Governing the Corporation Around the World

OPENING CASE Global Competition in How to Best Govern Large Firms

In global competition, large firms not only compete in product markets, but also in terms of how they are organized, financed, and governed. Definitions of what consists of a "large firm" vary around the world. A reasonable definition is that if a firm is large enough to be publicly listed, then it would be a "large firm" in that country. Almost all large firms started as small firms. Small firms typically feature *concentration* of ownership and control—the founders own, manage, and control them. There was a time that many small firms aspired to become large enough so that they could become publicly listed, which would be an awesome hallmark that these firms have "made it." As firms grow larger, the founding families may run out of money so that introducing outside shareholders would be necessary. The founding families may also run out of sons, daughters, in-laws, and relatives to staff key positions so that employing non-family, professional managers would be a *must*—so the theory goes. This theory was first published in a 1932 book *The Modern Corporation and Private Property* by law school professor Adolf Berle and economist Gardiner Means. Generalizing from several decades of transformation at leading American firms in which founding families such as the Carnegies and the Rockefellers gradually reduced their holdings and introduced outside shareholders and professional managers, Berle and Means argued that such transformation would be inevitable. In brief, their theory predicted *separation* of ownership and control as firms grow larger. What if the founding families refused to let go? In 1983, economists Eugene Fama (who won a Nobel prize in economics in 2013) and Michael Jensen asserted that failure to separate ownership and control "tends to penalize the corporation in the competition for survival."

The question is: Really? The other two major forms of corporate governance are family ownership and state ownership. While the Berle and Means theory does a good job characterizing the evolution of large firms in the United States (and, to a lesser extent, Britain), the theory ends up *not* explaining the ownership and control pattern in the rest of the world very well. Numerous publicly listed firms continue to feature concentration of ownership and control in the hands of families. At present, about 85% of $1 billion-plus firms in Southeast Asia are in family hands, 75% in Latin America, 67% in India, and 40% in China. In Europe, families control 40% of listed firms. In the United States, 15% of the largest firms—those in the *Fortune* Global 500—are family owned and controlled. While there is no shortage of family drama and intrigue—remember the TV show *Dallas*?—evidently family ownership and control have no problem surviving and prospering.

The Fama and Jensen prediction that large firms with concentration of ownership and control would suffer from terrible performance cannot really be supported. In South Korea, Samsung Group, led by the capable Lee Kun-hee family, has marched from victory to victory, contributing 20% of GDP. In India, Tata Group, in the hands of the House of Tata, contributes 5% of GDP. An extension of the Fama and Jensen prediction is that while some large family firms may do well domestically, once they go overseas they would surely fail to become world-class in global competition. Again, this conjecture can be refuted. For example, Tata Group has emerged as one of the leaders of Indian firms' globalization. In Britain, Tata Group is now the single largest private sector employer, proudly supporting 50,000 jobs—an accomplishment none of the UK-owned (and non-family-managed) firms can match. In the United States, some of the best-performing and largest firms, such as Wal-Mart, Ford, and McKesson, are family owned and controlled. Newly listed high-tech firms such as Google and Facebook have carried on this tradition.

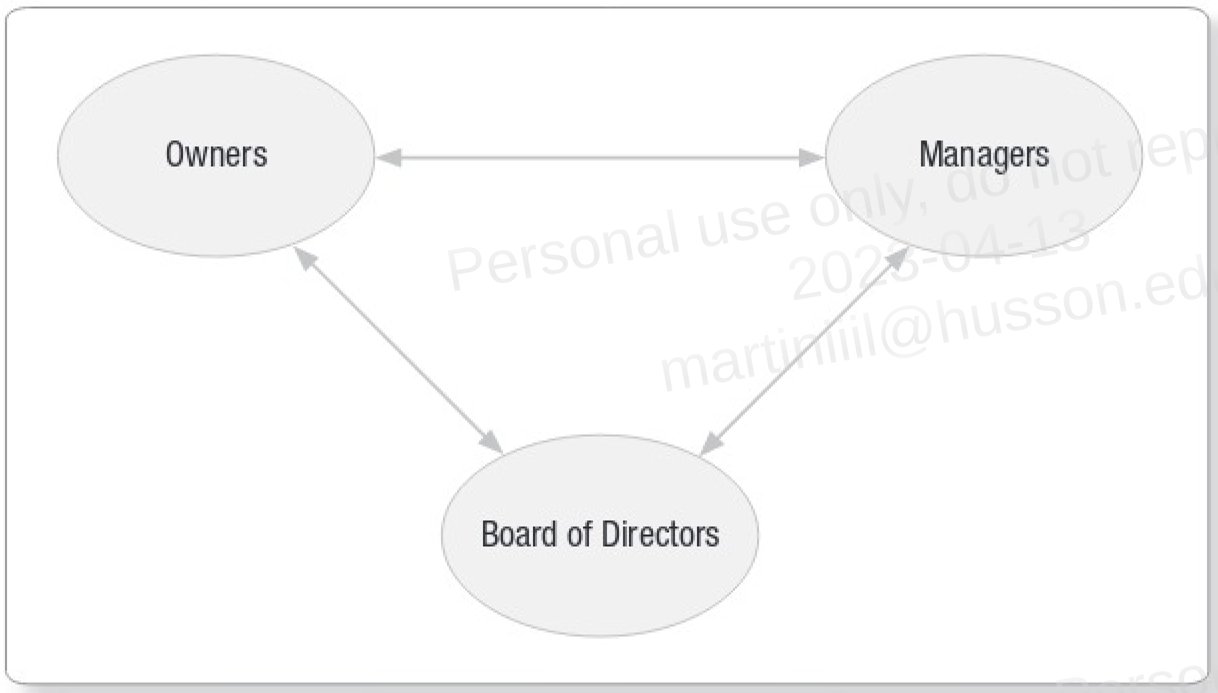
In addition to family ownership, state ownership remains a rival form of corporate governance. Despite privatization around the world between the 1980s and the 2000s, during the Great Recession of 2008–2009, Western governments in an effort to rescue ailing firms nationalized numerous private firms and turned them into state-owned enterprises (SOEs). Today SOEs represent approximately 10% of global GDP. Even in developed economies, they command 5% of GDP. Anchored by SOEs, China over the past three decades has grown its GDP by 9.5% per year. SOEs represent 80% of China's stock market capitalization. But China is not alone. In Russia, the figure is 62%, in Brazil 38%, and in Norway 38%. SOEs include some of the largest oil and gas companies (such as Sinopec), the biggest telecom service provider (China Mobile), and the biggest ports operator (Dubai Ports). In 2014, they also represented six of the top ten most-profitable firms globally (measured by the amount of profits): Fannie Mae and Freddie Mac of the United States, ICBC of China, Gazprom of Russia, China Construction Bank, and Agricultural Bank of China (in descending order). In short, SOEs as an organizational form can be both large and successful.

Recently what seems to be under siege is the publicly listed corporation. In 1997, the number of US listed firms reached a high watermark: 7,888. Since 1997, their number has dropped dramatically—by 38% in the United States and by 48% in Britain. The hassles associated with public ownership have facilitated the rise of private equity. Michael Dell, for example, has taken Dell (the corporation) private, because private ownership would give the firm "more time, investment, and patience." Private equity deals now routinely represent 25% of all mergers and acquisitions (M&As) in the world (and 35% in the United States). While existing firms can go private, many aspiring new firms do not bother to list at all. As a result, there is now a severe initial public offering (IPO) *famine*: between 1980 and 2000, on average there were 311 IPOs a year in the United States. The average went down to a mere 99 a year between 2001 and 2011. In short, going public is no longer as sexy as it was before. Commenting on the global competition in terms of how to best organize, finance, and govern large firms, the *Economist* suggests that "there is every reason to celebrate the fact that businesses have more corporate forms to choose from."

SOURCES: Based on (1) *Bloomberg Businessweek*, 2014, Private equity discover deals in the Middle East, September 29: 47–48; (2) G. Bruton, M. W. Peng, D. Ahlstrom, C. Stan, & K. Xu, 2015, State-owned enterprises around the world as hybrid organizations, *Academy of Management Perspectives*, 29: 92–114; (3) *Economist*, 2012, The endangered public company, May 19: 13; (4) *Economist*, 2012, The big engine that couldn't, May 9: 27–30; (5) *Economist*, 2013, Dell goes private, February 9: 63–64; (6) *Economist*, 2014, Business in the blood, November 1: 59–63; (7) *Economist*, 2014, Relative success, November 1: 12–13; (8) *Fortune*, 2014, Global 500, July 21: F-13; (9) E. Fama & M. Jensen, 1983, Separation of ownership and control, *Journal of Law and Economics*, 26: 301–326; (10) Y. Jiang & M. W. Peng, 2011, Are family ownership and control in large firms good, bad, or irrelevant? *Asia Pacific Journal of Management*, 28: 15–39.

What are the advantages and disadvantages of the public listed corporation? Why is there an IPO famine lately? What are the advantages and disadvantages of family ownership? What about state ownership and private equity? While each type of organizing, financing, and governing a firm has its attractiveness and drawbacks, three fundamental question are: (1) What is the most optimal way to govern corporations so that investors will reap returns? (2) What is the proper role of the board of directors? (3) How can top managers such as chief executive officers (CEOs) be properly motivated and compensated?

FIGURE 11.1 The Primary Participants in Corporate Governance.



These are some of the key questions addressed in this chapter, which focuses on how to govern the corporation around the world. **Corporate governance** is "the relationship among various participants in determining the direction and performance of corporations."[1] The primary participants in corporate governance are (1) owners, (2) managers, and (3) board of directors (Figure 11.1). This chapter first discusses the primary participants. Next, we cover internal and external governance mechanisms from a global perspective, followed by a comprehensive model drawn from the strategy tripod. Debates and extensions follow.

