

Welcome to Mastering Corporate Governance

During the past few years, corporate governance has rarely left the headlines. Beginning with the collapse of Enron in 2001, a wave of scandals in the US, Europe and elsewhere has left investors reeling and spurred on politicians and regulators to focus their attention on tightening up governance processes.

With a host of new regulations and codes in place, what has changed for today's corporation? Are boards

more efficient and effective, or does the focus on compliance come at the expense of strategy and innovation? With confrontations between shareholders and companies becoming increasingly frequent, have investor relations become more strained? And is there a growing consensus among investors themselves that well-governed companies demonstrate better performance than those with more lax processes?

Over the next four weeks, **Mastering Corporate Governance** will explore these questions and many more. Written by academics from the world's leading business schools, it will be essential reading for executives grappling with compliance and corporate governance best practice, investors keen to protect their assets and anyone interested in the trends that are shaping global business.

B. ESPEN ECKBO

Strong insiders invite weak governance

Voluntary shareholder absenteeism and a powerful culture of "corporate insiders" have led to a crisis in corporate governance. Without a fundamental shift in the balance of power, the problems will only worsen

Recent corporate scandals have resurrected public suspicion that there is plenty of potential for mischief inside large public companies. For many, the scandals affirm the warning of the economist Adam Smith, which dates from 1776:

"The directors of [joint stock] companies, however, being managers rather of other people's money than of their own, it cannot be well expected that they should watch over it with the same anxious vigilance [as owners]...Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company."

Heeding this fundamental wisdom, investors around the world are searching for a system of corporate governance that will minimise the potential for "negligence and profusion". In today's debate, the words are "expropriation" and "theft", but they amount to the same. Without protection from these risks, no rational investor will finance a company.

◆ The absentee shareholder

In countries with highly developed financial systems, much of the governance debate focuses on the balance of power between shareholders, boards and top executives in widely held public companies. This balance is the result of three main influences, which differ substantially across countries: legal precedent (case law); the cost of shareholder activism; and the political strength of employee unions.

When a company is founded, this balance of power is hardly an issue. At that time, directors, executives and employees all understand that shareholders own the company. Employees readily accept fixed-wage contracts with no demands for control rights. And directors view themselves as agents of shareholders with the primary task of hiring and firing management and setting compensation.

However, as the company grows and prospers, attitudes start to change. With growth comes the need for additional capital. Naturally, with limited wealth, the founding shareholders relinquish control, preferring instead to diversify personal holdings.

New investors are brought in and the shareholder base becomes dispersed.

Corporate insiders increasingly view shareholders as a remote constituency and as largely irrelevant for the company on a daily basis. By choosing to diversify, shareholders for their part agree to play a diminished role in the company's affairs. The cost of actively monitoring the performance of management swamps investment returns, so they no longer show up to annual meetings and either vote with management or throw the proxy in the wastebasket.

The combination of voluntary shareholder absenteeism and strong corporate insiders creates a problem that lies at the heart of today's governance crisis. The important historical lesson is that the absentee shareholder system breeds arrogance on the part of corporate insiders. A vigorous corporate governance system is thus required to prevent shareholder rights being expropriated by insiders.

◆ Corporate insiders on boards

A common but self-serving argument made by corporate insiders is that the corporation has a "social responsibility" to constituencies other than shareholders. In other words, the board is saddled with the impossible task of adjudicating the many conflicting objectives of its various constituencies. The winner in the ensuing breakdown of the board's decision-making process is, of course, the corporate insider.

A major task of the board is to hire and fire top managers, and to set their compensation. Therefore, corporate

insiders come with an inherent conflict of interest when they sit on boards. Nevertheless, corporate insiders sit on boards in all major developed countries.

In the US, it is common for the CEO also to occupy the post of board chairman. For the first time, the governance debate is openly questioning this tradition. Institutional shareholders and other governance activists recommend separation of the roles. In Europe, the tradition has been not to place the CEO in the chair, in some countries by statute. However, while non-executive members make up a clear majority of directors in the US, there is a tradition in Europe for placing a greater portion of employees on boards.

