

NEW DIRECTIONS IN CORPORATE GOVERNANCE

Gerald F. Davis

*University of Michigan Business School, Ann Arbor, Michigan 48109-1234;
email: gfdavis@umich.edu*

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■ **Abstract** Corporate governance describes the structures, processes, and institutions within and around organizations that allocate power and resource control among participants. Law and economics scholars have developed a view of the public corporation as a nexus-of-contracts whose structure is driven by the requirements of financial markets, and thus features of the corporation and its surrounding institutions are theorized in terms of their function in directing corporations toward share price as a criterion of value. Working from this base, more recent research has studied historical and cross-national variation in governance institutions, producing highly varied interpretations of their sources and function. Sociological work, particularly within organization theory, has critiqued this functionalist view and provided alternative interpretations based on networks, power, and culture. The most promising contemporary work seeks to analyze governance in terms of the dynamics of institutions—where they originate, how they operate, how they change, and how they spread beyond their original purposes.

INTRODUCTION

Investors in corporations require assurance that their contributions—financial capital, human capital, social capital—will generate a return. Corporate governance concerns the institutions that make these investments possible, from boards of directors, to legal frameworks and financial markets, to broader cultural understandings about the place of the corporation in society. Thus, corporate governance consists of “the whole set of legal, cultural, and institutional arrangements that determine what publicly traded corporations can do, who controls them, how that control is exercised, and how the risks and returns from the activities they undertake are allocated” (Blair 1995, p. 3). When public corporations are among the most dominant actors transnationally, examining corporate governance is essential to understanding global structures of power. More broadly, corporate governance describes the institutional matrix that channels financial flows. In a world where foreign exchange trading tops \$1.5 trillion per day, it is an essential component of the contemporary world economy.

This article reviews recent research on corporate governance in sociology and law and economics. I focus in particular on the debates that have arisen in the past decade on the financial aspects of corporate governance. [Excellent summaries of work prior to that can be found in Mizruchi's (1996) review of interlocking boards of directors, Keister's (2002) review of financial markets and banking, and Kang & Sorenson's (1999) analysis of the ownership and control of corporations.] I begin with a discussion of managerialism and the contractarian approach to the corporation in finance and law that arose during the 1970s and 1980s. This approach views the corporation and its surrounding institutions as solutions to the problem of accountability and control created by dispersed ownership in large enterprises, and theorizes a set of markets and mechanisms that orient corporate managers toward the criterion of shareholder value. Because of the policy dominance of the contractarian approach, and because it is less familiar to sociologists than other views of the corporation, the review revolves primarily around this framework and its critics. I then discuss sociological approaches to the corporation and their critique of this functionalist approach. More recent work in law and economics responds to the limitations of the earlier functionalist stance by taking history, power, and culture into account in explaining the trajectory of governance institutions around the world, as the next section documents; indeed, financial economists have spawned a sort of para-sociology in attempting to explain cross-national variation in corporate governance over time, and both Marx and Weber have found unexpected admirers. I close by describing especially promising domains of future research as financial markets become ever more central parts of economy and society. The institutional structure of capitalism is increasingly oriented toward the signals generated by financial markets, and there is much sociological work to do on corporate governance in the contemporary economy.

THE CORPORATION AS A NEXUS OF CONTRACTS

Since Berle & Means published their famous book *The Modern Corporation and Private Property* in 1932, the folklore of the American corporate form has become a widely shared myth. The standard story runs as follows: Railroads and other American firms grew to enormous size during the nineteenth and early twentieth centuries in order to serve continent-wide markets economically. The capital needs of such enormous private companies—in contrast to their European counterparts—were too great to be met by wealthy families, and the United States had little precedent for state ownership, leading to dispersed ownership among thousands of shareholders in the largest firms. As Berle & Means (1932) put it, ownership was centrifugal, whereas management control was centripetal. The outcome of this process was the separation of ownership and control, as dispersed shareholders in large corporations became effectively powerless over the professional managers who ran the firms—a situation that came to be called managerialism. Berle & Means argued that managerialist firms were subject to several pathologies that led

them to deviate from what profit-maximizing firms did. Freed from the constraints of actively engaged owners, managements of such firms would seek only profits “sufficient to keep the security holders satisfied” (p. 342) and would instead pursue “prestige, power, or the gratification of professional zeal” (Berle & Means 1932, p. 122). By the 1950s, managerialism was regarded as a settled fact: The trends outlined by Berle & Means had allegedly overtaken most substantial enterprises, at least in the United States (Dahrendorf 1959; cf. Zeitlin 1974). So-called managerialist economists (e.g., Marris 1964) built on this characterization of the modern corporation to model the consequences for the economy when firms pursued growth first and profits second, and organization theorists followed suit, assuming ownership to be largely irrelevant (Davis & Stout 1992, Kang & Sorenson 1999).