OWNERS

Owners provide capital, bear risks, and own the firm.[2] Three broad patterns exist: (1) concentrated versus diffused ownership, (2) family ownership, and (3) state ownership.

Concentrated versus Diffused Ownership

Founders usually start-up firms and completely own and control them. This is referred to as **concentrated ownership and control**. However, at some point, if the firm aspires to grow and needs more capital, the owners' desire to keep the firm in family hands may have to accommodate the arrival of other shareholders. Approximately 80% of listed US firms and 90% of listed UK firms are now characterized by **diffused ownership**, with numerous small shareholders but none with a dominant level of control.[3] As predicted by Adolf Berle and Gardiner Means in *The Modern Corporation and Private Property* (1932), there is a **separation of ownership and control** in such firms. Specifically, ownership is dispersed among many small shareholders and control is largely concentrated in the hands of salaried professional managers who own little (or no) equity (see the Opening Case). In short, this refers to separation of ownership (by dispersed shareholders) and day-to-day control (by managers).

If majority or dominant owners (such as founders) do not personally run the firm, they are naturally interested in keeping a close eye on how the firm is run. However, dispersed owners, each with a small stake, have neither incentives nor resources to do so. Most small shareholders do not bother to show up at annual shareholder meetings. They prefer to free-ride and hope that other shareholders will properly monitor and discipline managers. If small shareholders are not happy, they will simply sell the stock and invest elsewhere. However, if all shareholders behave in this manner, then no shareholder would care, and managers would end up acquiring significant *de facto* control power.

The rise of institutional investors, such as professionally managed mutual funds and pension pools, has significantly changed this picture.[4] Institutional investors have both incentives and resources to closely monitor and control managerial actions. However, the increased size of institutional holdings limits the ability of institutional investors to dump the stock. This is because when one's stake is large enough, selling out depresses the share price and harms the seller.

While the image of widely held corporations is a reasonably accurate description of most modern large US and UK firms, it is *not* the case in other parts of the world. Outside the Anglo-American world, there is relatively little separation of ownership and control (see the Opening Case). Most large firms are typically owned and controlled by families or the state.[5] Next, we turn our attention to such firms.

Family Ownership

The vast majority of large firms throughout continental Europe, Asia, Latin America, and Africa feature concentrated family ownership and control.[6] On the positive side, family ownership and control may provide better incentives for firms to focus on long-term performance. It may also minimize the conflicts between owners and professional managers typically encountered in widely owned firms. However, on the negative side, family ownership and control may lead to the selection of less-qualified managers (who happen to be the sons, daughters, and relatives of founders), the destruction of value because of family conflicts, and the expropriation of minority shareholders (discussed later). At present, there is no conclusive evidence on the positive or negative role of family ownership and control on the performance of large firms.[7]

State Ownership

Other than families, the state is another major owner of firms around the world. Since the 1980s, many countries—ranging from Britain to Brazil to Belarus—realized that their **state-owned enterprises (SOEs)** often perform poorly. SOEs typically suffer from an incentive problem. Although in theory all citizens (including employees) are owners, in practice, they have neither the rights to enjoy dividends generated from SOEs (as shareholders would) nor the rights to transfer or sell "their" property. SOEs are *de facto* owned and controlled by government agencies far removed from ordinary citizens and employees. Thus, SOE managers and employees have little incentive to improve performance, which they can hardly benefit from personally. In a most cynical fashion, SOE employees in the former Soviet Union summed it up well: "They pretend to pay us and we pretend to work." A wave of privatization swept the world since the 1980s. However, SOEs staged a spectacular comeback recently. In 2008, many governments in developed economies nationalized major firms ranging from General Motors (GM, which reads "Government Motors") to Royal Bank of Scotland (RBS) in order to prevent massive bankruptcies and job losses.

MANAGERS

Managers, especially executives on the top management team (TMT) led by the CEO, represent another important group of players in corporate governance.

Principal–Agent Conflicts

The relationship between shareholders and professional managers is a relationship between principals and agents—in short, an **agency relationship**. **Principals** are persons (such as owners) delegating authority, and **agents** are persons (such as managers) to whom authority is delegated. **Agency theory** suggests a simple yet profound proposition: To the extent that the interests of principals and agents do not completely overlap, there will *inherently* be **principal–agent conflicts**. These conflicts result in **agency costs**, including (1) the principals' costs of monitoring and controlling the agents and (2) the agents' costs of bonding (signaling their trustworthiness).[8]

In a corporate setting, when shareholders (principals) are interested in maximizing the long-term value of their stock, managers (agents) may be more interested in maximizing their own power, income, and perks. For example, in 2001 HP's chairman and CEO Carly Fiorina, in an effort to acquire a PC maker Compaq, clashed with dissenting shareholders led by co-founder Bill Hewlett's son Walter Hewlett. Fiorina won the battle, but shareholders ended up footing the bill for the performance mess afterwards. Overall, manifestations of agency problems include:

- Excessive executive compensation.
- On-the-job consumption (such as corporate jets).
- Low-risk short-term investments (such as maximizing current earnings while cutting long-term R&D).
- Empire-building (such as value-destroying acquisitions).
- Excess CEO returns (CEO financial returns in excess of shareholder returns).[9]

Consider executive compensation. In 1980, the average US CEO earned approximately 40 times what the average worker earned. Today, the ratio is 400 times. Despite some performance improvement, it seems difficult to argue that the average CEO improved his/her productivity ten times faster than his/her workers since 1980. In other words, one can "smell" some agency costs.

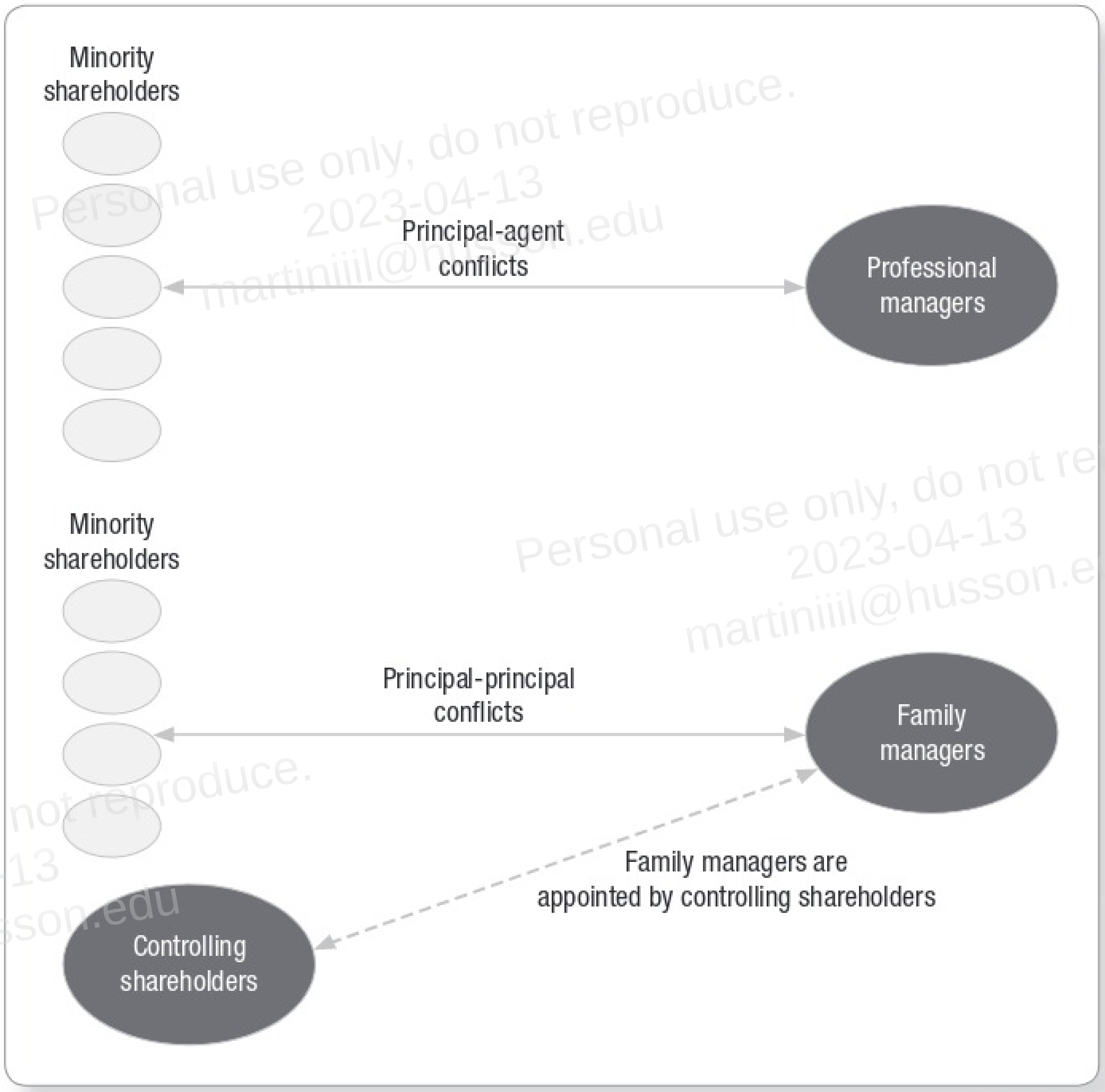
Directly measuring agency costs, however, is difficult. In two most innovative (and hair-raising) studies to directly measure agency costs, scholars find that some sudden CEO *deaths* (plane crashes or heart attacks) are accompanied by an increase in share prices of their firms.[10] These CEOs reduced agency costs that shareholders had to shoulder by dropping dead (!). Conversely, we could imagine how much value these CEOs destroyed when they had been alive. The capital market, sadly, was pleased with such human tragedies.

