Corporate Governance

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University of Augsburg, GBM and CCSE

Finance 2 – Silvio Vismara
Outline of the Course

I. Motivation and Introduction

II. Theory of the Firm
   • Microeconomic Theory, Principal Agent Theory, Transaction Cost Theory, Property Rights

III. Separation of Ownership and Control

IV. Shareholder and Stakeholder Society

V. Mechanisms in Corporate Governance
   I. Market Mechanisms
      Product market, Market for Corporate Control, Market for Managers
   II. Institutional Mechanisms
      • Boards of Directors, Regulatory Mechanisms, Codices

VI. Corporate Governance and Future Developments
   • Corporate Social Responsibility, Business Ethics
Before we start with “Corporate Governance” in large and public listed Corporations….some thoughts….

- …there are still many other type of firms that are important
  - entrepreneurial firms
  - family firms
  - cooperatives
  - universities
  - government owned firms…
  - …..tbc….

- should we be looking for several theories?
- or should we be looking for one theory that encompasses all of these firms?
I. Motivation and Introduction

I. Creation and Distribution of Value in Societies

II. Corporate Governance comes in many guises
   I. Moral hazard
   II. Adverse selection
   III. Institutional settings
   IV. Historical context

III. Definitions of Corporate Governance
Two main questions in society:

• How to create value?
  • ...by division of labor and specialization
  • ...by organizations and markets

• How to distribute values?
  • ...by coordination and motivation
  • ...by organizations and markets
Two main questions in the creation and distribution of values...

- Places of creation and distribution of value?
  - markets are anonymous (“invisible hand”)
  - organizations are pyramidal (“visible hand”)
- How should value be distributed (legitimization)?
  - everyone participating in the value creation process (stakeholder)?
  - should the created value be divided equally across the stakeholders?
  - ....
- Problem: neither markets nor organizations are perfect and lead to underinvestment (welfare loss)
- Solution: Corporate Governance!
Questions in the creation and distribution of values...and thus Corporate Governance...

• ...is related to all institutions shaping the creation and distribution of value...
  • OECD...
  • European Union...
  • State governments ...
  • Organizations and firms...
  • ....

• is concerned about the managerial discretion at the top of the pyramids...
  • ... selection of the best managers  
    (solving the adverse selection problem...) 
  • ....ensuring that managers are accountable for their actions  
    (solving the moral hazard problem...)
...consequences... of governance problems in creating and distributing value and wealth...

- OECD/UN...
  (migration, economic and social disparity, civil wars, revolutions…)
- European Union...
  (economic and social disparity, underinvestment, inequalities, radicalisms, unemployment…)
- State government …
  (regional inequalities, unemployment, social inequalities, underinvestment,…)
- Organizations and firms…
  (organizational slack, underperformance, fluctuation, insolvency, ….)
Corporate Governance problems come in many guises...

- **Moral hazard**
  - excessive bonus payments…
  - insufficient efforts…
  - corruption and fraud..
  - self dealing…
  - extravagant investments…
  - entrenchment strategies…
  - ….
Corporate Governance problems comes in many guises…

- **Adverse selection**
  - lack of skills and abilities….
  - wrong attitudes toward risks
  - personal traits….
  - ….
Corporate Governance problems comes in many guises…

• Institutional settings
  • governments….
  • for-profit organizations ..”firms”
  • non-profit organizations....
  • relationships....
  • ....
Corporate Governance problems comes in many guises…

- **Historical context** innovations indicating governance problems…
  - …development of characters (Mesopotamia, Babylonia, …~ 4,000 B.C.)
  - …development of administration and compliance rules …(Egypt, ~ 2,000 B.C.)
  - …incentive systems for managers with residual claims …(Rom, ~ 250 B.C)
  - …

- **Philosophical context**
  - Legitimation of Governance and Market Structures and the distribution of value
    - Macchiavelli (1469-1527): *Discorsi* (1531), *Il Principe* (1532)
    - Karl Marx (1818-1883): *Das Kapital* (1867)
    - Adam Smith (1723-1790): *Wealth of Nations* (1776)
Focus in this course:

• Creation and distribution of value in firms
  • Modern capitalistic firm (“Corporate America”)

• Governance structures in firms (top management)
  • Legitimization of governance structures
    • Normative: How should good governance mechanisms work?
    • Positive: How could good governance mechanisms work?
I. Motivation and Introduction

Value creation (FTSE 100) and Distribution (CEO, Employee earning)

I. Motivation and Introduction

Value creation (US Performance) and distribution (CEO Remuneration)

Excessive CEO compensation?

