



# *Corporate* **Governance**

**Accountability, Enterprise and  
International Comparisons**

EDITED BY KEVIN KEASEY,  
STEVE THOMPSON, MICHAEL WRIGHT

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Edited by

**Kevin Keasey**  
**Steve Thompson**  
and  
**Mike Wright**



John Wiley & Sons, Ltd



# Corporate Governance



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**Kevin Keasey**  
**Steve Thompson**  
and  
**Mike Wright**



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# Introduction

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Kevin Keasey, Steve Thompson and Mike Wright

## INTRODUCTION

*Corporate governance*, a term that scarcely existed before the 1990s, is now universally invoked wherever business and finance are discussed.<sup>1</sup> The subject has spawned consultancies, academic degrees, encyclopaedias, innumerable articles, conferences and speeches. Almost all the OECD nations are currently revising their corporate governance practices or have recently done so (OECD, 2003), while the establishment of a viable corporate governance system has become a priority objective for emergent economies from Latin America to China. In the midst of so much interest, the underlying issues of the subject are always in danger of being swamped. Moreover, since 'good governance', like 'fair trade' and 'free competition', is an abstraction that commands near-universal respect but diverse interpretation, it has also become the destination board for a bandwagon carrying those who would, in fact, take the corporation in myriad directions.

Not merely does the term corporate governance carry different interpretations, its analysis also involves diverse disciplines and approaches. For example, the behaviour of senior managers is variously constrained by legal, regulatory, financial, economic, social, psychological and political mechanisms which are themselves sometimes substitutes and sometimes complements. Academic researchers, predominantly coming from a single subject background, will typically explore the operation of merely a subset of these and then in the context of the priorities of their own discipline. This inevitably means that research on the subject becomes Balkanised and less accessible.

The quantity and variety of material being produced on corporate governance has forced us to be selective in compiling this volume. The book aims to bring together scholars from a variety of backgrounds, particularly accounting and finance, economics and management, to present a series of overviews of recent research on issues within corporate governance and on governance developments within particular countries and institutional regimes. Coverage of the subject has inevitably involved a trade-off between breadth and depth, and in largely restricting ourselves to these business disciplines we have been mindful of the need for coherence. This is not to say that other perspectives, perhaps drawing upon social sciences including politics and sociology, would not have a valid contribution.

Since corporate governance carries such a wide variety of interpretations, it seems appropriate to begin by setting out the approach generally adopted in the volume. Here it is assumed that an effective system of corporate governance has two requirements, one micro and one macro: at the micro level it needs to ensure that the firm, as a productive organisation, functions in pursuit of its objectives. Thus if we follow the traditional Anglo-American conception of the firm as a device to further the well-being of its owner–shareholders, good governance is a matter of ensuring that decisions are taken and implemented in pursuit of shareholder value. Importantly, this involves actions that reconcile the need to protect the downside risk to shareholders (that is, accountability of managers) as well as to encourage managers to take risks to increase shareholder value (that is, encourage managers to act entrepreneurially (Keasey and Wright, 1993)). If the purpose of the firm is modified, perhaps to accommodate the interests of other ‘stakeholders’, including employees, suppliers etc., the objective changes but the need for mechanisms to further this objective does not.

At the macro level corporate governance, in the words of Federal Reserve Chairman Alan Greenspan: ‘has evolved to more effectively promote the allocation of the nation’s savings to its most productive use’.<sup>2</sup> Thus in financing corporate activity, whether through equity or debt, savings are channelled into productive activities, the return on which ultimately determines national prosperity. The recent US experience with Enron, WorldCom and other failures is a reminder that if failures at the firm level are sufficiently serious and/or widespread, there will be a misallocation of funds in the short term and systemic consequences for longer-term investment if confidence is damaged.<sup>3</sup> Similarly, a major problem for transition economies has been to create governance systems which engender sufficient trust to allow private savers to supply local entrepreneurs with their funds.<sup>4</sup>

## ALTERNATIVE PERSPECTIVES ON CORPORATE GOVERNANCE

Whether success at the micro and macro levels is separable is itself very much part of the debate. It reflects, in particular, the individual’s perception of the nature of governance and the degree of confidence held in the efficiency and effectiveness of financial markets. We might broadly distinguish four perspectives in the governance debate: the *principal–agent* or *finance* perspective, the *myopic market* view, the *stakeholder view* and the *abuse of executive power* critique.<sup>5</sup>

Those approaching corporate governance issues from a *principal–agent* or *finance* perspective, following Jensen and Meckling (1976), see governance arrangements, including the apparatus of non-executive directors, shareholder voting etc., as devices that the suppliers of finance require to protect their interests in a world of imperfectly verifiable actions. Jensen and Meckling (1976) consider the case of a 100% owner–manager considering the sale of an equity interest to outsiders. As the original owner’s share falls, so does the incentive to exert effort to generate shareholder wealth. In the absence of any controls on the owner–manager’s anticipated post-float behaviour, the issue price of outside equity would fall to reflect the corresponding threat to shareholder wealth. Therefore, with full anticipation of the consequences of the manager–shareholder relationship the total *ex ante* cost falls on the would-be issuer of outside equity, that is, the owner–manager. This generates a corresponding incentive to introduce devices to control and monitor managerial behaviour – that is,

to establish corporate governance arrangements – at least up to the point where the marginal cost of so doing equals the marginal benefit. On such a view, an efficient capital market will generate effective governance arrangements without the need for external intervention.

It follows that those adopting this principal–agent perspective tend to see unrestricted capital and managerial labour (Fama, 1980) markets as the most effective checks on executive malperformance. On such a view, well-functioning capital markets will tend to solve both the micro-level governance problem and, by directing funds to the use of those managers that appear to offer the best risk–return combinations, ensure compatibility with the macro-level objective of efficient funds allocation.

Conversely, those who view the capital market as fundamentally flawed and *myopic* in its concern for short-term returns, argue that purely private bargaining between a firm’s owners and the supplier of funds will not produce effective governance. On this view, a myopic stock market encourages managers to underinvest in long-term projects. Effectively a higher cost of capital is applied than is strictly economically justifiable, thus screening out many longer-term investments. This problem is intensified in environments where a hostile takeover threat – see below – further restricts managerial discretion.

Adherents to the *myopic market* position unlike, say, supporters of the *stakeholder* view do not necessarily question shareholder value maximisation as an objective. What they do conclude, however, is that in the presence of a myopic capital market there is likely to be a macro failure of corporate governance in that there will be systematic distortions of investment in the economy to the detriment of long-run growth. On such a view insulating managers from stock market pressures will also benefit shareholders in the longer term. Thus some myopic market critics would endorse the involvement of other stakeholders – for example, employees – in governance not necessarily to further the interests of the latter themselves, but where these might have interests that favoured long-term projects.<sup>6</sup>

Proponents of the *stakeholder* perspective contend that the traditional Anglo-American view of the firm’s objectives is too narrow and that it should be extended to embrace the interests of other groups associated with the firm, including employees, community groups etc. These stakeholders are considered to have interests that depend, in part, on the continuing development of the firm. Therefore, a governance process that offers no explicit voice to such groups is unlikely to take sufficient account of their interests. On this view, it is the firm objective of unalloyed shareholder value-maximisation that leads primarily to a micro failure of governance arrangements.

Finally, there is a view that corporate governance reforms should be used to restrict, if not prevent, the pathologies that arise from the *abuse of executive power*. Supporters of such a position may variously hold to shareholder value or stakeholder interests as the optimal objective for the firm, but they suggest that the pursuit of any such objective may be flawed if dysfunctional behaviour by senior executives emerges. On such a view executives may be able to exploit situations that were simply unanticipated or even inconceivable at the time of share flotation. Governance arrangements can be created to reflect principles of transparency, representation and a division of responsibility, but there will be a need for a periodic reform of procedures to reflect evolving circumstances in the firms themselves. While the misuse of power by the CEO of firm A is primarily a micro failing, perhaps hurting firm A’s shareholders, bondholders, pensioners or employees, if the As are too big or too numerous the problem develops into a systemic macro one.



## BACKGROUND TO CORPORATE GOVERNANCE REFORM

In the early 1990s much of the debate on corporate governance concerned the alleged weaknesses of the Anglo-American corporate form (see Charkham, 1994). In economies such as the USA and UK, with liquid stock markets in which the overwhelming proportion of shares were held by financial institutions, it was widely assumed that monitoring of managers would be deficient. Shareholders, whose investments were held in diversified portfolios, were considered to have weak incentives to involve themselves in information collection and participation in company AGMs etc. Here the dominant strategy for individually dissatisfied investors was to utilise the opportunities generated by a liquid stock market and exit. In the face of diffused shareholder power the divorce of ownership from control, long ago identified by Berle and Means (1932), was assumed to be the norm. Managers thus had considerable discretion to further their own interests in ways that included diverting cashflow to preferred investments, often involving unnecessary diversification or the undertaking of entrenching activities, and in giving themselves overly generous salary and bonus rewards.

While the takeover threat was always present for underperformers – and probably remained quite potent for the more egregious examples – the takeover is a blunt and costly instrument and the probability of being acquired falls with size. Indeed critics pointed to the high apparent failure rate among takeovers to suggest that the market for corporate control was as much a part of the problem of inadequate monitoring as it was a solution.<sup>7</sup> Value-destroying mergers were interpreted as evidence of managers furthering their own aspirations for growth at the expense of the shareholders. Furthermore, in the UK at least, a series of high-profile corporate failures involving the apparent misuse of executive power by domineering CEOs such as Robert Maxwell and Asil Nadir pointed to the absence of effective checks and balances.

Nor did the Anglo-American corporate form escape criticism at the macro level. It was widely noted by its supporters and critics alike that executives were ultimately constrained by the ease of shareholder *exit*, employing the term of Hirschman (1970). Dissatisfied shareholders would sell and if they did so in sufficiently large numbers the share price would fall and the firm's assets would ultimately become attractive to some rival group of managers who would thus bid for them, perhaps via a hostile takeover. Supporters saw this 'market for corporate control' (Manne, 1965) as a key check on managerial malfeasance or incompetence. Critics complained it engendered perverse incentives. They pointed out that even a poorly performing target firm's shareholders could usually expect some recompense for past underperformance via a bid premium, thus further eroding their incentives to participate in the monitoring of management. The principal losers appeared to be the target's senior management, many of whom would lose their jobs. Critics (for example, Charkham (1994)) argued that such a fear, coupled with perceived myopia in the capital market, encouraged a short-termist attitude in the Anglo-American corporate form. This was contrasted with lending-based systems such as those in Japan and Germany, countries where stakeholder representation is also more pronounced and where finance is typically supplied by a bank in a long-term relationship with its client firm.

Thus it was argued that in firms financed by debt and/or retained profits managers could afford to take a longer-term perspective and invest in physical and human capital without day-to-day concerns about the consequences of share price falls. While this short-termist charge remained highly contentious, not least because it implied serious capital market inefficiency,<sup>8</sup>

it became quite influential. This was not least because its supporters could point to the superior performance of the German and Japanese economies in the 1970s and 1980s, in comparison to the sluggish growth in the US and UK.

## GOVERNANCE REFORMS: THE EARLY DAYS

The modern process of corporate governance reform can be said to have started in the UK with the establishment of the Cadbury Committee (on the *Financial Aspects of Corporate Governance*) in 1991. It was set up in response to three inter-related areas of concern in the existing arrangements: first were anxieties over the use of ‘creative accounting’ devices, which were believed to be obfuscating the calculation of shareholder value (Whittington, 1993). Second were concerns over a string of corporate failures, particularly those associated with high-profile, domineering CEOs who were apparently able to conceal financial weaknesses through the opacity of their control mechanisms. Finally, there was a growing public unease over the rapid growth of executive remuneration, especially an apparent failure to relate increases more strongly to firm performance (Keasey and Wright, 1993).

Cadbury’s recommendations, which are explored in detail by Keasey, Short and Wright in Chapter 2, centred on ways to increase the accountability of executives. Thus the Committee proposed a series of reforms designed to decentralise power within the firm and to increase the role and independence of non-executive directors in the monitoring of executives. These included the splitting of the functions of chair and CEO and the establishment of a series of main board committees, to be dominated by non-executives, which would take responsibility for organising the audit function, executive remuneration and the nomination of future non-executive directors.

In the UK and elsewhere Cadbury has been followed by further moves to strengthen the indirect *voice* of shareholders by enhancing further the role and independence of non-executives. There is a growing realisation that independence is compromised where directors remain in-post for too long, spend too little time on their duties to understand the complexities of their firm’s activities or where the executives remain in de facto control of non-executive appointments. Thus successive corporate governance reviews have introduced limited terms of appointment (Greenbury, 1995), redefined responsibilities and suggested still more independent recruitment procedures (Higgs, 2003).

Executive pay arrangements offer a particularly interesting proving ground for corporate governance reforms. From Cadbury onwards, successive reformers have tried to increase the transparency of the pay-setting process, distance it from the influence of affected executives while generally looking for a pay determination process which strengthens the link between rewards and corporate performance. However, they have also had to accept that executive pay remains a market price, determined by a managerial labour market where companies are in competition for scarce talent. Therefore, harsh restrictions on the permissible provisions of a managerial contract could restrict a company’s ability to hire international talent.

In institutional terms, Cadbury established the principle of a non-executive director-dominated remuneration committee, which would have access to outside pay consultants and be accountable to the shareholders’ AGM. However, executive rewards continued to increase post-Cadbury,<sup>9</sup> often spectacularly. In the mid-1990s this was driven by option gains. The use of executive share options had spread from the US, to the UK and beyond in the 1980s.

This development was widely seen by contemporaries as a governance improvement in that options directly tie the rewards of the manager to the well-being of the shareholders and hence more closely align the interests of principal and agent.<sup>10</sup> However, the bull market of the mid-1990s generated option gains for all, even those whose companies did not appear to be particularly successful. In the UK, particular media wrath was heaped on the ‘fat cat’ directors of newly privatised utilities, for example regional water distributors, who were seen to enjoy a very substantial growth in rewards over this period. These companies’ share price growth did not appear to be indicative of especially good entrepreneurial management. Their primary activity was scarcely competitive: each was a monopoly supplier of an essential commodity at a generously regulated price and their newer activities were often wildly unsuccessful diversifications purchased with the shareholders’ money.

Thus in the UK at least executive stock options were widely seen as insufficiently discriminating between well-run and mediocre firms. In a bull market almost everyone benefited; while in a bear market options would soon become overpriced (‘out of the money’ or ‘underwater’) and irrelevant and need to be replaced by new option grants with a more generous strike price. Following another report (by Greenbury (1995)) the emphasis was moved to long-term incentive plans (LTIPs) under which grants of shares (and/or cash) typically depend upon the benchmarking of the firm’s performance against that of a sample of rivals over time. LTIPs were soon adopted and substantially displaced options. However, early attempts to assess the effectiveness of LTIPs in aligning executive rewards more closely to firm performance (see Bruce and Buck, Chapter 6) suggest they have been largely unsuccessful.

In the US, where stock options have long been a major element of executive remuneration, concern has been less with the level of option gains but rather with the size of option grants. These anxieties intensified after the Enron debacle where, in 2000 immediately prior to the corporation’s collapse, it emerged that executive option grants covered some 96m shares, or 13% of common shares outstanding. This gave rise to two major concerns: first, that options were not being clearly expensed in the firm’s accounts and hence that they were made to appear to be a costless way of remunerating managers, rather than a dilution of shareholders’ equity. Second, it emerged in the Enron case that very large tranches of option grants may encourage earnings manipulation. It became apparent that the senior executives had strong incentives to ramp up the share price prior to the exercise date for these major blocks of options. The Sarbanes-Oxley Act (2002) has directly addressed both issues.<sup>11</sup>

The corollary of paying for success is not rewarding failure. In addition to finding a satisfactory way of encouraging managers to boost firm performance, corporate governance reformers have been concerned to reduce the pay-offs to sacked managers. In the early 1990s pressure for reform came from institutional investors under the leadership of Hermes Asset Management which wrote to the FTSE 100 announcing its intention to vote against the then typical three- year rolling contracts for executives. These contracts had the effect of ensuring that any sacking was likely to involve extensive compensation. Greenbury (1995) endorsed these concerns and recommended that directors’ notice should not exceed one-year rolling. PIRC (2003) reports that the ‘immediate effect’ of the post-Greenbury best practice guidelines, supported by institutional lobbying, was a reduction in the length of the typical executive contract to two years. The DTI green paper recently reported that notice periods have continued to fall such that by 2002 some 80% of FTSE 350 executives were on a one-year rolling contract.

A reduction in the notice period clearly has the effect of lowering the severance pay-off. However, there remains an issue about what compensation is appropriate for fired executives,

some of whom will be losing jobs which may prove difficult to replace, for reasons beyond their control. Two alternative approaches exist for determining compensation. Under a *liquidated damages* arrangement the contract specifies a formula detailing compensation in the event of termination by the company. By contrast, *mitigation* involves reducing severance pay in recognition of the outgoing manager's opportunities for earnings *prior* to the completion of notice and, more controversially, in recognition of any poor performance suffered by shareholders. Penalising failed managers strictly requires the use of mitigation, but appointing risk-averse individuals to senior positions usually requires a contract that details compensation in the event of termination and proving managerial failure in a court or employment tribunal is difficult and costly. So reducing the rewards for failure has proved no less difficult for corporate governance reformers than linking rewards to success.

In matters of executive remuneration, as with other aspects of corporate governance, much of the effort of reform has gone into the establishment of structures and procedures intended to function on the shareholders' behalf. However, there are indications that increasing the direct voice of shareholders may be at least as effective. It was noted above that the initial pressure for a reduction in the duration of management contracts, to facilitate the easier removal of underperforming incumbents, came from institutional investors. Since early 2003 shareholders in the UK have been required to approve the remuneration committee report, detailing the remuneration packages of executive board members. The early results are indicative of high levels of institutional participation, especially where generous liquidated damage provisions are incorporated in the CEO package. Institutions have been traditionally viewed as unwilling to withhold support for the current board except where corporate performance is seriously defective. By contrast, the early votes on remuneration have shown a surprisingly high level of opposition, with at least one high-profile package being rejected.<sup>12</sup>

## NEW PERSPECTIVES FROM THE 1990s

Much of the process of corporate reform in the Anglo-American system has been concerned with protecting the interests of outside shareholders whose diffuse holdings and reluctance to become involved in monitoring leave them vulnerable to self-serving behaviour by executives. In the 1990s interest in corporate governance issues spread to other corporate systems. If the agency problems of the Anglo-American firm stem from maturity and capital market development – that is, they generally arise when the equity holdings of the founding families have become diluted as ownership is dispersed and market liquidity permits easy exit – the problems encountered elsewhere are frequently those of immaturity and capital market underdevelopment.

The transition economies of Central and Eastern Europe faced a governance problem in the need to provide protection for minority shareholders. If outside equity was to be subscribed, the potential investors needed to have confidence that the managers of the firm would not misappropriate corporate assets. In the general absence of such confidence equity was perceived to be unattractive and priced accordingly. In 1995 Shleifer (1997) estimated that the lack of an appropriate governance system in Russia left Russian private industry valued at under 5% of the level it would have reached under western governance arrangements. The consequences of such an undervaluation included both severe underinvestment in the emergent private economy and the widespread transfer of assets at unrealistic prices. Each of these had serious implications for the longer term.

The financial crises of 1997–98 threatened countries in Asia and beyond that had become accustomed to unprecedented growth. After years of double digit growth, economies such as Malaysia, Thailand, Singapore, Korea etc. suffered a severe shock as output fell and instability threatened the corporate sector. Companies that had financed very rapid growth with high debt obligations found these difficult to sustain in more straightened times. Furthermore, the problem had systemic implications as corporate failure brought unpaid trade creditors who themselves were pushed into failure and debtholders, including the principal banks, who were left looking at unserviced loans. That such financial contagion occurred so easily has been attributed to both balance sheet weaknesses and a governance system that left huge discretion in the hands of senior executives. The latter could finance preferred growth from compliant banks with minimal accountability to shareholders.

The third major change to the debate has been the change in the position of the Japanese and German economies, whose economic growth record could be said to have gone from ‘hero to zero’ over the period. In each case, the very absence of shareholder pressure that was considered advantageous in insulating managers from the risks of short-termism is now widely seen as contributing to a reluctance to restructure. Low growth is at least partially attributed to a system that protects managers from the need to exit from declining sectors. Close bank–company relationships that were once seen as the foundation of security are now blamed for scandals, corporate indebtedness and a financial system that is burdened with bad loans.

The result has been a convergence of Japanese and Anglo-American systems, if not in the direction envisaged a decade ago. Since 2003 larger Japanese firms can opt for a US-style governance system and almost one half has done so. Shareholder activism, both institutional and private, has increased sharply with some pension funds taking the previously unthinkable step of publicly exercising their votes against the incumbent managers. Since 1999, Yoshiaki Murakami, a former MITI official, has run M&A Consulting as a hostile takeover specialist,<sup>13</sup> in a complete reversal of the country’s former corporatist tradition. In addition, restructuring activities typically associated with Anglo-American systems, notably leveraged management buy-outs, have also become a significant feature of the Japanese context (Wright *et al.*, 2003).

A similar shift is apparent in Germany. Close bank–client relationships, underpinned by cross shareholdings, bank stewardship of proxy holdings and bank representation on the supervisory boards, have come under attack. Banks are moving away from long-term shareholdings and looking to develop their more entrepreneurial investment banking arms. Shareholder voice has been extended in numerous ways, together with the rights and responsibilities of the supervisory boards. Moreover, in an echo of earlier UK reforms the appointment, tenure, and accountability of non-executive supervisory board members have been reformed with the intention of sharpening their scrutiny of the operating board.<sup>14</sup> In both Japan and Germany, institutional and cultural factors, however, continue to constrain the wholesale shift to an Anglo-American system. In general, these institutional and cultural influences pose major questions for the diffusion and adoption of corporate governance mechanisms in different countries.

## **THE VOLUME’S CONTENTS**

Reflecting the issues outlined in this Introduction, the chapters in this volume are essentially divided into three parts. The first part covering Chapters 2 to 7 reflects the development of the various aspects of corporate governance mechanisms, that is to say the development of corporate governance codes, the role of ownership, institutional shareholders, boards of directors

and executive remuneration. The second part covering Chapters 8 to 10 deals with alternative arrangements to traditional internal governance mechanisms, notably the role of the market for corporate control, the role of (entrepreneurial) leadership in conjunction with corporate governance mechanisms, and newer active forms of governance notably those involved in venture capital firms and management buy-outs. The third part (Chapters 11 to 17) considers corporate governance in different institutional environments, both in general and specifically in respect of Germany, Japan, France and transition economies.

Keasey, Short and Wright (Chapter 2) chart the development of corporate governance policy in the UK between the formation of the Cadbury Committee and the publication of the first Combined Code in 1998, and then between the publication of the first and second Combined Code in 2003 and to the present day. They provide an overview of the changing approach to governance policy which has occurred since the publication of Cadbury Report (1992) and consider how current government initiatives towards greater legislation may risk harming the balance between accountability and business prosperity. They show that the developments in policy from the Cadbury Report to the Combined Code 1998 represented a shift from a narrow approach which focused mainly on accountability, to a more balanced one that recognised the need for governance systems to produce structures and incentives to allow business enterprise to flourish. However, they go on to observe that recent government initiatives provide a signal that governance policy in the UK may be about to undergo a fundamental change away from self-regulation. They caution that while a self-regulatory system has previously been criticised for failing to deliver improved corporate governance standards, there is a danger that increased regulation will simply lead to more 'box-ticking' by both companies and shareholders. Furthermore, they suggest that greater emphasis on legislation risks forcing particular governance structures on all companies, regardless of whether they are suitable for the particular circumstances of the firm. A legislative approach risks changing the 'comply or explain' ethos developed hitherto into a 'comply or else' stance which is likely to result in companies adopting suboptimal governance structures simply to avoid the threat of sanctions from failing to comply. They note that it is important to remember that while corporate governance has come to embrace those mechanisms and structures which act as a check on managerial self-serving behaviour, the purpose of doing so is to promote the efficient operation of the firm. Devices employed to improve accountability cannot be seen as efficient if they also hamper the performance of the firm. 'Good' corporate governance, therefore, needs to refer to the mix of those devices, mechanisms and structures which provide control and accountability while promoting economic enterprise and corporate performance.

Watson and Ezzamel (Chapter 3) examine corporate financial structure decisions and some of their implications for corporate practitioners and stakeholders. More specifically, the chapter examines how a firm's leverage may impact on firm value and the riskiness of different stakeholders' financial claims. In practice, how far the economic welfare of corporate stakeholders is significantly affected by corporate financial structure decisions depends on how far their financial claims are protected by legal, regulatory and governance arrangements typically available and utilised by stakeholders. This type of analysis suggests that, if the reliability of firms' financial information disclosures is assured, most debtholders can normally be confident (assuming a degree of diligence) that their contractual claims can be adequately protected via legal/contractual means. However, as emphasised by Watson and Ezzamel, firms are by their nature risky and, therefore, any number of factors have the potential to produce unanticipated business outcomes that render the fulfilling of existing contractual promises excessively costly. The chapter then goes on to examine why a broader view of the firm (as compared to a nexus

of contracts and maximising the value of the firm from a shareholder perspective) might be more fruitful; it concludes that fundamentally all stakeholders are dependent on management maximising the value of the company given their own specific objectives.

Short and Keasey (Chapter 4) address the abilities and incentives of institutional shareholders to enhance corporate governance in larger publicly quoted companies. The Cadbury, Greenbury, Hampel and Higgs reports have all stressed the importance of institutional investors as a mechanism of corporate governance. This chapter identifies the objectives of institutions with respect to their ownership and investment behaviour, examines their incentives in terms of management behaviour, and considers whether incentives can be altered such that a more proactive corporate governance role can be achieved. The chapter concludes that although the perceived degree of institutional activism has increased in recent times, due largely to government pressure, there are many factors which act to provide incentives for institutions *not* to involve themselves in corporate governance issues. Institutions have few incentives to act on an individual basis and their so-called short-termist attitudes are in part a rational response to the market, institutional and corporate arrangements which have existed in the UK. In fact, intervention tends to occur only in cases of extreme underperformance by the investee companies and if changes in corporate governance are to be brought about, fundamental changes in the market and institutional arrangements in the UK will be required. However, in the present context it is not clear that increased intervention, especially as a response to government pressure, will significantly improve the situation because this may just end up as another 'box-ticking' exercise with little real meaning or substance.

A key element of the corporate governance process is the operation of the board of directors. A number of factors, including several cases of management excesses and corporate collapses, led to major criticism of the UK's unitary board structure in the 1990s. Ezzamel and Watson (Chapter 5) examine the duties and composition of the board of directors, with particular focus on the roles of non-executive directors in monitoring and disciplining senior executives. They outline the role of the board in mitigating agency problems and review the literature relating to the effectiveness of boards. Key themes to emerge from this literature, which is largely US based, are that CEOs have typically played a central role in selecting non-executive directors (NEDs), that outsider-dominated boards enhance board independence and power over CEOs as well as improving performance, but may demotivate managers from taking decisions that involve higher expected risks and associated higher returns, that NEDs are able to influence the process of strategic choice and control, but that boards may not have sufficient information or expertise compared to the CEO. Ezzamel and Watson point to the conflicts arising from NEDs being required to wear two hats, that is to say, to monitor senior executives but at the same time contribute as equal board members to the leadership of the company. They then consider how recent reforms of UK corporate governance regulation have served to alter the duties, objectives, composition and incentives of boards. They suggest that, while voluntary codes have their limitations, the UK experience indicates that these are more adaptable and responsive to problems arising from developments elsewhere in the corporate and financial worlds than would be possible with a formal legal code. They do, however, argue that the relative success of the UK's approach to corporate governance compared to the US has been aided by a large institutional base, fewer restrictions on shareholder voting rights and the functioning of the market for corporate control and less reliance on overly generous stock options granted to senior executives. These differences have meant that fewer UK CEOs have been able to develop the level of entrenchment and power over the board that is more evident in the US.

Perhaps the most controversial aspect of corporate governance relates to executive pay. Bruce and Buck (Chapter 6) provide an overview of the nature and anatomy of contemporary executive pay in the UK and the significance of executive pay for corporate governance. They show that the design of executive payment systems is influenced by a number of factors apart from the promotion of strong governance and that the firm's payment regime is only one of a number of mechanisms that the firm may seek to employ in assembling a robust governance regime. They then go on to review the significant body of empirical work in this area. Third, they focus on the recent evolution of executive pay in the UK and in particular the emergence of the Executive Stock Option (ESO) in the 1980s, its relative demise and the increasing popularity of the LTIP in the 1990s, and the current situation, where the coexistence of ESOs and LTIPs is commonplace among larger corporations. They note an increasing shift from the traditional focus on alignment of incentives in terms of returns to executives and shareholders, towards a consideration of alignment in terms of attitudes to risk. This is an important development since, while it is often assumed that the use of performance-contingent elements in aggregate pay serves to increase risk taking by eligible executives, newer evidence suggests the contrary may be true with the use of ESOs often increasing the risk aversion of CEOs. They conclude, however, that the cases for and against UK executive pay packages remain unproven. While there is some evidence that sensitivity between total share return and executive rewards has been found, this sensitivity only explains a small proportion of total pay variance. Innovations like LTIPs, designed to increase this sensitivity, do not seem to have made a spectacular improvement, and firm size remains a more significant influence on executive pay, lending support to the further tightening of the regulation of executive pay in the UK. They observe that while there has been a focus on ESOs, LTIPs, severance payments, perquisites and salary, a neglected aspect of remuneration relates to short-term bonuses which are subject to weak disclosure requirements and possibly abuse. They also note that despite the extensive empirical evidence on executive remuneration, there remain gaps in our understanding of the complex issues of causality in the relationship between pay and performance. They also suggest that there is a need for greater understanding of the process of executive remuneration setting in terms of the relations between board representation, remuneration committee membership and nomination procedures for new directors.

Taking up this theme of the remuneration process, Bonet and Conyon (Chapter 7) examine the effectiveness of the primary corporate institution that determines executive compensation in US and UK publicly traded firms, that is, the compensation (or remuneration) committee. They document the structure and ubiquity of compensation committees in the population of UK publicly traded firms and show that most companies have remuneration committees, their size varies positively with market capitalisation, and that few companies have insiders on these committees. They then go on to examine whether poorly constituted compensation committees, as measured by insider membership of this committee, result in agency costs. Based on a panel data sample of about 500 publicly traded firms, their analysis indicates that executive compensation is higher when there is an insider (executive) present on the pay committee. Finally, their evaluation of prior academic research shows that self-interested behaviour and pay outcomes are more likely in the presence of poorly governed compensation committees. However, they note that the evidence is ambiguous. Some studies have failed to find evidence of higher agency problems in the presence of insiders in the remuneration committee. They suggest that the advice of compensation consultants to the remuneration committee may be particularly important in influencing the remuneration–performance relationship and warrants further investigation.



Where internal governance does not adequately monitor the behaviour of managers, takeovers, and especially hostile bids, represent an important external governance mechanism whereby shareholders can replace underperforming or opportunistic managers. O'Sullivan and Wong (Chapter 8) review the evidence in relation to the underperformance of bid targets, the failure of takeover bids, the role of bid defences and the behaviour of target management in the context of takeovers, particularly concerning why managers resist some bids and accept others and the influence of internal governance characteristics on this decision. They find mixed and inconclusive evidence from both event and accounting studies regarding the link between preacquisition performance and takeovers is mirrored in respect of accounting studies. They also show that when takeover targets are categorised between hostile and friendly, no consistent performance differences are identified, suggesting that takeovers have a weak governance role. However, they point to recent research identifying higher rates of CEO turnover in takeover targets showing weak pre-bid performance provides some support for takeovers having a governance role. With respect to reaction to bids, evidence indicates that independent boards and active blockholders seek to ensure the maximisation of shareholder wealth in the takeover process. Initial hostility to bids falling short of forcing abandonment can be a means of increasing the bid price. When managers possess significant equity in the target company, takeovers are more likely to be friendly while managerial resistance is associated with low ownership levels, although high levels of managerial ownership may deter the disciplining of entrenched managers. O'Sullivan and Wong note that the significant decline in hostile takeovers since the mid-1990s may be the result of a general improvement in the internal governance of companies. O'Sullivan and Wong also find that from the perspective of shareholders in target companies, there is clear evidence of significant wealth gains arising from takeover bids. These gains appear to have been relatively consistent over the past three decades. There is emerging evidence that the size of shareholder gains may be greater where the takeover is financed by cash and where a bid is hostile especially in the presence of more independent boards. Boards resisting takeovers appear to possess a greater proportion of non-executive members and such resistance appears to result in greater bid premiums for shareholders. However, such board-oriented resistance does not impede the likelihood of bid success. The effects of takeovers on the shareholders of bidding companies have produced inconclusive results but the impact of specific bid characteristics suggest that the announcements effects of cash-financed bids and bids resisted by target management may be more positive. Research on the post-bid performance of bidders suggests that bids have a negative impact on the long-run performance of bidders. The majority of studies suggest that corporate efficiency does deteriorate in the years after the acquisition. The main conclusions regarding top management turnover is that rates of change after takeover are higher than either prior rates of turnover in targets or turnover levels in non-targets. There is some evidence that top management replacement is more likely subsequent to hostile bids. The abandonment of a bid typically results in a revaluation of the target by investors that may persist for many years after the abandonment with the long-term profitability of the targets improving. The successful defence of a takeover by management does not appear to guarantee management's own employment, the rate of management turnover in abandoned targets appearing to exceed what might be expected in non-targets prior to the bid. Consequently, it appears that such bids also have an important governance role.

Corporate governance issues have typically been focused on large firms with diffuse ownership. Filatotchev and Wright (2004) argue that they are also important for younger founder-managed firms, particularly for those reaching a point in their development when they begin to face constraints on their ability to realise growth opportunities. The agency-based corporate

governance lens may be applied to these threshold firms since it is at this point that issues arise surrounding the pressures on founders to cede control if their firms are to grow. Yet, at the same time these firms need to find the resources and knowledge to enable them to grow. Corporate governance may thus need to be viewed as a dynamic system that may change as firms evolve over these stages. The firm's evolution is accompanied by changes in ownership structure, board composition, the degree of founder involvement etc. The balance of the accountability and enterprise roles of the various governance elements may change over this life-cycle from establishment, growth, maturity and decline. There is then a need to understand governance issues in firms that are more entrepreneurial.

Dalton *et al.* (Chapter 9) consider these issues and in particular focus on the intersection of governance and strategic leadership with firm performance. They find little evidence of a positive link between founders and firm financial performance, and also that research both on the link between founder characteristics and firm performance and on the difference between founders and non-founders is inconclusive. However, there appears to be a strong relationship between founders' strategic decisions and performance. Duality among publicly traded entrepreneurial firms tends not to be related to firm performance but establishing an effectively functioning top management team is critical to the success of an entrepreneurial firm. Boards of directors may also have an important role to play in entrepreneurial firms, where the founder is likely to be dominant and where there may be benefits from external oversight provided by an independently structured board. Studies have yielded inconsistent findings but do suggest that board of director composition and size are important for firm financial performance and that board composition is associated with the market's response at the time of an IPO. Dalton *et al.* also note that studies of venture-backed firms do indicate that venture capitalists add value, yet how much and at what price remains to be determined.

This last issue provides a link to the focus of the chapter by Wright, Thompson and Burrows (Chapter 10) which examines the contribution of the mechanisms involved in venture capital investments and leveraged management buy-outs to dealing with corporate governance problems in a wide variety of enterprise types. Both venture capitalists and leveraged and management buy-out financiers represent developments in capital markets that address the governance problems encountered therein. Both involve relationship investment with management, managerial compensation oriented towards equity and likely severe penalties for underperformance. The principal differences between them concern the nature of the relationship between investor and investee and that in investments by buy-out financiers most of the funding required to finance an acquisition is through debt. Investments by venture capitalists, which may also involve buy-outs as well as start-ups and development capital, make greater use of equity and quasi-equity. These differing relationships and financing instruments may be used to perform similar functions in different types of enterprise, so widening the applicability of the active investor concept within the Anglo-American system of corporate governance. Wright *et al.* review the evidence relating to the effects of buy-outs and venture capital investment and show that such changes in the ownership and financial structure may yield large gains in shareholder value and operating performance, but that both pre- and post-transactional governance problems also need to be addressed. They also suggest that the governance issues raised by buy-outs and venture capital investments have implications for the general corporate governance debate. First, they identify a need for a flexible approach to governance under which the forms adopted take account of specific factors such as the firm's product market and life-cycle circumstances. This approach recognises a role for enhanced voice, even in the context of exit-dominated capital markets. Second, their review of evidence relating to the monitoring problems of active

investors suggests that even in cases where they have a major incentive to exercise voice, their ability to do so may be constrained by both access to information, the nature of the relationship with the management of the firm being monitored and the effort–cost–reward trade-off involved in close involvement. Third, it is clear from the evidence on the longevity of both buy-out and venture capital investments that governance structures are not necessarily fixed over time. As enterprises develop they may need to change their governance structure if value for shareholders is to be optimised.

There is growing recognition that corporate governance may vary between countries. Roe (Chapter 11) provides the first of two chapters considering international differences by examining the importance of corporate law, and in particular its ability to protect minority shareholders, in building securities markets and separating corporate ownership and control. Roe concludes that studies that examine corporate law worldwide tend to overpredict its importance in the world's richest nations. In these countries, where contract can usually be enforced, it is typically feasible to develop satisfactory corporate law. In such cases, if ownership and control have still not separated widely, Roe suggests that other institutional arrangements (such as product competition, tax laws, incentive compensation etc.) probably explain the situation. These other institutional arrangements may mean that there are high managerial agency costs of ownership and control being separated, such as relatively weak product market competition and relatively stronger political pressures on managers to disfavour shareholders. Roe also points out that there is too much that is critical to ownership separation that corporate law does not seek to reach. With respect to transition and emerging economies, there is the possibility that development agencies and governments may do what is necessary to get the corporate law institutions ready for ownership separation but the potential problem is that 'no one comes to the party'.

Denis and McConnell (Chapter 12) survey two generations of research on corporate governance systems outside the US. They show that the first generation of international corporate governance research is patterned after the US research that precedes it, with studies examining individual governance mechanisms, notably board composition and equity ownership, in individual countries. This research tended to focus on Germany, Japan and the UK and identified, even across these three very developed countries, significant differences in ownership and board structure. Of particular note in this first generation research is that ownership concentration in virtually every other country in the world is higher than it is in the US and the UK. They also find that in many countries, major shareholders' control rights exceed their cashflow rights. Importantly, they observe that the realities of ownership and control are such that the primary agency conflict in the US is relatively unimportant in many other countries. Rather, there is a different agency conflict between controlling shareholders and minority shareholders. The second generation of international corporate governance research considers the possible impact of different legal systems on the structure and effectiveness of corporate governance and compares systems across countries. This research shows that the extent to which a country protects investor rights has a fundamental effect on the structure of markets in a country, on the governance systems adopted and on the effectiveness of those systems. Strong legal protection for shareholders, they note, appears to be a necessary condition for diffuse equity investment. In countries with weak protection, it appears that only ownership concentration can overcome the lack of protection.

The German corporate governance regime is characterised by the existence of a market for partial corporate control, large shareholders, cross-holdings and bank/creditor monitoring, a two-tier (management and supervisory) board with codetermination between shareholders and employees on the supervisory board, a non-negligible sensitivity of managerial compensation to performance, competitive product markets, and corporate governance regulations largely

based on EU directives but with deep roots in the German legal doctrine. Another important feature of the German regime is the efficiency criterion that corporate governance is to uphold. In Germany, in contrast to the Anglo-American system, the definition of corporate governance explicitly mentions stakeholder value maximisation. Goergen, Manjon and Renneboog (Chapter 13) provide an overview of the German corporate governance system. They describe the main theoretical models regarding the various alternative mechanisms and summarise the relevant empirical evidence on Germany. They also compare Germany to other countries to illustrate the peculiarities of the German case. They discuss the governance role of large shareholders, creditors, the product market and the supervisory board of directors. Furthermore, they focus on the importance of mergers and acquisitions, the market in block trades, and the lack of a hostile takeover market. Given that Germany is often referred to as a bank-based economy, particular attention is paid to the role of the universal banks. Voting control in Germany has often been eroded by ownership pyramids, the issue of non-voting shares, the application of voting restrictions (recently abolished) and the issue of multiple voting rights (recently abolished). Proxy voting also gives the banks' voice a disproportional vote on the general meetings. They show that the relationship between ownership or control concentration and profitability has changed over time, becoming negative in the 1990s. While the authors show that there is no clear evidence that banks play a positive monitoring role in German firms, their positive contribution is less ambiguous in financially distressed or poorly performing companies. This can be attributed to the banks' importance as creditors. The long-term lending relationships give banks considerable power, which is frequently strengthened by bank representation on the supervisory board of the firm. The authors also conclude that there is little evidence that the German codetermination system leads to superior corporate governance. Although there is a positive sensitivity of managerial pay to performance in Germany, the size effect (positive) dominates the compensation equation. Importantly, the pay-for-performance relation is influenced by large shareholder control: in firms with controlling blockholders, the CEO receives lower total compensation (compared to widely held firms) and the pay-for-performance relation is no longer statistically significant. When a universal bank is simultaneously an equity-holder and provider of loans, the pay-for-performance relation is lower than in widely held firms or blockholder-controlled firms. They show that the market for corporate control in Germany is very limited as the vast majority of firms have a large controlling shareholder and because pyramiding (with multiple layers of financial holdings sandwiched between the ultimate investor and the target firm) and cross-holdings hinder takeover attempts. Takeover regulations have created further barriers by facilitating court action by dissenting shareholders, board entrenchment, proxy voting, voting restrictions, multiple votes and non-voting shares. They do, however, note that since 1995 several regulatory initiatives have increased transparency and accountability such as the removal of powers of minority shareholders to stall restructuring and of voting restrictions and multiple voting shares.

Like Germany, the Japanese corporate governance system has also been characterised by the important role played by the banks. Japanese banks are allowed to maintain equity holdings of up to 5% in firms, a majority of which are also their clients. These bank equity holdings of client firms tend to be fairly stable over the years, with the intent to foster long-term client relationships. While close bank–firm relationships have been widely credited as being influential in increasing corporate governance efficiency and the development of long-term investment horizons, and a major global presence of Japanese firms, this has been called into question in recent years as the Japanese economic miracle came to a halt. In the light of this questioning of the bank–client relationship as the basis for an efficient corporate governance system, Wan

*et al.* (Chapter 14) offer a different perspective to understanding Japan's banking industry. This perspective recognises the complex, rich, social relationships that define Japan's bank-centred systems. They view these bank-centred systems as social exchange governance networks, focusing on embedded social elements such as roles, power, reciprocity, expectations, and obligations. The explicit incorporation of these social elements into network structures allows them to uncover the underlying, complex relationships among exchange parties. They argue that while many network studies focus on the opportunities created by relational ties, network constraints may also reduce firms' flexibility or responsiveness. Banks in Japan, in addition to being lenders, may implicitly serve as 'insurers' for their affiliated firms against bankruptcy. To the extent that banking networks in Japan have heterogeneous characteristics, they propose that banks' strategic actions and hence performance are likely to vary in accordance with network characteristics. When the Japanese economy is growing, banks benefit substantially by facilitating network members in business expansion, in turn boosting banks' incomes. When the Japanese economy is contracting, some banks may be tightly constrained by their network ties and thus are unable to pressure their network members for restructuring because the banks are expected to fulfil their social obligation as *insurers* and stand behind financially distressed network members. As such, bank performance would be negatively affected in the contracting economy. The authors argue that Japan's almost sole reliance on bank-centred governance is a dangerous path since it is difficult to maintain efficient corporate monitoring and governance where board members have extensive interests tied with other member firms, an external market for corporate control is virtually non-existent, or where overdominance by one type of owner (that is to say, the bank) exists. In this regard, governance reform such as more independent directors or the development of an active external market for corporate control would be necessary. However, given that close bank-client relationships have spread and persisted as a result of historical, institutional, and social factors, regulatory changes alone may not be sufficient to induce banks and firms to abandon time-honoured practices and adopt new ones instead.

An important aspect of the debate about appropriate governance systems concerns the question of whether insider governance systems such as those found in much of Continental Europe, can survive in an environment of increasing pressure from financial markets dominated by outsiders, portfolio investors and without strong links with enterprises. Mary O'Sullivan (Chapter 15) examines these issues in the context of changes in corporate governance in France. First, O'Sullivan examines changes in the ownership structures of French corporations over the last quarter of a century. The notable changes identified are a decline in the ownership role of the state, the subsequent creation and unwinding of cross-shareholdings and the increased importance of foreign ownership of listed corporations, and an important continuity of family ownership. Second, O'Sullivan analyses the interaction between French corporations and the financial system, finding evidence of a decline in the financing role of the state, a major increase in reliance on equity issues as a source of external finance together with an increase in market as opposed to intermediate debt. These changes have been associated with developments in the distribution of corporate control. However, while corporate control remained firmly in the hands of insiders, they have exercised that control differently by pursuing strategies to expand internationally. O'Sullivan takes the view that a shift from insider to outsider control is only likely to occur under specific conditions confined to a small number of cases. Importantly, she argues that ownership structure does not make a major contribution to explaining recent developments in French corporate governance. Rather, she takes the view that other structural characteristics may also be important, such as industrial structure and the exaggerated hierarchies of French corporations that accord great power to the PDG (President

Directeur General) and the networks that closely link these top managers. These arguments support those of Roe in Chapter 11.

Liu and Sun examine in Chapter 16 the situation of corporate governance in China. The changing aspect of governance in China is clearly an important topic given China's continued growth into one of the world's major economies and its perceived move from state to public ownership. This chapter examines the performance impacts and evolution of ownership and control mechanisms in Chinese publicly traded companies. After describing the institutional environment of China's state-dominated capital market and corporate governance system, Liu and Sun present research findings on the ultimate and intermediate control of Chinese companies, and the evolution of these ownership structures over the past decade. From a series of nested performance comparisons across three pairs of ownership – state direct control versus state indirect control, investment holding company versus industrial firms, and diversified business groups versus specialised companies – they find that the least inefficient intermediate control agent is the diversified industrial conglomerate in the indirect state control chain. In terms of the evolution of governance in China, Liu and Sun conclude that though the ownership of companies has changed, control, largely, still lies with the state through the use of pyramid structures. They argue more research is needed to understand a stylised fact in China: the least profitable firms are given top priority for privatisation, while the state keeps a firm grip on the most profitable companies.

