The Allocation of Corporate Power between Shareholders and Managers

Institutional Investor Activism and Engagement

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Essence of a Dynamic Market Economy

- Resources over time are transferred to higher valued uses

- Private property achieves this through the collocation of decision rights and wealth effects
  - Owners have residual decision rights and they also have the exclusive right to any residual cash flows

- Corporations present a challenge:
    - Shareholders are the residual claimants, but there are too many of them to make many decisions
        - Collective action problems; coordination problems

- Solution: Shareholders delegate some but not all decision rights to a board of directors who they elect; the board selects and monitors the top officers (especially the CEO)

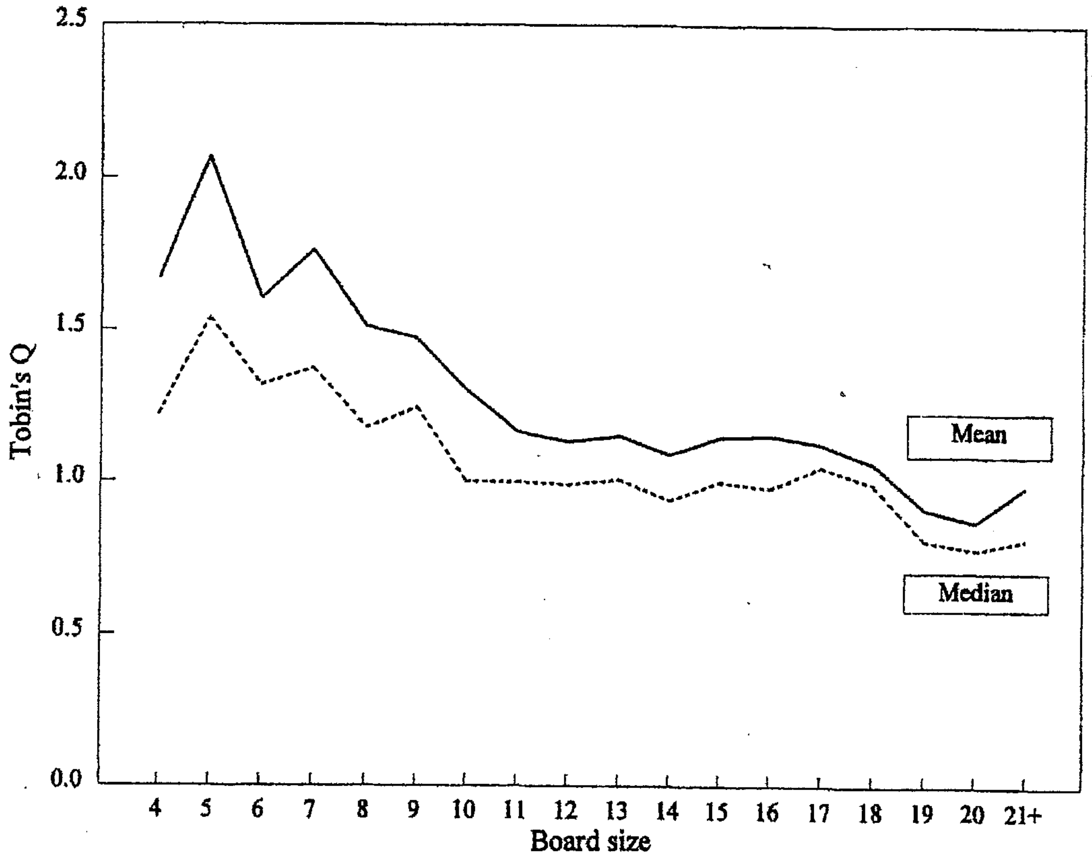
- Two unusual facets of corporations:
    - A <u>governance structure</u> for decision making shared among shareholders, board of directors, and managers.
    - Extensive but never total <u>delegation of decision rights</u> from shareholders to managers

Governance Structure

Corporate Architecture Choices (examples):

- Single or Dual Class Common Stock?
- Separate Chair and CEO?
- Size of Board of Directors?

Market Valuation and Size of Board of Directors



David Yermack, Higher Market Valuation of Companies with a Smaller Board of Directors, *Journal of Financial Economics* (1996).