I. Motivation and Introduction

**America's biggest insider-trading cases**

SEC enforcement actions, 2000-10

<table>
<thead>
<tr>
<th>Fiscal year</th>
<th>Case</th>
<th>Alleged illegal profit or loss avoided, $m</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td>SEC v Angelo Mozilo et al.</td>
<td>140.0</td>
<td>Former Countrywide Financial CEO Angelo Mozilo charged with selling Countrywide stock based on non-public information. Settled for $67.5m.</td>
</tr>
<tr>
<td>2004</td>
<td>SEC v Kenneth Lay et al.</td>
<td>90.0</td>
<td>Wide-ranging scheme to defraud by falsifying Enron's financial results and trading Enron stock based on material non-public information. Convicted on fraud and conspiracy charges but not insider trading.</td>
</tr>
<tr>
<td>2010</td>
<td>US v Raj Rajaratnam and Danielle Chiesi and SEC v Galleon Management, LP, Raj Rajaratnam et al.</td>
<td>52.0</td>
<td>Galleon Group founder Raj Rajaratnam convicted on 14 counts of insider trading.</td>
</tr>
<tr>
<td>2008</td>
<td>SEC v Lou L. Pai</td>
<td>31.5</td>
<td>Former Chairman and CEO of Enron Energy Services charged with selling Enron stock on the basis of non-public information. Settled for $31.5m.</td>
</tr>
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<td>2010</td>
<td>SEC v Laxexa Management LLC and Thomas C. Hardin</td>
<td>20.0</td>
<td>Three lawyers charged for tipping in exchange for kickbacks from traders and a proprietary trading firm. Hardin ordered to pay $19,000 judgement.</td>
</tr>
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<td>2007</td>
<td>SEC v Michelle S. Guttenberg et al.</td>
<td>15.0</td>
<td>14 defendants charged in connection with two related insider trading schemes involving employees at UBS Securities and Morgan Stanley. Guttenberg settled for $15.8m.</td>
</tr>
<tr>
<td>2010</td>
<td>SEC v James W. Self, Jr., and Stephen R. Goldfield</td>
<td>14.0</td>
<td>Charged with insider trading around announcement that AstraZeneca would acquire MedImmune, Inc. Settled for $16.7m.</td>
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<tr>
<td>2009</td>
<td>SEC v Nicos Achilloas Stephanou et al.</td>
<td>11.6</td>
<td>Seven charged with insider trading based on non-public information about impending corporate acquisitions. Settled for $592,202.</td>
</tr>
<tr>
<td>2009</td>
<td>SEC v Reza Saleh and Amir Saleh</td>
<td>8.6</td>
<td>Charged with trading on non-public information of Dell Inc's tender offer for Perot Systems. Settled for $8.3m.</td>
</tr>
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</table>

Sources: Laura Beny, University of Michigan Law School; SEC

I. Motivation and Introduction

Two main problems discussed in the Corporate Governance literature

- Selection of the wrong Managers (ex ante) „Adverse Selektion“
  - Attituded towards riks
  - Skills and abilities

- „Moral Hazard Behavior“ (ex post)
  - Illegal
  - Illegitim

### Moral hazard behavior – illigetimate or illegal?

<table>
<thead>
<tr>
<th>Managerial misbehavior and discretion „moral-hazard“</th>
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</thead>
<tbody>
<tr>
<td><strong>illegitimate</strong></td>
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<tr>
<td><strong>deliberately</strong></td>
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<tr>
<td>▪ Self dealing</td>
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<tr>
<td>▪ Insufficient efforts</td>
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<td>▪ Creative accounting techniques</td>
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<tr>
<td>▪ Manipulation of performance measures</td>
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<tr>
<td>▪ Excessive or insufficient risk taking</td>
</tr>
<tr>
<td>▪ …</td>
</tr>
</tbody>
</table>

Corporate Governance…

• “…ways in which the suppliers of finance to corporations assure themselves of getting a return on their investments…” (Shleifer/Vishney, 1997)

• “…ways in which a corporation`s insiders can credibly commit to return funds to outside investors and can thereby attract external financing“ (Tirole, 2007, S. 16).

• „…is to persuade, induce, compel, and otherwise motivate corporate managers to keep the promises they make to investors…“ (Macey, 2008, S. 1).

• „… the mechanisms by which corporations and their managers are governed“ (Holmstrom/Kaplan, 2001, S. 121)

• …. mechanisms by which organisations are governed to create and distribute value …(Audretsch/Lehmann, 2012)
I. Motivation and Introduction

Summing up: Corporate Governance...