Yet by the 1970s, theorists in law and economics began to question the plausibility of this account (as did some sociologists—see Zeitlin 1974). Why would sensible people invest in companies whose managers were going to squander their funds? If dispersed ownership was a sign of imminent mismanagement, then surely investors would shun such firms in favor of, say, family-run businesses where the people that ran the company had a stake in doing it well. And if investors shunned these companies, then their share price would suffer, and sooner or later someone would buy the company, fire the laggards in charge, and renovate it for quick profit (Manne 1965). But if corporate managers knew this, they would have an incentive to keep the share price up to avoid unemployment. They might do this in a number of ways: appointing tough-minded outsiders to the board of directors to show that their decision making was subject to thoughtful scrutiny; hiring rigorous auditors to signal the quality of their accounting; incorporating in a state with high-quality investor protection; listing on a stock market with stringent requirements; demanding payment in stock rather than cash to demonstrate that their interests were aligned with those of shareholders; and so on (see Jensen & Meckling 1976 for an influential initial statement).

This insight into the institutional pressures facing managerialist firms was behind the nexus-of contracts (or contractarian) theory of the corporation: financial markets render continuous judgments on corporate performance, and management has good reason to care about these judgments and to demonstrate convincingly that they are guided by the stock market. During the 1970s and 1980s, this solution to the puzzle of managerialism became perhaps the dominant theory of the public corporation, as well as a normative guide for the shareholder value approach to management. To survive, public corporations must demonstrate their fitness to financial markets by showing that they are oriented toward shareholder value. The institutions of corporate governance could thus be seen as a sort of financial global positioning system, a set of devices that mesh to guide corporate executives toward the North Star of shareholder value. Moreover, unlike product markets, whose selection processes may take years to weed out inefficient firms, financial markets are swift in their judgments. The features of public corporations and their surrounding institutions that survive can thus be assumed to serve a function in promoting shareholder value.

Working backwards from this premise, theorists explained the functions of a number of features of public corporations that were previously seen by managerialists as ineffective or even pathological. First, Berle & Means (1932) got it wrong when they claimed that dispersed ownership allowed managers discretion to pursue ends other than profit. Whether ownership was dispersed or concentrated depended on the monitoring needs of the firm: Firms with more variable performance came to have more concentrated ownership than those with predictable performance, and thus in equilibrium the degree of ownership concentration has no effect on profitability (Demsetz & Lehn 1985). Managerialists argued that boards of directors are often staffed by insiders (executives of the company) and their cronies, thus allowing management to evade significant oversight. But insiders know the business better than outsiders do, and outside directors who fail in their tasks as overseers suffer soiled reputations and negative labor market consequences (Fama & Jensen 1983). By the same token, top executives are extravagantly compensated because a well-articulated managerial labor market operates to reward them according to their contribution to shareholder value over the long term, not because they select their own overseers on the board of directors (Fama 1980). And while managerialists saw the proxy system of annual corporate elections as a sham democracy, in which unopposed candidates for director were offered along with policy proposals supported by information from the managers who mailed out the ballots, contractarians see this as a positive feature. Shareholders follow a policy of “rational ignorance”: The expected financial benefit of voting wisely is not worth the expense to become informed, and in any case shareholders’ specialty in the corporate division of labor is bearing risks through their ownership, not managing (Easterbrook & Fischel 1991).

This functionalist approach to economic structures spread from the features of firms to their surrounding institutions. Scholars of law and economics applied the same economic principles that had worked to explain organizational structures to understanding corporate law and self-regulating stock markets. Thus, corporate law could be seen as a framework for constructing value-maximizing corporate structures, providing off-the-rack contractual solutions for firms that their managers can then customize to their own situation (Easterbrook & Fischel 1991). Law arrives at this situation through competition among providers: Firms can incorporate in any state, whether they have any operations there or not, and thus state legislatures implicitly compete for incorporation fees through the legal “product” they provide, with Delaware (the incorporation state of choice for most large firms) generating nearly 20% of its state budget through corporate fees (Romano 1993). Similarly, firms choose which stock market to list their shares on among competing vendors with different listing standards (Rao et al. 2000). Managers choose among vendors of laws and other governance devices with an eye toward shareholder value: “The corporation and its securities are products in financial markets to as great an extent as the sewing machines or other things the firm makes. Just as the founders of a firm have incentives to make the kinds of sewing machines people want to buy, they have incentives to create the kind of firm, governance

structure, and securities the customers in capital markets want” (Easterbrook & Fischel 1991, pp. 4–5). And “If the managers make the ‘wrong’ decision—that is, choose the inferior term from the investors’ point of view—they must pay for their mistake” (p. 17). For instance, investors in Pennsylvania corporations lost approximately \$4 billion because of share price declines after the state adopted a strict antitakeover law in 1990.

Corporate structures, state corporate law, and securities markets have all evolved to serve the function of enhancing shareholder value, according to this approach. Also, a number of “reputational intermediaries” serve to enforce shareholder value. Public corporations must have their books certified by an outside auditor, and accounting firms have incentives to maintain their reputation for doing rigorous, high-quality audits because the value of their certification is only as good as their auditing quality. Investment banks do repeat business with the same large investors over and over again, and they accordingly have compelling reasons to underwrite only the securities of firms they have carefully vetted. And financial analysts working at brokerage houses are like private detectives, uncovering all the relevant information about the companies they evaluate and making judicious recommendations to their firms’ clients. In each case, incentives to maintain sterling reputations for quality work ensure that accountants, investment bankers, and analysts uphold high standards of corporate governance.

