Canada's economic system.

Adrian Tschoegel, a noted expert on the Japanese economy, emphasises that small countries can be home bases for global companies, and suggests that this is a feasible future for Canada. He then emphasizes the roles of debt and equity, and how they differ across countries, and argues that these considerations might supplement the analysis in Johnson and Neave's chapter. He emphasizes the work of Allen (1993), who argues that debt financing is acceptable to investors in mature industries, where monitoring is easy. In newer, less well understood industries, where monitoring is difficult, equity is predominant. He then provides insightful summaries of recent work on the roles of markets and intermediaries, and again connects them to Johnson and Neave's chapter. Finally, he comments at length on Morck and Nakamura's chapter. He points out that Japanese keiretsu are unique among conglomerates for their mutual cross holding. Firms own stock in each other collectively, and no single firm may dominate. Japanese banks are owned by other keiretsu firms. He adds that vertical monitoring is important in Japan: that firms monitor the governance of their suppliers. In a discussion of the history of Japanese banking, he points out that Japan originally copied U.S. banking regulations in 1872, but was dissatisfied with the results. A series of modifications modelled on Belgian, British, and French laws or institutions followed in the later part of the 19th century, and led towards the present system. Thus, the current similarities of the Japanese and German systems result from both retaining aspects of earlier practice that was once common to much of Europe.

Corporate Governance and Social Responsibility

Although a considerable amount of ink has been spilled on the issue of directorial social responsibility, meaning the extent to which directors owe duties to non-shareholder constituencies, the fact remains that public concern with corporate misconduct typically involves a failure on the part of the corporation to adhere to explicitly legislated duties and responsibilities. In other words, the only question is how the board should ensure compliance with legislatively prescribed goals, not whether these goals should be pursued in the first place.

The chapter by Professors Ronald Daniels and Robert Howse of the Faculty of Law University of Toronto, "Rewarding Whistleblowers: The Costs and Benefits of an Incentive-Based Compliance Strategy" focusses on one relatively underutilized instrument in the Canadian context for achieving corporate compliance with social responsibilities: whistleblower bounties. Daniels and Howse argue that whistleblower bounties contain considerable promise as a cost-effective means of enforcing legislated responsibilities. The researchers provide two principal arguments in favour of such bounties. First, whistleblower bounties increase the effectiveness of sanctions by raising the probability that misconduct will be detected, which means that the state will not have to use excessive sanctions to secure social optimal penalties (product of both probability of detection and quantum of penalty). Second, whistleblower bounties take advantage of existing information and control systems within the corporation, thereby reducing the state's need to establish more costly and, ultimately, less effective external monitoring systems.

Nevertheless, despite these arguments in favour of whistleblower bounties, state reliance on whistleblower bounties has proved to be extremely controversial. In the United States, for instance, there has been intense criticism of the bounties provided by the federal government under the False Claims Act. Critics allege that the existence of such bounties distorts internal information flows, causes managers to make lower-level employees over-invest in firm specific capital so as to magnify the downside costs of whistleblowing, and subverts the ability of managers to create durable commitments to firm culture and teamwork. Daniels and Howse find these concerns overstated, arguing that careful design and enforcement of whistleblower incentives can correct for many of these problems.

The comment by Professor Jennifer Arlen of the University of Southern California Law Center on Daniels and Howse's chapter is sympathetic to enhanced reliance on whistleblower bounties in the control of corporate crime. However, she stresses that bounty provisions should not be enacted unless accompanied by a thorough reform of criminal law. Arlen is concerned with the interrelationship between bounties and the background system of criminal and quasi-criminal sanctions. Specifically, if bounty awards are employed in circumstances where corporations are in essence absolutely liable for agents' crimes, the awards may result in increased corporate crime because they may reduce the corporation's own efforts to reduce crime. Arlen thus argues for the adoption of alternative corporate liability rules, such as mitigation rules, negligence-based corporate liability or an evidentiary privilege.

The chapter "Patient Capital? R&D Investment in Canada" by Ron Giamarino of the University of British Columbia is a thorough summary of recent research on links between R&D spending and firms' share values. Corporate managers often complain that focusing on maximizing the share value necessitates adopting a short term planning horizon and forsaking long term investments like R&D. The inescapable conclusion of this chapter is that this complain is bunk. High R&D spending is statistically significantly related to above average market to book ratios (i.e. high share prices). We know increased R&D spending causes share prices to rise and not the converse. This is because stock prices have been found to rise significantly immediately after announcements by high tech firms of increased R&D. Interestingly, this is even true when the firms in questions have quarterly operating losses. (R&D in older industries, which might rationally be seen as less valuable, does not increase share value and may reduce it.) Still, in general, shareholders apparently like long run investments, or at least R&D, and would clearly like to see more.

