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An Organizational Approach to Comparative Corporate Governance: Costs, Contingencies, and Complementarities

Ruth V. Aguilera
Department of Business Administration and Institute of Labor and Industrial Relations,
University of Illinois at Urbana-Champaign, Champaign, Illinois 61820, ruth-agu@uiuc.edu

Igor Filatotchev
Cass Business School, City University London, London EC1Y 8TZ, United Kingdom,
igor.filatotchev@city.ac.uk

Howard Gospel, Gregory Jackson
Department of Management, King's College University of London, London SE1 9NH, United Kingdom
{h.gospel@kcl.ac.uk, gregory.2.jackson@kcl.ac.uk}

This paper develops an organizational approach to corporate governance and assesses the effectiveness of corporate governance and implications for policy. Most corporate governance research focuses on a universal link between corporate governance practices (e.g., board structure, shareholder activism) and performance outcomes, but neglects how interdependencies between the organization and diverse environments lead to variations in the effectiveness of different governance practices. In contrast to such *closed systems* approaches, we propose a framework based on *open systems* approaches to organizations, which examines these organizational interdependencies in terms of the costs, contingencies, and complementarities of different corporate governance practices. These three sets of organizational factors are useful in analyzing the effectiveness of corporate governance in diverse organizational environments. We also explore the impact of costs, contingencies, and complementarities on the effectiveness of different governance aspects through the use of stylized cases and discuss the implications for different approaches to policy such as *soft law* or *hard law*.

Key words: corporate governance; comparative corporate governance; effectiveness; organizational environments; board independence; information disclosure; insider control; institutional; costs; contingencies; complementarities; Germany; Japan; Italy; France; Russia; United States; United Kingdom
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Introduction

Corporate governance relates to the structure of rights and responsibilities among the parties with a stake in the firm (Aoki 2001). Effective corporate governance uses mechanisms to ensure that executives respect the rights and interests of company stakeholders, and that those stakeholders are held accountable for acting responsibly regarding the protection, generation, and distribution of wealth invested in the firm. Such effectiveness may be based on a number of different dimensions, ranging from monitoring and control over managerial discretion to promoting entrepreneurial leadership and innovation. Underpinning corporate governance are also various policy approaches that aim to improve its effectiveness by regulating managerial power (Parkinson 1993, Davis 2005).

Most of the empirical literature has attempted to understand corporate governance in terms of agency theory and explored links between different corporate governance practices and firm performance. This literature assumes that, by managing the principal-agent problem between shareholders and managers, firms will operate more efficiently and perform better. This *closed system* approach within agency theory posits a universal set of linkages between corporate governance practices and performance and devotes little attention to the distinct contexts in which firms are embedded. Despite considerable research, empirical findings on this causal link have been mixed and inconclusive. For example, empirical studies of the effects of board composition and ownership structure on financial performance have failed to identify any consistently significant effects (Ketchen et al. 1997, Dalton et al. 2003, Deutsch 2005). Critiques of agency theory have pointed out its *under contextualized* nature, and hence its inability to accurately compare and explain the diversity of corporate governance arrangements across different institutional contexts (Aguilera and Jackson 2003). Similarly, much of the resulting policy prescriptions enshrined in codes of good corporate governance rely on universal notions of best practice, which often need to be adapted to the local contexts of firms or translated across diverse national institutional settings (Aguilera and Cuervo-Cazurra 2004, Fiss and Zajac 2004, Ahmadjian and Robbins 2005). As Thompson (1967,

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p. 4) noted, "[Since] much of the literature about organizations has been generated as a by-product of the search for improved efficiency or performance, it is not surprising that it employs closed-systems assumptions."

By contrast, the literature in organizational sociology has largely advocated an *open systems* perspective, which suggests that different corporate governance practices may be more or less effective depending on the contexts of different organizational environments (Thompson 1967, Scott 2003). Within the field of corporate governance, stakeholder theory (Freeman 1984) comes closer to an open systems approach by recognizing that the effectiveness of corporate governance practices depends on a wider set of firm-related actors. Stakeholder theory shifts attention from efficiency arguments (e.g., narrow definitions of performance) toward a broader understanding of effectiveness in terms of goal attainment in relation to the multiple objectives of different constituent stakeholders (Connolly et al. 1980). Other approaches, such as resource dependence (Pfeffer and Salancik 1978) and comparative institutional theory (Aoki 2001), have also focused growing attention on how corporate governance relates to different organizational environments. While we draw upon these theories, we argue that the study of corporate governance needs to move to an open systems logic of studying organizations, which gives greater attention to the broader environmental context. Surprisingly, very little research has built on the large and robust body of organizational sociology, which explicitly examines the alignment between organizations and their broader environment (Thompson 1967). In this paper, we aim to close this theoretical gap.

We propose an organizational sociology approach to comparative corporate governance that will better account for the interdependencies of governance practices within diverse technical, managerial, and institutional environments. Our conceptual framework suggests that the problems outlined by the agency and stakeholder perspectives must be challenged better to capture the patterned variation that results from interdependencies between firms and their environment. Thompson (1967) argues that the focus on universal aspects of organizations is necessary, but leads to a static conceptualization of organizations. As Thompson (1967, p. vii) suggests, "to get leverage on a topic, we must begin to see some of the universal elements as capable of variation." Along these lines, recent studies have attempted to explain the dynamic dimensions of corporate governance over the company life cycle (Johnson 1997, Filatotchev and Wright 2005), as well as the diversity of arrangements across countries and over time (Aguilera and Jackson 2003, Gospel and Pendleton 2005). Thus, an important task in this research is to uncover the diversity of arrangements and to understand how the effectiveness of governance practices is mediated by their fit or alignment with situational variables (*context*) arising in diverse organizational environments.

The open systems perspective of organizational sociology suggests viewing corporate governance in terms of its effectiveness or the degree of goal attainment by key constituents of the firm. In this context, effectiveness in the broadest sense involves the accountability of corporate decision-makers and the legitimacy of decisions about their different economic and noneconomic goals and values. However, because multiple stakeholder constituents are likely to have different goals and objectives, effectiveness tends to be a complex and multidimensional construct that often defies single measures (Connolly et al. 1980).[1] Thus our aim is not to advocate a particular definition or measure of effectiveness, but to highlight the ways in which our framework may be useful for studying different aspects of effectiveness in relation to corporate governance. Throughout the paper, we use examples of effective governance concerned not just with the protection of investors' wealth, as in agency theory, but also with the creation of new wealth and the distribution of wealth among stakeholders. This context-specific view of effectiveness contrasts sharply with agency theorists, who argue that different elements collapse into a single long-term organizational objective and that accountability is impossible without a singularity of objectives (Jensen 2001).

We propose a novel conceptual framework for understanding the effectiveness of corporate governance practices. We believe effectiveness is mediated by interdependencies between organizations and their environments, which we conceptualize in terms of three constructs: costs, contingencies, and complementarities. *Costs* refer to the value of inputs to corporate governance, such as compliance with existing regulations or opportunity costs of managing relations with institutional investors. Because these costs will vary for different firms operating in different environments, cost-benefit analyses are rarely universal. *Contingencies* refer to how corporate governance interrelates with variations in internal and external strategic resources that shape a firm's interdependence with market, sectoral, regulatory, or institutional environments. For example, older firms in the mature phases of their business life cycle may have a deeper and more diversified resource pool, and thus a greater demand for accountability to external stakeholders than younger firms in their start-up phase, which may have narrower resource bases, and thus higher focus on internal, capability-related aspects of governance. *Complementarities* refer to the overall *bundles* of practices that are aligned to mutually enhance the ability to achieve effective corporate governance. For example, the effectiveness of independent board members depends on the presence of other complementary factors, such as high shareholder involvement and strong legal protection for investors. Although the notions of

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contingencies and complementarities may be interrelated, it is useful to separate them as two independent theoretical constructs. In our framework contingencies impact the effectiveness of a particular corporate governance practice, ceteris paribus, whereas complementarities describe interactions among multiple practices notwithstanding the firm's contingencies.