Shareholder Retention of Key Decision Rights

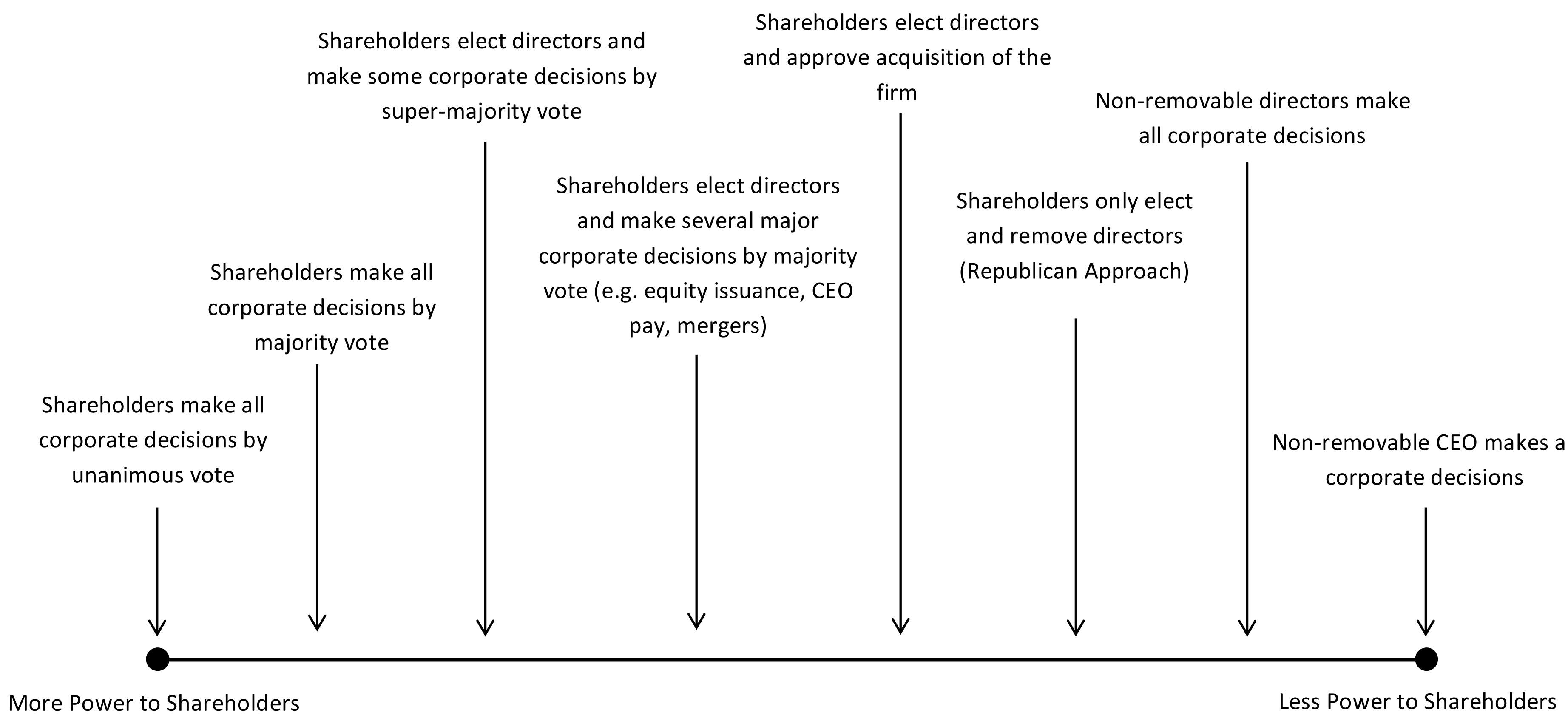
- Pure Republican Approach
    - Shareholders only elect directors

