AN AGENDA FOR BOARD RESEARCH

Sandra Guerra*, Adalberto Fischmann, Cláudio Antonio Pinheiro Machado Filho*****

Abstract

Scholarly investigations on the board of directors, although intense from the mid-1990s onward, did not lead to entirely convincing results. This study proposes discussion on building a multidisciplinary and integrated theoretical framework able to capture the complexity and distinctive dimensions of the board as a group decision-making process. This is achieved through an essay developed from analytical and descriptive review of the literature. A synthesis on board research is presented, aiming to understand theoretical models lenses used to study corporate governance issues. The strengths and weaknesses of these models are pointed out, and their influence on board investigation is observed. This essay concludes by proposing a research agenda that considers the addition of psychological and sociological approaches to economic models of the analysis of group decision-making.

Keywords: Board of directors, corporate governance, agency theory, strategy, trust, decision-making process

*Master's candidate, University of São Paulo, School of Economics, Business Administration and Accountancy, Graduate Program in Business Administration. Principal of Better Governance.

**Full Professor, Department of Business Administration, University of São Paulo School of Economics, Business Administration and Accountancy (FEA/USP).

***Professor, Department of Business Administration, University of São Paulo School of Economics, Business Administration and Accountancy. (FEA/USP).

1. Introduction

The attention received by corporate governance has been proportional to that afforded to what has been described as its fulcrum: the board of directors. Many investigators have pored over the board's variables in attempts to establish a link between these variables and company performance. Most such studies were carried out after theoretical market models, with particular emphasis on agency theory. Several researchers have concluded that results are unsatisfactory, and suggest alternative routes of investigation that consider psychological and social aspects and observe the dynamics of the board rather than its characteristics.

The second section of this essay outlines concepts and theories on which presently dominant theoretical models were based, most notably agency theory. We then discuss different understandings of the application of this theory, demonstrating the model's importance and broad application and, conversely, its observed limitations. Section four focuses on the study of the board of directors in its core role, that of a mechanism meant to foster and exercise control over the relationship of all governance agents. Section five discusses new research approaches. The study concludes with a discussion on building an integrated, multidisciplinary model to analyze the theme that accounts for psychological and sociological approaches as well as economic and organizational ones.

2. A Theoretical Perspective on Analyzing Corporate Governance Issues

One of the most influential analyses of the development of corporate governance in the 20th century was carried out by Berle and Means of Columbia University (Clarke, 2004). In 1932, they documented the separation between ownership and control in the United States, showing that shareholder dispersion creates discretion, which may be abused; this is presented as the starting point of the academic thinking that would go on to become corporate governance (Tirole, 2006). Berle and Means argued that this separation "produces a condition where the interests of owner and of ultimate manager may, and often do, diverge, and where many of the checks which formerly operated to limit the use of power disappear" (Demsetz, 1983).

In the same year Berle and Means published "The Modern Corporation and Private Property", 21-year-old Ronald Coase, a recent graduate of the London School of Economics, gave a lecture outlining an argument he would later present in detail in his landmark 1937 article "The nature of the firm" (Coase, 1991). The seminal concept, which would earn him a Nobel 60 years later, questioned *why* the firm – defined as the relationship system which comes into existence when directing resources becomes dependent on an entrepreneur – existed. Coase defied neoclassical thinking on the efficiency of markets led by the price mechanism, by asking why firms should exist if the market coordinated transactions so efficiently; he had laid the cornerstone of the theory of the firm (Coase, 1937). Coase proposed that the transaction cost of using the market could exceed that of procurement within the boundaries of an organization (Barney & Hesterly, 2004, p. 133), in which case the existence of firms is justified.

These two tenets would shape dominant thinking in the field of organizational economics for the rest of the 20th century. Of the new economic theories of the firm, "agency theory […] became by default the dominant force in the theoretical understanding of corporate governance in the last decades of the twentieth century." (Clarke, 2004).