Even though these three constructs may not comprehensively account for the complexity of interdependence between organizations and their environments, we believe that costs, contingencies, and complementarities are useful conceptual tools to analyze why effective corporate governance can be reached through different paths and nonlinear trajectories. Our main contribution is to demonstrate how this research, largely based in agency theory, can be enriched by drawing more systematically on key traditions in organizational sociology. Both research fields are concerned with diverse organizational environments, but corporate governance research tends to pay less attention to how governance factors affect the adaptation of organizations to different environments. Our approach also contributes to an emerging literature, more specifically to the micro-foundations of this literature, by focusing on the level of organizations, rather than on broader national systems with diverse institutional legacies and traditions. For example, Schmidt et al. (2002) and Schmidt and Spindler (2004) analyze potential complementarities between various elements of national governance systems. We further develop this framework by focusing on complementarities between governance practices at the organizational level. Recent comparative work stresses the potential for organizational diversity within national systems, so that institutions may support certain types of organizations at the expense of others (Williamson 1991b, Aoki et al. 2007). A contextual- and organizational-level view of corporate governance provide a better understanding of organizational effectiveness resulting from the coincidence and interaction among multiple factors (Davis and Marquis 2005).[2] This view is consistent with recent set theoretic approaches to studying organizational practices (Fiss 2007) that focus on equifinality, whereby different initial conditions lead to similar effects or multiple conjunctural causation (Ragin 2000, Kogut et al. 2004). In short, our framework helps explain why no *one best way* exists to achieve effective corporate governance. Rather arrangements are diverse, but exhibit patterned *variation* across firms and their environments.

Grounding this research in organizational sociology has important implications for future research and policy analysis. First, the framework can be applied to the study of governance processes in diverse types of organizations, such as entrepreneurial firms or multinational firms, which have often been overlooked in the corporate governance literature. Second, similarities and differences in corporate governance can also be more systematically compared within and across industries, as well as in broader sets of national institutions and regulation. Third, our framework can help explain the impact of different policy approaches based in hard law, such as the U.S. Sarbanes-Oxley Act, or soft law, such as the U.K. Combined Code, on different types of firms.

The rest of the paper is structured as follows. First, we develop a critique of existing literature based on universalistic approaches to understanding the effectiveness of corporate governance, and we argue for greater attention to patterned variation drawing on organizational sociology theory. Second, we propose a particular approach to looking at the organizational aspects of corporate governance based on the costs, contingencies, and complementarities in different types of organizational environments. Our framework is not based on a typology of such environments, but rather presents a set of constructs to capture the interdependencies between corporate governance and its environment that draws upon classic approaches in organizational sociology (Thompson 1967). Third, we explore the interactions among costs, contingencies, and complementarities by applying our framework to several stylized examples drawn from the literature. Fourth, we apply our framework to assess the effectiveness of public policy approaches based on their impact on the costs, contingencies, and complementarities associated with governance.

From Universalism to Diverse Organizational Environments

Much of the research in this field is based on a universal model outlined by principal-agent theory (Fama and Jensen 1983, Jensen 1986). The central premise of this framework is that shareholders and managers have different access to firm-specific information, and managers as agents of shareholders (principals) can engage in self-serving behavior that may be detrimental to shareholders' wealth maximization. This stream of research identifies situations in which shareholders' and managers' interests are likely to diverge and proposes mechanisms that can mitigate managers' self-serving behavior. As Shleifer and Vishny (1997, p. 703) elaborated in their survey article, "corporate governance deals with the agency problem: the separation of management and finance. The fundamental question of corporate governance is how to assure financiers that they get a return on their financial investment." A substantial body of literature is based on this straight-forward premise and suggests that, to constrain managerial opportunism, shareholders may use a diverse range of mechanisms, including monitoring by boards of directors and mutual monitoring by managers (e.g., Fama and Jensen 1983, Rediker and Seth 1995), as well as monitoring by large outside shareholders (Holderness and Sheehan 1988).

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In addition, internal mechanisms may include various equity-based managerial incentives that align the interests of agents and principals (Jensen and Murphy 1990). Finally, external factors, such as the threat of takeover (Manne 1965, Jensen and Ruback 1983), product competition (Hart 1983, Jensen 1993), and managerial labor markets (Fama 1980) may constrain managerial opportunism. These governance practices are considered effective to the extent that they reduce agency costs and are hypothesized to result in positive efficiency outcomes and better firm financial performance. In sum, agency theory is primarily concerned with efficiency from the perspective of shareholders, who invest resources and seek maximum return on their investment.

Meanwhile, studies in organization theory and strategic management suggest a number of alternative views on the nature of corporate governance. Stewardship theory has relaxed some of the assumptions about managerial behavior found in agency theory, arguing that managers may act as stewards for the good of the organization in situations where only relatively minor conflicts of interests exist (Davis 2005, Deutsch 2005). Likewise, stakeholder theory recognizes that the effectiveness of corporate governance practices depends on a wider set of firm-related actors and their interactions (Freeman 1984). Stakeholder theory shifts attention from efficiency arguments (e.g., narrow definitions of performance) toward a broader understanding of effectiveness in goal attainment in relation to the multiple objectives of different constituent firm stakeholders (Connolly et al. 1980). Yet, it has not developed a comprehensive and systematic framework that captures the interactions of different stakeholders with the environment or with each other.

Despite their differences, a common tendency within these research streams is their reliance on similar closed systems logic to posit universalistic models of efficiency that abstract away from important environmental complexities. In agency theory, the under-contextualized approach remains restricted to mostly two actors (shareholders and managers) with little attention to how agency problems may vary across diverse task and resource environments, the life cycle of organizations, or different institutional environments. Although Williamson (1991a, b) suggests that transaction costs may be different in different institutional and organizational contexts, he also suggests that mainstream corporate governance research is "too preoccupied with issues of allocative efficiency ... to the neglect of organizational efficiency in which discrete structural alternatives were brought under scrutiny" (Williamson 1991a, p. 277). Stewardship and stakeholder theory remove some restrictive assumptions of the agency approach, yet do not provide a comprehensive research framework that links corporate governance with the broader context of different organizational environments. Rather, most corporate governance research continues to view organizational outcomes in a context-free or universal manner, rather than based on how different organizational environments mediate hypothesized relationships between sets of practices and organizational outcomes, such as effectiveness, efficiency, or performance (Ketchen et al. 1997). However, Jensen and Warner (1988, p. 21) suggest in an article widely cited in financial economics research that, "ownership, voting structure, capital structure, and managerial discretion interact with internal organizational forces and affect corporate behavior in important ways." They conclude that further study of these issues by scholars from other disciplines may bring exciting contributions to the development of a science of organizations.