The causal imagery in this approach to corporate governance is of intersecting markets acting to orient the corporation toward shareholder value. Markets for underwriters, accountants, state laws, corporate managers and directors, and the takeover market (“market for corporate control”) all combine into an institutional matrix to guide corporate decision making. Underlying all these markets is the stock market. Indeed, share price is the ultimate criterion of value in these accounts, the measure by which all other markets are calibrated. But why? The answer is the efficient market hypothesis (EMH), the claim that financial markets are “informationally efficient”—that is, that they value capital assets (such as shares of stock) according to all available public information about their expected future ability to generate value. Faith in EMH is the bedrock of the contractarian approach: According to Jensen (1988, p. 26), “no proposition in any of the sciences is better documented” than the EMH. Because financial markets are future oriented—they value expected income rather than current or past performance—they are a useful augur of the consequences of present-day actions. Stock market reactions thus provide indications of the wisdom of corporate strategies and structures much more quickly than product market reactions (which may have long lags and, in any case, are well predicted by financial market reactions), and “a firm whose managers feel the necessity to respond to capital market signals will move quicker and will adapt more rapidly to a changing competitive environment” (Gordon 1997, p. 1486). And their future orientation and informational efficiency imply that financial markets can, for a price, provide capital for highly uncertain investments with payoffs expected far in the future, such as with biotech firms, which would have difficulty raising sufficient capital from banks or founders.

The evident success of stock and bond markets has led to an enormous expansion of the uses of similar institutions to fund other income-producing entities, from home mortgages, to credit card receivables, to future payouts of insurance and lawsuit settlements. And to the extent that corporate governance concerns the institutional structures that allow corporations and other entities to trade on financial markets, the domain of its study expands accordingly. Shiller (2003) argues that many social problems are essentially financial market failures. For example, poverty could be greatly reduced if the poor were able to capitalize on expected improvements in future income from education and training by in effect issuing bonds. As the cost of information and communication technologies goes down and their power goes up, the range of things that can be traded on financial markets expands tremendously, making it feasible to solve mere technical problems (such as the lack of a market for “human capital bonds”). It is already possible to speculate in quasi-markets for Hollywood film openings and elections on the Internet, and to buy bonds whose payoffs are tied to natural disasters. The Pentagon briefly (and surreally) contemplated creating an online “market for terror” in which traders could speculate on various classes of tragedy, the better to gather information about possible attacks. (The presumption was that traders had incentives to invest in gathering relevant information and that price changes would reflect the appearance of new data relevant to possible attacks. Critics pointed out that the market created a potential investment opportunity for terrorists to cash in on future attacks.) If the EMH were right, then creating financial markets not only provides better potential matches between investors and those needing capital, but the epistemological side benefit of informative prices (see Wolfers & Zitzewitz 2004 for a general discussion of prediction markets).

Although the plausibility of the EMH is not essential to the study of corporate governance, it is useful to dispel some of the stock critiques that do not hold up to thoughtful scrutiny (see Malkiel 1996, Zuckerman 2004). Some argue that financial markets are myopic and only reward short-term profits, but of course if this were true neither the biotech industry nor any of the many briefly well-funded Internet businesses would have existed. Moreover, some stock market investors (such as public pension funds) have effectively infinite time horizons. The fact that prices change rapidly in response to new information, such as corporate earnings that were lower than expected, is hardly a sign of myopia, although it may be interpreted that way by those who suffer from the price decline. Others argue that the stock market is a giant casino driven by fads and mob psychology. Presumably such individuals are sensible enough to avoid vesting their retirement in CREF or, alternatively, use their superior knowledge of mob psychology to beat the market. [McCloskey (1998) calls this the American question: “If you’re so smart, why aren’t you rich?”] Moreover, according to law and economics scholars, EMH does not have to be literally true to be useful as the best available option (e.g., compared to investment decisions guided by bank vice-presidents): “[I]t does not matter if markets are not perfectly efficient, unless some other social institution does better at evaluating the likely effect of corporate governance devices” (Easterbrook &

Fischel 1991, p. 19). The wiser proponents of the shareholder value system are pragmatists in the Oliver Wendell Holmes sense. William Allen (1992), for years the most influential jurist in Delaware, asserted that the contractarian/shareholder value approach “is not premised on the conclusion that shareholders do ‘own’ the corporation in any ultimate sense, only on the view that it can be better for all of us if we act as if they do.” And the question of why firms should be run for the benefit of shareholders receives an equally pragmatic response: “[I]f the statute did not provide for shareholders, we would have to invent them” because share price is such a useful criterion of value (Gilson 1981). Shareholders are simply placeholders in this account; the stock market value is what is essential.