The typical defence of having insiders on boards is one of efficiency: the board requires CEO and other management input to make proper decisions. What is not explained, however, is why the CEO needs a vote on the board – let alone the chairmanship – in order to supply the board with his or her input. It takes strong-willed character to resist the will of the CEO-chairman, even for directors that meet technical criteria for independence. In today's system, the vast majority of directors sit on boards because the CEO recommended their appointment, so a certain loyalty can be expected.

The widespread practice of placing insiders on boards appears to have its roots in politics as much as in organisational efficiency. In 1976, Germany expanded its co-determination law, requiring companies with more than 2,000 employees to allocate half of the supervisory board seats to employees.



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Co-determination has an important effect on the company's investment policy. If I hire you with a fixed salary and then give you a board seat, the rational thing for you to do is to push for an investment policy that reduces your risk of job and wage loss. It is like placing your main creditor in charge of taking risks. Indeed, research suggests that sluggish risk-taking has contributed to a slower postwar growth in the German economy when compared with the US.

Germany is not alone. Research shows more generally that countries with a French civil law tradition – as opposed to British common law – rely primarily on banks to finance corporate growth. With poorly developed stock markets, and with creditors and employees having a major influence on boards, risk-taking is muted.

In addition to Germany, civil law countries with historically small stock markets but broad-based banking systems include France, the countries of Scandinavia, Italy, Spain, Japan, South Korea and China. These economies are also characterised by insider-controlled companies, corporate cross-holdings of voting stock and pyramidal ownership structures allowing founding families to maintain control.

In contrast, countries with a common law tradition, such as the UK, US, English Canada, Australia and India, have developed a greater reliance on external equity markets, resulting in a more pronounced dispersion of share ownership and a more specialised role for banks.

Ultimately, international trade and the global competition for capital force a Darwinian convergence of both civil law and common law countries towards a system of corporate governance and finance that promotes maximum economic efficiency.

Countries with small stock markets today must prepare these markets for the influx of future pension savings. In western countries, pension funds increasingly prefer to use broadly diversified, international stock and bond portfolios. These and other institutional investors demand international harmonisation of trading systems, insider trading regulations and rules governing transparency. They also expect boards to be responsive to shareholder wealth maximisation.

In 1998, German corporate law was amended to mandate “protecting shareholder value” as a corporate objective – for the first time in German history. It is a small step for mankind, but a giant step forward for German corporate governance. Adam Smith would have approved.

◆ Draconian takeover defenses

In his best-selling book *Economics*, Nobel laureate Paul Samuelson explains that “Takeovers, like bankruptcy, represent one of Nature's methods of eliminating deadwood”.

In the case of a hostile takeover bid designed to replace inefficient executives (presumably one form of “deadwood”), those very same executives sit on a board vested with powers to thwart the takeover. Are they likely to put the interests of shareholders ahead of their own?

US courts have never recognised this conflicted situation as justifying intervention. Instead, the Supreme Court of the state of Delaware has, over the past two decades, granted directors broad powers to “just say no”

to unsolicited takeover bids and to defend against them. As a result, insiders have largely succeeded in blocking the right of small shareholders to even sell their shares to someone who wants to accumulate a controlling block of stock.

A particularly effective defence is the so-called “poison pill”. This is typically triggered if an investor accumulates a 15 per cent shareholding in the target company. When this happens, all shareholders except the 15 per cent blockholder get to purchase new shares for, say, half their market value. It is equivalent to asking the blockholder to pay a dividend to all the other shareholders, financed out of the blockholder's private wealth. Boards can issue such pills without consulting shareholders, even right after receiving a hostile bid (a so-called “morning after pill”).