By integrating agency theory, property rights theory, and finance theory, Jensen and Meckling developed what they termed the ownership structure theory (1976). This study, which would later gain broad recognition and acceptance, was strongly influenced by a 1972 article by Alchian and Demsetz and, to a lesser extent, by transaction cost theory (Barney & Hesterly, 2004). Jensen and Meckling (1976) introduced the concept of management behavior into this equation to define agency relationships: executives act as agents on behalf of shareholders (the principals); they are paid to act in the best interests of the firm's owners. Nevertheless, managers' decisions are not always driven by this purpose – rather, decisions may be made with personal interests in mind. This may result in expropriation of shareholder wealth and, consequently, conflict. Agency theory therefore became the dominant model for analysis of corporate governance matters, so much so that it has been used to define governance:

> *At general level corporate governance can be described as a problem involving an agent – the CEO of the corporation – and multiple principals – the shareholders, creditors, suppliers, clients, employees, and other parties with whom the CEO engages in business on behalf of the corporation. […] Using more modern language the corporate governance problem can also be described as a "common agency problem"[…].* (Becht, Bolton & Röell, 2002, p. 14)

The authors argue that, at its most basic level, the corporate governance problem arises whenever an external investor wishes to exercise control in a manner differently from company management. The reasoning behind this argument is that dispersed ownership heightens the governance problem, as it gives rise to conflicts of interest between various claimholders and creates a collective action problem among investors. Expressive growth of institutional ownership over a 50-year period[2] and U.S. corporate scandals at the turn of the 21st century provided prime real-world examples of the damaging effects of agency conflict. The Enron case in particular could be considered a historical event that created prime conditions for practical evidence of the theory. "Enron is a resounding historical proof of the historical validity of agency theory – a classical illustration of how self-interested managers can strip the wealth out of the company." (Clarke, 2004 p. 19).

3. Criticism of Agency Theory and Economic Theories of The Firm

The prominence and acceptance of agency theory have been paired with a fair amount of criticism. Demsetz (1983) presents what he called "mild disagreement" with the literature on the separation of ownership and control, claiming he does not believe the use of agency relationships (as opposed to the business being managed directly by its owner) decreases the value of the firm to its owners, but, conversely, increases it. Demsetz did not believe managerial on-the-job consumption to be greater with professional management than it is in firms managed by their owners, explaining that agency cost is created by the firm and not by agents. He viewed the ownership structure of the firm as "an endogenous outcome of a maximizing process in which more is at stake than just accommodating to the shirking problem" (Demsetz, 1983, p. 376).

Critics of the agency theory also note its key contribution to organization theory. Eisenhardt (1989a) points out the broad scholarly use of the agency model in several fields, the enthusiasm regarding the theory's power on the part of its proponents, and the pointed criticism leveled by its detractors, and enquires: "Which is it: grand theory or great sham?" (Eisenhardt, 1989a, p. 57). She concludes that agency theory "offers unique insight into information systems, outcome uncertainty, incentive, and risk and [...] is an empirically valid perspective, particularly when coupled with complementary perspectives" (Eisenhardt, 1989a).

If, on the one hand, agency theory was brought

[2] Gordon (2006, p. 59) presents a chart of data obtained from the Federal Reserve System demonstrating what he refers to as impressive growth of institutional ownership of publicly traded stocks over 50 years. Institutional ownership of stocks had increased by around 70% by 2005, both in absolute and percentual terms.

further into the center of attention after the corporate scandals of the early 21st century, these very events shed light on some of its limitations. Becht, Bolton, and Röell (2002) explain that much of the theory, which justifies unrealistic compensation schemes for top management, presumes that stock results and prices cannot be manipulated. This is precisely the point classified by the authors as the greatest weakness of agency theory, as evidenced by recent corporate scandals.

