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The Mechanisms of Governance: An Introduction

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3.1 Introduction

Given agency problems, the central governance problem is how they are solved. How do the shareholders ensure that managers or large blockholders act in their best interests? There are several mechanisms of governance, all of which serve to mitigate agency problems. We list some of them in Table 3.1.

As you can see, there are many corporate governance mechanisms. Some are clearly more important than others, and some are logically prior to others. For example, you can argue that the owners elect the board and that the board hires/fires the CEO and sets his pay, so ownership is logically prior to board structure and board structure is logically prior to incentives. All this take place within a regulatory framework which the market participants have to take for granted, at least in the short run. So regulation is logically prior to ownership. And law is shaped by social forces such as culture, although in this case it is less clear what comes first.

In Table 3.1 we have grouped the mechanisms in categories, which we use to structure this chapter. We begin with the soft factors under the heading of 'culture', e.g. social norms, reputation and the like (media pressure). Next we have law and regulation, including company law and best practice codes (soft law), which border on culture. Then we have ownership: the role of large owners, takeovers and shareholder activism. We go on to the board, a huge topic in corporate governance, of course, and to the role of incentives (executive pay). Finally, a large group of mechanisms have to do with pressure exerted on managers by external stakeholders like banks, auditors, analysts and competition.

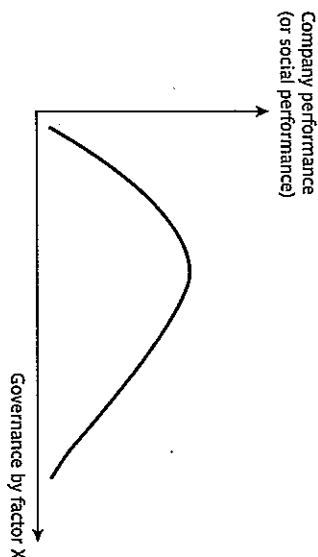
In this chapter we argue that each of these mechanisms has its costs and benefits. Therefore, good corporate governance essentially consists of tailoring these mechanisms to the individual firm. The general logic is that of the Aristotelian golden mean (Figure 3.1) or, in the wording of neoclassical economics, declining marginal productivity.

Up to a point, most corporate governance mechanisms will improve company economic performance, for example because the mechanisms press managers to work harder or enable the

Table 3.1 Mechanisms

Informal governance
Social norms
Reputation and trust
Codes
Regulation
Company law
Ownership
Large owners
Shareholder activism
Takeovers
Boards
Incentive systems (pay)
Stakeholder pressure
Creditor monitoring
Auditors
Analysts
Competition

Figure 3.1 Declining marginal productivity



shareholders to make better choices. Beyond this point, which is difficult to define and varies from mechanism to mechanism and from firm to firm, the costs start to kick in. From that point increasing use of this governance mechanism will destroy the value.

In other words, corporate governance is about finding the golden mean, that is, how a particular set of mechanisms create most value in a particular situation. Note that this could be a corner solution: it may be that some companies are better off without large owners or even without a board. We will go through the different mechanisms of corporate governance and will point to some of their costs and their benefits.

3.2 Social norms

At the most basic level corporate governance depends on social norms or what we call morality. Suppose a manager gets an opportunity to steal shareholder funds and knows it will never be detected. Will he do it? Economic man would. Would you? Suppose that it was a lot of money, so much that you could live on it comfortably for the rest of your life. Maybe the temptation is stronger in that case. There is a good chance that many people would, so morality is an imperfect solution to governance problems. On the other hand, there are many examples of people who would not steal and many cases in which most people would not steal. It would be difficult to run a modern society if people were completely amoral; the same applies to corporate governance. Corporate governance scandals from Maxwell to Enron, Parmalat and Lehman are often regarded as expressions of immorality.

To see that morality plays a role in governance, think of the market for blood. Some people voluntarily give blood, but you can also buy it on the professional market or order others to give blood, as in the military. When people voluntarily give blood, there is less need for a market or for authority. This substitution between markets and other institutions led Nobel prize laureate Kenneth Arrow to propose that social norms may arise to compensate for market failure: '... when the market fails to achieve an optimal state, society will, to some extent at least, recognize the gap and nonmarket institutions will arise attempting to bridge it' (Arrow, 1962, p. 21). As an illustration of this principle Arrow (1963) argued that a medical ethic among doctors is a way to overcome failures in the market for medical services due to information asymmetries between doctors and patients. Because patients generally lack information about the nature of their illness and the effectiveness of

alternative treatments, doctors could manipulate them in their own interest. A medical ethic among doctors, enforced by powerful collective sanctions, helps to overcome this problem (Arrow, 1973, p. 139). The Hippocratic oath which doctors still take is a prime expression of the ethics. Indirectly, the medical ethic also serves the interests of the doctors because more patients will use doctors if they do not suspect them of being quacks. Other professions have their own ethical codes and Harvard Business School students recently proposed a code and an oath for managers.

Morality is related to what management researchers call 'stewardship', 'citizenship' or corporate social responsibility (CSR), which we will talk more about in this book. To the extent that managers act morally, as good stewards, there is a tendency for agency problems to disappear. However, they do not disappear entirely. As a manager, you may feel a moral duty to be an equal opportunity employer or help people in need, but your shareholders may not agree. Moreover, while some managers have high moral standards, others do not, and there are many who would be willing to compromise on their standards if the incentives were right. This can happen if the rewards are very high, but it may also happen if they are very low. For example, few managers hesitate to 'borrow' a pen at the office. Consider the classic story about Bernard Shaw:

¶ George Bernard Shaw once found himself at a dinner party, seated beside an attractive woman. 'Madam,' he asked, 'would you go to bed with me for a thousand pounds?' The woman blushed and rather indignantly shook her head. 'For ten thousand pounds?' he asked. 'No, I would not.' 'Then how about fifty thousand pounds?' he continued. The colossal sum gave the woman pause, and after further reflection, she coyly replied: 'Perhaps.' 'And if I were to offer you five pounds?' Shaw asked. 'Mr. Shaw!' the woman exclaimed. 'What do you take me for? We have already established what you are,' Shaw calmly replied. 'Now we are merely haggling over the price.' ¶

Although shareholders cannot usually raise the moral standards of their employees, morality matters in corporate governance because moral standards differ between nations and may change over time. Some observers claim that corporate governance in the USA has become more of an issue because moral standards have fallen. Moreover, there may have to be more monitoring in countries where moral standards are low (or different). For example, corruption is more of a problem in some countries than it is in others. Finally, it is possible to influence morality among managers by carefully selecting who is hired (and fired) and by crafting corporate policies for what is and what is not acceptable behaviour.