A primary reason agency problems persist is because of **information asymmetries** between principals and agents—that is, agents such as managers almost always know more about the property they manage than principals do.[11] While it is possible to reduce information asymmetries through governance mechanisms, it is not realistic to completely eliminate agency problems.

Principal–Principal Conflicts

Since concentrated ownership and control by families is the norm in many parts of the world, different kinds of conflicts are at play. One of the leading indicators of concentrated family ownership and control is the appointment of family members as board chairman, CEO, and other TMT members. In East Asia, approximately 57% of the corporations have board chairmen and CEOs from the controlling families.[12] In continental Europe, the ratio is 68%.[13] The families are able to do so, because they are controlling (although not necessarily majority) shareholders. For example, at News Corporation, neither the board nor angry shareholders can get rid of the Murdochs, who are controlling shareholders.

FIGURE 11.2 Principal–Agent Conflicts and Principal–Principal Conflicts



SOURCE: Adapted from M. Young, M. W. Peng, D. Ahlstrom, G. Bruton, & Y. Jiang, 2008, Corporate governance in emerging economies: A review of the principal-principal perspective (p. 200), *Journal of Management Studies*, 45: 196–220.

The Murdochs case is a classic example of the conflicts in family-owned and family-controlled firms. Instead of between principals (shareholders) and agents (professional managers), the primary conflicts are between two classes of principals: controlling shareholders and minority shareholders—in other words, **principal–principal conflicts** (Figure 11.2 and Table 11.1).[14] Family managers such as the Murdochs, who represent (or are) controlling shareholders, may advance family interests at the expense of minority shareholders. Controlling shareholders' dominant position as *both* principals and agents (managers) may allow them to override traditional governance mechanisms designed to curtail principal–agent conflicts such as the board of directors.

A manifestation of principal-principal conflicts is that family managers may have the potential to engage in **expropriation** of minority shareholders, defined as activities that enrich controlling shareholders at the expense of minority shareholders. For example, managers from the controlling family may simply divert resources from the firm for personal or family use. This activity is vividly nicknamed "**tunneling**"—digging a tunnel to sneak resources out. While such "tunneling" (often known as "corporate theft") is illegal, expropriation can be legally done

TABLE 11.1 Principal–Agent versus Principal–Principal Conflicts.

	Principal–Agent Conflicts	Principal–Principal Conflicts
Ownership pattern	Dispersed—shareholders holding 5% of equity are regarded as "blockholders."	Dominant—often greater than 50% of equity is controlled by the largest shareholders.
Manifestations	Strategies that benefit entrenched managers at the expense of shareholders (such as shirking, excessive compensation, and empire building).	Strategies that benefit controlling shareholders at the expense of minority shareholders (such as minority shareholder expropriation and cronyism).
Protection of minority shareholders	Formal constraints (such as courts) are more protective of shareholder rights. Informal norms adhere to shareholder wealth maximization.	Formal institutional protection is often lacking. Informal norms are typically in favor of controlling shareholders.
Market for corporate control	Active, at least in principle as the "governance mechanism of last resort."	Inactive even in principle. Concentrated ownership thwarts notions of takeover

SOURCE: Adapted from M. Young, M. W. Peng, D. Ahlstrom, G. Bruton, & Y. Jiang, 2008, Corporate governance in emerging economies: A review of the principal-principal perspective (p. 202), *Journal of Management Studies*, 45: 196–220.

through **related transactions**, whereby controlling owners buy firm assets from another firm they own at above-market prices or spin off the most profitable part of a public firm and merge it with another private firm of theirs.

Overall, while corporate governance practice and research traditionally focus on how to control professional managers because of the separation of ownership and control in a majority of US and UK firms, how to govern family managers in firms with concentrated ownership and control is of equal or probably higher importance around the world (including in certain US and UK firms, such as News Corporation).

BOARD OF DIRECTORS

As an intermediary between owners and managers, the board of directors oversees and ratifies strategic decisions and evaluates, rewards, and if necessary penalizes top managers.

Board Composition

Otherwise known as the insider/outsider mix, board composition has attracted significant attention. **Inside directors** are top executives of the firm. The trend around the world is to introduce more **outside (independent) directors**, defined as non-management members of the board. Often ideally labeled "independent directors," outside directors are presumably more independent and can better safeguard shareholder interests.

Although there is a widely held belief in favor of a higher proportion of outside directors, academic research has *failed* to empirically establish a link between the outsider/insider ratio and firm performance.[15] Even "stellar" firms with a majority of outside directors on the board (on average 74% of outside directors at Enron, Global Crossing, and Tyco before their scandals erupted) can still be plagued by governance problems. In the world's largest financial services firms, the more outside directors on their boards, the *worse* their stock returns during the 2008 crisis.[16] It is possible that some of these outside directors are *affiliated* directors who may have family, business, and/or professional relationships with the firm or firm management. In other words, such affiliated outside directors are not necessarily "independent."

Leadership Structure

Whether the board is led by a separate chairman or by the CEO who doubles as a chairman—a situation known as **CEO duality**—is also important. From an agency theory standpoint, if the board is to supervise agents such as the CEO, it seems imperative that the board be chaired by a separate individual. Otherwise, how can the CEO be evaluated by the body that he/she chairs? In other words, can a schoolboy grade his own papers? However, a corporation led by two top leaders (a board chairman and a CEO) may lack a unity of command and experience top-level conflicts. As a powerful executive, a CEO obviously does not appreciate being constantly second-guessed by a board chairman. Not surprisingly, there is significant divergence across countries. For instance, while a majority of the large UK firms separate the two top jobs, many large US firms combine them. A practical difficulty often cited by US boards is that it is very hard to recruit a capable CEO without the board chairman title.

Academic research is inconclusive on whether CEO duality (or non-duality) is more effective.[17] However, pressures have arisen around the world for firms to split the two jobs to at least show that they are serious about controlling the CEO. In 2010, only 12% of the new CEOs around the world were also appointed as chairmen. In 2002, the percentage was 48%. Even in US firms that typically favor CEO duality, Standard & Poor's 500 firms practicing CEO duality fell from 78% in 2002 to 59% in 2010.[18]

Board Interlocks

Directors tend to be economic and social elites who share a sense of camaraderie and reciprocity.[19] When one person affiliated with one firm sits on the board of another firm, an **interlocking directorate** has been created.[20] Firms often establish relationships through such board appointments. For instance, outside directors from financial institutions often facilitate financing. Outside directors experienced in acquisitions may help the focal firms engage in these practices.

In the United States, Frank Carlucci, a former Secretary of Defense and chairman of the Carlyle Group (a leading private equity firm), served on 20 boards (!) at one time. In Hong Kong, the most heavily connected director, David Li, chairman of the Bank of East Asia, sat on nine boards. Critics argue that such directors are unlikely to effectively monitor management. In fact, one of the boards David Li served on was Enron's. In the post-Enron environment, such unusual practices are increasingly rare.

The Role of Boards of Directors

In a nutshell, boards of directors perform (1) control, (2) service, and (3) resource acquisition functions. Boards' effectiveness in serving the control function stems from their independence, deterrence, and norms. Specifically:

- The ability to effectively control managers boils down to how *independent* directors are. Outside directors who are personally friendly and loyal to the CEO are unlikely to challenge managerial decisions. Exactly for this reason, CEOs often nominate family members, personal friends, and other passive directors.[21]
- There is a lack of *deterrence* on the part of directors should they fail to protect shareholder interests. Courts usually will not second-guess board decisions in the absence of bad faith or insider dealing.

- When challenging management, directors have few *norms* to draw on. Directors who "stick their necks out" by confronting the CEO in meetings tend to be frozen out of board deliberations.

In addition to control, another important function of the board is service—primarily advising the CEO.[22] Finally, another crucial board function is resource acquisition for the focal firm, often through interlocking directorates.

Overall, until recently, many boards of directors simply "rubber stamp" (approve without scrutiny) managerial actions. Prior to the 1997 economic crisis, many South Korean boards did not bother to hold meetings and so board decisions were literally "rubber stamped"—not even by directors themselves, but by secretaries who stamped the seals of all the directors, which were kept in the corporate office. However, change is in the air throughout the world. In South Korea, board meetings are now regularly held and seals are personally stamped by the directors themselves.[23]

Directing Strategically

If boards are to function effectively, being a director is one of the most demanding jobs, calling for an active "nose in but hands off" approach. Given the comprehensive functions of control, service, and resource acquisition and the limited time and resources directors have, directors must strategically prioritize.[24] How directors strategically prioritize differs significantly around the world. In US and UK firms, the traditional focus, which stems from their separation of ownership and control, is on the boards' control function. While the service function is still important, the resource acquisition role, although important in practice, tends to be criticized by policymakers, activists, and the media, who often regard activities such as interlocking directorates as "collusive." Consequently, recent US regulations, especially the Sarbanes-Oxley (SOX) Act of 2002, emphasize the control function almost to the exclusion of the resource acquisition function. For example, Apple acquired certain resources from Google to power its iPhones and Google's CEO Eric Schmidt used to serve on Apple's board. However, as the competition between Apple and Google (which launched its own Android phone) heated up recently, Schmidt had to give up his Apple board membership.

Since outside directors are not likely to have enough first-hand knowledge about the firm, they are thus forced to focus on financial performance targets and numbers—known as financial control (see Table 11.2). Financial control may encourage CEOs to focus on the short term, at the expense of long-term shareholder

TABLE 11.2 Outside Directors versus Inside Directors.