Empirical corporate governance research has begun to cast doubt on whether there is a direct and universal link between governance practices and firm efficiency. Many have begun to question whether this association holds across the multiple variants of agency conflicts (Van den Berghe et al. 2002), different organizational contingencies (e.g., entrepreneurial ventures, initial public offerings (IPOs), or mature firms), and in different national settings (Whitley 1999, Crouch 2005, Gourevitch and Shinn 2005, Kogut and Ragin 2006). For example, a large sector of empirical literature has sought to predict the drivers of firm performance using various main precursors—either board independence and size (Dalton et al. 1998), dual leadership arrangements (Beatty and Zajac 1994, Boyd 1994, Ocasio 1994, Dalton et al. 1998), executive pay (Bebchuk and Fried 2004), or ownership structure (Hoskisson et al. 2002). Yet, empirical analyses have often failed to report any consistent effects, as in the case of board composition (see Daily et al. 2003). This ambiguity is found in many areas of the corporate governance literature (Filatotchev et al. 2007).

Perhaps more important is the fact that the performance impact of corporate governance practices appears to differ with respect to organizational contexts. For example, the impact of the market for corporate control has been shown to be different for different stakeholder groups. Takeovers create value for target firm shareholders (Datta et al. 1992, King et al. 2004), but are detrimental for acquiring firm shareholders or stakeholders such as employees (see Shleifer and Summers 1988, Conyon et al. 2001). Different aspects of the organization and its environment may also impact the role of governance practices, such as shifts in the role of the corporate board over the life cycle of companies (Hillman and Dalziel 2003, Lynall et al. 2003). Empirical results also show the opposite effects in different countries or even in the same country in different time periods. For example, studies of executive pay show strong correlations between pay and performance in the United Kingdom (Kubo 2001), whereas executive pay in Japan does not have incentive effects, so increasing the sensitivity of pay and performance has no impact on stock market performance (Kubo 2005). Similarly, whereas many studies reported a positive effect of monitoring by Japanese

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main banks on firm performance in the 1970s and 1980s (see Hoshi 1994), a decline in lending rates and changes in the macroeconomic climate have led to a strong negative relationship during the 1990s (Miyajima 2007).

We propose that corporate governance research should adopt a more open-systems approach that draws more robustly on existing literature in organizational sociology (Thompson 1967, Scott 2003). Open systems approaches treat organizational features as being interdependent with the diversity, fluctuations, and uncertainties of their environment, and reject universalistic *context-free* propositions. The effectiveness of corporate governance practices will depend on threats and opportunities within a particular organizational environment, and how stakeholders strategically choose corporate governance practices response to environmental pressures (Child 1997). An advantage of this approach is its ability to capture how organizations buffer, level, adapt to, or ration these interdependencies with their environments in ways that influence core characteristics and behavior of the organization. Interdependencies have also been underlined by work related to organizational structure (Blau and Schoenherr 1971) and strategy (Hambrick 1984), as well as in resource dependency theory (Pfeffer and Salancik 1978) and comparative institutional analysis (Aoki 2001, Crouch 2005). In short, open-systems approaches emphasize the importance of examining corporate governance practices within a holistic context, rather than as single factors acting in isolation.

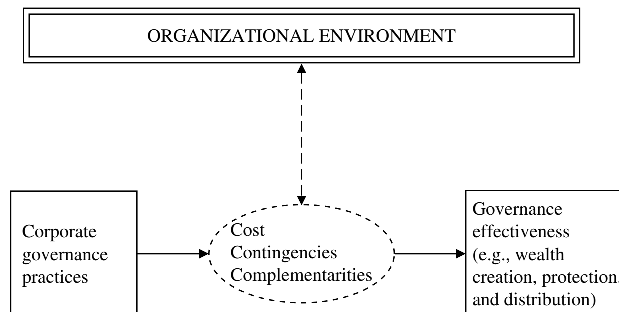
A further advantage of an open-systems perspective is in understanding how environmental factors shape the costs, contingencies, and complementarities, and, in turn, organizational outcomes, such as governance effectiveness. In line with organizational sociology, we view corporate governance practices as being effective within the context of different stakeholder constellations, their goals, values and resources, and specific organizational environments. While this concept of effectiveness goes beyond particular measures of financial performance, we suggest that the open-systems approach may be useful in studying the impact of corporate governance on a wide range of organizational outcomes that may range from a narrowly defined financial performance (e.g., return on assets, book-to-market ratio, etc.) to broader economic and social indicators (e.g., innovation, sustainability, and employee satisfaction). But studying effectiveness in an open-systems context suggests the need to appreciate that corporate governance may take on different functions across different contexts and that the relative salience of these functions may shift as the firm develops. For example, innovation and growth may constitute performance goals at earlier stages of the enterprise, whereas broader stakeholder involvement may be more important at its maturity. For purposes of this paper, we have identified several specific economic dimensions of effectiveness used widely in organization studies. These include the more traditional functions of wealth protection and the distribution of wealth among the firm's stakeholders, as well as wealth creating aspects of corporate governance (O'Sullivan 2000). The wealth-creation function is often associated with encouraging entrepreneurial leadership and innovation even in large mature organizations (Filatotchev and Wright 2005, Talaulicar et al. 2005). Although this function should ultimately lead to superior performance and growth, its effects on organizational outcomes are facilitated by entrepreneurial acts and innovation rather than by reduction in agency costs.

The open-systems approach is particularly suggestive for this field of research because governance itself plays a crucial role in mediating between more open institutional dimensions of the environment and the more closed internal aspects of the firm. Despite strong development of more contextualized or environment-centered approaches in other areas of organization theory, similar contextual or environmental factors have largely been ignored within corporate governance research.[3] In the following section, we develop our conceptual framework that is grounded in organizational theory and that synthesizes various empirical findings through a relatively parsimonious set of constructs.

An Organizational Approach to Corporate Goveranance

We propose an organizational approach to corporate governance that draws on three specific constructs for understanding the interdependence between governance practices and the organizational environment in which these practices are conducted. These constructs are costs, contingencies, and complementarities. We believe that the combination of certain corporate governance practices will lead to greater or lesser governance effectiveness, depending on the costs, contingencies, and complementarities associated with different environments as illustrated in Figure 1. An important caveat is that our aim is not to construct typologies of different sorts of environments, such as technical, managerial, and institutional. Nor do we systematically map

Figure 1 An Organizational Approach to Corporate Governance



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the differing dimensions within particular environments, such as the cross-national diversity of governance institutions or industry comparisons. Rather, our focus is on *how* various environments may impact the different arrangements of corporate governance practices, and ultimately measurable aspects of their effectiveness. We discuss each of these constructs in turn.

Costs

The core of corporate governance research is the potential benefit of various governance practices. Most approaches posit that improved company performance results from minimizing agency costs or maximizing the firm's resource base. In addition, we consider governance in the context of potential cost implications related to the inputs of corporate governance. These costs often appear as *externalities* or unintended consequences that stem from or are manifest in the broader environment of the organization, and reduce the effectiveness of corporate governance. However, such costs will vary across firms to the extent that they operate in different sorts of environments. In this regard, cost-benefit analyses are rarely universally applicable to all organizations.

The implementation of different practices may have several types of associated costs, starting with the systemic costs of compliance that are reflected in the firm's balance sheet and other accounting documentation (e.g., the audit costs or directors' insurance). In addition, corporate governance imposes less explicit opportunity costs (e.g., directors' time spent on governance issues instead of business strategy or changes in managerial risk preferences), proprietary costs (e.g., costs of disclosure of strategic information), and reputational costs (e.g., costs of fraud, misconduct, or corporate irresponsibility). These various costs may have different effects on the multiple parameters of governance effectiveness, implying potential trade-offs between them.