Along the same lines – though recognizing that economic theories highlighting the importance of management monitoring to solve the agency problem were validated by the Enron case –, Clarke (2004) points out flaws in two key aspects. Firstly, offering generous stock options plans as a way of aligning managers' and shareholders' interests actually provides a "more powerful incentive to manipulate short-term corporate earnings than to improve long-term performance". Furthermore, emphasis on the importance of shareholder value leads to a disconnection of corporations "from their essential moral underpinnings, encouraging them to concentrate exclusively on financial performance and to neglect not just the wider stakeholder interests […] but the essential interests of the economies and communities in which they operate" (Clarke, 2004, p. 19).

From a distinct point of view, other critics point to the fact that early studies based on agency theory ignored other behavioral sciences, and that studies combining the theory with ideas from other fields have produced new evidence that calls agency theory itself into question (Barney & Hesterly, 2004). The human issue in economic theories of the organization was discussed by Reed (1999), who argued that the market model in no way attempts to address the issue of social power and human intervention. He notes that market-based organizational theories remain negligent on the matter of interorganizational power structures and struggles, through which firms respond to supposedly objective and neutral economic pressures (Reed, 1999, p. 74).

Eisenhardt (1989a) states that agency theory holds a partial view of the world that, while valid, mostly ignores the complexity of organizations (p. 60). In order to address this point, she recommends that agency theory be used in conjunction with complementary theories, and argues that additional perspectives may capture greater complexity. Huse (2007) argues that agency theory has been viewed "almost as having divine authority" (p. 29) by several actors in the corporate governance debate. He advocates that agency theory and the shareholder supremacy paradigm be questioned, and directs criticism at the fact that, in this context, "individuals are viewed as opportunistic and one-dimensional economic entities, with the legal system taken as the underlying principle for decision-making." Huse points to the social role of individuals, and suggests that trust may in fact be the underlying principle.

In a similar direction, stewardship theory operates on behavioral-based definitions of relationships, disagreeing with the individualistic utility motivation viewpoint of the principal-agent perspective and proposing it does not apply to all managers (Davis, Shoorman & Donaldson, 1997). It proposes that organizational relationships are more complex than those analyzed through agency theory are. The authors propose that the situational and psychological processes behind these relationships be observed.

Stakeholder theory, on the other hand, views organizations as the set of relationships between the firm and its various stakeholders, such as employees, owners, suppliers, creditors, investors, and clients. Its premise, unlike that of agency theory, is that firms do not exist solely to provide shareholders with results; rather, as socially responsible institutions, they should be managed pursuant to public interests (Blair, 1995). Governing an organization would therefore imply cultivating transparency, keeping principals informed, as respecting the rights of stakeholders – those who, while not owning shares of a company, are affected by its actions and strategic directions.

4. The Study of Boards

The board of directors is the core of the corporate governance system. Its importance among other governance mechanisms has been noted and reinforced from several perspectives: (i) as cornerstone of corporate governance, and the critical nexus at which the company's fate is decided (Clarke, 2007); (ii) as the body ultimately responsible for ensuring the integrity of the organization in all matters (Fuller & Jensen, 2002); (iii) as occupying "a critical position in the modern free enterprise system" – the board "has the responsibility, as well as the opportunity, to make a significant difference" (Charan, 2005); as a competitive necessity that may be used to gain a competitive advantage (Charan, 1998); (iv) as providing equity and managers with the safeguard of governance, and is an important internal control instrument (Baysinger & Hoskisson, 1990); (v) as the key body through which the corporation makes decisions on behalf of its shareholders, and a repository of the company's highest power (Millstein, 2006); (VI) as fulcrum of the governance system and focal point for shareholders and the market system (Cadbury & Millstein, 2005) (VII) as being among the most venerable instruments of corporate governance (Zahra & Pearce, 1989).