It is clear, therefore, that good morals can increase company and social performance. Is it conversely true that moral standards can be too high? It is easy to think of examples of people who become so dogmatic that they are unable to act. From a strictly moral viewpoint we should perhaps give all our money to the poor, should only do business with the poorest countries, or should only employ people who have difficulties in finding a job. Perhaps there is a limit to morality; after all, many academics would then argue that true morals would take all the constraints into account, but this is no different from saying that there is a limit even to morality.

3.3 Trust and reputation

Informal governance mechanisms like trust and reputation are also important. Managers who cheat investors will not find it easy to obtain more money or to get a new job. This means they have an incentive to protect their reputations. Thus, reputation may be a powerful deterrent to both adverse selection and moral hazard problems. In past centuries huge investment projects like the railroads were financed without much corporate governance or company law. Apparently, entrepreneurs and financiers asked the general public for money in good faith based on their reputation. However, a history of financial scandals testifies that the system was far from perfect.

¹ Jensen (1998).

Following Kreps (1990) and the ensuing literature, it can be shown formally that reputation can under certain circumstances help companies overcome opportunism in dealing with other market participants (buyers, sellers, employees and investors). The standard argument uses the prisoners' dilemma from game theory in which two players must both decide whether to cooperate or be opportunistic. If one prisoner decides to tell on the other he may get a lower penalty at the other's expense. But if both prisoners tell on the other, they will both get high penalties. Depending on how the players view their gains or losses in the different outcome each player may seem to be better off by acting opportunistically: she may get a slightly better deal if the other chooses to cooperate and avoids losses of trying to cooperate and being let down by the other. As a result opportunism prevails and both parties end up in the worst case equilibrium. The same logic can apply to a company manager dealing with a stakeholder (e.g. an outside investor). In so-called extended form the game is depicted in Table 3.2.

For example, the investor may choose to invest in the company, and the manager may take the money and run (opportunism) instead of putting it to good use in the company (cooperation). Expecting this, the investor may choose not to invest, so the company goes bankrupt. There are many other situations like it. Managers may decide to sell a bad product at a high price, breaching consumer trust. Employees who have committed their lives to a company in the assurance of life-time employment may suddenly be fired. And so on. Even the manager himself may suffer: shareholders may fire a manager who has done a good job before she is properly rewarded. The worst case opportunistic equilibrium appears inevitable.

However, the bad spell may be broken in repeated games. If one player decides to play opportunistic, the other player will not play cooperation in the next round and she will be punished. In contrast if she consistently cooperates, she will get a reputation for cooperation, and other players will be far more likely to cooperate with her. In the same way a company with a reputation for being ethical will find it much easier to attract finance and do business. In the long term the ethical company will therefore outcompete its less ethical rival. A good reputation becomes a valuable asset which the company manager and owners have a self-interest in protecting and investing in. Social norms, corporate culture and business ethics may arise and be sustainable for the same reasons.

Kreps argues that a company needs to be consistent to maintain its reputation. For example, opportunism in one market may damage its reputation in other markets. It also needs to be consistent over time. This may translate into a corporate culture which reinforces patterns of behaviour (values, principles, ethics, ...) that may not be profitable in the short run but may sustain the company in the long term.

As Dyck and Zingales (2002) emphasize, the media can influence corporate governance through the reputation mechanism. Bad corporate governance and bad company performance can lead to media exposure, which is unpleasant for the managers and which may induce them to change their ways. Media exposure seems to work for both listed and unlisted companies regardless of ownership structure. Media exposure may have a more pervasive effect than the other mechanisms mentioned. However, there is little doubt that media exposure is a very blunt instrument which often targets the wrong cases and which overlooks other cases which should have been addressed.

Table 3.2 Extended form of the prisoners' dilemma

	PLAYER 2: The stakeholder	
	Cooperation	Opportunism
PLAYER 1: The manager	Cooperation	Joint optimum Both players win
	Opportunism	Player 1 wins at player 2's expense Worst case Both players lose

Personal reputations also matter. Managers have an interest in maintaining a good track record if they want to advance in their careers (Pana, 1980). Even if the top managers do not care, perhaps because they plan to retire after their present job, their mid-level managers may be concerned. Moreover, a good track record will be helpful to managers who would like to have post-executive careers as board members after they retire. Therefore, the managerial labour market can also be regarded as a corporate governance mechanism. One of the correction mechanisms available to mid-level managers is 'whistle blowing'. They can leak information to the press so that shareholders or government organizations can take action before a scandal takes the whole company down (and the employee loses his job). Sarbanes-Oxley, an American corporate governance law enacted in 2002, specifically recognizes the social value of whistleblowers and tries to protect them against reprisals.

It would no doubt be impossible to sustain effective corporate governance without trust, but reputation is no panacea. It does not work in end-game situation where the game is not continued after a certain point in time. If a mature company does not need more external finance, it has less of an incentive to please investors.

Moreover, trust and reputation are difficult to sustain in large societies with impersonal exchange. Tadelis (1999) shows that a market for reputation, for example, when new owners unknown to the business partners acquire the reputations of other firms by acquisitions, gives rise to adverse selection problems and market failure. The reputation mechanism works better in small societies where everybody knows everybody else and information flows easily. It cannot work if market participants are anonymous, as they may be in large markets or large countries. Globalization will, therefore, tend to attenuate reputation mechanisms. Franks, Mayer and Rossi (2004) document that the industrial revolution in the UK was financed to a large extent by informal governance, e.g. gentlemen's agreements within the 'old boys' networks. Specialized stock exchanges, like the textile exchange in Manchester, were places where everybody knew everybody else and it was more difficult to get away with bad behaviour.