There is a fascinating sociological literature on the origins and operations of financial markets that gives insight into the mechanics of where prices come from (see Keister 2002 for a review). Carruthers (1996) finds the origins of many contemporary financial market practices in the financial revolution in England around the turn of the eighteenth century, when a set of reforms implemented to allow the state to finance war via sovereign debt created an apparatus useful for raising finance for other large-scale ventures, such as joint-stock companies. Baker’s (1984) famous study of an options exchange shows how networks among traders dampened the volatility of prices, and others have followed with examinations of the origins and impacts of the social structures of financial markets (e.g., Knorr-Cetina & Bruegger 2002). MacKenzie & Millo (2003) interviewed a number of the principals who created the Chicago Board Options Exchange to show how the Black-Scholes options pricing model, initially a relatively poor empirical description of options prices, became true over time as traders implemented the theory. This work makes an essential contribution to understanding market institutions, but from the perspective of law and economics scholars, the critical question is whether there is a plausible alternative, as Easterbrook & Fischel (1991) note above.

CONTEMPORARY SOCIOLOGICAL CRITIQUES OF CORPORATE GOVERNANCE

The contractarian approach to the corporation rapidly established itself as the dominant framework in the 1980s, and it had a substantial influence on public policy and managerial discourse (see Davis & Stout 1992). The notion that corporations should be run to create shareholder value became managerial orthodoxy, taken for granted by investors, executives, and policymakers alike. Yet a number of sociological studies questioned the empirical and theoretical underpinnings of this approach. The general theme of these studies followed from Granovetter’s (1985) critique of economic functionalism and atomism: While the contractarian approach contemplates a world relatively free of the friction of social structure and politics, systematic empirical work found pervasive influences of both on the operations of corporate governance mechanisms. Moreover, the approach of working backwards

from contemporary institutional structures to infer the function they must serve has a rather notorious history in sociology.

Two important books retell the history of the large U.S. corporation from a nonfunctionalist perspective. Roy's *Socializing Capital* (1997) recovers the origins of the modern corporation by examining the corporate revolution around the turn of the twentieth century. Fewer than ten manufacturers had shares traded on major exchanges in 1890, with a minimal net worth, yet by 1903 the aggregate value of the sector's stocks and bonds was over \$7 billion. Incorporation, and selling stock on exchanges, was transformed from a rare and relatively insignificant phenomenon to the essential characteristic of the American corporate system during this period. Roy traces the political, legal, and class roots of this genesis, creating a stark contrast to the traditional law and economics approach: "Compared with efficiency theory, power theory thus proposes a very different agenda for research: Who made the decisions that created large industrial corporations? What were the alternative choices they faced? To what extent did rationality, social influence, or other decision-making logics shape their decisions?" (Roy 1997, p. 14).

Fligstein's (1990) *The Transformation of Corporate Control* traces the history of the large American corporation in the years following the corporate revolution up through the 1980s. The book builds on several themes in organization theory—that corporations have strategies and structures used for achieving characteristic aims (growth and survival) and that those strategies and structures reflect and shape power struggles within organizations; that corporations are embedded in a field of other organizations, including buyers, suppliers, competitors, regulatory agencies, and others, with their own strategies and structures reflecting their own internal power struggles; and that the state defines the rules of the game for their interaction, generating conditions either for turbulence or order. Those running corporations monitor others in their field for hints as to appropriate strategies and structures, and fields may tend toward relatively stable configurations. But configurations that are desirable from the perspective of those running corporations—say, a monopoly or oligopoly—are often undesirable from the perspective of other constituencies, such as their consumers. Thus, the state has intervened at several critical junctures in ways that destabilized the field of the largest corporations, primarily through antitrust legislation: the Sherman Act of 1890, which limited the viability of trusts and cartels; the Clayton Act of 1914, aimed at collusion; and the Celler-Kefauver Act of 1950, limiting vertical and horizontal mergers. Fligstein (1990) thus provides a four-part periodization of the history of the large American corporation. He argues that as fields achieved a form of stability through the use of common strategies and structures, state intervention changed the ground rules of competition and thus generated a search for new strategies and structures adapted to the new ground rules. As these were adopted and spread among large firms, fields achieved a new stability, which was again disturbed by the next round of state regulatory change.

The links between state regulation and organizational action are conceptions of control—"totalizing world views that cause actors to interpret every situation

from a given perspective. They are forms of analysis used by actors to find solutions to the current problems of the organization” and are “collectively held and reflected in their organizational fields” (Fligstein 1990, pp. 10, 12). Direct control, the first conception of control, used predatory competition, cartels, and the creation of monopolies to control competition, and it predominated in the late nineteenth century. The manufacturing conception of control sought oligopoly through horizontal mergers (acquiring competitors) and vertical integration (buying suppliers and distributors). When these tactics became problematic, the sales and marketing conception of control took off in the 1920s, focusing on product differentiation and line extension, advertising, and related diversification. Finally, the finance conception of control was encouraged by the Celler-Kefauver Act and promoted the rapid spread of the diversified conglomerate and a variety of “financial ploys to increase the stock price. . . and the use of financial controls to make decisions about the internal allocation of capital” (Fligstein 1990, p. 15). In each instance, as old conceptions of control were ruled out by state action, firms experimented with new approaches that, once proven successful at promoting growth, spread widely throughout the field of the largest corporations, enhancing the careers of those with the functional expertise that the conception advantaged (manufacturing, sales and marketing, finance) and changing the “functional demography” of those at the top of the largest corporations. Thus, by 1980, the median large American firm operated in three wholly unrelated industries (Davis et al. 1994), and finance was the modal background of their CEOs.