Corporate governance in transition economies is distinguished from the economies of the west by the initial complete absence of the necessary prerequisites of an appropriate legal infrastructure and financial institutions in an environment where incumbent management and employees have entrenched rights within enterprises. The governance problem in transition economies focuses on identifying how one might move towards a structure that will better enable efficiency benefits to be delivered. Wright, Buck and Filatotchev (Chapter 17) discuss the nature of governance problems in transition economies and analyse the potential for the various elements of a corporate governance framework to resolve these difficulties. They outline the nature of corporate governance in the various types of approaches to privatisation adopted in transition economies and examine the role of and evidence relating to the various parties available in principle to undertake corporate governance. A common feature of transition economies is that after privatisation there is a decline in employee share ownership and a corresponding increase in managements' and outside investors' stakes. Increases in management equity holding may have some positive impact on corporate governance, especially if managers have to borrow to fund the purchase of shares and are constrained to improve performance in order to be able to repay loans. There remains a need for the state to create an adequate regulatory environment, to ensure that the newly established relations between recently privatised companies, financial and non-financial stakeholders and lending institutions will ensure economic efficiency improvements and promote corporate restructuring and technological modernisation. In the underdeveloped market systems found in transition economies, and the barriers to developing institutional voice mechanisms, it may be as important to emphasise measures to enhance entrepreneurial skills as it is to develop good governance systems.

## **NOTES**

1. At the time of writing (July 2004) Google lists some 3.3m entries under the heading 'corporate governance'.

2. Speech to the Conference on Bank Structure and Competition, Chicago, 8 May 2003.
3. Holmstrom and Kaplan (2003) argue that contemporaries have exaggerated the negative spillovers from these US corporate governance failings. They argue that in the long run, defined so as to include the events of Enron etc., returns on US stocks still exceed those in almost all other economies, suggesting the systemic damage is not too severe.
4. See Shleifer (1997).
5. These perspectives are explored in more detail in Blair (1995) and reviewed in Keasey *et al.* (1997), Chapter 1.
6. Margaret Blair (1995) provides a hypothetical example from Germany. Here she suggests that expectations of lifelong employment, underpinned by employee participation in governance, encouraged workers and employees alike to invest in specific human capital to a greater extent than would be feasible in the US or UK, with productivity benefits over the long term.
7. See Hughes (1993) for a review of the evidence and a somewhat pessimistic assessment of the effectiveness of the takeover sanction.
8. The short-termist critique is explored in more detail in Keasey *et al.* (1997), Chapter 1, and by Blair (1995). Tests of the critique typically involve the assessment of share price reactions to new events to determine whether the market overdiscounts long-term gains (for example, from R&D or capital investment spending announcements) relative to those with an immediate effect. The results typically reject short-termism (for example, Chan *et al.*, 1990), but this research is predicated on a semi-strong form efficiency assumption that proponents of the short-termist view would generally reject.
9. This is discussed in Thompson (2004).
10. Murphy (1999) provides a comprehensive review of the incentive aspects of executive stock options together with a discussion of their advantages and disadvantages as elements of a remuneration package.
11. The Act is discussed in Demski (2003).
12. The GlaxoSmithKline report of 2003 was rejected at the AGM following intense criticisms of the generous termination provisions being offered to CEO Jean-Paul Garnier (see Thompson, 2004). A substantial number of remuneration committee reports have attracted votes against of over 20%: see Chambers (2003), p. 809.
13. See Darrel E. Whitten: 'Japanese Corporate Governance: Buzzwords are not Enough', RIETI, 6 February 2003, at: [www.rieti.go.jp/en/miyakodayori/060.html](http://www.rieti.go.jp/en/miyakodayori/060.html).
14. Dr Ulrich Siebert, Federal Ministry of Justice: 'Control and Transparency in Business (KonTraG): Corporate Governance Reform in Germany', at: [www.Burkardlaw.com/corporategovernance/](http://www.Burkardlaw.com/corporategovernance/).

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# The Development of Corporate Governance Codes in the UK

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Kevin Keasey, Helen Short and Mike Wright

## INTRODUCTION

Corporate governance issues, arising from the agency problems engendered by the separation of ownership and control and the inability to write complete contracts for all possible future eventualities (Hart, 1995; Shleifer and Vishny, 1997), have been recognised for many decades, if not centuries (Berle and Means, 1932; Marshall, 1920; Smith, 1776). Although a long-standing issue, the debate was given fresh impetus in the UK by a number of well-published corporate problems in the late 1980s. These involved creative accounting, spectacular business failures, the apparent ease with which unscrupulous directors could expropriate other stakeholders' funds, the limited role of auditors, the claimed weak link between executive remuneration and company performance, and the roles played by the market for control and institutional investors in generating apparently excessive short-term perspectives to the detriment of economic performance. Concern over standards of corporate governance in the UK led to the formation of the UK's first corporate governance committee (the Cadbury Committee) in 1991.

Since the setting up of the Cadbury Committee and the publication of the Cadbury Report on the Financial Aspects of Corporate Governance in 1992, the corporate governance structures and practices within UK companies have undergone significant changes in response to the recommendations of the various committees and reports. The Cadbury Committee's terms of reference were 'to review those aspects of corporate governance specifically related to financial reporting and accountability' (para. 1.2), and as a result, the main thrust of its recommendations were directed towards issues of control and accountability. However, since the publication of the Cadbury Report, the debate has moved on to consider the wider issues of corporate governance. In particular, the Cadbury Report met with considerable criticism, particularly from industrialists, in that its emphasis on the accountability aspects of governance risked stifling enterprise activity. The Hampel Committee, set up in 1995 to review the

implementation of the Cadbury code, recognised that the emphasis on accountability has obscured ‘a board’s first responsibility – to enhance the prosperity of the business over time’ (Hampel Report, 1998, para. 1.1). In response to the criticisms levelled at Cadbury, the Hampel Report (1998) stated that it wished to see the balance between business prosperity and accountability corrected. Furthermore, the Report argued that the ‘box-ticking’ approach to the Code adopted by many companies and their shareholders had led to the belief that accountability itself could deliver success. The overriding emphasis of the Hampel Report is the need for good corporate governance to be based on principles rather than prescription.

Between the publication of the Cadbury Report and the Hampel Report and in response to public disquiet over high levels and large increases in directors’ remuneration, the Greenbury Committee was set up in January 1995 by the Confederation of British Industry (CBI) at the request of the government. The Greenbury Report and Code of Best Practice on the determinants of directors’ remuneration was issued in July 1995. Following the publication of the Hampel Report, the Hampel Committee has produced a document providing a set of principles and codes to embrace the Cadbury, Greenbury and Hampel recommendations – the Combined Code (Committee on Corporate Governance, June 1998).

However, since the publication of the first Combined Code in 1998 and the advent of a new Labour government in 1997, developments in corporate governance policy have undergone a change in emphasis away from an approach based on the ethos of self-regulation by companies and shareholders towards an approach based on legislation or the threat of legislation.

The purpose of this chapter is to plot the development of corporate governance policy in the UK since the formation of the Cadbury Committee in 1991 to the present day. The chapter is organised as follows. The first section provides a discussion of the definition and framework for corporate governance policy within the UK. The second section considers developments occurring between the formation of the Cadbury Committee and the publication of the first Combined Code in 1998, whilst the third section presents developments occurring in the period between the publication of the first and second Combined Code in 2003 and to the present day. The fourth section provides an overview of the changing approach to governance policy which has occurred since the publication of Cadbury and considers how the current government initiatives towards greater legislation within the corporate governance arena may risk harming the balance between accountability and business prosperity. The chapter concludes with some final remarks.

## **CORPORATE GOVERNANCE IN THE UK – DEFINITIONS AND FRAMEWORK**

Corporate governance was defined by the Cadbury Report as ‘the system by which companies are directed and controlled’ (para. 2.5). Furthermore, Cadbury recognised that a system of good corporate governance allows boards of directors to be ‘free to drive their companies forward, but exercise that freedom within a framework of effective accountability’ (para. 1.1). The Hampel Report, whilst accepting the Cadbury definition of corporate governance, also noted that ‘the single overriding objective’ of companies is ‘the preservation and the greatest practical enhancement over time of their shareholders’ investment’ (para. 1.16). In a similar vein, Charkham (1994) identified two basic principles of corporate governance:

- (i) That management must be able to drive the enterprise forward free from undue constraint caused by government interference, fear of litigation, or fear of displacement.
- (ii) That this freedom – to use managerial power or patronage – must be exercised with a framework of effective accountability. Nominal accountability is not enough. (p. 325)

These principles recognise that whilst accountability is essential, it should not be enforced without recognising the need to allow an organisation to create wealth for its stakeholders, howsoever defined. Moreover, these principles also recognise that enterprise and the pursuit of wealth creation should not be allowed to progress in an unfettered manner, but in recognition of the fact that effective accountability to stakeholders is necessary. In other words, long-term performance is a function of both accountability and enterprise.

Essentially, corporate governance failures may come about for two broad reasons. First, management may operate the firm inefficiently, resulting in an overall decrease in firm profits, compared to the potential profitability of the firm. Second, while managers may operate the firm efficiently and generate ‘maximum’ profits, they may divert a proportion of those profits from shareholders via the consumption of excessive perquisites, for example by paying excessive remuneration not limited to performance. Hence a system of corporate governance needs to consider both efficiency and stewardship dimensions of corporate management. Stewardship emphasises issues concerning, for example, the misappropriation of funds by non-owner-managers. Equally important, however, is the issue of how the structure and process of governance motivates entrepreneurial activities which increase the wealth of the business. Corporate entrepreneurship concerns the reallocation of economic resources in new combinations and may involve both new innovations as well as major corporate restructuring (Guth and Ginsberg, 1990). Good corporate governance is thus as much concerned with correctly motivating managerial behaviour towards improving the performance of the business as it is directly controlling the behaviour of managers. Given the above, it is clear that policy recommendations on corporate governance need to address both the accountability and enterprise aspects of governance.

## **THE EVOLUTION OF POLICY RECOMMENDATIONS – FROM CADBURY TO HAMPEL**

In this section, we outline the development of the governance codes in the UK from the creation of the Cadbury Committee in 1991 to the formulation of the first Combined Code in 1998. As well as discussing the detailed recommendations provided in the codes, this section also considers the motivation behind the codes and details the criticisms which the codes attracted at the time. The key developments in UK governance policy are presented in Table 2.1.

### **The Cadbury Report**

The Cadbury Committee was set up in May 1991 by the Financial Reporting Council, the London Stock Exchange and the accountancy profession. The Cadbury Committee’s terms of reference were limited to reviewing ‘those aspects of corporate governance specifically related to financial reporting and accountability’ (para. 1.2) and as a result, the main thrust of its recommendations was directed towards issues of control and accountability. Ezzamel and

## Corporate Governance

**Table 2.1** *Key Developments in UK corporate governance policy*

Date	Event
May 1991	The Committee on the Financial Aspects of Corporate Governance (the Cadbury Committee) established.
May 1992	Publication of the draft Cadbury Report.
Dec 1992	Publication of final report of the Cadbury Committee and Code of Best Practice.
April 1993	UK Stock Exchange Listing Rules amended to require statement of compliance with Cadbury Code of Best Practice.
Dec 1994	Publication of the Rutteman Guidance on the reporting of the system of internal control as required by Cadbury.
Jan 1995	The Study Group on Directors' Remuneration (the Greenbury Committee) established.
July 1995	Publication of the Greenbury Report and Code of Best Practice.
Oct 1995	UK Stock Exchange Listing Rules amended to require statement of compliance with Greenbury Code of Best Practice.
Nov 1995	Committee on Corporate Governance (the Hampel Committee) established to review the implementation of Cadbury and Greenbury.
Aug 1997	Publication of the draft Hampel Report.
Jan 1998	Publication of the final Hampel Report.
March 1998	Publication of 'Modern Company Law for a Competitive Economy' consultation paper by the Company Law Review Steering Group.
June 1998	Publication of the Combined Code (derived from Hampel, Cadbury and Greenbury)
Feb 1999	Publication of 'Modern Company Law for a Competitive Economy: The Strategic Framework' report by the Company Law Review Steering Group.
July 1999	Publication of 'Directors' Remuneration: A Consultative Document' by the Department of Trade and Industry (DTI).
Sept 1999	Publication of the Turnbull Report on Internal Control (providing guidance on the requirements of the Combined Codes relating to internal control).
March 2001	Publication of the Myners Review on 'Institutional Investment in the United Kingdom: A Review'.
Feb 2002	Publication of the government consultation document 'Encouraging Shareholder Activism'.
July 2002	Publication of the government's White Paper 'Modernising Company Law'.
Aug 2002	The Directors' Remuneration Report Regulations 2002 came into force for reporting periods ending on or after 31 December 2002.
Oct 2002	Publication of the ISC's Statement of Principles.
Jan 2003	Publication of the Higgs 'Review of the Role and Effectiveness of Non-executive Directors'.
Jan 2003	Publication of the Smith Report 'Audit Committees Combined Code Guidance'.
June 2003	Publication of 'Rewards for Failure; Directors' Remuneration – Contracts, Performance and Severance: A Consultative Document' by the DTI.
July 2003	Publication of the Combined Code on Corporate Governance to apply for reporting periods beginning on or after 1 November 2003.

## *Development of Corporate Governance Codes in the UK*

Watson (1997) argue that, partly because of its terms of reference, the Cadbury Report assumed that accountability to shareholders was the primary objective of corporate governance.

Cadbury relied largely on improved information to shareholders, continued self-regulation, more independent directors and a strengthening of auditor independence to improve accountability. The main recommendations of the Cadbury Report (as laid down in the Code of Best Practice) can be summarised as follows and are detailed in Table 2.2:

- Ideally the role of chairman and CEO should be separated. However, if both posts are held by one individual, there should be a strong independent element on the board (that is, a strong and independent set of non-executive directors).
- The majority of NEDs should be independent of management and free from any business or other relationships which could materially interfere with the exercise of their independent judgement.
- Executive directors' contracts should not exceed three years without shareholder approval.
- Full disclosure of the remuneration of the chairman and highest paid director should be provided.
- Executive directors' remuneration should be subject to the recommendations of a remuneration committee comprised wholly or mainly of NEDs.
- Boards should establish an audit committee of at least three NEDs.
- Directors should report on the effectiveness of the company's system of internal control and confirm that the business is a going concern.

Essentially, the Cadbury Report required that a board of directors be comprised of at least three NEDs of which at least two should be independent. In addition, Cadbury placed great emphasis on the role of institutional shareholders in influencing corporate governance standards at the individual firm level. The emphasis on the role of non-executive directors and institutional shareholders reflects the fact that corporate governance in the UK at the individual firm level acts through two bodies: the board of directors and the annual general meeting (AGM). The system operating in the UK was described by Ezzamel and Watson (1997) as 'accountability through disclosure', whereby the board of directors is required to produce at the AGM externally audited accounts to enable shareholders to assess the adequacy of the directors' stewardship. The Code of Best Practice was not mandatory but listed companies had to include a statement in their Annual Report outlining their compliance with the Code. The compliance statement had to identify and give reasons for any areas of non-compliance. Cadbury relied on self-regulation to ensure compliance, where non-compliance (for example, having fewer than three NEDs) should cause shareholders, particularly institutions, to question governance practices within the non-complying company.

The Cadbury Report was successful in that its recommendations were generally adopted, at least by the larger public companies. A 1995 survey commissioned by the Cadbury Committee which examined compliance with the Code reported that 97% of the top 100 quoted companies had three or more NEDs and 82% had a separate chairman and CEO (Cadbury, 1995). In contrast, only 39% of the smallest quoted companies (with market capitalisation between £1 million and £10 million) had three or more NEDs. Furthermore, while 90% of the top 100 companies issued compliance statements claiming full compliance, only 26% of the smallest companies could claim full compliance. However, while compliance with the Code is of obvious interest, it is important to note that the disclosure requirements of the Code themselves represented a significant departure from previous practice. Prior to Cadbury, companies

**Table 2.2** *Summary of corporate governance codes from Cadbury to Combined Code (1998)*

Cadbury Report	Greenbury Report	Combined Code
<p><b>Directors</b> The roles of CEO and chair should ideally be separated.</p>		<p>The combination of the roles of CEO and chair should be publicly explained.</p>
<p>Where the post of CEO and chair are combined, there should be a strong independent set of NEDs.</p>		<p>A senior independent NED should be identified in the annual report (regardless of whether CEO and chair are combined).</p>
<p>There should be a minimum of three NEDs of which at least two should be independent.</p>	<p>There should be a minimum of three independent NEDs.</p>	<p>There should be a minimum of three NEDs and NEDs should comprise not less than one-third of the board. The majority of NEDs should be independent.</p>
<p>Independent NEDs are those who are 'independent of management and free from any business or other relationships which could materially interfere with the exercise of their independent judgement'.</p>	<p>Independent NEDs are those who have 'no personal financial interest other than shareholders in the matters to be decided, no potential conflicts of interest arising from cross-directorships and no day-to-day involvement in the running of the business'.</p>	<p>Definition of NED independence as Cadbury.</p>
<p>Nomination committees should make recommendations to the board regarding all new board appointments.<sup>5</sup></p>		<p>Nomination committees should be established (unless the board is small) comprising a majority of NEDs, chaired by the board chair or NED and all members should be identified in the annual report.</p>
<p>NEDs should be appointed for specified terms and reappointment should not be automatic.</p>		<p>All directors should be required to submit themselves for re-election at regular intervals and at least every three years.</p>

### **Directors' remuneration**

Executive directors' remuneration should be subject to the recommendations of a remuneration committee comprised wholly or mainly of NEDs.	The remuneration committee should be comprised exclusively of independent NEDs.	The remuneration committee should consist of independent NEDs.
Full disclosure is required of directors' total emoluments and those of the chair and highest paid director (including pension contribution and share options).	The remuneration committee should report to shareholders annually.	The remuneration report should be in the name of the board, rather than of the remuneration committee.
Executive directors' contracts should not exceed three years without shareholder approval.	Full disclosure is required of all elements of the remuneration package (including share options and pension entitlements) of each named director. Remuneration report should provide an explanation of the company's policy on the setting of executive remuneration. Executive directors' contracts exceeding one year should be disclosed and explained. Shareholders' approval is required for the adoption of long-term incentive plans. Share options should never be issued at a discount, should be phased in rather than issued in one block and should not be exercisable in under three years.	As Greenbury. As Greenbury. As Greenbury. As Greenbury. As Greenbury. Awards in one large block rather than phased in should be explained and justified.

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*(Continued)*



**Table 2.2** (Continued)

Cadbury Report	Greenbury Report	Combined Code
<b>Shareholders</b>		
		<p>Companies should indicate level of proxy votes logged on each resolution proposed at the AGM and the balance for and against each.</p> <p>Companies should propose a separate resolution at the AGM on each substantially separate issue.</p> <p>The chairmen of the audit, remuneration and nomination committees should be available to answer questions at the AGM.</p> <p>The notice of the AGM and related papers should be sent to shareholders at least 20 working days before the AGM.</p>
<b>Accountability and audit</b>		
<p>Audit committees comprising at least three NEDs should be established.</p>		<p>Audit committees should consist of at least three NEDs, the majority of whom should be independent and all members are to be named in the annual report.</p>
<p>The directors should report on the effectiveness of the company's system of internal control.</p>		<p>The board should, at least annually, conduct a review of the effectiveness of the group's system of internal controls and should report to shareholders that they have done so.</p>
<p>The directors should report that the business is a going concern.</p>		<p>As Cadbury.</p>

effectively were free to choose whether to disclose matters such as the existence of board committees and the existence and identity of NEDs.<sup>1</sup>

The recommendations of the Cadbury Committee were met with criticism from opposing camps; on the one hand, for failing to go far enough in setting corporate governance standards, and on the other hand, for going too far in prescribing procedures to improve corporate governance. While Cadbury argued that adherence to the Code would ensure that companies will strike 'the right balance between meeting the standards of corporate governance now expected of them and retaining the essential spirit of enterprise' (para. 1.5), a recurrent criticism at the time was that the recommendations of the Cadbury Code merely represented disruptions to the proper management of a company, and, furthermore, they risked damaging the spirit of enterprise necessary for commercial and economic success. For example, Lawrence (1994) argued that certain aspects of the Cadbury Report represented 'a bureaucratic response that may not actually be effective but will certainly be costly'. Lord Young (1995) argued that while transparency was necessary, the 'additional bureaucracy' created by Cadbury resulted in boards participating in an exercise of 'following the form rather than the substance, often ticking boxes rather than doing anything meaningful'. The accusation that compliance with a corporate governance code would lead to 'box-ticking' is one which would continue to be levelled at the various codes, from Cadbury to the present time.

Those commentators appeared to suggest that there is a trade-off between accountability and enterprise, in that too much accountability stifles enterprise activity. Furthermore, the possibility of the stifling of enterprise by too much accountability is a particular matter of concern if the form of that accountability is limited in some way. The mandate of the Cadbury Committee was limited to 'the financial aspects of corporate governance'. It has been argued above that financial or fiscal accountability forms only part of a fully defined notion of accountability. Framing his analysis in terms of the need for the Cadbury reforms to improve 'the sorry state of British business ethics', Boyd (1996) argued that managerial accountability was effectively narrowed by the late 1980's focus on financial fraud. The scandals highlighted that it was possible for self-interested directors to manipulate the traditional operations of governance structures to their own advantage and to the disadvantage of shareholders or other financial stakeholders. The resulting mandate given to the Cadbury Committee dealt with those aspects of corporate governance structures which would address such financial scandals but failed to address non-financial accountability. The Cadbury Code said virtually nothing about the application of ethics and responsibility in the boardroom, nor about changing boardroom values. This was despite events at the time such as the Zeebrugge ferry disaster, and the King's Cross London Underground fire which highlighted the need for a wider approach to the determination of the responsibility and accountability of boards. In summary, then, enterprise may be therefore being sacrificed first for accountability improvements of 'form rather than substance', and second, for a limited notion of fiscal accountability/responsibility.

It may be argued that a major failing of the Cadbury Code was its reliance on voluntary compliance. One extreme view of business ethics requires that regulations designed to protect against financial scandals should be compulsory and that enforcement mechanisms, including legal sanctions, should be put into place in order to provide as full protection for shareholders and other financial stakeholders as possible. Such a deontological perspective ignores rather more pragmatic issues concerned with who gains and who loses from such an ethical stance. It has already been argued that even voluntary codes may generate a bureaucratic response to accountability. Compulsory regulations/legislation may do nothing to change this. The Cadbury Report itself resisted statutory regulation on the grounds that it feared compliance

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with the letter rather than the spirit of the law (para. 1.10). Some commentators have concluded that it is virtually impossible to design a system of governance structures which is 'scandal-proof' (Martin, 1992). There may, therefore, be relatively limited benefits to be derived from a highly constraining 'ethical' system of governance. The costs, on the other hand, may be considerable in terms of the direct costs of regulation and the indirect costs of constraints on enterprise and the wealth-creating process. Instead, some business ethicists focus on ethics at the level of the individual organisation, rather than on corporate governance regulations or legislation.

The truth is that corporate governance is more about commitment than compliance. The real solution resides with the board which must lift its integrity and raise its standards and its performance. (Bain, 1992)

For example, the Cadbury Report made recommendations concerning the need for appropriate internal controls which needed to include mechanisms for risk assessment and management. Mills (1997) found that although the majority of companies in his sample had adopted the Cadbury recommendations, their focus was primarily on the short-term rather than long-term risks. Only 3% of companies saw risk in terms of exposures to the adverse impact on R&D capabilities.

Lipworth (1996) argued that in entrepreneurial companies, particularly those involving complex technology and which have grown beyond a certain size, there is a need for formal internal controls in order to protect against the potential adverse effects of people taking short cuts and not following established procedures. Similar controls may also need to apply to marketing and sales activities. The focus of attention here is the perceived need to protect the company against fraud and related problems and also to prevent damage to its external reputation. The danger is that in protecting against downside risks, upside potential may be unnecessarily constrained. Entrepreneurial individuals may become too risk averse. To reduce this possibility there appears to be a need for an appropriate internal control system to assist entrepreneurial actions by focusing principally on material problems.

## The Greenbury Report

After the Cadbury Report was published, attention was given to the supposed shortcomings of its recommendation, particularly with regard to the emotive subject of directors' remuneration. Concerns were raised regarding the absolute level of directors' remuneration; the size of increases in directors' remuneration, apparently unrelated to increases in company performance; the amount of remuneration awarded in the form of share options, particularly to the directors of privatised utility companies; the length of directors' contracts which led to large compensation payments ('golden handshakes') when such directors were dismissed; and the lack of disclosure of directors' remuneration, particularly with regard to share options. The Cadbury recommendations that companies should use remuneration committees to determine directors' remuneration led to the accusation that remuneration committees simply acted as a legitimising device to ratchet up pay (see, for example, Ezzamel and Watson, 1998). In response to public disquiet over these issues, the Greenbury Committee, headed by Sir Richard Greenbury (the then CEO of Marks and Spencer), was set up in January 1995 by the Confederation of British Industry (CBI) at the request of the government, to identify good practice in the determination

of directors' remuneration. It reported in July 1995 and the main recommendations of its Code of Best Practice were as follows (details are provided in Table 2.2):

1. Remuneration committees should consist exclusively of non-executive directors with no personal financial interest other than as shareholders in the matters to be decided, no potential conflicts of interest arising from cross-directorships and no day-to-day involvement in running the business.
2. The remuneration committee should report to shareholders annually.
3. The remuneration committee's report should include:
  - (i) the company's policy regarding the setting and awarding of executive remuneration.
  - (ii) full details of all elements of the remuneration package (including share options and pension entitlements) of each named individual director.
  - (iii) details and reasons for directors' contracts with notice periods in excess of more than one year.
4. Shareholders' approval is required for the adoption of long-term incentive plans.
5. Share options should never be issued at a discount, should be phased in rather than issued in one large block and should not be exercisable in under three years.

Although the Greenbury Report focused solely on the process of determining directors' remuneration (indeed the focus was on the disclosure aspects of the process, rather than on the process *per se*), it provided a significant development in UK corporate governance structures. In particular, it re-emphasised the importance of independent non-executive directors in the governance process. A major theme running through the debate on directors' remuneration was the perceived lack of justification given to shareholders for pay levels and increases, and the suspicion that directors were free to set their own pay awards without reference to shareholders. The Cadbury Committee attempted to take control of remuneration issues from executive directors by recommending that all companies should have remuneration committees, comprised wholly or mainly of NEDs, which would advise the board on remuneration. The Greenbury Committee went further and recommended that remuneration committees should consist entirely of 'independent' NEDs. Whilst the definition and issue of independence of NEDs was and continues to be a debated area, the effect of the Greenbury Code was to prescribe the inclusion of three independent NEDs on the board (as opposed to a minimum of two independent NEDs recommended by Cadbury).

In addition to the issue of the number of independent NEDs, the effect of the Greenbury Report was to significantly increase the amount of disclosure of remuneration required. Prior to the Cadbury Report, companies had to disclose the salary and bonus of the chairman and the highest paid director (if not the same person), the aggregate of directors' remuneration (including pension contributions) and the remuneration of directors analysed in £5000 bands (Companies Act 1985). Importantly, there was no requirement to provide the remuneration of individual named directors and information necessary to place a value on executive share options. The Greenbury Report provided for the comprehensive disclosure of all components of remuneration of individual named directors (including share options, pension rights etc.) and a policy statement on the setting of directors' remuneration. The huge increase in the amount of remuneration-related disclosure led to accusations that the volume of information had become 'a barrier to effective communication' (Ernst and Young, 1996) and provided more fuel for those who argued that the governance codes led to increased bureaucracy and burdens on companies without providing real benefits to shareholders.

## The Hampel Report

The successor body to the Cadbury Committee, the Hampel Committee was set up in November 1995 and issued its final report in January 1998 (Hampel, 1998). The Committee responded to the criticisms levelled at both Cadbury and Greenbury and attempted to turn the focus of governance away from issues of accountability and to reduce the burden on companies. Hampel suggested that the emphasis on accountability had obscured 'a board's first responsibility – to enhance the prosperity of the business over time' (para. 1.1). In addition, the Hampel Committee's explicit brief was the need to restrict the regulatory burden on companies by 'substituting principles for detail wherever possible'.

Hampel argued that the intentions of the Cadbury and Greenbury Committees were that their associated codes of best practice should be applied flexibly. Both committees, Hampel argued, recognised that there are no universal answers to questions of best practice; whilst guidelines may provide solutions which will be appropriate in the majority of cases, there will be situations when it is valid to a company to depart from these guidelines. The Hampel Report recognised that some shareholders and their representatives had adopted a 'box-ticking' approach to adherence to recommended practice and considered such an approach to be 'neither fair to companies nor likely to be efficient in preventing abuse' (p. 57).

The Hampel Report argued that while accountability by public companies was essential, the emphasis in accountability had obscured business prosperity, 'the most important aspect of corporate performance'. It suggested that Cadbury and Greenbury had made important contributions to enhancing the accountability of UK companies, but the box-ticking approach to those respective codes adopted by many companies and their shareholders had led to the belief that accountability itself could deliver success. Hampel explicitly stated that, based on the notion that the public debate on corporate governance had been dominated by issues of accountability, it wished to see the balance between business prosperity and accountability corrected. In Hampel's view, accountability required rules and regulations about structure, but

Good governance is not just a matter of prescribing particular corporate structures and complying with a number of hard and fast rules. There is a need for broad principles. All concerned should then apply these flexibly and with common sense to the varying circumstances of individual companies. (para. 1.11)

The overriding emphasis of the Hampel Report was on the need for good corporate governance to be based on principles rather than on prescription. The Hampel Report laid out 17 'principles of corporate governance' organised into four distinctive categories – directors, directors' remuneration, shareholders, and accountability and audit.

## The Combined Code (1998)

Following the publication of the Hampel Report, the Hampel Committee produced 'The Combined Code' (June 1998), a set of principles and codes embracing the Cadbury, Greenbury and Hampel recommendations. The Combined Code consisted of 18 principles and 48 code provisions. Stock Exchange listed companies were required to make a two-part disclosure statement on their adherence to the Combined Code. The first part of the disclosure statement required a company to report on how it applies the principles of corporate governance; the second part required a company to confirm that it complies with the individual code provisions

or to provide explanations where those provisions were not adhered to. The principles were essentially those contained in the Hampel Report. In substance, the code provisions do not vary from those of the Cadbury and Greenbury Codes, with the following exceptions (which are also detailed in Table 2.2):

- Cadbury recommended that boards should be composed of at least three NEDs. The Combined Code stated that NEDs should comprise not less than a third of the board and audit committees should comprise at least three NEDs. Hence, three NEDs became the minimum requirement. Larger boards (those with more than nine members) had to comprise more than three NEDs in order to comply with the Combined Code.
- The Combined Code required the company to identify those NEDs considered to be independent. The definition of independence is that of Cadbury, that is 'independent of management and free from any business or other relationship'.
- Cadbury recommended that where the role of the CEO and the chair was combined, there should be a strong and independent element on the board, with a recognised senior member. The Combined Code went further and required companies to publicly justify the combination of the posts of CEO and chair, and to identify a senior independent NED in the annual report (regardless of whether the posts of CEO and chair are combined).
- Cadbury suggested that nomination committees should be set up, comprising a majority of NEDs and chaired by either the chairman of the board or a NED. The Combined Code made this a recommendation (unless the board is 'small') and required that the members of the nomination committee be identified in the annual report.
- The Combined Code required that all directors submit themselves for re-election at least every three years.
- The Combined Code states that the board (rather than the remuneration committee, as recommended by Greenbury) should report to shareholders on remuneration.
- The Combined Code made specific recommendations regarding relations with shareholders and the use of the AGM. In particular, companies should indicate the level of proxy votes lodged on each resolution proposed at the AGM and the balance for and against each resolution. The chairs of the audit, remuneration and nomination committees should be available at the AGM to answer questions.
- The audit committee should consist of all least three NEDs, the majority of whom should be independent and all members named in the annual report.

The Combined Code, therefore, increased the amount of disclosure required by companies, by requiring disclosure of adherence to the codes contained in Cadbury and Greenbury, with additional disclosure as outlined above. In terms of governance structures, the main substantive change was the requirement that NEDs made up a third of the board, subject to a minimum of three. However, in line with the Hampel Report's contention that the board principles of corporate governance should be applied flexibly to the varying circumstances of individual companies, the Combined Code does stress that shareholders (institutional shareholders in particular) should take into consideration the company's explanations for non-adherence to the Code provisions.

Essentially, the approach of the Combined Code was to insist on disclosure of all important aspects of corporate governance structures and practice, but to stress that shareholders need to recognise that there will be instances where departures from the Code provisions are justifiable. However, despite the calls to move away from box-ticking, accusations still persist that many

institutional shareholders, coupled with the growth of organisations which provide governance voting advice (such as PIRC, Manifest and the institutional investors' professional bodies), are applying a box-ticking approach to corporate governance issues.

## The Turnbull Report

Guidance on the reporting of the system of internal control as required by Cadbury was provided by a Working Group on Internal Control (known as the Ruttelman Guidance, Ruttelman Working Group, 1994). The Ruttelman Guidance required that directors report only on internal *financial* control. The Combined Code laid down additional requirements with respect to internal control and significantly widened the definition of internal control on which directors are required to report. Each year, a review covering all controls, including financial, operational and compliance controls and risk management, should be undertaken. Finally, those companies which do not have an internal audit function should periodically review the need for one. Following publication of the Combined Code, the Institute of Chartered Accountants in England and Wales was asked to establish a working party (known as the Turnbull Committee) to provide guidance to assist companies in the implementation of the requirements of the Combined Code relating to internal control.

The Turnbull Committee produced a draft consultation report in April 1999 and a final report in September 1999 (Turnbull, 1999). The Turnbull Report argues that the role of internal control is to manage risk appropriately, rather than to eliminate it, and the aim of the report is to develop practical and robust guidance that companies can tailor to their own individual circumstances. Companies are required to adopt a continuing system of internal control that analyses all risks to the business, rather than just narrow financial risks. Specifically, the report calls on companies to embed the process for reviewing internal control systems into their continuing operations and not to treat it as an exercise merely undertaken for regulatory purposes. The effectiveness of the internal control system should be subject to monitoring on a continuous basis.

The Turnbull Report represents a further step in the attempts by Hampel to move away from the 'box-ticking mentality'. The Turnbull Report makes it clear that it views internal control and risk management as essential in ensuring that the company performs to the best of its ability. It recognises that 'profits are, in part, the reward for successful risk taking in business' (para. 13) and attempts to encourage companies to provide meaningful information to shareholders to enable them to assess the level of risk faced. However, the implementation of the Turnbull recommendations is expected to place additional responsibility on the NED members of the audit committee, particularly in respect of non-financial risk, such as those relating to technical, market and environmental aspects of the business, and so is likely to face accusations of increasing the burdens on business.

## **THE EVOLUTION OF GOVERNANCE POLICY – FROM COMBINED CODE I TO COMBINED CODE II**

The evolution of governance policy in the UK from the creation of the Cadbury Committee to the publication of the Combined Code in 1998 was a move from narrowly defined financial accountability under Cadbury to an approach which also recognised that the interests of shareholders were also served by allowing managers to exercise enterprise in terms of risk taking

and innovation (Short *et al.*, 1999). However, since the publication of the first Combined Code, developments in corporate governance policy have been marked by a seeming departure from such an evolution. In particular, the establishment of a major programme to review company law to incorporate corporate governance issues (Company Law Steering Group, 1999, 2000a, b etc.) and the introduction of 'The Directors' Remuneration Report Regulations' in 2002 signal a departure from self-regulation by companies and shareholders in corporate governance matters and provide a clear marker that the current Labour government is unwilling to take a back seat in the corporate governance debate. Whereas the framework encapsulated in the first Combined Code was formulated by committees largely made up of industrialists and institutions with the intention of reinforcing the ethos of self-regulation, the government's intervention, particularly on the issue of directors' remuneration, signals the belief that self-regulation may be failing to deliver accountability. Whilst the government's interest in corporate governance matters stems from the late 1990s, the current interest in the accountability of companies, fuelled by the recent US and European corporate scandals, has provided fresh impetus to the government's initiatives. In this section, therefore, we examine the key developments in corporate governance policy since the publication of the first Combined Code, paying particular attention to the role the government has played in the process.

## Directors' Remuneration Report Regulations

In 1999, the Government issued a consultation document, *Directors' Remuneration* (DTI, 1999a), which signalled the government's belief that many quoted companies were failing to comply with the spirit of the Greenbury recommendations. Specifically, the document proposed the increased disclosure of the linkages of performance to pay; for example, disclosure of the criteria used to measure directors' performance, disclosure of the comparator companies used and how the company has performed relative to those comparators over preceding financial years, and the disclosure of the relationship between awards made under incentive schemes and company's performance in the years in which those awards are earned. In addition, it was proposed that either shareholders should be allowed to vote on the board's remuneration report each year, or that special procedures are created to allow shareholders to move a resolution on remuneration at the AGM. The proposals did not seek to limit directors' pay awards but required companies to provide justification, backed by empirical evidence, of their remuneration policies.

Following on from the consultation document, the government announced that new disclosure requirements on remuneration would be required, and furthermore, that quoted companies would be required to put forward a resolution at the AGM each year on the directors' remuneration reports. The Directors' Remuneration Report Regulations 2002 (DRRR) came into force for quoted companies from 31 December 2002. Whilst the result of the vote on the remuneration report is advisory, a large vote against a report will clearly signal to companies that shareholders have lost faith in the remuneration committee and other board members.

The legal requirement prescribing the form and content of the remuneration report and the requirement that shareholders must be able to vote on the directors' remuneration report represents a sea change in the evolution of corporate governance policy in the UK. In addition, institutional investors have been quick to use their new voting powers to vote against the remuneration reports of companies where it is clear that the usual 'behind-the-scenes' dialogue has not been successful. For example, in May 2003, shareholders at GlaxoSmithKline voted by a narrow



majority (50.72%) to reject its remuneration report in response to the pay package of its CEO, which although not bound by the vote, forced the company to revise its remuneration policy.

Following on from the perceived success of the DRRR in increasing shareholder activism on the issue of directors' remuneration, the government moved its attention to the issue of pay-offs made to directors who leave a company. A consultative document, *Rewards for Failure*, was issued in June 2003 (DTI, 2003) which specifically addresses the issue of severance payments made irrespective of how the company has performed and considers possible legislative reform to cap the size of severance payments.

### The Myners Review

The Myners Review was commissioned by the Treasury in 2000 to investigate institutional investment, with particular consideration given to whether institutional investment behaviour was rational, well informed, subject to the correct incentives and, as far as possible, undistorted. The Review considered a broad range of issues of industry and public concern: pension funds; investment decision making by trustees; actuaries and investment consultants; fund managers, defined contribution schemes; local authority schemes; pension fund surpluses; the minimum funding requirement; life insurance; pooled investment vehicles; and private equity.

Of particular interest from a corporate governance policy perspective were the proposals put forward in the Review (Myners, 2001) for the adoption of a set of principles to codify best practice for pension fund decision making. The corporate governance reports from Cadbury to Hampel have all stressed the role of institutional investors (of which pension funds, until recently, have been the largest group of institutional shareholders<sup>2</sup>) in ensuring that companies adhere to best practice in issues of corporate governance. Of central importance to Myners' assessment of the UK pensions industry was the issue of 'trust' ownership and governance. A range of features of this system was explicitly criticised, whilst the position of the 'trust' system itself was not addressed. Points of particular criticism included the lack of expertise of pension fund trustees; the lack of clarity concerning the timeframes over which the performance of pensions funds and their managers was assessed; and the possible lack of incentives for participants in pension investment decisions to maximise returns from these investments.

The incentive structure for different participants, including professional advisers, fund managers and trustees, was deemed by the Review to have a significant influence in distorting the investment behaviour of pension funds and other institutional investors. In particular, it was argued that wholly unrealistic demands are placed on pension fund trustees, who often have neither the resources nor the expertise to take the crucial investment decisions for which they are ultimately responsible. Myners suggested that the US model for pension fund trustees should be followed, in that trustees should have a legal requirement to be familiar with the issues when they take investment decisions.

The Review was critical of the role of institutional investors in corporate governance issues. Specifically, it found evidence that pension fund managers are reluctant to take pre-emptive actions to tackle underperformance in investee companies. Although the Review was presented with reasons for the lack of intervention (including potential conflicts of interest and the lack of incentives to intervene), it found none of the reasons given to be compelling. The Review argued that 'if fund managers are truly to fulfil their duty of seeking to maximise value for their shareholders, there will be times – certainly more than at present – when intervention is the right action to take'.

A central feature of the Review is the setting out of a set of principles, akin to the Combined Code of the Committee on Corporate Governance, which attempts to codify best practice for pension fund decision making. The principles include:

- decisions should be taken only by those with the right skills, information and resources needed to take them effectively
- fund managers should be set clear objectives and timescales
- funds should explicitly consider whether the index benchmarks that they have selected are appropriate
- trustees should measure the performance of all advisors and managers and should also assess their own performance.

Analogous to the Combined Code, it is proposed that adherence to the principles will not be mandatory, but that pension funds choosing not to comply with a particular principle should explain the reasons for their decision in an enhanced annual Statement of Investment Principles.

Following on from the publication of the Myners Review, the government issued a document, *Encouraging Shareholder Activism* (HM Treasury/DWP, 2002), which set out proposed legislation for incorporating into UK law a duty for those responsible for the investment of pension scheme assets to actively monitor and communicate with the management of investee companies and to exercise shareholder votes where, after taking into account the costs of any action, there is a reasonable expectation that such activities are likely to enhance the value of the investment.<sup>3</sup> In response to the threat of legislation, the Institutional Shareholders Committee published a statement of principles setting out the responsibilities of institutional shareholders and agents (ISC, 2002). The statement recommends that institutional shareholders in respect of the companies in which they invest should maintain and publish a statement of their policies in respect of their engagement; monitor the performance of and maintain an appropriate dialogue with these companies; intervene where necessary; evaluate the impact of their policies; and in the case of fund managers, report back to their clients on whose behalf they invest. In response to the ISC's statement, the government has drawn back from the threat of immediate legislation and is reviewing the impact of the principles after two years. However, if it feels that a non-legislative approach has failed to increase shareholder activism, it has signalled that a legislative approach will be adopted.

## The Higgs Report

In 2002, the government commissioned Derek Higgs to lead a review of the role and effectiveness of non-executive directors in the UK. Building on from the central role of NEDs in corporate governance as set down in the Combined Code, the terms of reference of the Review were to investigate the current operation of boards of directors and the contribution of NEDs, and to identify actions which could be taken to strengthen the quality, independence and effectiveness of NEDs. At the same time, a group was set up to review the UK audit and accounting regime (the Coordinating Group on Audit and Accounting Issues chaired by Robert Smith) and to produce guidelines to help audit committees to increase their effectiveness (Smith Report, 2003).

The Higgs Report was published in January 2003. Its publication came in the wake of regulatory pressure following the governance scandals at the US firms Enron and Worldcom. The Higgs Report (2003) laid down a revised Combined Code, incorporating the changes suggested by the Higgs Review and the Smith Report. Prior to its publication, the general

expectation was that the Report would simply reaffirm current governance practice as laid down in the Combined Code and perhaps suggest ways in which non-executives may be drawn from a wider pool of candidates and be provided with training for their duties. However, when the Report was published, it contained a number of significant governance reforms, which were met with considerable opposition from many leading companies and sparked a very heated debate between company management and institutional shareholders.

The significant changes in the Combined Code recommended by the Higgs Report were as follows:

- At least half of the board, excluding the chairman, should comprise independent non-executive directors.
- A new definition of independence with respect to NEDs was proposed. A NED is considered independent when judged by the board to be independent in character and judgement, and there are no relationships or circumstances which could affect, or appear to affect, the director's judgement. Relationships or circumstances which could affect the director's judgement included being a former employee during the last five years, having a material business relationship with the company within the last three years, the granting of any payments other than the director's fee, having close family ties with any of the company's advisers, directors or senior employees, holding cross-directorships or other significant links with other directors, representing a significant shareholder and serving on the board for more than ten years.<sup>4</sup>
- A senior independent non-executive director (SID) should be identified in the annual report and be available to shareholders if they have reason for concern on which contact through the normal channels of chairman or CEO is inappropriate or has failed to resolve.
- The SID should regularly attend meetings of management with major shareholders in order to be able to understand the themes, issues and concerns of shareholders, and communicate these views to other NEDs. NEDs should be able to attend regular meetings with major shareholders.
- The NEDs should meet regularly as a group without the executives present and at least once a year without the chairman present. The meeting should be led by the senior independent director.
- The nomination committee should be chaired by an independent non-executive director, and not the chairman of the board.
- An executive director should not take on more than one NED position, nor become chairman, of a FTSE 100 company. No individual should chair the board of more than one FTSE 100 company.
- A CEO of a company should not go on to become chairman of the same company.
- No one NED should sit on three board committees.
- Comprehensive induction programmes should be provided to all new NEDs and resources should be provided for ongoing training and development of the members of the board.

The proposed new Combined Code consisted of 18 principles and 84 code provisions – a significant increase in code provisions as compared to the first Combined Code. The publication of the Higgs Report was met with vocal opposition from business leaders. The recommendations laid down in the Report were criticised for being too prescriptive, divisive in terms of the relationship between executive and non-executive directors and would undermine the role of the chairman of the board. The recommendations that attracted the most criticism were those concerning the enhanced role of the senior independent NED (SID) and the recommendation

that the chairman of the board should not chair the nominations committee. The strengthening of the powers of the SID was argued to undermine the role of the chairman, particularly with respect to the recommendation that the SID should be available to meet with shareholders and to chair a yearly meeting with NEDs without the chairman present. This was felt by many to allow for the opening up of separate and potentially divisive channels of communications with shareholders (CBI, 2003) and to provide a separate powerbase for the SID, threatening the unity of the board. Moreover, the recommendations implicitly assume that the chairman is no longer classed as an independent director.