Finally, reputation is not a fine-tuned instrument. Suppose that a Russian manager forgets to pay dividends to some Italian investors. He may not care very much about his reputation in Italy. And if there is disagreement among the parties, it may be unclear to what side public opinion will lean. One of the advantages of the law is that the courts are able to take large amounts of information into consideration which could not realistically and accurately be handled by reputation.

3.4 Company law

Legal protection of shareholder rights is clearly very important. For example, managers can be sent to jail if they steal from stockholders. Moreover, the law obligates companies to many practices which protect the interests of investors. For example, there must be a shareholder meeting at least once a year. All shareholders must be duly informed about the meeting. Boards are elected by shareholders. The decisions made at the shareholder meetings are binding for the company. In between meetings all major decisions, including the choice of manager, must be ratified by the board. Managers must respect whatever shareholders decide to write into the bylaws and so on.

The law stipulates duties for officers and directors in the corporation. Directors have a duty of loyalty (to shareholders) and a duty of care (to actively live up to their responsibility).

Shareholders may use the court system and sue the company if they feel that the company is being mismanaged. Knowing this helps to keep managers on their toes.

The law also protects the interests of other stakeholders, for example creditors and employees. Banks can demand compensation from board members and managers who have acted recklessly with their money. In some countries, employees have the right to elect members of the company's board.

Corporate governance would not be possible without some enforcement of property rights, and it certainly helps shareholders control managers. But it is not a perfect mechanism. Sometimes managers break the law. And shareholders may not be satisfied with a manager just because he abides

by the law. Too many rules and too large penalties would lead to a loss of flexibility and risk aversion, which would make it difficult to do business.

Consider stock market regulation as a case.² Theoretically, a stock exchange is a firm that creates a market in shares (Mulheirn et al., 1991). The market is attractive to buyers and sellers of shares because it economizes on their transaction costs, that is their search, information, bargaining, decision, policing and enforcement costs (Coase, 1992; Mulheirn et al., 1991; Dahlman, 1979). An important instrument in this is a certain standardization of the shares traded (Taisei, 1981) which reduces the need for a continuous detailed assessment of individual firms and transforms their stock into 'homogenous, fungible securities' (Pirrong, 1995). Standardization and other rules are provided by the law, by the exchanges themselves (Coase, 1992) through listing requirements and corporate governance codes (Cadbury Commission, 1992). This regulation applies to ownership and board structure, corporate governance practice, financial reporting, disclosure, capital structure, and firm size.

Governance rules and standards are valuable to investors and therefore also to issuers, because they reduce their cost of capital, but they come at a cost. There are direct costs, which include listing fees, fees for auditors and lawyers, liability and insurance costs, larger fees for non-executive and executive directors etc. In the USA the costs of compliance with the Sarbanes-Oxley act would fit into this category. Indirect costs would include costs of disclosure to competitors, loss of flexibility with regard to board structure, opportunity costs of top management time, box-checking and bureaucratic procedures. Most of these costs will be fixed, while the variable cost of trading shares will be negligible (Foucault and Parlour, 2004).

It is difficult to determine the optimal level of regulation with any degree of precision because regulation is so multifaceted. It is not a given, that optimal regulation will maximize the number of listed companies or that it will minimize the number of delistings. However, it seems important to consider both costs and benefits. The widely used investor protection index originally proposed by La Porta et al. (1998) was justified to a large extent by a positive effect on the size of the stock market. This so-called 'anti-director rights' index summarized measures which were believed to strengthen the rights of minority investors vis-à-vis company boards.

The investor protection index constructed by La Porta et al. (1998) and updated by Pagano and Volpin (2005) is a sum of six dummy variables:

- 1 whether proxy by mail is allowed,
- 2 whether shares are/are not blocked before a shareholder meeting,
- 3 whether cumulative voting for directors is allowed,
- 4 whether oppressed minorities are protected,
- 5 whether the percentage of share capital required to call an extraordinary shareholder meeting is less than 10%, and
- 6 whether existing shareholders have pre-emptive rights at new equity offerings.

There are clearly both costs and benefits associated with these provisions. For example, the right to file lawsuits against boards involves cost, as does the right to call an annual meeting or a prohibition against dual class shares.

Theoretically, it can be argued that the optimal level of investor protection for listed companies is greater than zero since stock exchanges use regulation to lower the costs of exchange. It is equally plausible that there are limits to the optimal complexity of regulation (Kaplow, 1995; Ehrlich and Posner, 1974) and that more regulation will at some point have a negative effect.

As an example, La Porta et al. assert that investors are better protected when an investor can call an extraordinary general meeting if she has more than 10% of the stock. It is clear that an extraordinary meeting involves costs not just for the managers who have to defend their decisions, but also for the other shareholders who have to attend the meeting or live with the outcome if they stay away. But what would happen if this threshold was lowered to 5%, would investor protection

² This section builds on Thomsen and Vinten (2008).

be higher? If so, what about 1%? Or should any shareholder be able to call a shareholder meeting at any time? In most situations, the transaction costs for both the shareholder and for the company would probably become too high at some point; the other shareholders would consider delisting, or, at least, the company's market value would drop. In contrast, few would argue with the proposition that a qualified majority of the shareholders should be able to call an extraordinary meeting.

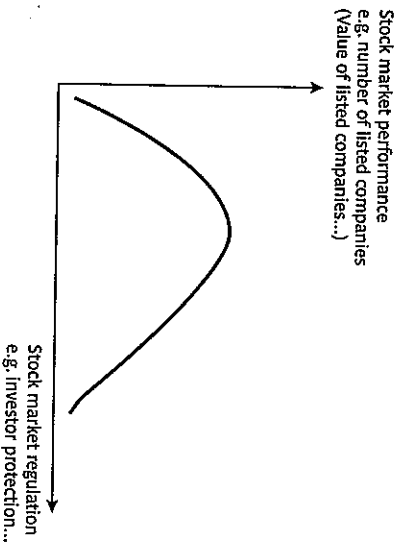
We therefore conjecture that there is a cost to stock market regulation, that more regulation is not necessarily better, and that regulation beyond a certain point will lead to fewer listed firms and lower firm value. We summarize these propositions in Figure 3.2.