	Pros	Cons
Outside directors	• Presumably more independent from management (especially the CEO). • More capable of monitoring and controlling managers. • Good at financial control.	• Independence may be illusionary. • "Affiliated" outside directors may have family or professional relationships with the firm or management. • Not good at strategic control.
Inside directors	• Have first-hand knowledge about the firm. • Good at strategic control.	• Non-CEO inside directors (executives) may not be able to control and challenge the CEO.

interests (such as maximizing current earnings by reducing R&D). Therefore, inside directors, who are executives, can bring first-hand knowledge to board deliberations, allowing for a more-sophisticated understanding of some managerial actions (such as investing in the future while not maximizing current earnings). A board informed by such inside views is able to exercise strategic control, basing its judgment beyond a mere examination of financial numbers. It seems that a healthy board requires both kinds of control, thus calling for a balanced composition of insiders and outsiders.[25]

GOVERNANCE MECHANISMS AS A PACKAGE

Governance mechanisms can be classified as internal and external ones—otherwise known as voice-based and exit-based mechanisms, respectively. **Voice-based mechanisms** refer to shareholders' willingness to work with managers, usually through the board, by "voicing" their concerns. **Exit-based mechanisms** indicate that shareholders no longer have patience and are willing to "exit" by selling their shares. This section outlines these mechanisms.

Internal (Voice-Based) Governance Mechanisms

The two internal governance mechanisms typically employed by boards can be characterized as (1) "carrots" and (2) "sticks." In order to better motivate managers, increasing executive compensation as "carrots" is often a must. Stock options that help align the interests of managers and shareholders have become increasingly popular.[26] The underlying idea is pay for performance, which seeks to link executive compensation with firm performance. While in principle this idea is sound, in practice it has a number of drawbacks. If accounting-based measures (such as return on sales) are used, managers are often able to manipulate numbers to make them look better. If market-based measures (such as stock prices) are adopted, stock prices obviously are subject to too many forces beyond managers' control. Consequently, the pay-for-performance link in executive compensation is usually not very strong.[27]

Boards are likely to use "carrots" before considering "sticks." However, when facing continued performance failures, boards may have to dismiss the CEO.[28] Among the world's largest 2,500 listed firms, CEO tenure has decreased from 8.1 years in 2000 to 6.3 years in 2012.[29] In brief, boards seem to be more "trigger-happy" recently.[30] In 2011, Léo Apotheker served only ten *months* as CEO before HP's board fired him.

Because top managers must shoulder substantial firm-specific employment risk (a fired CEO such as Apotheker is extremely unlikely to run another publicly traded company), they naturally demand more generous compensation—a premium on the order of 30% or more—before taking on new CEO jobs. This in part explains the rapidly rising levels of executive compensation.[31]

External (Exit-Based) Governance Mechanisms

There are three external governance mechanisms: (1) market for product competition, (2) market for corporate control, and (3) market for private equity. Product market competition is a powerful force compelling managers to maximize profits and, in turn, shareholder value. However, from a corporate governance perspective, product market competition *complements* the market for corporate control and the market for private equity, each of which is outlined next.

The Market for Corporate Control

This is the main external governance mechanism, otherwise known as the takeover market or the mergers and acquisitions (M&A) market (see Chapter 9). It is essentially an arena where different management teams contest for the control rights of corporate assets. As an external governance mechanism, the market for corporate control serves as a disciplining mechanism of last resort when internal governance mechanisms fail. The underlying logic is spelled out by agency theory, which suggests that when managers engage in self-interested actions and internal governance mechanisms fail, firm stock will be undervalued by investors. Under these circumstances, other management teams, which recognize an opportunity to create new value, bid for the rights to manage the firm (see Chapter 9). How effective is the market for corporate control? Three findings emerge:

- On average, shareholders of target firms earn sizable acquisition premiums.
- Shareholders of acquiring firms experience slight but insignificant losses.
- A substantially higher level of top management turnover occurs following M&As.[32]

In summary, while internal mechanisms aim at "fine-tuning," the market for corporate control enables the "wholesale" removal of entrenched managers. As a radical approach, the market for corporate control has its own limitations. It is very costly to wage such financial battles, because acquirers must pay an acquisition premium. In addition, a large number of M&As are driven by acquirers' sheer hubris or empire building,[33] and the long-term profitability of post-merger firms is not particularly impressive (see Chapter 9). Nevertheless, the net impact, at least in the short run, seems to be positive, because the threat of takeovers does limit managers' divergence from shareholder wealth maximization—as recently reported in Japan.[34]

The Market for Private Equity

Instead of being taken over, a large number of publicly listed firms have gone private by tapping into **private equity**—equity capital invested in private (non-public) companies (see the Opening Case). Private equity is primarily invested through **leveraged buyouts (LBOs)**. In an LBO, private investors, often in partnership with incumbent managers, issue bonds and use the cash raised to buy the firm's stock—in essence replacing shareholders with bondholders and transforming the firm from a public to a private entity.[35] As another external governance mechanism, private equity utilizes the bond market, as opposed to the stock market, to discipline managers. LBO-based private equity transactions are associated with three major changes in corporate governance:[36]

- LBOs change the incentives of managers by providing them with substantial equity stakes.
- The high amount of debt imposes strong financial discipline.
- LBO sponsors closely monitor the firms they have invested in.

Overall, evidence suggests that private equity results in relatively small job losses (about 1%–2%) and improves efficiency by about 2%, at least in the short run.[37] The picture is less clear regarding the long run, because LBOs may have forced managers to reduce investments in long-term R&D. Recent research reports that private equity-backed firms do not suffer from a reduction of R&D in the long run.[38]

Internal Mechanisms + External Mechanisms = Governance Package

Taken together, the internal and external mechanisms can be considered a "package."[39] Michael Jensen, a leading agency theorist, argues that in the United States, failures of internal governance mechanisms in the 1970s activated the market for corporate control in the 1980s.[40] Managers initially resisted. However, over time, many firms that are not takeover targets or that have successfully defended themselves against such attempts end up restructuring and downsizing—doing exactly what "raiders" would have done had these firms been taken over. In other words, the strengthened external mechanisms force firms to improve their internal mechanisms. Overall, since the 1980s, American managers have become much more focused on stock prices, resulting in a new term, "**shareholder capitalism**," which has been spreading around the world.[41]

A GLOBAL PERSPECTIVE

Illustrated in Figure 11.3, different corporate ownership and control patterns around the world lead to a different mix of internal and external mechanisms. The most familiar type is Cell 4, exemplified by most large US and UK firms. While external governance mechanisms (M&As and private equity) are active, internal mechanisms are relatively weak due to the separation of ownership and control that gives managers significant *de facto* control power (see the Opening Case).

The opposite can be found in Cell 1, namely, firms in continental Europe and Japan where the market for corporate control is relatively inactive (although there is more activity recently). Consequently, the primary governance mechanisms remain concentrated ownership and control.

Overall, the Anglo–American and continental European–Japanese (otherwise known as German–Japanese) systems represent the two primary corporate governance families in the world, with a variety of labels (see Table 11.3). Given that both the United States and the United Kingdom as a group and continental Europe and Japan as another group are highly developed, successful economies, it is difficult and probably not meaningful to argue whether the Anglo–American or German–Japanese system is better.

FIGURE 11.3 A Global Perspective on Internal and External Governance Mechanisms.

Internal governance mechanisms	*External governance mechanisms*: Weak	*External governance mechanisms*: Strong
Strong	(Cell 1) Germany Japan	(Cell 2) Canada
Weak	(Cell 3) State-owned enterprises	(Cell 4) United States United Kingdom

SOURCE: Cells 1, 2, and 4 are adapted from E. Gedajlovic & D. Shapiro, 1998, Management and ownership effects: Evidence from five countries (p. 539), *Strategic Management Journal*, 19: 533–553. The label of Cell 3 is suggested by M. W. Peng.

TABLE 11.3 Two Primary Families of Corporate Governance Systems.

Corporations in the United States and United Kingdom	Corporations in Continental Europe and Japan
Anglo-American corporate governance models	German-Japanese corporate governance models
Market-oriented high-tension systems	Bank-oriented network-based systems
Rely mostly on exit-based external mechanisms	Rely mostly on voice-based internal mechanisms
Shareholder capitalism	Stakeholder capitalism

Some other systems do not easily fit into such a dichotomous world. Placed in Cell 2, Canada has *both* a relatively active market for corporate control and a large number of firms with concentrated ownership and control—over 380 of the 400 largest Canadian firms are controlled by a single shareholder.[42] Canadian managers thus face powerful internal and external constraints.

Finally, SOEs (of all nationalities) are typically in a position of both weak external and internal governance mechanisms (Cell 3). Externally, the market for corporate control usually does not exist. Internally, managers are supervised by officials who act as *de facto* "owners" with little control.

Overall, firms around the world are governed by a combination of internal and external mechanisms. For firms in Cells 1, 2, and 4, there is some partial substitution between internal and external mechanisms (for example, weak boards may be partially substituted by a strong market for corporate control).

A COMPREHENSIVE MODEL OF CORPORATE GOVERNANCE

Figure 11.4 shows a comprehensive model drawn from the strategy tripod. This section discusses the model.