### The Combined Code (2003)

Following on from the criticisms of the Higgs Report, the Financial Reporting Council (FRC) commenced a consultation exercise on the content and wording of the proposed new Combined Code and in July 2003 issued the new Combined Code. The consultation process was largely successful, in that, although most of the Higgs reforms are preserved, the language and tone of the recommendations were tempered in such a way as to appease its business critics. The number of code provisions was reduced to 48, with many of the original code provisions reclassified as a new category called 'supporting principles'. As with the original Combined Code, companies have to provide a two-part statement in the annual report explaining first, how they apply the principles (and now supporting principles), and second, confirming that they comply with the code provisions or providing an explanation where they do not. The reclassifying of many of the Higgs code provisions into supporting principles significantly reduces the amount of 'complex or explain' disclosure compared to that suggested by Higgs. Concerns raised by critics of Higgs that some of the recommendations would threaten board unity and undermine the role of the chairman were met by revising a number of recommendations – for example, the recommendation that the chairman of the board should not chair the nomination committee was dropped and the role of the chairman in meetings between NEDs and between NEDs and major shareholders was reinforced and that of the SID reduced. In addition, the recommendation that the CEO should not become chair of the same company was tempered to allow such an appointment after consultation with major shareholders. Finally, some of the recommendations were relaxed for smaller companies, for example the recommendation that over half the board should consist of independent non-executives was relaxed in the case of companies below the FTSE 350.

### Other Government Initiatives

In addition to the introduction of regulation governing directors' remuneration and the threat of legislation to govern institutional shareholders, the government has instigated a number of fundamental reviews of many aspects of company law and corporate governance issues. Central to many of the proposed changes is the major review of company law which was launched in 1998 and undertaken by an independent Steering Group. In response to the group's recommendations, a White Paper, 'Modernising Company Law', was published in July 2002. The White Paper seeks to codify directors' duties and responsibilities and to increase transparency of the workings of the AGM. The Committee on Standards in Public Life issued a report in 1998 (the Neill Report) which recommended that companies obtain consent from their shareholders prior to making political donations. In response to this report, the government stated its intention to introduce legislation to this effect (DTI, 1999b). The Political Parties and

Referendums Act 2000 prohibits companies from making donations or incurring expenditure in relation to political organisations in the European Union in the 12-month period following the company's AGM (and in each succeeding 12-month period) in excess of an aggregate £5000, unless authorised by the company's shareholders.

## **OVERVIEW OF POLICY EVOLUTION**

The publication of the Cadbury Report in 1992 marked the beginning of an ongoing evolution in corporate governance policy in the UK. Whilst both the Cadbury and Greenbury committees were set up in response to public concerns regarding specific governance issues, they set in place the ongoing debate on how corporate governance structures and practices can be best improved in UK companies.

The Hampel Report represented a significant departure from the previous reports by stressing that the emphasis on accountability had obscured the need for companies to maintain and enhance business prosperity. It was argued that adherence to the letter of the code provisions does not necessarily lead to 'good' governance, and that adherence to broad principles was of more importance. Hence, the developments in policy from Cadbury to Hampel (as presented in the Combined Code 1998) represented a shift from a narrowly defined approach which focused mainly on accountability, to a more balanced approach which recognised the need for governance systems to produce structures and incentives to allow business enterprise and prosperity to flourish. However, recent government initiatives provide a signal that governance policy in the UK may be about to undergo a fundamental change. The history of corporate governance codes in the UK, until recently, has been one of self-regulation. Since the original Cadbury Code of Best Practice, the approach has been that of 'comply or explain'; that is, companies are required by the Stock Exchange Listing Rules either to comply with the governance codes or to explain why they do not comply. Whilst this approach still holds in the case of the 2003 Combined Code, it is clear that the current Labour government is unwilling to take a back seat in the corporate governance debate. The government's intervention in many areas (such as the Modernising Company Law White Paper and the Directors' Remuneration Regulations) signals the belief that self-regulation may be failing to deliver accountability.

Whilst a self-regulatory system has previously been criticised for failing to deliver improved corporate governance standards, there is a danger that increased regulation will simply lead to more 'box-ticking' on the part of both companies and shareholders. The sheer amount of governance disclosure presented in the annual report provides both companies and shareholders with disincentives to pay more than lip service to governance issues – companies have incentives to adopt a 'boiler plate' approach to governance disclosure, whilst the huge amount of information provided encourages shareholders to adopt a box-ticking approach to whether a company meets the governance recommendations. Furthermore, given that Hampel recognised that governance should not be a matter of prescribing corporate structures and complying with hard and fast rules, a move towards increased legislation risks removing flexibility and the application of common sense to individual company governance structures.

Furthermore, the emphasis on legislation as opposed to self-regulation risks forcing particular governance structures on all companies, regardless of whether they are suitable for the particular circumstances of the firm. It is important to keep upmost in mind the reason why improved corporate governance is a desirable outcome. From an agency perspective, the need to establish an appropriate corporate governance framework arises because the separation

of ownership and control produces agency problems stemming from the inability to write complete contracts for all future eventualities (Hart, 1995). As a result, management are able to pursue their own objectives at the expense of those shareholders. The term 'corporate governance' has come to embrace those devices, mechanisms and structures which act as a check on managerial self-serving behaviour (John and Senbet, 1998). However, the purpose of checking self-serving behaviour is to promote the efficient operation of the firm. Devices employed to reduce self-serving behaviour and hence improve accountability cannot be seen as efficient if they also hamper the performance of the firm. 'Good' corporate governance, therefore, can be seen as referring to the mix of those devices, mechanisms and structures which provide control and accountability whilst promoting economic enterprise and corporate performance (Short *et al.*, 1999). However, there is no clear evidence that the recommendations of the governance codes do act to achieve 'good' governance from both the accountability and enterprise perspectives. For example, Young's (2000) study of the increasing use on NEDs following the Cadbury Report recognised that the extent to which the appointment of additional NEDs to the board resulted in an improvement in board performance and on managerial enterprise remained an open question (p. 1339). Indeed, the preliminary report of the Hampel Committee (1997) noted that 'it is important to recognise that there is no hard evidence to link success to good governance, although we believe that good governance enhances that prospect' (para. 1.2).

As Short *et al.* (1999) argued, the development of corporate governance policy in the UK has been based on a paucity of UK evidence relating to the relationships between governance, accountability and enterprise. Although there is a growing body of US literature which examines these relationships (see Short *et al.* for a review), research on UK companies which examines the complex relationships between governance, accountability and enterprise remains limited. Furthermore, given that companies have changed their governance structures (particularly in respect of NEDs and board committees) in response to the recommendations of the various codes, research into whether the changes have actually led to improvements in both accountability, enterprise and ultimately long-term performance is fraught with difficulty. For example, the Cadbury recommendation that the board should consist of three NEDs led to many companies increasing the number of NEDs on the board (Young, 2000). However, given that many companies simply comply with Cadbury, research aimed at investigating the 'optimal' board structure in terms of the mix of executive and NEDs becomes impossible post-Cadbury. Whilst it is possible to test whether, for example, an increase in NEDs from one to three has led to improved performance, this does not identify whether three NEDs is the optimal number – two may be the optimal number for a particular individual company.

These issues highlight the importance of the 'comply or explain' approach which relies on self-regulation. The increasing emphasis on legislation championed by the government risks changing the 'comply or explain' ethos into a 'comply or else' stance which is likely to result in companies adopting suboptimal governance structures simply to avoid the threat of sanctions from failing to comply. The threat of legislation to force institutions to exercise their voting power also risks forcing companies into adopting suboptimal structures. Compulsory voting does not mean 'informed' voting and the result may simply be that institutions are more likely to 'box-tick' and companies to 'boilerplate' their governance structures and practices, regardless of whether such structures and practices are optimal for the individual company. Instead of an increasing emphasis on a legislative approach, consideration needs to be given to the cost and benefits of 'poor' corporate governance as defined by a code, versus 'poor' performance caused by suboptimal corporate governance structures.

## CONCLUSION

This chapter has plotted the development of corporate governance policy in the UK since the formation of the Cadbury Committee in 1991 to the present day. It is clear from the above discussion that the ethos governing such policy has undergone fundamental changes since the publication of the Cadbury Report. Whilst the Hampel Report moved away from an emphasis on accountability and stressed the importance of business prosperity and enterprise, recent developments suggest a return to an emphasis on prescription rather than principle. In particular, various government initiatives to legislate on many aspects of corporate governance risk may put the emphasis on enterprise at risk. Legislation is likely to lead to increased ‘box-ticking’ and a greater emphasis on disclosure rather than on the incentives required to ensure that the enterprise potential of the firm is maximised. There is a need to weigh the costs and benefits of efforts to enhance accountability in terms of the potential entrepreneurial actions forgone in order to achieve a greater balance in the approach to corporate governance. Specifically, it is crucial to recognise that the appropriate balance will vary according to the characteristics of individual firms. Indeed, recent policy developments may at worse be detrimental to the development of enterprise performance in the UK.

## NOTES

1. Prior to Cadbury, listed companies had to provide biographical details of NEDs, but if details of all directors were provided, companies could meet those requirements without actually identifying which directors, if any, were non-executives.
2. See Chapter 4 for a detailed discussion of the role of institutional shareholders in corporate governance in the UK.
3. This is similar to US legislation under the Employment Retirement Income Security Act 1974 (ERISA).
4. This was changed to nine years in the Combined Code (2003).
5. The establishment of a nomination committee was suggested by Cadbury, but not included as a recommendation in the code of best practice.

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# Financial Structure and Corporate Governance

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## INTRODUCTION

This chapter examines corporate financial structure decisions and some of their implications for shareholders, the debt suppliers, other stakeholders and corporate governance practitioners. The most obvious consequence of financial structure decisions is their impact on corporate financial risk; that is, leverage increases the variance of the residual cashflows accruing to shareholders. As first analysed by Jensen and Meckling (1976), however, in a world of non-trivial agency costs, financial structure decisions are not likely to be independent of investment or ownership choices – decisions that can have a significant impact on the size and riskiness of the firm's underlying operating cashflows. Such simultaneous changes in business risk and financial leverage have the potential to significantly alter managerial incentives and the distribution of financial risk between different corporate stakeholders, primarily from shareholders to debtholders and employees.

Nevertheless, Jensen and Meckling argue that, given reasonably efficient markets and economically rational individuals, such possibilities will have been anticipated by the parties involved and all such 'agency costs of debt' will be reflected in the prices and other characteristics of equity and debt securities – and managerial contracts since a similar line of reasoning underpins the 'agency costs of equity', i.e. the costs associated with the separation of ownership from control. Jensen and Meckling's resulting 'optimal capital structure' model is, therefore, based on a simple trade-off between these two types of agency cost and the shareholders' desire to minimise 'total agency costs'.

Variations on Jensen and Meckling's agency cost trade-off model of a firm-specific optimal capital structure and their 'nexus of contracts' view of the corporation and its efficient governance (namely, that corporate decision-making authority should be controlled by those groups that are most exposed to the financial consequences) are now widely held by academics and corporate governance practitioners. However, consistent with casual observations, much recent research has confirmed that markets are often highly inefficient because of bounded rationality and widespread incomplete and costly contracting. Thus, realistically, many of the

wealth effects of financial structure decisions will not have been anticipated by stakeholders, and therefore, in practice, many corporate decisions will inevitably involve contractually uncompensated wealth transfers. This would seem to imply that not all the agency costs of debt will necessarily be borne by shareholders.

Clearly, then, leverage decisions can heighten conflicts of interest between shareholders and other stakeholders, particularly those groups that become further exposed to corporate risks but who are excluded from corporate decision processes and/or are least able to protect their financial claims via contractual or other means. In an incomplete contracting environment, both the importance of trust and the difficulties that the system of corporate governance has to overcome in order to achieve a commercially viable and acceptable trade-off between minimising leverage-induced stakeholder conflicts (i.e. reducing the agency costs of debt) and the provision of appropriate decision criteria and incentives for management to maximise shareholder value (i.e. reducing the agency costs of equity) are necessarily greatly increased.

In both the UK and US corporate governance thinking and practice has overwhelmingly focused on the second issue, i.e. the separation of ownership from control and its potential to generate significant agency costs for shareholders if managers are not adequately monitored and/or lack the necessary financial incentives to act in ways that maximise shareholder returns.<sup>1</sup> As shareholders are considered to be the primary residual claimants (risk bearers), once the contractual claims of other, non-equity, stakeholders have been satisfied, shareholders expect managers to exercise whatever decision-making discretion remains on their behalf. Despite their ownership rights (including the right to appoint and dismiss the board of directors) and residual claimant status, it has long been recognised (e.g. Berle and Means, 1932) that shareholders of widely held firms (with limited liability) may not actually have the appropriate incentives to monitor and exercise control over executive decision making. This is because the costly and public good nature of managerial monitoring reduces the incentives of well-diversified individual shareholders to monitor managerial actions. Corporate governance reforms in these countries have therefore tended to concentrate on ways of reducing these agency costs associated with equity by requiring more extensive and transparent (i.e. trustworthy) corporate financial disclosures, encouraging greater institutional shareholder 'activism' and more independent boards with incentives to discipline and reward senior executives in ways that efficiently align executive and shareholder interests.

In contrast, the agency costs associated with debt finance appear to have been less of a concern to corporate governance reformers. The possibility that a firm may default on its promises to repay debtholders their contractual claims has always been a well-recognised danger given the existence of limited liability and the inherent uncertainties regarding future corporate cash-flows. Not surprisingly, then, debtholders have developed a variety of well-established ways of protecting themselves and/or obtaining financial compensation for any perceived exposure to corporate risks. Nevertheless, the agency costs of debt can be both substantial and unanticipated and capital structures that increase the probability of default can have a severe adverse impact upon the financial claims and total wealth of other stakeholders, many of whom have ambiguous, i.e. legally unenforceable, 'implicit' claims that may be lost if the firm becomes financially distressed or experiences a change in ownership. The largely implicit nature of their financial claims and the absence of control rights should be of particular concern to employees since typically they will have inadequately diversified (wealth and human capital) portfolios with a high exposure to firm-specific risks. Employees, with significant personal holdings of shares in their employing firm and/or who are members of the firm's 'defined benefit' (or 'final salary') pension schemes will be especially exposed to such firm-specific risks.

In practice, then, not all potential losses to stakeholders can be anticipated or protected by legally enforceable contractual agreements. Highly incomplete contracting and extensive *ex post* recontracting as unanticipated outcomes falsify the assumptions on which the previous contracts were based and the probability of uncompensated losses to non-equity stakeholders are always a possibility. In this context, corporate governance arrangements, such as the reliability of information disclosure and financial reporting, confidence in the internal mechanisms by which conflicts of interest are resolved and the ability of non-equity stakeholders to influence and/or control some aspects of corporate decision making, are therefore of considerable importance in generating trust and reputational capital amongst the non-equity stakeholders.

The recognition that shareholders may not be the only residual claimants has led some writers to claim that this undermines the justification for the nexus of contracts view that major corporate decisions should always be made on the basis of maximising shareholder wealth. Several writers<sup>2</sup> have suggested that this problem requires a more fundamental rethink of the theory of the firm and its governance because the boundaries of the firm are much wider than the highly legalistic ‘nexus of (explicit) contracts’ view that underpins much of the standard agency theory analyses of corporate decision making and governance. It has also been suggested (Kay and Silberston, 1995; Zingales, 2000) that, if the decisions of corporate controllers have the potential to create significant negative externalities for groups other than shareholders, then it is more appropriate to view the firm as a ‘social institution’ with obligations that extend far beyond its legally enforceable nexus of formal contracts.

The view of the firm as a social institution<sup>3</sup> opens up to debate the traditional answers to governance issues such as what ought to be the legitimate objectives of the corporation, in whose interests management ought to be exercising their discretion and the degree of influence that other stakeholders should have upon corporate decision making. Some critics of the shareholder–primacy model characteristic of the US and UK have also advocated the introduction of what they take to be the alternative stakeholder governance models embedded in the corporate governance regulations institutions and practices of several major developed economies, most notably Germany and Japan.

In the following section of this chapter we examine what finance researchers have had to say regarding the capital structure decision and how leverage may or may not impact on firm value and the riskiness of different stakeholder financial claims. The conflicts of interest generated by leverage decisions and the ways that managers, if they were actually motivated to act in shareholders’ interests, could attempt to shift uncompensated risks onto other stakeholders are then examined from an option pricing perspective. Whether in practice the economic welfare of other corporate stakeholders is significantly affected by corporate financial structure decisions depends upon how far their financial claims are adequately protected by the set of legal, regulatory, and governance arrangements typically available and utilised by stakeholders. This analysis suggests that, if the reliability of firms’ financial information disclosures is assured, most reasonably diligent debtholders can normally be confident that their contractual claims can be adequately protected via legal/contractual means. However, we emphasise that firms are by their nature risky and rapidly changing economic conditions, and the inventiveness of corporate and financial entrepreneurs are continually exposing the firm to new and incalculable risks. Any number of factors, such as increased product market competition, securities market pricing inefficiencies and overoptimistic business plans, therefore have the potential to produce unanticipated business outcomes that render the fulfilling of existing contractual promises excessively costly. The financial claims of shareholders and unsecured debtholders, along with

the future earnings expectations and occupational pension promises made to employees, are essentially contingent claims that depend upon the long-term financial success and continuity of a risky enterprise, whose management may have both the resources and incentives to act in ways that make the fulfilment of the firm's promises less likely in the future.

We then discuss governance arrangements that attempt to foster long-term mutual trust between the contracting parties and the suggestion that such arrangements greatly facilitate the resolution of recontracting conflicts. Governance systems that encourage the continuation of such long-term relationships will also tend to discourage management from exploiting contractual incompleteness, information advantages or from taking actions that intentionally or otherwise further damage stakeholders' claims. Even so, once it is recognised that firms are inescapably risky enterprises, it should be self-evident that no corporate governance system can guarantee that corporate promises, particularly as with employee pensions where these promises can extend over many decades, can or will be honoured or that any stakeholder will not turn out to be a residual claimant.

Many critics of the shareholder-primacy model have used similar arguments regarding the inescapably contingent nature of corporate financial claims to suggest that the alternative stakeholder models characteristic of Germany and Japan provide a more satisfactory solution to the governance problems associated with managing the long-term contractual claims of non-shareholders, particularly employees. Indeed, several of these authors suggest that recent public policy changes in the UK, largely stemming from the implementation of EU Directives, have altered the 'trajectory' of corporate governance away from the single-minded pursuit of shareholder interests (e.g. Armour *et al.*, 2003). We briefly discuss these institutional and legal developments in the UK which appear to provide important safeguards in respect of non-shareholder financial claims and analyse whether these significantly alter either the nature of the financial claims of non-shareholders or the incentives of management to pursue shareholder wealth.

## **CAPITAL STRUCTURE AND FINANCIAL RISK**

Capital structure refers to the manner in which firms are financed. Firms may raise funds from external sources or plough back profits rather than distribute them to shareholders as dividends. Should a firm require additional external financing, it may choose between equity (risk capital) and various forms of long- or short-term debt (e.g. bonds, bank loans and short-term credit). In an efficiently functioning capital market, the price a firm will expect to pay for access to these different forms of finance will represent a fair return on investors capital given the perceived risks of the relevant security issued by the firm. The price of debt tends to be lower than for equity since debt obligations are less exposed to long-term corporate risks. Unlike equity finance, which is a security with no maturity date and which makes no explicit cashflow promises, debt contracts have maturity dates and normally require the firm to pay out regular fixed interest and capital repayments irrespective of the success or otherwise of the firms' investment projects.

For any given level of business risk, i.e. the variance of a firm's operating cashflows, the higher the proportion of such 'fixed charges' against corporate cashflows, the greater will be the variance of the residual cashflows accruing to shareholders. That is, debt creates additional risk via financial leverage and the higher the debt relative to equity finance, the greater is this financial leverage. In addition, because of 'limited liability', if the firm finds that it is unable to honour its debt interest and capital repayment obligations, it has the option of default, at which

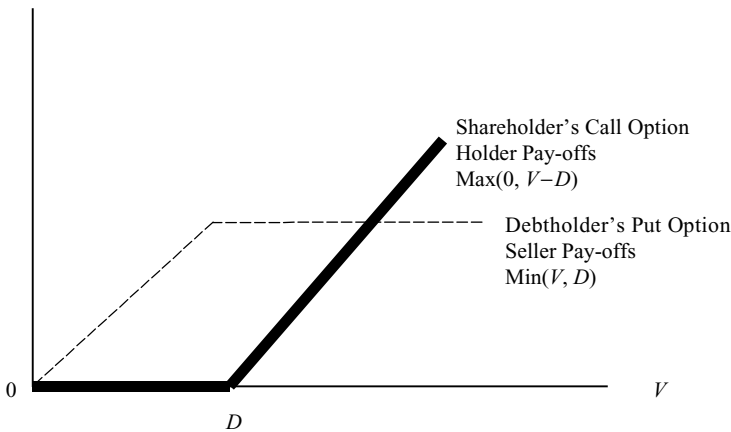


Figure 3.1 Shareholder and debtholder pay-offs given the value of the firm ( $V$ ) and the debt obligations ( $D$ )

point control over the firm’s assets is transferred to the debtholders. If the net realisable value of the firm’s assets is insufficient to satisfy their financial claims, debtholders have to bear this loss since shareholder liability is limited to their equity stake, i.e. their shares simply become worthless. As can be seen from Figure 3.1, the respective pay-off functions to shareholders (i.e.  $\text{Max}(0, V - D)$ ) and debtholders (i.e.  $\text{Min}(D, V)$ ) are therefore analogous to that of a ‘call option’ holder and the writer of a ‘put option’ on the underlying value of the firm and with strike prices equivalent to the value of the outstanding debt obligations.

We can examine the effect upon shareholder and debtholder pay-offs of a pure leverage decision involving a share ‘buyback’ using borrowed funds, i.e. neither the assets of the firm nor its anticipated cashflows are affected by the decision. To illustrate, suppose we assume no transactions or information costs and that both parties have perfect knowledge regarding expected future cashflows and their variance. Let us also assume that the firm’s initial (pre-buyback) outstanding debt obligations,  $D_0$ , are £50. The expected value of the firm ( $E(V)$ ) is £100, and the symmetrically distributed range of possible firm value outcomes is  $E(V) \pm X$ , where  $X = £20$ . The initial value of the firm’s equity ( $S_0 = E(V) - D$ ), which we require in order to calculate shareholder returns, is therefore £50. Though the expected return in terms of both total firm value and shareholder rewards is 0%, because debt constitutes 50% of the total finance used by the firm, the actual minimum and maximum possible returns to shareholders (–40% and +40%) are exactly twice as great as the minimum and maximum percentage changes in firm value, i.e. –20% and +20%. The debtholders will, however, be unconcerned at this level of leverage since whatever outcome occurs there will always be sufficient value in the firm to fully satisfy their financial claim of £50.

If we now assume that the firm decides to borrow a further £30 (i.e.  $D_1 = £80$ ) in order to buyback some of its shares, given our assumptions, this will also not impact on firm value or operating risks. It will, however, further increase financial leverage and hence the variability in shareholder outcomes since their minimum and maximum possible pay-offs will now be respectively £0 (i.e.  $S = 100 - 80 - 20 = 0$ ) and £40 ( $100 - 80 + 20 = 40$ ) which, given a new equity base of £20 (i.e.  $100 - 80$ ), represent returns to shareholders of –100% and +100%. Once again, however, the debtholder’s claims can be honoured irrespective of the cashflow outcome for the firm.

Though in the above case, the debtholders' claims can be honoured even if firm value is at its minimum value of £80, any further debt-financed buybacks will be at the expense of the debtholders. Clearly, if presented with the above information, the debtholders would refuse to fund any additional share buybacks. However, shareholders can increase their potential returns if they can persuade the debtholders to lend the firm further funds, say by convincing the debtholders that the cashflow distribution is less variable than it really is. We can drop the assumption that debtholders have accurate information regarding the cashflow distribution and assume instead that the firm's managers have convinced them that the minimum and maximum deviations from the expected firm value of £100 are  $\pm£10$  rather than £20. If this induces the debtholders to lend the firm an additional £10, then the debtholders will be exposed to the possibility of bearing some of the business risk without sharing any of the upside potential.

To illustrate, the minimum and maximum pay-offs for the shareholders now become £0 and £30 which, given their equity investment of £10, generates shareholder returns of  $-100\%$  and  $+200\%$  respectively. If the minimum outcome occurs (with firm value at £80, i.e.  $£100 - £20$ ), not all of the debtholders' £90 can be honoured, i.e. the firm will exercise its option to default and the debtholders will be left with the firm's assets – which in this case are worth £80. The truncated downside pay-off profiles to equity holders of firms with high debt levels may therefore encourage managers to mislead outside investors regarding actual business risks since if the firm defaults some or all of these downside losses will be borne by the debtholders. Conversely, all upside gains will still accrue to the shareholders which, due to their smaller equity investment, will earn them proportionately higher percentage returns than the same firm value outcome would generate for the shareholders of low or no debt firms. As discussed below the distorted incentives associated with high leverage and limited liability may also encourage corporate decision makers to maximise any leverage effects by altering the composition of the firm's assets and/or the riskiness of its cashflows. The proposition that managers always act in shareholder interests and that the convexity in shareholder pay-offs at high debt levels may result in the expropriation of debtholders, is one of the major insights to be derived from the application of option pricing ideas to corporate securities (for a review, see Harris and Raviv, 1991).

## **DOES CAPITAL STRUCTURE MATTER?**

Whether financial leverage creates value, i.e. increases the value of the firm, or simply increases the financial risks and fair returns to shareholders (i.e. is irrelevant) or encourages shareholder–managers to shift uncompensated risk onto debtholders (as illustrated in Figure 3.1), are issues that have been central to much of corporate finance since the publication of Modigliani and Miller's (1958) famous irrelevance theorems. As indicated in the discussion below, subsequent research has established that the answers to these questions largely depend upon the extent to which the contracting parties are able to adequately anticipate and assess likely future business cashflow risks and/or are able to find efficient contractual ways of protecting their financial claims in the event of poor business outcomes.

The original Modigliani and Miller (1958) capital structure model shows that in a perfect and complete market setting with no transactions costs or taxes, how the firm is financed will have no effect upon its value. What determines firm value is the size and riskiness of the cashflows arising from its investments in risky projects. The underlying investment and operating decisions that determine corporate cashflows are assumed to be independent of financing decisions, i.e. are unaffected, and therefore capital structure decisions will merely

result in changing the distribution of these cashflows between the different claimants. Capital structure decisions will, of course, alter shareholder's anticipated risk and returns but this will not have any impact on total firm value because in a perfect and complete capital market investors can costlessly profit from any market mispricing via the application of 'homemade leverage' (arbitrage). Thus capital structure is irrelevant in respect of determining firm value.

The Modigliani and Miller analysis and conclusions have not, however, gone unchallenged and many subsequent investigations into these issues have shown that their perfect and complete market model, because it leaves out a host of highly relevant institutional features, is itself irrelevant to understanding the capital structure choices of actual firms operating in realistic market settings. In fact, Modigliani and Miller's model not only renders capital structure choices irrelevant, it also implies that the corporate form (and therefore corporate governance) is irrelevant since in a perfect and complete market setting, all corporate stakeholders could equally well directly contract with each other via market transactions. In such a setting, it is unclear what the economic rationale for the existence of the corporate form would be (see Zingales, 2000). Indeed, Modigliani and Miller (1963) themselves recognised the importance of one institutional feature not included in their original model, namely, the existence of a corporate tax regime that treated debt-interest payments as a tax-deductible expense.

The inclusion of the corporate debt-interest tax shield into their analysis dramatically altered their original conclusions; because of the tax advantages of debt-interest payments, firm value would now be maximised at 'almost' 100% debt finance. As discussed earlier, the leverage effects of high debt levels and limited liability tend to generate incentives for shareholders to take higher risks since some of the potential default costs may be borne by the debtholders. Modigliani and Miller were able to ignore the possibility of default and/or excessive risk taking by shareholders because in their model they assumed that both parties had free access to the actual future cashflow distribution of the firm and hence could avoid investing in firms that might subsequently default. In practice, of course, investors do not have access to such information and therefore few if any firms actually have debt to total value ratios anywhere close to 100%.

Empirically it appears that individually firms typically tend to have fairly stable intertemporal capital structures, with the relative amount and types of debt used being related to the riskiness of the firm's operations, the likely financial distress/failure costs and other agency-related factors specific to the firm.<sup>4</sup> As most firms also have some debt, this suggests that there may be a firm-specific optimal capital structure. Thus, several post-Modigliani and Miller studies have developed models of optimal capital structure which involve maximising the value of the firm in the context of a trade-off between the tax shield advantages of debt and/or the agency costs of equity, both of which increase firm value as debt levels rise, and the increasing agency costs of debt and bankruptcy/distress costs that increase as debt levels rise.

## **THE AGENCY COSTS OF DEBT**

Perhaps the most influential optimal capital structure model is that developed by Jensen and Meckling (1976), who argued that in a world without corporate taxes but with costly contracting and non-trivial agency costs, ownership and capital structures were not independent of each other, but rather were chosen so as to minimise total agency costs. At the centre of the Jensen and Meckling model is the potential for *ex post* wealth transfers from debtholders to shareholders arising from the so-called 'asset substitution' problem, i.e. how can debtholders stop shareholders from using their funds on a more risky project than originally claimed



when the contract was negotiated? However, as Jensen and Meckling assume that all economic agents are rational contractors and that financial markets are efficient, they argue that these and other possibilities for expropriation will have been anticipated by all concerned and therefore the risk adequately priced and/or protected against at the contract negotiation stage. Thus, all agency costs are ultimately borne by shareholders and, by assuming that the agency costs of equity decline as the proportion of debt increases whilst the agency costs of debt increase as debt levels rise, they derive their ground-breaking optimal capital structure model. Jensen and Meckling were pioneers in the development of agency theory and what has subsequently become known as 'optimal contracting'.

Other factors, such as the corporate debt tax shield and anticipated failure costs which both increase as debt levels rise, can be, and have subsequently been, incorporated into this basic agency cost trade-off model of optimal capital structure. The incorporation of potential deadweight bankruptcy costs into optimal capital structure models highlights the fact that firms are more than simply an aggregation of assets and explicit contracts, i.e. their implicit contracts and reputational capital with employees, suppliers and customers are valuable assets that make the going concern value of the firm greater than its break-up value. For most large firms, the direct costs of bankruptcy are generally a relatively small percentage of firm value<sup>5</sup> – though, in the case of several recent financial scandals, e.g. Enron and WorldCom in which the share price had been greatly inflated by a variety of means, most stakeholder groups suffered large losses in the value of their financial claims. The indirect costs are often far more significant and firms can suffer costs of financial distress even when bankruptcy is ultimately avoided. These costs reflect the conflicts of interest between shareholders and debtholders and the option-like incentives of leveraged equity, particularly when the firm is in or close to financial distress. Such a situation generates strong incentives for shareholder controlled firms to act opportunistically since existing debtholders' and other stakeholders' may be made to bear much of the down-sized losses.

Since Jensen and Meckling first published their model, several studies have examined other ways that corporate managers, acting in shareholder interests, may attempt to increase and shift business risk onto other stakeholders. The so-called 'underinvestment' problem, first developed by Myers (1977), provides an indication of the distorted incentives that may arise when a firm is in financial distress. Basically, shareholders could lose if the management invest in a positive NPV project and then the firm subsequently becomes bankrupt. Under these conditions, the benefits of the project accrue to the debtholders (and other creditors).

For example, assume a firm has £30m of outstanding debt that matures in one year's time and, because of poor demand for its products over the past few years, its forecasted assets at redemption are expected to be only £20m. However, the firm has an opportunity to invest in a fairly safe, but positive NPV project, with an expected cashflow of £8m in a year's time. The project would require the shareholders to pay £5m in additional investment now and this would make the project a £3m NPV proposition.

The project has the following pay-offs: 0.5 probability of £10m and 0.5 probability of £6m. Even though the worst outcome (£6m in one year's time) would produce £1m in additional wealth, the shareholders would not want the firm to undertake the project because, whatever the final outcome (£6m or £10m), the firm will be forced to default on its debts and the shareholders would be £5m worse off by investing in the project.

All of the benefits from investing in the project would accrue to the debtholders. In the event of default they would receive either £30m (£20m + £10m) or £26m (£20m + £6m) rather than the £20m they would receive if the firm did nothing.

Another value-destroying initiative that management could attempt is the launch of a new project which even though it (may) have a negative NPV, it could still increase shareholder wealth by more than the money invested if it is sufficiently risky. This is because for a very risky investment undertaken by a firm with a significant risk of default, shareholders benefit if a more favourable outcome is actually realised, while the cost of unfavourable outcomes is borne by bondholders. For example, assume that the above firm had another £5m project (that could be financed by selling some of its existing assets). This new project has an NPV of –£2m with a 0.2 probability of generating cashflows of £30m and a 0.8 probability of generating cashflows of –£10m. Such a project is in the shareholders' interests because it creates a 20% chance that the firm will not default and provides the shareholders with a pay-off of £20m after paying the debtholders their £30m. The project is, however, not in the debtholders' interests (i.e. it's a negative NPV proposition from their point of view) because there is an 80% chance of their pay-off declining from £20m to only £10m and only a 20% chance of them receiving the full £30m they are owed.

For a firm in danger of default, shareholders can be expected to put pressure on managers to declare a large dividend so that they receive a large proportion of the firm's remaining assets. A large lump-sum dividend ensures that shareholders get a substantial proportion of the firm's value and therefore when the debtholders take control subsequent to the firm defaulting, the latter will be left with little more than an empty shell of a company.

If debtholders and other creditors become aware of the financial distress, then they can be expected to anticipate the above motivations and risks to their financial interests. Creditors will attempt to take actions that limit the ability of managers and shareholders from engaging in behaviour that shifts the risks/costs associated with possible bankruptcy onto them. Hence, managers and shareholders have a common interest in keeping bad news about the firm from becoming public. The manipulation of financial reporting rules and pressures on auditors to keep quiet are, not surprisingly, a more or less universal characteristic of financially distressed firms.

These conflicts of interest are severe only when the company is in or close to financial distress. The consequences of these high leverage-related actions can be very costly to some stakeholders and also very costly to safeguard against. Typically debt contracts contain a wide range of 'covenants' (legally binding promises) to protect the financial interests of the debtholders. For firms with suitable types of assets (collateral), the debt can be secured on these assets which the debtholders automatically take over ownership of should the firm default on its debt obligations. Using a specific item or class of asset as security for a loan restricts the business's ownership rights over the asset in the sense that it cannot be sold without first seeking the approval of the debtholder. Other commonly used covenants are also designed to restrict the actions of the firm in areas such as the issuing of new debt with equal or superior rights to the existing debt, limits on dividend payments and share buybacks. Accounting-based covenants that require a firm to maintain some minimum ratio of, say, the profit margin or current ratio or debt to equity ratio are often important as early warning systems of impending financial problems and violation of these accounting ratio covenants often triggers a process of renegotiation of the debt contract. All of these contractual provisions are costly to design, monitor and enforce and therefore, as the various 'trade-off' models suggest, it may be agency cost minimising for the firm to avoid temptation by limiting the amount of debt issued. Adherence to a moderate target debt ratio therefore clearly limits the potential for conflicts between stakeholders and any agency-related debt and bankruptcy costs.

What has now become the orthodox view of optimal capital structure has the firm balancing the present value of interest tax shields and the falling agency costs of equity against the rising

agency costs of debt and bankruptcy or financial distress costs. Agency and bankruptcy costs negatively impact on current firm value and it is worth emphasising again that Jensen and Meckling argued that in an informationally efficient capital market, the present value of these costs would be reflected in the prices that equity and debt suppliers would be prepared to pay for these corporate securities and hence in their model agency costs are ultimately borne by the shareholders.

As mentioned in the introduction to the chapter, corporate governance policy initiatives have concentrated on the agency costs associated with equity, i.e. how to ensure that managers act in shareholders' interests. As debt requires the regular payment of interest and capital repayments, it has been argued, for example in Jensen's (1993) 'free cashflow' model, that relatively high debt levels can play a disciplinary role in reducing the agency costs of equity in firms with significant free cashflows that might otherwise be spent by management on negative NPV investments. As we have seen, the agency costs of debt can, however, be substantial given the opportunities and financial incentives of shareholders to take actions *ex post* that can have significant negative wealth consequences for the lenders.

### Incomplete Contracting and the Residual Claimant Status of Other Stakeholders

The corporation is clearly the dominant form of business organisation, largely because limited liability removes a major constraint on the size of the firm by making possible the separation of ownership from the management and control of corporate decision making. Strategic and operational control can (but need not) be undertaken by professional, skilled, managers irrespective of their limited personal wealth holdings, while the financing of operations can (but need not) be undertaken by outside investors with no interest or skills in managing the corporation. This specialisation of management and financial risk-bearing functions has certainly facilitated business investment and growth and allowed the exploitation of scale economies, technical innovations and the development of highly specialised human capital, all of which have had significant beneficial consequences in respect of labour productivity and wealth generation.

The corporate form is, of course, simply a legal fiction, largely invented in the eighteenth century in England and the US. This legal fiction is most obvious in the case of small owner-managed corporations where, despite the existence of limited liability, it has always been generally accepted that corporate decisions are and/or ought to be undertaken to further the interests of its equity owners. The UK and US both had relatively well-developed legal systems that offered a high degree of protection to creditors and court systems that were able to interpret and enforce commercial contracts on the basis of common law principles. Indeed, the success of the corporate form, and its subsequent spread around the globe, has required potential investors and creditors to have an exceptionally high degree of confidence in the system of legal protections and institutional mechanisms that impose financial, reporting and ethical duties and other constraints upon the behaviour of corporate decision makers. With an increase in the separation of ownership from control, however, 'agency problems' provide opportunities for a controlling shareholder and/or managers to run the business in ways that further their own interests rather than those of the remaining shareholders. Moreover, as discussed earlier, the decisions of large corporations have the potential to impact on the welfare of many internal (e.g. employees) and external (debtholders, customers, suppliers) groups other than shareholders. Given these potential externalities, there is naturally much less consensus regarding what the

legitimate objectives of large, publicly listed, corporations ought to be and in whose interests management should be making corporate investment and financing decisions.

Corporate governance, how the discretionary actions of executives are exercised in a manner consistent with the interests and rights of other stakeholders, is of economic importance only in a world characterised by both agency costs and incomplete contracts (Hart, 1995). An incomplete contract exists whenever the contracting parties are unable *ex ante* to fully specify the actions to be taken in every possible future 'state-of-nature'. All long-term labour contracts that do not fully specify an employee's duties are an obvious and widespread example of an incomplete contract. With such contracts, it is implicit that the employee will be frequently required to undertake activities which, due to the inability to specify what these will be *ex ante*, are not explicitly detailed in the contract.

In a similar fashion, debt contracts are necessarily incomplete because although the contract may, in addition to the repayment terms, specify many restrictions, such as dividend and debt/equity caps, the firm's actions are not perfectly controlled. It is common in practice for a firm to comply fully with all of the restrictions contained in its debt agreements while still being able to undertake many changes in corporate policy which impact upon the debtholder's wealth. As Garvey and Swan (1994) have noted in respect of bond prices,

so long as such explicit promises are fulfilled, the bondholders bear any losses and enjoy any gains that may flow from changes in corporate policy. (p. 141)

This incompleteness exists despite the fact that, at the time of writing a contract, the parties are able to incorporate (i.e. price) their expectations regarding the most probable future events that are likely to materially affect their interests. Even contracts which incorporate the most complex and detailed set of rules, and which have low monitoring and enforcement costs, will be incomplete because expectations may, nevertheless, be confounded by events which were not even conceived of *ex ante*. Clearly a contract cannot incorporate the inconceivable, and in this situation one or more of the contracting parties will have freedom of action (i.e. discretion). Hence, from an incomplete contracting perspective, residual risk bearing is inescapable in an *ex post* sense for all parties contracting with the firm. The incompleteness of contracts means that, though only shareholders are entitled to the residual profits after all other legally binding claims to other parties have been met, in terms of economic consequences any differences in the residual claimant status of the various contracting parties is simply a matter of degree. The agency model is premised on the idea that shareholders 'own' the company and that executives should be made more accountable to shareholders so as to encourage them to take actions which conform to shareholder concerns. However, Kay and Silberston (1995) argue that:

If a company is not 'owned' by its shareholders, and the shareholders are simply one of a number of stakeholder groups, each of whom enjoy claims against it, then there is no particular reason to think that the interests of shareholders do or should enjoy priority over the interests of these other stakeholders. From a legal perspective, even the rule that shareholders have exclusive claim to the residual assets in the event of liquidation (established in 1962) was reversed by the 1985 Companies Act, which entrenches the interests of employees and imposes on directors an explicit duty to strike a balance between their interests and those of other members. (p. 88)

Recognition that shareholders are not the sole residual claimants 'suggests that a more explicitly "political" view of corporate objectives is appropriate, since members of the firm besides shareholders are affected by executive decisions' (Garvey and Swan, 1994, p. 148).

Kay and Silberston believe that recent proposals for reform in the UK, i.e. the Cadbury and Greenbury reports, have attempted to make reality conform more closely to the theoretical model rather than attempting to make the model conform to reality.

Kay and Silberston argue that both the model and the recent governance reforms have failed to take fully into account the implications of incomplete contracting, namely, that large public companies are much more than simply a set of legal contracts; such firms are made up of several stakeholder groups, each with legitimate interests and concerns. In an incomplete contracting world, executives cannot act solely in shareholder interests; they have discretion and no one (other than a shareholder) would be willing to contract with an organisation in which all managerial discretion is exercised in the interests of another party. Hence, reforms which make executives solely accountable to shareholders (particularly as due to free-rider and other problems these shareholders are uninterested in monitoring and controlling executives) are unlikely to lead to either more accountable executives or better performing companies. What is required is a system which views executives as 'trustees' of the company (which is a 'social institution') and which requires them to consider the interests of the firm itself and all its various stakeholder groups. Kay and Silberston propose that the theory of how companies are to be governed should be brought more into line with reality and, in order to 'put the matter beyond doubt', they propose a new company statute which would clearly state that it is a fiction to suppose that corporate managers are the agents of the shareholders rather than being 'trustees of the assets of the corporation'. In addition, they propose a fixed four-year term (renewable only once) for CEOs plus a wide-ranging review of effectiveness involving advisors, affiliated companies, employees and debtholders and not merely the senior management and shareholders.

## **EMPLOYEES AS RESIDUAL CLAIMANTS**

From the above discussion, it is clear that with incomplete contracting the notion of agency costs need not be restricted to the costs associated with obtaining debt and equity financing. Titman (1984), for example, analysed the relationships between a firm supplying durable goods that require significant after-sales inputs and its customers and between a firm and its employees that have developed specialised, firm-specific, skills. In both cases, keeping the (explicit and implicit) contract between the firm and these stakeholders will be dependent upon the firm staying solvent and continuing in business. Corporate financial policies that put this assumption in doubt will therefore make such promises less convincing to suppliers and employees. If product and labour markets are competitive, then Titman (1984) argues that highly leveraged firms will find that they incur higher costs than other less highly leveraged comparable firms.

The Titman (1984) analysis continues the assumption found in Jensen and Meckling (1976) that agency costs are ultimately borne by shareholders since most agency costs can be anticipated, efficiently priced and/or guarded against at the contract writing stage via the use of restrictive covenants, security etc. This 'optimal contracting' view seems especially implausible in the case of employees, and particularly so for those employees that are also members of their employer's 'defined benefit' pension schemes. Membership of these schemes greatly increases the employee's already high exposure to firm specific risk – a risk exposure that will continue for the remainder of the employee's (and perhaps their dependants') lifetime. The basic problem is that the firm is an inherently risky entity due to the nature of its business activities.

This inherent business risk renders the firm a highly inefficient risk bearer over long time horizons irrespective of how financially conservative its current financial strategies appear to be.

Employee members of company pension schemes are therefore especially exposed to high levels of long-term, firm-specific risk as their pensions depend upon the sponsoring firm both staying in business and not taking ‘excessive’ risks that may jeopardise its ability to honour its pension obligations. Currently, many of these pension schemes are heavily in deficit, i.e. the present value of the pension promises made to fund members exceeds the value of the pension fund assets. This creates conflicts of interest between shareholders and employees (and between current pensioners and employee members), and therefore the firm’s internal governance systems and the value it places on its relationship/reputation with employees will be important in determining whether the firm chooses to close down the scheme or is willing and able to continue to make significant contributions into the scheme for many years into the future. Moreover, in the event of a scheme closing down and there being a shortfall in resources in the fund to honour its pension promises, the pension scheme members are actually in a much riskier position than the firm’s other creditors, or indeed the shareholders. This is because, unless the trustees of the pension fund have explicitly secured the fund’s pension obligations on the firm’s non-pension fund assets, pension fund members will generally not even be classed as unsecured creditors nor entitled to a share in the firm’s other assets in the event of the scheme and/or the firm being wound up.

The current company pensions ‘crisis’ in the US and UK clearly illustrates that neither the firms involved nor their employees had anticipated the consequences of promises to provide pensions based upon final salaries and the number of years that employees have been making contributions into the scheme. Demographic changes, increasing actuarial life-span projections, globalisation, more mobile capital and labour and (in a low inflation world) the greatly reduced returns associated with equities have made many company pension promises unrealistic.<sup>6</sup> Whatever the original motivation for providing employee pensions, the result is to make employees even more exposed to firm-specific risk than they already are as employees.

## The Trajectory of UK Corporate Governance

As we have seen, the recognition that debtholders, employees and other stakeholders are likely to be exposed to uncompensated business and financial risk has led several writers to conclude that these groups should be given formal decision rights and that shareholder interests should not dominate corporate decision making. Some of these writers (e.g. Armour *et al.*, 2003) have claimed that recent developments in the UK have significantly reduced the centrality of shareholder interests and, largely due to the implementation of EU Directives, have succeeded in moving the UK’s system of corporate governance closer to that of Germany where debtholders and employees already have a variety of formal decision rights that limit managerial discretion in several important areas relating to investment, financing and restructuring strategies.