Roy (1997) and Fligstein (1990) both provide sociological critiques of the functionalism inherent in the contractarian approach. Rather than accepting contemporary structures as self-evidently appropriate and inferring an “efficient history” that got us here, they document the critical historical junctures that shaped the developmental trajectory of the corporation. More recent work has also examined the operations of specific current corporate governance mechanisms, such as boards of directors, managerial labor markets, financial analysts, and so on, and uncovered stark divergences from the law and economics view. Boards of directors in practice look little like the antiseptic monitoring devices contemplated by theorists, and are indeed very much social institutions (see MacAvoy & Millstein 2003 for an accessible account). Many sociological governance studies in the past ten years have concerned the impact of interlocking boards of directors, in which individual directors serve on two or more boards at once (see Mizruchi 1996 for research prior to that). The cumulative findings of this literature provide a compelling critique of the shareholder value approach, in which directors are dutiful agents of their shareholder principals disciplined by the operations of a market for corporate directors. Boards with relatively powerful CEOs are more prone to choosing new directors from relatively weak outside boards, while boards that are relatively more powerful than their CEO evidently do the opposite (Zajac & Westphal 1996). Corporate boards are more likely to share members to the extent that they are geographically proximate and located in cities with institutions such as elite social clubs (Kono et al. 1998), but this effect is contingent on the

historical economic development of the company's headquarters city (Marquis 2003). And while banks have historically held central positions in city networks, staffing their boards with the CEOs of important local businesses, this practice declined during the 1980s and 1990s as corporations increasingly turned away from banks and toward markets for their debt financing and banks moved into more profitable lines of business than corporate lending (Davis & Mizruchi 1999).

Several studies document what difference board interlocks make, concluding that they act as conduits for information flow from board to board. For instance, companies were more likely to adopt poison pill takeover defenses to the extent that they shared directors with similar companies that had previously done so (Davis & Greve 1997). Directors that had adopted a pill on one of their boards appeared to act as infectious agents, spreading the pill to other boards they served on—despite the fact that institutional investors were almost universally opposed to the pill. Similarly, firms took on more debt when they had bankers on their board (Mizruchi & Stearns 1994), were more prone to making contributions to local nonprofits when their leaders had network ties to nonprofit leaders (Galaskiewicz 1997), and relied less on shared directorships for information about acquisitions when their CEO had access to other relevant sources of high-level intelligence (Haunschild & Beckman 1998). Corporations, in short, were embedded in a network of information flows via the pervasive practice of sharing directors. Board ties can also act as devices for promoting cohesion among elites, a theme going back to C. Wright Mills's *The Power Elite* (1956). For instance, corporations with well-connected boards were less likely to receive an unwanted takeover bid in the 1960s (Palmer et al. 1995), but not during the 1980s (Davis & Stout 1992). And states with densely connected local corporate elites were quicker to adopt antitakeover laws during the 1980s than states with sparse local elite networks (Vogus & Davis 2005).

A related line of work examines board dynamics and compensation practices, including power relations within boardrooms (Gulati & Westphal 1999, Westphal & Poonam 2003), practices for replacing CEOs (Ocasio 1999, Thornton & Ocasio 1999), and the origins of innovations in pay (Westphal & Zajac 1994). Gulati & Westphal (1999), for example, find that firms are less likely to form alliances when they have “independent” boards, implying that such independence generates mistrust. Thornton & Ocasio (1999) document that the process of changing CEOs in college publishers changed over time as publishing was transformed from a gentlemen's game to a commodity business. And Westphal & Zajac (1994) argue that poor-performing firms, and firms with powerful CEOs, adopt incentive compensation programs as a cynical measure to fend off potential outside criticism from shareholders and others, decoupling the rhetoric of shareholder value from actual practice. In each case, the researchers document the influence of both behavioral and structural factors (such as the content of relationships between CEOs and members of their board) and broader cultural factors (such as how changes in the prevailing rhetoric around corporate governance were filtered through discrete corporate practices).

A third line of research examines ownership and changes in control, documenting how different categories of owners—families, banks, or other financial institutions—pursue different agendas through their influence on corporate strategy (cf. Davis & Stout 1992; Palmer & Barber 2001; see Kang & Sorenson 1999 for a review). Palmer & Barber (2001) find that the conglomerate owners of the 1960s, who built the diversified firms of the late 1960s and 1970s, tended to be well-connected social climbers who were unconstrained by family owners. On the other hand, Davis & Stout (1992) find that family owners helped ward off hostile takeover efforts in the 1980s, but that other types of major shareholders (such as banks or other institutional investors) provided no such protection. Thus, ownership—taken as a relatively “asocial” category of explanation in law and economics—turns out to have different meaning depending on who is doing the owning.