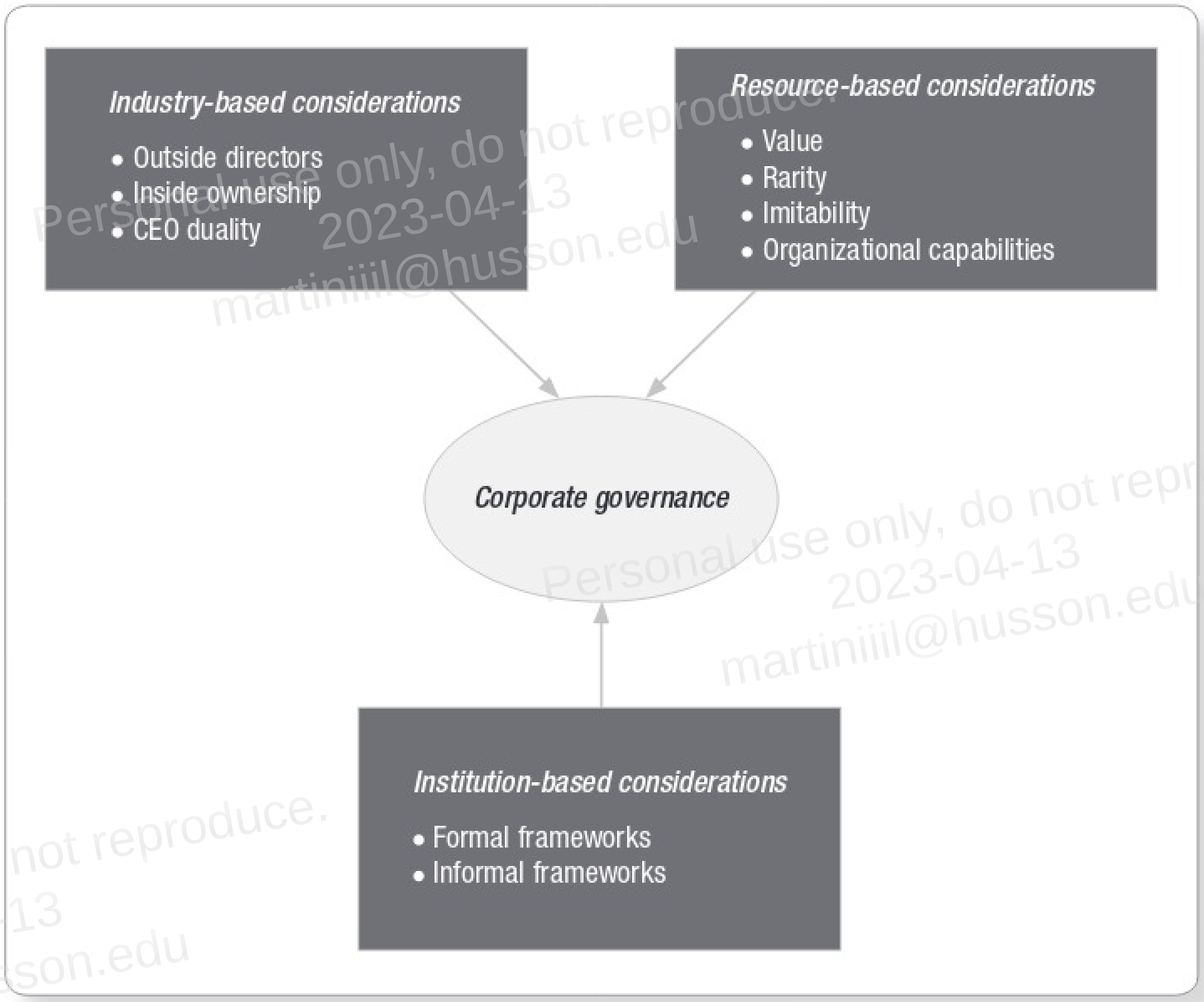
Industry-Based Considerations

The nature of industry sometimes questions certain widely accepted conventional wisdom regarding (1) outside directors, (2) insider ownership, and (3) CEO duality. Having more outside directors on the board is often regarded as a performance-enhancing practice. However, such thinking ignores industry differences. In industries characterized by a rapid pace of innovation requiring significant R&D investments (such as IT), outside directors often have a *negative* impact on firm performance.[43] This is because of the necessity for directors to have intimate knowledge about these industries, which require more strategic control. Inexperienced outside directors often focus on financial control—inappropriate in these industries.

Another example is the widely noted link between inside management ownership and firm performance. However, such relationship may not exist in low-growth stable industries. Only in relatively high-growth turbulent industries has this relationship been found. While increased insider ownership is designed to encourage managers to take more risks, opportunities to profitably take such risks probably may be more likely in high-growth turbulent industries.

A third example is the often-criticized practice of CEO duality. In industries experiencing great turbulence, the presence of a single leader may allow a faster and more unified response to changing events. These benefits may outweigh the potential agency costs brought by such duality.

FIGURE 11.4 A Comprehensive Model of Corporate Governance.



Overall, governance practices need to create a fit with the nature of the industry in which firms are competing. This cautions against universal prescriptions of certain "best" practices.

Resource-Based Considerations

From a corporate governance standpoint, some of the most valuable, rare, and hard-to-imitate firm-specific resources (the first three in the VRIO framework) are the skills and abilities of top managers and directors—often regarded as **managerial human capital**.[44] Some of these capabilities are highly unique, such as international experiences. Executives without such first-hand experience are often handicapped when they try to expand overseas. In addition, the social networks of these executives, often through board interlocks, are likely to add value, highly unique, and hard to imitate.[45]

In another example, the abilities to successfully list on a high-profile exchange such as New York Stock Exchange (NYSE) and London Stock Exchange (LSE) are valuable, rare, and hard-to-imitate. In 1997, the valuations of foreign firms listed in New York were 17% higher than their domestic counterparts in the same country that were either unable or unwilling to list abroad.[46] Now, despite hurdles such as SOX, the select few that are able to list in New York are rewarded more handsomely: Their valuations are now 37% higher than comparable groups of domestic firms in the same country.[47] London-listed foreign firms do not enjoy such high valuations.[48] This is classic resource-based logic at work: Precisely because it is much more challenging to list in New York in the SOX era, the small number of foreign firms that are able to do this are truly exceptional. Thus, they deserve much higher valuations.

The last crucial component in the VRIO framework is O: organizational. It is within an organizational setting (in TMTs and boards) that managers and directors function.[49] Overall, the few people at the top of an organization can make a world of difference—Steve Jobs at Apple was a great example. Governance mechanisms need to properly motivate and discipline them to make sure they make a positive impact.

Institution-Based Considerations

Formal Institutional Frameworks

The institution-based view posits that differences around the world are affected on the one hand by formal securities laws, corporate charters, and codes, and on the other hand by informal conventions, norms, and values—collectively known as "institutions."[50] A fundamental difference is between the separation of ownership and control in (most) Anglo–American firms and the concentration of ownership and control in the rest of the world (see the Opening Case). Why is there such a difference? While explanations abound, a leading answer is an institutional one. In brief, better formal legal protection of shareholder rights in the United States and the United Kingdom, especially those held by *minority* shareholders, encourages founding families to dilute their equity to attract minority shareholders and delegate day-to-day management to professional managers.[51] Given reasonable investor protection, founding families themselves (such as the Rockefellers) may, over time, feel comfortable becoming minority shareholders of the firms they founded. On the other hand, when formal legal and regulatory institutions are dysfunctional, founding families *must* run their firms directly. In the absence of investor protection, inviting outside professional managers may invite abuse and theft.

Strong evidence exists that the weaker the formal legal and regulatory institutions protecting shareholders, the more concentrated ownership and control rights become—in other words, there is some substitution between the two. Common-law countries generally have the strongest legal protection of investors and the lowest concentration of corporate ownership.[52] Among common-law countries, such ownership concentration is higher for firms in emerging economies (such as Hong Kong, India, and Israel) than developed economies (such as Australia, Canada, Ireland, and New Zealand). In short, concentrated ownership and control is an answer to potentially rampant principal–agent conflicts in the absence of sufficient legal protection of shareholder rights.

However, what is good for controlling shareholders is not necessarily good for minority shareholders and for an economy. As noted earlier, the minimization of principal–agent conflicts through concentration of ownership and control, unfortunately, introduces more principal–principal conflicts. Consequently, many potential minority shareholders may refuse to invest. "How does one avoid being expropriated as a minority shareholder?" one popular saying suggests, "Don't be one!" If minority shareholders are informed enough to be aware of principal-principal conflicts and still decide to invest, they are likely to discount the shares floated by family owners. For example, thanks to the "Murdoch discount," News Corporation's stock performance has trailed behind that of its rivals such as Time Warner, Walt Disney, and Viacom. Overall, such principal–principal conflicts can result in lower valuations, fewer publicly traded firms, inactive and smaller capital markets, and, in turn, lower levels of economic development in general.

Given that almost every country desires vibrant capital markets and economic development, it seems puzzling why strong investor protection is not universally embraced. This is because corporate governance ultimately is a choice about *political* governance. For largely historical reasons, most countries have made hard-to-reverse political choices. For example, the German practice of "codetermination" (employees control 50% of the votes on supervisory boards) is an outcome of political decisions made by postwar German governments. If German firms had US/UK-style dispersed ownership and still allowed employees to control 50% of the votes on supervisory boards, these firms would end up becoming *employee*-dominated firms. Thus, concentrated ownership and control becomes a natural response.

Changing political choices, although not impossible, will encounter significant resistance, especially from incumbents (such as German labor unions or Asian families) who benefit from the present system. Some of the leading families not only have great connections with the government, sometimes they *are* the government. Three recent prime ministers of Italy and Thailand—Silvio Berlusconi, Thaksin Shinawatra, and Yingluck Shinawatra—came from leading families and were the richest individuals in these countries.

Only when extraordinary events erupt would some politicians muster sufficient political will to initiate major corporate governance reforms.[53] The spectacular corporate governance scandals in the United States (such as Enron) are an example of such extraordinary events prompting more serious political reforms, such as SOX. The 2008 financial crisis resulted in the enactment of the Dodd-Frank Act in 2010, which for the first time allows shareholders to cast proxy votes on executive compensation—in short, "say on pay."

Informal Institutional Frameworks

In the last three decades around the world, why have informal norms and values concerning corporate governance changed to such a great extent?[54] As the idea of shareholder capitalism rapidly spreads, three underlying sources can be identified: (1) the rise of capitalism, (2) the impact of globalization, and (3) the global diffusion of "best practices."