An analysis of the developments that Armour *et al.* (2003) and others are referring to do not actually provide any additional formal decision rights – merely rights to be consulted. But, would granting additional decision rights to UK corporate stakeholders actually be a good thing in terms of efficient risk bearing and governance? As in Germany, effective control rights for non-shareholders would require formal involvement in decision processes – including having a veto on decisions that have an adverse impact on their situation. For a market-oriented economy and system of governance such as the UK, formally entrenching debtholder and/or

employee representatives into corporate decision making would be a radical departure from existing practice. Moreover, neither debtholders, employees nor, if the wider community that may be affected by corporate decisions is also to be included, state officials are likely to have any particular expertise in evaluating corporate strategies and management. It is unclear, therefore, that formal entrenchment of these stakeholders in the corporate decision-making process, along with the corollary, which is the downgrading of shareholder interests, is likely to provide managers with appropriate incentives to maximise corporate value.

An alternative solution to the problem of residual risk bearing by non-shareholder groups would be to encourage new forms of insurance cover. That is, to concentrate public policy initiatives upon reducing these group's exposure to firm-specific risk, which is, in fact, the main effect of the recent changes in UK law actually listed by Armour *et al.* (2003). For example, with respect to employees, redundancy payments and cessation of employment notice periods and public and/or private unemployment insurance clearly reduce the negative wealth effects associated with losing one's job. Active labour markets, profitable firms and an expanding economy also greatly facilitate the search for alternative employment. Employee pensions can be made considerably less exposed to firm-specific risk by the creation of a state and corporate funded collective insurance scheme for pension fund members, as has been done in the UK, and by direct improvements in the governance of the pension schemes themselves. For example, currently in the UK, the most obvious conflict of interest responsible for severely limiting the effectiveness of most funds in looking after their beneficiaries' interests arises because the majority of scheme trustees and their actuarial consultants are appointed by corporate management. As has happened in relation to company main boards which now have significant numbers of independent non-executive members, a requirement for pension schemes to have some minimum number of independent trustees and requiring scheme actuaries to be appointed by these independent trustees would greatly reduce the conflicts of interests that currently inflict company pension schemes.

Ultimately, of course, the majority of defined benefit company pension schemes are unsustainable – corporate entities are far too risky to be efficient risk bearers over the timescales involved. The switch to 'defined contribution' pension schemes in the UK over the past few years will greatly reduce employee's exposure to firm-specific risk. With these schemes, which operate exactly like mutual funds, all members have clear ownership rights in the underlying diversified portfolio purchased by their contributions and hence all firm-specific risk is eliminated. Employees would still be subject to systematic risk, but this can easily be reduced simply by risk averse employees choosing/switching to funds that contain differing proportions of risky equities and less risky bonds. Perhaps the greatest advantage associated with defined contribution schemes is that they make it significantly more obvious to all concerned that the interests of pension fund members are identical to those of any other shareholder – i.e., both groups gain from the existence of profitable and well-managed companies.

## NOTES

1. Though in neither country has there actually ever been an explicit legal requirement for managers to act in shareholder interests.
2. See, for example, Kay and Silberston (1995); Armour *et al.* (2003); Plender (2003).
3. See Parkinson (2003) and Zingales (2000) for discussions of the different models of the firm and the residual risk-bearing justification for the shareholder primacy.

4. See Denis (2001) and Copeland and Weston (1988) for reviews and further references to the relevant literature.
5. See, for example, Miller (1977), who claimed that bankruptcy costs were typically far too small to account for any trade-off with the corporate tax benefits of debt – indeed, he declared that they were a ‘recipe for a horse and rabbit stew – namely, one horse and one rabbit’.
6. See Plender for an analysis of the causes of the current pensions crisis – particularly its relationship to corporate governance.

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# Institutional Shareholders and Corporate Governance in the UK

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Helen Short and Kevin Keasey

## INTRODUCTION

Within the general corporate governance debate, there has been an increasing emphasis over the last 15 years on the need for institutional shareholders to play an active role in the governance of UK companies. Since the setting up of the Committee on the Financial Aspects of Corporate Governance (the Cadbury Committee) in May 1991, there have been four key committees and reports which have examined aspects of corporate governance in the UK – Cadbury, Greenbury, Hampel and Higgs (see Chapter 2 for detailed discussion). All of these reports have stressed the importance of institutional investors in ensuring that companies follow their corporate governance best practice recommendations. For example, the Cadbury Report (1992) stated that, ‘Because of their collective stake, we look to the institutions in particular, with the backing of the Institutional Shareholders’ Committee, to use their influence as owners to ensure that the companies in which they have invested comply with the Code’ (para. 6.16) – similar views were expressed by Greenbury, Hampel and Higgs.

Prior to and following the publication of the Cadbury Report, there were many discussions in both the academic and non-academic media of the need for an increased involvement by institutional shareholders in corporate governance issues. The academic literature has focused on a consideration of objectives of institutions and their willingness and ability to actively govern corporations. In particular, consideration has been given to agency problems which exist between the ultimate beneficiaries of institutional funds and the fund managers responsible for the investment of those funds, which may act to emphasise short-term profits at the expense of the longer-term corporate governance issues. In this context, it is unclear that the role of institutions as shareholders can easily be reconciled with their role as investors with a duty to maximise the return for the beneficiaries of the funds that they invest. Furthermore, institutions

face a free-rider problem, which further reduces their incentives, at least on an individual basis, to devote resources to active monitoring.

However, since the publication of the Cadbury Report, the evolution in governance policy in respect of institutional shareholders has undergone a change in stance since the election of a Labour government in 1997. Whilst the various codes of best practice have stressed the importance of institutional shareholders in ensuring that companies do follow best practice in corporate governance, there has been little real effort concerted to encourage institutional shareholders to take an active role in the governance of their investee companies. However, the Labour government seems to have reservations regarding the self-regulatory nature of the relationship between companies and their institutional shareholders in respect of corporate governance issues, and has instigated a number of measures which provide new legislation or threaten legislation which directly affects institutional shareholders. As detailed in Chapter 2, legislation is now in place which makes it mandatory for companies to put the report of the remuneration committee to shareholder vote at the AGM (Directors' Remuneration Report Regulations, 2002). In addition, the Myners Review was critical of the role of the institutional investors in corporate governance issues and argued that pension fund managers were reluctant to take pre-emptive actions to tackle underperformance in investee companies (Myners, 2001). In response to Myners' criticisms, the government issued a consultative document (*Encouraging Shareholder Activism*, HM Treasury/DWP, 2002), which set out proposed legislation for making active monitoring and communicating with investee companies a legal duty for pension funds. The document also considered measures to make voting mandatory for pension fund managers in certain circumstances.

The threat of legislation has prompted a response by institutional shareholders. The Institutional Shareholders' Committee (ISC, 2002) published a statement of principles which made clear that institutional shareholders have a responsibility to monitor and communicate with investee companies and, moreover, intervene where necessary. Whilst empirical evidence on any increase in institutional shareholder activism in the UK remains limited, there is undoubtedly a perceived increase in public activism by institutional investors. For example, in May 2003, shareholders at GlaxoSmithKline voted by a narrow majority to reject its remuneration report in response to the pay package of its CEO, which although not bound by the vote, forced the company to revise its remuneration policy. Very recent examples of public activism include the removal of Sir Philip Watts as chairman of Shell in March 2004 and the removal of Peter Davis as CEO of Sainsbury's in June 2004. In addition, the publication of the Higgs Report in 2003 led to a rather public breakdown in relations between the institutions and the leaders of large companies.

The purpose of this chapter is to detail the issues facing institutional investors in their role as shareholders and investors and the incentives and disincentives they face in deciding whether or not to actively intervene in the companies in which they invest. This chapter is structured as follows. The first section provides a brief summary of the level of institutional shareholdings in the UK. The second section provides a general overview of the objectives and incentives of institutions in respect of their shareholdings in UK companies. A discussion of the willingness and ability of institutions to become actively involved in the governance of corporations is presented in the third section. The fourth section evaluates the methods by which institutions can intervene in governance matters. The empirical evidence relating to the ability of institutions to successfully monitor and control companies is evaluated in the fifth section. The final section provides a summary and conclusions.

## **INSTITUTIONAL SHAREHOLDINGS IN THE UK**

Over the last three decades, individual equity ownership has continued to decrease in terms of the total percentage of equity owned from 54% in 1963 to less than 15% in 2002. The corollary to the declining proportion of total equity held by individual shareholders has been the dominance of institutional shareholders. Table 4.1 indicates that ownership by financial institutions peaked at a total of approximately 62% of ordinary shares in 1993, this percentage having more than doubled since 1963. However, since 1993, ownership by institutions has fallen, reaching a low of approximately 48% in 2000, before increasing to over 51% in 2002.

As Table 4.1 illustrates, the major growth in institutional shareholders up until 1993 was mainly due to the growth in pension funds and, to a lesser extent, insurance funds. Both pension and insurance funds grew as the result of the increase in private retirement savings, in the form of occupational or personal pension schemes and long-term life insurance/assurance. As personal pensions often take the form of investment plans operated by life insurance companies, a significant proportion of investment by life insurance companies represents pension funds. The decline in institutional equity ownership since 1993 is largely due to the decline in ownership by pension funds – ownership by pension funds fell from its peak of 32% in 1992 to a low of approximately 16% in 2002, its lowest ownership level since the early 1970s. This fall in pension fund ownership reflects the decline in defined-benefit (final salary) occupational pension schemes.

The growth in institutional ownership up until the mid-1990s represents an indirect growth in equity investment by individuals, as pensions and life insurance are merely a vehicle for long-term personal savings. As Table 4.2 illustrates, life insurance and pension funds, valued at £1377 billion, accounted for approximately 24% of the financial assets of the personal sector at the end of 2002; whereas direct holdings of UK company securities accounted for only 8% of personal financial assets. One of the reasons why pension funds are favoured over personal portfolios of shares is the tax advantages currently accruing to pension contributions and pension benefits, as compared to personal equity holdings.

Table 4.3 shows the value of company equity shares (both UK and overseas) held by institutions and the percentage of the institutions' total assets that those equity shares represent. Until 1998, equity shares represented over half of the total assets held by both pension and long-term insurance funds. Given that the performance of equities was the key determinant of the performance of these major institutions, it might be supposed that institutional investors, from a pure self-interest perspective, would have a major role to play in the governance of UK companies. However, since 1998/99, the percentage of total assets of pension and long-term insurance funds represented by equity shares has fallen sharply. This reflects the fall in the stock markets following the crash in dot-com shares in 2000, and the relatively poor performance of equity shares thereafter.

The figures provided in Tables 4.1 to 4.3 suggest a number of questions with respect to active institutional involvement in corporate governance issues. First, given that institutional ownership was growing and reached its peak in 1993, why did corporate governance first emerge as such a major issue in the early 1990s, resulting in the publication of the Cadbury Report? Second, as institutions have reduced their ownership of equity shares and the importance of equity shares as a percentage of total assets has fallen significantly since the late 1990s, why has public activism by institutions in corporate governance issues increased?

**Table 4.1** *The pattern of share ownership in the UK*  
 Percentage distribution by sector, 1963–2002.

Beneficial owner	% of total equity owned, 31 December															
	1963	1969	1975	1981	1989	1990	1991	1992	1993	1994	1997	1998	1999	2000	2001	2002
Pension funds	6.4	9.0	16.8	26.7	30.6	31.7	31.3	32.4	31.7	27.8	22.1	21.7	19.6	17.7	16.1	15.6
Insurance companies	10.0	12.2	15.9	20.5	18.6	20.4	20.8	19.5	20.0	21.9	23.5	21.6	21.6	21.0	20.0	19.9
Unit trusts	1.3	2.9	4.1	3.6	5.9	6.1	5.7	6.2	6.6	6.8	6.7	3.0	2.7	1.7	1.8	1.6
Investment trusts					1.6	1.6	1.5	2.1	2.5	2.0	1.9	1.9	1.9	2.1	2.2	1.8
Other financial institutions	11.3	10.1	10.5	6.8	1.1	0.7	0.8	0.4	0.6	1.3	2.0	4.1	5.1	4.6	9.9	10.5
Banks	1.3	1.7	0.7	0.3	0.7	0.7	0.2	0.5	0.6	0.4	0.1	0.6	1.0	1.4	1.3	2.1
Total financial institutions	30.3	35.9	48.0	57.9	58.5	61.2	60.3	61.1	62.0	60.2	56.3	52.9	51.9	48.5	51.3	51.5
Private non-financial companies	5.1	5.4	3.0	5.1	3.8	2.8	3.3	1.8	1.5	1.1	1.2	1.4	2.2	1.5	1.0	0.8
Individuals	54.0	47.4	37.5	28.2	20.6	20.3	19.9	20.4	17.7	20.3	16.5	16.7	15.3	16.0	14.8	14.3
Rest of the world	7.0	6.6	5.6	3.6	12.8	11.8	12.8	13.1	16.3	16.3	24.0	27.6	29.3	32.4	31.9	32.1
Charities, churches etc.	2.1	2.1	2.3	2.2	2.3	1.9	2.4	1.8	1.6	1.3	1.9	1.4	1.3	1.4	1.0	1.1
Public sector	1.5	2.6	3.6	3.0	2.0	2.0	1.3	1.8	1.3	0.8	0.1	0.1	0.1	—	—	0.1
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: ONS, 2003.

(Note: Figures may not add up to 100.0 due to rounding errors.)

**Table 4.2** *Composition of total assets of the household sector*

	£ billion at 2002 <sup>1</sup> prices									
	1991		1996		2000		2001		2002	
	£	%	£	%	£	%	£	%	£	%
Non-financial assets	1897	52	1651	41	2463	43	2586	46	3078	54
Financial assets										
Life assurance and pension funds	817	22	1211	30	1741	30	1628	29	1377	24
Securities and shares	340	9	498	12	780	14	584	10	451	8
Currency and deposits	511	14	556	14	665	12	701	13	743	13
Other assets	86	2	82	2	93	2	94	2	91	2
Total assets	3651	100	3998	100	5742	100	5594	100	5740	100

<sup>1</sup>Adjusted to 2002 prices using the expenditure deflator for the household sector.

Source: Office for National Statistics.

## GENERAL OVERVIEW OF THE OBJECTIVES AND INCENTIVES OF INSTITUTIONS

Part of the emphasis of the Cadbury Report on institutional investors as a means of improving corporate governance rested on the premise that because of their very size, they have the ability to influence the actions of companies. Such a premise was reiterated in the Hampel Report which stated that

60% of shares in listed UK companies are held by UK institutions . . . It is clear from this that a discussion of the role of shareholders in corporate governance will mainly concern the institutions. (para. 5.1)

The successive governance reports have placed emphasis on the ability of market solutions rather than on external regulation to solve corporate governance problems, and rely on shareholders (institutional investors) to shake off their traditional apathy and take a more active interest in the companies they own. However, in order for institutions to adopt a proactive monitoring role, it is necessary that they see themselves as owners of UK corporations rather than viewing equity shares as short-term investment vehicles. Charkham (1990) argued that because many institutions view shares as ‘commodities’ with no intrinsic qualities other than that they can be readily tradable in an active market, the system of corporate governance as laid down in the Companies Act breaks down because directors cannot be accountable to shareholders who refuse to accept their role as shareholders.

Institutional investors are responsible to the owners of the funds in which they invest. The institutional investing arrangements which exist in the UK mean that, with the exception of insurance companies investing their own insurance funds, funds are in general invested by fund managers rather than the beneficial owners of those funds. The trustees of pension funds, for example, have a fiduciary relationship with the beneficiaries of the pension fund, and must act in their best interests. In a similar vein, quoted insurance companies (such as the Prudential) have a responsibility to their own shareholders. In this context, institutional investors have a duty to maximise their investment returns.

**Table 4.3** *Portfolio holdings of institutions at the end of 2002: market value*

	Pension funds		Insurance long term		Insurance other than long term		Unit trusts		Investment trusts	
	£ million	%	£ million	%	£ million	%	£ million	%	£ million	%
Short-term assets (net)	18 414	3.0	44 958	5.3	2 899	3.0	8 041	4.1	—	—
British Government Securities	84 461	13.8	131 305	15.4	18 390	18.9	7 078	3.6	471	1.2
Local authorities' securities	42	0.0	1 427	0.2	10	0.0	—	—	5	0.0
UK company securities:										
Ordinary shares	186 437	30.5	230 772	27.0	6 786	7.0	82 711	41.8	19 475	51.3
Other	30 450	5.0	147 496	17.3	6 891	7.1	26 909	13.6	946	2.5
Overseas securities	131 809	21.6	130 500	15.3	14 550	15.0	73 297	37.0	15 930	42.0
Loans and mortgages	144	0.0	9 592	1.1	895	1.0	—	—	—	—
Unit trusts	42 399	6.9	65 267	7.6	1 685	1.7	—	—	47	0.1
UK property	31 658	5.2	52 658	6.2	805	0.8	—	—	532	1.4
Other	84 627	13.9	40 370	4.7	44 261	45.5	—	—	561	1.5
Total net assets	610 441	100	854 345	100	97 172	100	198 036	100	37 967	100

Source: Adapted from *Financial Statistics*, ONS, March 2004.

In their role as major shareholders, both the Cadbury and Hampel Reports expected institutions to take on the role of the large shareholder, who will monitor company management on behalf of smaller shareholders. Hence, in this context, institutions are expected to take a long-term view of their shareholding positions, and where necessary, incur expense in intervening to correct mismanagement. However, in their role as investors, institutions need to be free to move funds around in order to find the best return for the beneficiaries of those funds. In this respect, it is difficult, certainly in a free market climate, to argue that institutions should continue to hold equity positions in problem companies and incur additional expense intervening in management, particularly when there are no guarantees that intervention will be successful. Indeed Drucker (1976) argued that,

The pension funds are not 'owners', they are investors. They do not want control . . . The pension funds are trustees. It is their job to invest the beneficiaries' money in the most profitable investment. They have no business trying to 'manage'. If they do not like a company or its management, their duty is to sell the stock. (p. 82)

From an alternative viewpoint, Hutton (1995) argued that,

Pension funds and insurance companies have become classic absentee landlords, exerting power without responsibility and making exacting demands upon companies without recognising their reciprocal obligation as owners. (p. 304)

As shareholders, it is, however, the right of institutions to appoint directors and, it could be argued, their 'moral duty' to ensure that companies are governed in the interests of shareholders. However, whilst Hutton suggested that institutions have obligations as owners, it is not clear, certainly under company law, what those obligations are, if indeed they do have obligations as owners. Furthermore, as will be argued in detail in 'the free-rider problem' below, all shareholders are faced with a potential free-rider problem. If, for example, an institution took costly actions to intervene in company management whilst institutions simply did nothing, the intervening institution would report lower returns, to the detriment of its beneficiaries/shareholders, at least in the short term. If the intervening institution is a fund manager investing funds on behalf of external pension funds, given the increasing competition in fund management, the intervening manager is likely to lose clients. It is difficult to see what incentives there are for institutions to bear a private cost for a public good (for other shareholders, both private and institutional, and for the economy as a whole).

Cadbury (1990) argued, however, that while 'free riding' may be an option for individual institutional investors, for institutions collectively, this situation was becoming less tenable as the proportion of equity they own increased. Whilst, as shown in Table 4.1, institutional equity ownership has declined somewhat since the publication of the Cadbury Report, Hampel (1998) further stressed this point, arguing that the combination of their increased ownership and the growth of index tracking meant that many institutions were committed to (either explicitly or de facto) retaining substantial shareholdings in companies. In such circumstances, Hampel stated that the institution 'shares the board's interest in improving the company's performance' (para. 5.3). It was therefore argued by Hampel that institutions were effectively becoming locked into companies in which they invest and were, furthermore, becoming locked into the UK economy. Whilst institutions are increasing the proportion of total assets invested in overseas equities (for example, pension funds have increased the proportion of total assets invested in overseas securities from approximately 17% in 1983 to 22% in 2002, as shown by



**Table 4.4** *Charkham's contrasting stances of institutional investment behaviour*

Characteristic	Type A	Type B
Portfolio make-up	Concentration on fewer stocks	Wide diversification
Stakes in companies	Large	Small
Communication with companies	Close	Superficial
Loyalty to companies	High	Virtually non-existent
Dealing activity	Fewer dealings and less freedom to deal due to high stake	Frequent dealing
Interest in corporate governance issues	High	Virtually non-existent

Table 4.3) over a third of their total assets are invested in UK securities despite the decrease in recent years. As they clearly cannot divest on any major scale from UK companies, it would seem that the long-term performance of British companies is of paramount importance to them. The classic public good dilemma, therefore, arises in that because individual institutional shareholders do not have the appropriate mix of incentives to become involved in the detailed governance of corporations, the emphasis is on short-term gains at the expense of long-term corporate performance. The different types of institutions may, however, have varying timeframes for their investment portfolios. For example, pension funds which should have a long-term perspective because of the nature of their business, would be expected to emphasise the importance of achieving long-term corporate performance.

With regard to the investment behaviour of institutions, Charkham (1994a) presented two contrasting stances of active institutional investing which he labelled Type A and Type B. These types illustrate the opposite ends of the investment spectrum on which all institutions can be placed. The differing characteristics of Type A and Type B investors with regard to their investment policies are presented in Table 4.4.

As Table 4.4 illustrates, a Type A fund manager places emphasis on the long-term performance of a relatively small portfolio of companies. In contrast, Type B fund managers emphasise the short-term performance of a relatively large portfolio of companies. Charkham suggested that the type of approach adopted by a particular institution is dependent not only on the purpose of the investment, but also on a complex mixture of factors relating to the management of those funds, such as the motivation and ability of the individual fund managers. Therefore, whilst pension funds as long-term investments would appear most likely to adopt a Type A approach, this may not be followed if the fund managers were motivated, particularly by virtue of their reward structure, to follow a Type B approach.

The contrasting types of investment behaviour discussed above concentrate on a fund manager's approach to active investing. Over recent years, however, passive institutional investing has grown in the form of index-matched funds. As index-matched funds have, by their very nature, a buy and hold policy, such fund managers should be willing to take a longer-term perspective. Nonetheless, a long-term investment horizon does not necessarily lead to increased monitoring and intervention. The use of index-matched funds obviously removes the pressure on fund managers to beat the index. However, as competition in terms of return has largely been removed in the case of indexed funds, this emphasises competition in terms of the cost of managing such funds. Whilst it may be argued that intervention will improve

performance of companies and hence the return on the index as a whole, it is again difficult to see what incentives individual fund managers would have to follow this course of action. As they are assessed on relative returns as against a matched index, any difference between the fund's return and the index is the result of management costs. Monitoring and intervention increases management costs for the individual fund managers, whilst potentially improving the performance of non-intervening index-matched funds. The result of this is that the intervening fund manager faces higher costs whilst all other index-matched funds show higher returns at lower cost. In this situation, the higher costs cannot be passed on to the beneficial owners without risk of them simply moving to a lower cost fund manager. This takes us to the crux of the problem – fund managers are not the beneficial owners of the shares and hence do not substantially share in the increased profits to be gained from intervention. Unless there is collective intervention by all fund managers, the costs of intervention simply reduce the individual fund manager's profits.

When examining the objectives of institutions and their investment managers, the general investment environment in the UK needs to be considered. The nature of ownership in the UK is essentially short term with equity shares seen as commodities (Charkham, 1990). However, institutions are not the only shareholding party to view equity in this way – small private shareholders are also likely to view holdings in equity merely as investment vehicles, particularly given the emphasis on equities as tax-efficient investments, for example in the form of ISAs and pensions. The majority of individual investors participating in the initial public offerings of the dot-com companies in the late 1990s were motivated not by the notion of holding a long-term ownership stake in a company, but by the 'promise' of a large capital gain on their sale. Similarly, in the 1980s and 1990s, the privatisation issues were sold on the basis that small investors would earn a substantial return in the early days of trading – the notion of the purchase of equity as a stake in the long-term performance of British industry was rarely mentioned. Furthermore, the relationship between the City and British industry has been essentially one of arm's length investment. The market for funds (both equity and debt) is seen essentially from a short-term perspective, with both sides of the funding transaction seeing the transaction in terms of price and availability. The arm's length market nature of the system promotes an emphasis for both sides of the system that militates against active, direct governance from the providers of finance: the logic of the system is a market based upon exit rather than voice. However, it is within this system that the institutions are expected to have the motivation and ability to adopt active and direct governance.

However, despite the fact that the nature of the market would seem to discourage monitoring, there are many examples of institutions having intervened in the management of problem companies (see Black and Coffee, 1994, for examples of institutional intervention and the circumstances surrounding such interventions, and the introduction to this chapter for more recent examples). However, as Black and Coffee noted, the majority of intervention is usually carried out in private rather than in the public arena and, moreover, usually as a last resort in times of crisis. Furthermore, as Ball (1990) commented,

As presently conducted, there is more VOICE being exercised than is commonly supposed, and this has certainly increased in the 1980s. Nevertheless, the nature of this VOICE is unsatisfactory. It is not systematic. It takes place behind closed doors. The process itself is not subject to any kind of monitoring. (p. 24)

Hence, because of its covert nature, it is not usually possible to examine the precise degree to which institutions intervene in the governance of corporations nor the effect of any intervention.

Indeed, Plender (2003, p. 146) suggests that the claim that fund managers were engaged in an active dialogue with management behind the scenes was ‘inherently unverifiable’. However, as noted in the Introduction, recent changes in UK company law which require the directors’ remuneration report to be put to a shareholder vote at the AGM and the threat of further legislation have resulted in more public interventions on the part of institutional shareholders.

To summarise, it is clear that a problem exists in attempting to reconcile the role of institutions as shareholders with their role as investors of funds. Although in the long term and at a collective level, the objectives of institutions as both shareholders and investors should be to improve corporate performance (brought about, it is assumed, by improving the standards of corporate governance), in the short term and at an individual level, it is not clear that institutions’ objectives from the investment perspective can be met by improving their role as shareholders.

## **THE WILLINGNESS AND ABILITY OF INSTITUTIONS TO INTERVENE IN THE GOVERNANCE OF CORPORATIONS**

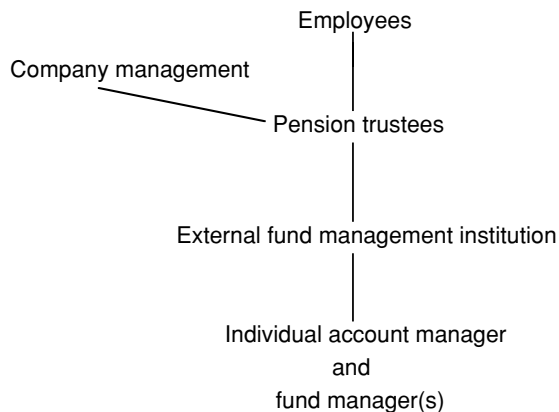
Prior to and following the publication of the Cadbury Report, there was much anecdotal evidence to suggest that institutional shareholders do not adopt a monitoring role, preferring to sell their holdings in ‘problem’ companies rather than intervening in the management of that company (to ‘exit’ rather than use ‘voice’, in Hirschman’s (1970) terms). There are several reasons why institutions may adopt such a stance. First, if they intervene publicly, they are effectively drawing to public attention the difficulties the company is facing. This is likely to be perceived as ‘bad news’ by the market, resulting in a fall in share price and a reduction in the value of their investment. Second, if they become involved in the management of such ‘problem companies’, they become privy to inside information and unable to trade in those shares, potentially compounding their losses. Finally, effective monitoring is costly in terms of time and money, especially for institutional investors with diverse portfolios. To counter the above, it may be argued, as Hampel (1998) did, that the option of exiting becomes more problematic as institutional investors increase their stakes in public companies, follow index tracking strategies and as the number of institutional players in the market decreases. Selling large blocks of shares in a ‘problem’ company is likely to be extremely difficult, particularly as the potential buyer is likely to be an alternative institution with knowledge of the potential problems which exist in the company. However, Myners (2001) notes that, even in circumstances where large institutions are unable to sell without affecting the share price, many ‘showed a marked reluctance to intervene in situations where companies were clearly experiencing strategic and leadership problems’ (p. 90).

In this section, the factors which affect the willingness and ability of the institutions to intervene to correct corporate governance failures (to use voice rather than exit) are evaluated. Specifically, this section considers the agency problems arising at all levels of the fund management relationship; the effect of the size of institutional equity holdings on the incentives of institutions to intervene; the public good nature of active monitoring and the associated problem of free riding; and, finally, the conflicts of interests faced by institutions when considering whether intervention is worthwhile.

## Agency Problems Arising between Institutions and Beneficiaries

At this stage, a number of crucial and related aspects of institutional investment and particularly occupational pension fund arrangements need to be outlined, in order to fully understand the objectives and incentives which institutions face when considering their investment and ownership stance. First, due to the structure of the fund management arrangements of occupational pension funds, agency problems arise at every level in the relationship between the ultimate beneficiary of the pension fund (the current or past employee). Second, the method and timing of the performance measurement of the fund and of the fund manager will have an important effect on the incentives of the fund manager, and may increase agency problems between the parties.

Because the mechanics of institutional investment management mean that there is often a division between voting control of shares and the ultimate beneficial owner, agency problems of ownership and control arise at every level of the relationship between the beneficiary and the fund manager. Such agency problems may lead to a fund being managed using, in Charkham's (1994a) terms, a Type B approach when a Type A approach is more appropriate. As an example, Figure 4.1 outlines the relationships which may exist between an externally managed company pension fund and its fund manager. Whilst the current and past employees are the ultimate beneficiaries, the fund trustees are those who have legal control over the assets of the fund. However, research carried out as part of the Myners Review of institutional investment in the UK found that the majority of pension fund trustees were not expert in investment – for example, 62% of trustees had no professional qualifications in finance or investment; 77% of trustees had no in-house professional to assist them; and over 50% of trustees received fewer than three days of training when they were appointed (Myners, 2001). Conflicts may arise between the interests of employees and of the company, particularly if the trustees are also directors of the company, as is often the case. Trustees/directors may wish to maximise the value of fund in order to minimise the company's contributions and possibly use any pension fund surplus to inflate company profits. The Robert Maxwell affair and the demise of the Mirror pension fund in the 1990s was an extreme example of the problems which may arise between beneficiaries and trustees/directors.



**Figure 4.1** *The relationship between pension funds and fund managers*

Furthermore, pension fund trustees can delegate investment management to an external fund manager to invest under a management contract. Within the marketplace for such business there is a great deal of competition among fund managers and, not surprisingly, much emphasis is placed on 'annual league' tables of fund performance. Two performance measurement services, the WM company and Russell/Mellon CAPS, produce performance figures for individual fund managers and also produce median figures for the fund managers they survey. Not surprisingly, therefore, fund managers are under a great deal of pressure to perform better than the median fund, which is often argued to have the consequence of focusing fund managers' attention on their performance relative to their competitors, rather than on their absolute performance. For example, Plender (2003) argues that

... many professional fund managers are no longer really interested in making money for their clients. They are preoccupied chiefly with their investment performance *relative* to their competitors, because they know that if they underperform by a wide margin they will lose the mandate to manage the client's money. (p. 62)

Thus agency problems may arise between the pension funds and a fund management institution if the trustees have incentives to maximise the long-term value of the fund but fund management performance is evaluated on a short-term basis, by virtue of quarterly trustees' meetings. The contested view that the quarterly trustees' meeting is the cause of short-termism is one which has been cited for a number of years. However, Marsh (1990) argued that concern expressed over the measurement of fund managers' performance on a quarterly basis reflects a misconception of the activities of the fund managers and the performance measurers. Essentially, he suggests that whilst a fund's performance may be monitored on a quarterly basis, the performance of fund managers is not evaluated on the basis of even a few quarters' performance data. Similarly, institutional evidence presented to the Trade and Industry Committee on Competitiveness of UK Manufacturing Industry (1994) suggested that, whilst performance was monitored on a quarterly basis, performance was assessed over a longer period. In addition, a survey by CAPS (1993) found that, of pension funds that changed their investment manager in 1993, the mean and median period of tenure of the outgoing manager was seven years. However, the Myners Review found that one-third of schemes had changed investment managers in 12 months prior to their survey.

The debate over whether the focus on quarterly figures was a cause of short-termism was considered by the Myners Review (2001). From a survey carried out for the Review, it is clear that there is much debate over this issue. The Review stated that, although it was not possible to arrive at an objective answer to the question, there were three clear facts:

- a large number of fund managers believe that their pension fund clients are very concerned about short-term performance;
- a number of pension funds and their advisors insist that they are not; and
- pension funds will inevitably look at quarterly performance figures. (Myners, 2001, p. 88)

The apparent confusion as to the timescales over which performance is assessed led the Myners Review to conclude that fund managers could assume rationally that they could be dismissed after any quarter's performance, and that this could lead to managers being unwilling to take a long-term perspective. Furthermore, the lack of clarity over timescales would weaken incentives for fund managers to actively intervene in underperforming companies.

These agency problems are enhanced when the compensation awarded to the fund manager is structured in such a way that in the event of the fund manager taking corporate governance actions, he/she bears the cost of intervention, but the beneficial owner gains the benefit. Fees are usually calculated on a fund's market value on a reducing percentage basis as the market value of the fund increases, subject to a fixed minimum charge. Therefore, for a fund manager to undertake significant monitoring activities, its increased management fee would need to outweigh the costs of such monitoring. Given that the funds under management are likely to spread across a large portfolio of companies, it seems unlikely that the benefits of monitoring and intervention to the fund manager in the form of increased fee income would exceed the costs. Coupled with the potential costs of lost business from the management of the offended companies (the fund manager may also be currently managing their pension funds or be a future contender), it would seem clear that there are few incentives for intervention at the level of the fund manager. This again takes us to the crux of the problem – fund managers are not the beneficial owners of the shares and hence do not substantially share in the increased profits to be gained from intervention. Unless there is collective intervention by all fund managers, the costs of intervention simply reduce the individual fund manager's profits.

### Effect of the Size of Institutional Holdings on Incentives

The UK corporate governance reports suggest that, by virtue of the size of their holdings, institutional investors have the potential to exercise considerable control over the actions of the board of directors – potential which is rarely available to other (small) shareholders. From a rational perspective, one aspect of the governance of corporations is that the costs of intervening must be less than the probable benefits of intervention if governance actions are to be effected. Given potential scale economies in accessing corporate data and a positive relationship between the value of shareholdings and increased corporate performance, then larger shareholders have greater incentives to become involved in governance issues than smaller shareholders. As Stiglitz (1985) argues, individual shareholders with relatively small holdings have little incentive to gather and bear the relatively fixed costs of collecting information to enable them to monitor and control the behaviour of the board. Alternatively, large shareholders may have sufficient incentives to obtain the information necessary to effectively control management if the benefits of such monitoring outweigh the associated costs. However, Stiglitz does note that control by large shareholders may have a cost; if such shareholders are limited in terms of their diversification, then their shareholders may conflict with those of small shareholders. Furthermore, Stiglitz suggests that large controlling shareholders and managers may cooperate in the diversion of resources from remaining shareholders.

Notwithstanding the desirability of governance via large institutional shareholders and the fact the benefit/cost ratio is likely to be more favourable for large as compared to small shareholders, there still remains the issue whether the probable benefits of governance are likely to outweigh the mostly certain costs for large shareholders. Given the general direction of the relationships between firm size and benefits/costs, and the highly firm specific nature of any individual relationship, this current issue boils down to a consideration as to whether given percentages of shareholdings enable institutions to alter the actions of corporations and thereby the probable benefits they receive. Although this is difficult to answer in the absolute, it is possible to form an impression from the current holdings of the UK institutions.

Whilst institutional investors as a collective own the majority of equity in UK companies, on an individual basis, their shareholdings are mostly in the region of 2–3% of issued shares. Clearly, institutional investors will be unwilling to take on substantially larger holdings of equity in a single company as that would effectively ‘lock’ them in to that company, and potentially present liquidity and portfolio diversification problems.<sup>1</sup> Whilst a shareholding in the region of 2–3% is large relative to individual shareholders, in comparison to the size of the company and the size of the institution’s total portfolio, it is small and may not warrant the expense which has to be incurred in actively monitoring management.

The issue to be considered here, however, is whether shareholdings of this size are sufficient to control/guide the actions of management. When the shareholder concerned is another company with acquisition intentions, then clearly a holding of this size can impact of managerial behaviour. For example, when Hanson built up a shareholding of 2.5% in ICI in the 1980s, this size of the shareholding was seen as enough of a threat to spark major changes at ICI.<sup>2</sup> However, a share position of that level taken by institutions is unlikely to have a similar effect, as they are unlikely to have takeover motivations.<sup>3</sup> Nevertheless, a shareholding by an individual institution needs to be taken in the context of City relationships and the potential to influence other institutions/shareholders. This issue reflects the importance of the nature of the overall distribution of shares for the potential influence of any individual shareholding. For example, part of the influence of a 3% shareholding will depend on the ability of an institution to marshal the support of other shareholders and this in turn is a complex function of the distribution of the size of other shareholders and their diversity of interests (the next section’s review of the free-rider problem in the context of institutional investment attempts to throw some light on these issues). However, given the difficulties of determining the potential influence of a particular block of shares and in the absence of fully understanding the institutional dynamics of the City, it is a brave step to conclude that institutional investors have the potential to exercise considerable control over the actions of boards.

The picture of the potential influence of institutional shareholders is yet further clouded by the relationship between institutions, such as company pension schemes, who are the beneficial owners of the shares and institutions who act as fund managers for such pension schemes. Fund managers often manage funds on a full discretionary basis which means that they have control over the composition of the fund portfolio and, in many cases, over the voting rights attached to the shares which make up that portfolio. Therefore, it is likely that the amount of shareholdings under the control of institutional investors is significantly greater than the amount of their beneficial holdings. Nevertheless, it would still appear to be a bold step to conclude that shareholdings of even 5–6% would be sufficient to affect the actions of corporations. The argument so far has, however, ignored the actual size of the institutions and their general ability to influence general impressions within the share buying market.

There is no doubt that many of the financial institutions are large as measured by any yardstick. For example, the Prudential had a market value of £9654 million in June 2004, placing it in the top 30 companies quoted on the London Stock Exchange in terms of market value. Hermes (which manages the BT and Post Office pension schemes) alone has approximately £44 billion in funds under its control, as at December 2003. This gives them a voice, via their impact upon the media, of considerable volume and a potential ability to influence general perceptions – an ability which Hermes have used with success in corporate governance matters for the past decade. For example, in June 1994, Hermes instigated a campaign against directors’ rolling contracts of longer than three years by taking the then highly unusual step of writing publicly to the chairmen of the top 100 companies. This break with the tradition of ‘behind the scenes’

negotiation produced a great deal of media interest (with virtually all media commentators being in support of Hermes' stance) and brought the issue to the attention of individual shareholders and the public in general. Interestingly, however, it would rarely pay an institution to publicly voice negative opinion because of the potential impact upon share prices. Furthermore, at the time, many institutional investors felt that the public stance taken by Hermes was damaging to the relationships between institutional investors and the companies in which they invest. A member of the investment committee of the Association of British Insurers was quoted in the *Financial Times* as saying

We want to try to contain the damage that has been done. There is general concern on our committee that we do not want to damage relationships with companies. (*Financial Times*, 17 August 1994, p. 13)

However, the potential for such public voice translates into private influence and the seeming willingness of corporations to manage specific sessions for institutional shareholders. The obvious benefits to be gained by corporations and institutional shareholders in ensuring 'control' is in the private rather than the public domain is one reason why it is difficult to gauge the influence of institutional shareholders. Thus, there is an argument which suggests that the large institutional shareholders may be able to influence the affairs of a corporation over and above their nominal shareholdings. This then moves us on to consider why the institutions bother monitoring the actions of individual companies when they can free ride on the actions of others.

### The Free-rider Problem

The above sections have mentioned the free-rider problem facing individual institutions. This section considers, in more detail, the merit of applying free-rider type arguments to institutional investors. An absence of governance by institutions because of the potential for individual institutions to benefit from the actions of others is indicative of a free-rider problem. Since the benefits of any collective action go to every individual in a group whether or not that individual has borne any of the costs of the collective action, it follows that, unless the group is small or meets certain other special conditions, the collective good will *not* be provided through market mechanisms or other straightforward and voluntary arrangements. Given that institutional investors are subject to such free-rider problems, it may be more relevant to examine why institutions ever engage in collective action when there are so many factors counting against such actions. For example, as Black and Coffee (1994) note, the absence of a generally accepted mechanism for cost sharing among institutions that undertake collective action presents a major obstacle to such collective action.

To some extent, the nature of the conflict which might lie between private and collective benefits/costs is analogous to that of the Prisoners' Dilemma. However, there are major differences between the Prisoners' Dilemma and the framework within which institutions operate which may help to overcome the seemingly insurmountable free-rider problems facing institutional investors. Before examining these differences in detail, it is necessary to note the environment in which the institutions operate. Another peculiar feature of the UK market for funds is its spatially concentrated nature within London's Square Mile. Historically, the investing institutions have a well-developed network of informal communication. Thus, one of the problems of trying to analyse and understand institutional governance in the UK is that it seemingly operates via a series of well-developed informal networks, usually behind closed doors. Although there may be a lack of publicly noted governance, this does not mean that governance



actions do not occur. Therefore, when analysing the actions of institutions, it is necessary to take into account the nature of the relationships within the Square Mile. Moreover, from a corporate governance perspective, there are two ways of viewing the investing institutions' marketplace; as a no-holds-barred competitive situation or as a competitive market underpinned by orderly conduct. All the available evidence (for example, see Holland, 1994) points to the latter being the most appropriate description. This suggests that, although the governance actions of institutions may be seen as being conditioned by a free-rider problem, the informal systems of the City allow collective solutions to be found. Thus, although the institutions may be seen as operating arm's length investment policies, the history and nature of the City may allow governance issues to be confronted in 'relational' rather than pure arm's length market terms.<sup>4</sup>

One feature of collective action to consider is whether the size of the group of institutional investors is an important factor in determining collective action. Specifically, would a sufficiently small group of institutional investors be able to overcome free-rider problems? The conclusion usually drawn from the Prisoners' Dilemma model is that even groups of only two members normally fail to obtain a collective good. It is only when two individuals repeat the Prisoners' Dilemma game a large number of times that they are able to achieve the gains from cooperation. In any single game (or in any set of games where the players know in advance how many games will be played), the dominant strategy for each player is to defect and not cooperate.

A crucial aspect of the Dilemma is that the prisoners are denied communication and hence the opportunity to make mutually advantageous deals. Clearly, such a situation does not exist within the City where there are well-developed networks and codes of practice and behaviour which have arisen from the City's long history of trading. Furthermore, within the context of the Prisoners' Dilemma, cooperation derives from the repeated play of a two-person game. Given that relationships which exist between the various institutions are generally long-term relationships, there are incentives for institutions to take a long-term view of cooperation in corporate governance matters. For example, institutions may take turns to play the role of 'lead institution' when intervention in a company becomes necessary (see Black and Coffee, 1994, for a summary of the process of forming coalitions of institutions to confront management, and the recent behaviour of Fidelity in response to the unwelcome appointment of Michael Green as chairman of the merged Granada/Carlton group).<sup>5</sup> If individual institutions refuse to play their part, it would seem likely that this will damage their reputation and other institutions will withdraw their goodwill towards that institution and refuse to cooperate in future interventions. Hence, the existence of communication networks and the long-term nature of mutually advantageous relationships between City institutions may contribute towards an environment in which cooperation can take place and free riding is reduced.

However, within the context of the Dilemma, the tendency towards cooperation is diminished as group size increases. In a sufficiently large group where no single member gets no more than a small share of the benefits of a collective good, the incentive to cooperate with other potential beneficiaries of the collective good disappears. In support of this, Black and Coffee (1994) note that when institutional coalitions do form, they are usually small in terms of the number of institutional participants but relatively large in terms of collective shareholding. Although the communication and interaction networks within the City may appear to reduce free riding, the increasing number of institutions within the City may help to break down the old codes of conduct and means of doing business.

Although coalitions between institutions do form, those coalitions still face free-rider problems from institutions who do not form part of the coalition. In the majority of situations, it is likely that institutions involved in collective action against an individual firm will not be

rewarded by substantial future profits from that firm. Furthermore, when the costs of taking such public action and the possibility that any action will be unsuccessful are taken into consideration, there remains the question of why institutions undertake such action when the benefits of doing so appear to be so small, if indeed any benefits exist. Public action is likely to be more costly than private action, as the very fact that public action has been taken suggests that previous 'behind the scenes' attempts to influence boards have failed. In addition, the particular institutions involved in such public action risk a loss of reputation if they are unable to force their desired outcomes. Given that public action is taken, albeit rarely, this suggests that there are some benefits to be gained, although these benefits may not be directly associated with the immediate action being taken against an individual firm. Rather, it is likely that action is taken to act as a deterrent to other companies' boards and to signal to the corporate community in general that intervention by institutions remains a credible threat.

Therefore, although it may be first assumed that institutions have very little incentive to become involved in the monitoring activities that corporate governance demands, it would appear that the relationships which exist between institutions act to limit free-riding behaviour. If collective action by institutions were to be viewed as a single play of the Prisoners' Dilemma game, it is clear that such collective action would be unlikely to take place due to the prevalence of free riding. However, given the City context in which the institutions operate, repeated play of the Prisoners' Dilemma is the more appropriate analogy to make, where cooperation between institutions becomes worthwhile. Furthermore, in the context of private versus public action, it would seem that, in the majority of cases, private action on the part of institutions would be the most appropriate course for institutions to take. When public action does occur, it is likely to be motivated by the need to enforce the notion that institutional intervention remains a credible threat.