Systemic costs are related to the out-of-pocket expenses associated with routine compliance with governance rules and regulations. More specifically, these costs include expenditures on recruitment and remuneration of executive and independent directors and costs of operating control and risk management systems, including board committees. Notably, these systemic costs differ according to different sectoral and national regulatory environments. For example, Aguilera (2005) suggests that U.S. accounting firms are increasingly concerned with being sued, and have developed a voluntary enhanced audit that costs more than traditional audit services. In addition, new corporate governance rules under the U.S. Sarbanes-Oxley Act raise litigation risks and result in increases in the firm's expenditures on directors' insurance and indemnity policies (Zhang 2005). An important implication is the differential impact of systemic costs on firms depending on their resource capacities. Large firms with sufficient resources can more easily buffer these systemic costs, while smaller firms with greater resource constraints may be unable to comply, and, consequently, face disproportional additional costs if forced to delist from the stock exchange. Delisting because of higher compliance costs is also more likely among foreign firms since listing requires greater adaptation to U.S. standards (Aguilera 2005).

Beyond these direct systemic costs, corporate governance entails less explicit and more indirect opportunity costs that are often difficult to quantify. These costs relate to the impact of governance on strategic priorities, and, consequently, the exploitation of business opportunities. For example, managing relationships with institutional investors can create opportunity costs by diverting managers' attention from strategic and operating decisions toward anticipating short-term expectations about share prices. Therefore, opportunity costs may particularly affect the effectiveness of governance in terms of wealth creation. However, this depends on the specific nature and composition of investors who have different expectations on company behavior. In addition, litigation risks may change management's risk-taking behavior, which is likely to impede firm growth. For example, the benefits of improving legal protection for shareholders, such as through greater disclosure, auditing, and control, may be offset by overregulating the corporate governance environment in ways that detract from flexibility and risk taking (Walsh and Seward 1990), again diminishing the effectiveness of entrepreneurial leadership.

A number of studies have found that corporate governance may have a high cost impact on the firm's proprietary information through disclosure requirements (Lang and Lundholm 2000, Healy and Palepu 2001). In market environments where competitive advantage depends on proprietary technology or timing of market entry, managers may face high costs to the extent that they are required to disclose information relevant to their trade secrets or other proprietary information about the firm's R&D in progress, innovations, or recent discoveries (Verrecchia 1983). Moreover, where parties face high legal liability for public statements, the extent or content of disclosure may be rationed to offset costs resulting from potential litigation (Beatty and Welch 1996).

Finally, corporate governance influences costs related to the reputation of the firm (Rao 1994, Rindova et al. 2005, Washington and Zajac 2005, Rhee and Haunschild 2006). During the heyday of American welfare capitalism, large U.S. corporations built strong reputations and trust with their employees based on strong managerial control (Jacoby 2005). However, trust was often irrevocably undermined through the wave of hostile takeovers during the 1980s, which often benefited shareholders, but undermined managers reputations and their ability to make credible commitments to employees or other stakeholders (Shleifer and Summers 1988). Some companies,

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such as auditing firms or food companies, may be more vulnerable to reputation costs than firms that are traditionally less reliant on reputational capital, such as steel or chemical firms. Companies may try to level reputational costs by adhering to voluntary standards developed to ensure legitimacy within the industry (Bansal and Roth 2000), or national corporate governance codes based on comply-or-explain principles (Aguilera and Cuervo-Cazurra 2004, v. Werder et al. 2005).

Costs therefore have a mediating impact on the effectiveness of various corporate governance practices as illustrated in Figure 1. The important point is that the degree of direct, opportunity, proprietary, or reputational costs associated with a particular practice will impact different aspects of effectiveness and their salience will vary across different organizational environments. For example, recent research on Silicon Valley firms shows that reputation-based governance mechanisms are likely to be more effective in environments characterized by high levels of uncertainty (Podolny 2001). However, if firms are unable to level or buffer against particular types of costs within their environment, the costs of a particular governance practice may exceed the expected benefits. As will be discussed next regarding contingencies, the salience of these different costs may be contingent on the critical resources of the firm.

Contingencies

Contingency theory examines how the effect of organizational (i.e., structural) characteristics on effectiveness or performance may be mediated or influenced by three variables, such as task uncertainty, task interdependence, or task size (Donaldson 2001). Although corporate governance might be considered a structural characteristic within this framework, contingency theory as it relates to the effectiveness of corporate governance has not been fully examined. Here, we build on this research and examine how the effectiveness of governance practice may be mediated by a different but important category of contingencies; namely, the resources and capabilities that shape firm interdependencies in different organizational environments (O'Sullivan 2000). As such, we examine how corporate governance operates within the parameters of the organization, its internal and external resources, and strategy.

One aspect of resource-related contingencies is grounded in the resource-based view of the firm that takes into account its internal capabilities, such as skills, knowledge, and information (Barney 1991, Mahoney and Pandian 1992, Peteraf 1993). For example, corporate governance may play an important role in internal coordination and the motivation of critical employees, depending on the nature of the skills and knowledge that are critical for a firms' competitive advantage. Much literature in strategy has stressed the role of tacit knowledge (Penrose 1959, Grant 1996) or information (Itami and Roehl 1987) in influencing competitive advantage. However, newer literature argues that corporate governance practices are likely to shape firms' internal capabilities and routines. For example, Zahra and Filatotchev (2004) show that corporate governance in a knowledge-intensive entrepreneurial firm can be used strategically to develop and supplement the existing knowledge and experience of the original entrepreneurs by acquiring and exploiting externally generated knowledge and experience. Likewise, the degree and nature of firm-specific skills determine the demands on corporate governance for stakeholder participation. Aoki (2001) shows that in Japan, insider-based corporate governance supports the formation of firm-specific skills and cooperative team-based production, which have contributed to success in industries characterized by incremental innovation.

A further aspect of resource-related contingencies comes from the resource dependency theory, which not only suggests that firms will respond to demands by external actors or organizations on whose resources they are heavily dependent, but also that organizations may seek to buffer against or minimize that external dependence (Pfeffer and Salancik 1978). For example, the degree and nature of external finance is likely to influence the demands placed on corporate governance for transparency or independence. Meeks et al. (1995) find that different patterns of disclosure are contingent on firm size, debt-equity ratios, country of incorporation, and international listing. Likewise, smaller and younger firms may have less need of these governance mechanisms to the degree that their operations are more focused and easier to monitor through hands-on involvement.

Contingencies thus imply that the role of corporate governance is likely to differ in ways contingent on both external and internal resources, which are critical within the context of the firms' organizational, market, sectoral, regulatory, or institutional environments. Because the nature and salience of these resources depends on the interplay with diverse organizational environments rather than being a universal model, we argue that contingencies associated with internal and external resources are likely to influence the effectiveness of particular governance practices. In other words, the effectiveness of these practices may depend on the firm's size or age, the phases of growth or decline in the company's development, the character of innovation in different markets and sectors, and the regulatory and institutional constraints on business activity (Hermalin and Weisbach 1998, Deutsch 2005). Although a contingency perspective rejects the notion of universal *best practices* (Donaldson 2001), it also suggests that policy will be more effective if it takes into account the potential diversity of governance mechanisms, which deal with important contingencies. In short, a *one-size-fits-all* approach is undesirable.

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Empirical research on boards highlights the growing attention to how the effectiveness of various corporate governance practices differ based on contingencies. Recent meta-analysis has found that the relationship between firm performance and board size is stronger for smaller, as compared to larger firms (Dalton et al. 1999). Filatotchev and Toms (2003) and Hambrick and D'Aveni (1992) argue similarly that board diversity and director interlocks may play an important role in crisis situations because, from a resource-dependency view, these board structures may generate more diverse networking opportunities to resource providers. Research on IPOs (Certo et al. 2001, Filatotchev and Bishop 2002, Sanders and Boivie 2004) also demonstrates that board diversity supports wealth-creating aspects of corporate governance in newly listed companies. On the other hand, Luoma and Goodstein (1998) focus on board representation of stakeholders, including employees, public officials, suppliers, and customers, and discover that such representation is more likely when companies are large or are in highly regulated industries.