- …is concerned about creation and distribution of value and wealth….
- … characterizes all kinds of organizations and institutions….
- …is neither a problem of the present, and is as old as human kind lives together in organizations
- …is a phenomenon which could not be solved perfectly
II. Theory of the Firm

I. Creation and Distribution of Value
   - How should value be created?
   - How should value be distributed?

II. Theories in Corporate Governance
   I. Microeconomic theory
   II. Principal Agent theory
   III. Transaction Cost Theory
   IV. Property Rights

III. Corporate Governance
II.1 Creation and Distribution of Value

How to create value...?

reservation utility

created value

consumer surplus

producer surplus (organization surplus)

total costs

market price

consumer benefit

revenue
II.1 Creation and Distribution of Value

How to distribute value...?

\[
(b_1 - v_1) + (b_2 - v_2) + b(n) - v(n) + b(\text{Consumer}) - \text{Price} = \text{added (created) Value}
\]
Theories of the Firms tries to provide answers on these two questions:

I. **Microeconomic theory:**
   • Value is created by firms and perfect markets equally distribute wealth and values between consumers and producers

II. **Transaction cost theory:**
   • Value creation depends on the transaction costs – value is either created by transactions within firms or markets

III. **Principal agent theory:**
   • Value is created and distributed within relationships governed by perfect contracts

IV. **Property rights theory**
   • Value is generated by specific investments and governed by authority and ownership as a substitute of perfect contracts

II.2 Microeconomic View of the Firm

Perfect Competition
1. Anonymous buyers and suppliers
2. No market power
3. Perfect and complete information
4. No entry and exit barriers

Equilibrium

Demand

Supply

Demand

Supply

Consumer surplus

Producer surplus

Equilibrium (p)

Equilibrium (p)
II.2 Microeconomic View of the Firm

production function

Cost minimizing production

Input factor $x_2$

Isoquanten

Quantity $Q$

Input factor $x_1$

Quantity $Q$

Input factor $x_2$

Input factor $x_2'$

Input factor $x_2''$

cost function

Costs, prices

Marginal costs

Average costs

Profit maximizing quantity

Marginal costs

Average costs

Quantity $Q^*$

Quantity $Q$

Price $P^*$

C (total)

C (fixed)

C (marginal costs)
Consequences for Corporate Governance?

- Value is created by the production set (production and cost function):
  - division of labor among households (labor), firms (production set) and financiers (capital) creates value
  - distribution of the generated value between consumers (consumer surplus) and producers (producer surplus).
  - Input factors (labor, capital) are paid with the marginal value they create within the production set
- Perfect markets leave now leeway for managerial discretion!
  Microeconomic theory helps to understand how value is generated and distributed in perfect markets
- Corporate Governance: the perfect market
  - Owners unanimously force the managers to maximize profits or market value
  - This increases their wealth and their set of consumption possibilities
II.2 Microeconomic View of the Firm

Reinements in Corporate Governance

• **Arrow-Debreu general equilibrium (~1970)**
  - Frictionless markets unhampered by transaction costs, taxes, information asymmetries, competitive and complete
  - all choices (decisions) are contractible and not affected by moral hazard
  - key issue is the allocation of risk among investors and the pricing of redundant claims by arbitrage

• **Corporate Governance ∼ Capital Structure**
  - Irrelevant! (Modigliani/Miller, 1953, 1963)
  - The value of a financial claim is then equal to the value of the random return of this claim

- The size of the pie is unaffected by the way it is carved (Tirole, 2006, p. 1)
- Firm value and value creation is independent from value distribution!
Consequences for Corporate Governance (a):

Transaction costs (Coase):

• Firm is associated with a production set, which is not exogenously given
• Firm boundaries are not exogenously given but change constantly
• Markets are imperfect – costs of price mechanisms
  • Costs of discovering what market prices are
  • Costs of negotiating a contract for each exchange
• Bargaining inside the firm is replaced by authority with its own costs
  • Costs of running a firm increases with size (limited capacity)
  • Manager charged makes mistakes and mistakes increase with firm size
Consequences for Corporate Governance (b): relationship-specific investments (Williamson)

- Value is created through relationship-specific investments (investments that are worth more inside a relationship than outside)
- Such investments are governed by long-term contracts but are hard to write because of the difficulties anticipating the future
- Such contracts are incomplete and will have to be revisited or renegotiated ex post
- Parties will engage in opportunistic and wasteful behavior to improve their bargaining position
- Result: a considerable amount of surplus may be lost!
II.3 Transaction Cost (Firms Perspective)

Markets

Costs of price mechanisms

- search and information costs
- cost of negotiating and contracting
- adjustment costs and costs of renegotiation

Hierarchies

Costs of hierarchies

- diseconomies of scale and scope
- managerial mistakes
- increasing input process

Consequences for Corporate Governance?