Therefore, in summary, the public good nature of corporate governance actions and the associated incentives for free riding would suggest that monitoring would not be provided. However, the rationality arguments do not take into account the institutional framework of the Square Mile that has evolved over a number of centuries. The institutional investors in the UK form a highly concentrated network, often operating in the confines of the Square Mile with a well-developed history of relationships and communication. This facilitates the operation of relational dynamics and the possibility of concerted/focused action. In this form of society, it may, of course, be extremely difficult to directly identify actions that could be definitely categorised under the banner of governance; actions taking place through gentle persuasion and the knowledge that the potential public disclosure of opinions can be extremely damaging. In fact, the tendency to work behind closed doors in the UK reinforces the strength of any potential threat to 'go public'. Such a threat, of course, is only likely to be credible if the companies believe it is in the interests of the institutions to publicly voice their concerns. It is clear, however, that the nature of governance within the UK is such that it is difficult to visibly determine how far it is in operation. In addition, the problems of coordinating collective action mean that such actions occur only in extreme circumstances.

## Conflicts of Interest

Whilst informal mechanisms may be in place giving institutions incentives to take governance actions (albeit in private rather than public), additional factors provide disincentives to institutional monitoring and intervention. This section examines the possible conflicts of interests

that certain institutions may face as a result of other (actual or potential) relationships with the company.

Pound (1988) presents three different hypotheses which may explain the relationship between institutions and their incentives to intervene in corporate governance – the efficient monitoring hypothesis, the conflict of interest hypothesis and the strategic alignment hypothesis. The efficient monitoring hypothesis suggests that institutional shareholders are more informed and able to monitor management at lower cost than small shareholders. Alternatively, the strategic alignment hypothesis suggests that institutional shareholders and the board may find it mutually advantageous to cooperate on certain issues. In a similar vein, the conflict of interest hypothesis suggests that institutional shareholders may have current or potential business relationships with the firm which make them less willing to actively curb management discretion.

Pound's hypothesis that the extent of institutional intervention will depend on the relationship between the institution and the company may be used to explain the Hermes campaign against directors' three-year rolling contracts in 1994, outlined above. Hermes manages the Post Office and British Telecom pension funds, acts as their in-house fund manager and is owned by the BT pension scheme (which is the UK's largest pension fund). At the time of the campaign, they were not open to business from any other sources and therefore did not have conflicts of interest which may have precluded them from actively opposing management.<sup>6</sup> Other pension fund managers such as merchant banks and insurance companies may have other business interests with the companies in question and hence are less likely to actively oppose management for fear of jeopardising those interests. In addition, fund management is a highly competitive business, and fund managers may understandably feel wary of criticising the very directors of a company whose pension fund management business they may be seeking in the future. It was notable that at the start of their campaign, Hermes could not get open support from the umbrella organisations, the Association of British Insurers and the National Association of Pension Funds, although this changed when the Greenbury Report specified that one-year contracts should be the norm for directors. Furthermore, many of the institutional investors are themselves quoted companies and at the time had directors on three-year rolling contracts (a good example was the Prudential). Hence, it could be argued in line with Pound that not only do such institutions face conflicts of interest, but that directors of institutions have reasons for aligning themselves with company management over certain issues for fear of specific practices, which they themselves adopt, becoming unacceptable. In addition, institutions may face conflicts of interest by virtue of their own ownership structure. In particular, certain fund-managing institutions are subsidiaries of investment banks. In such situations, conflicts of interest may arise between the institution and its parent with regard to corporate governance matters. Actions to curb management discretion by the institution may have long-term consequences for its parent if it has current business relationships with the firm or is likely to act as an advisor to the firm on future matters such as takeovers, rights issues etc.

However, although there are obvious disincentives as a result of conflicts of interest to institutions becoming involved in governance issues, there are examples of direct involvement which suggest that the disincentives are not insurmountable and institutions do find it worthwhile to voice their concerns. For example, Hermes is a particularly useful example of an institution that finds the benefits of open intervention to outweigh the costs. As Britain's largest in-house pension fund investor, it is estimated to own 1½% of British industry and owns shares in a large percentage of all quoted companies. Therefore, the cost to firms of

large compensation payments in the event of a director's loss of office as a result of three-year rolling contracts directly affects the fund's revenues. Its campaign focused on one issue which was common to all companies and hence the costs of intervention were much less than if it campaigned on individual firm-specific issues.

Pension funds such as Hermes have characteristics which are similar to Coffee's (1991) notion of the 'optimal corporate monitor'. Coffee suggests that the optimal corporate monitor should be relatively free from conflicts of interest such that its monitoring and control activities are not biased by opportunities to earn other income from the company in question. It should also have a long-term investment horizon and its stake in the corporation should be large enough to justify the expenditure of significant monitoring costs. Coffee argues that pension funds are in a better position than other institutions to perform this role. However, whilst this is true of in-house managed pension funds such as Hermes, the position is not so clear in the case of externally managed pension funds. As discussed in the subsection on agency problems, above, the agency problems arising between pension funds and external fund managers may prohibit monitoring by pension funds. Furthermore, large pension funds tend to be highly diversified with relatively small holdings in any one company which places constraints on the amount of monitoring activity which can be undertaken, in terms of both cost and in-depth knowledge of management. In addition, the trustees of pension funds managed internally may face pressure from their own company's management to form strategic alliances with the management of the companies in which they invest. Their own companies may be faced with corporate governance problems to which they would rather not draw attention. Thus the point to note is that the institutions themselves are organisations where there is a separation between management and owners and hence the same potential governance problems are as likely to apply here as they are to corporations; essentially, in promoting institutions as a partial solution to the governance problem, there is an inherent belief that institutions themselves are less prone to governance issues than corporations.

Whilst there has been much debate concerning the ability of institutions to effectively monitor corporate management, relatively little attention has been paid to the monitoring of institutions themselves. Jenkinson and Mayer (1992) argue,

Why precisely managers of institutional funds are supposed to be so much better at administering non-financial enterprises than the management of these enterprises themselves, or why similar problems of corporate governance do not afflict the funds themselves are questions that are never very clearly answered. (p. 2)

Indeed, Coffee (1991) suggests that there are reasons to believe that some institutional investors are less accountable to their owners than are corporate managers to their shareholders and argues that the usual mechanisms of corporate accountability are limited or unavailable at the institutional level. The extent of the problem depends on the nature of the institution concerned. For example, self-administered occupational pension schemes are obviously immune from mechanisms such as takeovers. In addition, their beneficiaries, the company's employees, are not in the position to sell their stakes in the pension fund if the fund underperforms. Furthermore, discipline in the form of monitoring by debtholders does not affect self-administered occupational pension funds.

A crucial aspect of the debate which is often ignored is the relationship between the fund manager, the occupational pension fund and the sponsoring company. As noted, the trustees of an occupational pension fund usually include directors of the sponsoring company. Throughout

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the above discussion, the pressures placed on the fund manager to maximise performance have been stressed, pressure which is in part placed on the fund manager by the sponsoring company. As Charkham (1994a) argues,

All company managers want their own shareholders to belong to the type A school. If they put pressure on their own pension fund managers for short-term results they push them toward type B. (p. 103)

The pressure that companies place on their pension funds to perform well in the short term has important implications for the corporate governance debate and the accusations levelled at fund managers that they are responsible for the short-termism which prevails in the market. Blake (1992), on the topic of hostile takeovers, argues strongly that,

This aspect of short-termism is a direct consequence of the companies themselves demanding that their own pension funds beat the average, when no more than half of them can do this. They cannot really complain when fund managers capitalise on the large price rises resulting from takeover bids by selling their stakes in an attempt to beat the average, knowing that if the bid fails, the share price will sink back again. (p. 86)

Hence, it may be argued that companies themselves are, at least in part, responsible for institutional behaviour of which they are then highly critical. This highlights the agency problems and conflicts of interest which are inherent in the occupational pension fund arrangements which operate in the UK. As Blake (1992) notes,

Pension scheme members are entitled to expect that their pension funds do not act in a way that destabilises the very companies for whom they work. (p. 94)

In summary, institutions face conflicts of interest in their dealings with companies as a result of their role as shareholder/investor and current or potential business service provider, which possibly inhibits their willingness to apply pressure to company management in the event of corporate governance deficiencies. Furthermore, it is clear that the institutions themselves are not immune from corporate governance problems and may be unwilling to draw attention to these problems by criticising the companies in which they invest. Finally, a related issue is the relationship between occupational pension funds and their sponsoring companies which is likely to affect the way those fund managers act towards other companies.

## **METHODS OF INTERVENTION**

The previous sections have drawn attention to the lack of incentives faced by institutions with regard to active monitoring and intervention. Furthermore, if as discussed in the subsection on the free-rider problem, above, the problems of coordinating collective action can be overcome, the question of what action institutions can take remains. The system of corporate governance in the UK operates through the Companies Act and recognises the power of the shareholder via their right to vote at the AGM. Whilst this may be the obvious way for institutional shareholders to exercise their power over company management, as discussed below, such public action has been, until very recently, usually eschewed by institutions. However, in their role as relatively large shareholders, there are a number of other actions which, although not available to individual shareholders, are available to institutional shareholders. In this

section, the actions which institutions can take to intervene in the management of a company are discussed. However, given the limitations of these actions (discussed below), the section evaluates arguments which suggest that institutions need to take more public action in the form of exercising their right to vote.

Within the 'outsider' system of corporate governance existing in the UK, institutional investors have a number of governance actions available to them. However, as will be discussed, the ability of institutions to act publicly is constrained by the possible adverse effects of those actions. Hence, it is the *threat* of public action which is the most powerful weapon open to institutions, although there are times when such threats have to be carried through for such actions to remain credible.

An obvious first course of action open to institutions is to refuse to partake in rights issues when companies come to the market to raise additional equity funding. Institutional shareholders are at their most powerful in such situations, for the onus is on management to negotiate with the institutional shareholders. Institutions may make the provision of additional finance subject to governance changes within the company, for example, by demanding board changes etc. Because management are appealing to institutions to support them at the time of the rights issue, many of the usual problems of organising collective action will not arise, in particular the cost of such action to institutions will be lower as they do not have to initiate the action themselves. However, this source of power obviously arises only when companies require additional equity finance; hence other forms of governance action are required in other circumstances.

The second course of action open to institutions is adverse public comment, which may damage the firm in terms of its share price and its overall business reputation. The problem with this form of action is that it risks damaging the investing institution and other investing institutions as well. Hence, when, in 1994, Hermes publicly criticised some companies' executive compensation contracts, it did not receive the warmest of responses from the companies concerned or from other institutions. Part of the problem with such an approach is that the institution puts itself in a light of being 'whiter than white' and hence leaves itself open to increased public scrutiny. Furthermore, although the relationship may be essentially arm's length, the institution needs the continued support of the firm if it is to access firm specific data on a timely basis. For these reasons, the institutions may prefer to comment privately; in this way, the firm, the institution and relationships with other institutions are not damaged. If this form of 'quiet' policing works, then it is to the benefit of all concerned as it avoids the costs of excess volatility. The problem with the UK system is that a large part of the shareholding in a firm is not privy to the discussions which take place behind closed doors and, therefore, there must always be a lingering doubt as to whose needs are being served.

The third potential action open to institutions is the removal of directors by direct action. This was an extremely rare course of action – the removal of Maurice Saatchi from his post as the director of Saatchi and Saatchi in 1994 and the prevention of Michael Green from taking the role of chairman of ITV plc in 2003 are not the norm and occur only in extreme cases when it is clear that the usual 'behind the scenes' action has not worked.

A slightly less public form of action is the threat of selling a firm's shares with the consequent damage upon share price and general reputations. Again, this action suffers from the fact that it will damage other institutions and, hence, it opens up the potential for retaliatory action.

The most obvious course of action open to institutions is to exercise their right as shareholders to vote at a company's AGM. The Institutional Shareholders' Committee (ISC, 1991) recommended that institutional shareholders should make positive use of their voting rights

and should register their votes wherever possible on a regular basis. Furthermore, the Cadbury Report (1992) stated that,

Voting rights can be regarded as an asset, and the use or otherwise of those rights by institutional shareholders is a subject of legitimate interest to those on whose behalf they invest. We recommend that institutional investors should disclose their policies on the use of voting rights. (para. 6.12)

The successor committees have placed greater emphasis than Cadbury on the importance of institutional voting. One of the principles of the Combined Code (1998) was that 'institutional shareholders have a responsibility to make considered use of their votes', and furthermore, the Code contained provisions stating that institutions should, on request, provide information to their clients on their voting behaviour and should take steps to ensure that their voting intentions were translated into practice.<sup>7</sup>

However, despite the increased pressure on institutions to exercise their voting rights, voting still remained low throughout the 1990s. Research by PIRC (1998) suggested that average voting at AGMs of the FTSE 350 companies had increased from approximately 38% in 1993 to 46% in 1998, two-thirds of companies still had a voting turn-out of less than 50%. In addition, the percentage of votes which oppose management resolutions or record an explicit abstention is approximately 2%. Newbold (1999) reported that voting levels were at the level of 40–45%, compared with 80% in the US due to the 'endemic passivity' among institutions. This was in spite of the calls made by numerous bodies, such as the Association of British Insurers (ABI), the National Association of Pension Funds (NAPF) and the Institutional Shareholders' Committee (ISC), as well as the successive corporate governance committees, for institutional shareholders to exercise the voting rights of the shares they control.

As noted in the Introduction, increased pressure has been placed on institutional shareholders to exercise their right to vote since the election of the Labour government in 1997. Prior to their election, the Labour Party had signalled that it was considering proposals to include an obligation to vote in the fiduciary duties of pension funds and to require fund managers to justify their voting decisions to trustees.<sup>8</sup> Their election to government led to a number of institutional initiatives aimed at encouraging greater institutional voting within the self-regulatory framework. In 1998, the National Association of Pension Funds sponsored an inquiry into proxy voting by institutions, chaired by Yves Newbold. The Newbold Inquiry reported in 1999 and recommended that regular considered voting should be regarded as a fiduciary responsibility, voting policy ought to be covered by agreement, companies should actively encourage the voting of their shares and electronic voting should be supported. The practical impediments to the casting of proxy voting were further reviewed in a report by Paul Myners (2004) to the Shareholder Voting Working Group, a group which was established to take the Newbold recommendations forward. In addition, the findings of the Myners Review (2001) of institutional investment led to the government setting out consultative proposals for the imposition of a legal duty on those responsible for the investment of pension scheme assets to exercise their votes where, after taking into account the costs of any action, there is a reasonable expectation that such activities are likely to enhance the value of the investment (HM Treasury/DWP, 2002). In response to these proposals, the Institutional Shareholders' Committee published a statement of principles setting out the responsibilities of institutional investors and their agents which stated that 'Institutional shareholders and/or agents should vote all shares held directly or on behalf of clients wherever practicable to do so' (ISC, 2002).

Whilst the threat of immediate legislation appears to have receded in the short term,<sup>9</sup> consideration needs to be given to the effect of legislation, in the form of mandatory voting, on

corporate governance within companies and on the relationship between companies and their institutional shareholders. The arguments for and against mandatory voting have been debated for a number of years. Davies (1993), for example, argued that mandatory voting would be

a useful discipline to monitoring if institutions were obliged to formulate and express a view on all issues put to a vote at shareholder meetings. (p. 92)

However, Davies does recognise that mandatory voting would have to be accompanied by an obligation that the votes were informed. Whilst mandatory voting coupled with the publication of voting policy may at first seem to make the voting process more transparent and force institutions to take a more active interest in corporate governance issues, it is not clear that such a policy would translate into real changes in fund managers' and pension trustees' attitudes. It is possible to place a legal obligation on institutions to vote, but placing a legal obligation on institutions to vote in a sensible and informed manner is likely to be a practical impossibility. If 'informed' voting were made mandatory, it is unclear how the subsequent voting behaviour of institutions would be policed. It is doubtful whether pension fund trustees, in general, are qualified to undertake a detailed evaluation of the external fund managers' voting decisions. Given the diversity of company resolutions on which they would be voting, fund managers' voting policy statements would necessarily be broad statements, and unlikely to commit institutions to specific actions.

If institutions were obliged to produce very detailed voting policy statements, there will always be instances when, in the interests of beneficiaries, institutions should vote contrary to their policy statements. In such circumstances, institutions could be obliged to publish justifications of their actions, but without detailed knowledge of the circumstances, it may be impossible for pension trustees or regulators to judge whether the institution's action was actually justified. Clearly, mandatory 'informed' voting would impose costs on the institutions. Furthermore, such legislation may have the opposite effect to that intended. If institutions find themselves in the position of voting, in the interests of good corporate governance, contrary to their policy statement, rather than endure the ramifications of this action, they may simply vote in accordance with their published policy (to the detriment of their beneficiaries) or they may simply sell their holdings.

Whilst the imposition of mandatory voting does have initial attractions in appearing to force institutions to take a more active governance role in the companies in which they invest, the above discussion suggests that it is unlikely to produce these desired benefits. It may be possible to ensure that fund managers and/or trustees vote their shares, but ensuring that they vote in an 'informed' way is impossible to police, particularly given the difficulties of defining 'good' corporate governance practices. Furthermore, given that pension fund trustees are often officers of the sponsoring company, they have little incentive to enforce voting policies (particularly on contentious issues) which may affect the sponsoring company in the future.

A perceived benefit of mandatory voting is that the costs of maintaining highly diversified portfolios would increase, potentially forcing fund managers to change their investment behaviour. Given that the costs of voting will, however, differ between different types of fund management arrangements, it is likely that, in the long term, pension funds will be channelled into lower-cost arrangements, particularly 'pooled funds', whilst still maintaining highly diversified portfolios (see Short and Keasey, 1997, for a discussion of these points).

Hence, whilst the introduction of legal obligations for pension funds to exercise their voting rights may at first seem an attractive option, it is unlikely to produce the desired benefits of increased monitoring. Given that institutions prefer to exercise any control they deem



necessary in private, the introduction of mandatory voting may simply lead to ‘lip service’ being paid to the voting procedure, without any changes to the underlying ethos of investment and ownership policy. Furthermore, in response to mandatory voting, institutions may simply resort to ‘box-ticking’ in response to individual company’s application of the Combined Code, rather than abiding by the ‘comply or explain’ ethos which underpins the corporate governance recommendations in the Combined Code, leading to companies simply following the Code, regardless of whether its recommendations provide the optimal governance structure for that individual company.

## **GOVERNANCE BY INSTITUTIONAL SHAREHOLDERS: EMPIRICAL EVIDENCE**

The empirical evidence regarding governance and institutional shareholders is discussed as follows. First, evidence regarding the supposed short-termism of institutions and the subsequent effect on long-term expenditure and dividend policy is outlined. Second, evidence regarding the relationship between firm performance and institutional shareholders is examined. Finally, this section discusses the evidence relating to the impact of institutions on directors’ remuneration.

### **Short-termism**

One criticism which emerged in the governance literature during the 1980s and 1990s was that institutions were only interested in short-term gains and, moreover, due to the concentration of shares in the hands of institutional shareholders, they have been responsible for the short-termism which the capital market as a whole is supposed to exhibit. Indeed, it is the alleged desire by institutional investors for short-term gains which is often blamed for the extent of takeover activity in the UK, the downward inflexibility of dividends payments and the relatively poor performance of the UK in industrial and economic terms. The argument that institutions are short-termist is essentially a criticism of the efficiency of the capital market; that is, the external capital market undervalues long-term investments. As Marsh (1990) states,

The crime of which the stock market stands accused is that of mispricing shares.

The evidence to support these criticisms is largely anecdotal. Very little empirical evidence exists which directly tests whether UK stock market valuations of companies is ‘short term’. However, that which does exist (Miles, 1993; Nickell and Wadhvani, 1987) suggests that long-term cashflows are discounted at much higher rates than shorter-term cashflows.<sup>10</sup> Whilst such findings are open to criticism regarding model assumptions (as indeed are all efficient market studies), they do present results which are difficult to reconcile with market efficiency. In contrast, Stapledon (1996) concluded there is little in the way of argument and/or evidence to suggest corporations have been short-termist and questioned whether the corporations have misinterpreted the objectives of the institutions. However, he further argued that rather than the system being actively short term, there is a lack of incentives to look long term. In the present arm’s length market system there is no real emphasis on the gains to be made from long-term commitments, in contrast to the relational systems of Germany and Japan. Hence, the problem may not so much be a consequence of the purposeful actions of individuals/organisations but rather a result of the inherent emphasis of the system as a whole.

One often cited consequence of institutional short-termism is that UK companies underinvest in long-term projects relative to their international competitors. Lack of investment in long-term projects as measured by expenditure on R&D is often blamed for the poor performance of the UK economy. However, the empirical evidence available for the US does not support this argument. Studies by McConnell and Muscarella (1985), Woolridge (1988) and Jarrell and Lehn (1985) indicate that announcements of long-term investment expenditure are regarded as good news by the market and result, on average, in positive abnormal returns. Overall, there is substantial evidence to support the contention that the market does not systematically discriminate against companies that undertake above average expenditures in R&D (Marsh, 1990). However, the lack of discrimination against companies undertaking R&D expenditure does not mean that the market is able to distinguish between R&D expenditure which will yield future positive net cashflows and that which will not. It remains to be seen whether market players are, on average, capable of correctly evaluating investment opportunities in certain highly technical industries and hence pricing the shares of such firms correctly. In a similar vein, Charkham (1994a, b) argues that many fund managers are not equipped to act as long-term (Type A) investors as their primary understanding is of short-term markets rather than industry.

The empirical research which examines the effect of institutional shareholdings on R&D expenditure, however, has produced mixed results. Hansen and Hill (1991) argue that there are two alternative hypotheses which may explain the potential relationship between institutional investors and R&D expenditure. The first, the myopic institutions theory, argues that institutions sell in response to a short-term decline in earnings. This results in a drop in the share price and an increase in the probability of a hostile takeover bid. This theory essentially argues that the external capital market is inefficient, undervaluing long-term investments. As a consequence, management cut back on long-term investments, specifically R&D expenditure, to inflate short-term earnings. Hence, the myopic institutions theory predicts a negative relationship to exist between institutional shareholdings and R&D expenditures. Alternatively, the efficient markets theory argues that all shareholders approve of investments which increase the future cashflows of the firm. Rational investors are not led by short-term profits and will approve of R&D expenditure which enhances future cashflows and may sell shares if a firm over- or underinvests in R&D. The efficient markets theory therefore predicts that no relationship between institutional shareholdings and R&D expenditure will be observable. Whilst Graves (1988) found evidence to support the myopic institutions hypothesis, Hansen and Hill (1991) and Jarrell and Lehn (1985) found no evidence of a negative relationship between R&D expenditure and institutional shareholders. Indeed, Hansen and Hill (1991) found a weak positive relationship to exist between institutional shareholdings and R&D expenditure, a result which they interpreted as being inconsistent with the efficient markets hypothesis as it suggests that the presence of institutions encourages greater R&D expenditure.

An alternative perspective on the relationship between long-term expenditure and institutional shareholders was put forward by Wahal and McConnell (2000). They argue that institutional investors may act as a 'buffer' between individual investors (who are impatient for short-term gains) and corporate managers. Because institutional investors may have an informational advantage relative to individual shareholders, institutional investors may be less likely to judge corporate managers on the basis of short-term reported earnings and hence allow managers to focus on projects with long-term pay-offs. The 'buffer' perspective predicts a positive relationship between institutional ownership and the level of expenditures for projects with long-term pay-offs. Testing the various hypotheses on a large sample of US

companies, Wahal and McConnell found a significant positive relationship between property, plant, equipment and R&D expenditure and institutional ownership.

A related area of research considers the effect of institutional shareholders on the enterprise activities of the firm and investigates whether different types of institution have different effects on such activities. Kochhar and David (1996) find that more active investors (such as pension funds and mutual funds) are more able to influence managers to increase new product development even after controlling for spending on R&D than are institutions such as banks and insurance companies which are less active. Long-term institutional shareholdings have a significant and positive effect on firm innovation (Zahra, 1996). Ownership by pension funds appears to have a positive effect on R&D intensity and new product intensity, but a negative effect on external innovation, whilst ownership by investment managers (mutual funds) is positively associated with international diversification and external innovation, where external innovation involves acquisitions to acquire new products, to develop new processes or build new markets (Hoskisson *et al.*, 1995). Hoskisson *et al.* (2002) argue that the different objectives and compensation arrangements of pension fund managers and professional investment fund managers result in differing preferences for the type of strategic action undertaken by their investee firms. They report that pension fund managers appear to prefer internal innovation whilst the preference of professional investment managers is for external innovation. Bushee (1998) examines the impact of institutional shareholders on R&D expenditure and finds that managers are less likely to cut R&D expenditure to reverse an earnings decline when institutional ownership is high. However, high ownership by institutions that have high portfolio turnover and engage in momentum trading significantly increases the probability that managers reduce R&D expenditure to reverse an earnings decline. Institutional shareholdings are also found to have a positive effect on corporate risk taking for firms with growth opportunities (Wright *et al.*, 1996).

A further consequence of institutional short-termism which is often cited for the UK is the relatively high level of dividend payouts of UK companies and the lack of flexibility (particularly downwards) of dividend payouts. The relatively high level of dividends paid by UK firms has been argued to reduce the amount of funds available for long-term investment to the detriment of long-term economic performance (Bond and Meghir, 1994). In particular, attention has focused on the alleged role of institutional shareholders in forcing firms to maintain high dividends, particularly in the face of falling profits in the UK recession of the late 1980s/early 1990s (for a detailed discussion, see the Report of the Trade and Industry Committee on Competitiveness, 1994). Whilst the high level of dividends paid by firms could be construed as reflecting the alleged short-term attitudes held by institutions, it could equally be construed as the result of the efforts of institutional investors to reduce free cashflows available to management (Eckbo and Verma, 1994; Jensen, 1986).

The relationship between dividends and institutional ownership may be seen as a trade-off between tax, agency and signalling considerations. From a tax perspective, up until recently, there were clear incentives for (tax-exempt) institutions to demand high levels of dividends as a result of a bias in the UK tax system in favour of dividends for tax-exempt shareholders (Lasfer, 1996). In addition, institutions require certain levels of dividends to meet their own liabilities. From an agency perspective, institutions may demand high levels of dividends in order to force firms to capital market for external funding and hence be subject to monitoring by the external market. Institutions may also counter management's tendency to retain excess free cashflow. Hence both the tax and agency perspectives suggest that a positive association exists between dividends and institutional shareholdings. In contrast, from a signalling

perspective, Zeckhauser and Pound (1990) suggest that dividends and institutions may act as alternative signalling devices and predict a negative relation between dividends and institutional shareholders.

The empirical evidence concerning the link between institutional shareholders and dividend payments is limited. Eckbo and Verma (1994) and Moh'd *et al.* (1995) report a significant positive relationship between dividends and institutional shareholdings, whilst Zeckhauser and Pound (1990) found no evidence to support that institutional shareholders had an impact of dividend policy. For the UK, Short *et al.* (2000) found a significant positive relationship to exist between dividend policy and institutional shareholdings. Faccio and Lasfer (2000) find no significant difference in dividend levels between UK firms with significant occupational pension fund shareholders and those firms without such a shareholder. However, whilst much of the available evidence does suggest that there is a positive association between the level of dividend payments and institutional shareholders, such a relationship does not necessarily indicate short-term behaviour on the part of institutional shareholders.

In summary, the empirical evidence available provides little support for the view that institutions are responsible for short-termism, or that institutional ownership has an adverse effect on long-term expenditure and enterprise activities. However, such evidence is mainly US based and there is a clear need for research into such relationships to be conducted on UK data.

## Firm Performance

Empirical investigation of the relationship between ownership/control structure, in terms of the identity of shareholders, and firm performance essentially attempts to test the managerial/agency theory propositions that different ownership/control structures result in differing performance (see Short, 1994, for a review of the relevant literature). Furthermore, it is assumed that if certain shareholders are acting as monitors of management behaviour (either actively or by virtue of their mere presence), performance will be better than in firms where monitoring does not occur (assuming that managers will not operate efficiently if monitoring does not take place). Much of the empirical literature utilises ownership stakes of institutional shareholders as a proxy for their willingness and ability to undertake monitoring activities. Ideally, the level of institutional activity with respect to intervention in board decision making etc., and its subsequent effect on corporate performance should be examined, but such information is rarely publicly available. However, when examining the empirical evidence on the effect of institutions on corporate performance, it is essential that the limitations associated with such research are borne in mind when attempting to draw conclusions from such work.

A number of empirical papers examine the relationship between firm performance and large shareholders in general (of which institutional investors may be seen as one identifiable group). With respect to the effect of large external shareholders, in general, on firm performance, the evidence is inconclusive. Holderness and Sheehan (1988), Murali and Welch (1989) and Denis and Denis (1994) found no evidence to suggest that performance differed between majority owned firms and diffusely owned firms. McConnell and Servaes (1990) found blockholder ownership to have an insignificant effect on performance when considered independently of other ownership interests. However, when blockholder ownership and director ownership were combined, a significant relationship was reported. Overall, their results do not support the notion that large block ownership plays an important role in monitoring management. In contrast, Zeckhauser and Pound (1990) reported results which suggested that the technical

nature of the industry in which the firm operates had an effect on the ability of large shareholders to provide effective monitoring.

Little empirical evidence exists which examines the role of institutional shareholders in monitoring the board of directors and that which does exist has produced conflicting results. Investigating proxy contests, Pound (1988) reported results which suggested that institutions did not act as efficient monitors, providing evidence to suggest that institutions were more likely to vote in favour of management. This suggests that institutions either face conflicts of interest or find it worthwhile to strategically align themselves with the current management. Alternatively, Brickley *et al.* (1988, 1994) examined institutional voting patterns in management-initiated anti-takeover amendments and found institutional opposition to be greatest when the proposal reduced shareholder wealth. In addition, their results suggested that institutions that are less subject to management influence, such as mutual funds and public pension funds, are more likely to oppose management than institutions, such as banks and insurance companies, who may have current or potential links with the firm. Therefore, although these findings are consistent with the efficient monitoring hypothesis, they do suggest that the conflict of interest hypothesis may hold for certain institutional shareholders.

A number of US studies investigate the effect of institutional shareholder activism by examining the characteristics and performance affects on firms which are subject to targeting by institutional shareholders (English *et al.*, 2004; Gillan and Starks, 2000; Smith, 1996; Wahal, 1996). Wahal (1996) investigates targeting by pension funds and finds no evidence of a significant long-term improvement in stock price or accounting measures of performance in the post-targeting period. Smith (1996) and English *et al.* (2004) among others examine the effect of targeting by the California Public Employees' Retirement Scheme (CalPERS), a leading institutional activist in the US. Whilst Smith (1996) found evidence of positive abnormal returns to firms targeted by CalPERS, English *et al.* (2004) find that the long-term effects of such targeting are limited to six months from the announcement.

Faccio and Lasfer (2000) analyse the monitoring role of occupational pension funds in the UK. Arguing that occupational pension funds are typical pressure-resistant institutions (using Brickley's classification) as compared to other types of institutions, it is argued that they are likely to have greater incentives to monitor companies in which they hold large stakes than other institutional shareholders. Comparing listed firms in which occupational pensions hold large stakes against a control group of listed companies, Faccio and Lasfer find no evidence to support the view that occupational pension funds act as effective monitors. Specifically, they found that ownership by such funds has no effect on whether companies complied with the recommendations of Cadbury and Greenbury in respect of board structure, no effect on accounting performance and indeed reported a weak negative relationship between ownership and firm value. However, they found that such funds did not appear to follow an exist strategy, but simply retained their shareholdings.

McConnell and Servaes (1990, 1995) found the percentage of shares owned by institutions to be positively and significantly related to Tobin's Q and that institutional ownership acted to reinforce the positive effect of directors' shareholdings on firm performance, a result they suggested was consistent with the efficient monitoring hypothesis. However, Chaganti and Damanpour (1991) found institutional ownership to have a significantly positive effect on the return on equity but not on other measures of firm performance (return on assets, price earnings ratio and total stock return). Woidtke (2002) examines the relationship between firm value and ownership by public and private US pension funds, arguing that the different compensation arrangements of the administrators of public and private funds has an effect on their incentives.

She finds that firm value is positively related to private pension fund ownership and negatively related to activist public pension funds and concludes that the larger, more performance-based compensation for administrators of private pension funds align their incentives with other shareholders.

In summary, it is clear that the empirical analysis of the relationship between institutional shareholders and performance has produced conflicting findings; a likely result of the exceeding complex web of interrelationships existing between the various ownership interests. Furthermore, empirical problems exist in attempting to model the relationship between institutional ownership and firm performance; for example, much research is constrained by the use of publicly available data on institutional ownership.<sup>11</sup> In addition, by focusing on the presence of institutional shareholders and/or the percentage of shares owned by institutions, there is an inherent assumption that a certain level of institutional shareholding is associated with a certain level of monitoring activity.

## Executive Remuneration

In the 1990s there was a lot of media attention placed on the perceived excessive level and growth in the pay of directors in a period of recession in the UK economy. The general perception was that directors are free to award themselves excessive remuneration without fear of interference from shareholders. In particular, institutional shareholders were frequently criticised for their lack of apparent intervention on this issue. Furthermore, the Greenbury Committee (1995) stated that institutional shareholders should act to ensure that companies implemented the recommendations set out in their code of best practice regarding the determination of directors' remuneration. Relatively few studies have, however, examined the relationship between ownership structure, performance and executive remuneration. Even fewer studies have examined the impact of institutional shareholders on executive remuneration. For the US, Bilimoria (1992) found a significantly positive relationship to exist between institutional shareholdings and the link between executive remuneration and performance, while Mangel and Singh (1993) found a significant negative relationship to exist between executive compensation and the percentage of shares held by institutions. For the UK, Conyon and Leech (1994) found no significant relationship between the level and growth in the pay of the highest paid director and the presence of pension fund and insurance company shareholders. Faccio and Lasfer (2002) found no significant difference in directors' remuneration between firms with a significant occupational pension fund shareholder and those without such shareholders. However, the papers by Mangel and Singh (1993) and Conyon and Leech (1994), by investigating the relationship between pay and institutional ownership, appear to be based on the assumption that, left to their own devices, directors will award themselves excessive remuneration. Therefore, the presence of large institutional shareholders who have the incentives and ability to control the board of directors should be associated with a lower level of remuneration or a reduced level of growth in remuneration. This assumption then leads to the conclusion that the insignificance of variables denoting institutional ownership suggests that these shareholders do not perform an effective monitoring role in this context (see, for example, Conyon and Leech, 1994).

However, the finding that the presence of institutional shareholders does not lead to significantly lower remuneration does not necessarily mean that these shareholders are failing in their assumed role as corporate monitors. There are two separate issues to be considered here; the

effect of ownership structure on the level or growth in remuneration, and the effect of ownership concentration on the relationship between remuneration and performance. If large shareholders are able to enforce monitoring devices such as performance-related remuneration, their presence should result in remuneration being more closely related to performance; a similar argument is employed by Main and Johnson (1993) in respect of the existence of remuneration committees. It therefore does not follow that large monitoring shareholders will automatically decrease the level of directors' remuneration; indeed in certain circumstances they may increase it. It is necessary to examine the interaction between institutional shareholdings and the relationship between performance and remuneration, rather than simply the relationship between institutional shareholdings and remuneration. The results of Short and Keasey (1995) indicate, however, that the presence of an institutional shareholder has little effect on either the level of executive remuneration or the relationship between pay and performance.

However, the implementation of the Directors' Remuneration Report Regulations 2002, which requires companies to put their remuneration report to a shareholder vote, has led to an apparent increase in public intervention by institutional shareholders on these issues. Therefore, new research investigating the links between directors' remuneration and institutional ownership is certainly warranted.

## **SUMMARY AND CONCLUSIONS**

Although the perceived degree of institutional shareholder activism has increased in recent times, due largely to government pressure, there are clearly many factors which act to provide incentives for institutions *not* to involve themselves in corporate governance issues. Whilst the level of monitoring by institutions is greater than that commonly supposed, such monitoring tends to be carried out in private and as Black and Coffee (1994) note, 'for most British institutions, activism is crisis driven'. Furthermore, it is unlikely that 'behind the scenes' monitoring is satisfactory, particularly from the point of view of the public, as it enhances the belief that institutions and company management are all simply part of the same 'old boy network'; a belief illustrated by the debate concerning the high level of directors' remuneration. However, on an individual basis, competition in the market means that institutions do not have incentives to partake in detailed and costly monitoring. From a collective position, however, it is clear that institutions do have incentives to monitor and intervene to improve the long-term performance of companies. The 'missing link' in the debate has been how collective incentives can be translated into collective action by individual institutions. Whilst it is apparent that institutions do appear to be taking a more public and active role, such intervention tends to occur only in cases of extreme underperformance by the investee companies. If changes in corporate governance are to be brought about, a more fundamental change to the market and institutional arrangements existing in the UK is required.

Many commentators (for example, Charkham, 1994a, b; Coffee, 1991; Sykes, 1994) suggest that enhanced monitoring by institutions can only come about if institutions reduce the number of companies in their portfolios and take on long-term ownership positions in the companies that remain. Clearly, a major factor acting against increased monitoring is the number of companies held in institutions' portfolios. Sykes (1994) advances radical proposals for institutions to group together to form long-term 'relationship' investors whereby they would agree to remain as shareholders for approximately five years. In a similar vein, Coffee (1991) suggests limiting

the number of holdings of any one institution. However, whilst there is much debate over the merits of diversification,<sup>12</sup> it is doubtful whether proposals to limit the number of companies in an institution's portfolio would be acceptable at the City and political level. Moreover, whilst institutional long-term investment is likely to increase the level of monitoring, such a change in investment stance is likely to affect the working of the stock market. If institutions adopt more long-term positions and reduce their trading activity, this may cause liquidity problems in the market and consequently the markets would be in danger of becoming inefficient. This illustrates the need for any changes in institutional behaviour to be viewed in the context of the market in which they operate.

Whilst there may be general agreement that institutions are acting as 'absentee owners' (Sykes, 1994), and that this resulted in corporate governance failures, this does not mean that institutions are to 'blame' for the situation. Throughout the 1980s, individuals have been encouraged to act as individuals, as encapsulated in the famous statement by Margaret Thatcher that 'there is no such thing as society'. Collective action had been discouraged (for example, the Conservative government's actions against trade unions and collective bargaining, and the moves towards individually negotiated contracts in the public sector). Now, however, institutions are expected to take *collective* action to correct corporate governance problems. This notion of collectivity is an important issue, because, as discussed above, institutions individually rarely own a large enough stake in any one company to make intervention worthwhile from a cost/benefit analysis point of view. The accusation that institutions are passive whilst individual shareholders are powerless (Sykes, 1994) assumes that institutions have the power to control management. However, whilst this may be true at the collective level, it is rarely true at the individual institutional shareholder level.

A further point to note is that many of the institutions themselves are listed companies and hence subject to the market for corporate control. Moreover, as witnessed by a number of recent takeovers of UK institutions by overseas institutions, the market for corporate control acts internationally. If UK institutions set aside the fact that in the short term, the most profitable action to take when faced with an underperforming company is to sell the stake rather than to bear the cost of intervention, this is likely to have an adverse impact on their own share price if this practice is carried out on a regular basis. As a result, this may make the institutions subject to takeover, particularly by overseas institutions.

In summary, it is clear that the 'so-called' short-term attitudes of institutions with regard to their ownership and investment positions are in part a rational response to the market, institutional and corporate arrangements which have existed in the UK. However, whilst it seems clear that institutions have been forced to take a more public stance on corporate governance issues, in the wake of the threat of legislation, it remains unclear whether the ethos of institutional shareholding has been affected. In addition, institutions themselves have come under public scrutiny in the UK for wider governance issues. The pensions mis-selling scandal, endowment mortgage mis-selling and shortfalls, the problems at Equitable Life and the fall in the value of pension funds have highlighted governance and control problems within the institutions themselves. Recent years have seen public confidence and trust in such institutions plummet in response to these issues. It could be suggested that recent public moves by institutions to intervene in underperforming companies and public stands against directors' remuneration packages might be a means of attempting to deflect attention away from their own governance and performance failures. Furthermore, as suggested in Chapter 2, it is not clear that increased intervention by institutional shareholders will act to significantly improve the governance and



performance of the companies in which they invest, if institutions are simply 'box-ticking' in response to the Combined Code and fail to consider the governance requirements of firms at the individual level. It therefore remains to be seen whether recent increases in activism will have the desired effect of delivering good governance and increased long-term performance in UK companies.

## NOTES

1. Black and Coffee (1994) report that Prudential Portfolio Managers Ltd, the investment subsidiary of the Prudential, own a stake of 5% or higher in about 200 companies, but become concerned about illiquidity at ownership stakes in the region of 10%. However, smaller institutions would clearly be required to take smaller stakes in the larger companies in order to maintain liquidity.
2. For a discussion of the impact on ICI of the Hanson shareholding, see Plender (2003), Chapter 5.
3. Although a large shareholding by an institution may provoke management into improving standards of corporate governance and performance if management believe that such an institutional shareholder may encourage a hostile bid if performance is not improved. An example of this often cited is the Granada takeover of Forte in 1996, where it was surmised that Mercury Asset Management (a major shareholder in both Forte and Granada) may have encouraged Granada to mount its hostile bid (see, for example, *Financial Times*, 1996, p. 19).
4. This reflects a style of regulation which is firmly within the tradition of 'British policy style' which emphasises consultation, persuasion, cooperation and accommodation between 'reasonable people' rather than compulsion and conflict. See Jordan and Richardson (1982) for a discussion of this style of negotiation.
5. In this case, institutional investors, led by Fidelity, opposed the appointment of Michael Green as chairman of the merged Granada/Carlton group. It was reported that Fidelity were responsible for forming a coalition of eight institutional investors to demand that an independent non-executive director from outside the enlarged group was appointed in place of Green.
6. In 1997, Hermes opened its business to other clients, but the Post Office and British Telecom pension schemes remain their biggest clients.
7. These code provisions in the Combined Code (1998) were translated into supporting principles in the Combined Code (2003).
8. See, for example, 'Harder Line From Labour', *Accountancy*, October 1995, p. 12, reporting Dr Jack Cunningham's comments at a Fabian Society seminar on corporate governance and 'Labour Attacks Investors' Secrecy', *Financial Times*, 5 June 1995, p. 16.
9. The government has indicated that it will review the impact of the ISC's statement of principles after two years.
10. See also dissenting comment by Satchell and Damant (1995) and the reply by Miles (1995).
11. In the UK, companies have to disclose external ownership interests amounting to 3% or more (5% or more prior to 1990) in their annual report. Whilst a complete record of shareholders' equity interests can be obtained from a company's register, problems associated with processing such a large amount of data normally prohibit its use, although some commercial organisations do produce shareholder lists online, detailing ownership interests in excess of, for example, 0.25%.
12. It has been argued (see Charkham, 1994b) that a widely diversified portfolio does not provide any additional benefits in terms of risk diversification than a more concentrated portfolio. It has been shown that most of the benefits of diversification can be achieved from a randomly selected portfolio of about 15–20 stocks (see, for example, Fama, 1976; Wagner and Lau, 1971). If a portfolio is comprised of carefully selected stocks, a smaller efficient portfolio may be constructed. Therefore, the benefits to be gained from a widely diversified portfolio are questionable and transaction/monitoring costs are obviously higher.

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# Boards of Directors and the Role of Non-executive Directors in the Governance of Corporations

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Mahmoud Ezzamel and Robert Watson

## INTRODUCTION

The regulators and corporate governance practitioners of many developed economies with a significant publicly listed company sector have been concerned for some time to improve the effectiveness of boards of directors and other governance mechanisms in the wake of a series of unexpected corporate collapses and massive financial losses to shareholders, often accompanied by overly generous pay awards to the executives involved. Irrespective of the country and system of corporate governance concerned, there have been some striking similarities in the cases involving the largest losses to shareholders and other stakeholders, e.g. Maxwell and Polly Peck in the UK, and more recently in the US, Enron, WorldCom, Tyco, Xerox, and, in Italy, Palmalat. The most striking feature in all the above-mentioned cases was the relative ease by which dishonest and firmly entrenched CEOs and other senior managers were able to dominate the board of directors. Given that the board is central to the formulation and implementation of corporate strategy and also responsible for information disclosures and financial reporting to external stakeholders, executive control of the board ensured that the CEOs involved were both able to perpetrate their frauds whilst also ensuring that these actions would remain hidden from external scrutiny. Not surprisingly, in the absence of reliable corporate disclosures to outsiders, the efficacy of external controls, such as shareholder (particularly, institutional shareholders) activism, monitoring by creditors and ratings agencies and the market for corporate control, were also greatly diminished.

The direct losses suffered by shareholders as a result of these scandals have been enormous, as have the additional losses borne by other stakeholders, such as debtholders, creditors, and current and former (e.g. pension scheme members) employees. The potential for further scandals with wide-ranging costs to the national economies concerned motivated major re-examinations of the effectiveness of boards, which, in several countries, has resulted in significant reforms to their corporate governance arrangements. In this chapter, we examine the managerial and governance functions of the board of directors and the changes in terms of their composition and governance roles brought about by recent reforms. We focus particularly on the governance roles now expected of the non-executive directors (NEDs) on the board. In the US and UK, these part-time NEDs are now expected to undertake two distinct and somewhat contradictory roles. On the one hand, they are expected to be full members of the top corporate management team with exactly the same responsibilities for the formulation and management of corporate strategy as their executive board colleagues. On the other hand, however, they are also required to be independent of these same colleagues. This is because NEDs are also now expected to be primarily responsible for ensuring the quality and reliability of corporate information disclosures, keeping executives focused on the generation of shareholder value, via the design and implementation of appropriate employment and remuneration schemes, and the disciplining of their executive director colleagues that appear to be underperforming.

We examine the difficulties NEDs face in fulfilling these dual roles and whether these corporate governance reforms are likely to produce significant improvements to the governance of companies. In examining these issues it is essential to be aware that the ubiquity and diversity of the corporate form around the world indicates that this organisational form is both highly adaptable and economically viable whatever the historical, socioeconomic, legal and political circumstances. This embeddedness within a wider institutional context implies that thinking and practice regarding how corporations function, what is (ought to be) their legitimate objectives, the role and composition of the board and the power of executives in relation to outside stakeholders and other control mechanisms, differs greatly between countries. As noted above, in many countries, the traditional institutional solutions to these corporate governance issues have recently been re-evaluated and reformed in response to specific failings laid bare by instances of corporate misbehaviour. Our literature review and analysis of the governance roles of boards is, therefore, restricted to countries such as the US and UK that have very similar institutional characteristics.