Although these studies provide useful insights into the concrete operations of some of the institutions of corporate governance (particularly boards of directors and the market for corporate control), they have not yet generated a robust sociological and institutional alternative to the law and economics approach reviewed above. There are hints at such an approach, however, in some of the recent work on how corporate managers configure themselves to conform, either earnestly or ritualistically, to the perceived demands of their evaluators in capital markets. Following Michael Useem’s (1996) book, *Investor Capitalism: How Money Managers Are Changing the Face of Corporate America*, several studies have documented more or less strategic efforts at conformity. Changes in compensation practices came to receive more positive reactions in the stock market when they were rationalized in terms of alignment with shareholder interests rather than with traditional human resource explanations, so naturally companies adopted the sanctioned rationales, even if this had little impact on the practices themselves (Westphal & Zajac 1998). Companies received lower market valuations when the portfolio of industries they operated in differed from the format preferred by financial analysts (Zuckerman 1999), and thus firms tended to divest the ill-fitting components to match the model held by market evaluators, even if those components were quite profitable (Zuckerman 2000). Biotechnology firms received better valuations upon going public (that is, first issuing shares on a stock market) to the extent that they had prominent investors (e.g., those with many alliances) and were underwritten by a prestigious investment bank (Stuart et al. 1999). Reputation ratings of established firms go up when they appoint well-connected directors to their boards, even though this has no discernible impact on corporate performance (Davis & Robbins 2004). And firms announce stock repurchase plans that they never implement, nonetheless receiving upticks in share price (Westphal & Zajac 2001). In combination, these studies suggest a useful new direction for sociological studies of governance, organized around performance and rhetoric in the context of financial markets. I take up this topic in the final section of this review.

RECENT TRENDS IN LAW AND ECONOMICS

Although most sociological work on corporate governance has focused on the operations of discrete institutions in the corporate governance matrix—boards of directors, the takeover market, and so on—there is relatively less work on the institutional matrix itself, with the notable exceptions of the work of Fligstein (1990) and Roy (1997) on the United States and Guillen (2001) on Argentina, Spain, and South Korea. In law and economics, in contrast, a para-sociology has arisen to explain the dynamics of governance institutions and their cross-national diversity. This focus partly reflects economic globalization and the spread of cross-border investment, but much of the research interest stems from practical problems that arose in postsocialist economies in the 1990s. Former Soviet and Eastern Bloc nations made abrupt transitions from state ownership to systems of public corporations, often under the guidance of U.S.-trained economists drawing on the American experience with financial markets, with wildly divergent results (see, e.g., Kogut & Spicer 2002). As events unfolded, and the varying results of postsocialist transitions became apparent, the central question for both policy and research became, “What are the necessary institutional conditions for public corporations to work?”

A flurry of research beginning in the mid-1990s sought to understand the etiology and functioning of corporate governance institutions, sometimes drawing explicitly on sociological theory, and generally taking the American system of corporate governance as the base case. Mark Roe’s *Strong Managers, Weak Owners* (1994) highlighted the idiosyncrasy of the American system of corporate governance which, with its weak financial intermediaries and dispersed patterns of ownership, contrasted sharply with Japan and Germany, where large banks held large and influential ownership positions. The central characteristics of the American system, Roe argued, evolved out of a history of financial regulation borne of populist mistrust toward concentrated economic power. With the easy path of monitoring and control by large banks blocked, over time the United States developed a series of second-best institutions to serve these functions. Others argued that the reverse was true: Because American firms such as railroads had capital needs that outstripped the capacities of indigenous investors, their backers created credible institutions to reassure overseas capitalists that their investments in the United States would be safe, setting the stage for the American system to evolve (Coffee 2001). Modigliani & Perrotti (2000) argued that market-based governance institutions of the sort seen in the United States represent a triumph of meritocracy over the particularistic ties seen in bank-centered systems. Societies that could sustain systems of arms-length financing did so, with benefits for economic growth, whereas those that could not were forced to rely on embedded social ties (crony capitalism) to channel capital and monitor investment. Indeed, the dispersion of ownership in the United States is not pathological, but rather a sign of institutional success: The fact that so much capital is invested by so many savvy investors in firms

with dispersed ownership is *prima facie* evidence of the quality of the surrounding institutions.

An influential series of papers by La Porta, Lopez-de-Silanes, Shleifer, and Vishny (now collectively known in law and economics as “LLSV”) sought to uncover the conditions that led to this institutional trade-off between bank-centered and market-centered governance, finding that the type of legal code—French civil law and its cognates or English common law—was a primary determinant of the level of investor protection observed in national systems, and thus the vibrancy of financial markets in those nations. Common law countries, including former British colonies such as the United States, provided strong protections for minority investors (those owning noncontrolling blocks of stock), which enabled both the growth of financial markets and the relative dispersion of shareholdings within companies (La Porta et al. 1998). LLSV also argued for a role for Protestantism, with a nod to Weber (e.g., La Porta et al. 1999): Nonhierarchical religions create favorable conditions for the type of horizontal ties that enable trust and thus financial market contracting, and Catholic nations accordingly have relatively smaller financial markets.