• Value is either created by division of labor within organizations or outside (the market)
• If transaction costs are lower than the price mechanism, they occur within organizations

• Corporate Governance:
  • Managers make mistakes (by chance): Coase (1937)
  • Parties behave opportunist to improve their ex post bargaining positions (Williamson, 1971, 1975)
  • Solution: Vertical integration – authority replaces bargaining!
Consequences for Corporate Governance (a):

- Value is created by a set of assets (financial assets, human capital)

- A firm is a nexus of contracts between the owners of such assets and the firm as the legal entity

- Value is created by reducing costs of negotiations and bargaining

- Corporate Governance:
  - Manager has a goal of his own which (may) differ from the owner’s interests
  - Value maximizing (profit maximizing) is not achieved
  - Solution: perfect contracts ensure both value generation and value distribution!
II.4 Principal Agent (Theory)

Negotiation, bargaining and contracting in the market place….
II.4 Principal Agent (Theory)

Negotiation, bargaining and contracting with the owner
(the firm as a nexus of contracts a legal fiction (and not an individual)
Consequences for Corporate Governance (b)

- Incentives provided to the manager to act in the owners interests
  - Perfect contract is self-fulfilling and solves both
    - the adverse selection (selecting the right managers) and
    - the moral hazard problem (prevent him from shirking)
- Capital structure is not irrelevant (Jensen/Meckling, 1976)!
  - only the owner-manager with 100% equity have no incentives to take excessive perks (100% residual claimant)
  - Issuing equity thus rises incentives to take excessive perks:
    1€ dividends < 1€ perks < 1 earning
  - Debt financing leads to gambling (upside risk taken by the owner, downside risk by the borrower)
- Optimal mix of debt and equity trades off these effects!
Consequences for Corporate Governance?

- Insiders incentives are (perfectly) aligned with the investors interests through performance-based contracts
- Interests of all parties (stakeholders) and the distribution of value and wealth is considered by (perfect) contracts and agreements
  - sales agreement (consumers)
  - loan agreement (banks)
  - delivery/supply agreement (supplier)
  - labor agreement (employees)
  - legal rules (government/society)
- With one exception: the interests of shareholders!
- Shareholders are the only relevant stakeholders and due to the lack of perfect contracts and thus the goal of managers is to maximize their value!
- **Shareholder Value!**
Consequences for Corporate Governance

• Value is created by relationship(firm)-specific investments
• Such investments generate quasi-rents (value of the second best opportunity)
• Investments are not protected by markets and (perfect) contracts and thus parties will engage in opportunistic and wasteful behavior to improve ex post bargaining power
• Owner of the asset has the residual rights of control
  • Grossman, Hart, Moore: owner of the physical assets
  • Brynjolfsson, Rajan, Zingales: owner of the intangible assets
• Shareholder is not the only relevant stakeholder!
• Distribution of value towards the relevant shareholders
  = all stakeholders with relationship-specific investments, who's investments are not (perfectly) protected by contracts!
Consequences for Corporate Governance

• Value is created by relationship(firm)-specific investments
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• **Distribution of value towards the relevant stakeholders**
  = all stakeholders with relationship-specific investments, who's investments are not (perfectly) protected by contracts!
Theory of the Firm and Consequences for Corporate Governance

- Value is created through the production set
  - Strategic interaction in imperfect markets leads to returns and thus superior value for the “firm” (Industrial organization or strategic management literature)
  - Relationship-specific investments generate quasi-rents (resource based view of the firm)
  - generated value of the firm could be distributed between the stakeholders
  - (perfect) contracts could provide incentives for stakeholders by guaranteeing an appropriate piece of the pie!

- transactions are not costless and the boundaries of the firm changes continuously
- **The size of the pie is affected by the way it is carved!**
The Separation of Ownership and Control

• Value is created through the production set
  • Strategic interaction in imperfect markets leads to returns and thus superior value for the “firm” (Industrial organization or strategic management literature)
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• **The size of the pie is affected by the way it is carved!**
III The Separation of Ownership and Control

Owner with 100% equity and thus \((F^*, V^*)\)

\[(I_1, I_1)\): owner’s indifference curve between wealth \((V)\) and non-pecuniary benefits \((F)\)

\[(VU, FU)\): (slope \(-1\)).