Another salient dimension of contingencies is the fact that the organizational resource base and its interdependence with external environments is not static, but an integral part of organizational dynamics. The application of a contingency-based concept has been developed within an emerging body of research on the life cycle of corporate governance (Johnson 1997, Lynall et al. 2003, Filatotchev and Wright 2005). This literature identifies a number of stages in the development of the firm where different *bundles* of characteristics are most effective. Corporate governance is viewed as a dynamic system, whereby practices may address changing sets of environmental interdependencies throughout the different stages of the firm's life cycle, such as start up, growth, maturity, and decline. Over these stages, firms may evolve from a very narrow resource base to a more extensive and heterogeneous resource base. This transition may require at least temporary reliance on external resources, creating new corporate governance demands by external resource providers to ensure that wealth is created on the basis of specific resources and distributed fairly in terms of providers, whether these are shareholders or other stakeholders. In addition, external financial resource providers may want to be sure that consumers can continue to obtain the product or that employees still have strong firm attachment, which is critical for innovation and sustainable growth. Likewise, mature firms with more heterogeneous resource pools may face a greater range of stakeholder demands for accountability. As firms evolve over the life cycle, we argue that the effectiveness of corporate governance also shifts in the balance between accountability roles versus resource and entrepreneurial roles, and as the nature of internal resources and interdependence on external resources also changes.

In the early stages of the life cycle, the entrepreneurial firm has a narrow resource base. It is usually owned and controlled by a tightly knit group of founder-managers and/or family investors, and the level of managerial accountability to external shareholders tends to be low. In this context, the resource and knowledge contribution of board members may be relatively more important compared to monitoring functions that play a key role in more mature firms. As the firm grows, it will require access to external resources, and, consequently, the board may be opened to external investors, such as *business angels* and venture capital firms. These board members supply financial resources, but equally, they provide the technical and industry expertise that broaden the firm's knowledge base and contribute to its entrepreneurial capability. At the maturity stage, the balance between entrepreneurial and accountability roles shifts as uncertainty about technology and markets diminishes and demand for financial resources to grow the business increases (for a discussion of these changes in uncertainty, see Podolny 2001). Consequently, corporate governance may shift toward greater transparency and increased monitoring and control by external resource providers. For example, an IPO is likely to offer the firm higher legitimacy and enhanced access to financial resources, but also an increased demand for accountability and scrutiny from the investment community and other stakeholders.

Life-cycle literature thus suggests that changes in resources and capabilities dynamically alter the interdependence of the firm, alongside transformations in the organizational and industry environment. Moreover, these changes may impose different demands on corporate governance practices. Therefore, to achieve effectiveness by fulfilling the interests of different stakeholders, corporate governance needs to adapt to different monitoring, resource, and strategy roles, depending on given contingencies such as the stage of the firm's life cycle. In this case, effective governance depends on patterned variation over the life cycle, rather than conforming to a universalistic model. In sum, contingencies underline the open nature of organizational interdependence. Whereas mature firms may be concerned with reducing agency costs, new entrepreneurial firms face different challenges in terms of anticipating future technological developments and growth opportunities as they try to buffer environmental uncertainties through long-term venture capital investments and network links associated with board interlocks (Filatotchev and Bishop 2002).

Complementarities

A growing literature has considered corporate governance as a system of interdependent elements by exploring how practices interact and potentially complement each other as related bundles. The rapidly expanding

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research on comparative governance systems (Schmidt and Spindler 2004) suggests that various elements may consistently complement each other to form path-dependent national systems within broader institutional and cultural context. As such, complementarities have emerged as a key concept in comparative work on the diversity of national systems of corporate governance (Aguilera and Jackson 2003, Schmidt and Spindler 2004). Just as with the contingencies literature, various governance practices are not seen as universally applicable. Rather than isolated best practices, corporate governance practices become effective only in particular combinations. However, this research is mainly concerned with complementarities between financial systems, legal institutions, and governance models on a national level. We develop this research further by focusing on complementarities between practices on a firm level notwithstanding national and institutional differences. Complementarities concern such interactions between practices, and how these interdependencies align governance to potentially diverse organizational environments. Although the effectiveness of corporate governance practices depends on a fit or adaptation to different contingencies and costs, as discussed in the previous sections, we treat complementarities here at the level of corporate governance practices themselves.[4] This perspective suggests mutual enhancement, as when the joint presence of two or more practices increases their effectiveness within the boundaries of particular costs and contingencies.

The notion of corporate governance as a system of interrelated elements having strategic or institutional complementarities has been proposed within the economics literature (Aoki 1994; Milgrom and Roberts 1994, 1995). Here, complementarity is usually defined as situations where the difference in utility between two alternative institutions or practices $U(x') - U(x'')$ increases for all actors in the domain X, when z' rather than z'' prevails in domain Z, and vice versa. If conditions known as *supermodularity* exist, then x' and z' (as well as x'' and z'') complement each other and constitute alternative equilibrium combinations (Milgrom and Roberts 1990, Aoki 2001). This view suggests interaction effects or clustering of characteristics into particular combinations suggested by work on set theoretic approaches, which have become important in management studies (Fiss 2007), comparative sociology of organizations (Maurice et al. 1986), and analysis of national business systems (Whitley 1999, Hall and Soskice 2001b). An important implication is that effectiveness does not result from a universal *one best way*, but suggests that particular practices will be effective only in certain combinations. Furthermore, complementary sets of corporate governance practices may be further linked with costs and contingencies, as discussed in the previous sections, to understand how different patterns may give comparative advantages for different business strategies or industry environments (Aoki 2001, Hall and Soskice 2001a).

Rather than focusing on broad institutional features described in the comparative literature, we examine complementarities in terms of the combinations practices at the level of organizations. We suggest that the simultaneous operation of multiple practices is important in limiting managerial opportunism (Walsh and Seward 1990, Rediker and Seth 1995, Hoskisson et al. 2002). For example, performance incentives for executives are more effective when complemented within a high level of board independence and an effective market for corporate control. These interdependent practices would be ineffective without further complementary practices, such as a high level of information disclosure to investors to allow the market to price shares accurately and a rigorous system of auditing to ensure the quality of that information. Consequently, information disclosure is demonstrably higher in the presence of corporate governance practices such as takeover bids (Brennan 1999), independent directors (Cheng and Courtenay 2004), and in firms where audit committees are independent and have financial expertise (Mangena and Pike 2004). Taken together, independent directors, executive pay incentives, information disclosure, and takeover markets form a key set of complementary elements at the core of the Anglo-American system of corporate governance. Such complementarities may also help explain why recent scandals, such as Enron, led to a systemic crisis in U.S. corporate governance. Disruption of one element of the system negatively affected other complementary elements so that the system failed to work in a reinforcing manner and gradually broke down as gatekeepers, such as auditors and even nonexecutive directors, became increasingly co-opted by managers (Coffee 2003), executive pay decoupled from performance (Bebchuk and Fried 2004), and the market for corporate control was tamed (Useem 1996).