First, recent changes in corporate governance around the world are part of the greater political, economic, and social movement embracing capitalism. The triumph of capitalism naturally boils down to the triumph of *capitalists* (also known as shareholders). Even some of the most developed countries have experienced significant governance failures, calling for a sharper focus on shareholder value.

Second, at least three aspects of recent globalization have a bearing on corporate governance.

- Thanks to more trade and investment, firms with different governance norms increasingly come into contact and expose their differences. Being aware of alternatives, shareholders as well as managers and policymakers are no longer easily persuaded that "our way" is the best way of corporate governance.
- **Foreign portfolio investment (FPI)**—foreigners purchasing stocks and bonds—has scaled new heights. These investors naturally demand better shareholder protection before committing their funds.
- The global thirst for capital has prompted many firms to pay attention to corporate governance. Foreign firms that list their stock in New York and London have to be in compliance with US and UK listing requirements.

Third, the changing norms and values are also directly promoted by the global diffusion of "best practices" in the form of corporate governance codes.[55] A lot of codes are advisory and not legally binding. However, strong pressures exist for firms to "voluntarily" adopt these codes. For example, in Russia, although adopting the Code of Corporate Conduct is voluntary, firms not adopting it have to publicly explain why, essentially naming and shaming themselves. The Organization for Economic Cooperation and Development (OECD)—a rich countries' club—has spearheaded efforts to globally diffuse "best practices" through the *OECD Principles of Corporate Governance*. The *Principles* are non-binding even for the 34 OECD member countries. Nevertheless, the global norms seem to be moving toward the *Principles*.

For example, China and Taiwan, both are non-OECD members, have recently taken a page from the *Principles* and allowed for class-action lawsuits brought by shareholders.

Slowly but surely, change is in the air. But such change is not necessarily in one direction. The ferociousness of the 2008 global financial crisis has caused tremendous resentment toward fat executive pay packages, income inequality, and the financial services industry in general. Movements such as Occupy Wall Street and Occupy London are a tangible indication of the changing informal sentiments as the swing of the pendulum (see Chapter 1), which has triggered or intensified formal regulatory changes.

DEBATES AND EXTENSIONS

Corporate governance often generates intense debates.[56] This section discusses three major debates: (1) opportunistic agents versus managerial stewards, (2) global convergence versus divergence, and (3) state ownership versus private ownership.

Opportunistic Agents versus Managerial Stewards

Agency theory assumes managers to be agents who may engage in self-serving opportunistic activities if left to their own devices. However, critics contend that most managers are likely to be honest and trustworthy. Managerial mistakes may be due to a lack of competence, information, or luck, and not necessarily due to self-serving motives. Thus, it may not be fair to characterize all managers as opportunistic agents. Although very influential, agency theory has been criticized as an "anti-management theory of management."[57] A "pro-management" theory, **stewardship theory**, has emerged recently. It suggests that most managers can be viewed as owners' stewards. Safeguarding shareholders' interests and advancing organizational goals will maximize (most) managers' own utility functions.[58]

If all principals view all managers as self-serving agents with control mechanisms to put managers on a "tight leash," some managers, who initially view themselves as stewards, may be so frustrated that they end up engaging in the very self-serving behavior agency theory seeks to minimize. In other words, as a self-fulfilling prophecy, agency theory may *induce* such behavior.

Global Convergence versus Divergence

Globally, is corporate governance converging or diverging? Convergence advocates argue that globalization unleashes a "survival-of-the-fittest" process by which firms will be forced to adopt globally best (essentially Anglo-American) practices. Global investors are willing to pay a premium for stock in firms with Anglo-American-style governance, prompting other firms to follow.

One interesting phenomenon often cited by convergence advocates is **cross-listing**, namely, listing shares on foreign stock exchanges.[59] Cross-listing is primarily driven by the desire to tap into larger pools of capital. Foreign firms thus must comply with US and UK securities laws and adopt Anglo–American governance norms. For instance, Japanese firms listed in New York and London, compared with those listed at home, are more concerned about shareholder value. A US or UK listing can be viewed as a signal of the firm's commitment to strengthen shareholder value, resulting in higher valuations.

Critics contend that governance practices will continue to diverge throughout the world.[60] For example, promoting more concentrated ownership and control is often recommended as a solution to combat principal–agent conflicts in US and UK firms. However, making the same recommendation to reform firms in the rest of the world may be counterproductive or even disastrous.[61] This is because the main problem there is that controlling shareholders typically already have too much ownership and control. Finally, some US and UK practices differ significantly. In addition to the split on CEO duality (the UK against, the US for) discussed earlier, none of the US anti-takeover defenses (such as "poison pills") is legal in the UK.

In the case of cross-listed firms, divergence advocates make two points. First, despite some convergence on paper (such as having more outside directors), cross-listed foreign firms do not necessarily adopt US governance norms before or after listing.[62] Second, despite the popular belief that US and UK securities laws would apply to cross-listed foreign firms, in practice, these laws have rarely been effectively enforced against foreign firms' "tunneling."[63]

At present, complete divergence is probably unrealistic, especially for large firms in search of capital from global investors. Complete convergence also seems unlikely. What is more likely is "cross-vergence," balancing the expectations of global investors and those of local stakeholders.[64]

State Ownership versus Private Ownership[65]

Private ownership is good. State ownership is bad. Although crude, these two statements fairly accurately capture the intellectual and political reasoning behind three decades of privatization around the world between 1980 and 2008. Table 11.4 summarizes the key differences between private ownership and state ownership. Obviously, both forms of ownership have their own pros and cons. So the debate boils down to which form of ownership is better—whether the pros outweigh the cons (see the Opening Case).

The debate on private versus state ownership underpinned much of the global economic evolution in the 20th century. The Great Depression (1929–1933) was seen as a failure of capitalism, and led numerous elites in developing countries and a nontrivial number of scholars in developed economies to favor Soviet-style

TABLE 11.4 Private Ownership versus State Ownership.

	Private ownership	State ownership
Objective of the firm	Maximize profits for private owners who are capitalists (and maximize shareholder value for shareholders if the firm is publicly listed).	Optimal balance for a "fair" deal for all stakeholders. Maximizing profits is not the sole objective of the firm. Protecting jobs and minimizing social unrest are legitimate goals.
Establishment	Entry is determined by entrepreneurs, owners, and investors.	Entry is determined by government officials.
Financing	Financing is from private sources (and public shareholders if the firm is publicly traded).	Financing is from state sources (such as direct subsidiaries or banks owned or controlled by governments).
Liquidation	Exit is forced by competition. A firm has to declare bankruptcy or be acquired if it becomes financially insolvent.	Exit is determined by government officials. Firms deemed "too big to fail" may be supported by taxpayer dollars indefinitely.
Appointment and dismissal of management	Management appointments are made by owners and investors largely based on merit.	Management appointments are made by government officials who may also use noneconomic criteria.
Compensation of management	Managers' compensation is determined by competitive market forces. Managers tend to be paid more under private ownership.	Managers' compensation is determined politically with some consideration given to a sense of fairness and legitimacy in the eyes of the public. Managers tend to be paid less under state ownership.

SOURCES: Based on (1) M. W. Peng, 2000, *Business Strategies in Transition Economies* (p. 19), Thousand Oaks, CA: Sage; (2) M. W. Peng, G. Bruton, & C. Stan, 2015, Theories of the (state-owned) firm, working paper, University of Texas at Dallas.

socialism centered on state ownership. As a result, the postwar decades saw an increase in state ownership and a decline in private ownership. State ownership was not only extensive throughout the former Eastern bloc (the former Soviet Union, Central and Eastern Europe, China, and Vietnam), but was also widely embraced throughout developed economies in Western Europe. By the early 1980s, close to half of the GDP in major Western European countries such as Britain, France, and Italy was contributed by SOEs.

Experience throughout the former Eastern bloc and Western Europe indicated that SOEs typically suffer from a lack of accountability and a lack of economic efficiency. SOEs were known to feature relatively equal pay between managers and the rank and file. Since extra work did not translate into extra pay, employees had little incentive to improve the quality and efficiency of their work.

Britain's prime minister Margaret Thatcher privatized a majority of British SOEs in the 1980s. SOEs throughout Central and Eastern Europe soon followed suit. After the former Soviet Union collapsed, the new Russian government unleashed some of the most aggressive privatization schemes in the 1990s. Eventually, the privatization movement became global, reaching Brazil, India, China, Vietnam, and most countries in Africa. In no small part, such a global movement was championed by the **Washington Consensus**, spearheaded by the US government and the two Washington-based international organizations: the International Monetary Fund (IMF) and the World Bank. A core value of the Washington Consensus is the unquestioned belief in the superiority of private ownership over state ownership. The widespread privatization movement suggested that the Washington Consensus had clearly won the day—or so it seemed.

But in 2008, the pendulum suddenly swung back (see Chapter 1). During the unprecedented Great Recession, many governments in developed economies, led by the US government, bailed out numerous failing private firms using public funds, effectively turning them into SOEs (see the Opening Case). As a result, the arguments in favor of private ownership and "free market" capitalism collapsed. Since SOEs had such a dreadful reputation (essentially a "dirty word"), the US government has refused to acknowledge that it has SOEs. Instead, the US government refers to them as "government-sponsored enterprises" (GSEs).

Conceptually, what are the differences between SOEs and GSEs? Hardly any! The right column in Table 11.4 is based on research on the "classical" SOEs in pre-reform China and Russia published more than a decade ago. This column also accurately summarizes what is happening in developed economies featuring GSEs now. For example, protecting jobs is one of the stated goals behind bailouts. Entry and exit are determined by government officials, and some firms that have been clearly run to the ground, such as AIG, GM, and RBS, are deemed "too big to fail" and are bailed out with taxpayer dollars. The US government forced the exit of GM's former chairman and CEO and is now directly involved in the appointment and compensation of executives at GM and other GSEs.