Market value expenditures: \(F\)
Firm value and wealth: $a(V-F)$

III The Separation of Ownership and Control

Separation of ownership and control: $(a[VU-F\ast],F\ast)$

Market value expenditures: $F$
The Separation of Ownership and Control: Implications

• Firm value increases with equity hold by the manager (owner-manager)
• Both, owners (shareholders) and managers of the firm could improve their wealth by incurring costs (agency costs):
  • Managers (agent): bonding expenditures
  • Owners (principal): monitoring expenditures
  • (residual losses)
• Corporate Governance: mechanisms that reduce agency costs and thus improve firm value
The Separation of Ownership and Control: Empirical Evidence

- Firm value increases with equity hold by the manager (owner-manager)
- Both, owners (shareholders) and managers of the firm could improve their wealth by incurring costs (agency costs):
  - Managers (agent): bonding expenditures
  - Owners (principal): monitoring expenditures
  - (residual losses)
- Corporate Governance: mechanisms that reduce agency costs and thus improve firm value
Theory: Societies differ according to their attitudes towards how to generate wealth and how to distribute it.

Shareholder Society (Anglo-Saxian Countries)
- Wealth is created by public firms and market forces lead to a distribution of wealth.
- Main stakeholder is the shareholder as the most relevant stakeholder (otherwise moderating effects for investments and thus growth).
  - lower taxes, less investments in employee protection, low social security and other social receivables,
- Stakeholder Society (Continental Europe)
Shareholder Society (Anglo-Saxian Countries)

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- Main stakeholder is the shareholder as the most relevant stakeholder (otherwise moderating effects for investments and thus growth).
  - lower taxes, less investments in employee protection, low social security and other social receivables,
  - Public policy is mainly concerned on markets (reducing market entry and exit barriers in labor markets, financial markets, product markets, …) and personnel (individual) freedom
  - Protection of shareholders at the costs of other stakeholders (suppliers, banks, employers, ..)
Stakeholder Society (Continental Europe, Japan)

- Wealth is created by firms, distribution of wealth by markets and policy
  - Higher taxes to distribute wealth across society
    - Higher investments in employee protection
    - Higher social securities and other social receivables
  - Public policy is mainly concerned on society (regulation in labor markets, financial markets, product markets, …) and imitated personnel (individual) freedom
  - Protection of stakeholders at the cost of shareholders (banks, employees, suppliers)
Shareholder versus Stakeholder Society

- Both systems exist for longer times and thus both systems are each associated with costs and benefits.
- Economic dynamic seems to be lower in stakeholder society but amplitudes are also lower.
- Social “costs” are lower in stakeholder societies.
- Inequality increases less in stakeholder societies.
- ....
V. Mechanisms in Corporate Governance

I. Overview markets and hierarchies

II. Market Mechanisms
   I. Product Market
   II. Market for Corporate Control
   III. Market for Managers

III. Institutional Mechanisms
   I. Board of Directors
   II. Large Shareholders
   III. The role of Debt
   IV. Law and Regulation
Overview

- Mechanisms in Corporate Governance could be separated into market mechanisms and institutional arrangements.
- According to transaction cost theory, governance mechanisms differ across their transaction costs.
  - Perfect market: no need for institutional governance mechanisms.
  - Perfect institutions: no need for market mechanisms.
- Economies differ according to their costs of institutional and market mechanisms.
  - Anglo-Saxon Countries: more market based mechanisms.
  - Continental Europe: more institutional based mechanisms.
Overview: Why corporate Governance?

• Necessity of Governance Mechanisms directly follows from the “efficiency principle” of Vilfredo Pareto (1848-1923)
  • An arrangement is efficient if there exists no other arrangement which leads to an improvement of at least one (group of) stakeholder(s) without losing value to another (group of) stakeholder(s).
• Owners and Policy makers have to select the governance mechanisms to lower agency costs and thus follow the “efficiency principle”
  • Problem: Mechanisms are either
    • complementary
      (a more in one mechanisms leads to a more in another mechanisms) or
    • Substitutive
      (a more in one mechanism leads to a substitution effect of another mechanisms)
Example: Dividends/Return to Equity for shareholders and wage paid to employees

- Return to Equity for Shareholders
- Minimum wage to employees
- Pareto-efficient allocation
- Firm Value
- Minimum Dividend expected by Shareholders
- wage for employees
Product Market Competition:

- (Perfect) market forces squeeze out inefficient firms
- Managers which take excessive perks waste resources inefficiently
- Managers are afraid of losing their jobs and thus are concerned about good performance

Mechanisms:

- Close competitors offer a yardstick against which the management can be measured
- Fear of bankruptcy and loss of the job
- Competition filters out exogenous shocks faced by the firm (luck and bad luck)
Product Market Competition:

- Problems:
  - yardstick Competition with a small number of competitors leads to collusive behavior
  - high market concentration leads to windfall profits and to the practice of monopoly power
- Empirical evidence: Rather small!
  - High hazard rates for young and entrepreneurial firms, bot not due to governance problems or managerial misbehavior
  - Anecdotal evidence (Germany: Karstadt/Quelle)
- **Competition is no Substitute for proper internal governance structure!**
Market for Corporate Control (Manne, 1965):

- mechanisms that substitutes entrenched, money wasting managers by an efficient team
- efficient capital markets enables an efficient management team to acquire the inefficient firm and replaces the management
  - Ex ante: managers are anxious about takeovers and losing their jobs:
    “a manager’s worst nightmare is to become the target of a takeover bid”
    (Tirole, 2008, p. 43)
  - Ex post: replacement after successful takeover
• **Mechanisms:**

  • **Friendly takeovers:**
    • negations with the management of the target firm (willing to be taken over)
  
  • **Unfriendly/hostile takeovers:**
    • target company's board rejects the offer,
  
  • **Proxy contests:**
    • strategy using shareholder's proxy votes (i.e. votes by one individual or institution as the authorized representative of another) to replace the existing members of a company's board of directors.
  
  • **LBO – Leverage Buy Outs:**
    • Takeovers paid by debt (see Raiders)
V.2.2 Market for Corporate Control

"This is a hostile take-over!"

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V.2.2 Market for Corporate Control

Source: MergerMetrics / FactSet Mergers
V.2.2 Market for Corporate Control
V.2.2 Market for Corporate Control

Announced Mergers & Acquisitions:
Italy, 1991-2011

http://www.imaa-institute.org/index.php
# Abnormal returns for takeovers (US, 1973-1998, in %)


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<tr>
<td><strong>combined</strong></td>
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<tr>
<td>[-1,+1]</td>
<td>1,5</td>
<td>2,6*</td>
<td>1,4*</td>
<td>1,8*</td>
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<tr>
<td>[-20, 0]</td>
<td>0,1</td>
<td>3,2</td>
<td>1,6</td>
<td>1,9</td>
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<td><strong>Target</strong></td>
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<tr>
<td>[-1,+1]</td>
<td>16,0*</td>
<td>16,0*</td>
<td>15,9*</td>
<td>16,0*</td>
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<tr>
<td>[-20, 0]</td>
<td>24,8*</td>
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<td>23,3*</td>
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<td>-0,4</td>
<td>-3,1</td>
<td>-3,9</td>
<td>-3,8</td>
</tr>
</tbody>
</table>

| Observations | 598     | 1226    | 1864    | 3688    |
Empirical Evidence:

- Scare evidence that takeovers are disciplining managers
- Poor performance of takeovers in general
- Only a very small number of takeovers are unfriendly or hostile (~5% in the US)
- Takeover threats force managers to boost (myopically) short-term at the expense of long-term performance
- Value-reducing raider gains
- Takeovers waves (due to changes in the cost/benefits of acquiring firms)
- Restrictive takeover laws in the US (Delaware; and continental Europe)
• **Takeover Defenses:**
  
  • Lobbying for restrictive anti takeover bids!
  
  • Adoption of takeover defenses:
    
    • *Corporate charter defenses (ratifications by shareholders):*
      
      • Staggered boards,
      
      • supermajority rules (instead of 50% majority rules)
      
      • Fair price clauses (offer a premium for all shares)
      
      • Differential voting rights (privileged voting rights, \(\rightarrow\)Volkswagen Law)
      
      • Dual class voting rights (Germany, Family Firms like Porsche…)
      
      • Move to a state with tougher antitakeover statutes (Delaware – more than about 50% of the Forbes 500 companies are located in Delaware)
• Takeover Defenses (continued…):
  • Adoption of takeover defenses:
    • *Diluting the acquirers (raiders) equity (board approval)*:
      • Poison pills (special rights of the target’s shareholders to purchase additional
        shares at lower prices, call or put options that have only value in a hostile
        takeover)
      • White knight (alternative acquirer with a friendlier attitude towards the current
        management)
      • Greenmails (repurchase of a targeted block – collusion with the acquirer at
        expense of the shareholders)
    • Question (puzzle): Why did boards allow managers to use takeover defenses in
      advance?
      • Is it an other illustration of managerial entrenchment and poor corporate governance?
      • Is it to increase incumbent shareholder’s wealth in takeovers?
V.2.2 Market for Corporate Control