In an important 1985 decision, the Delaware court upheld the board's right to refuse to remove a poison pill in the face of an all-cash, non-coercive tender offer, even though a majority of the company's stockholders had tendered their shares into the offer. With this decision, boards were given the right to ignore a thunderous demand



by their own shareholders to allow lucrative offers to move forward.

The poison pill has proven extremely effective. Hostile takeovers, which in the period 1975-85 resulted in numerous restructurings of inefficiently run companies, have come to a virtual standstill in the US.

The poison pill stands as a symbol of state-sanctioned expropriation of the fundamental shareholder right to sell shares to the highest bid. Today, no takeover can go ahead unless corporate insiders agree to remove the pill. Some boards refuse to remove the pill because it means they will lose their positions in the company. It is no accident that this legal precedent has precipitated an era of governance decline in corporate America.

◆ Institutional activism

The past 30 years has seen pension funds and other investment pools, such as mutual and hedge funds, accumulate close to 50 per cent of household stock market savings. It is not unusual for the largest institutions to own 2-3 per cent of the total equity of an underlying portfolio company.

With some institutions raising governance concerns, the absentee

shareholder has regained a voice. Over the past decade, there has been a push-back on corporate insiders, focusing on issues such as executive pay and separation of the posts of CEO and board chairmanship.

For example, investor leverage is credited with forcing Disney's Michael Eisner to step down as chairman. And in early May, a shareholder resolution led to the drug giant Merck refusing to offer Richard Clark, the new CEO, the chairmanship. Instead the board took the unusual step of having a troika of directors acting as “chair”.

Institutions in the US have also forced a debate over shareholder access to the company's ballot for electing directors. In the current system, the company proposes a new slate of directors up for election, and sends out the election ballot to all shareholders. When receiving the ballot, shareholders have two options: abstain or vote “yes”. If all but a single shareholder abstains, the directors are formally elected (albeit with embarrassment).

The Securities and Exchange Commission recently proposed reforms to make it easier for shareholders to elect directors. The idea was that,

lowering the costs of mounting a proxy fight. In order to place its preferred candidates on the board, Calpers, like any shareholder, would need to convince a majority of the other investors.

Moreover, characterising large shareholders as “just another interest group” highlights the fact that companies are run by the special interest group called “corporate insiders”. In a system where competition has been muted by draconian takeover defences, it is difficult to assume that “corporate insiders” are somehow a more legitimate special interest.

The large institutional investor represents a fundamental change in the governance landscape. The balance of power between corporate insiders and shareholders is likely to tip in favour of outside investors. The result is increased competition among corporate insiders and, ultimately, increased corporate competitiveness.

◆ Emerging markets

It is clear that no capitalist system is immune to expropriation and theft. However, developed economies have a key advantage over emerging countries – strong judiciary and (relatively) transparent accounting systems. A poisonous mix of accounting opacity and judicial corruption is a major roadblock to financial development in emerging markets.

Academic research has firmly established that countries offering greater levels of judicial protection are

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better able to attract foreign investment, experience greater financial development and economic growth, and have higher corporate valuations.

For example, the 1997 Asian currency crisis led to widespread stock market crashes in the region. Research shows that investors in countries with the weakest legal protection suffered the largest losses from the crash. The expropriation mechanisms ranged from corrupt courts that made it impossible to receive protection for debt claims to “tunnelling” of assets offshore. Empirical research also concludes that the key to establishing investor credibility is a transparent accounting system coupled with a legal tradition that respects and enforces contractual rights.

It is extremely difficult to create a rule of law and a workable legal system from scratch. To some extent, a country's legal tradition is an accident of history. For example, countries such as the US benefit from the tradition left behind in the colonies after the fall of the British Empire.

Today, international capital flows, aided by organisations such as the IMF and the World Bank, appear to be the main catalysts for legal change in emerging markets. In designing their governance systems, these economies would be well advised to heed the lessons of the corporate scandals of the major western economies as well.