- Bidding Firm Shareholder Approval of Acquisitions

- Shareholder Approval of Equity Issuances

Figure 1

Allocation of Decision Rights between Shareholders and Managers



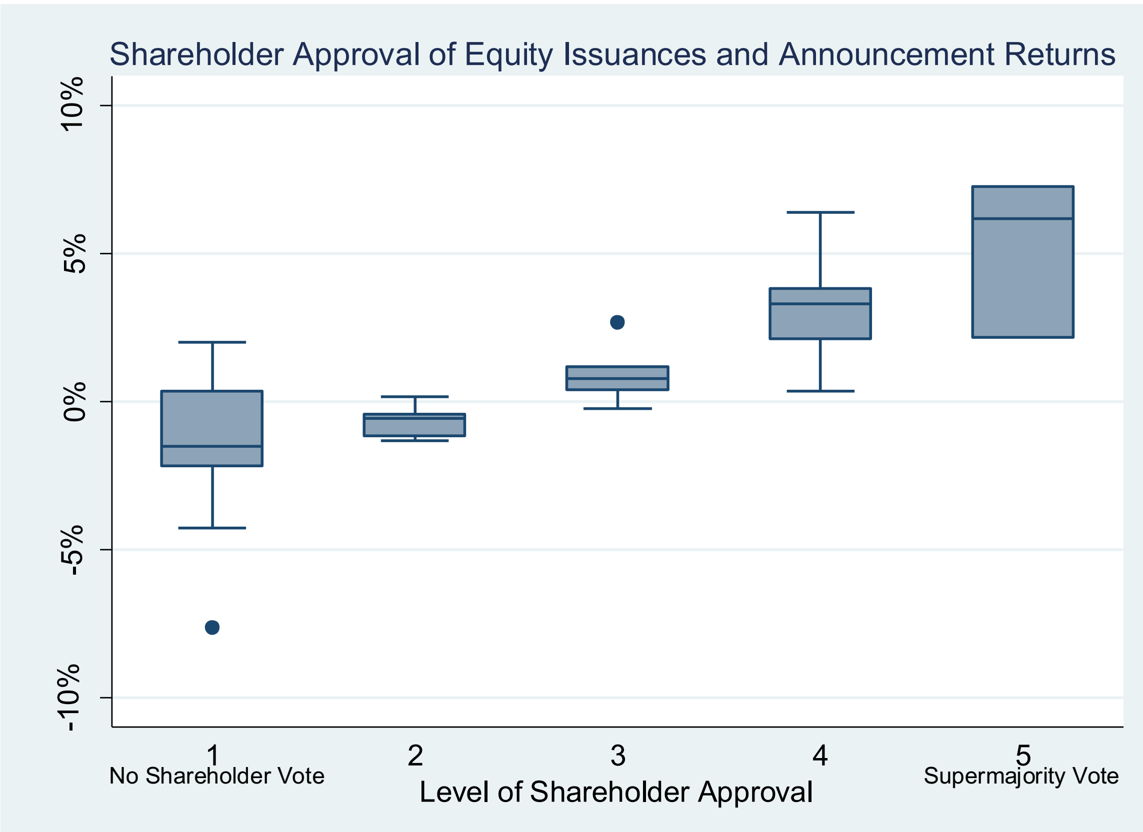
Bidding Firm Shareholder Approval of Acquisitions

Marco Becht, Andrea Polo, and Stefano Rossi, Does Mandatory Shareholder Voting Prevent Bad Acquisitions? *Review of Financial Studies (*2016).

Shareholder Approval of Equity Issuances

- When shareholders around the world vote to approve equity issuances, average announcement return is positive (2%).
  - When managers unilaterally issue equity, average announcement return is negative (–2%).
- When shareholder approval required, rights offers are used instead of public offers (90/10).
  - Managers make the opposite choice (10/90).
- Managers try to avoid shareholder votes.

Shareholder Approval of Equity Issuances and Announcement Returns



Clifford G. Holderness, Equity Issuances and Agency Costs: The Telling Story of Shareholder Approval around the World, *Journal of Financial Economics* (forthcoming).

Announcement Returns and Shareholder Approval by Issue Method

	Level of Shareholder Approval	Abnormal Returns
Public Offerings		
Hong Kong	4	3.14%
Taiwan	4	1.74%
United Kingdom	3	1.19%
Netherlands	2	-0.41%
Japan	1	-1.17%
France	2	-1.18%
Canada	1	-2.04%
United States	1	-2.22%
Israel	1	-4.26%

Announcement Returns and Shareholder Approval by Country

	Shareholder Vote	Abnormal Returns
United States		
Private Placements Shareholder Approved	4	2.87%
Private Placements Not Shareholder Approved	1	0.13%
Rights	1	-1.23%
Public Offerings	1	-2.22%
Hong Kong		
Private Placements	4	6.20%
Public Offerings	4	3.14%
Rights	1	-9.25%
Sweden		
Private Placements to Insiders	90% Vote	11.67%
Other Private Placements	66% Vote	5.10%
Rights	50% Vote	0.37%