3.5 Large owners

The vast majority (most likely 99%) of all companies are owned by one or two shareholders who also manage the company. It is not difficult to understand why. Owner-management aligns the interests of owners and managers. It is their own money so they have every incentive to manage it well. In other words, it is a solution to the moral hazard problem. Owner-management also addresses the adverse selection problem. Suppose that you inherit a firm, but you know that you are not a good manager. In this case you have an incentive to have someone else manage it; you might even see an incentive to sell it to somebody who can create more value than you can. It is your money and you have the incentives to manage it as well as you can. Both in theory and in practice it makes more sense to have a manager own the firm than somebody from the outside, because the manager has more information and is therefore in a better position to make decisions (Hart, 1995).

The vast majority of all firms are small, with no or only a few employees. Most of their owners are single individuals or family members so their corporate governance challenges are related to family business. There are also instances, however, when partners working together (for example lawyers, engineers, consultants) establish partnerships or joint stock corporations. Ownership in these companies is often intentionally equally distributed (e.g. 50:50), which creates special challenges related to deadlock and abuse of minority investors. Two partners, each with a 50% share, may disagree and their company may go completely limp as a result. In other cases, a minority investor

Figure 3.2 Stock market regulation v. performance



with $\frac{1}{3}$ of the shares may find that her shares have no value because the majority decide to pay no dividends and instead take out salaries to themselves. Since the shares are not listed she will typically be unable to sell her shares to others. In both cases the most effective solution is a shareholder agreement, which regulates governance and exit, and is signed when the company is founded, before the trouble starts. For an overview of shareholder agreements see Madejon and Thomsen (2009) and references therein. But it is well known that most partnerships do not have such clauses, because they are considered to be irrelevant at the beginning of the partnership which has to be founded on trust in any case (just like many people don't think about divorce the first time they marry). As a result, a lot of value is being destroyed across the world when unlisted companies break up. An effective solution would be to build in a generic shareholder agreement as default clauses in the standard corporate form which shareholders could then deviate from if they wanted (in the same way that newly weds do not normally have to think about divorce which is already built into law).³ But this is still just an idea.

Even for listed companies, a blockholder can be a solution to a corporate governance problem because she has both the incentives and the power to influence what happens in the company. Large owners may therefore act as watchdogs on behalf of minority investors who can free ride on their efforts. Many blockholders even in large firms are individuals or families, but there is more variance here: governments, financial investors, other corporations and other entities may all be large owners.

Large owners are not a perfect solution. First, as a rule they will be more risk averse than other investors because they have invested so much in this particular company (i.e. they have placed all their eggs in one basket), and this will influence corporate strategy. Secondly, there is a risk that they may exploit the minority investors, particularly in countries with low investor protection. Tunneling occurs when controlling owners take money out of the company, for example by organizing transactions on unfavourable terms with companies which they themselves own (this seems to have happened in the Italian Parmalat case). Large owners may also have idiosyncratic preferences which do not maximize shareholder value. For example, they may prefer that the company is managed by a family member or they may want to retain ownership in the family despite an attractive offer from the outside which the minority shareholders would prefer. Failed succession, e.g. from a clever father to a stupid son, is the Achilles heel of family-owned companies. Our discussion of family-owned companies will continue in Chapter 17.

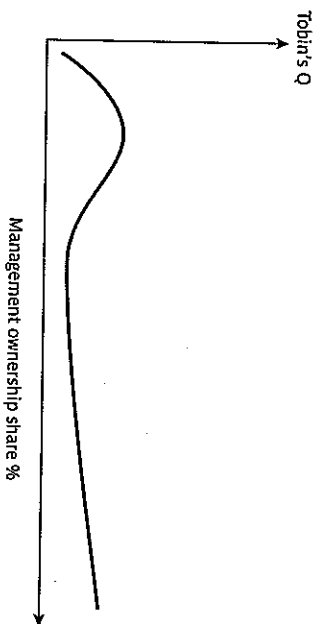
The effects of large owners on corporate governance and performance depends critically on owner identity. A financial investor with a clear preference for shareholder value might be expected to exercise ownership in a way that is aligned with the interests of minority investors. In contrast, a government owner will usually have objectives which differ very much from shareholder value maximization. Families are probably somewhere in between. More on ownership structure will follow in Chapter 12.

So what is the relation between company performance and ownership concentration? Morck, Shleifer and Vishny (1988) were the first to examine the relationship between management ownership and market valuation of the firm, as measured by Tobin's Q . In a 1980 cross-section of 371 Fortune 500 firms, they found evidence of a significant non-monotonic relationship. They found that Tobin's Q first increases, then declines, and finally rises slightly as ownership by the board of directors rises. Their results suggested a positive relation between ownership and Q in the 0–5% board ownership range, a weak negative relation in the 5–25% range, and then perhaps a further positive relation beyond 25%. Their proposed interpretation was that the positive incentive effects dominate management ownership shares up to 5%, but that further ownership has negative effects because of entrenchment effects, which make it difficult for the other investors to replace the board. Beyond 25% the company is anyhow effectively dominated by the dominant owner who internalizes more and more of the costs of deviation from shareholder value as her ownership share increases and is therefore more aligned with shareholder value (Figure 3.3).

Others (e.g. McConnell and Servaes, 1990) have found bell-shaped curves which peak at much higher levels, and a bell-shaped curve has also been estimated for the share of the largest owner (see the ownership chapter for a survey).

³ We are grateful to Professor Neville, University of Aarhus, for suggesting this idea.

Figure 3.3 Relationship between management ownership and market valuation of the firm



3.6 Shareholder activism⁴

In the absence of a large owner, shareholders are much weaker, but it is not true that they have no power at all. They can turn up at annual meetings, they can criticize the management, and they can vote against it. Even if they lose a vote, the pressure can be unpleasant for the managers and it may damage their reputation. So managers have incentives to keep them happy.