• **Cost of Takeovers:**
  • Freeriding behavior of dispersed and minority shareholders rises costs of the acquirer over expected profits
  • Takeover defenses!
  • Takeovers as a substitute for ineffective governance structures (ineffective monitors)

• **Recent developments:**
  • Hostile takeovers are mostly observed with Hedge-Funds and Leverage Buy Outs
  • Friendly takeovers are a desired exit option for Founders and Venture Capital firms
  • Friendly takeovers increase the income via stock options for both the management of the target and acquiring firm
• **Market for Managers (Fama, 1980)**
  
  • Firm performance reflects and signals the (unobserved) quality and human capital of the CEO
  
  • Competition of CEO position out- and inside the firm
    
    • Outside: other managers want to replace the CEO and bad performance increases the competition for the respective position
    
    • Inside: other managers want to climb up within the firm and thus compete for this position
  
  • Empirical Evidence: weak….managers are often replaced in the context of takeovers
  
  • Market for Managers and Market for corporate control are complementary mechanisms
V.3 Institutional Mechanisms in Corporate Governance

• Overview

• If market mechanisms would work perfectly in governing corporations – then, according to theory – there would be no space for additional, institutional mechanisms.

• Institutions are mechanisms or arrangements, induced by market imperfections to solve or attenuate the agency costs:
  • Contracts and Compensation
  • Boards of directors
  • Presence of large shareholders
  • Debt
  • Law and regulatory mechanisms
V.3.1 Contracts and CEO Compensation

- **Problem**: Markets are imperfect and managerial interests differ from those of the owners!

- **Solution**: Aligning their interests with a (perfect) contract!
  - Follows directly from Principal-Agent Theory
  - A perfect contracts solves both problems:
    - Selecting the right manager (adverse selection)
    - Aligning the interests with the owners’ interests (moral hazard)

- **Theory**:
  - Owner offers a set of contracts, with some fix and variable remuneration (depending on the success)
  - Risk averse manager selects a contract to maximize his own utility
  - Nash-equilibrium: no party has an incentive to deviate from the initial contract!
V.3.1 Contracts and CEO Compensation

\[ \beta_1^* = \frac{1}{1 + 2r\sigma^2} \]

- Optimal share of variable remuneration only depends on:
  - Risk aversion of the manager (r)
  - Riskiness of the project (firm risk) \( \sigma^2 \)

- Optimal share of variable remuneration if:
  - manager is highly risk averse?
  - Firm project is extremely high?
V.3.1 Contracts and CEO Compensation

\[ \beta_1^* = \frac{1}{1 + 2r\sigma^2} \]

- Empirical evidence:
  - Risk aversion of the manager (r) and project risk
    - Risk averse managers tend to select projects with a low risk
    - Equity (as a kind of remuneration) hold by managers is lower in risky firms
  - Pay for performance:
    - No robust empirical evidence!
    - Reverse causality: Success in the past affects future income
      (increased bargaining power of the CEO)
V.3.2 Board of Directors

• Problem:
  • Market mechanisms are not sufficient in governing corporations.
  • Also contracts are incomplete and by far not costless.
  • If there exists no single owner, who signs the contracts with the manager?
  • Who controls managerial behavior and firm performance?

• Solution: Board of Directors!

• Theory: Board of Directors are second best mechanisms to solve agency problems better than the market

  (Adams/Hermalin/Weisbach (2010), Journal of Economic Literature:
  • Selecting a manager (transaction costs)
  • Contracting with the manager (writing a contract ..)
  • Monitoring the manager (CEO dismissal…..)
Problem in Boards: Board composition

- Board members differ in their interests (Adam Smith, 1776!):
  - Majority vs. minority shareholders (Europe)
  - Insider and Outsiders (US)
  - Family Members (all countries)
  - Workers representatives (Germany, …)
  - Shareholders and Banks (Continental Europe, Germany)

Theory: Mainly based on the One-Tear Board in the US, where board composition matters!