Meanwhile, many elements common to Anglo-Saxon corporate governance remain absent in other countries. Where one specific mechanism is absent, others may be present and constitute alternative systems (Schmidt et al. 2002). Different constellations may provide different economic functions but result in equally effective outcomes (Agrawal and Knoeber 1996). For example, in German and Japanese systems, monitoring has been based on relationship-oriented banks rather than an active market for corporate control (Baums 1993, Aoki 1994). Jensen (1986) also suggests that when the market for corporate control is less efficient, the governance by debt holders may play a particularly important role in restraining managerial discretion. The long-term nature of bank-firm relationships may also complement a more active role for other stakeholders, such as employees, as employees' investments in firm-specific capital are

protected from breaches of trust (Aoki 2001). Employee voice helps to make managers more accountable internally because managers have to more thoroughly justify and negotiate key strategic decisions (Streeck 1992).[5]

Among all potential combinations of corporate governance practices, complementarities suggest that some combinations will be more effective than others. However, it must be noted that these combinations remain to be systematically theorized, let alone investigated empirically. For example, the complementarities between corporate governance and organizational architecture may depend on three sets of institutions, such as the domain of the state and polity (Aoki 2001). As a result, recent literature has found more complex combinations of corporate governance variables than implied by early works that focused on dichotomous comparisons of insider versus outsider or shareholder versus stakeholder systems. For example, the introduction of shareholder value practices in stakeholder-oriented governance contexts suggests a number of surprising interactions, such as coalitions of employees and investors to promote greater transparency (Gourevitch and Shinn 2005, Jackson 2005a). While mapping such combinations is beyond the scope of this paper, the important analytical point is that the effectiveness of particular governance practices cannot be seen in isolation. In fact, a particular governance mechanism, such as the market for corporate control or monitoring by independent board members, may have opposite effects in different organizational contexts. Whereas the market for corporate control may help exert discipline in the context of dispersed ownership and high transparency, it may also undermine the effective participation of stakeholders. Analytically, it is also critical to examine effectiveness in the context of the goals of different stakeholders. Corporate governance may have potential trade-offs in terms of different aspects of effectiveness and firm performance (Crouch et al. 2005). Strong employee participation may increase agency costs but lower transaction costs. Takeovers may lower agency costs, but increase transaction costs. Inferences about the overall complementarity between particular practices or institutions remain challenging, and we cannot tell a priori which dimension will drive overall effectiveness (Jackson 2005a). At the level of institutions, corporate governance embodying conflicting principles may also allow for more heterogeneous combinations of practices while maintaining the requisite variety for future adaptation in a population of firms (Stark 2001).

Interaction of Costs, Contingencies, and Complementarities in Determining the Effectiveness of Corporate Governance

Costs, contingencies, and complementarities do not exist in isolation, but jointly mediate the relationship between corporate governance practices and their effectiveness. Looking at these parameters in combination and in terms of how they interact with other organizational environments is particularly important because these three factors may add to, subtract from, or multiply each others' effects. Policy or governance practices that raise costs may be beneficial to the extent that they help firms adapt to particular contingencies or increase effectiveness by complementing other aspects of corporate governance. Conversely, attempts at saving marginal costs by rationing inputs to governance may undermine potential complementarities and render them ineffective.

In Table 1, we provide a set of stylized cases that show how costs, contingencies, and complementarities may interact in influencing the effectiveness of particular aspects of corporate governance. For the sake of illustration, we have selected three aspects of governance: board independence, information disclosure, and employee participation. In the first two examples, we compare two stylized cases that are *most similar* in terms of broader national corporate governance systems (i.e., Anglo-Saxon and Latin systems), but show distinct sets of interdependencies at the organizational level

Table 1 Stylized Cases of Interactions Among Costs, Contingencies, and Complementarities

	Board independence		Information disclosure		Insider control	
Stylized case	U.S. *Fortune* 500 firm	U.K. post-IPO firm	Italian family-owned firm	French privatized firm	Russian automobile producer	Japanese automobile producer
	Salience of mediating factors					
Costs	High costs	High costs	High costs	Low costs	Moderate costs	Moderate costs
Contingencies*	Extensive resource base	Narrow resource base	Extensive resource base	Extensive resource base	Extensive resource base	Extensive resource base
Complementarities**	Strong	Weak	Weak	Strong	Weak	Strong
Effectiveness of corporate governance practices	**High**	**Low**	**Low**	**High**	**Low**	**High**

*To exemplify contingencies, each cell scores the nature of firm resources in terms of being narrow or extensive.

**To exemplify complementarities, each cell represents the strength of complementarities between the corporate governance mechanism in each column with other mechanisms of corporate governance typically found in each stylized context.

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in terms of costs, contingencies, and complementarities. In the last example, we compare cases across different national environments to highlight the presence or absence of complementarities. To provide an initial stylized application of our framework, we operationalize each of the three variables in terms of their degree of salience. Because we cannot analyze all potential costs, contingencies, or complementarities, we focus on specific examples related to the extent of the firms' resource base and the strength of a given cost, contingency, or complementarity among stylized governance practices. Finally, we posit whether each constellation will have a positive or negative impact on the effectiveness of corporate governance overall.

Case 1: Board Independence

To analyze the potential effectiveness of board independence, we compare the case of a large and mature public U.S. *Fortune* 500 firm with a small U.K. post-IPO venture firm. We suggest that for the U.S. firm, the systemic costs of compliance with requirements of board independence entail large out-of-pocket expenses, but such large firms have a high capacity to absorb these costs and receive strong benefits in terms of enhanced confidence among investors. Still, substantial opportunity costs may arise if the overall board lacks strategic *inside* knowledge of the firm's operations or industry environment. Hence we suggest a medium to high level of costs for this sort of stylized firm. On the other hand, by appointing independent directors, the U.K. venture firm faces high systemic costs that may be hard to bear for small companies. Moreover, independent directors may increase risks of proprietary costs when strategically sensitive information is shared with company outsiders. In this case, the overall cost of board independence is generally high, and may negatively affect the effectiveness of the wealth-creating and wealth-protecting roles of independent directors.

In terms of contingencies, the large U.S. firm may operate in a mature or even declining industry context. Meanwhile, the resource base of the firm is broad and diverse. The stability of industry environment and large size of the firm generally reduce the overall level of uncertainties. Consequently, board independence may contribute to greater accountability to external stakeholders, who provide the firm key resources (O'Sullivan 2000). On the other hand, the IPO firm is likely to operate in an emergent or growing industry characterized by greater uncertainty regarding technologies and market position. This smaller and younger firm is also likely to have a narrower resource base from which to buffer environmental uncertainty. In this context, the contribution of board directors will largely consist of anticipating environmental change and encouraging entrepreneurial decisions aimed at securing survival and long-term growth, whereas the traditional role of promoting accountability will be less salient. In such situations, the boundaries between learning and monitoring often become blurred (Sabel 1994), and the board members' knowledge and strategy roles are relatively more important than their monitoring capacity (Filatotchev and Bishop 2002).

Board independence may also display complementarities with other elements of corporate governance. For the mature U.S. firm, board independence is likely to be more effective because of the presence of information disclosure, which enhances communication between investors and the board. Without this complementary dialogue, outside board members are likely to be less truly independent and their effectiveness will diminish. Likewise, independent boards complement several other typical corporate governance practices. For example, independent directors generally decide on executive pay and assure appropriate incentive alignment between executives and shareholder interests. At a broader institutional level, the independence of directors is enhanced by the existence of comparatively strong legal protection of shareholder rights. For the U.K. IPO firm, board independence may be less effective because of the lack of similar complementarities with other corporate governance practices. Venture firms tend to have large block shareholding by venture capitalists or entrepreneurs who hold seats on the board and provide a strong monitoring role without the presence of independent *outside* directors.[6] Institutionally, the stock market segment for U.K. entrepreneurial IPOs (e.g., the Alternative Investment Market) have relatively less demanding disclosure requirements, which may impair the effectiveness of independent directors and their accountability to the generally fewer outside shareholders. Notably, the interdependence of board structure with other corporate governance elements differs here at the organizational level despite being part of a similar Anglo-American *system*.