Moreover, small shareholders may sell their shares: 'do the Wall Street walk'. This will tend to lower share prices and increase the costs of capital for the corporation. Corporate bondholders may sell out, too. This could make it more difficult for managers to compete, e.g. to grow the company, which provides an additional incentive to try to please shareholders. Shareholder pressure is obviously no less imperfect than all the other mechanisms. Small shareholders cannot be expected to be well informed, and there are 'free rider' problems between them: if one shareholder makes an effort he bears all the costs while all the other shareholders benefit as well.

The research on shareholder activism has studied the effects on firm value or shareholder returns, and has primarily studied pension funds and hedge funds rather than private individuals. Attempts by pension funds to reform corporate governance by making proposals at shareholder meetings are regarded by many researchers as unsuccessful in influencing firms and increasing their value (Gillan and Starks, 2000), although there is some evidence that voting against proposals by the board in targeted firms may have positive value effects (Del Guercio, Seery and Woidtke, 2008).

In contrast, so-called entrepreneurial shareholder activists like hedge funds and private equity investment funds (Becht, Franks, Mayer and Rossi, 2009), hedge funds (Bray, Jiang, Partnoy and Thomas, 2008; Klein and Zur, 2009), corporate raiders (Holderness and Sheehan, 1985) and large blockholders (Barclay and Holderness, 1989, 1991) have all been found to have a positive effect on firm value. Becht et al. (2009) and Klein and Zur (2009) found that such entrepreneurial investors are very successful in accomplishing their objectives, for example in replacing board members, changing corporate strategy or opposing a merger.

Formally, shareholders' annual general meetings serve as an arena for face-to-face interaction between shareholders and management, where shareholders can hold management to account (Lawton and Rigby, 1992; Strating, 2003). However, large shareholders including major institutional investors are known to favour private negotiations with management over public appearances

⁴ This section draws on Poulsen, Strand and Thomsen (2010).

(Keasey and Short, 1999a). This tendency is reinforced by proxy voting in favour of the board (Strating, 2003), and sidestepping the general meetings has undoubtedly contributed to a drop in meeting attendance (Nilsson and Hassel, 2003; Strating, 2003). Annual general meetings are often seen only as rituals (Aggarwal, 2001; Hodges, Macniven, and Mellett, 2004; Schilling and Steensma, 2001) or 'annual headaches' at which management is questioned by social activists (Apostolides, 2007; Saxon, 1966). Nonetheless, even when ownership concentration is high, meetings may still contribute to accountability, since minority shareholders can criticize managers at the meetings with an element of surprise, which forces managers to be on their toes (Catastis and Johed, 2007; Gray, Owen and Maumers, 1988).

Following Pozen (1994), activism can be regarded as rational (in a financial sense) when shareholders balance the expected costs and benefits and take action only when the benefits exceed the costs. The costs of activism are determined by factors such as the opportunity cost of share ownership, analysis costs, management time, possible reprisals by the incumbent management, legal uncertainty (possible liability for insider trading, cornering the market, etc.), number of shareholders to be contacted, their identity and association with the firm and the level of engagement intended. The benefits of activism are determined by factors such as the probability of successful intervention, the shareholder's investment and expected holding period, the volatility of the stock and general economic uncertainty.

The expected rationality of activism goes beyond these apparent costs and benefits. First, it may be possible to exercise influence on management or the ruling coalition of shareholders through social pressure. Second, for professional investors, activism at an annual general meeting may serve a broader purpose, i.e. it may be part of a general campaign for or against certain management practices or a deterrent against unwanted behaviour in other companies which learn about events through the media (Norden and Strand, 2009). While activity in one context may appear symbolic, it may be fully rational if understood in a broader setting. This also applies if a fund manager uses the public limelight to draw attention to a fund as an opportunity for investment. Finally, some activism may be privately optimal for a particular fund manager. Some may enjoy public visibility per se, while others may use it to prepare future careers in politics or public administration (Woidtke, 2002).

3.7 Takeovers

Hostile takeovers are a famous and dramatic governance mechanism. If company performance is bad, the stock price drops, and a raider can make a tender offer for its shares, acquire control, fire the management, restructure and sell his shares again at a significant gain.

However, empirically we observe few hostile takeovers. Thus, while they can make a contribution in some cases, they only rarely work in practice. One simple reason is that most companies around the world (including the USA) employ takeover defences specifically geared to prevent hostile takeovers. Another reason is that hostile takeovers may not create value for the acquirer, since significant costs are involved, whereas the gains to a very large extent go to the incumbent shareholders who almost always get a value premium.

To see why (following Grossmann and Hart, 1980; Becht et al., 2003), imagine a raider contemplating a bid for a firm, which he can restructure and thereby increase the value of the shares by $V = 1$ if he succeeds in getting more than 50% of the shares (votes). In contrast under the current management there will be no value increase, $V = 0$. He makes a conditional offer to the incumbent shareholders of a price premium of p per share. If there is competition among raiders, other raiders will have an incentive to overbid (raise p), until $p = 1$, in which case there is no incentive to raid. In jargon, the incumbent shareholders appropriate all the rents. This may happen even if there is no rent. The incumbent shareholders get p per share, if they sell. But if they hold and wait for the raider to restructure the firm, they get 1. So, they will only sell if $p \geq 1$. Hence, since the raider will have to pay a premium of $p = 1$ $\Rightarrow$ he will have no incentive to raid, and there will be no takeover (and there will be no value increase, i.e. $V = 0$). Solutions to this problem could be reduced disclosure (so that a raider could secretly acquire control without paying a premium), 'squeeze out' rules (which force minority shareholders to sell to

a seller which controls more than e.g. 90% of the votes) or doing away with the mandatory bid rule which requires raiders to make a bid for all shares and pay the same price to all shareholders. However, these suggestions limit minority investor rights and may therefore be impossible to get passed.

There is empirical evidence that takeovers improve company performance and that barriers to hostile takeovers reduce it (Masulis et al., 2007). Gompers et al. (2003) and Bebchuk et al. (2009) find that takeover defences are negatively related to company performance. But as mentioned they are clearly no panacea. Empirically, far from all hostile takeovers are directed at companies with bad corporate governance and bad performance. M&A may even be a symptom of bad governance as when a company with plenty of free cash flow uses it to build empires by buying other companies.

