MPI Collective Goods

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# Contracts vs. Institutions

## A Critique of Corporate Governance Theory

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# Introduction: What has been Happening?

- In 1985, „Shareholder Value“ was a dirty word for corporate managers, by 2000, it had become an acknowledged objective – rhetorically at least
- Dramatic Changes in Management Remuneration
- Large Increases in Share Prices in the 1990s
- Rise of Hedge Funds and Hedge Fund Activism
- Prominence of „Market Discipline“ Rhetoric
- Significant Corporate Restructuring
- Improvements in Corporate Governance?

# Introduction:
# What has been Happening?

What are we to make of this?

- Political and popular discontent … and helplessness
- Conventional Economics: Improved incentive systems to solve agency problems
- Criticism: Remuneration schemes serve for enrichment rather than incentives
- Why did all this take place?
- Why did it take place in this particular period?

# Carl Fürstenberg's view

- Shareholders are stupid and impertinent
- Stupid because they give their money to someone else without any control
- Impertinent because they ask to be rewarded for their stupidity and clamor for dividends
- ... And because they sometimes love raiders.

# Conventional Economics: Contract Theory and Governance

- Shareholders as Owners - Managers as Agents
- Separation of Ownership and Control as a Problem (Berle and Means)
- Shareholder control rights as a consequence of ownership
- … Needed to protect shareholder prospects of earning returns
- … And to support the viability of th efinancial system

# The Conventional Approach to Corporate Governance

## Shleifer and Vishny (1997)

- “corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investments”
- “advanced countries … have assured the flow of enormous amounts of capital to firms and the actual repatriation of profits to the providers of finance”

# The Conventional Approach to Corporate Governance

Story:

- The corporate sector needs funds for investment.
- The financial sector channels funds from the household sector to the corporate sector.
- In this system, external providers of funds are – or ought to be – protected by rights and customs giving them scope for interfering with management misbehaviour.

# The Conventional Approach to Corporate Governance

La Porta et al. (1997 ff.):

- Different legal systems are compared and assessed according to how well they provide for the protection of external financiers.
- Common-Law systems are ranked first, largely because they have the “best” protection of shareholder rights

# The Conventional Approach to Corporate Governance

"Washington Consensus":

- The IMF makes assessments of legal systems and governance structures part of their overall system of policy intervention.
- Deviations from US style systems of rules and governance are assessed as problematic and give grounds to ask for change
- Example: Korea 1998

  (why not US 2000?)

# Contract Theory and Governance

## Underlying conceptual structure

- Jensen and Meckling: “The firm” is a “nexus of contracts” linking the many individuals that are involved.
- Contracting takes account of information and incentive problems. Observed contracts and institutions can be understood as efficient responses to such problems.
- At the time of contracting, there is a perfect understanding of what is going to happen along each possible path of the game tree.

# Contract Theory and Governance

- „Incomplete‟ contracting has the same conceptual structure:
  - Contracts stipulate decision powers (control rights) rather than actions and decisions
  - Assigment of decision powers affects moral hazard from renegotiation and holdup problems
  - Some control rights assignments have the property of „residualness‟ – they come in whenever the contract says nothing else

# Applications

- Debt finance (Jensen-Meckling, Townsend/Gale-Hellwig, Aghion-Bolton, Hart-Moore)
- Residual Control Rights of Shareholders (Hart)
- Rules for Corporate Takeovers (Grossman-Hart)
- One-Share-One-Vote Rules (Grossman-Hart etc.
- Intermediation and „Delegated Monitoring" (Diamond, Sharpe)
- Runnable Debt as a Disciplining Device (Diamond-Rajan)
- Remuneration Schemes (Holmström-Tirole)
- Allocation of assets to firms (Hart-Moore)

# Contract Theory and Governance

Analytical structure:

- Finite time horizon, usually two or three periods, common knowledge. At the end, remaining assets are paid out.
- At the time of contracting, there is a perfect understanding, in people's minds if not on paper, of what a given contract or system of contracts implies for the development of events along each possible path of the game tree.

# Contract Theory and Governance

- Contracting is Pareto-efficient for the parties involved; one party's payoff is maximized subject to participation and incentive constraints (renegotiation proofness, time consistency) on contractually stipulated behaviours.
- Equivalently, if behaviours are not stipulated in contracts, the implications of contracting for behaviour are foreseen and determine assessments of different contracting alternatives.