Why then do firms not make their shareholders happier and richer by spending more on R&D than they do? Perhaps managers skimp on R&D because long term investments invite takeovers? If this were true, we should expect to find higher R&D in firms protected by poison pills and other anti-takeover defences. In fact, after firms adopt such defences, R&D falls significantly. Moreover, L.B.O.s, the type of takeover most likely to divert earnings away from long term investments, are extraordinarily rare in industries where R&D spending is important. This suggests raiders usually stay away from high R&D firms. When two R&D intensive firms merge, the R&D spending of the resulting firm is often lower than the combined R&D of the two merged firms. But this is not evidence of inefficiency. In fact, the motive for such mergers is often the savings attainable by pooling things like R&D.

The answer, Giamarino argues, may lie in how firms make investment decisions. A recent survey by Jog and Srivastava shows that many Canadian firms use out of data and conceptually flawed capital budgeting decision criteria in evaluating long term projects. Accounting rates or return and payback periods fall into this category. Even firms that use conceptually valid methods like net present values or internal rates of return often do not employ them correctly. For example, an R&D investment typically involves high risk in the early stages, but much greater certainty as the project develops. This means a high discount rate should be used for the first cash flows, but a lower rate is appropriate for cash flows in the more distant future. Failing to do this would bias firms against R&D spending. Also, it is important to recognize that R&D investments have many of the characteristics of options. There is a small chance of big payoffs, as in a call option. Valuation techniques for options are complex, but evaluating R&D projects as options would tend to give them higher values than standard net present value analyses would assign. Managers' understandable aversion to high risk investments like R&D perhaps encourages them not to question the negative

verdicts simpler decision criteria produce.
Overall, the best way to increase R&D spending may be to better educate managers about how to value R&D properly. Improve corporate governance in this dimension, and firms' R&D spending will take care of itself.

The chapter "Corporate Governance: A Means for Addressing Worker and Public Concerns about Worker Training" is by Alice Nakamura, John Cragg, and Kathleen Sayers. They point out that businesses may be loath to invest in worker training because of cost considerations, for example, a centralized educational institution may be more efficient, and because the employees whose training they pay for may leave for highly paid jobs elsewhere, denying the firm a return on its investment in training. Yet in the new global economy, as the chapter by Morck and Yeung points out, continuous innovation is critical to success. This would seem to require highly educated employees to create innovations and continuous education for other employees to apply innovations. The solution to this underinvestment in training by employers is either making workers pay for their own training or public education. For egalitarian and other reasons, Canada has focused on the latter. Because of the fiscal problems now facing government in Canada, this decision is being reevaluated.

Can firms be encouraged to invest more in training through changes in corporate governance, for example by requiring worker representation on boards? The answer Nakamura *et al*. give is "perhaps, but other approaches would be much preferred". First, requiring workers on boards might drive investment out of Canada. Second, employee representatives on boards would protect the interests of existing employees, especially senior employees, but would see little point in encouraging firms to spend money training the presently unemployed. Yet this is where the greatest social need is. We add a third reason, it might also simply marginalize boards. In Germany, which has mandatory labour representation on the *Aufsichtsrat*, or supervisory board, major decision making has been transplanted to the *Vorstand*, or management board, which consists of directors who are also top executives. The *Aufsichtsrat* has become an ornament.

Nakamura *et al*. argue that focusing on an alleged training deficit detracts from a more basic problem underlying many of Canada's social problems. One such problem is the structure of Unemployment Insurance. They argue for UI reforms that would allow employers who commit to job security to pay lower UI taxes. Another underlying problem is the promotion of students who are illiterate from grade to grade in primary and secondary schools. The costs of correcting twelve wasted years are immense. Better monitoring of student achievements and teacher performance are imperative. A third underlying problem is the prohibitive expense of lengthy post-secondary education for students from poor families and students supporting families. Some type of government subsidy would seem reasonable here. Finally, students often have little information about what particular training would make them most employable. To correct this, they argue that information on the employment and average earnings of graduates of various post secondary programs should be made available to the public.