Clarke (2007) proposes that study of the influence of boards and directors on company performance reflects a broader concern with corporate governance, and lists questions yet unanswered:

How the boards effect performance? How is performance defined in terms of accountability or profitability? What enhances board accountability? Does board size and composition influence performance? What influences board independence? What contributes to board authority? How important are board committees? How can boards contribute to company strategy? What contributes to board dynamics? How is board selection and development achieved? What is the relationship between board and shareholders? Though intensively researched for some years the academic evidence on theses critical issues remains inconclusive. (Clarke, 2007, p. 45)

4.1 Prevalence of the ownership dispersion viewpoint

Scholarly work on the board of directors is largely influenced by and produced in markets where dispersion of ownership (typical of mature capital markets) prevails (McCarthy & Puffer, 2007), alongside expropriation of shareholders by hired executives, and is mostly based on agency theory (Zahra & Pearce, 1989). Discussion on corporate governance was mostly outlined by situations and facts in the U.S. and in the United Kingdom (Huse, 2007). The main points identified when boards are scrutinized include lacking independence, attention, and incentives, and the possibility of conflicts of interest (Tirole, 2006). In their classic paper on the separation of ownership and control, Fama and Jensen (1983) present a simplified model of the corporate decision-making process, noting the board and the managers' responsibilities:

Table 1. Corporate decision-making process: responsibility model for managers and the board of directors

MANAGER (AGENT)	BOARD (PRINCIPAL)
Initiation Generation of ways to use resources	*Ratification* Choice of initiatives to be implemented
Implementation Execution of ratified proposals	*Monitoring* Measurement and evaluation of manager performance

Source: Adapted from Fama & Jensen (1983).

This frame of reference is particularly valid when there is a clear separation of ownership and control, as in the case of professionally managed companies with highly dispersed ownership, common in Anglo-Saxon economies. It suggests that processes are generally *initiated* by managers (agents), who make proposals meant to be further developed by the company.

The board of directors must then *ratify* (approve) or dismiss the proposal. The following step, *implementation*, is once again the responsibility of managers. The board is then charged with *monitoring* and evaluating how management implemented the ratified proposal. In companies with highly concentrated capital – in which shareholders effectively take part in controlling the organization – the Fama and Jensen model does not apply entirely, as, in such firms, many proposals are made by the principals themselves rather than by agents.

Analysis perspectives have mostly focused on the monitoring role of the board, at the expense of its counseling and advisory functions and of its participation in defining the firm's strategic directions; these have been relegated to the background. The board is analyzed as a field where executives and non-executives face off; its main goal is minimizing agency conflict. Moreover, the dominant board model has shifted from that of the "advising board" to the "monitoring board" (Gordon, 2006). Research on boards has sought indicators of favorable conditions for the monitoring function, and much has been studied on the presence of independent directors, but empirical research on boards and independent members has produced disappointing results (Becht, Bolton & Röell, 2002).

Most studies on decision mechanisms have focused on board makeup, including the relevance and optimal proportion of independent board members, the number of directors on the board, separation (or not) of the roles of chairman of the board and CEO, member selection, and other elements concerning board structure. Results were not particularly encouraging: board composition is unrelated to company performance, whereas board size is inversely associated with performance (Hermalin & Weisbach, 2003); the impact of contextual forces on board variables has been largely ignored (Zahra & Pearce, 1989); most studies on boards and the impact of independent boards have been empirical, and have produced mixed findings (Becht, Bolton & Röell, 2002); most studies find little correlation between performance and board independence, and more recent ones have actually found a negative correlation between the two factors (Bhagat & Black, 1999); and firms with more independent boards fare no better than others (Bhagat & Black, 2002).