# A Real World Example
# Union Bank of Switzerland

- 1975: Introduction of registered shares, with a provision giving management the right to refuse registration of a new shareholder
- 1990: The right of refusal to register a new shareholder is abandoned. Instead, one shareholder or group of shareholder acting in concert may vote more than 5 % of outstanding voting rights.
- 1994: The distinction between registered shares and bearer shares is abolished
- 1997: The bank has itself taken over by SBC.
- 2008: The new UBS is insolvent – but for a government bailout

# A Real World Example: Voting in Union Bank of Switzerland

- By law, proxy voting of banks on behalf of shareholders was in favour of management proposals unless the shareholder gave explicit instructions to the contrary.
- All classes of shares voted together; in 1994 the law professor who had previously written a commentary saying that votes concerning the relative status of different classes of shares would have to be done separately now considered it natural that management's proposal for a single vote should be accepted.
- A large block of registered shares in the bank's own portfolio was sold to Mr. Kirch who voted in favour of management; the sale was accompanied by a futures contract by which the bank bought the stock back for a date nine months later – at the pre-vote price.

# A Real World Example Union Bank of Switzerland

- Voting rights restrictions: In 1995, management wrote to shareholders saying that unanimity in opposition to management was evidence of concerted action and therefore a reason for invoking the 5 % rule.
- Merger: Ostensibly a merger among equals, in fact a takeover by SBC, providing the CEO with an escape from having to explain 650 Mio. CHF of losses in Asian derivatives (A year later, in the wake of the LTCM scandal, he was kicked out anyway)

# What does the example tell us?

- Whereas contract theoretic analyses work in terms of finite time horizons, with payoff on securities in the last period, the corporation enjoys a certain permanence.
- There was a lot of “renegotiation”, much of it about decision powers and control rights, much of it in ways that could hardly have been anticipated.
- All of this “renegotiation” occurred at the initiative of incumbent management, usually in the name of their “social and economic responsibility”, with applause from stakeholders, politicians and the media.
- Incumbency, initiative, and inventiveness as sources of “residual” power – including the effective power to rewrite contracts

# A management-focussed interpretation

## Hellwig (2000, 2001, 2005)

- The power that is provided by incumbency and the ability to invent new initiatives puts management into the driver‛s seat.
- The political and legal systems are willing to help (Proxy voting law in Switzerland, Williams Amendment, Antitakeover Laws, Poison Pill jurisdiction in the US, Takeover Law in Germany)
- Managerial power over company resources is politically more convenient than shareholder interference with company resources (hostility to corporate raiders, hedge funds, etc.)

# Why then the Ascendancy of „Market Discipline"

## A Paradox

- The same years, 1990 – 1995 in the US, that see the ascendancy of „market discipline" are the years in which anti-takeover laws and jurisdiction virtually eliminate the scope für hostile takeovers.
- „Market discipline" works because of managerial submission, not because of shareholder power!
- A hedge fund with 6 % of shares only has power because management pays attention
- Why then the submission of management to „market discipline"?

# Why the Ascendancy of „Market Discipline“

- Changes in Remuneration Structures and Levels
- Jensen-Murphy 1990: No more than 3 % of top management remuneration in the US depends on earnings or stock market valuation
- Complete change in US by 1995
- Contract theory: Incentive payments
- Reality: Remuneration schemes that are used have poor incentive properties

# Why the Ascendancy of „Market Discipline"

- Bebchuk and Fried (2006): „Pay without Performance" – New Remuneration Schemes are a source of managerial enrichment, initiated by management itself
- „Shareholder Value" Rhetoric provides a smoke screen to hide personal enrichment
- „Market Discipline" works because remuneration depends on share prices
- … and this has changed the rules of boardroom discussion!

# Why in the nineties?

- Emancipation of management from local stakeholders?
- Change in tradeoff wealth – power? Mean incumbency period has declined significantly
- Changes in relative factor prices as a result of underlying real changes:
  - „globalization" (Asia) the opening of Eastern Europe favour capital relative to labour and the public sector;
  - the electronic revolution favours capital and high-skilled labour relative to low-skilled labour;
  - the increase in pension saving …(?)