The results of legal differences, LLSV argued, were realized in the economic trajectory of former British and French colonies, yet Acemoglu et al. (2001) find that the ultimate cause of different institutions among former colonies was the mortality rate of European colonizers. Low mortality rates encouraged settlement and the development of legal and other institutions that laid the groundwork for later economic growth, even after independence, whereas high mortality rates encouraged extractive approaches to colonization and weak institution building, realized in sustained lower economic growth. Comparisons of the twentieth century history of wealthy economies also cast doubt on the primacy of legal origin for financial system development: Rajan & Zingales (2003) point out that nations in continental Europe had very large equity markets relative to the United States and United Kingdom on the verge of World War I, but they argue that when internal political processes closed economies off to foreign trade and investment, this stunted subsequent financial development. Carlin & Mayer (2003) find a contingency in the relationship between the stage of economic growth and the use of banks or markets to finance industrial activity, suggesting that stock markets are effective at financing newer, risky activities dependent on research and development, which characterizes advanced economies, whereas banks are more effective for funding routine activities and tangible investments of the sort needed by developing economies. Finally, Roe (2003) agrees with Rajan & Zingales (2003) that politics, not legal systems *per se*, determines the shape of corporate governance systems. Social democracies generally have smaller financial markets and firms with more concentrated ownership than neoliberal states such as the United States, a fact Roe attributes to the incentives of owners to maintain relatively powerful bargaining positions within firms *vis-à-vis* labor. (Gourevitch 2003 provides an excellent critique and extension of this political model of corporate governance.)

TOWARD A CONTEMPORARY SOCIOLOGY OF CORPORATE GOVERNANCE

There is a vibrant intellectual community researching and debating the development of corporate governance systems, but sociologists are largely absent from this community. Indeed, it is a peculiar state of affairs when Jeffrey Sachs (2000) (in an article titled “Notes on a New Sociology of Economic Development”) needs to remind us of the relevance of Marx for understanding divergent trajectories of capitalist economies. Yet behind much of the recent work in law and economics is a rather stylized depiction of the American (or Anglo-American) system of corporate governance that is often at odds with how that system operates on the ground, as we have seen. As the corporate scandals of the late 1990s and early 2000s indicate, the American system is hardly an arms-length meritocracy organized around impersonal institutions, as portrayed in the theories. Granovetter’s (1985) caution against the functionalist tendencies of economic theories of institutions is still apt. This provides an entry point for a sociology of corporate governance.

The sociologically interesting questions going forward focus on explaining the dynamics of the institutions around financial markets. For these markets to work requires an infrastructure of corporate governance—an institutional matrix to guide the entity being traded. As I stated at the outset, investors need assurance that they will get a return, and those that seek to sell financial instruments—from shares of stock to sovereign national debt—need to provide credible evidence that their investors will get a return. That is, they engage in corporate governance. But the logic behind the institutions of corporate governance is not limited to public corporations; it applies to other things traded on financial markets, an increasingly broad category. The significance of this is that entities that seek to attract investors, from states and corporations to bundles of credit card receivables, need to demonstrate their institutional fitness to distant, often dispersed investors. In a world in which financial flows are the lifeblood of the global economy and in which more and more entities are traded on markets, corporate governance is critical to understanding the contemporary world polity and the dynamics of its institutions. “Geared as it is to electronic money—money that exists only as digits in computers—the current world economy has no parallels in earlier times” (Giddens 2000, p. 27). Thus, the focus of a sociology of corporate governance should be on those institutions—where they originate, how they work, how they influence social actors, and how they change.

The institutions of corporate governance at both the micro level (who serves on a board of directors, which investment bank is chosen) and the macro level (laws governing the corporation, mechanisms for trading securities) are self-evidently human constructions. A sociology of corporate governance can provide an understanding of their origins and trajectories that brackets the assumptions of financial economics and is more self-conscious about the limits of functionalist explanation (cf. Fligstein 1990, Roy 1997). Particularly useful is work that unpacks the interaction of theories about the institutions and their actual enactment. Thus,

MacKenzie & Millo (2003) describe how the Chicago Board Options Exchange came into being despite the questionable legitimacy of options at the time, drawing on Callon's (1998) notion of "performativity"—that is, that "economics, in the broad sense of the term, performs, shapes and formats the economy, rather than observing how it functions" (p. 2). Much the same is true of the American institutions of corporate governance and the discovery of hitherto unnoticed markets. The so-called market for corporate control was of relatively trivial importance when Manne (1965) named it, and it held far more significance in the finance-based theory of the firm than it ever did in reality until the 1980s, when sympathetic scholars gained influential policy positions in the Reagan administration and enacted the theory (Davis & Stout 1992). The market for corporate law became more market-like after it was named by law and economics scholars (although the notion of states competing for incorporation fees appears in practice to apply only to Delaware). In short, economic and legal theorists have had substantial influence in formatting the institutions that grew up around the shareholder value system of corporate governance, and tracing their impact is an apt topic for sociological analysis.