There are, of course, many specific differences between the UK and US in terms of the relative importance of institutional investors, investor activism and voting rights and the extent to which executive entrenchment reduces the efficiency of the market for corporate control. Nevertheless, the corporate governance systems of both countries are so-called 'shareholder-oriented' systems of corporate governance, i.e. it is generally accepted that the primary or sole objective of boards is to further the interests of shareholders. Both countries also rely heavily upon information disclosure, the integrity of 'unitary' boards of directors and the efficiency of external markets for capital, corporate control and managerial labour. However, the timing and extent of recent corporate governance reforms in both countries constitute unique political responses to specific instances of corporate misbehaviour and performance failings and, when we examine recent reforms, it is the evolution of the UK's corporate governance system that we focus on.

We begin the chapter by briefly discussing the nature of the corporate form, the primary generic governance issue created by this type of organisation and the central role of the board

of directors in mitigating this governance problem. We then provide a summary of the most salient research on the effectiveness of boards, followed by a discussion of the main features of the UK's traditional 'governance by disclosure' system. We then examine recent developments in the UK and the extent to which these reforms, starting with the introduction of the Cadbury (1992) code of best practice, have significantly altered the duties, objectives, composition or incentives of UK boards. Finally, we assess the likely impact of the most recent developments in corporate governance on the effectiveness of UK boards and discuss possible future developments.

## **THE CORPORATE FORM, GOVERNANCE AND THE BOARD OF DIRECTORS**

The corporate form involves the creation of a new entity that is legally distinct from both the owners of its share capital, who nevertheless retain many of the rights normally associated with ownership, and its management who, though having control over the use of corporate assets, are merely employees of the corporation. Historically, and in terms of the majority of contemporary (mainly small and medium size) companies, these legal distinctions between the 'company', its shareholders and its management are precisely that; simply legal distinctions since the owners are few in number, they invariably constitute the management team and the business is operated solely for the benefit and purposes of these owners. Nevertheless, even for closely held, owner-managed, businesses, there are clear benefits associated with incorporation, chief of which is that it allows owner-managers to enjoy the benefits of limited liability; this is because creditors and others contract with the 'company' and hence any unpaid debts are the responsibility of the 'company', not its shareholders or managers.

Though relatively few incorporated firms actually take advantage of it, the primary benefit arising from the creation of a separate legal identity is that it facilitates (but does not require) the separation of ownership from control. This combination, the ability to separate the ownership of shares from the strategic and day-to-day managerial control of business operations whilst limiting investor and manager liabilities, has had far reaching economic consequences. The corporate form allows the firm to be managed by suitably qualified professionals, whilst being attractive to risk averse savers who, though having no interest or expertise in participating in the management of the business, are willing to provide investment capital through the purchase of shares with limited liability. Not surprisingly, the corporate form first developed in countries such as the UK and US with well-functioning court systems that protected the rights of creditors and minority shareholders (La Porta *et al.*, 2000). In such contexts, this organisational innovation quickly proved itself to be capable of providing an excellent solution to many of the managerial skill, succession and financial limitations associated with having to rely upon a small group of owners, the factors that had typically previously constrained the size and growth of firms and the realisation of scale economies. The ability to access vast quantities of investment capital from the public and to employ skilled and energetic professional managers to manage the business on behalf of shareholders greatly increased the size, productivity and wealth generation potential of incorporated businesses.

Direct monitoring and evaluation of professional managers by shareholders clearly becomes increasingly difficult with the growth in business size and the complexity of operations.



Information disclosure rules go some way to remedying the information asymmetries between the professional managers and a greatly enlarged and increasingly defuse body of shareholders. However, given the public good characteristics associated with costly monitoring of managerial actions, free-rider problems have also tended to limit the incentives of individual shareholders to actually monitor and discipline the management team. Hence, as noted by Adam Smith as far back as 1776, but first analysed by Berle and Means (1932), the separation of ownership from control in the modern, large organisation has created what has subsequently become known as an agency problem (Fama and Jensen, 1983a, b; Jensen and Meckling, 1976); namely, how to ensure that managers use their discretion in ways that are consistent with investors' interests?

In countries such as the US and UK that have long-established active capital and managerial labour markets, a partial solution to the agency problem is to rely upon these external markets to monitor and discipline poorly performing managers. Efficient capital markets are assumed to act as a powerful disciplining mechanism for underperforming and/or opportunistic managers. First, capital markets mark down the share values of firms whose managers behave opportunistically or are incompetent. Further, poor performing firms are obvious targets for takeovers by other firms, thereby threatening the employment of managers of these firms (Jensen, 1993). Efficient managerial labour markets are assumed to value managers on the basis of their competence and ability to make decisions that maximise the wealth of owners, which creates a disincentive for rational managers to act opportunistically (Fama, 1980). These two external governance mechanisms are frequently not welcome by managers: the discipline of capital markets can lead to them losing their jobs and reputation, whilst the discipline of managerial labour markets can result in lowering the value of their human capital.

Whatever the efficacy of these external market governance mechanisms today, the creation of companies predates the development of capital and managerial labour markets. The traditional solution to the agency problem has been to make management accountable to shareholders via a board of directors. Legal requirements for incorporation typically stipulate that a board of directors is set up, and hence boards may be thought to be a product of regulation, created to meet specific legal requirements, in particular to ensure their own independence and proper action. However, it is noteworthy that governing boards in general predate legal regulations, and many unincorporated entities that are not legally required to have a formal board nevertheless still have a governing body of a similar nature (Hermalin and Weisbach, 2003), which suggests that their roles must extend beyond the purely legal and regulatory. As evidence of this, Hermalin and Weisbach (2003) have noted that the size of boards of directors tends to be much larger than required by law. This leads them to suggest that 'boards are a market solution to an organizational design problem, an endogenously determined institution that helps to ameliorate the agency problems that plague any large organization' (p. 9). Hermalin and Weisbach go on to suggest that from the outset the main functions of the board were to collectively monitor and supervise the work of managers to ensure that they were acting in shareholder interests:

One idea explaining why boards have emerged is that the directors' mutual monitoring was critical for inducing shareholders to trust the directors with their money. (p. 10)

As we shall see later in the chapter, with increasing problems associated with directly monitoring managerial actions and greater diffused ownership, boards in more recent times are being encouraged to rely more heavily upon appropriately designed incentive schemes to align managers' interests with those of the shareholders. Whether the mitigation of agency

problems is the outcome of optimally designed incentive schemes or the mutual monitoring of board members, both mechanisms are built on economic reasoning. Economic explanations offer powerful insights into many issues surrounding the existence of boards of directors, their functioning and the impacts they may have. Thus, a larger board size may signify an economic response to specific agency problems, so that the larger the size of the board the more likely agency problems will be reduced, for example through more adequate monitoring or separation of decision responsibilities. However, it is equally plausible that larger size boards of directors are also intended to enhance board legitimacy by creating the myth that the larger the board, the more diffused are the responsibilities of individual members, the less likely is collusive action among members of the board. Increasing board size may therefore be mainly intended to create a favourable impression rather than to make a genuine change in the way the board functions.

## Board Composition and Performance

In the Anglo-US system, the primary role of the board is to ensure that shareholders have reliable information regarding corporate performance, risks and prospects and that the management take actions that further shareholder interests. Although the distinction is without any legal foundation, the boards of most large UK (and US) companies actually consist of more than one type of director: first, those who in addition to being members of the board also have full-time executive responsibilities (executive or internal directors) and, second, those directors, normally part-time, that have no executive responsibilities with respect to the enterprise's day-to-day operations (outside directors). Non-executive directors are not homogeneous in terms of expertise, function or affiliation. A useful categorisation of non-executive directors is the distinction between those individuals that owe their place on the board primarily because of some pre-existing business connection with the firm (e.g. former executives and representatives of the firms' major affiliates, suppliers or customers), and directors without any other contractual relationship with the business other than their fees and (possibly) their ownership of shares. The first group are normally referred to as 'affiliated outsiders' whilst the latter group are referred to as either 'non-affiliated outsiders' or, as in the Cadbury Report (1992), as 'independent non-executives'. In this chapter, unless otherwise stated, the term 'non-executive directors' (NEDs) will normally refer only to the independent or non-affiliated board members.

The question of board composition, in terms of who is represented on the board and how those represented get selected, has therefore been central to many research agendas. This is because board composition is likely to impact upon how the board functions, how important investment and financing decisions are made (see Watson and Ezzamel, Chapter 3, this volume) and on how power and influence are allocated and become manifest within the board.

Selection of board members reveals further dimensions of power within the board in relation to who hires executive and non-executive directors and how the board is likely to be run. Issues of personal loyalty within the board and degree of independence loom large in this context. Understanding board members' turnover and selection is therefore crucial in gaining a sound understanding of how boards function, the extent to which they are effectively governed, and the shifts in power dynamics within the board.

The literature points to the critical role played by the CEO in selecting non-executive directors (Mace, 1971; Vancil, 1987). A newly appointed CEO is likely to bring in some

external members to help give advice. Also, poor performance provides an incentive to bring in new non-executives to enhance monitoring of the board (Hermalin and Weisbach, 1988). There is evidence of the power and effectiveness of non-executive directors in disciplining executive directors. A study by Weisbach (1988) suggests that the association between poor performance and CEO resignation was stronger for firms with outsider-dominated boards, compared to firms whose boards were dominated by insider directors. This result points to the strong possibility that outsider board members enhance board independence and monitoring power over CEOs. Recent evidence from the UK suggests that immediately post-Cadbury, there was a notable increase in both board sizes and the proportion of non-executive directors to executive directors (Dahya *et al.*, 2002; Ezzamel and Watson, 1998, 2002).

Baysinger and Hoskisson (1990) have theoretically proposed that outsider-dominated boards are likely to favour rewarding top management on the basis of objective financial measures, intensify managerial effort to maximise short-run profits and direct their efforts away from greater investment in research and development, and high-risk-return strategies favoured by shareholders and towards greater diversification. In other words, outsider-dominated boards will demotivate managers from making strategic decisions that involve higher expected risks and associated higher expected returns, in a sense resulting in a very cautious top management team.

McNulty and Pettigrew (1999) reported from interviews with 108 UK directors that NEDs do not simply play the role of ratifying decisions made by powerful members of the board. Rather, NEDs were able to influence the process of strategic choice, change and control by shaping both the ideas that become included in corporate strategy and also the methods and processes by which these ideas develop and evolve. McNulty and Pettigrew quickly note that the influence of NEDs on strategic choice is moderated by factors such as changing norms about corporate governance, the history of the organisation and its performance, the process and conduct of board meetings and the informal dialogues among directors between board meetings.

Carpenter and Westphal (2001) reported that directors' networks of appointments to other boards impact on the strategic knowledge and perspective they acquire to monitor and advise management in the strategic decision-making process. Strategically related board ties were reported to enhance board involvement in firms facing relatively stable environments and strategically heterogeneous board ties enhanced involvement in firms facing relatively unstable environments. Kosnik (1987) found that boards that were more effective in resisting greenmail had, among other characteristics, more outside directors. Greenmail transactions refer to threats that a significant shareholder will challenge the incumbent management in a takeover or proxy fight. Management could prevent this threat by paying a premium over the market price to buy back the shareholder's interest in a private transaction, and hence managers' ability to conduct greenmail transactions suggests weaker board governance as these transactions are not likely to be in the best interest of shareholders.

Pearce II and Zahra (1991) reported that boards with a healthy representation of outside members are associated with better financial performance compared to those with a smaller percentage of outside directors. Westphal (1999) reported that social ties between the CEO and the board enhance the provision of advice and counsel from outside members of the board on important strategic issues. CEOs, it seems, are more likely to seek advice when they feel they can rely on the loyalty of members of the board as reflected in social ties.

Boyd (1994) reported that the ratio of inside directors was negatively related to CEO compensation, thereby providing support to the argument that insiders are not pawns of CEOs,

in the sense that they do not side with CEOs or become intimidated by them to make decisions that favour CEOs. If internal governance mechanisms can be as effective as the study by Boyd suggests, and there are also supportive arguments elsewhere (see Mizruchi, 1983; Walsh and Seward, 1990), then, from the perspective of CEOs, independent, strong boards of directors could be a genuine 'lesser evil' than market-based governance. Hallock (1997) reported that salaries of CEOs in firms with interlocked boards were higher than in other firms, although the difference reduces substantially once CEO and firm characteristics are controlled. Reciprocal interlocks refer to situations when one director (either current or retired) from one firm sits on the board of another firm and vice versa.

Golden parachutes are contracts between the CEO and the firm that offer additional compensation to the CEO if a change of control or ownership occurs. They are often justified as a form of insurance for executives against the possibility of losing their jobs subsequent to a takeover and, therefore, the higher the risk of takeovers, the more likely are golden parachutes. This optimal contracting explanation for golden parachutes rests on the assumption that this form of payment is in shareholders' best interests since it provides executives with fewer incentives to resist value-increasing takeover bids. Alternative perspectives, however, suggest that the incidence of golden parachutes may be an indication of weaker boards of directors that fail to protect shareholders' interests by allowing CEOs to behave opportunistically. Cochran *et al.* (1985) has reported that firms with comparatively higher percentages of inside directors were less likely to award senior managers with golden parachutes, pointing to a stronger, more proactive role for boards of directors that have a high proportion of external directors.<sup>1</sup>

As mentioned in the introduction to the chapter, it appears that boards have not always been diligent monitors and this is often (invariably so in the cases of the corporate governance scandals previously mentioned) because over time the board has become dominated by executives. Jensen (1993), for example, has criticised the internal governance of large US firms and provided evidence (both anecdotal and more systematic, such as the productivity of corporate R&D and capital expenditures), which points to the failure of internal governance systems. He argues that few boards of directors have successfully performed their jobs properly: hiring, firing, and compensating the CEO and providing high-level council. When the board succeeds in removing an opportunistic or an incompetent CEO, this seems to happen much too late because of a board culture that inhibits criticism:

Board culture is an important component of board failure. The great emphasis on politeness and courtesy at the expense of truth and frankness in boardrooms is both a symptom and cause of failure in the control system. (p. 863)

Jensen lists additional reasons that explain why board control fails: unavailability of appropriate information and expertise to board members compared to the CEO, legal incentives that encourage the minimisation of downside risk rather than maximising shareholder value, lack of sufficient management and board member equity holdings, oversized boards that limit effective board monitoring, and the high percentage of internal directors that are likely to be more responsive to CEO desires than to protecting shareholders in order to avoid animosity and retribution from the CEO. Jensen recommends that the CEO should be the only inside director on the board, and for the board to be modelled as a political democracy based on open debate and active participation.

The above studies into the appropriate structure and functioning of boards place a high value on the governance roles of outside directors, particularly in regard to the motivation,

monitoring and disciplining of executives. Basically, these outside directors are seen as being primarily responsible for writing and managing executive contracts that efficiently mitigate the agency costs of equity that arise from the separation of ownership from control. In the UK, until relatively recently, this has not been the principal means by which the potential agency costs of equity have been mitigated. Traditionally UK shareholders have relied upon the system of ‘governance by disclosure’ and their rights to dismiss the board of directors at shareholder meetings, the analysis of which we now turn.

## **THE UK’S GOVERNANCE BY DISCLOSURE**

In this section we discuss the characteristics of the UK corporate governance system and how the reforms since 1992 have sought to retain and improve upon what currently existed, i.e. there has been no attempt to fundamentally alter the UK’s long-standing reliance upon the ‘unitary’ board and ‘governance by disclosure’ (Ezzamel and Watson, 1997). The central legal responsibilities of the UK’s unitary boards of directors are fairly clear, namely to collectively manage the business in accordance with its constitution for the benefit of its shareholders and to comply with the financial reporting and other disclosure requirements stipulated by company law. For UK companies, then, the unitary board of directors fulfils two main, and apparently incompatible, functions. First, the board is the firm’s supreme executive body. It is legally responsible for formulating and implementing business strategy on behalf of shareholders and for ensuring that business activities are conducted in a manner that complies with company law and other legal requirements. Second, the board is the primary institutional mechanism by which the shareholders render the executives appointed to manage the assets on their behalf accountable for their stewardship.

Traditionally, these two functions have been reconciled in company law by relying upon the system of ‘accountability through disclosure’. There are two essential elements to this system of accountability: shareholder rights and information disclosure. Shareholder rights consist of voting at the annual general meeting (AGM) and any other shareholder gatherings that may be called throughout the year to appoint and/or dismiss from office directors and to determine the conditions of employment, terms of office and remuneration of the board. Without adequate information regarding the performance and financial consequences of the board’s stewardship, these shareholder rights are probably meaningless. Hence, UK company law requires the board to produce and make available to shareholders prior to the AGM ‘independently’ audited financial statements. These financial statements are presumed to contain sufficient information for shareholders to assess the adequacy or otherwise of the board’s stewardship over the period, thereby facilitating informed voting.

Developments in the 100 years or so since this ‘accountability through disclosure’ system was first introduced has, however, seriously undermined its ability to provide an adequate solution to the governance responsibilities of the UK unitary board. Over that period, the increased size of companies and the complexity of many of the transactions undertaken have created financial reporting problems not evident when the system was devised. Today, a multitude of ‘creative accounting’ practices which exploit the inevitable ambiguities and many alternative methods of reporting the financial effects of transactions are both available and routinely used by executives to mislead rather than inform shareholders (see Smith, 1992). Moreover, as is also the case in the US (Jensen, 1993), executives in the UK have tended

to dominate the board of directors. Effectively, this means that the board is unable to provide an independent internal check on the information disclosures and actions of its executive members.

In 1990 several high-profile corporate financial scandals involving highly entrenched CEOs, acquiescent boards, inadequate disclosure and auditing failures made it increasingly apparent that the UK corporate governance system was failing to adequately protect investors. With investor confidence at a low ebb and concerns that the government may impose their own reforms if the financial and corporate sector did not come up with their own proposals, the Committee on the Financial Aspects of Corporate Governance (the Cadbury Committee) was set up jointly by the Stock Exchange Council and the Financial Reporting Council to make recommendations for improving the UK's system of corporate governance.

The Cadbury (1992) and subsequent corporate governance reports made recommendations that focused on the composition of the unitary board and emphasised the monitoring role of non-executive directors in relation to the executive board members. The Cadbury Report viewed NEDs as having a major role in improving the accountability of executives to their shareholders. The report, though recognising that legally NEDs have exactly the same duties as other board members for the conduct of the business, emphasised their role as independent monitors of senior executives.<sup>2</sup> Unfortunately, the Cadbury recommendations with respect to NEDs did nothing to resolve the problem regarding these conflicting roles; the Cadbury Report simply re-emphasised, without any recognition of the potential conflicts involved, that NEDs are expected to wear two hats:

The emphasis in this report on the control function of non-executive directors is a consequence of our remit and should not in any way detract from the primary and positive contribution which they are expected to make, as equal board members, to the leadership of the company.

The Cadbury Report stipulated that each public company should employ a minimum of three independent NEDs. In this context, the notion of 'independence' is somewhat formal since the report simply defines the notion in terms of having no pre-existing business relationship with the firm (para. 2.2). Even the holding of shares in the firm was seen as non-essential and, indeed, the report suggests that such shareholdings may even compromise NEDs' independence. Nevertheless, as Ezzamel and Watson (1997) noted, 'the dual roles required of NEDs can be expected to undermine any initial "independence of judgement" before too long, particularly since the proposals do not increase either the power or incentives to oppose executives when the latter appear to be acting contrary to shareholder interests'.

The establishment of subcommittees does not resolve the inherent conflict of interest caused by NEDs being both an integral part of the management team and monitors of their executive colleagues on the board. It is clear that a commitment to the unitary board system lay behind the Cadbury Committee's requirement that NEDs combine these two inherently conflicting roles. It is equally clear that the members of the Cadbury Committee believed that the UK's corporate governance system was basically sound and their report was, therefore, primarily focused on increasing its effectiveness rather than attempting to fundamentally restructure it (para. 1.7). The independence of NEDs could have been more readily achieved if the Cadbury Report had considered more radical solutions such as seeking a change in UK company law to restrict the duties of NEDs to those of monitoring and/or introducing a two-tier board structure, with the NEDs serving solely on the supervisory board without any formal executive responsibilities.<sup>3</sup>

The Cadbury Committee rejected legislative changes of any kind and its centrepiece, the code of best practice, is entirely voluntary. As with all voluntary codes, it lacks any effective sanctions which can be applied to firms which fail to comply. As Stanley (1993) has noted,

voluntary proposals like these will mean nothing unless they change corporate culture. If boards continue to appoint non-executive directors who are 'one of us' ... rather than independent watchdogs, then the sensible reforms of the Cadbury Committee will have been in vain.  
(p. 53)

This commitment to the existing regulatory regime, albeit supplemented by a voluntary code, and the lack of any institutional means for appointing truly independent NEDs and for ensuring that they remain independent of management has meant that the Cadbury Committee could only simply endorse, and ultimately legitimise, current 'best practice' in the UK corporate sector. This lack of a radical change in corporate governance has been further highlighted by Cadbury's failure to directly increase the incentives of shareholders themselves to be more active monitors.

The influence and independence of NEDs was, however, strengthened through the establishment of three board subcommittees: the nominations committee (to advise on the appointment of new directors), the audit committee (to advise on the audit and to have free access to company financial information and its auditors) and the remuneration committee (to advise on directors' emoluments and service contracts). With respect to executive compensation, the Cadbury recommendations stated that the total emoluments of directors and those of the chairman and the highest paid UK directors should be fully disclosed and split into their salary and performance-related components and the basis by which the latter is determined should also be explained. Moreover, executive directors' remuneration should be subject to the recommendations of a remuneration committee made up wholly or mainly of non-executive directors.<sup>4</sup>

The establishment of these board subcommittees clearly offered more scope for NEDs to discuss financial disclosure and remuneration policy options and to collectively influence management than was previously the case. For example, establishing a remuneration committee with NEDs members could, *in principle*, avoid the conflict of interest that inevitably exists when executives are permitted to determine their own rewards. Similarly, having an audit committee comprising solely of NEDs could, *in principle*, improve financial disclosure practices, communications with shareholders and the independence of the firms' auditors by discouraging their dependence upon the executives who employ and pay them.

The three board subcommittees, i.e. the nomination, remuneration and audit committees, recommended by the Cadbury Report were meant to give NEDs greater scope to exercise their independent influence on the way executives manage certain aspects of the company's affairs. As indicated above, the dual roles expected of NEDs and the political and organisational constraints within which the committees have to operate are likely to result in outcomes far removed from the rhetoric and aspirations contained in the Cadbury Report. The voluntary nature of the Cadbury proposals and the vagueness of the terms of reference of the new committees allow firms considerable flexibility in implementing the proposals. For example, it is now well known that the formal terms of reference for remuneration committees vary considerably across different companies, ranging from, at one extreme, being solely concerned with the remuneration of the chairman and senior executives to, at the other extreme, ensuring the matching of personnel policy to business strategy, overseeing succession planning and

share schemes, and the remuneration of all employees (see Bell, 1994). Clearly, if the board subcommittees have wide, largely managerial, terms of reference, then this can be expected to inhibit the monitoring function. In this situation, NEDs become more closely involved with managerial concerns and the committee's time and other resources get dissipated in dealing with matters which have little to do with ensuring that executives act in ways that are not detrimental to shareholders' interests.

Accounts given by several commentators (e.g. Bell, 1994; Davis and Kay, 1993) also make it clear that a significant proportion of companies look for management leadership from their NEDs. For example, Bell (1994, p. 9), in commenting on companies' desire for the remuneration committee to perform the dual role of watchdog and contributor to management, has pointed out that:

In order to fulfil the latter role, companies seek directors who have a strong record of managing a company, so that they can bring this expertise in their role as non-executive director.

There are also additional issues of concern, in particular, the composition of committee membership and *how* the committees function in practice. Ezzamel and Watson (1995) conducted an empirical investigation of committee membership in the first year after the Cadbury proposals were implemented for a sample of 224 UK companies with year ends December–January in 1992–93. Their examination of the membership of the three main committees indicated that in the majority of cases, executives were members of the committees, and indeed often chaired the committee. To the extent that membership of committees offers scope for influencing deliberations, then executive directors in UK companies can still be seen to have ample scope to do this. Also, as we have already suggested, given the conflicting roles of NEDs and their close associations with executive directors, the added constraint of having executives working alongside them on what are meant to be monitoring committees is unlikely to encourage them to use their 'independence of judgement' or is conducive to them seeing their primary role as guardians of shareholders' interests.

Indeed, accounts of how committees, such as the remuneration committee, are *managed* (Bell, 1994) indicate that:

- Remuneration committee meetings tend to be held immediately before or after board meetings, lasting just about an hour and allowing little time for detailed discussion.
- In many companies, executive directors either chair or are members of the remuneration committee. Even when the CEO is not a member of that committee he almost invariably attends the meeting, leaving the meeting when his own pay is discussed.

In summary, Bell (1994, p. 12) argues:

Our discussions suggest that whether or not the chief executive is technically a member of the committee has little significance. In either case, the CEO will take a full part in the discussions and decisions are rarely, if ever, arrived at through a vote of the members.

Apparently 'excessive' executive pay awards, unrelated to firm performance, led the Cadbury Committee to recommend the setting up of remuneration committees. Since the introduction of remuneration committees in the UK in 1993, executive pay has, however, continued to rise unabated. Several alternative explanations for the rise in executive pay have suggested



that it is simply the largely unintended consequence of individual board decisions motivated by increased managerial labour market competition and signalling pressures. These pressures appear to have been greatly increased by the Cadbury reforms which have led to greater disclosure of CEO pay packages and the institutionalisation of inadequately motivated or resourced remuneration committees that have been encouraged to implement performance-related executive pay schemes. Indeed, in the UK most, but not all, of the increase in senior executives' pay appears to have been due to remuneration committees basing cash pay awards (salaries and bonuses) upon generous interpretations of the pay received by 'comparable' CEOs in similar sized firms (Ezzamel and Watson, 1998, 2002) and their greater use of 'equity-based' compensation schemes, i.e. the awarding of stock and stock options (Conyon and Murphy, 2000). Subsequent corporate governance reforms (i.e. Greenbury, 1995; Hampel, 1998; Higgs, 2003), now embodied in the 'Combined Code', have increased disclosure and further entrenched the use of remuneration committees and the focus on performance-related pay. At this juncture, it is worth stressing that none of these corporate governance reports have suggested that it is the role of the remuneration committee to hold down executive pay; the primary role of the remuneration committee is to increase the transparency of the pay setting process and to ensure that significant pay awards were justified by improvements in firm performance.

The assumption embodied in the Cadbury and subsequent corporate governance codes appears to have been that part-time non-executive directors would experience no difficulty in designing and implementing appropriately structured performance-related pay packages. In practice, it has turned out that devising and monitoring appropriate performance-related pay systems that minimise perverse incentives and unintended consequences involves significant expertise and resources that remuneration committees, which meet on average only once or twice per year, simply do not have. Indeed, even prior to their widespread introduction in the UK, it was apparent that firms with remuneration committees tended to award more generous pay increases to their CEOs and that their remuneration committees were largely reliant upon the recommendations of outside 'pay consultants' to provide them with details regarding 'comparable' market pay rates and additional complex, but usually tax-efficient, performance-related pay schemes (see Forbes and Watson, 1993, and Main and Johnston, 1993, for reviews of the evidence).

Clearly, with greater disclosure of what other CEOs earn, coupled with an inability to unambiguously evaluate current and potential CEO job-related skill and effort levels, in the absence of sustained poor corporate performance, neither outside pay consultants nor non-executive directors can be expected to wish to be seen as being unduly parsimonious in respect of their assessment of the worth of the current incumbent. In this context, risk averse and resource constrained remuneration committees can minimise unnecessary boardroom conflict, recruitment and retention costs and avoid inadvertently signalling low managerial quality to outsiders simply by paying their senior executives somewhat more than the apparent market rate. Though being relatively generous to the current management team makes sense from the perspective of each individual remuneration committee, it is, of course, statistically impossible for all CEOs and other senior executives to be simultaneously better than average or to be paid more than average. Hence, this combination of labour market pressures and remuneration committee pay-setting processes have inevitably resulted in the raising of average senior executive pay over time. The empirical results of recently published studies (Ezzamel and Watson, 1998, 2002) have indicated that the upward drift in UK CEO pay appears to be at least partly driven by attempts to reduce prior period external market pay anomalies and

that this adjustment process is asymmetric, as there is a pronounced bias towards ensuring that CEOs are not paid significantly below average market rates. This apparent ‘bidding-up’ of executive pay via the use of relatively generous pay comparisons has not, however, gone unnoticed by the business world. For example, the Institute of Directors (1995, p. 4) felt obliged to advise its members that remuneration committees ‘should avoid setting packages which are generous in relation to market levels and beware of pressure always to be in the “upper quartile”’.

The situation in respect of the audit committee is in some ways even more problematic since the primary problem that the audit committee has to overcome is that the independent audit suffers from a serious structural problem that has led to an ‘expectations gap’ among users (i.e. the difference between what an audit actually achieves and what users believe it can or should achieve). On the one hand, competitive pressures encourage firms to both minimise the costs of the audit and present financial results which meet the perceived expectations of its shareholders. On the other hand, the diversity of accounting rules allows auditors, who also face competitive pressures, have close relationships with executives and are appointed and paid by the executives, to adopt a strategy of evasion by not seriously questioning the figures produced by management. In the wake of the *Caparo* case,<sup>5</sup> the credibility of the auditing process has declined significantly since it is now also unclear what exactly the objectives of the independent audit are. The *Caparo* case is important

because it exposed two misconceptions: first that the audit report is a guarantee of the accuracy of the accounts and the soundness of the company; second, that anyone can rely on the audit. (Stanley, 1993, p. 55)

This questioning of audit credibility has been further exacerbated by more recent, highly publicised, audit failures, such as those of Enron and WorldCom. Moreover, unlike the duties of directors, the Companies Acts are silent in respect of the duties of the auditors. Without a clear idea of what a properly conducted audit can actually achieve, the so-called ‘expectations gap’ is likely to persist which can only further undermine the credibility of the audit irrespective of the activities and diligence of the audit committee.

The Cadbury reforms introduced in 1993 marked not the end, but the beginning of a process of corporate governance reform in the UK. Subsequent reports and recommendations have addressed some of the major gaps in the Cadbury reforms, particularly the problems detailed above relating to the need to adequately resource NEDs and to ensure that they were independent of management and had the necessary skills and incentives to adequately monitor and discipline poor performing executives on behalf of shareholders. Below we list the main post-Cadbury reports and recommendations, all of which are now incorporated into the ‘London Stock Exchange Combined Code’ which now forms part of the listing requirements for companies on the London exchange:

- 1995: Greenbury Study Group on Directors’ Remuneration;
- 1997: Hampel Committee on Corporate Governance, which investigated the effect upon corporate governance of the Cadbury and Greenbury reforms and made proposals further safeguarding the rights of shareholders;
- 1999: Turnbull Committee on the reporting of internal control mechanisms;
- 2002: Higgs Report to review the role and effectiveness of non-executive directors;
- 2003: Smith Report on the composition and conduct of the audit committee.

## *Corporate Governance*

All of these reforms followed Cadbury in that their primary objective was to improve the traditional 'governance by disclosure' system in the UK. The current situation, as embodied in the 'Combined Code', still relies upon the board providing shareholders with sufficient and reliable information for them to evaluate for themselves the risks and prospects of their investments. In brief, companies now have to comply with the enhanced disclosure and code of best practice requirements or explain in their financial statements to shareholders why their internal governance systems depart from the code (a system dubbed as 'comply or explain'). Given our focus on boards, particularly the independence and effectiveness of NEDs, below we briefly describe and evaluate the innovations contained in the Higgs (2002) Report.

### Higgs (2002) Report on Improving the Effectiveness of Non-executive Directors

Higgs (2002) produced a consultation paper aimed at providing a review of, and recommendations on, the role and effectiveness of NEDs in the UK. His review was wide ranging, including issues relating to attracting, appointing, and providing support for NEDs, debating their roles, re-examining the structures of their accountability, and strengthening their relationships with shareholders.

The main recommendations contained in the Higgs Report were as follows:

#### *The board*

The annual report should describe how the board operates, state the number of board (and subcommittee) meetings and the attendance of individual directors and, though there should be a strong representation of executives on the board, at least 50% of the board membership (excluding the chairman) should be independent directors.

#### *The chairman*

The respective roles of the chairman and the CEO should be set out in writing and agreed by the board and no one individual should simultaneously occupy both roles. The chairman must meet the independence test of NEDs and hence a retiring CEO should not become the chairman of the same company.

#### *The non-executive directors*

The company should offer NEDs suitable guidance and training on how to maximise their effectiveness and NEDs should thoroughly investigate the board and the company prior to appointment to satisfy themselves that they have the knowledge, skills, experience and time to make a positive contribution to the board. NEDs should normally expect to serve no more than three terms and only NEDs with the requisite skills and experience should chair the main board subcommittees (nomination, remuneration and audit), though no NED should chair more than one of these committees.

The NEDs should meet as a group a minimum of once per year without either the chairman or any of the executive directors present and these meetings should be reported in the financial statements.

A senior NED should also be identified and he/she should be available to shareholders if there are issues and concerns that have not been resolved via the normal channels of communication with the chairman and CEO.

All NEDs, particularly the chairmen of the main board subcommittees, should attend the AGM and be prepared to discuss any issues raised in relation to their specific roles. The senior NED should also attend meetings between the executives and major shareholders to develop a balanced understanding of the issues and concerns of shareholders and to communicate these views to the other NEDs and/or the whole board as appropriate in the circumstances.

In examining the roles of NEDs, Higgs was concerned to open up the terms of the debate to incorporate issues relating to the role of the board, the chairman and NEDs. It is straightforward to see that the board and its chair have a dual responsibility as we suggested earlier; ensuring that shareholders receive adequate returns on their capital and satisfying statutory regulations. In the context of NEDs, both roles remain relevant, except that greater emphasis should be placed upon satisfying statutory regulations (Keasey and Hudson, 2002). Higgs further raises the question as to the extent to which the roles of individual NEDs should be similar; what is clearly more critical here is not recruiting NEDs with identical skills but rather assembling a portfolio of skills that complement each other. The question of independence is then raised, and as Keasey and Hudson (2002) have noted, it is difficult to see how NEDs' independence could be maintained if they are to be responsible for corporate performance, which implies a close working relationship with executive directors. The potential for conflict can perhaps be reduced if NEDs have an infrastructure that provides them with strong advice and support when needed. Further, in order for NEDs to discharge their responsibilities properly, they need to commit considerable time to their jobs which is a highly unrealistic expectation given the relatively small financial rewards they receive.

Higgs' concern for attracting and appointing NEDs clearly emphasises the importance of NEDs possessing the requisite personal qualities, attributes, skills and expertise to be able to discharge their responsibilities effectively. He also raises the issue of how best NEDs could be identified and appointed and whether it would be desirable to make international NED appointments. However, given the relatively small level of NED remuneration (approximately £25K per year on average; Keasey and Hudson, 2002) at present, this is an unlikely scenario.

Concerning accountability, Higgs raises the question of board objectives and performance measures; without these being defined and pursued regularly, it is difficult to envisage how a sensible notion of accountability for NEDs could be promoted and monitored. To enhance their sense of responsibility towards shareholders, Higgs is also correct in pointing out the desirability of building stronger relationships between NEDs and shareholders, by institutionalising meetings between them and facilitating a greater understanding of shareholder concerns. Another relevant issue that would enhance the accountability process for NEDs is to make them more familiar with company and sector characteristics through formal induction and training programmes.

The value of the Higgs Report is not so much in the solutions or recommendations it puts forward, although some of these are useful. Rather, the key message of the report is that much remains to be done in developing the role of NEDs and ensuring that they have the right education, expertise, training, and above all else sufficient independence to act. Higgs' report invites us to remember that the current situation regarding the role of NEDs in corporate governance remain woefully inadequate and the questions he raises are extremely useful in drawing a tentative boundary around many of the key issues that need to be fully debated.

## **CONCLUSIONS**

The main purpose of this chapter has been two-fold: first, to examine how appropriately structured and motivated boards of directors may mitigate the main governance problem at the heart of the corporate form of organisation, and second, to evaluate recent changes in the structure and functioning of UK boards and the role of NEDs in reconciling the dual, and apparently contradictory, management and governance duties UK company law places on the board of directors. Due to a combination of factors, such as the increasing complexity of business operations and the lack of transparency in financial reporting methods and management control over boards, often coupled with relatively poor corporate performance, a number of well-publicised management ‘excesses’ and unexpected corporate collapses, the UK’s unitary board structure and the accountability through disclosure system were heavily criticised in the early 1990s. Improving executives’ accountability to shareholders became an urgent priority among many sectors of the business community in the UK though, as we have seen, no substantial changes in company law were actually initiated. Rather, reforms have generally been restricted to corporate compliance with voluntary codes of best practice and increasing quality of information disclosures, the numbers, quality and powers of NEDs and/or exhortations to institutional shareholders to become ‘more active’.

Though it is clear that voluntary codes of this nature have their limitations, the UK experience suggests that these are far more adaptable and responsive to the emergence of both long-standing and new problems arising from developments elsewhere in the corporate and financial worlds than would be possible with a formal legal code. This evolutionary approach to corporate governance reform has been undoubtedly helped by the fact that since the early 1990s, outside of the financial services sector, the UK has experienced very few corporate failures that have generated widespread outrage among investors and/or the general public. The contrast with the post-dot-com scandals that engulfed the US from 2000 could not be greater. Even so, the relative success of the UK’s approach to corporate governance was also aided by the existence of a large institutional shareholder base, fewer restrictions on shareholder voting rights and the functioning of the market for corporate control, and less reliance upon overly generous stock option grants to senior executives. These long-standing differences between the US and UK meant that typically few UK CEOs have ever enjoyed the degree of entrenchment and power over the board commonplace among US CEOs. However, the one thing that is certain is that there is little room for complacency since, whatever its recent relatively good performance, the UK’s corporate governance system has now become more reliant upon NEDs, despite the inherent conflicts their dual roles impose, having the necessary resources and incentives to ensure that corporate decision making and reporting are driven by the desire to increase shareholder welfare.

## **NOTES**

1. See also the analysis of Gibbs (1993).
2. The ‘public good’ characteristics (joint supply and non-excludability) of monitoring and control are thought to imply that, in the absence of collective provision, there is likely to be insufficient resources devoted to managerial monitoring (see Grossman and Hart, 1980; Stiglitz, 1985).
3. The two-tier board issue is somewhat controversial. Discussions regarding its desirability are often confused with whether or not it promotes/is associated with superior economic performance (see,

for example, Owen, 1995). We are simply arguing that it is likely to produce greater accountability than the current unitary board structure. Though we doubt that this greater accountability will lead to a deterioration in company performance, even if it did, this would not affect the accountability characteristics of the system, but would merely indicate that it imposes some costs on one or more of the groups contracting with the firm. Moreover, problems such as ‘excessive’ employee entrenchment, a ‘slowness of response’ to environmental changes, insufficient information flows to and/or meetings of the supervisory board other than external regulations, are often attributed to the two-tier board system when, in fact, they are not essential features of the two-tier board system itself, though clearly they are of some importance in the current German context. For recent thinking on these issues, see the contributions by Charkham (1994), Demb and Neubauer (1992), Dimsdale and Prevezer (1994) and Edwards and Fischer (1994).

4. The Greenbury Report (1995) went further and recommended that the remuneration committee should consist *solely* of non-executives.
5. In 1990, the *Caparo* case established in UK law that the auditors did not owe a duty of care to third parties (i.e. non-shareholders) who may have relied upon the audited financial statements for decision-making purposes, such as whether or not to make a takeover bid (as was the situation in the *Caparo* case). See O’Sullivan (1993) for further discussion of the case and its implications.

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# Executive Pay and UK Corporate Governance

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Alistair Bruce and Trevor Buck

## INTRODUCTION

Interest in executive remuneration as an element in the architecture of governance in contemporary corporations has become an established feature of the governance literature in the last 30 years. Much attention has been devoted to the theoretical potential of alternative remuneration instruments and systems as key components of governance regimes. Equally, there has been significant empirical scrutiny of the ability of payment regimes to contribute to the alignment of executives' and shareholders' interests.

Academic enquiry into the nature and impact of executive remuneration has been fuelled by interest from a variety of sources. Shareholders, and particularly institutional shareholders and their representative bodies, the business community in general, trades unions, government and the media, have all, for a variety of reasons, shown a keen interest in understanding what determines the structures and levels of executive pay and how those structures and levels relate to corporate performance and the welfare of the wider community of corporate stakeholders.

Much of the curiosity surrounding executive pay relates to its chameleon-like potential to either promote more robust governance and stronger corporate performance via the alignment of stakeholder interests or drive further a supposed wedge between the interests of the executive elite and other stakeholders. As anxiety over the health of the Anglo-American model of corporate governance in general has increased in recent decades, so executive pay has provided a focus for concerns regarding how, and in whose interests, large corporations are run. In the UK, for example, there is a strong popular perception that 'fat cat' executives may influence the design of their remuneration packages at the expense of the owners of corporations. Evidence of the disjunction between executive pay and corporate performance and the apparent resilience of pay levels in the face of adverse company results has led to an increase in shareholder activism and militancy. It has also been a factor in the business community's desire to address governance concerns via successive committees of enquiry and has attracted the attention of government.

These concerns and doubts about executive pay to a large extent mirror different theoretical approaches to the subject. Proponents of the effectiveness of executive pay packages in aligning the preferences of shareholders and executives may generally be seen to rely on an *agency* model of their relationship and the notion of optimal contracting (Murphy, 2002). On the other hand, a *managerial power* perspective (Bebchuk and Fried, 2003) would emphasise the discretionary power that senior executives wield in the design of their own pay, and how they can use this power to emphasise firm size at the expense of shareholder return. Institutions such as remuneration committees and remuneration consultants may be seen as camouflage, concealing the realities of executive power.

This perspective is further buttressed by a *resource dependency* view (Daily *et al.*, 2003) that sees executives' skills as a crucial enterprise resource that attracts economic rents. Finally, with *stewardship* theory, executives are not motivated by cash and shares, but seek to act in the interests of 'the enterprise', creating a viable, successful firm that benefits executives, shareholders and employees (Tosi *et al.*, 2000).

Away from this theoretical debate, interest in executive pay has been further stimulated by the recent emergence of innovative instruments of executive pay. In the UK, these include executive share options (ESOs) and long-term incentive plans (LTIPs). Such innovations, in the same way as aggregate payment regimes, provoke particular interest in relation to their ability to either reinforce or compromise the robustness of corporate governance.

The suspicion that innovations in executive pay may reflect the self-serving behaviour of executives is reinforced by the increased complexity of executive packages in recent years and by the often opaque nature of payment regimes in an area where disclosure requirements have failed to keep pace with new developments.

The aim of this chapter is three-fold. First, we provide an overview of the nature and anatomy of contemporary executive pay in the UK and the significance of executive pay for corporate governance. This involves understanding that the design of executive payment systems is influenced by a number of factors apart from the promotion of strong governance. Equally, it requires the reader to understand that the firm's payment regime is only one of a number of mechanisms which the firm may seek to employ in assembling a robust governance regime.

Second, we consider and review the significant body of empirical work in the area of executive pay which developed during the latter part of the twentieth century. We trace the evolution of key research questions, survey and interpret the main findings of key empirical studies and reflect on some of the methodological challenges associated with work in the area.

The third section focuses in more detail on the recent evolution of executive pay in the UK. This explains the emergence of the ESO in the 1980s, its relative demise and the increasing popularity of the LTIP in the 1990s, and the current situation, where the coexistence of ESOs and LTIPs is commonplace among larger corporations. This forms the basis for a brief consideration of contemporary empirical work, which offers a first insight into the emergent impact of LTIPs on governance.

The chapter closes with some concluding remarks and identification of emergent themes for future enquiry.

## **EXECUTIVE PAY AND CORPORATE GOVERNANCE IN THE UK: AN OVERVIEW**

The form and composition of the executive remuneration package in large UK corporations has been the subject of considerable change over the last two decades. The design of executive pay packages is susceptible to a variety of influences, including the desire to build governance-enhancing models of pay, tax efficiency considerations and the need to sustain an edge in international executive markets. For the contemporary large UK company, leaving aside perquisites, pension rights and other ancillary elements, three major components dominate remuneration: salary, annual bonus, and longer-term performance-contingent elements, principally ESOs and LTIPs. Whilst there is considerable cross-company variation in the relative significance of these components, both in terms of actual and potential value, Conyon *et al.* (2000) offer some sense of their relative magnitudes.

It is important, at this stage, to reflect on the factors which have shaped the current situation and in this context to consider briefly the functions of executive pay. A company's executive pay policy may be regarded as serving a range of functions. These would include, most obviously, providing effective reward and incentive to existing staff, supporting their retention, and attracting new talent by providing the company with a positive profile in executive labour markets. In this case, there is interdependence between rewards offered to attract and retain staff and internal pay structures. According to Tournament Theory (Conyon *et al.*, 2001) internal pay structures resemble a tournament where the number of levels of pay and the gaps between them provide internal incentives to achieve promotion. Of course, the number of levels will tend to increase with firm size, resulting in higher top-level pay, and the gaps between the levels have been found to be related to the number of tournament participants (Conyon *et al.*, 2001). This, and other, reasons for an empirical relation between firm size and executive pay are further discussed below.

An important element in the attractiveness of a pay package is likely to be the balance between relatively certain cash or near-cash components and more speculative performance-contingent elements. Clearly here an individual executive's risk preferences will be important in their subjective evaluation of a particular pay format. Beyond these immediate functions of pay, a company's policy on remuneration may serve to reflect and thereby enhance its corporate image, for example as an innovative or a risk-taking organisation. More fundamentally, and at the heart of the issue so far as this chapter is concerned, executive pay may be used, alternatively, to further the interests of those in a position to influence pay design, contrary to the interests of other stakeholders, or to promote greater alignment between corporate stakeholders, most notably executives and shareholders, agents and principals. Much of the governance literature in relation to executive pay has focused on the theoretical potential for pay to either enhance or damage corporate governance and the empirical evidence in relation to these questions. Thus executive pay may be seen as having a variety of functions: building corporate governance is merely one factor, albeit an important factor, among a wider set of considerations in the design of executive pay.