One crucial concern is that despite noble goals to rescue the economy, protect jobs, and fight recession, government bailouts serve to heighten **moral hazard**—recklessness when people and organizations (including firms and governments) do not have to face the full consequences of their actions.[66] In other words, capitalism without the risk of failure becomes socialism. It is long known that managers in SOEs face a "soft budget constraint" in that they can always dip into state coffers to cover their losses.[67] When managers in private firms make risky decisions that turn sour, but their firms do not go under—thanks to generous bailouts—they are likely to embrace *more* risk in the future.

Although the worst fear about the recession is now over, debates continue to rage. From the ashes of the Washington Consensus emerged a **Beijing Consensus**, which centers on state ownership and government intervention. Anchored by SOEs, China's economy has emerged to become the second largest in the world. But China is

TABLE 11.5 Top Ten Largest and Top Ten Most Profitable Firms in the World.

	Top ten largest firms measured by sales		Top ten firms with the largest profits
1	Wal-Mart (USA)	1	Vodafone Group (UK)
2	Royal Dutch Shell (Netherlands)	2	Fannie Mae (USA)—SOE
3	SINOPEC (China)—SOE	3	Freddie Mac (USA)—SOE
4	China National Petroleum Corporation (China)—SOE	4	Industrial & Commercial Bank of China (China)—SOE
5	Exxon Mobil (USA)	5	Apple (USA)
6	BP (UK)	6	Gazprom (Russia)—SOE
7	State Grid (China)—SOE	7	China Construction Bank (China)—SOE
8	Volkswagen (Germany)—SOE	8	Exxon Mobil (USA)
9	Toyota (Japan)	9	Samsung Electronics (South Korea)
10	Glencore (Switzerland)	10	Agricultural Bank of China (China)—SOE

SOURCE: Adapted from *Fortune*, 2014, Global 500, July 21: F-1 and F-13.

not alone.[68] Overall, SOEs not only occupy four spots among the top ten largest firms worldwide (measured by sales), but also represent six of the top ten most-*profitable* firms globally (measured by amount of profits) (see Table 11.5). While some SOEs have become large and profitable, the majority of them have continued to be inefficient. Despite the hoopla about the alleged "muscle" of Chinese SOEs, as a group their return on assets (ROA) since 2008 has been barely 3%.[69] In summary, some SOEs do well, most muddle through, but they are unlikely to disappear any time soon.[70]

THE SAVVY STRATEGIST

In the corporate governance arena, the savvy strategist capitalizes on three strategic implications for action (Table 11.6). First, understand the nature of principal–agent and principal–principal conflicts to create better governance mechanisms. For example, the rise of private equity is a direct response to principal–agent conflicts typically found in publicly listed firms. Amazingly, private equity typically makes the *same* managers, managing the *same* assets, perform much more effectively. In terms of mechanisms to alleviate principal–principal conflicts, one practice is to introduce a second controlling (dominant) shareholder that may monitor and constrain the action of the first controlling shareholder.[71]

Second, savvy strategists need to develop firm-specific capabilities to differentiate on governance dimensions. In India, a leading IT firm Infosys has emerged as an exemplar. It is the first Indian firm to follow US generally accepted accounting principles (GAAP), the first to offer stock options to all employees, and one of the first to introduce outside directors. Since its listings in Mumbai in 1993 and NASDAQ in 1999, it has gone far beyond disclosure requirements mandated by both Indian and US standards. On NASDAQ, Infosys *voluntarily* behaves like a US domestic issuer, rather than subjecting itself to the less-stringent standards of a foreign issuer.

TABLE 11.6 Strategic Implications for Action.

- Understand the nature of principal–agent and principal–principal conflicts to create better governance mechanisms.
- Develop firm-specific capabilities to differentiate a firm on corporate governance dimensions.
- Master the rules affecting corporate governance and anticipate changes.

The primary reason is to gain credibility with Western customers. In other words, excellent governance practices make Infosys stand out in the product market.

Third, savvy strategists need to understand the formal and informal rules, anticipate changes, and be prepared.[72] In the first year that shareholders were granted a "say on pay" in US firms (2011), median pay for CEOs at Standard & Poor's 500 firms *jumped* 35% to $8.4 million.[73] While shareholders only rejected executive pay at fewer than 2% of public firms, this practice of significantly increasing CEO compensation seemed to deviate from the spirit—if not the letter—of the Dodd-Frank Act that unleashed "say on pay." As a result, more tightening of the rules can be expected down the road.

Overall, a better understanding of corporate governance can help us answer the four fundamental questions in strategy. First, why do firms differ? Firms differ in corporate governance because of the different nature of industries, different abilities to motivate and discipline managers, and different institutional frameworks. Second, how do firms behave? Given that most corporations throughout the world have similar basic components of corporate governance (owners, managers, and boards), the primary sources of differences stem from how these components relate and interact with each other. Third, what determines the scope of the firm? From a corporate governance standpoint, a wide scope may be indicative of managers' empire-building and risk reduction. Finally, what determines the success and failure of firms around the globe? Although research is still inconclusive, there is reason to believe—in the aggregate and in the long run—that better governed firms will be rewarded with a lower cost of capital and better firm performance.[74]

CHAPTER SUMMARY

1. Differentiate various ownership patterns (concentrated/diffused, family, and state ownership)
- In the US and UK, firms with separation of ownership and control dominate.
- Elsewhere, firms often feature concentrated ownership and control in the hands of families or governments.

2. Articulate the role of managers in both principal–agent and principal–principal conflicts
- In firms with separation of ownership and control, the primary conflicts are principal–agent conflicts.
- In firms with concentrated ownership, principal–principal conflicts prevail.

3. Explain the role of the board of directors
- The board of directors performs (1) control, (2) service, and (3) resource acquisition functions.
- Around the world, boards differ in composition, leadership structure, and interlocks.

4. Identify voice-based and exit-based governance mechanisms and their combination as a package
- Internal voice-based mechanisms and external exit-based mechanisms combine as a package to determine corporate governance effectiveness.
- The market for corporate control and the market for private equity are two primary external mechanisms.

5. Acquire a global perspective on how governance mechanisms vary around the world
- Different combinations of internal and external governance mechanisms lead to four main groups.
- Privatization around the world represents efforts to enhance governance effectiveness.

6. Elaborate on a comprehensive model of corporate governance
   - Industry-based, institution-based, and resource-based views shed considerable light on governance issues.
7. Participate in three leading debates concerning corporate governance
   - (1) Opportunistic agents versus managerial stewards, (2) global convergence versus divergence, and (3) state ownership versus private ownership.
8. Draw strategic implications for action
   - Understand the nature of principal–agent and principal–principal conflicts.
   - Develop firm-specific capabilities to differentiate on corporate governance dimensions.
   - Master the rules affecting corporate governance and anticipate changes.

CRITICAL DISCUSSION QUESTIONS

1. If you can choose to list your firm anywhere in the world, which country would you prefer? Why?
2. Recent corporate governance reforms in various countries urge (and often require) firms to add more outside directors to their boards and separate the jobs of board chairman and CEO. Yet, academic research has not been able to conclusively support the merits of both practices. Why?
3. ***ON ETHICS:*** You are 30 years old and obtained your MBA from a top business school two years ago. You are being promoted to be CEO of a multibillion-dollar firm that is publicly listed in your country. There is loud minority shareholder resistance to your appointment because you are too young. Too bad, your father and your family are the controlling shareholders and you get the job. What are you going to say at your first press conference as CEO, knowing that there will be some tough questions from reporters?

TOPICS FOR EXPANDED PROJECTS

1. Starting from Berle and Means (see the Opening Case), some argue that the Anglo-American style separation of ownership and control is an inevitable outcome in corporate governance for large firms. Others contend that this is one variant (among several) on how large firms can be effectively governed and that it is not necessarily the most efficient form. What do you think?
2. How do you participate in the debate on state ownership versus private ownership?
3. ***ON ETHICS:*** As a chairman/CEO, you are choosing between two candidates for one outside director position on your board. One is another CEO, a long-time friend on whose board you have served for many years. The other is a known shareholder activist whose tag line is "No need to make fat cats fatter." Placing him on the board will earn you kudos among analysts and journalists for inviting a leading critic to scrutinize your work. However, he may try to prove his theory that CEOs are overpaid. Who would you choose?

CLOSING CASE 11.1

Emerging Markets: The Private Equity Challenge

Private equity is one of the hottest and most controversial buzzwords in corporate governance. Private equity firms often take an underperforming publicly listed company off the stock exchange, add some heavy dose of debt, throw in sweet "carrots" to incumbent managers, and trim all the "fat" (typically through layoffs). Private equity firms get paid by (1) the fees and (2) the profits reaped when they take the private firms public again through a new IPO.

Private equity first emerged in the 1980s, with a stream of deals peaked by Kohlberg Kravis Robert's (KKR) $25 billion takeover of RJR Nabisco in 1988—then the highest price paid for a public firm. While KKR disciplined deadwood managers who destroyed shareholder value, it received a ton of bad press, cemented in a best-selling book Barbarians at the Gate that portrayed KKR as a greedy and barbarous raider.