The American system of corporate governance is regarded as the prototype market-oriented system of arms-length transactions organized around impersonal financial markets. Yet as Karl Polanyi (1957) famously put it, "The human economy. . . is *embedded and enmeshed* in institutions, economic and noneconomic," including social relationships among the players, and the corporate governance scandals of the early part of this decade highlight the divergence between the American theory of corporate governance and what happens on the ground. The Panglossian portrayal of investment bankers, accountants, and financial analysts all disciplined by a reputational market proved problematic at best, as each faced well-documented conflicts of interest. Market participants are aware of the theories used by the stock market to evaluate companies and can be quite savvy in playing to them. Thus, investment bankers know that firms get better valuations when they are allied with prominent firms (Stuart et al. 1999) and can facilitate these alliances by allocating valuable IPO shares to decision makers at those prominent firms. The CEO of telecommunications firm WorldCom, for instance, made \$11 million from the IPO shares he was allocated in startup firms, many of which would have benefited from announced alliances with WorldCom (before it went bankrupt after revelations of accounting fraud). Meanwhile, WorldCom competitor AT&T fired executives of units that failed to achieve the chimerical profitability of their WorldCom counterparts. Enron famously set up a Potemkin trading floor to impress visiting analysts with the volume of their business, while simultaneously hiding much of their real business in off-shore accounting entities invisible to investors.

The social structures in which governance is embedded are themselves both conduits for the spread of practices and acts of rhetoric in themselves. Podolny (2001) describes networks serving as "pipes" (sources of information and resources) and "prisms" (indicators of status for outside evaluators) and the tension between connections created for access to resource and those created to impress the outside

world. This tension is at the center of many of the conflicts of interest in corporate governance and is, notably, part of the folklore of participants in these markets, who are acutely sensitive to the signals conveyed by the prestige of their alliance partners, board members, investors, and accounting and law firms. Demands for greater transparency and accountability in corporate governance, such as those in the Sarbanes-Oxley Act of 2002, are often met with the ritualistic adoption of practices and structures intended to convey compliance, much as firms created Equal Employment Opportunity offices as tokens of their compliance with federal antidiscrimination laws (Edelman 1992). Investors may require credible evidence of accountability and transparency in corporate governance, but what is credible is a matter of rhetoric—that is, what does it take to convince others of the validity of one's assertions (McCloskey 1998).

It would of course be an overstatement to regard corporate governance as an entirely symbolic free-for-all, but it is equally inappropriate to believe the anti-septic portrayal of governance in the law and economics literature. Rather, the best approach is to problematize how corporate governance institutions are shaped to respond to financial markets. The need to attract financing can be a potent lever of institutional change. Consumers may buy clothing or electronic goods with little idea of whether they were made by well-paid union labor or in sweat shops. Investors in securities, in contrast, require evidence of effective corporate governance within the firm to “assure themselves of getting a return on their investment” (Shleifer & Vishny 1997, p. 737), and this can generate significant impetus for change. Yet what counts as credible is inherently social, and the American case suggests that one should be skeptical of the direction this change takes. Compliance with external demands often takes the form of cynical adoption of token structures decoupled from actual practice; moreover, when structures are not decoupled, they can often produce unintended consequences that are worse than the problem being addressed. Tetlock (2002) reviews the now-substantial evidence that increasing the accountability of decision makers—their need to explain the rationale for their judgments and choices—is by no means an insurance of superior decision quality, as decision makers become “intuitive politicians.” As institutions of corporate governance are adopted by firms, states, and other investment vehicles around the world to enable commensuration (cf. Carruthers & Stinchcombe 1999), the need for careful sociological study becomes more pressing.

Beyond the level of specific firms and governance markets, the concerns around corporate governance extend to the level of national economic development. Nations vary widely in their constellations of governance institutions, even among the wealthiest economies, as the previous section noted. Both postsocialist and emerging market economies have had quite divergent experiences with public corporations and financial markets, and much work remains to be done in explaining this diversity. In law and economics, financial markets are akin to a power source for national economic development, providing local entrepreneurs who conform to the requirements of corporate governance with access to distant capital. In practice, however, entrepreneurs are often like tourists whose appliances do not fit the local

outlets. Mauro Guillen (Guillen 2001, Biggart & Guillen 1999) provides useful historical comparisons of the development of economies in Spain, Argentina, and South Korea, rendering a thoughtful interpretation of how national institutional structures articulate with the evolving global division of labor. Again, further research on the dynamics of institutional transference, both among nations and among financial vehicles, is critical to the development of a sociology of corporate governance.

CONCLUSION

The contractarian approach to corporate governance in law and economics has generated a large and variegated literature on the institutions of corporate governance, from why firms structure their board of directors the way they do, to how national economies' growth rates depend on the legal and market institutions in which firms are embedded. At the center of this approach is the notion that financial markets are informationally efficient, and thus that the prices that prevail on these markets are epistemologically privileged as economic guides. Institutions are explained by their function in orienting decision makers toward signals in financial markets. Once documented, these institutions came to be seen as a transferable blueprint for economic vibrancy for economies around the world (see Davis & Useem 2002 for a critique). Sociological work on corporate governance provides a useful curative to this functionalist approach, finding that corporate governance does not work as advertised even in the United States, the prototype case. The late 1990s bubble and related corporate scandals provide vivid evidence consistent with the sociological critique. Yet sociologists have not developed a compelling alternative account of the institutions of corporate governance in an era of hyperexpansive financial markets. I have suggested several areas of research that should prove promising, along with a brief review of some of the more engaging work on this topic in law and economics. We may hope that in five years there will be a fully developed sociology of corporate governance to provide a theoretical counter-weight to the deficiencies of the contractarian approach.

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