3.8 Boards

Boards are a generic corporate governance mechanism. They are elected by shareholders with the explicit aim to address corporate governance issues. Since it would be costly for shareholders to meet and to monitor the company, they hire a group of professionals to do it for them. Boards meet regularly to examine company performance, to ratify major investment decisions, and if necessary, to replace management.

The basic theory of boards is agency theory. Boards deal with moral hazard by monitoring managers and motivating them through incentives (like stock options) and sanctions (like dismissal). They may also play a role in type 2 agency problems by safeguarding the interests of minority shareholders against dominant blockholders.

Fama and Jensen (1983) argue that boards will arise whenever there is separation of ownership and control. It is then necessary for shareholders to delegate monitoring. The solution is to elect a board consisting of a number of board members who can monitor each other as well as the managers. In contrast, Fama and Jensen argue that there is less of a role for boards when ownership is concentrated and owners can do their own monitoring. However, boards are known also to have functions other than the agency theoretic control role, for example they provide advice to managers and they help create networks to important stakeholders. These latter roles, advice and networking, may still be valuable even though ownership is concentrated. In addition, the boards of companies with multiple owners may function as a platform for resolving conflicts among the owners, particularly in small firms with a few large shareholders.

While there are no doubt many vigilant boards, and while corporate governance would no doubt be worse without them, boards are only a partial solution to the governance problem. For one thing, boards can be no better than the shareholders who elect them. If the shareholders are badly informed, or foolish, it is unlikely that they will elect the best board members, that they will monitor them well, and that they will replace bad board members. Secondly, board members have little knowledge about what goes on in the company compared with the CEO. Board members should not know too much, since they should not interfere with the day-to-day management of the company. Moreover, board culture appears to make it psychologically difficult for an outside board member to voice a critical opinion; see the following quote by the second richest man in the world, who has extensive board experience.

*It's almost impossible, for example, in a boardroom populated by well-mannered people, to raise the question of whether the CEO should be replaced. It's equally awkward to question a proposed acquisition that has been endorsed by the CEO, particularly when his inside staff and outside advisors are present and unanimously support his decision. (They wouldn't be in the room if they didn't.) Finally, when the compensation committee – armed, as always, with support from a high-paid consultant – reports on a mega grant of options to the CEO, it would be like belching at the dinner table for a director to suggest that the committee reconsider ...*⁵

There is much more about boards in Chapters 8 and 9.

⁵ Buffet (2003).

3.9 Incentive systems

By incentive systems we mean the incentives given to managers. Managerial pay (compensation) consists of fixed salary, bonuses, stock options, stock grants, and other benefits (i.e. health insurance, fringe benefits or pension scheme). Changes over the past decades imply that US managers in large listed companies are currently paid mostly according to performance (i.e. bonus or stock options schemes) while the greater part of management compensation in continental Europe is still fixed (i.e. a fixed amount per month).

Incentive systems can clearly give managers incentives to work in the interest of the shareholders: they can help address governance problems both of the moral hazard and the adverse selection variety. But incentive systems are not perfect solutions. Badly designed incentives are more part of the disease than the cure since they involve large transfers of money from the shareholders to the managers, which is exactly what many shareholders want to avoid in corporate governance. Moreover, programmes may lead to perverse incentives, for example earnings management, accounting fraud or excessive risk taking. Finally, because of risk aversion, performance-based pay should theoretically be higher than fixed pay, which is consistent with what we observe in practice.

There is more on executive pay in Chapter 10.

3.10 Creditors and capital structure

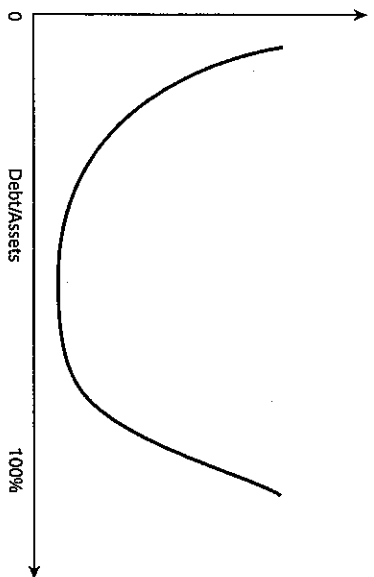
If companies need to borrow, creditors exercise tremendous influence on what they do. Banks may make demands on board composition, management and capital structure as a condition for lending. They may also insist on covenants which limit the strategic flexibility of companies (for example, new investments may need to be approved by creditors). In some cases a meeting with a major creditor may be more important than a board meeting for deciding the future of the company. Banks often influence who sits on boards of distressed firms, and in some countries like Germany the bankers themselves often sit on company boards even in well-performing firms. As an alternative to both equity and bank loans, companies may also issue corporate bonds to the market. Since bondholders have no voting rights, they have less influence on corporate governance, although bond prices may influence the company's cost of capital.

Empirically, credit (bank finance) is much more important than outside equity as a source of finance. Banks finance small corporations which cannot access the stock market and lend even in countries with underdeveloped equity markets. One reason may be that loan contracts are relatively simple (pay back or go bankrupt!) compared with equity which requires an elaborate system of governance (shareholder meetings, boards, annual reports and so on). However, there are also important agency costs of debt which banks incur and charge on to firms in the form of interest premiums. For example, managers may take excessive risks which will benefit the shareholders if they go well, while creditors lose if they don't. Many corporate finance textbooks therefore propose a graph as shown in Figure 3.4.

Here very high and very low levels of debt are believed to be associated with high average cost of capital as the threat of bankruptcy, financial distress and creditor-shareholder conflicts is weighted against agency problems of overcapitalization (e.g. excessive spending). In between the two there is a relatively long flat bottom where capital structure is less critical.