Contractual Theory of the Firm

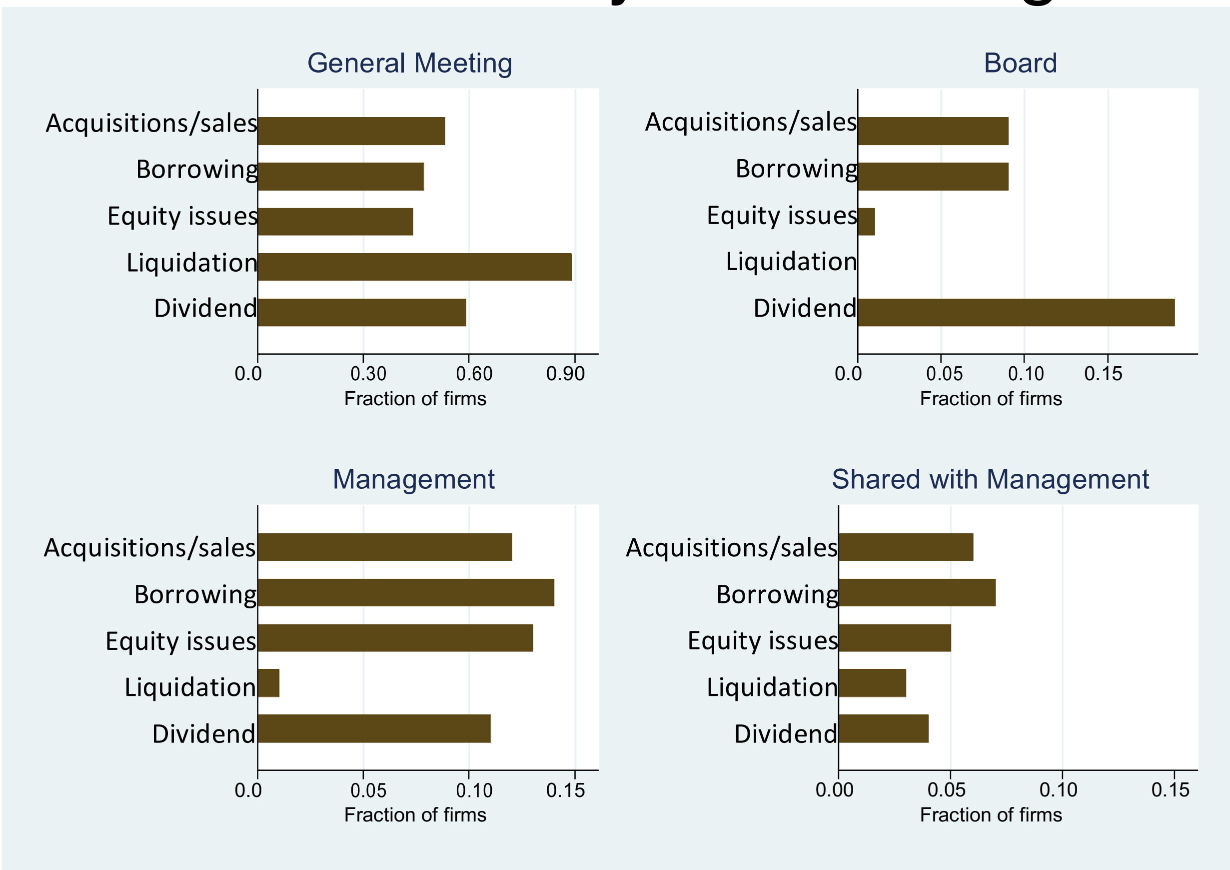
- Shareholders will contract amongst themselves to arrive at that governance structure and allocation of decision rights that maximizes firm value
    - Easterbrook & Fischel (1991)
        - Darwin, Alchian, Coase

- Expect to see diversity in corporate charters and bylaws

- Analogy: How much work do you do on your kitchen before you sell your house?