# Why the Ascendancy of „Market Discipline"

## Why in the nineties?

- Opportunities and Needs for Restructuring as part of a process of structural change
- … driven by the computer as a general purpose technology (Philippon 2008)?
- … or simply by geriatrification of old industries (US oil industry in the eighties)?
- … would also explain the vastly increased role of banking (corporate finance, lending, m&a) in the economy

# Does it Matter? Challenges for Economic Theory

- Need to distinguish between descriptive and normative concerns.
- Outrage about management usurpation of powers must not lead us to neglect the underlying forces and processes at work.

# Challenges for Descriptive Analysis

- Institutional arrangements are the result of evolution rather than contracting
  - What structures are favored by evolution? What structures are ephemeral?
  - What is the role of fraud (the „residual power to embezzle“) in evolution?
- Commitment technologies as a major factor
  - Shareholder rights
  - Funding structures – leverage ratchet effect (Admati et al.)
  - Observational implications?

# Challenges for Descriptive Analysis

- Choices are not based on backward induction
  - How can we think about such choices with some intellectual discipline?
- Open-endedness of the time horizon of the institution (permanence) as key element.
  - What theory do we have for funding by dispersed outside shareholders? What rights and what powers do they have?

# Implications for Investment Allocations

- Shleifer et al.: Too much management power would induce financiers leads to a scarcity of investment in the economy.
- Counterargument : Corporate managers with discretion over large sums of money can finance a lot of investment. In fact, most investment finance in the economy comes from internal funds. Myers-Majluf!
- The problem is less one of an excessive scarcity of investment finance and more a problem of matching available funds and available investment opportunities.
- Jensen's free cash flow argument is flawed: If management has discretion over payouts, it can be seen as a residual claimant!?

# Implications for Investment Allocations

## Chandler (1990):

- Personal capitalism (power of large shareholders) in the UK was responsible for the UK's missing out on the second industrial revolution 1870 – 1930.
- The success of US and German corporations in this period was based on the ability and willingness of incumbent management to commit large resources to investment in technologies involving significant economies of scale and scope
- Philippon has similar results for the fifties and sixties

# Normative Concerns

- "Market discipline" enforcing significant cash payouts with subsequent reinvestment through markets seem to have played a major role in financing IT and biotech firms in the US. Structural change through the new "crazies"
- German relative backwardness in these sectors seem to be related to the weakness of such payout/reinvest mechanisms and the failure/unwillingness of incumbent managements in large chemical/pharmaceutical and electronics corporations to recognize revolutionary developments involving basic changes of paradigms.

  Structural change through the old "dodos" does not work

# The role of *permanence*:

- From the perspective of Shleifer et al., the power of incumbent management is a problem. The effective power to influence retentions and the uses to which retentions are put is seen as an expropriation and a disenfranchisement of shareholders ("owners").
- In contrast, Blair and Stout (2007) argue that in the US itself, the corporation developed as a device to remedy problems of excessive owner power in traditional partnerships.
- Blair (2004): the public corporation was invented to *eliminate* ownership powers of shareholders

# The role of permanence

- According to this account, the power to withdraw one’s shares and the resources to which these shares at will put the other partners and stakeholders at excessive risks, either of hold-ups or of destruction of the venture.
- In this view, the corporation provides a mechanism of commitment that partners will not exercise ownership rights against the venture’s assets. Their need for liquidity of their assets is satisfied by the ability to sell shares. Permanence of the institution is not the result of expropriation and disenfranchisement, but is the very raison d’être of the institution.

# Mechanisms of governance

- Contracts, Laws, Voice
- Debt holders have well defined (?) legal claims, shareholders do not
- Debt holders and shareholders have different claims to voice
- Workers? Other stakeholders?
- Statutory regulation as part of the *ordre public*.
- Biased in favour of incombents

# The Politics of Corporate Governance

- Bias in favour of incumbents reflects not only simple political forces but also the power of the incumbents.
- Uncontrolled power over large resources poses a risk for social and political systems
- How much power of this sort can a society tolerate without running the risk that basic decision and communication systems in politics, the judicial system and the media are corrupted?