This illustrative discussion suggests that board independence will have a positive influence on the effectiveness of corporate governance in the U.S. firm, but a potentially negative influence in the U.K. firm. In the United States, costs are moderate, the firm's resource base is relatively extensive, the board's monitoring role is buffered from environmental uncertainty, and complementarities with other practices are high—all of which align the role of board independence with the broader organizational environment. By contrast the U.K. IPO firm faces higher costs, greater environmental uncertainties (which disrupt the monitoring role of the independent board), and fewer complementary corporate governance practices. Taken together, board independence is less well aligned to the organizational environment of the U.K. firm.

Case 2: Information Disclosure

To explore the effectiveness of information disclosure as a corporate governance practice, we draw on two stylized

cases from the Latin model (Rhodes and van Apeldoorn 1997, Aguilera 2003, Goyer 2003, Hoskisson et al. 2004, Trento 2005). We compare information disclosure patterns for a large family-owned and publicly traded Italian firm and a large recently privatized French firm. Both firms are publicly traded to provide access to equity capital. The critical difference between the two is in the nature of their blockholder interests.

Previous studies suggest that family owners may have superior monitoring abilities relative to diffused shareholders, especially when family ownership is combined with family control over management and the board (Anderson and Reeb 2004). Because current generation owners have the tendency and obligation to preserve wealth for the next generation, family firms often have longer time horizons compared to nonfamily firms. Family members therefore represent a special class of large shareholders that may have a unique incentive structure, a strong voice in the firm, and powerful motivation to make longer term strategic decisions (Becht and Roel 1999, Dhnadirek and Tang 2003). In terms of information disclosure costs, the close-knit nature of family ownership may lead families to resist disclosing information to outside parties, such as the government and other nonfamily share-holders, because they do not want to lose strategic control or because they want to preserve family network-based relationships with suppliers and customers (Khanna and Rivkin 2001). The majority of family-owned firms will also encounter high opportunity costs in compiling all the necessary disclosure information as they tend to keep majority control even for listed companies, and hence continue making all key firm strategic decisions (Van den Berghe et al. 2002). Alternatively, a recently privatized French firm will benefit from privatization process information disclosure spillovers. Thus, the systemic costs associated with information disclosure should not be as high when the firm becomes public. In addition, because this large privatized firm will have a broader shareholder base, the opportunity costs of disclosure are low because the information process is a core part of raising capital, particularly when targeting foreign investors (Goyer 2003), and will contribute to positive reputation in terms of governance accountability and transparency.

Regarding contingencies, both the Italian and French firms are large and most likely in mature or even declining industries characterized by relatively few environmental uncertainties and a broad resource base. Both possess a stable legacy and deep pool of internal resources either provided by their family-ownership tradition or by being former state-owned firms, which traditionally did not need to rely much on outside resources. Hence we categorize the contingencies of these two firms as an extensive resource base accompanied by low environmental uncertainty.

Finally, information disclosure may interact with quite different sets of complementary governance practices in these two cases. In Italy, disclosure is likely to display only weak complementarities with other existing governance practices because ownership structure is concentrated and pyramidal. Family majority owners thus have the power to monitor management effectively without high public disclosure requirements. In fact, disclosure may even undermine this effectiveness. Likewise, the minority shareholders in Italy acquire shares on a fairly underdeveloped stock market with low accountability standards, weak mechanisms to exercise voice, and a minimal presence of active shareholders, such as foreign institutional investors, who would claim and benefit from disclosure. Thus the large family-owned, publicly traded Italian firm will not find that information disclosure as a governance practice is highly effective in terms of wealth creation, protection, and distribution given the high associated costs and low complementarities with other practices. By contrast, in the French firm, information disclosure exhibits a strong complementarity with other governance practices, such as the market for professional (i.e., nonfamily) management, dispersed ownership, and the critical presence of foreign institutional investors who rely heavily on information disclosure to fulfill their governance roles through extensive shareholder engagement with company policy. State blockholders may also require transparency to avoid claims of unfair competition in international markets. In this regard, for the large recently privatized French firm, information disclosure will generate high governance effectiveness in terms of wealth creation, protection, and distribution among the shareholders, given the low costs of implementation and the strong complementarity fit with other practices.

Therefore, even when firms have similar resource-related contingencies, information disclosure may have different effectiveness as a corporate governance practice, depending on the nature of the blockholders and their interaction with the local environment of the firm. In the Italian example, because of the high disclosure cost and low complementarities with other corporate governance practices, information disclosure is unlikely to be very effective in terms of the main roles of corporate governance, such as wealth protection for family owners and other aspects of longer term wealth generation that may be related to their stable control. In the French firm, information disclosure is likely to be highly effective because disclosure are low, and because this practice is reinforced by other existing practices.

Case 3: Insider Control

Finally, we compare two stylized cases of employee or insider control in postprivatization Russia (Buck et al. 2000) and in Japan (Aoki 1988) to explore the effectiveness of employee participation as a corporate governance practice. Our examples concern large automobile

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companies that are integral to the economic development of these two countries. Insider control emerged in the Russian firm as a result of mass privatization, which was designed to transfer state ownership to private investors and to promote the development of Anglo-Saxon governance based on active capital markets. Instead, employees and managers receive large ownership stakes that guarantee absolute insider control, while outside minority investors are effectively excluded from participation in strategy decisions (Buck et al. 2000). Employee share ownership is also very common in Japan, although the size of the stakes is smaller. Shares were given to employees in the wake of postwar efforts to ban ownership by zaibatsu families and lessen the concentration of economic power, but the families quickly began selling these shares, which led banks to intervene to stabilize the market (Jackson 2001, Gourevitch and Shinn 2005). In Japan, however, insider control was built through a system of cross-shareholdings among group companies and financial institutions, where managers of one firm control stakes in other firms.

Regarding costs, both companies exhibit similar patterns. Systemic costs of insider control are shifted largely to minority shareholders who have weak legal rights and little capacity to exert influence on the company given that a stable majority of shares are controlled by insiders. Opportunity costs, however, may be relatively high because of the strong commitment of resources to employee welfare and provision of stable employment. Therefore we assume that costs of employee and insider forms of ownership range from low to moderate.

In terms of contingencies, the automobile industry is dominated by large mature firms with extensive resource bases and which operate within established markets. However, Russian firms are often faced with strong legacies of central planning and need substantial modernization and restructuring. In addition, firm resources may be extensive and suggest high dependency on external resources, but business strategy in automobiles is dominated by incremental innovation and quality-based product competition that also demands very strong internal capabilities and long-term orientation (Hall and Soskice 2001a). In both organizational contexts, therefore, the wealth-creating functions of corporate governance are very important, even with the Russian firm having a particularly strong need in terms of entrepreneurial transformation. Here, stable commitments to employees may be critical to ensuring smooth production coordination, involving workers in raising quality, and reducing transaction costs (Streeck 1987). A large literature on Japanese production methods suggests that employee participation is a key governance factor in mobilizing the commitment and cooperation of shop floor workers engaged in lean production (Sako 1992). Given the importance of buffering and adjusting to environmental uncertainties related to complex modular production and smooth central resource inputs, strong insider control is a potentially effective corporate governance arrangement.