- One-Tier Board: US, UK, Spain
- Two-Tier Boards: Germany, Netherlands (large Italian Firms)
- Mixture: Italy, France
V.3.2 Board of Directors

• Board composition in the US
  • Insiders (Members of the Top Management Board)
    • Insider: CEO, CFO, COO, CIO,
    • No interest as a strong monitor of the CEO (and their own work)
  • Outsiders (members outside the firm), seldom large shareholders…).
    • ~ 60% - 80% outsider
    • no labor representatives
    • No representatives from interest groups
    • uncommonly large shareholders
    • Weak monitors if selected by the CEO (friends…)
    • Strong monitors (reputation effects to other firms as strong monitors)
V.3.2 Board of Directors

- **Audit Committee**
  - internal revision
  - nomination and selection of accounting company

- **Compensation Committee**
  - CEO compensation package
  - Management succession

- **Nominating Committee**
  - Selection of new directors
  - not mandatory

- **Executive Committee, Finance Committee**
  - meetings between two board meetings
V.3.2 Board of Directors

Causes
- Past performance (CEO bargaining power)
- Firm size (human capital, …)

Board Composition
- Insiders/Outsiders (replacement of insiders in weak performing firms)
- Board size (moral hazard and freeriding in boards)

Actions
- CEO compensation
  - higher variable remuneration with smaller boards
  - Higher income with outsiders
  - Income increases with cross-memberships of CEOs (collusive behavior)
- CEO dismissals (increases with outsiders, longer survival rate with outsiders)
- Takeover defenses (increases with insiders)

Performance
- Financial Performance (weak performance with smaller boards)
- Takeovers (lower probit with outsiders, long battles with insiders)
V.3.2 Board of Directors

• Board composition in the US

• No robust empirical results on performance:
  • Reflects the trade-off between costs and benefits of board composition
    • Insiders/outsiders are both associated with costs and benefits
    • also “independent” directors have own interests which may not be aligned with (financial) performance measures
  • Problem of endogeneity effects
V.3.3 Large Shareholders

- **Problem:** Widely dispersed equity ownership (minority or small shareholders) induce the governance problems (and thus agency costs): Jensen/Meckling (1976)
  - Moral hazard and freeriding of minor shareholders (Holmstrom, 1982):
    - Costs of gathering and evaluation of information (balance sheet data etc…) per share is significantly lower than the expected benefits per share
    - High coordination costs of minority shareholders
    - Lack of human capital and experience
    - Active monitoring leads to spillover effects to other shareholders (and thus induces the moral hazard problem)

- **Solution:** Presence of large shareholders to overcome the moral hazard problem
  - Costs of diversity leads to incentives to monitor the managers
  - Economies of Scale and Scope in monitoring managers (costs per share are lower than the expected profits per share)
  - Experience and human capital to monitor managers
V.3.3 Large Shareholders

Enriques/Volpin (2007), Corporate Governance Reforms in Continental Europe, JEP 21(1), 121)
V.3.4 Debt as a Governance Mechanism

• **Problem:** sticky fingers of Managers (free cash flows)

• **Solution:** debt
  - Debt prevents managers from taking out cash of the firm (-consuming it)
  - Debt incentivizes managers
    - Repay creditors on time
    - Fear of bankruptcy (liquidation of the firm) and losing their jobs

• **Empirical Evidence:**
  - Positive, since creditors acquires control rights and have strong incentives to monitor and discipline the managers
  - Negative, since probability of liquidation increases with debt (see first rider-wave in the early 1980's ~ “Wallstreet”. About 1/3 of the firms went bankrupt after ~1985)
  - Problem: banks as debt- and shareholders (see Deutsche Bank)
    - Kirch Ag, Hochtief, …
Problem: weak internal and external mechanisms to discipline managers

Solution: Legal mechanisms
- ~ since thousands of years!
- Increasing the costs of managerial misbehavior by law

Evidence:
- Accounting Rules all over the World! (IAS, US-GAAP, …)
- Sarbanes-Oxley Act in the US
- ….
VII. Future Developments

- Strengthening internal Governance Mechanisms
  - Greater independence of directors and (re)defining the board’s function, powers, and internal working:
    - Auditing,
    - setting executive compensation,
    - screening related-party transactions,
    - disclosure of information flows
  - Compliance Mechanisms
VII. Future Developments

- Empowering shareholders
  - Restrict insider abuse
  - Fostering the market for corporate control
  - Right to sue managers and directors
  - ...

- Enhancing disclosure requirements
  - Mandatory disclosure of related-party transactions
  - Mandatory disclosure of compensation packages

- Tougher public enforcement
  - Enforcement of corporate governance and securities law through Supervisory agencies
  - Impose sufficient sanctions (prison terms, ….)
VII. Future Developments, Summary & Conclusion

- (New) Developments in Management and Politics:
  - Importance of Corporate Social Responsibility
  - Business Ethic
  - ...

- All mechanisms in Corporate Governance are associated with Costs and Benefits
- There is no “One size fits it all”!
  - Firm and industry characteristics affect the costs and benefits of corporate governance mechanisms
  - Country specific effects
  - Complementary and substitute effects of mechanisms are still unknown
  - Lack of theory (in particular multi-principal and multi-agent models)
  - ...

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