The classic paper on agency theory by Jensen and Meckling (1976) was an integrated theory of ownership and capital structure based on similar arguments. Subsequently Jensen (1986, 1989) championed the idea that debt finance could be an effective way to restrain managers from using up free cash flow. Hoshi et al. (1991) and many other studies (reviewed in Degryse, Ongena and Timmer-Alkan, 2008) find empirical support for this idea by observing that investment is less correlated with

Figure 3.4 Cost of capital



cash flow in companies with strong bank relationships. Jensen argued that many large companies could benefit from higher leverage and that the demise of the public corporation was at hand. A wave of private equity investment during the next two decades did exactly that. Companies sought what they believed to be appropriate (typically higher) leverage. However, with the advent of the financial crisis of 2008, many companies again found themselves lacking equity finance when faced with a credit crunch.

Intermediaries such as banks play a key role in debt markets (Degryse, Ongena and Tümer-Alkan, 2008). Instead of financing companies directly, savers put their money in the bank or another intermediary. Diamond (1984) provides a rationale by observing that the firms in pure credit markets may be capital-rationed and unable to finance all positive NPV projects. Banks take deposits (typically short term) and give short- or long-term loans to customers to suit their needs. In dealing with large company clients banks therefore come to play a role in corporate governance as the borderline between equity and debt becomes blurred. The saying goes that if you owe the bank a million you have a problem, but if you owe it a billion, the bank has a problem. Banks will hesitate to declare a big client bankrupt and will often interfere with the company in what is called relationship banking. They monitor company behaviour and regulate it by loan conditions (covenants), demanding to have certain people on the board etc. Debt can be regarded as conditional equity so in times of crises banks often effectively come to own companies. The influential role of banks in Germany and many other economies has led observers to talk of bank governance as distinct from market governance. There is more on banking in Chapter 13.

Altogether, the evidence indicates that banks play a valuable role in corporate governance, but there are also limitations to creditor monitoring. First of all, it only works when companies have significant debt. There are many kinds of companies which banks are reluctant to finance: for example, those companies with highly specialized and immaterial assets which cannot be used as collateral. In contrast, businesses with collateral value – property, land and inventory – are easier to debt finance. Secondly, creditors are naturally risk averse; unlike shareholders they do not gain when things go better than expected, but they lose when things go worse than expected and firms are unable to pay their debts. Since there is a trade-off between risk and return, lower risk will lead to lower returns, and lower overall performance. Finally, creditors may use their market power to extract rents from companies so that on average companies do not gain from more debt finance (Degryse, Ongena and Tümer-Alkan, 2008).

3.11 Auditors

Accounting and auditing are part of the corporate governance system (Watts and Zimmerman, 1978, 1986, 1990). Monitoring by shareholders and debt holders is much easier if an audit of the company's accounts can ensure that they present a 'true and fair view' of the company's performance and its financial situation. Auditing can reduce the information asymmetry which is at the core of the agency problem and thus help solve governance problems. Company managers have an incentive to use external auditors with a good reputation to audit their accounts because this will increase investor and business confidence in the company (and make it easier to attract finance or do business). The auditor has an incentive to provide accurate information because this will influence demand for her services.

Watts and Zimmerman show that auditing and accounting practices emerged in the British Ipswich guild as far back as 1200 and continued up to the British and US joint stock banks in the mid-19th century and the present day, when they have become law. Generally, positive account theory (Watts and Zimmerman, 1986) sees accounting and auditing practices as efficient (value enhancing) methods to reduce agency problems.

There is some evidence, however, that neither accounting nor auditing is always accurate and that managers opportunistically exploit accounting practices (Watts and Zimmerman, 1990). There is support for a bonus plan hypothesis, i.e. that managers influence earnings by accounting practices in order to maximize their bonuses. There is also support for the debt/equity hypothesis which states that managers will seek to maximize accounting income when the debt/equity ratio is high. Finally, there is support for the political cost hypothesis, i.e. that large and more publicly visible firms will seek to understate their profitability in order to avoid political attention.

One way of looking at this is to say that auditors and accountants are also agents which gives rise to a new set of agency problems. Audit and accounting are not free, so there is a limit to the demand for auditing services. Moreover, more information does not always lead to greater transparency. The number of pages in annual reports has increased rapidly over the past decade, but it is not clear whether they have become more informative. In fact, for some users, they have become more confusing and less transparent. The move from historical cost accounting to market-based valuation may in some respects have made accounts more subjective and easier for managers to manipulate. And the auditing business has probably become more competitive. Auditors who are paid by companies have an incentive to accommodate the wishes of company managers for 'creative accounting'.

Altogether, like other governance mechanisms, accounting and auditing can help address agency problems, but they cannot solve them completely.

3.12 Analysts

Analysts employed by investors, stockbrokers, and rating agencies issue reports which help shareholders and creditors understand companies and evaluate company performance. This provides information which is useful for shareholders who have neither the capacity nor the time to do their own analysis and may help shareholders act more intelligently in corporate governance. A reasonably correct stock price is an important signal for shareholders and directs capital allocation in a market economy. But the value of analysis for corporate governance is limited when analysts have incentive problems of their own. For example, analysts have been criticized for issuing too many 'buy' recommendations in order to stimulate trading and commissions, which is how their employers make their money. Rating agencies in particular were criticized for having been far too optimistic up to the financial crisis, in part because they are paid by client companies who ask for a rating. Thus analysts may in principle contribute to better governance but is clearly no panacea.

Theoretically, analysts are up against strong fundamentals since the efficient markets hypothesis indicates that all relevant publicly available information is already incorporated in stock prices. But empirically many studies (Bjerring, Lakonishok and Vembaelen, 1983; Dimson and Marsh, 1984; Beneish, 1991; Womack, 1996; Barber et al., 2001; Jegadeesh et al., 2004) have found that analysts' recommendations do have a positive and significant impact on stock prices, either because they are good at their job or because the market believes in them. However, there is also evidence that stock market forecasts are too optimistic, e.g. too many buy relative to sell recommendations (Elton et al., 1986; Lin and McNichols, 1998). The most common explanation appears to be the conflict of interests relative to clients. Analysts often depend on communication with corporate executives and analysts in particular may be pressured by their employers (stockbrokers, investment banks and rating agencies) to favour their customers. This is evident for sell-side analysts employed at stockbrokers or banks, but buy-side analysts at pension funds (and alike) may also have vested interests if they are employed by institutions which already own significant amounts of stock.