Despite these similarities in terms of costs and contingencies, the effectiveness of insider control is influenced by strikingly different sets of complementary institutions. In Russia, insider control lacks any ultimate checks and balances. Employees usually place their shares in manager-controlled trusts and can only sell on a restricted basis. Outside shareholders have only limited possibilities to exert control over managerial discretion. Furthermore, state credit guarantees have led to substantial soft-budgeting problems, and lenders are not generally involved in corporate governance. Facing unchecked insider control, external investors are generally reluctant to finance much-needed restructuring and modernization. As a result, the effectiveness of employee ownership as a corporate governance practice is low.

In Japan, insider control is constructed within a context of other complementary governance practices. First, while employees and insiders maintain control under normal circumstances, the Japanese main bank plays an important role in contingent governance, whereby it may intervene when the business situation deteriorates and the viability of the enterprise in threatened (Aoki and Patrick 1994). Second, employee voice is not based solely on ownership, but linked with enterprise-based unions, long-term employment guarantees, seniority wages, internal training, and job rotation to ensure the flexibility and commitment of this stable labor force (Jeong and Aguilera forthcoming, Dore 1996). Thus, insider control in Japan remains effective because it is complemented by the shadow of outside intervention by the main bank, as well as being internally structured through an independent system of incentives, rewards, and participatory practices. Both of these elements are absent in the Russian case, making insider control highly ineffective.

In sum, our three hypothetical case comparisons highlight a range of the different interdependencies among costs, contingencies, and complementarities. In the first case, the firms were different along these three contextual dimensions. In the U.K. IPO example, these factors had a compounding and negative impact on the effectiveness of board independence, whereas in the U.S. *Fortune* 500 case, high costs were offset by the fit of contingencies and complementarities with other corporate governance parameters. In the second case, we compared firms with similar resource endowments, but facing different costs and complementarities. In the Italian family firm example, information disclosure imposed high costs and had negative complementarities with other governance practices such as concentrated ownership. By comparison, information disclosure imposed fewer costs

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on the French privatization case, because this firm faces fewer opportunity costs and has other complementary governance practices in the board along with investor engagement. In the final case, we compare firms from Russia and Japan, which are similar in terms of costs and contingencies, but differ in terms of the extent of complementarities. Again, we argue that this would create differences in the effectiveness of governance practices (e.g., employee participation). Together, these stylized cases suggest that even a one-dimensional difference in contextual factors may affect the efficiency of governance practice, although we are not able to evaluate differences in effectiveness further here in a quantitative sense.

Discussion and Policy Implications

Our framework has highlighted the importance of *contextual factors* based on different organizational environments. Much corporate governance research is limited to homogeneous contexts, the results of which may be hard to generalize across different samples of firms or national systems. In addition, the majority of previous studies focused on particular governance practices, without taking into account potential interdependencies and/or costs involved. We suggest that these should not be treated, in theoretical or methodological terms, simply as *control variables* in understanding otherwise universal relationships. We further argue that theory and empirical research should progress to a more context-dependent understanding of corporate governance and that this, in turn, will prove very useful for practitioners and policymakers interested in applying corporate governance in particular situations. In theoretical terms, more attention must be paid to the diversity of empirical results and these differences must be more explicitly built into theoretical models. In empirical terms, recent methodological advances may help operationalize and test more complex and context-dependent theories in ways that are difficult in large-scale sample-based research, which often relies on very broad proxies for context factors. For example, comparisons and case analysis based on set-theoretic methods can be a very fruitful avenue for further research. A potentially more contentious argument is that understanding effectiveness requires greater sensitivity to how corporate governance affects *different aspects* of effectiveness for different stakeholders and in different contexts. Whereas return on equity may be relevant for the governance of mature firms, younger entrepreneurial firms' performance may be better measured by innovation and growth. A balance between different functions of governance may also change when the firm evolves from its entrepreneurial stage through an IPO to growth and maturity stages. Likewise, corporate governance is likely to be associated with different distributive outcomes among corporate stakeholders, which show how risks and rewards to their relative resource contributions reflect governance.

The argument for a more contextualized approach to corporate governance has implications for public policy. In light of scandals and perceived advantages in reforming governance systems, debates have emerged over the appropriateness of different policy approaches based on hard law or regulation that draws on soft law, such as codes based around comply-or-explain principles. The hard law approach to regulation, such as U.S. Sarbanes-Oxley Act, seeks to strengthen corporate governance through legal rules that cover all companies operating in a particular jurisdiction. Such an approach mandates high minimum standards and severe legal penalties for the failure to meet these standards. Soft law, such as the U.K. Combined Code, is based on an alternative approach of comply-or-explain principles. Although this approach has been criticized for its weaker degree of enforcement and inability to mandate uniform minimum standards, it also has potential benefits in dealing with costs, contingencies, and complementarities. The flexibility for firms to adapt or mix various practices under soft law may help them to tailor corporate governance to diverse organizational environments. For example, Arcot and Bruno (2006) find that giving good quality explanations for noncompliance with the U.K. code is associated more with higher corporate performance than box ticking compliance.

The jury is still out on the two approaches. However, we suggest that the trade-offs involved can be better understood by analyzing the implementation of policy in terms of costs, contingencies, and complementarities. For example, Sarbanes-Oxley has been criticized as being too rigid and imposing excessively high costs, whereas the U.K. codes needed to be strengthened by greater legislative underpinnings to ensure enforcement. However, the fact that the U.K. approach is arguably the less universalistic and more contextualized may also help explain why, as other countries look to the United States and United Kingdom as early pioneers in the field, they have adopted some aspects of the U.S. approach, but on the whole have tended more to follow the U.K. approach (Aguilera and Cuervo-Cazurra 2004). This may also explain the present tendency for a growing number of firms to prefer listing in London rather than in New York.

Conclusion

In this paper we developed a critique of corporate governance research, especially within principal-agent theory, but also within stakeholder traditions. We were motivated by the absence in the lieterature systematic attention to contextual factors grounded in diverse organizational environments. While the open-systems approach to understanding organizations and their environments has been a staple of organization theory, similar lines of inquiry remain surprisingly underdeveloped in corporate

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governance literature. We have suggested a framework for looking at environmental interdependencies of corporate governance in terms of costs, contingencies, and complementarities related to various well-known practices. To take systematic account of these factors in future empirical research, studies must explore the patterned variation of corporate governance practices, their combinations, and their effectiveness in terms of alignment of organizations with a more contextualized view of organizational environments.

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Endnotes

[1]The relationship between effectiveness and efficiency is complex, because (1) sometimes efficiency leads to effectiveness and (2) sometimes organizations achieve their goals effectively but fail to achieve maximum efficiency in some dimension.

[2]This approach stresses the study of cases as complex and interdependent "wholes," rather than isolated characteristics, where the marginal impact of particular variables may be studied under the presence of statistical control factors or assumptions of "all things being equal."

[3]One notable exception in economics concerns work linking corporate governance to diverse organizational architectures, where information is bundled and shared in different ways depending on interdependencies among tasks and with external environments (Aoki 2001).

[4]Generically, the concept of complementarities can be applied to analyze the relation of corporate governance practices and particular types of resource contingencies, such as various categories of human assets (Aoki and Jackson 2007). In this section, we limit our discussion of complementarities to corporate governance practices.

[5]The recent experience of Germany suggests that employee representation on the board may have important effects on the design of executive stock option plans, leading to adoption of more and qualitatively stricter performance conditions than similar U.S. companies (Buck and Shahrim 2005).

[6]An alternative interpretation is that the presence of independent "outside" directors would actually complement this corporate governance arrangement in a different way by providing access to external resources, and a further check against the domination of large owners.

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