The lack of support for a correlation between greater number of independent directors and company performance notwithstanding, the general trend in many markets has been an increase in their ranks. In his 2006 study – the first to plot a growth curve of independent director representation in U.S. boards, from 1950 to 2005 – Gordon argues that one of the most important developments of the last fifty years in U.S. corporate governance was change in board composition. Insiders and affiliates[3] (outsiders having some sort of relationship with insiders) were increasingly replaced with independent directors. In 1950, independents accounted for approximately 20% of board members; by 2005, their representation was up to 75%. Gordon argues, "In the United States, independent directors have become a complementary institution to an economy of firms directed to maximize shareholder value." The 2006 Spencer Stuart Board Index, a survey of S&P 500 companies conducted by Spencer Stuart (a leading executive recruiting firm), found a 17% increase in the demand for independent directors from 2005 to 2006.

Useem (2006) recognizes the value of changes in board structure made in response to corporate scandals such as Enron and WorldCom, but notes that these changes "don't go to the heart of a board's work: making the choices that shape, for good or ill, a company's future." He reasons that, in order to avoid such corporate fiascos, companies need boards capable of making efficient decisions, and that better decision-making processes can be generative as well as protective. In line with other authors, he advocates a broader-than-traditional role of the board, and calls on directors to examine their processes and create a personalized set of rules to promote effective board decisions, which he claims are the essence of good governance. The relevance of decision-making processes was defended by Pound (1995), who argued that the fundamental governance problems do not stem from power imbalances, but from failures in the corporate decision-making process. He further argues that governance issues are due to such subtle flaws in the decision process – to how managers and the board make decisions and monitor company progress. Pound defined this new model of the firm as the *governed corporation*, "because it reconnects two critical parts of the corporate governance equation—shareholders and board members—to the decision-making process".

5. Considerations on New Research Approaches

There is a consensus that research must go beyond approaches used so far if it is to understand the performance implications of board characteristics (Zahra & Pearce, 1989; Pettigrew, 1992; Forbes & Milliken, 1999; Becht, Bolton & Röell, 2002; Hermalin & Weisbach, 2003; Clarke, 2007).

In contrast to empirical study of board composition, formal analysis of the role of the board of directors is practically nonexistent. Most studies fail to measure the most important dimension of boards, that which matters most for corporate performance: their functioning (Becht, Bolton & Röell, 2002). Hermalin and Weisbach (2003) also highlight the importance of better modeling boards and their functions, but note that it is a difficult task. They point out that the key determining factor of board effectiveness is its independence from the CEO, and conclude that the inability of empiric study to observe this variable is much of what makes it so challenging. Understanding the nature of how the board functions is among the most important areas in management research. Forbes and Milliken (1999) came to this conclusion after reviewing past study on the board of directors and creating a process-oriented model, encouraging researchers to focus directly on what boards must do in order to fulfill their responsibilities more effectively, treating boards as decision-making groups, and elaborating on existing knowledge of group dynamics.

Hermalin and Weisbach (2003) underscore the importance of better modeling of boards and their functions, and recommend research on modeling the inner workings of the board. A major impediment to researchers is gaining access to the board in order to study it directly, which has led some authors to refer to the board of directors as the *black box* (Leighton & Thain *apud* LeBlanc & Schwartz, 2007). Observing the board over time is one of the greatest challenges to its study (Zahra & Pearce, 1989).

Reforms based on the "governed corporation" model[4] focus on roles and behavior rather than on power shifts, and the result is "a positive change in the way companies debate, review, and decide policy" (Pound, 1995, p. 82). This corroborates the recommendation that future research should focus on board behavior. The board is viewed as an open system, and it is proposed that research directions be integrated and made to consider the dynamic nature of relationships both within and without the boardroom (Pettigrew, 1992). Quantitative methods, which have so far been dominant in board research, may be unable to capture the contribution dimensions of the board process. Citing Gillies and Mora, LeBlanc and Schwartz (2007) state that researchers must explore the use of a more in-depth qualitative approach of direct board study and contact with directors before further quantitative studies are conducted. They argue

[3] Gordon (2006) defines *insiders* as executives working in the firm, *affiliates* as outsiders who relate with insiders (such as the firm's bankers or lawyers), and *independents* as those wholly uninvolved in management of the company save for their role in its board of directors.