However, just as the quest for more robust corporate governance represents only one of the elements which might help us to make sense of pay structures, so executive remuneration is just one of a number of factors which together define the architecture of corporate governance. Whilst linking an element of an executive's pay to variables which enhance shareholder value

may have the potential to contribute to strong governance, executive pay exists alongside a range of other internal characteristics and within an external environment which together determine the effectiveness of a corporate governance regime. Hence, *inter alia*, a firm's overall ownership and financial structure, the presence and relative significance of large individual and institutional shareholders, board structure and personnel, the composition of board committees and the organisational configuration of the company all have the potential to contribute to or militate against good governance. Equally, the rules, protocols, practices, processes and customs which influence the way in which the company conducts its internal affairs and factors in the external environment such as the competitiveness of product markets and the sophistication of the equity market also contribute to the nature of corporate governance. This implies a *contingency* view of executive pay (Li and Simerly, 1998; Rajagopalan, 1996) and the idea that the impact of pay packages depends on a number of strategic and other variables.

Clearly, therefore, whilst there are evident linkages between executive pay and corporate governance, this relationship is nested within a complex and interdependent set of additional factors and influences on both pay and governance. This is an important point to keep in mind as we review the empirical literature on executive pay in the context of corporate governance.

## THE EMPIRICAL ANALYSIS OF EXECUTIVE PAY

The first aim of this section is to provide a brief commentary on the evolution of empirical studies in the area of executive pay. It is not, by design, intended to provide a comprehensive coverage of literature in the area. There are a number of contemporary contributions which offer a fuller survey of this increasing volume of work; see, for example, Murphy (1999); Tosi *et al.* (2000); Daily *et al.* (2003).

A second aim is to comment on some of the methodological issues which have challenged researchers in this field and, to a degree, compromised the results of empirical investigation.

A dominant theme in the empirical analysis of executive pay in the UK and US has been investigation of the degree of correlation between pay, variously measured, and performance, again variously measured. Within this theme, most of the emphasis has been on identifying the implications on executive pay of corporate performance; that is to say, treating executive pay as the dependent variable. Here, a strong, positive relationship is seen as indicative of the potential for executive pay to promote alignment between executives' and shareholders' interests, thereby contributing to robust governance.

In most empirical studies, various other factors with the potential to explain executive pay, such as firm size and rates of corporate growth, are considered alongside performance-related variables. Indeed, it has been seen that Tournament Theory predicts higher executive pay with firm size, though this could also be explained by rigid size/pay rules-of-thumb applied by remuneration consultants and the effect of a market for executive labour where the complexity of large firms demands more managerial effort and responsibility.

Besides size, however, much of the impetus for this significant body of empirical work came from a need to understand how innovations in executive pay, and in particular longer-term performance-contingent pay components, impacted on the performance-pay relationship. It should be remembered, however, that any positive relationship between any one pay component and firm performance is only *suggestive* of an improved alignment of manager/shareholder interests (i.e. some mitigation of agency problems) and no more.

Among early American studies of the pay determination, Lewellen (1968) and Lewellen and Huntsman (1970), analysing a panel of 50 US companies over a 22-year period, found that incorporation of long-term pay components had a negligible impact on the relationship between pay and performance. In the UK, earlier contributions to the empirical evidence included the work of Cosh (1975) and Meeks and Whittington (1975). Cosh (1975), analysing 1601 firms which, in 1971, were responsible for two-thirds of the UK's industrial and commercial assets, capitalised on new disclosure requirements in the 1967 Companies Act to examine the pay of highest paid directors (HPDs). Firm size emerged as the most powerful explanatory variable for HPD pay, with a negligible effect attributed to performance. This is unsurprising given the narrow definition of pay employed and the fact that Cosh's study predated the significant adoption of longer-term pay components by UK companies by about a decade. Meeks and Whittington (1975) found a stronger profit effect, with similar levels of influence for profit and growth rate in pay determination for a sample of 1008 HPDs. Coughlan and Schmidt (1985), analysing 597 observations of executive base pay plus bonus across 249 companies between 1978 and 1980, found a positive relationship between the real rate of growth of pay and market performance.

Murphy's (1985) analysis of 461 individuals in 72 US firms over the period 1964–81 highlighted the importance of building a comprehensive pay variable as a basis for investigating the performance–pay relationship and attributed the failure of earlier studies to identify correlations to the use of overnarrow measures of pay. Although he used the controversial Black–Scholes formula for valuation of stock options – to be addressed later – this did facilitate a comprehensive measure of pretax pay which included options, other deferred pay components and various fringe benefits. Murphy found strong links between aggregate pay and both shareholder return and firm size. Among other US studies in the same period, Deckop (1988) identified profit as a percentage of sales as a more significant explanatory variable than sales *per se* in determining pay, a somewhat surprising result given the narrow base plus bonus pay variable employed. The significance of industry effects on the performance–pay link was stressed.

Jensen and Murphy (1990) again emphasised the importance of assembling a comprehensive pay measure. Their analysis of 1688 executives between 1974 and 1986 demonstrated how broadening the pay variable increased the performance–pay relationship compared with the simpler base plus bonus measure. They also identified stock options as offering a much stronger basis for strengthening the performance–pay link than other pay components. Thus, for each \$1000 of increased shareholder wealth, option-related returns increased by 14.5 cents. This compared with only a 3.3 cent increase in aggregate pay excluding options and a 1.35 cent increase in base plus bonus pay (all values in 1986 prices). Abowd's (1990) study was important in reversing the traditional line of enquiry to consider the relationship between the performance–pay relationship and subsequent performance. As such, the focus was more on the function of pay as incentive, rather than on reward. His analysis of 16 000 US managers in 250 companies between 1981 and 1986 found some evidence for this form of causal link, where market performance data were employed.

Besides these agency-based studies, a stream of papers from the managerial power tradition have emphasised the personal characteristics of executives, particularly CEOs, and pay–performance sensitivities. Such characteristics should not matter on an agency view, but length of tenure and dual chair/CEO roles have all been found to have a significant influence (Westphal and Zajac, 1994), together with executives' holdings of stock (Murphy and Oyer, 2003).

Nevertheless, the agency-based findings are broadly reflected in a 'meta study' of the impact of executive pay in the US (Tosi *et al.*, 2000). In this 'study of studies', Tosi *et al.* (2000) found that, consistent with a managerial power perspective, around 40% of the variance in CEO pay is attributable to firm size, around 5% to changes in size, less than 5% to share performance and around 4% to changes in financial performance. Possible explanations for the overwhelming significance of firm size in these regressions are discussed above.

A number of UK agency studies in the early 1990s also appeared to cast doubt on the potential for longer-term pay components to effect stronger financial performance–pay links.

Szymanski's (1992) study of 51 companies between 1981 and 1991 identified a much greater role for size and sales growth than for performance in explaining executive pay, though there was a lack of clarity as to how the details of ESOs were incorporated into the pay variable. Gregg *et al.* (1993) used HPD base plus bonus data for 288 large UK companies and note only a weak performance–pay relationship until 1988, with a complete breakdown of the link thereafter. Conyon and Gregg (1994) also used base plus bonus pay for 170 HPDs and reported sales growth as a significant pay predictor, with market and accounting performance only weakly predictive and negligible in effect respectively. Conyon and Leech (1994), as part of a wider study which incorporates analysis of non-pay governance factors, also found a weak performance–pay link using a base plus bonus pay variable.

The problem with each of these UK studies of the early 1990s is their failure to incorporate an element of executive pay, the ESO, which by the late 1980s had become an established feature of UK boardrooms. Weak performance–pay relationships and strong sales–pay relationships are entirely predictable if the pay variable employed is simply base pay plus (generally sales-related) annual bonus, but the usefulness or relevance of this pay measure is highly questionable in the context of UK executive remuneration practice from the mid-1980s onwards.

Main *et al.* (1996) addressed this concern by constructing a much more comprehensive pay measure, incorporating data for all ESO awards and exercises for board members of 59 large UK companies through the 1980s. Their analysis revealed strong performance–pay sensitivities for boards as a whole, for HPDs and for chief executives. Thus, for example, a 10% increase in shareholder wealth was seen to generate increases of 8.94% and 7.2% in the aggregate pay of HPDs and chief executives respectively.

Taken as a whole, the literature regarding the importance of corporate performance *vis à vis* other factors in determining executive pay, of which the above offers merely a sample, both fails to deliver a clear consensus and appears vulnerable to the charge that it has overfocused on the performance–pay link at the expense of other potentially interesting aspects of executive pay. In many respects this is unsurprising. As a general observation, Murphy (1999) points to the multicollinearity problems associated with this type of study, which seeks to disentangle the various strands of influence on pay.

More specifically, the invariably rather simplistic pay variables employed, as noted above, also frustrate the identification of clear or reliable relationships. Whilst the use of incomplete pay variables cannot be condoned, it is at the same time important to acknowledge that assembling comprehensive pay measures is not straightforward for a number of reasons.

First, the quality of disclosure of details of executive pay has been highly uneven, especially in the UK, so that compiling uniformly complete or reliable data across large sets of companies is often frustrated by cross-company differences in reporting procedures. This is in a sense alleviated, but in another sense compounded, by evolving practice in relation to the transparency of executive pay, as successive codes of practice and compliance conditions shift the boundaries

of acceptable disclosure. Longitudinal studies, in particular, may be compromised where they straddle different ‘eras’ of disclosure regime.

Second, it is now realised that comprehensive pay valuations must embrace the stock of executives’ share ownership accumulated over the years, much of it from the exercise of options. This contrasts with the flow of cash, shares and options received and disposed of during any one year, but is no less important in the measurement of the sensitivity of the executive’s overall wealth to firm performance in any one year (Skovoroda *et al.*, 2004). Furthermore, serious shortcomings of Black–Scholes option valuations in the context of executive pay have been noted (Murphy, 1999). This formula was originally derived for tradable options, rather than ESOs, which are not transferable. In addition, however, it is clear that the formula only gives an approximation to the *cost of options to the shareholders* who award them. They can make no estimate of their *value to the executives* who receive them (Hall and Murphy, 2002), since executives are assumed to discount them according to their degree of risk aversion.

Whilst the uncertainty of ESOs must significantly reduce their value, it also provides any incentive effect. Recently, Skovoroda *et al.*’s (2004) risk-adjusted valuations of ESO benefits to executives have been compared with Black–Scholes estimates of their cost to shareholders to arrive at a ‘Minimum Assumed Incentive Effect’, whereby if value to the executive exceeds cost to the shareholder, the difference must be assumed to occur because shareholders judge the incentive effect to be greater than a cash award equal to the Black–Scholes value.

A third problem relates to the evolution in payment systems themselves, discussed in greater detail in the following section. In short, there has been a tendency for executive pay to become increasingly complicated, in terms of the number of pay components and the complexity of each. It is perhaps unsurprising, though not defensible, that academic researchers are tempted to default to more basic measures of pay (such as base plus bonus) which were legitimately employed in an era of less complex pay structures. The company-specific idiosyncrasy of certain contemporary pay components, such as long-term incentive plans, is at the very least inconvenient for researchers conducting large-scale studies which seek to test general propositions relating to pay. Even where poor disclosure and cross-firm heterogeneity are not a problem, there are well-rehearsed concerns relating to the valuation of certain pay elements. Most notable here are those performance-related instruments, the ultimate monetary value of which is contingent on a range of factors such as absolute and relative corporate performance (whether defined in market and/or accounting terms) and the uncertain future date at which executives choose to ‘cash in’ their entitlement.

A further feature of the body of empirical work, alluded to in relation to Abowd’s (1990) work, is the relative absence of debate regarding the direction of causality between pay and performance. Whilst most studies have focused on probing how performance affects pay (essentially the ‘reward’ factor), the way in which pay affects subsequent performance (the ‘incentive’ factor) also needs to be considered. In other words, is reward an antecedent or consequence of performance (Daily *et al.*, 2003)? Disentangling these distinct causal relationships is unlikely to be straightforward and is scarcely acknowledged in much of the empirical work.

## **EXECUTIVE PAY EVOLUTION IN THE UK**

This section provides a review of the evolution of executive pay in the UK over the last two decades, a period of considerable change in the components of pay packages in large UK companies. Particular emphasis is given to considering the significance of two elements of



longer-term performance-contingent pay, ESOs and LTIPs, and the potential contribution of each to the establishment of more robust corporate governance regimes.

## Setting Executive Pay: Institutions and Processes

As a prelude to discussion of the above innovations in executive pay, it is instructive to consider briefly, and in general terms, the peculiarities of institution and process associated with pay determination in British companies.

An important issue here relates to the role and composition of the board of directors and its committees. Invariably, executive directors are numerically dominant on British company boards (Cosh and Hughes, 1987; Hemmington-Scott, 1992), whilst the independence of non-executive directors from executive influence has been questioned, given their tendency to be appointed on the recommendation of the chief executive officer (see, for example, Ezzamel and Watson, 1997). The increased propensity of companies to channel appointments via nominations committees has done little to diminish the suspicion that independence is compromised. Conyon (1997), for example, noted that in a sample of 143 nominations committees in large British companies in 1995, 69% involved membership of at least one executive director. Similarly, whilst the proximate responsibility for setting directors' pay now rests with remuneration committees, which were operating in the overwhelming majority of large companies by the mid-1990s, again the ability of these bodies to operate outwith the influence of the executive cadre is questionable. Whilst in just over half the cases in a sample of 287 British companies in 1995, remuneration committees were comprised exclusively of non-executives, in the remaining 49% there was an executive presence at the table, which fuels concerns over independence (Conyon, 1997). In terms of the potential for remuneration committees to moderate levels of executive pay, Main and Johnston (1992) observed a significant premium for CEO pay for companies with remuneration committees at a time when committees were not, as now, virtually ubiquitous. As regards their role in promoting pay formulae which deliver greater alignment, Ezzamel and Watson (1997) observe:

existing research suggests that the effectiveness of remuneration committees in linking CEO pay to performance is fairly limited.

If there are already well-established concerns relating to the process, it seems fair to suggest that, as the composition of executive pay becomes more complex, the potential for perceptions of weak governance in relation to the setting of executive pay by remuneration committees increases.

## The Emergence of the Executive Share Option

The last two decades have witnessed considerable variation in the components of executive remuneration employed by large British companies. The late 1980s and early 1990s were characterised by the vigorous and near-ubiquitous uptake of the ESO to supplement more traditional base plus bonus components of executive reward. A range of factors motivated this. First, stock options had become established as a remuneration component in large American corporations and this innovation was replicated in the UK as the American experience was

digested. Relatedly, it was clear that there was a sharp disparity between the earnings potential of UK and US senior executives (see, for example, Main *et al.*, 1990) and for British firms conscious that they were operating in a global executive labour market, the greater use of ESOs offered a partial response. At the same time, the late 1980s saw a degree of fiscal incentive (through the 1984 Finance Act) for option-based pay components, though this was to be relatively short lived, effectively ending in 1988. Finally, as the use of ESOs became more extensive, so it increasingly became a standard component of executive pay which firms, whether enthusiasts of the device or not, could ill afford to ignore.

At a more fundamental level, the ESO offered the opportunity to redraw the nature of the contract between the firm's shareholders and its executives and to effect a closer alignment between these groups. This prospect endured because, as noted above, although the empirical evidence for a significant pay–performance link, where ESOs were used, was weak in the early 1990s, in large part this reflected the difficulty experienced by researchers in satisfactorily incorporating ESO-related data (see, for example, Conyon and Leech, 1994, and Gregg *et al.*, 1993), rather than any genuinely identified lack of correlation. A less optimistic view of the ESO scheme was that it did little to address governance concerns and that it offered executives the prospect of significant reward as a result of merely achieving 'soft' performance conditions, especially in a rising market. The perception of ESOs as an instrument to be exploited by self-serving managers was fuelled by a number of cases of very substantial gains to individual executives, which captured the imagination of the media and other interested groups. Prominent among these were examples of newly privatised utilities which were subject to very significant share price increases with attendant substantial financial benefits for option-holding executives. This was to prompt a response initiated by the business community in the establishment of the Greenbury Committee, one of a series of bodies designed to explore the wider issue of corporate governance and, within this, executive remuneration. The work of these committees, amounting to processes of self-regulation by the UK capital market, is discussed below.

## The Public Scrutiny of Executive Pay

With hindsight, it seems clear that in the late 1980s and early 1990s, self-regulatory arrangements did little to sharpen the incentive effects of ESO schemes. Although schemes which sought Inland Revenue approval were subject to rules regarding scheme design and the amount eligible individuals could gain, it was the discipline imposed by the institutional shareholding community, led by the Association of British Insurers (ABI), which brought the issue of performance targets to prominence by requiring that award under ESO schemes should be subject to genuine improvements in corporate performance, measured against a relevant comparator. At the same time, the ABI recommended limiting the value of awarded ESOs to four times salary, a rule with implications for pay–performance sensitivity.

The Cadbury Committee (1992) paved the way for the later Greenbury and Hampel committees by recognising the role of executive pay within the wider governance debate. Its recommendations in this area were concerned mainly with the role of the board and the procedures relating to the determination of executive pay and its disclosure. For example, it suggested mechanisms to guarantee the independence of non-executive directors and it was the Cadbury Committee that assigned non-executives a key role, via membership of remuneration

committees, in setting pay levels for executives. The London Stock Exchange listing requirements provided that compliance with the code should be verified via an audited statement, although non-compliance merely had to be explained in the company's annual report.

The Greenbury Committee (1995) developed the regulatory debate further by suggesting a number of additional modifications relating to the design of executive remuneration packages, the determination of levels of award and the transparency of procedures and outcomes. These modifications were to be reflected, to varying degrees, in recommendations of the Accounting Standards Board and via amendments to the listing rules of the London Stock Exchange after 1996. The effect of these self-regulatory developments was to render more accessible details relating to the pattern of ESO use in British companies. Significantly, in the light of subsequent developments, the Greenbury Committee echoed concerns over levels of ESO-related reward by suggesting that firms might compare the merits of ESOs with alternative forms of longer-term, performance-contingent pay component. The Hampel Committee's recommendations (1998) added little of material significance to earlier pronouncements in this area, but essentially consolidated and reaffirmed the views expressed. This process of consolidation was further advanced by the introduction in 2000 of a Combined Code based on the Cadbury and Greenbury Reports, subsequently amended in 2003 (Financial Reporting Council, 2003).

## The Decline of the ESO and the Emergence of the LTIP

Before charting more recent changes in the relative significance of ESOs and LTIPs in large UK companies, it is instructive to reflect briefly on the essential characteristics of the ESO and its potential as a governance-enhancing pay component. This provides a context for reviewing recent developments and exploring the characteristics of the LTIP in greater detail.

Fundamentally, the ESO's major strength may be seen as its ability to effect a closer alignment between shareholder and executive interests, in terms of the necessarily positive relationship between share price appreciation and ESO-related rewards. A further positive feature is the relative simplicity of the instrument, which offers ease of scheme administration and ease of interpretation of scheme benefits to those eligible. The increased level of transparency associated with increasingly rigorous disclosure requirements, coupled with the near-ubiquitous use of performance targets, limits the scope for abuse in scheme design and operation, a factor reinforced by the tendency towards scheme standardisation.

Against these positive features, the ESO may be criticised on the grounds that share price, key to the determination of award, is a crude measure of individual executive performance, especially when bull markets generate substantial reward irrespective of relative performance. In addition, as noted above, the methodological problems associated with valuing share options have limited the amount of useful empirical work on the pay-performance link where options form part of the remuneration package.

It seems reasonable to suggest that the sustained public scrutiny of governance issues in general (and remuneration issues in particular) and consequent regulatory amendments may have been influential in reducing the relative importance of ESOs within the executive pay package in the mid- to late 1990s. Certainly, the tighter controls on procedure and disclosure limited the opportunity for covert abuse of ESO schemes by self-serving executives. Perhaps more significant, however, was the disproportionate attention focused on a small number of cases where executives enjoyed substantial financial gains without parallel improvements in corporate performance which had, by the mid-1990s, tended to discredit ESO schemes

more generally. As a result, firms were encouraged to explore alternative long-term incentive instruments, a development supported by Greenbury.

The drift from favour of ESO schemes in the mid-1990s applied both to firms which had previously abused ESO schemes and to those which had embraced them as a means of improving governance regimes. For the former, the fact that Greenbury-inspired tightening of regulatory arrangements was focused largely on ESOs meant that alternative forms of long-term incentive were relatively neglected from a regulatory perspective. Hence, they presented more fruitful opportunities for discrete adjustments to executive pay. For the latter, the perception of ESOs as operating against shareholder interests rendered reduced use of the instrument advisable from a public relations point of view. However, by the end of the 1990s, there was some evidence that the decline in the use of ESOs had been arrested (PIRC, 1999, p. 12). This may in part have been a reflection of a reduction in anti-ESO sentiment which existed in the mid-1990s – a ‘decent’ period of time had elapsed since the worst reported excesses of ESO schemes. It may also be the case that the sheer complexity of new payment instruments such as the LTIP, a theme developed below, encouraged reintroduction of simpler ESO schemes in some companies. Notwithstanding recent evidence of a halt to the relative decline in ESO use, its dominance in the overall pay portfolio is significantly less marked than was the case in the mid-1990s.

An irony of the general trend away from ESO schemes is that new evidence was beginning to emerge by the mid-1990s that ESO schemes in general carried the potential to significantly realign shareholder and executive interests (Main *et al.*, 1996) via strong pay–performance links. This evidence resulted from the more comprehensive and precise measurement of ESO-related gains via the use, for the first time, of Registers of Directors’ Interests, an initially rather opaque but ultimately fertile data source for investigating companies’ use of ESO schemes.

The declining relative significance of ESO schemes within aggregate executive pay has been matched by the parallel increase in the role of the LTIP. Fundamentally, the LTIP may be regarded as a conditional ESO scheme with a zero exercise price, whereby it is shares (or shares and cash; or, exceptionally, cash only) rather than a right to purchase stock which are awarded to eligible executives. Awards under LTIPs are contingent on the achievement of a level of *relative* performance (variously defined) over a specified period of time and awards may be subject to trading restrictions in the short term.

A key potential advantage of the LTIP, therefore, is that it offers a potentially much more tailored, company-specific vehicle for rewarding executive performance which is relatively insensitive to broad stock market trends. This means that executives must be seen to ‘earn’ their LTIP gains. At the same time, this property means that LTIP gains can still accrue if a firm’s share price falls in absolute terms, but LTIP performance conditions (e.g. above-average TSR) are met. This feature can now be seen as yet another element of the wider ‘payments for failure’ debate prompted by the DTI’s consultative document in 2003: LTIPs involving gifts of shares which enable executives to gain whilst shareholders lose, sometimes massively. Indeed cynics would explain the immediate popularity of LTIPs as evidence that executives anticipated continued gains through impending bear markets. Just as cynically, Chambers (2003) argued that LTIPs were welcomed by executives anxious to evade the four times salary ceiling applied to ESOs.

At the same time, the idiosyncratic and complex nature of individual schemes and the absence, to date, of standardisation in scheme form makes the LTIP potentially less transparent to eligible executives and others (most notably shareholders) and potentially more susceptible, in the detail of scheme design, to abuse by self-serving executives. To a considerable degree, lack of transparency in relation to LTIPs is a function of the fact that

the evolving self-regulatory regime through the 1990s focused on addressing the regulatory concerns associated with ESO schemes.

The rate of uptake of LTIPs in larger UK companies became significant after the Greenbury Report in 1995 and by the early years of the twenty-first century around 50% of the FTSE top 350 operated schemes.

The parallel decline in the relative significance of ESO schemes and increase in the uptake of LTIP schemes raises significant issues from a governance perspective. Of primary importance is the diminished use of a remuneration instrument which embodies demonstrable potential to align executive and shareholder interests and the growth of a new instrument which is as yet untested in terms of either its effectiveness or its potential for abuse. To be more specific here: although ESOs link executive rewards to share price, guaranteeing automatic rewards in a rising market without increased executive effort, at least the interests of executives are more aligned with those of shareholders with this mechanism. By introducing and focusing on relative performance conditions, LTIP schemes have the potential to reward executives even when shareholders are suffering from poor stock market performance or even share price decline. This type of issue is the more significant in that the LTIP has, as noted above, been relatively unfettered by regulatory constraints, compared with the ESO.

In terms of exploring their potential contribution to robust governance, therefore, there is a clear need to develop a fuller understanding of the way in which LTIP schemes operate and how they impact on pay levels and pay–performance sensitivities. A first step in this is a more detailed explanation of the anatomy and mechanics of the instrument and an examination of early trends in LTIP design in large UK companies, based on a study of characteristics of existing LTIPs in FTSE 350 companies up to 1999. The impact of these schemes on the pay–performance link is the subject of a recent study by Buck *et al.* (2003) which is reported in more detail below.

## The Anatomy of the LTIP

It has been observed above that a characteristic feature of the LTIP *vis-à-vis* the ESO scheme is the range of discretionary elements in scheme design and operation. In practice, the effectiveness of the LTIP as an instrument is likely to depend largely on the precise way in which discretion is exercised – it is the detail which determines the effect. This section catalogues the discretionary elements of LTIPs and reviews the exercise of discretion in large UK companies. The emphasis in this section is devoted to the exercise of discretion in relation to performance measures and comparator groups, which are regarded as carrying the greatest potential significance from a governance perspective. Some attention is also given to other discretionary elements of LTIP design, however, because whilst their governance significance may be less obvious, ultimately it is the particular combination of all elements in LTIP design which is likely to influence its ability to act as an instrument of governance, or otherwise.

## PERFORMANCE INDICATOR(S)

A central feature of any LTIP is the nature of the indicator(s) selected as the basis for measuring company performance. The two most established and familiar forms of performance indicator are total shareholder return (TSR) and earnings per share (EPS). Though each of these purports

to offer an insight (market based or accounting based) into performance, the merit of the former is a function of the efficiency of the market in factoring performance into valuation. Equally, the latter is susceptible to a degree of manipulation in terms of managerial discretion (Murphy and Oyer, 2003) and the method of calculation employed, in large part associated with the complexity of the calculation, particularly where the picture is affected by different classes of shares, rights issues etc. This is in spite of the development of accounting standards to guide policy in relation to EPS.

The preferred performance measure for the aggregate population of LTIPs in 1999 was TSR, which was the unique measure employed by 77 (51%) of FTSE 350 companies with LTIPs at this time. EPS was used as a unique measure by 22 (15%), whilst a further 24 (16%) employed both TSR and EPS. The remaining 27 (18%) schemes used a variety of alternative internal measures, including share price, dividend growth, value of asset base, cashflow and profit growth. This latter range of alternative performance indicators invites questions regarding the basis for their adoption, for whilst there are well-ventilated concerns with aspects of TSR and EPS, such measures at least have the merit of being common currency and reasonably useful in effecting cross-company comparison.

Interestingly, whilst TSR as a unique measure dominated the stock of LTIPs in 1999, only around a quarter of the new schemes introduced during 1999 used this criterion. Equally the proportion of new schemes featuring TSR in conjunction with EPS halved in 1999, compared with the previous two years.

Taking TSR and EPS together and observing developments over a slightly longer timeframe is instructive: in 1995/96 the two measures, individually or in tandem, were used in over 90% of new schemes; this compared with a figure of 54% for schemes submitted for approval in 1999.

This fall in the popularity of TSR, individually or in combination, during the early years of LTIP uptake, was balanced by an increase in the use of alternative single or composite criteria, which together accounted for around 30% of new schemes by 1999. This shift may reflect the desire of companies to develop performance criteria which constituted more meaningful or challenging targets, as advocated, for example, by successive ABI guidelines. At the same time, the use of individual and rather more opaque measures, which militate against straight-forward comparison, may reflect more self-interested motivations. The comparison between the evolution of ESO schemes and LTIPs, during the early years of uptake, is compelling. Whilst the former manifested a marked drift towards greater standardisation in scheme design, the momentum with LTIPs was in the opposite direction.

## Comparator Group(s)

The feature of LTIPs which is arguably most open to the exercise of managerial discretion and hence most vulnerable to the introduction of 'soft' performance conditions is the comparator against which the firm's performance is evaluated. There are, essentially, three bases for comparison which, when employed individually or in combination, together accounted for practice in the majority of schemes by 1999. The first requires eligibility for some award to be contingent on terms of the achievement of a given real growth in the chosen performance yardstick; for example, earnings per share must grow by  $RPI + n\%$ , where  $n$  is at the discretion of the scheme designer. The second relates the firm's performance target to a published market index, or sector thereof. The third, and perhaps most interesting form of comparator,

evaluates the firm's performance against a peer group of companies, selected individually. The composition of this peer group offers wide scope for discretion. Clearly, within any broadly defined peer group, there is the ability to construct, alternatively, a portfolio of traditionally weakly performing or strongly performing peers, which have quite differing implications for the achievement of performance targets. The process involved in constructing a peer group is rarely transparent and indeed the disclosure of peer group details is very uneven across companies. A number of leading UK companies have proved extremely sensitive about the composition of peer groups, in spite of the Greenbury recommendation for transparency in this area. It is also the case that a number of companies have changed peer group membership during the life of an LTIP, thereby adding a further discretionary element, though the motivation for such changes may be explicit, for example where a peer company is absorbed by takeover.

Within the stock of firms with LTIPs in 1999, the most common benchmark against which to evaluate performance was the peer group, with 49 (33%) of companies using individually constructed comparator groups. Typically, the key factor in determining the level of award with such a model was the rank of the company within its peer group. Thirty-seven (25%) firms used the FTSE 100 as a benchmark; there were then small groups of companies (5% or less of the aggregate in each case) using FTSE 250, FTSE 100 and a peer group, or a sectoral index. This left 46 (31%) companies which either used no comparator group, relying merely on an absolute performance measure (e.g. EPS growth at RPI + 3%), or some other composite benchmark.

These aggregate figures conceal a trend away from the use of comparator groups in LTIPs. PIRC (1999) reported that only 54% of schemes submitted for shareholder approval in 1999 featured comparators. Where such groups were used, there was a marked shift towards peer groups in 1999, with 78% employing either a single or multiple group (i.e. award contingent on performance tested against more than one comparator group) model. This compared with a figure of just 27% for peer group comparison by LTIPs submitted for approval in 1995/96. By contrast, only 16% of new LTIPs in 1999 used a broad FTSE comparator, whereas in 1995/96, around two-thirds of schemes related performance to a broad market index.

This marked move away from broader market benchmarks may, of course, have reflected a desire for more meaningful and relevant bases for comparison. Again, the observed trend resonated with the declared preferences of the institutional shareholding community at the time, as signalled in the ABI 1999 provisions. Best practice in the use of peer groups featured full disclosure of group membership, with each member's inclusion individually justified. At the other extreme, however, there was often a complete absence of information relating to group membership, let alone any justification for group composition. This counsels that the construction of bespoke peer groups carries with it the potential for the deliberate design of relatively unchallenging performance criteria.

Taken together, the aggregate population data and observable trends in relation to performance targets and comparator groups suggested a significant movement away from the use of more established and broader bases for performance evaluation, during the early years of scheme take-up, towards a more idiosyncratic and firm-specific approach. Thus, the combined use of familiar market or accounting-based measures such as TSR and EPS with a broad, index-based comparator has given way to narrower, company-specific criteria judged against a specially constructed and firm-specific benchmark.

## **FURTHER DISCRETIONARY ELEMENTS IN LTIP DESIGN**

There are various additional bases for exercising discretion in LTIP design which merit brief discussion.

### **Scheme Duration**

There are a number of aspects related to scheme duration. Whilst the overwhelming majority of companies operate three-year ‘test’ periods in relation to the setting of performance targets, there is greater variation in whether or not companies enforce holding periods (prior to trading) for shares awarded under LTIPs and whether companies operate overlapping or temporally discrete LTIPs. In certain cases, companies permit explicit extensions to the performance period (‘retesting’), where targets are not met within the originally specified timeframe. In other cases, where performance is sustained beyond the specified period, additional awards may be made.

### **The Structure of Vesting Scales and Award Maxima**

The structure of the LTIP, in terms of the relationship between successive levels of performance and successive awards, offers wide scope for variation. In general, an initial proportion of the maximum possible award will vest on achievement of a particular level of relative performance. Typically, successive tranches of award would then vest at successively higher levels of relative performance, culminating in full award as the company achieves the highest level of performance relative to its comparator group, however defined. Where exactly these minimum and maximum levels are set and the pattern of vesting between these points are all matters of detail in design. Variants include initial vesting triggers associated with median sectoral performance, with subsequent tranches awarded as successive deciles of performance are achieved. A significant proportion of earlier LTIPs actually triggered initial awards for sub-median performance. Another model involves successive awards associated with a company’s ranking within its peer group. A significant issue in the design of vesting scales relates to how incentive is sustained when companies are operating at levels either well below the minimum vesting point or beyond the maximum performance level. As such, there would appear to be a danger of ‘flat zones’ within the overall performance range.

There is a degree of variation in the magnitude of LTIP-related award, as a proportion of annual salary, for which executives are eligible. Whilst the majority of schemes offer potential awards in the range between 25% and 100% of salary, with the latter figure predominating, there are a number of cases where maximum award can exceed 100% of annual salary. An important factor to note in comparing limits of award across schemes is that, as noted earlier, some firms employ discrete LTIPs, whilst others operate overlapping plans. In the latter case, clearly, executives could at any time be eligible for total LTIP-related remuneration of 300% of annual salary, via simultaneous participation in three plans, each with a 100% limit.



## MIX OF REMUNERATION COMPONENTS

Whilst the focus in this section has been on the LTIP *per se* and the discretionary elements in its design, there is in a sense a further discretionary element relating to the broader remuneration context within which a company LTIP is located. For example, it is at the discretion of the company as to whether it operates an LTIP as a substitute for or in parallel with an ESO scheme. Indeed, it may be the case that the specific form in which discretion in LTIP design is exercised may be influenced by the existence or otherwise of alternative pay elements, such as ESO schemes, annual or deferred bonuses. Retention of ESO schemes alongside new LTIPs, a relatively common feature in contemporary large UK corporations, may reflect companies' desires to broaden the base of remuneration components. Such a policy allows firms to compare the effects of parallel instruments and may lessen vulnerability to regulatory pressure on one or other individual instrument. Retention of ESO schemes alongside LTIPs may also reflect the fact that the latter have yet to develop a track record in terms of their likely value to executives.

## DISCLOSURE

Whilst, in general, the transparency of executive remuneration in UK companies has improved markedly in the last decade, it remains the case that the discretion which firms feel able to exercise in terms of LTIP details leads to some variability in disclosure. Though some companies, and notably here the former public utilities, are characterised by a high degree of transparency, there is frequently a reluctance to release details in relation to comparators and the structure of LTIP awards. One of the major challenges of research in this area is that of developing a comprehensive and detailed set of information on LTIPs across a large sample of companies. Whilst many companies pay lip service to the disclosure requirements via anodine statements regarding principles of remuneration policy and claims of compliance, assembling the data to generate informed and accurate estimates of the actual and potential value of all pay components normally only receives a start from the annual report and generally requires considerable additional investigation of detail.

The various discretionary elements in LTIP design, detailed above, give rise to a wide diversity of LTIP practice. It is this discretion and diversity which prompts questions as to the contribution of the LTIP to governance regimes in larger British companies. The results of the first large-scale investigation of LTIP impact on UK executive pay and its implications for the robustness of governance in UK companies are provided below.

It is clear from the above that the nature of executive remuneration arrangements in large UK corporations has been subject to significant change during the last two decades of the twentieth century. By the end of this period, a significant majority of UK executives were rewarded by at least one form of long-term performance-contingent pay component. The impact of the most recent innovation of this type, the LTIP, on pay levels and the pay–performance relationship, has remained uninvestigated until very recently. In large part, this reflects the fact that it is only very recently that it has become feasible to incorporate and assess the effect of maturing LTIP schemes on the overall pay picture.

The earliest empirical scrutiny of the impact of LTIPs is presented in Buck *et al.* (2003). This study is based on an analysis of boardroom pay in 307 of the FTSE 350 companies in 1998/99. The study involved the incorporation of all pay components in a comprehensive measure of

executive reward. As far as the incorporation of LTIP-related information was concerned, this involved assembling both public domain information and eliciting unpublished details of scheme design from companies with LTIPs.

The results offer an interesting first insight into the effect of LTIPs. Two aspects stand out. First, LTIPs have a significant positive impact on aggregate pay, amounting to an average enhancement to aggregate pay of 31.2% for all executives. More interesting, arguably, is the impact that the use of an LTIP has on the pay–performance relationship, where the presence of an LTIP in the pay package results in a reduced link between pay and performance. Here, for all executives, a 10% increase in TSR generates an average of 15.5% increase in aggregate pay, where LTIPs are a feature of the remuneration package, compared with a 19.9% pay increase in the absence of LTIPs. This suggests that LTIPs do not serve to align shareholder and executive incentives. This is unsurprising, of course, to those who suspect that LTIPs are used mainly to further the interests of self-serving executives, rather than contributing to more robust governance.

## CONCLUSIONS

Recent work in the area of executive remuneration from a governance perspective suggests that the field will continue to be active in the future, and there is still so much about executive pay that is unproven and not fully understood. Among the more interesting contemporary themes is the analysis of the risk characteristics and implications of alternative payment regimes. This area, exemplified by Hall and Murphy (1999), represents a shift from the traditional focus on alignment of incentives in terms of returns to executives and shareholders, towards a consideration of alignment in terms of attitudes to risk. Whereas, for example, it is often assumed that the use of performance-contingent elements in aggregate pay serves to increase risk taking by eligible executives, there is emergent evidence that the contrary may be true in many cases. Skovoroda *et al.* (2004) conclude that for a significant majority of CEOs, the use of ESOs increases their risk aversion.

Accepting the existence of risk aversion, an interesting area for further work relates to whether the ‘Minimum Assumed Incentive Effect’, i.e. the difference between Black–Scholes estimates of ESO costs to shareholders and risk-adjusted executives’ gains, shows any stable association with firm performance.

Further areas for fruitful future enquiry include the challenge of unpicking the complex issues of causality in the relationship between pay and performance. Causality analysis is desperately needed in this area, but of course this requires large panels of data.

The focus of shareholder activists on ESOs, LTIPs, severance payments, perquisites and salary may ultimately switch to pay elements that have so far evaded attention. For example, *short-term bonus* is a neglected pay component subject to weak disclosure requirements and possibly abuse. Continued research on the relation between governance institutions, e.g. board representation, remuneration committee membership and nominations procedures for new directors, seems necessary as the price of continued vigilance.

Meanwhile, one must conclude that the cases for and against UK executive pay packages remain unproven. Certainly, some evidence of sensitivity between total share return and executive rewards has been found, but this sensitivity only explains a small proportion of total pay variance. Recent innovations like LTIPs, designed to increase this sensitivity, do not seem to have made a spectacular improvement, and firm size remains a more significant influence on

executive pay, arguably supporting further tightening up of the regulation of executive pay in the UK, as reflected in the stricter 2003 Combined Code for Corporate Governance (Financial Reporting Council, 2003).

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# Compensation Committees and Executive Compensation: Evidence from Publicly Traded UK Firms

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## INTRODUCTION

The primary function of the compensation (or remuneration) committee is to determine the pay of the board of directors (Conyon, 1997). Academic evidence on the effectiveness of this key corporate committee is sparse. This is surprising given the voluminous academic literature that has been produced on the phenomenon of executive pay (Murphy, 1999).<sup>1</sup> Clearly, the institution of the compensation committee warrants further investigation.

The paucity of academic research on the compensation committee phenomenon, then, provides the main motivation for this chapter. Other reasons can also be articulated. First, shareholders are increasingly concerned about executive compensation. A recent and startling example is that of the pharmaceutical firm GlaxoSmithKline (GSK) which suffered an unparalleled defeat at its 2003 Annual General Meeting when the firm's shareholders voted against million pound pay packages for its executives.<sup>2</sup> At a minimum this raises questions about the effectiveness of GSK's compensation committee. Second, there are important legal dimensions to consider. Recent changes in UK corporate law significantly upgrade the information to be disclosed about UK director remuneration and the operation of the compensation committee (Directors' Remuneration Report Regulations, 2002).

We make the following contributions to the extant corporate governance literature. First, we document the structure and ubiquity of compensation committees in the population of UK publicly traded firms. Our data pertains to all publicly traded UK firms in fiscal year 2002 and

so represents the most comprehensive evaluation of the compensation committee phenomenon using British data so far. We show that most companies have remuneration committees, their size varies positively with market capitalization, and that few companies have insiders on these committees.

Second, we estimate econometric models of executive pay determination and test whether poorly constituted compensation committees result in agency costs. Our metric for poor compensation committee governance is insider membership of this committee. Our evidence, based on a panel data sample of about 500 publicly traded firms, indicates that executive compensation is higher when there is an insider (executive) present on the remuneration committee.

Finally, we contribute to the wider governance literature by evaluating prior academic research that has focused on compensation committees. Our general understanding of this literature is that self-interested behavior and higher pay outcomes are more likely in the presence of poorly governed compensation committees.

The rest of the chapter is organized as follows. The first section outlines our main hypothesis that significant agency costs arise in the presence of poorly governed compensation committees (e.g. insider membership but more generally undue insider influence). We predict that such arrangements lead to higher executive compensation, *ceteris paribus*. We also outline recent changes in UK company law that relate to the compensation committee report that is supplied to investors. The second section presents a review of existing empirical literature on compensation committees and executive compensation. It illustrates that agency costs arise in the absence of a properly constructed remuneration committee. The third section explains our governance and pay data and presents new results. In the final section, we present our summary and concluding remarks.

## COMPENSATION COMMITTEES AND EXECUTIVE PAY

Jensen (1993) states,

The board, at the apex of the internal control system, has the final responsibility for the functioning of the firm. Most importantly, it sets the rules of the game for the CEO. The job of the board is to hire, fire and compensate the CEO and to provide high level council.

In the United Kingdom and the United States the primary corporate institution responsible for the determination of executive and senior management compensation is the compensation committee (Canyon, 1997).<sup>3</sup> The compensation committee discharges the board of directors' responsibilities (delegated power and authority) relating to the determination of CEO and executive compensation.

Theoretically, the compensation committee is an institutional device to resolve the potential conflict of interest between insiders (executives) and the firm's owners. A general result from principal-agent theory, applied to the managerial labor market, is that a compensation contract can be designed to reduce executive malfeasance. These models characterize the optimal contract in terms of the relationship between incentives (the sharing rate), agent risk aversion, agent productivity, wealth volatility and the cost of agent effort (e.g. Milgrom and Roberts, 1990). However, these models rarely theorize the labor market institutions that determine the compensation contract.

The presence of an executive director on the compensation committee has a number of effects. Economic benefits may arise: first, the full-time executive director may have a more

complete and reliable information set than the part-time directors. Second, the inside director can act as an important source of council (or sounding board) when deciding on the appropriateness of pay levels and structures. However, economic costs may also arise. First, there is an incentive for the executive to claim that higher pay is warranted in instances when it is not. There is a conflict of interests since, *ceteris paribus*, the executive would prefer higher pay. Second, the executive's committee presence can yield misleading signals to the non-executive directors since they do not know the intention of any proffered advice. Third, the executive may generate influence costs in trying to persuade part-time non-executive directors to favor a particular pay package advantageous to the executive (e.g. by offering the gift of reappointment). Finally, the presence of an executive on the committee may dissuade assiduous monitoring by the outside directors if the outsiders suspect recrimination is possible (e.g. by firing them). Overall, our theoretical perspective is that the potential costs of executive presence on the compensation committee are dominant. There is a clear conflict of interests that can compromise committee independence. As Oliver Williamson (1985) once quipped, the absence of an independent compensation committee is akin to the CEO writing his pay check with one hand and signing it with the other!<sup>4</sup>

In our empirical work below we test the hypothesis that a poorly constituted compensation committee is positively correlated with favorable executive compensation outcomes. We construct three pay measures. The first is the log of executive compensation; the second is the value of options exercised; the final one is the fraction of executive compensation that is made up of a bonus. We will measure weak committee governance by the incidence of executive membership on the remuneration committee. The data is described in detail below.

## Regulatory and Legal Environment

Executive compensation in UK publicly traded firms is governed by the edicts of the Combined Code arising from the Hampel Committee (1998). The Combined Code is amended to, but does not form part of, the listing requirements of the London Stock Exchange. A company confirms that it complies with the provision of the Code, or where it does not provide an explanation.<sup>5</sup> Part B of the Code deals with 'Directors' Remuneration'. Section B.1 outlines the principle and provisions relating to the level and make-up of remuneration. Section B.2 outlines the principle and provisions relating to the procedures of directors' remuneration. Finally, section B.3 outlines the principle and provisions relating to the disclosure of directors' remuneration.

Section B.2 is most germane. The principle indicates that:

Companies should establish a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration.

The Code next outlines six provisions related to this principle. These can be summarized as follows. The board of directors should set up remuneration committees of independent non-executive directors to make recommendations to the board (B.2.1). Remuneration committees should consist exclusively of non-executive directors who are independent of management (B.2.2). The members of the committee are to be listed in the board's remuneration report (B.2.3). The board itself should usually determine the compensation of the non-executive directors (B.2.4). The remuneration committee should consult the chairman and/or CEO about their proposals relating to the remuneration of other executive directors. Also, they should



take professional advice inside or outside the firm as necessary (B.2.5). The chairman should ensure that the contact is maintained with shareholders about remuneration (B.2.6).

The set of procedures outlined in the Combined Code indicates that policy makers are mindful of the agency costs arising from executive influence over the compensation committee. It is worth also stressing that the legal environment governing UK executive compensation has recently changed. The Directors' Remuneration Report Regulations (2002) came into force on 1 August 2002 and amend existing legislation that regulates directors' remuneration.<sup>6</sup> The new law affects all quoted companies and must be adhered to for fiscal years ending 31 December 2002 onwards. This change is significant since executive remuneration disclosure and certain governance practices are now integrated into a body of company law, rather than a self-regulated stock exchange listing requirement.

The new regulations require quoted companies to provide significantly upgraded and detailed information on executive/director compensation than has hitherto been the case in company law. For instance, quoted companies are now required to provide details on emoluments, share option schemes, other equity incentives such as Long Term Incentive Plans (LTIPS), and pensions of each director separately. The new regulations amend the pre-existing Companies Act of 1985 by providing a new Schedule 7A.