3.13 Competition

Competition in the market for products and services is a fundamental correction mechanism for any kind of inefficiency in a market-based system, and this also includes inefficiency in corporate governance. Bad management will ultimately lead to higher costs, loss of competitiveness, slower growth, decline or bankruptcy. But competition will tend to lower profit rates and shareholder returns. Thus, from a shareholder viewpoint, it is not a satisfactory solution even though it works well for society as a whole. Moreover, it may take a long time for competition to eliminate a large company, even if it is inefficient.

Competition can help address governance problems in several different ways (Nickell, 1996; Nickell et al., 1997). It can eliminate companies with persistently bad governance through price competition and eventual bankruptcy. It can also reduce slack and thereby limit managerial discretion and agency problems in those firms which are sufficiently flexible to adapt and cut costs. Moreover, shareholders can benchmark their company against competitors (Hart, 1983). This can make it more transparent whether bad performance is attributable to bad management or to more general conditions. It is also possible that product market competition makes profits more responsive to the actions of managers, so that owners have a greater incentive to monitor which will keep managerial effort and company performance high. Nickell (1996) and Nickell et al. (1997) find evidence that productivity growth is higher in companies which are faced with competition. This is important from a social viewpoint since productivity generates economic growth. Shareholders will also benefit from high productivity and low costs, but profits will obviously be squeezed by price competition, so shareholders have an incentive to avoid competition. Chou et al. (2008) find that governance has no significant impact on stock market returns when product market competition is low.

Most economists would claim that the market ultimately gets it right. Grossly inefficient firms will adapt or go out of business. But it may take a long time, particularly if they are sitting on large amounts of cash or have strong market positions. In the meantime (and when the market fails to do the job) there is a role for other governance mechanisms.

3.14 Discussion

Altogether, if you think about it, there is an impressive array of corporate governance mechanisms. We can argue that they all work to some extent but have their strengths and weaknesses which make them more or less appropriate in a given situation. In other cases the same mechanism may create more problems than it solves. For example, personal ownership may be a blessing under an

enlightened owner, but a curse under his idiot son. However none of the governance mechanisms, not even all of them together, can completely eliminate the governance problem.

In the real world these mechanisms are not independent. On the contrary, there are strong causal connections between them. For example, boards are elected by shareholders. Thus there must be a causal connection between ownership structure and board structure. In other words, governance mechanisms are parts of a system (Holmström and Milgrom, 1994). There may be both substitutability and complementarity between mechanisms so that some mechanisms tend to substitute for each other (i.e. if you have one, you do not need the other), while other mechanisms tend to coexist. These interdependencies are what make governance mechanisms form a system.

Moreover, some governance mechanisms are logically prior to others. For example, individual shareholders or board members will usually not be able to influence laws and regulation, which they have to take for granted. However, laws and regulation will influence ownership structure. In the same way, the shareholders elect the board and are therefore logically prior to board members who are again logically prior to the managers which they hire and fire. Chinese managers and boards, for example, are constrained by their majority shareholders (often government organizations) who are again constrained by the political system (communism). Finally, not all governance mechanisms are equally important. Most economists tend to emphasize product market competition (Allen and Gale, 1999), some financial economists emphasize takeovers, and there is widespread scepticism with regard to boards' morality.

We try to address some of these complexities in the next chapter on international corporate governance.

Minicase

Armand Hammer and Occidental Petroleum

In 1989, Occidental Petroleum announced that it would build and run a museum to house the art collection of its chairman and CEO, Armand Hammer, then aged 89. Armand Hammer was a legendary business tycoon and colourful personality: a stout Republican and world traveller, personal friends with Lenin and a friend of the Soviet Union during the Cold War. Rumour has it that he was named Arm-and-Hammer by his socialist father after the symbol of the American Socialist Party. Hammer had grown the company from only three employees to a major listed corporation. The company clearly benefited from his investments and international connections. The company announcement claimed that the museum would add to the company's goodwill. It later turned out that Hammer had used the company's money to buy some of the exhibits.

The announcement led to a furore among investors and some lawsuits. *Time Magazine* called most of the collection 'junk'. Oxy (Occidental Petroleum) was planning to spend \$86 million on the museum, substantially more than is allowed in the US for charitable giving. Hammer also had other privileges, among them a (then) very attractive salary of \$2 million guaranteed for 10 years. On the day Hammer died in 1990, Oxy's value increased by \$500 million.

We do not have precise information about the ownership structure, but let's assume that Hammer had a large minority share of 11% and the rest was quite dispersed. We also don't have information on the capital structure but let's assume that it was conservatively managed with little debt and large cash reserves. The board consisted mainly of company insiders (Oxy executives, company lawyers and Hammer's friends). Rumour had it that Hammer had written resignation letters in his desk drawer. Half of the board members were over 72. Executive pay was mainly fixed – by Hammer. The courts declined to intervene because of the business judgement rule.

Source: This classic corporate governance case was first developed by Monks and Minow in *Corporate Governance* (Wiley-Blackwell, 2003). This minicase builds on their work. See also http://en.wikipedia.org/wiki/Armand_Hammer.

Discussion questions

- 1 Is there an agency problem here? If so what kind is it? Type I, II or III?
- 2 How do the standard governance mechanisms work?
 - The law?
 - Ownership pressure?
 - The board?
 - CEO incentives?
- 3 What other mechanisms could be at work?
- 4 What (if anything) could/should be done about it?

Summary (learning points)

- There are many mechanisms which can address agency problems.
- None of them works perfectly.
- Social norms lead managers to behave decently even in the absence of incentives and sanctions.
- Reputation concerns can also reduce agency problems.
- The law punishes extreme agency problems like criminal behaviour.
- Large owners have both the incentives and the power to induce managers to act in their interests.
- The board is the formal, organizational solution to agency problems.
- Incentives (pay for performance) can motivate managers to act in the interest of shareholders.
- Capital structure (creditor monitoring) can also help control agency problems.
- Information providers (auditors, analysts) reduce agency problems by providing information to shareholders and other stakeholders.
- Ultimately competition helps reduce agency problems because inefficient firms with large agency problems will be outcompeted and disappear.



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