[4] John Pound (1995, p. 82-3) refers to the "governed company" as opposed to the "managed company" model, in which top executives are in charge of leadership and decision-making.

that the "what" and the "how" of boards, their work, and their processes constitute the research direction to be pursued. As Becht, Bolton, and Röell (2002) propose, empirical board analyses are in need of a third-generation study.

Several concepts outlined in the New Institutional Economics (NIE) appear highly appropriate to assist in better understanding board relationships, which are viewed as a nexus of relationships mirroring contracts. The several approaches in which information cost plays a key role – all relevant here – have been tallied by Barzel (1997): agency theory (also known as the principal-agent model), rent seeking, bounded rationality, information asymmetry, and contract theory. Property rights theory may also contribute to understanding the relations that influence board dynamics, as it constitutes a relevant aspect of their context. In 1965, Alchian defined the property rights system as "a method of assigning to particular individuals the 'authority' to select, for specific goods, any use from an unprohibited class of uses" (Eggerstsson, 1990, p. 33). The role of the board in this system requires analysis. Another aspect to be considered by a future research agenda is that much of the board literature has documented empirical facts and relationships, while formal theory development has been limited (Hermalin & Weisbach, 2003). Before this can be rectified, it may be necessary to develop theoretical models better adapted to capturing the complexity of the board process.

6 Discussion: A Research Agenda

The investigation of boards as mentioned above is in need of a new-generation study (Becht, Bolton & Röell, 2002). We propose that future studies consider theoretical structures that will reveal the board dynamics and analyze boards' distinct dimensions. Such studies will require the use of research instruments capable of capturing the depth of interrelatedness both within and without the board. Viewing the board process as one of administrative elites, as proposed by Pettigrew (1992), appears to lead to other fields of understanding when one accounts for context and the time aspect.

The best of what has been learned from agency theory-based models should be put to use, but other models may be integrated into it to provide a broader perspective on the complex object of study that is the board of directors. Eisenhardt (1989a) suggests a model for evaluation of organizational phenomena based on multiple sources, a model that considers the complementary nature of agency and institutional theories and the fact that a less one-dimensional perspective may improve understanding. The argument that a multiple perspective may contribute to more robust explanation of a study phenomenon should be considered in board research.

The relationship between variables connected to individuals – and those connected to the group of individuals that constitute a board of directors – warrants a more specific study approach with a focus on governance. Several aspects may be included in this set of variables, such as individual motivations (financial or otherwise), power relations, corporate culture, leadership style, and directors' personality traits, as well as the diverse players represented by directors (e. g. shareholders with controlling interest, minority shareholders), and the several types of independent director (subject experts, business experts, method and model experts). Integration of individual and group dimensions gives rise to new perspectives for *process* analysis of board functioning.

We conclude this essay by discussing whether researchers should dedicate their efforts to building an integrated, multidisciplinary theoretical framework that models the complexity and distinct dimensions of the board of directors as a group decision-making process, to which elements such as trust may add dimensions not previously captured by economic models. Economic theories of the organization – agency theory, transaction cost theory, property rights theory – and stakeholder and stewardship theory perspectives may be combined with lessons from psychology and sociology. Trust, cognitive aspects, cohesion, commitment, and consensus are among the elements to be observed. Simply put, it's all about adding the behavioral and social dimensions of the board to its already-studied economic and organizational facets. In order to achieve such in-depth analysis, qualitative methods, particularly the case study, appear useful. Eisenhardt (1989b) noted several strengths of building a theory from case study. These include the likelihood of creating new theory, which may later be tested through measurable constructs and falsifiable hypotheses; the likelihood that resulting theory will be empirically valid, and, due to close ties between as the theory building process and evidence, a high probability that resulting theory will be consistent with empirical observations. The path to understanding board dynamics has only just begun.

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