Norway circa 1900

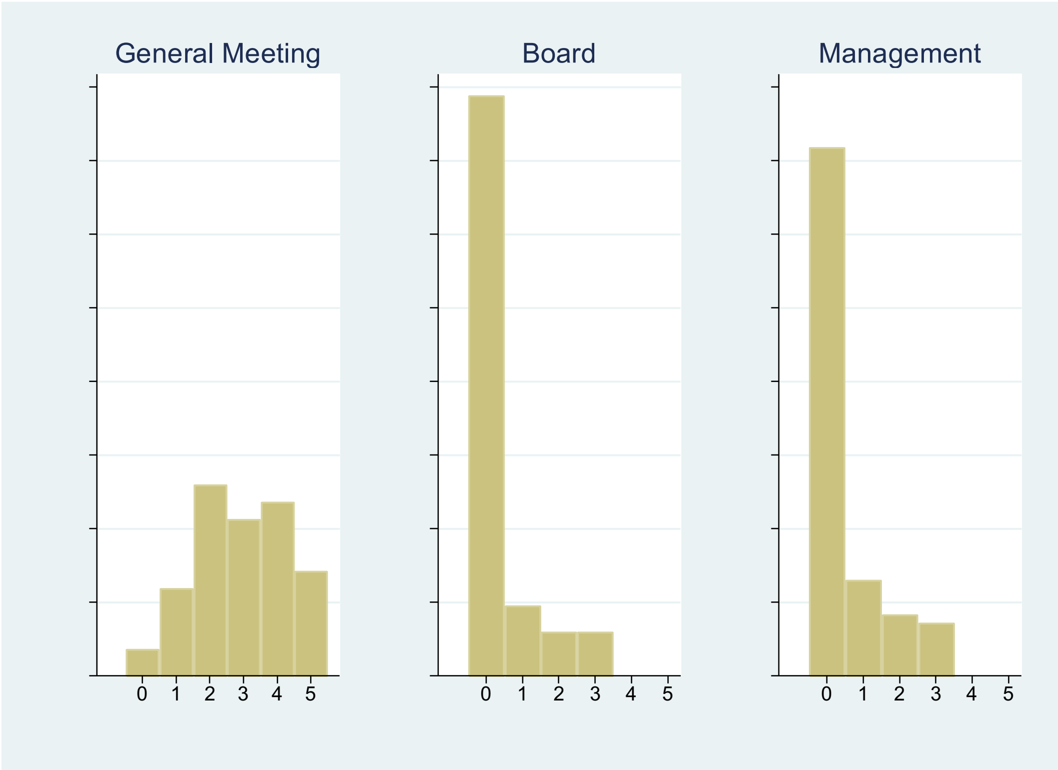
Allocation of Key Decision Rights



Mike Burkart, Salvatore Miglietta, and Charlotte Ostergaard, Why do Boards Exist? Governance Design in the Absence of Corporate Law, unpublished working paper.

Norway circa 1900

Allocation of Key Decision Rights



Great Britain circa 1850-1900

- Substantial variety in articles of association of Victorian British public companies (Acheson et al 2016)
  - Companies voluntarily supplied many of protections that British corporate law would not supply for 100 years
  - Authors did not examine the allocation of decision rights between shareholders and managers

Today—A Different Story

- IPOs in the United States
  - IPO stage is where we should see the most customization
  - Firms seldom customize their charters or bylaws (Klausner 2013)
    - Only exception is staggered boards which most think reduce firm value
  - Instead, intense focus by investors on pre-IPO revenues
    - Trend toward giving a blank check to managers in some IPOs (Snap, Google, Facebook)

- Charter amendments for mature firms
    - Historically, very few changes and little variety
    - Post 2005: More activity due to changes in SEC Regulations
        - Elimination supermajority voting
        - Declassification of board
        - Voting in uncontested director elections
        - Shareholders' right to call special meeting
        - Relaxation or elimination of state anti-takeover statutes

Institutional Shareholders U.S.

- Relatively little apparent interest by institutional investors (particularly in the U.S.) on the allocation of decision rights between shareholders and managers

    - "The number of shareholder proposals submitted on social and environmental issues continued to increase from 2007 levels despite the decline observed in other subjects." (Conference Board)

Why so Little Variation in Allocation of Corporate Power?

- Freedom of contract is limited?

- Allocation of corporate power doesn't matter?
  - Substitution by market for corporate control and product market competition?
  - How to explain emerging results with shareholder voting?

- All firms are basically the same; should not expect variation?

- Large shareholders asleep at the switch?
  - "American institutional investors act like investors. European institutional investors act like owners."

Why is Allocation of Decision Rights Important?

If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls on government would be necessary. (James Madison, Federalist No. 51.)

Enlightened statesmen will not always be at the helm. (James Madison, Federalist No. 10.)

Nothing can be more fallacious than to infer the extent of any power proper to be lodged in the national government from an estimate of its immediate necessities. (Alexander Hamilton, Federalist No. 34.)

Summary

- Investors and academics should pay more attention to the allocation of decision rights between shareholders and managers
- Evolution applies to corporate governance
- One size does not fit all
- Lots of unanswered questions
- Lots of fundamental corporate change ahead?