After the RJR Nabisco deal, the private equity industry stagnated during the 1990s. However, in the 2000s, private equity scaled new heights. In 1991, just 57 private equity firms existed. In 2007, close to 700 chased deals. Private equity deals now routinely represent 25% of all mergers and acquisitions (M&As) in the world (and 35% in the United States). Since 2005, Europe has had more actions (measured by deal values) than the United States. In 2007, Cerberus, a private equity firm, purchased Chrysler from Daimler-Chrysler (now Daimler) for $7.4 billion. APAX Partners spent $7.75 billion to buy Thomson Learning—the publisher of this book—from The Thomson Corporation now Thomson-Reuters) listed in New York and Toronto. However, private equity suffered a tremendous setback since 2008. Many deals struck in the easy credit environment of 2006–2007 collapsed, resulting in severe losses. In a record-breaking $43 billion deal in 2007, Texas Pacific Group (now known as TPG Capital) and KKR jointly took over Dallas-based utility TXU, which is now called Energy Future Holdings. However, by 2011, KKR valued its investment at only ten cents on the dollar.

Private equity has always been controversial. Proponents argue that private equity is a response to the corporate governance deficiency of the public firm. Private equity excels in four ways:

Private owners, unlike dispersed individual shareholders, care deeply about the return on investment. Private equity firms always send experts to sit on the board and are hands-on in managing.

A high level of debt imposes strong financial discipline to minimize waste.

Private equity turns managers from agents to principals with substantial equity (typically 5% equity for the CEO and 16% for the whole top management team). Private equity firms pay managers more generously, but also punish failure more heavily. Managers' compensation at firms under private ownership, according to leading expert Michael Jensen, is 20 times more sensitive to performance than at firms listed publicly. On average, private equity makes the same managers, managing the same assets, perform much more effectively. On average there is a 2% boost in productivity and efficiency.

Finally, privacy is fabulous. For managers, no more short-term burden to "meet the numbers" for Wall Street, no more burdensome paperwork from regulators (an especially crushing load thanks to SOX), and better yet, no more disclosure in excruciating detail of their pay (an inevitable invitation to be labelled "fat cats"). Top managers under private ownership are indeed fatter cats. It is not surprising that more managers prefer a quieter but far more lucrative life. In 1997, over 7,000 firms were listed on US stock exchanges. In 2012, thanks to private equity only over 4,000 bothered to be listed.

All of the above, according to critics, are exactly what is wrong with private equity. Other than "barbarians," private equity has also been labeled "asset strippers" and "locusts." As high executive compensation at public firms has already become a huge controversy, private equity has further increased the income inequality between the high financiers and top managers as one group and the rest of us as another group. Private equity has rapidly proliferated around the world. Some of the fuss reflects the shock in countries suddenly facing the full rigor of Anglo-American private equity. In Germany, some politicians labeled foreign private equity groups as "locusts who feast on German firms for profit before spitting them out." In South Korea, Lone Star Funds of Dallas was initially hailed in 2003 as a brave outsider willing to save troubled Korean firms. However, in 2006, when Lone Star tried to cash out by selling its 51% equity of Korea Exchange Bank, unions took to the street to protest and prosecutors issued a warrant to arrest its co-founder for alleged financial manipulation.

To be sure, private equity results in job cuts (about 1%–2% of the jobs at the firms that were taken over were lost). But the same would happen if targets were acquired by public firms. In other words, private equity buyers are no more barbaric than public firms. In terms of financial returns, private equity investors earn slightly more than the Standard and Poor's (S&P) 500 before the fees are charged. However, after the fees are charged, private equity performs slightly below S&P. In other words, outside investors would do as well or better with their money in an S&P index fund. In summary, while private equity is under attack for destroying jobs, its real problem is that returns to investors are low.

Private equity is inherently global. As the homeland of private equity is now engulfed in economic recession and widespread resentment (think of Occupy Wall Street), the outlook is grim. Is private equity "Monsters, Inc.?" asked an Economist editorial. Thus, private equity firms have increasingly targeted emerging economies, especially China, for future growth. The following quote is from a speech in 2010 given by David Rubenstein, co-founder and managing director of one of the largest private equity firms, Carlyle Group:

> *When I'm in Washington, DC, people are barraging me, saying that I'm not paying enough taxes, I'm not worried enough about labor concerns. I've got labor unions protesting me. I've got everybody telling me that I didn't do something right. In China, people want my autograph. In China, private equity professionals are like rock stars. Because China has taken the view that private equity is a value-adding technique and a value-added resource, they encourage it … Honestly, I tell people … the center of capitalism is Beijing, and the center of non-capitalism is Washington, DC. Now obviously, that's an exaggeration to make a point, but there's no doubt that in China, what private equity people do is very much welcomed and not criticized.*

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Questions

1. If you were a private equity specialist, what kind of target firms would you look for?
2. If you were CEO of a publicly traded firm and were approached by a private equity firm, how would you proceed?
3. If you were a Chinese regulator, how concerned should you be after you have learned about the criticisms against private equity in the United States, Germany, South Korea, and elsewhere?

CLOSING CASE 11.2

Emerging Markets: GE Innovates from the Base of the Pyramid

In global competition, large firms not only compete in product markets, but also in terms of how they are organized, financed, and governed. Definitions of what consists of a "large firm" vary around the world. A reasonable definition is that if a firm is large enough to be publicly listed, then it would be a "large firm" in that country. Almost all large firms started as small firms. Small firms typically feature concentration of ownership and control—the founders own, manage, and control them. There was a time that many small firms aspired to become large enough so that they could become publicly listed, which would be an awesome hallmark that these firms have "made it." As firms grow larger, the founding families may run out of money so that introducing outside shareholders would be necessary. The founding families may also run out of sons, daughters, in-laws, and relatives to staff key positions so that employing non-family, professional managers would be a must—so the theory goes. This theory was first published in a 1932 book The Modern Corporation and Private Property by law school professor Adolf Berle and economist Gardiner Means. Generalizing from several decades of transformation at leading American firms in which founding families such as the Carnegies and the Rockefellers gradually reduced their holdings and introduced outside shareholders and professional managers, Berle and Means argued that such transformation would be inevitable. In brief, their theory predicted separation of ownership and control as firms grow larger. What if the founding families refused to let go? In 1983, economists Eugene Fama (who won a Nobel prize in economics in 2013) and Michael Jensen asserted that failure to separate ownership and control "tends to penalize the corporation in the competition for survival."

The question is: Really? The other two major forms of corporate governance are family ownership and state ownership. While the Berle and Means theory does a good job characterizing the evolution of large firms in the United States (and, to a lesser extent, Britain), the theory ends up not explaining the ownership and control pattern in the rest of the world very well. Numerous publicly listed firms continue to feature concentration of ownership and control in the hands of families. At present, about 85% of $1 billion-plus firms in Southeast Asia are in family hands, 75% in Latin America, 67% in India, and 40% in China. In Europe, families control 40% of listed firms. In the United States, 15% of the largest firms—those in the Fortune Global 500—are family owned and controlled. While there is no shortage of family drama and intrigue—remember the TV show Dallas?—evidently family ownership and control have no problem surviving and prospering.

The Fama and Jensen prediction that large firms with concentration of ownership and control would suffer from terrible performance cannot really be supported. In South Korea, Samsung Group, led by the capable Lee Kun-hee family, has marched from victory to victory, contributing 20% of GDP. In India, Tata Group, in the hands of the House of Tata, contributes 5% of GDP. An extension of the Fama and Jensen prediction is that while some large family firms may do well domestically, once they go overseas they would surely fail to become world-class in global competition. Again, this conjecture can be refuted. For example, Tata Group has emerged as one of the leaders of Indian firms' globalization. In Britain, Tata Group is now the single largest private sector employer, proudly supporting 50,000 jobs—an accomplishment none of the UK-owned (and non-family-managed) firms can match. In the United States, some of the best-performing and largest firms, such as Wal-Mart, Ford, and McKesson, are family owned and controlled. Newly listed high-tech firms such as Google and Facebook have carried on this tradition.

In addition to family ownership, state ownership remains a rival form of corporate governance. Despite privatization around the world between the 1980s and the 2000s, during the Great Recession of 2008–2009, Western governments in an effort to rescue ailing firms nationalized numerous private firms and turned them into state-owned enterprises (SOEs). Today SOEs represent approximately 10% of global GDP. Even in developed economies, they command 5% of GDP. Anchored by SOEs, China over the past three decades has grown its GDP by 9.5% per year. SOEs represent 80% of China's stock market capitalization. But China is not alone. In Russia, the figure is 62%, in Brazil 38%, and in Norway 38%. SOEs include some of the largest oil and gas companies (such as Sinopec), the biggest telecom service provider (China Mobile), and the biggest ports operator (Dubai Ports). In 2014, they also represented six of the top ten most-profitable firms globally (measured by the amount of profits): Fannie Mae and Freddie Mac of the United States, ICBC of China, Gazprom of Russia, China Construction Bank, and Agricultural Bank of China (in descending order). In short, SOEs as an organizational form can be both large and successful.

Recently what seems to be under siege is the publicly listed corporation. In 1997, the number of US listed firms reached a high watermark: 7,888. Since 1997, their number has dropped dramatically—by 38% in the United States and by 48% in Britain. The hassles associated with public ownership have facilitated the rise of private equity. Michael Dell, for example, has taken Dell (the corporation) private, because private ownership would give the firm "more time, investment, and patience." Private equity deals now routinely represent 25% of all mergers and acquisitions (M&As) in the world (and 35% in the United States). While existing firms can go private, many aspiring new firms do not bother to list at all. As a result, there is now a severe initial public offering (IPO) famine: between 1980 and 2000, on average there were 311 IPOs a year in the United States. The average went down to a mere 99 a year between 2001 and 2011. In short, going public is no longer as sexy as it was before. Commenting on the global competition in terms of how to best organize, finance, and govern large firms, the Economist suggests that "there is every reason to celebrate the fact that businesses have more corporate forms to choose from."

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Questions

1. What are the advantages and disadvantages of the public listed corporation?
2. Why is there an IPO famine lately?
3. What are the advantages and disadvantages of family ownership?
4. What about state ownership and private equity?