Although Professor Michael Trebilcock of the Faculty of Law, University of Toronto shares Nakamura's scepticism surrounding the scope for worker-based governance structures to address job training objectives, he is less sympathetic to the various alternative policy initiatives she would prescribe. Trebilcock believes that the instruments suggested by Nakamura are not in themselves sufficient to address the need for job training or retraining. As a starting point for policy reform, Trebilcock stresses the need to disaggregate the potential demanders of job training or retraining services on the grounds that the appropriate policy mix for each constituency may vary dramatically. In determining the desired policy response for each group, Trebilcock argues for more supply side competition in training programmes. Trebilcock worries about the excessive amount of centralized control exerted by the federal government (through, for instance, the purchase of seats in community colleges) manifest in the current regime. Ultimately, Trebilcock believes that the most effective way to encourage competition is through a demand side scheme, such as that which is associated with school voucher programmes.

Ron Hirshhorn's chapter, "The Governance of Nonprofits", is useful in identifying the scope for governance problems in the third or not-for-profit sector. The analysis is salient given the growing reliance of the state on for nonprofit organizations in delivering a range of public goods and services. Hirshhorn's analysis draws on a well developed literature of organizational theory that explains the nonprofit organization as a response to market failures that are too costly to solve through either for-profit or state providers. In particular, Hirshhorn focuses on the perverse incentives that for profit delivery introduces in areas where outputs are hard to measure. Hirshhorn stresses the need to evaluate the rationale for nonprofit delivery on a case by case basis having regard to the elaborate criteria that he develops. Hirshhorn cautions that mere evidence of some gap in the operation of private and political markets does not support reliance on nonprofit modes of delivery. The calculus boils down to one of balancing the transaction cost savings in some areas against the increases in enforcement costs in other areas.

To illustrate this analysis, Hirshhorn examines three case studies involving community health care, local airport authorities and universities. Whereas Hirshhorn regards the case for nonprofit delivery to be relatively robust for community health care, he is sceptical of its value in the airport context (given monopoly properties) and universities (given the complexity of defining and measuring outputs).

Hirshhorn proposes several different avenues of policy reform designed to strengthen the operation of nonprofits. He argues generally for independent management reviews of nonprofit performance and for the imposition of stringent reporting requirements. Hirshhorn acknowledges that securing performance improvements through the adoption of these measures will not be easy. The difficulty is that many nonprofit services are hard to define precisely and even more difficult to monitor. Indeed, it is often the case that these very properties are the reason why for-profit providers eschew provision of these services. Nevertheless, Hirshhorn is optimistic that meaningful performance measurements can be created for a number of nonprofit services, improving significantly the degree of product market pressure that can be directed at these providers. In any event, Hirshhorn's focus on the state's role in providing information on nonprofits is well placed. It is clear that in the globalized economy of the next millennium, the state's role will increasingly shift from that of a direct producer of goods and services to that of an external monitor of, and supplier of information on, goods and services produced by others, particularly nonprofits.

One particularly interesting set of recommendations favoured by Hirshhorn relates to the paucity of effective governance provisions in the Canada Corporations Act, Part II (CCA), which applies to Canadian nonprofits. In contrast to the relatively crisp lines of accountability set out in standard corporate legislation, Hirshhorn stresses the failure of nonprofit legislation to specify comparable duties. Hirshhorn argues that "reasonable rules could be established to determine those who would qualify as significant stakeholders based on their contributions to the organization".

Professor Bruce Chapman's comment on Hirshhorn's study is concentrated on the charitable component of the nonprofit sector. Chapman develops a rationale for nonprofit delivery of charitable services that draws on a supply-side rather than demand-side analysis, emphasized by Hirshhorn. Chapman argues that charitable nonprofits can be used to supply public goods in a way that avoids problematic and destabilizing political conflict that might occur were the goods provided in the public sector. Chapman also claims that the nonprofit form prevents not only contract failure, but also permits donors and investors on the supply side to control the specific nature of the in-kind transfers that frequently characterize charitable nonprofits. This rationale supports the use of a disbursement obligation on charitables that forces managers of nonprofits to go back regularly to their benefactors for further funding, thereby limiting the scope for agency drift. Chapman also argues in favour of "line of activity" restrictions that limit the capacity of nonprofit managers to stray from benefactor objectives.

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