The new disclosures also signal requirements for compensation committees. Part 2 of the new regulations, which are not subject to an external audit, explains matters of remuneration policy. A compensation committee is not mandated under the new regulations. However, if there is such a committee, constituted of the company's directors, then the directors' remuneration report shall

- (a) name each director who was a member of the committee at any time when the committee was considering any such matter; (b) name any person who provided to the committee advice, or services, that materially assisted the committee in their consideration of any such matter; (c) in the case of any person named under paragraph (b), who is not a director of the company, state (i) the nature of any other services that that person has provided to the company during the relevant financial year; and (ii) whether that person was appointed by the committee.

## **PRIOR LITERATURE**

Extant academic papers have centered their attention on the impact of the existence of a compensation committee in the boardroom on executive pay as a test of the effectiveness of the committee as a means of control.<sup>7</sup> Empirical results, however, have been mixed. While some papers have found that the existence of compensation committees affects the level and structure of the top director payment according to the interests of shareholders (e.g. Conyon and Peck, 1998), other papers have failed to do so (e.g. Daily *et al.*, 1998). On balance, our perspective is that insider-influenced compensation committees are prone to agency costs and yield outcomes divergent with shareholder interests.

Main and Johnston (1993) attempted to measure the extent to which the open and publicly disclosed existence of remuneration committees had spread to British boardrooms and to describe their composition and effects. The authors analyzed a sample of 220 companies.<sup>8</sup> The findings revealed that remuneration committees seemed to have established a place in company boardrooms since 30% of the 220 companies reported operating such a committee in 1990, large companies in terms of sales being more likely than smaller ones to have adopted this innovation. With respect to the composition of the remuneration committee the authors

found that for this sample, in one of five cases, there were two or more executives on the committee. In less than half of the cases was the remuneration committee made up entirely of just outsiders. More surprisingly, in two of five cases the highest paid director was a member of his own compensation committee.

In order to study the effect of remuneration committees on CEO pay the authors performed two cross-sectional regressions analyzing first the effect on the level of compensation of the highest paid director and then on the structure of it. The level of pay for the highest paid director was found to be higher in the presence of a remuneration committee by a statistically significant 21% although the size and significance declined when the ratio of non-executive to executive directors on the board was introduced. When the highest paid director was CEO and also chairman there was a 40% increase in his current emoluments. The authors analyzed the structure of the pay of the highest paid director in order to see whether the remuneration committee was tying compensation more closely to performance. The authors found that there was no significant positive effect that could be attributed to the declared existence of such a committee. Main and Johnston (1993) concluded that there was little empirical support for the view of the existence of the remuneration committee as an effective means of producing incentive effects in the benefit of shareholders.

Evidence contrasting with these results was found by Conyon (1997b). Conyon analyzed the impact of innovations in boardroom governance structures on top director compensation estimating a first-order difference top pay equation. Specifically, he studied the compensation impact of the adoption of a remuneration committee and of the separation of the role of CEO and chairman.<sup>9</sup> The sample used by Conyon (1997b) to estimate the model consisted of an unbalanced sample of 213 large UK quoted companies.

Considerable innovations in governance practices over the period 1988–93 were observed. Thirty-six percent of the sample of companies introduced a remuneration committee over the period and 24% of the companies separated the role of CEO and chairman. The model estimated the change in compensation of the highest paid director as a function of the lagged change in compensation (to allow for persistence), company performance, the introduction of corporate governance innovations, company size and relative performance evaluation term. Two models were estimated – one that entered current date returns and another that entered lagged returns. This was made because current top executive compensation and shareholder return might be jointly determined and using lagging returns would make the causality issue less ambiguous. Conyon found evidence in the sample that companies that have introduced remuneration committees between 1988 and 1993 had lower rates of growth in top director pay. However, these results were not robust and were sensitive to particular company inclusion. On the other hand, separating CEO and chairman had no effect on top director pay. Evidence was also found of significantly positive effects on directors' pay when current dated returns were entered into the equation but not when predated returns were used. An interesting result is that last period's compensation seems to be important in influencing current pay.<sup>10</sup>

Benito and Conyon (1999) assessed the effects of adoption of remuneration and nominating committees on pay as well as the effect of splitting the roles of CEO and chairman. The authors used a sample of 211 companies over the period of time 1984 and 1994.<sup>11</sup> The results indicated that remuneration committee adoption and the company previously separating the posts of CEO and chairman had no significant statistical impact on directors' compensation. The nomination committee variable also had an insignificant coefficient. Governance variables were not jointly significant either. The authors argued, though, that these results did not necessarily mean that reorganization of the boardroom governance had no real effect and gave three potential reasons

for that. The impact of governance variables may be contained in the firm fixed effects; focus had been only in one economic variable: the direct compensation of the highest paid director and the boardroom governance innovations of the 1990s have resulted in greater information becoming available to shareholders which has value itself. Little evidence was also found when estimating the model with interaction effects between performance and governance variables on top pay. When the return variable was dated contemporaneously the authors found some evidence for the performance effect being stronger in companies that have adopted a remuneration committee.<sup>12</sup>

In a more general framework, Conyon and Peck (1998) analyzed the role of the board and not just of the compensation committee, in determining top management pay. The authors assessed the empirical relation between boards of directors, remuneration committees and top management pay. They tested whether the proportion of outsiders on a board, the presence of a remuneration committee and the existence of CEO duality were determinants of top management compensation pay in the UK.<sup>13</sup> Almost all of the FTSE 100 companies had remuneration committees for the purpose of setting directors' compensation and the average proportion of outside directors in the committee was 0.89 suggesting an executive presence at some companies.<sup>14</sup>

The authors used panel data econometric methodology and estimated the log of compensation for a specific company in a specific time point as a function of the proportion of directors who were not executives on its main board, the existence of a remuneration committee, CEO duality and time dummies. The results indicated no evidence (for this sample) that compensation was negatively related with the proportion of outsiders in the board. Surprisingly and contrary to expected, the existence of a remuneration committee and of a higher proportion of outsiders on it were positively associated with management pay. CEO duality and the existence of a nominating committee played little role in shaping top management pay.<sup>15</sup>

Daily *et al.* (1998) focused on the composition of the compensation committees. They analyzed the impact of the structure of the compensation committee on the top management pay instead of the effect of the existence of the compensation committee, *per se*. Their interest was to investigate the extent to which board members subject to management influence may more directly align themselves with management as opposed to shareholders. The authors used a random sample of 200 publicly traded US companies from the 1992 Fortune 500. They were concerned with the effect that the structure of the compensation committee would have on the level of CEO compensation as well as on the structure of compensation. They differentiated among affiliated directors and interdependent directors. Affiliated directors included non-management directors who maintained some form of personal/professional relationship with the firm, subsidiaries or its management. Interdependent directors included only non-management directors who had been appointed during the tenure of a focal firm's incumbent CEO.

Executive compensation was measured in three different ways: non-contingent pay, contingent pay and total pay. The authors used a structural equation modeling procedure to assess the relationship between compensation committee composition and the change in CEO compensation during the three one-year intervals between 1991 and 1994 as well as absolute pay and pay ratio for 1992 through 1994. The results demonstrated that for this sample a higher proportion of affiliated and interdependent directors, as well as with more presence of CEOs in the compensation committee, did *not* result in higher levels of CEO compensation in subsequent years. These findings applied to non-contingent, contingent and total pay as well as to pay mix and the absolute level of and change in CEO compensation. The study could not conclude for the US, then, that the structure of the compensation committee has associated agency costs in terms of executive compensation.

Newman and Mozes (1999), too, studied the effects of the composition of the compensation committee. The authors were interested in studying whether the mix of insiders and outsiders affected the firm's decisions. Thus, the authors explored whether the insider/outsider composition of the compensation committee influenced CEO compensation practices.<sup>16</sup> The sample used for this study included Fortune 250 for the year 1992 sample of firms with a 31 December fiscal year-end and with an available firm proxy for 1992 and 1993. The companies should have a compensation committee and should not have had a CEO departure during 1992. The results supported the hypothesis that when insiders were on the compensation committee, CEO compensation practices were more favorable for the CEO at the expense of shareholders. In concrete they found no differences among the full sample of firms in the level of CEO compensation between firms whose compensation committees consisted of at least one insider-and one outsider-influenced firm. However, the results supported that the relation between CEO compensation and firm performance was more favorable toward CEOs of insider-influenced firms. Interestingly, the authors found no difference between the two sets of firms (insider- versus outsider-influenced firms) when performance was favorable but less weight was placed on unfavorable performance when insiders serve on the compensation committee. Moreover, when performance was unfavorable, CEOs of insider-influenced firms are partially compensated for declines in the value of their pre-existing options through additional stock-option grants.<sup>17</sup>

Canyon and He (2004) considered a three-tier hierarchy model that adds a third party (the supervisor) to the classical two-tier principal-agent model. In this model, the supervisor (compensation committee) is employed by the principal (shareholders) to help them to design an incentive scheme for the agent (managers). However, the effectiveness of the supervisor can be compromised if she and the agent collude by a side payment agreement between themselves, which reduces the wealth of the principal. Personal stakes of committee members in the transaction are thus key factors that influence their decisions. Thus, according to this model, the authors predicted that when committee members' interests are more closely aligned with shareholders, they will work to maximize shareholder values and to design the CEO contract for the benefits of shareholders. Elsewhere, they may collude with CEOs and provide CEOs with generous terms if they receive a side payment.

The authors addressed three types of hypotheses relating CEO compensation with committee members' interests, with compensation committee composition and with compensation committee composition diversity. In addition, they analyzed the determinants of compensation committee compensation. The sample used to estimate the model consisted of 455 firms that became an IPO in 1999.<sup>18</sup>

Two measures of CEO compensation – total compensation and pay for performance incentive (how well CEO interests are linked to shareholder value) – were used as the dependent variable. The results showed evidence that firms with significant shareholders sitting on boards were more likely to design a compensation contract with lower overall pay and higher incentive components.<sup>19</sup> Moreover, CEO pay and incentive level were highly correlated with committee members' payment. Committee members who were paid higher were more likely to offer the CEO a generous term characterized by higher overall pay and lower incentive components. The authors found no evidence in the sample showing that insiders or CEO members tended to offer generous terms to overpay CEOs or reduce their compensation risks by giving fewer equity incentives. Venture capitalists sitting on the compensation committee resulted in a lower equity incentive, while no significant impact on overall compensation level was observed. Finally, no evidence was found showing that compensation committee occupation diversity will influence CEO compensation. With respect to the compensation of the committee members, the

authors found that firms with significant shareholders sitting on the compensation committee tended to offer fewer fees to committee members. The higher percentage of venture capitalists serving on the compensation committee was associated with lower committee fees. However, no evidence was found between insider or CEO director percentage and committee member payments. Contrary to expectations, compensation committee occupation diversity was related with higher rather than lower committee member payments. Overall, the paper indicated that compensation committee members make decisions on the CEO and their own compensation based on their personal stakes involved in the firm rather than simply aligning with either shareholders or CEO interests as assumed in previous research.

A different focus appears in Newman (2000). Newman examined how the firms' ownership structure affected the decision to use insider directors on the compensation committee. The difference between this paper and the others reviewed is that this paper does not examine the impact of ownership structure on the outcome of the compensation decision-making process but on a characteristic of the decision-making process itself: whether there are insiders on the compensation committee or not.

Three aspects of ownership structure were examined: the percentage of the firm owned by the CEO, non-executive employees as a group and outside shareholders with the largest stockholdings. The composition of the compensation committee was measured by the percentage of compensation committee members who were outsiders using the same insider and outsider classification than in Newman and Mozes (1999). The sample used for estimation of the model was the same sample of 161 firms used in Newman and Mozes (1999). Using a cross-sectional regression analysis the author found that two of the three ownership structure variables were associated with the composition of the compensation committee. CEO stock ownership was positively associated with the proportion of insiders suggesting that significant CEO stockholdings provide the CEO with power over the board of directors to get insiders appointed to the compensation committee. On the other hand, stockholdings of non-executive directors as a group were negatively related with the presence of insiders on the compensation committee. The author suggested that the main underlying assumption under this result was that CEOs have incentives to build goodwill among non-executive employees with significant stockholdings and that these employees have a greater interest in monitoring actions associated with CEO compensation. A regression analysis of compensation on the percentage of equity attracted a statistically significant negative coefficient of equity of non-executive directors as a group suggesting that CEOs have lower compensation when non-executive directors have a significant ownership. Finally, there was no empirical evidence in the data of a negative relation between the largest stockholdings of an outside blockholder and the presence of insiders on the compensation committee. The author attached this lack of evidence to the possibility of the existence of alternative means of control over the CEO for this group. However, the results should be taken with caution since they were drawn from a cross-sectional analysis and problems of spurious correlation could be present.

## **NEW DATA AND RESULTS**

### **Data**

Our data was supplied by Hemmington Scott. They assemble information about all publicly traded firms on the London Stock Exchange. For the purposes of this chapter we have access to

the executive compensation and corporate governance data. The data is constructed from three separate files. The first file is the main data set which contains the population of UK publicly traded firms in 2002. The unit of observation is the firm. The information contained in this file includes market capitalization, sector information, market status, etc. The second file is the director appointment file and contains a cross-section of directors. The unit of observation is the individual director seat. The information contained in this file includes the type of director (i.e. executive or non-executive), committee membership, etc. The third file contains information on director remuneration. The unit of observation is a director at a company at a point in time. The file is longitudinal and contains a short time series on different aspects of remuneration for the directors (e.g. salary, bonus, etc.). The remuneration file is a more recent addition to the Hemmington Scott product portfolio. Because of this, and the fact that the data is collected manually by Hemmington Scott, the remuneration file is less comprehensively complete than the other files.

The sample selection procedure can be described as follows. Our version of the data set was created in March 2002. The population of UK publicly traded firms in the main data set was 2238. We excluded sectors which were described as investment trusts, asset managers, insurance companies, banks, etc. This resulted in 1475 firms. We then excluded 471 firms that were listed on the Alternative Investment Market (AIM). This resulted in 1004 firms. We included only UK enterprises resulting in 941 firms. Finally, we excluded companies who were not allocated to a major sub index leaving 912 firms. The director appointment data file originally contained 13,304 separate director seats including executive (inside) and non-executive (outside) directors. We merged the firms selected from the main file to the director appointment file. There were 93 firms with missing director appointment information. This resulted in 819 firms for which we had both the main and director appointment data. We then merged in the compensation data. There were 315 companies for which we did not have remuneration data. This left a final maximum sample size of 504 firms.

## Results

Table 7.1 contains the mean and median board of director characteristics for UK publicly quoted firms. The first row gives the number of firms. There are 819 firms of which 72 were in the FTSE 100 index, 167 in the FTSE Mid 250 index, 211 in the FTSE Small Cap and 369 in the FTSE Fledgling index.

The data indicate that average (median) board size is 7.43 (7) members. There is a strong size (market capitalization) effect. The average (median) board size in FTSE 100 companies is 11.1 (11) members and falls to 6.03 (6) members in the FTSE Fledgling index. Board size, then, increases with market capitalization. The same is true for remuneration committee size. The average (median) size of the committee is 2.8 (3) members. However, in the largest companies (FTSE 100) the average (median) is 3.8 (4) and falls to 2.37 (2) in the small companies (FTSE Fledgling). The number of insiders on the board of directors also increases with market capitalization. The average (median) for the whole sample is 3.7 (3) but in the FTSE 100 it is about 4.7 (5). The data implies that there is roughly a 50:50 split, then, in the composition of UK boards between insiders (executives) and outsiders (non-executive), given our results on aggregate board size.

The final substantive finding from Table 7.1 is that there is evidence of some presence of insiders on the remuneration committee. The average number of insiders overall is 0.13,

## Corporate Governance

**Table 7.1** Mean and median of board characteristics for the companies of the sample classified by their index

Variables	All	FTSE 100	FTSE Mid 250	FTSE Small Cap	FTSE Fledgling
Number of firms from the specified index	819	72	167	211	369
Average board size	7.432	11.055	9.084	7.341	6.030
Median board size	7	11	9	7	6
Average remuneration committee size	2.867	3.805	3.473	2.933	2.376
Median remuneration committee size	3	4	3	3	2
Average number of insiders on the board	3.673	4.653	4.425	3.668	3.146
Median board number of insiders	3	5	4	3	3
Average remuneration committee number of insiders	0.130	0.014	0.090	0.099	0.190
Median remuneration committee number of insiders	0	0	0	0	0
Proportion of insiders on the remuneration committee (average)	0.044	0.003	0.020	0.032	0.070
Proportion of insiders on the remuneration committee (median)	0	0	0	0	0

whereas the average percentage of the committee comprised of insiders is 4.4%. The median figure in both instances is zero. We notice, too, that insider presence, on either metric, decreases with firm size. Large firms are less likely to have insiders on their compensation committee. Conyon (1997a) finds that in his sample of 287 firms in 1995 almost 50% of the firms had an insider as a member of the compensation committee. Clearly, there has been a significant move towards reducing conflicts of interest. Comparisons along the size dimension are not available in the Conyon (1997a) study.

To probe this issue further we provide more details in Table 7.2, which contains information on the size of the compensation committee and the number of inside members. Table 7.2 indicates that the majority of firms have remuneration committees. Thirty firms from the 819 do not have a remuneration committee (measured by zero board members allocated to this function).<sup>20</sup> This figure, representing 3.66% of firms, can be compared with Conyon (1997a). He finds that 2.01% had not established a committee by 1995. However, his data is based upon the 1000 largest UK firms and would have excluded Fledgling enterprises. A more realistic comparison, then, is to exclude these firms. The data in Table 7.2 indicates that only 5 (or 0.61% of the total) do not have remuneration committees. Clearly, the overwhelming majority of established firms have compensation committees to set executive pay. The results show that the majority of committees have a membership of three or more. For instance in the FTSE 100 sample 61 from 72 have a committee of three or more members (i.e. 85%). In the FTSE 250 sample 144 from 167 have a committee of three or more members (i.e. 86%).

Table 7.2 shows that the overwhelming majority of firms – about 90% – have no insider presence (732 from 819 firms). The non-presence of insiders is proportional to firm size. In the FTSE 100 71 firms from 72 (99%) do not have insiders on the committee. Of the FTSE 250 158 from 167 (95%) have no insiders. In the FTSE Fledgling firms 308 (or 83%) have no insider presence. We conclude that insider presence is much more likely in smaller companies.

## Compensation Committees and Executive Compensation

**Table 7.2** *The size and number of insiders on the remuneration committee by FTSE sub index*

Size of company remuneration committee	Total number of firms	FTSE 100 firms	FTSE Mid 250 firms	FTSE Small Cap firms	FTSE Fledgling firms
No remuneration committee (=0)	30	1	1	3	25
Committee size = 1	44	3	3	6	32
Committee size = 2	218	7	19	53	139
Committee size = 3	328	22	75	102	129
Large remuneration committee(>3)	199	39	69	44	47
<b>Total number of firms</b>	<b>819</b>	<b>72</b>	<b>167</b>	<b>211</b>	<b>369</b>
<b>Number of insiders on the remuneration committee</b>					
No insiders (=0)	732	71	158	195	308
Insiders = 1	73	1	6	13	53
Insiders = 2	10	0	1	2	7
Many insiders (>2)	4	0	2	1	1
<b>Total number of firms</b>	<b>819</b>	<b>72</b>	<b>167</b>	<b>211</b>	<b>369</b>

## Regressions

Table 7.3 contains descriptive statistics on the key variables for the sample of companies in the FTSE 100 and FTSE Mid 250 index. Our regression results are contained in Tables 7.4 and 7.5. Our maintained hypothesis is that insider-influenced compensation committees are more likely to result in compensation arrangements favoring executives. To measure this influence we

**Table 7.3** *Summary statistics on key variables for the sample of companies FTSE 100 and FTSE Mid 250*

Variable	Mean	Standard Deviation
Log (market capital)	7.278	1.232
Board size	10.326	2.765
Remuneration committee size	3.545	1.240
Insiders on remuneration committee	0.071	0.400
Insider-dominated remuneration committee	0.044	0.206
Log (total compensation)	12.591	0.739
Log (1 + options exercised in the year)	0.686	2.760
Log (1 + (bonus/salary + bonus + other))	0.200	0.151
CEO	0.224	0.417

- (1) Board size: Sum of the number of directors (executive and non-executive) on the board.
- (2) Remuneration committee size: Number of directors (executive and non-executive) on the remuneration committee.
- (3) Insiders on remuneration committee: Number of executive directors on the remuneration committee.
- (4) Insider-dominated remuneration committee: Dummy variable = 1 if the remuneration committee has at least one executive director.
- (5) Total compensation: Defined as the direct compensation (salary, bonus and other type of compensation but excluding the value of exercised stock options) received by the director.
- (6) Options exercised during the year. Market value of exercised options.
- (7) CEO: Dummy variable = 1 if the director is also a CEO.



**Table 7.4** Results of regression analysis for management compensation for the sample of companies on FTSE 100 and FTSE Mid 250

Variable	Log (total executive compensation)		Log (1 + options)		Log (1 + bonus/total pay)	
	(1)	(2)	(3)	(4)	(5)	(6)
<b>Agency cost variables</b>						
Number of insiders on remuneration committee	0.163** (0.064)		0.439* (0.230)		0.014 (0.012)	
Any insider on (i.e. dominated) remuneration committee		0.241* (0.128)		0.677 (0.461)		-0.009 (0.024)
<b>Control variables</b>						
CEO	0.527** (0.056)	0.526** (0.057)	0.159 (0.203)	0.154 (0.203)	0.008 (0.011)	0.007 (0.011)
Board size	0.007 (0.010)	0.004 (0.010)	0.052 (0.038)	0.045 (0.037)	0.011** (0.002)	0.010** (0.002)
Size of remuneration committee	-0.030 (0.022)	-0.023 (0.021)	0.002 (0.078)	0.019 (0.077)	-0.001 (0.004)	0.001 (0.004)
Log (market capital)	0.234** (0.025)	0.232** (0.025)	0.200** (0.091)	0.195** (0.091)	0.003 (0.005)	0.003 (0.005)
Industry dummies	Yes	Yes	Yes	Yes	Yes	Yes
Time dummies	Yes	Yes	Yes	Yes	Yes	Yes
Number of groups (executive directors)	623	623	623	623	623	623
Observations	1536	1536	1536	1536	1536	1536

Notes: (1) Asymptotic standard errors are in parentheses (2) Models estimated by panel data Random Effects specification. (3) \*\* Significant at the 5% level; \* Significant at the 10% level.

define two variables. The first is the number of insiders on the compensation committee (which has a mean of 0.071 – table 7.3). The other is the insider-dominated remuneration committee which is an indicator variable = 1 if there is at least one insider on the compensation committee and zero otherwise (which has a mean of 0.044 – table 7.3). These metrics are consistent with the prior literature (Newman, 2000; Newman and Mozes, 1999).

We construct three different measures of executive pay. The first is simply the log (total executive compensation) where executive compensation is the sum of salary, bonus and other cash emoluments for each director.<sup>21</sup> The second measure is the log (1 + options) where options are the market value of exercised options. The third measure is the log (1 + (bonus/total executive compensation)), which represents the fraction of executive compensation made up of bonus. These three measures of pay are constructed in order to test the effect of an insider-influenced remuneration committee on level of pay as well as on structure of pay. This is consistent with prior literature (Daily *et al.*, 1998; Main and Johnston, 1993). If insider-influenced compensation committees result in higher agency costs then we should expect a positive correlation between the metrics of insider-influenced compensation committees and executive pay.

Table 7.4 contains our main results.<sup>22, 23</sup> The sample of companies analyzed consists of companies listed on the FTSE 100 and FTSE Mid 250 indexes. We choose to analyze these companies because these are big companies characterized by diffuse-ownership separate control. The effect of the presence of insiders in the remuneration committees may be different for

## Compensation Committees and Executive Compensation

**Table 7.5** Results of regression analysis for management compensation for the sample of companies on FTSE 100, FTSE Mid 250 and FTSE Small Cap

Variable	Log (total executive compensation)		Log (1 + options)		Log (1 + bonus/total pay)	
	(1)	(2)	(3)	(4)	(5)	(6)
<b>Agency cost variables</b>						
Number of insiders on remuneration committee	0.097** (0.048)		0.224 (0.146)		0.019** (0.009)	
Any insider on (i.e. dominated) remuneration committee		0.148 (0.093)		0.254 (0.285)		0.011 (0.018)
<b>Control variables</b>						
CEO	0.525** (0.047)	0.523** (0.047)	0.039 (0.143)	0.034 (0.143)	0.016* (0.009)	0.016* (0.009)
Board size	0.013 (0.010)	0.011 (0.010)	0.022 (0.029)	0.018 (0.029)	0.009** (0.002)	0.008** (0.002)
Size of remuneration committee	-0.011 (0.018)	-0.005 (0.018)	-0.060 (0.056)	-0.044 (0.054)	-0.003 (0.003)	-0.001 (0.003)
Log (market capital)	0.235** (0.016)	0.235** (0.017)	0.205** (0.050)	0.204** (0.050)	0.013** (0.003)	0.013** (0.003)
Industry dummies	Yes	Yes	Yes	Yes	Yes	Yes
Time dummies	Yes	Yes	Yes	Yes	Yes	Yes
Number of groups (executive directors)	996	996	996	996	996	996
Observations	2257	2257	2257	2257	2257	2257

Notes: (1) Asymptotic standard errors are in parentheses (2) Models estimated by panel data Random Effects specification. (3) \*\* Significant at the 5% level; \* Significant at the 10% level.

these companies than for smaller companies with different ownership structure characteristics and very likely with different governance problems. For example, smaller companies are likely to have their own founders in their committees.

Columns 1 and 2 focus on the log (total executive compensation) measure. We introduce controls that prior research has argued affects the pay of the director (see Conyon, 1997, Murphy, 1999). In particular, we control for market capital value, industry sector, board size, compensation committee size, CEO job position (whether the director is a CEO) and time effects. After controlling for these variables we find that insider influenced compensation committees are associated with higher executive compensation. This is valid for either measure of insider-influence of the compensation committee. Columns 3 and 4 model the log (1 + options) and find that there is a significantly positive correlation in the case of the number of insiders on the committee (column 3) but not for the presence of at least one insider (column 4). Columns 5 and 6 model the log (1 + (bonus/compensation)). The results indicate that there is no relationship between this pay variable and insider-influenced compensation committees. In this sample, then, insider-dominated committees do not seem to influence the structure of the compensation awarded to the director but seem to affect the level of compensation.

To check the robustness of our results we expand the sample of companies to include those firms in the FTSE Small Cap. These are firms too small to appear on the FTSE All Share index and may have different ownership and business characteristics to the 'diffuse

ownership – separate control’ firms listed on the main indexes. The results are contained in Table 7.5. We only find a significant positive correlation between the number of insiders and the log (total executive compensation) and log (1 + bonus). In general we find less evidence for a higher pay to directors when including also smaller companies into the sample. A potential explanation for this finding is that the presence of insiders in remuneration committees for smaller companies may reflect other factors than just weak corporate governance.

## **DISCUSSION AND CONCLUSIONS**

This chapter has examined the relation between compensation committees and executive compensation. We have contributed to the corporate governance literature in three distinct ways. First, we have documented the prevalence of compensation committees in the population of UK publicly traded firms. Our data set relates to all publicly traded UK firms in fiscal year 2002. In consequence, it is ideally suited to examine the compensation committee phenomenon. We show that most companies have remuneration committees, their size varies positively with market capitalization, and that only a few companies have insiders on these committees. Our results have updated those contained in Conyon (1997a, b) which showed the trend towards companies adopting such committees during the early 1990s.

Second, we have provided further econometric evidence on the relationship between executive compensation and compensation committee structure. The econometric evidence suggests tentative and qualified support for the proposition that insider-influenced compensation committees result in favorable pay outcomes for executives. We find evidence that the level of executive compensation is higher in companies where executives are present on the compensation committee. However, there was also evidence that this result may be sensitive to sampling. Adding smaller (FTSE Small Cap) companies caused loss of significance of some results. At a minimum the results suggest the need for further investigation.

Finally, we contribute to the wider governance literature by evaluating prior academic research that has focused on compensation committees. Our general understanding of this literature is that self-interested behavior and pay outcomes are more likely in the presence of poorly governed compensation committees. However, the empirical evidence does not point unambiguously in one direction. Some studies have failed to find evidence of higher agency problems in the presence of insiders in the remuneration committee. Identifying when these problems are more likely to happen should be considered by further research. For instance one potentially important avenue for research would be the role of the compensation advisor to the compensation committee. Anecdotal evidence suggests that such compensation consultants are used widely and so investigating their influence may further help our understanding of executive pay and corporate governance.

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## NOTES

1. Since 1990 there have been in excess of 300 articles published on executive compensation (source ISI Web of Science, May 2003). Our literature review found less than 10 published articles whose main focus was the compensation committee.
2. The BBC reports that “GSK had called in City accountants Deloitte & Touche to review its pay policies after a majority of shareholders voted against its executive pay packages. It was the first time that shareholders had voted down pay proposals at a British company.” By all accounts other leading UK firms (such as Tesco, Barclays Bank, Shell and Sun Alliance) have also been subject to significant shareholder dissent. Source: <http://news.bbc.co.uk/2/hi/business/3045143.stm>
3. The term ‘compensation committee’ is the vernacular used in the United States whereas in the United Kingdom it is more commonly referred to as the ‘remuneration committee’. The nomenclature can be used interchangeably.
4. Reda (2002) has produced a handbook for compensation committees. It provides practical advice on the compensation committee’s role and responsibilities. It describes best practices, fundamental operational procedures, including self-assessment. All important issues are covered such as: ideas on forming a compensation committee, how to select and train members, and meeting frequency and conduct.
5. In practice most companies observe the Combined Code since otherwise the firm bears additional costs trying to assuage investor fears about governance practices. The Hampel Committee drew together thinking about ‘best practice’ in corporate governance at the end of the 1990s. It can be viewed as a consolidation of the ideas contained in the Cadbury Committee (1992) report and the Greenbury Committee (1995) deliberations on executive compensation.
6. <http://www.legislation.hmso.gov.uk/stat.htm> Search in the calendar year section 2002. Then find statutory instrument SI1986. Current web address: <http://www.legislation.hmso.gov.uk/si/si2002/20021986.htm>
7. There is a very large literature evaluating the general effectiveness of the board of directors. Hermalin and Weisbach (2003) review the economic evidence in this area. Since much of this literature is concerned with the impact of the proportion of outsiders on the board, or the size of the board, it is not within the scope of our review. We refer interested readers to the Hermalin and Weisbach article and their earlier theoretical work (Hermalin and Weisbach, 1998). We concentrate on those papers directly addressing the compensation committee. Much of this evidence is confined to the last 10 years.
8. These were selected from two separate overlapping samples, the top 500 companies as ranked from ELC International Britain’s 1000 Largest Companies in 1991 and the top 500 companies in the Charterhouse Top Management Remuneration Sample for the years 1989 and 1990. They required also that these companies were listed in the London Stock Exchange and were available in Datastream.
9. The first difference econometric specifications controls for unobserved time invariant factors that could be shaping top director pay and so, with this empirical strategy, it is possible to overcome the potential problem of omitting firm fixed effects.
10. The author estimated also the model with an interaction effect between performance and innovation of corporate governance to analyze whether there was a greater link to performance with innovations in corporate governance adopted. However, he could not find evidence in the sample for a significant effect of these innovations on the sharpening pay for performance link.
11. The data for this study came from three different sources, Hemmington Scott corporate information database, Datastream bank of company accounts and a proprietary survey of UK companies conducted during the period November 1994–March 1995.
12. The authors estimated a panel data model where the dependent variable was salary in logarithmic terms of the highest paid director and where the independent variables were shareholder returns,

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relative performance evaluation, total company sales and dummy variables for the existence of remuneration committee, nomination committee and for the separation of the role of the CEO and chairman respectively.

13. Using data from the UK Financial Times top 100 companies by market value they selected a sample of companies for which they had suitable compensation, performance, size and governance data for the four-year period 1991–94. Data on highest paid director compensation, company employment and ownership was obtained from Hemmington Scott Publishing Limited. The final sample contained 94 companies.
14. The authors also observed that the proportion of non-executive directors on main boards increased over the period of study and that the number of companies with combined posts of CEO and chairperson declined.
15. Finally, the authors tested whether the link between top management pay and corporate performance was stronger in companies where outsiders dominated the main board and where the proportion of outsiders on remuneration committees was large. They estimated separately pay for performance models for subsamples in which the proportion of outsiders was big versus those in which it was small and found a large and significant coefficient of the shareholder return for the sample with high a proportion of outsiders. Therefore, an important result of this paper is that top management pay and corporate performance may be more aligned in companies with outsider-dominated boards and remuneration committees.
16. An interesting aspect of this paper is that the authors create a definition of insider. They consider that any member who is likely to be positively biased in determining CEO compensation should be considered as an insider. Therefore they consider that an insider can be an employee of firm A, a former employee of firm A, an employee of firm B when B has business dealings with firm A or when the CEO of firm A is on the board of directors of firm B, or a former employee of firm B when the CEO of A is on the board of directors of B. An insider-influenced firm is a firm whose compensation committee has at least one insider.
17. Newman and Mozes (1999) concluded that the composition of the compensation committee influences CEO compensation practices and hence the value of the firm and gave some suggestions for public policy. The SEC could require a shareholder vote on compensation committee membership. However, since management proxy-statement proposals are almost always passed, the shareholder vote might not be an effective solution. An alternative could be to enact laws in order to prohibit insiders from serving on compensation committees. The main problem associated with this alternative is that sometimes insiders are necessary. Finally the authors suggested an increased disclosure of compensation committee appointments as a more appropriate policy initiative.
18. Data was extracted from Thomson Financials' SDC database. After excluding closed-end funds, limited partnerships, American Depositary Receipts and foreign firms that do not file online reports to the SEC the authors came up with a sample of 455 firms. For each of these companies the authors created a panel of financial, CEO compensation, board and compensation committee data which covers the year before IPO (1998) and all subsequent years (either to year 2001 or firm death) and lead to a sample size of 1605 firm year observations.
19. The authors estimated the dependent variable as a function of: the presence of significant shareholders in the committee, the compensation committee composition measured in percentage terms relative to the compensation committee size (insiders, venture capitalists, CEO directors), the committee member occupation diversity controlling for CEO characteristic variables, general board information and economic variables. The authors used OLS with robust standard errors to estimate the model and they estimated also a fixed effect model as robustness tests (to reduce the problem of omitted variables).
20. Surprisingly, there is one company in the FTSE 100 which does not have a remuneration committee (as measured by the number of members aggregated from individual director data). This is Wm Morrison Supermarkets PLC. This company is idiosyncratic also in that it does not have any outside directors.

21. The measure excludes the value of options granted in the fiscal year. It also does not include the value of options exercised. Currently in the UK it is tremendously difficult to get information on the expected value of options granted to executives. As indicated in Conyon and Murphy (2000) the data collection is highly labor intensive. One potential defense for excluding option grants is that they are less prevalent in the total compensation package compared with US firms. Our results should be interpreted with this caveat in mind.
22. We use a random effects panel data estimator – the equation errors are permitted to be correlated across time. The fixed effects estimator is precluded since we do not have time series data on the remuneration committee agency cost variables. We have time series data on executive ‘i’ in company ‘j’ at time period ‘t’. We can choose to cluster either the director ‘i’ group or the company ‘j’ group – but not both. We report group effects based on the director ‘i’ since we want to control for unobserved pay setting strategies within the enterprise that may be correlated with our remuneration committee variables. It turns out that our results are not sensitive to choosing company ‘j’ as the group effect.
23. An important assumption when estimating the model is that the errors are uncorrelated with the regressors. In order to be able to estimate this model we need to assume that directors are randomly selected by companies. In other words, there are no sorting problems on the sample. If this is not the case (that is, if certain individuals choose to go to certain companies or companies select certain individuals), then our estimated coefficients would be confounded by individual unobservable effects. We should then bare this assumption in mind when interpreting our results.

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# The Governance Role of Takeovers

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## INTRODUCTION

Even though agency theory emphasises the contractual nature of firms and the potential for a variety of internal governance mechanisms to reconcile the interests of shareholders and managers in public companies, it also recognises that in some instances internal governance may not adequately monitor the behaviour of managers. Consequently, it is often suggested that takeovers represent an important external governance mechanism whereby shareholders can replace underperforming or opportunistic managers. The launch of a hostile takeover bid, for example, is generally perceived as a signal by the bidder that the target's assets are not being maximised for the benefit of shareholders. Indeed, Jensen (1986) suggests that takeovers play an important role in protecting shareholders when the company's internal controls are ineffective. This governance role of takeovers is grounded in Manne's (1965) argument that the stock market represents an objective evaluation of managerial performance. When the opportunity to create new value via the redeployment of assets or the displacement of existing managers becomes apparent, the company becomes an attractive target in the market for corporate control.

Over the past three decades a significant amount of academic attention has examined the governance role of takeovers. Throughout this period the takeover environment has not been static and most commentators identify a series of 'takeover waves' each with its own characteristics and motivations (Andrade *et al.*, 2001; Holmstrom and Kaplan, 2001; Jarrell *et al.*, 1988; Shleifer and Vishny, 1991). The past decade has seen a renewed desire on the part of corporate policymakers to improve companies' governance structures, focusing specifically on seeking to ensure that management behaviour is sensitive to the interests of shareholders (e.g. Cadbury, 1992; Hampel, 1998; and Higgs, 2003; in the UK and similar committees in other countries). Even though takeovers occur for a variety of reasons, not least synergistic, researchers continue to investigate the precise role of takeovers in the governance environment of firms. The purpose of this chapter is to present a comprehensive review of research in the area.



If takeovers are seen as an important mechanism in reconciling the interests of shareholders and managers it might be expected that takeover targets exhibit weaker pre-bid performance compared to non-targets. This issue has attracted a significant amount of research, using a variety of performance measures. The first section reviews the main findings of this work. Once a takeover bid is launched there is no guarantee it will be successful. Takeover bids fail for a variety of reasons including, *inter alia*, successful defence by target management, intervention by the regulatory authorities, voluntary withdrawal on the bidder's part or rejection of the bid by target shareholders. From a governance perspective, the decision of target companies to resist certain takeovers is especially interesting as it provides an opportunity to try to understand whether such resistance is motivated by a desire to maximise shareholder wealth or to protect incumbent managers from market discipline. The second section explains the regulatory environment in which takeovers occur and reviews research on the influence of internal governance characteristics on the likelihood and impact of bid resistance. The third section looks at the *ex post* impact of takeovers. It reviews empirical evidence on the wealth effects of takeovers for both target and bidder shareholders. It also looks at more recent evidence on the real effects of merger activity, especially the impact of takeovers on productivity, employment and wages. Central to the governance role of takeovers is the desire to ensure company assets are utilised for the benefit of shareholders. This expectation focuses attention on the possible replacement of inefficient managers subsequent to takeover. A number of studies have examined the post-bid turnover of senior managers and this work is reviewed in the fourth section. Even though the vast majority of takeover research focuses on completed takeovers, a number of researchers have argued that takeovers do not have to be successful to have a governance impact (Chiplin and Wright, 1987; Wong and O'Sullivan, 2001). The fifth section examines the post-bid performance of targets of unsuccessful bids as well as investigating the extent to which failed bids result in changes in the governance characteristics of targets (including management turnover). The final section summarises the main findings of each of the areas reviewed.

## TAKEOVERS AND COMPANY PERFORMANCE

Central to the governance role of takeovers is a belief that takeovers seek to correct for inadequate company performance and occur primarily to reconcile the interests of shareholders and managers by improving the performance of target companies. In seeking to understand company performance surrounding takeover activity two distinct approaches have been employed in the literature. One approach argues that the appropriate measure of performance should reflect changes in shareholder wealth. Supporters of this view argue that shareholders 'are the ultimate holders of the rights to organisational control and therefore must be the focal point of any discussions concerning it' (Jensen, 1984). This view of performance suggests that the appropriate measure is obtained from an analysis of stock market data, measuring the economic impact of takeovers by focusing on abnormal share price movements at specific points (dates) during the takeover process. This procedure is commonly referred to as 'event studies' due to the importance of specific dates (e.g. announcement date, outcome date etc.) in each takeover bid.

Other researchers argue that alterations in a company's share price merely reflect shareholders' expectations and these expectations can be compromised by an asymmetry of information between managers and company outsiders (Morck *et al.*, 1989; Porter, 1987). Furthermore, it is

often suggested that share price movements surrounding takeover activity merely reflect shareholders' anticipation of wealth transfers from existing bondholders or wealth benefits arising from taxation readjustments and thereby serve as an inappropriate measure of improvement in corporate efficiency (Shleifer and Vishny, 1988). An alternative method of measuring performance surrounding takeover activity is the use of accounting information. This approach uses traditional historic accounting measures such as returns on sales, assets, and capital employed as well as profitability and sales growth measures. The following summarises separately the principal findings of market and accounting-based studies on the pre-bid performance of takeover targets.

If the principal motive for takeovers is to correct for managerial failure, the pre-bid share price performance of targets is expected to be significantly negative before the bid announcement. In a recent review of over three decades of event study evidence, Agrawal and Jaffe (2003) conclude that there is no consistent evidence of target underperformance prior to takeover. With the exception of some very early studies by Smiley (1976) and Asquith (1983) in the US and Firth (1979, 1980) in the UK, the majority of studies fail to identify target performance that is significantly different from a variety of market-related performance benchmarks. A possible explanation for the lack of evidence of target underperformance might be that all takeovers are unlikely to be motivated by governance objectives. In order to get a better insight on this issue, more recent studies have sought to focus specifically on takeovers that might be undertaken for governance reasons. This has resulted in a number of studies examining the pre-bid performance of hostile takeovers and tender offers. In the US, Martin and McConnell (1991) and Kini *et al.* (1995) fail to identify weak pre-bid performance by samples of tender offers. Agrawal and Jaffe (2003) find some evidence of underperformance by targets of hostile bids and tender offers five or more years prior to the bid but argue that the length of time between this weak performance and the subsequent takeover was too long to be consistent with such takeovers performing a governance role.

In the UK, Franks and Mayer (1996) find no evidence of abnormal performance in the five years prior to hostile takeover bids while O'Sullivan and Wong (1999) fail to identify abnormal returns over the three previous years influencing the likelihood of a hostile bid. It should be noted, though, that Kennedy and Limmack (1996) report lower abnormal returns to targets of disciplinary bids compared to targets of non-disciplinary bids. In the Kennedy and Limmack (1996) study, bids were deemed disciplinary if the CEO of the target was replaced within two years of the acquisition, rather than the reaction of target management at the time of the bid. In the US, Martin and McConnell (1991) also report significantly weaker pre-takeover returns in the case of targets where managers are replaced after the bid while Kini *et al.* (1995, 2004) also report a significant negative relationship between pre-bid performance and the likelihood of top management turnover.

The mixed and inconclusive findings from event studies regarding the link between pre-acquisition performance and takeovers is mirrored in respect of accounting studies. Support for the notion that takeovers are associated with weak performance has been provided by a number of early studies. For example, Shrieves and Stevens (1979) found that takeover targets showed stronger symptoms of bankruptcy (using Altman's (1968) model of bankruptcy prediction) than a control group of non-targets; Hasbrouck (1985) finds acquired firms possessing significantly lower Tobin's Q compared to a matched sample of non-acquired firms; Malatesta and Walkling (1988) find companies adopting poison pill defences exhibited significantly lower profit margins, return on capital and return on net worth than their industry counterparts over the three years prior to the bid announcement. However, studies by Boyle (1970), Mueller

(1980), Harris *et al.* (1982) and Herman and Lowenstein (1988) find targets exhibiting greater return on assets than non-target firms. UK evidence is similarly mixed with studies by Kuehn (1975) and Cosh *et al.* (1980) suggesting that targets may display inferior performance; Meeks (1977) suggesting targets perform better; and Levine and Aaronovitch (1981) failing to find any distinguishing performance differences.

In the belief that distinguishing takeover bids on the basis of management's reaction may provide a richer insight on the governance role of takeovers, a number of studies both in the US and UK have incorporated the mood of the bid in their analysis of pre-bid accounting performance. Morck *et al.* (1988) find that the likelihood of a firm being a hostile takeover target is negatively related to the Q ratio of the firm's industry but not to the firm's Q ratio relative to that of the industry. No such relationship was identified for non-hostile acquisitions. On the other hand, Lang *et al.* (1989) find no significant difference in the average Q ratios of hostile as opposed to friendly targets for the year preceding the bid while Song and Walkling (1993) fail to report a significant link between takeover likelihood and either ROE or market-to-book values, whether the bid is contested or not. In the UK, Powell (1997) finds that the likelihood of hostile takeover is negatively related to accounting returns in the period 1984–91, with the relationship being particularly important in the 1988–91 period. However, both Franks and Mayer (1996) and O'Sullivan and Wong (1999) fail to identify any significant differences in the accounting performance of hostile targets compared to matched samples of non-targets.

Overall, the evidence reviewed here does not provide consistent support for the notion that takeover targets exhibit inferior pre-bid performance compared to non-targets. Furthermore, when takeover targets are categorised between hostile (often seen in the literature as representing examples of market discipline) and friendly, no consistent performance differences are identified. On the face of it, the absence of convincing pre-bid underperformance using both market- and accounting-based studies points to takeovers having a weak governance role. However, recent research identifying higher rates of CEO turnover in takeover targets showing weak pre-bid performance provides some support for takeovers having a governance role. This research also raises some important issues regarding the categorisation of hostility (Schwert, 2000). It should be noted that the vast majority of studies examining pre-bid performance focus on completed bids. However, a significant number of takeover bids are unsuccessful and many due to the inability of bidders to overcome managerial resistance. The next section focuses on this issue, especially trying to understand why target companies react negatively to some bids and positively to others. Furthermore, the section on the consequences of takeover failure, below, examines the governance role of failed bids, specifically investigating whether targets that maintain their independence improve their performance and/or undertake shareholder-oriented restructuring.

## THE LIKELIHOOD OF TAKEOVER SUCCESS

Once a takeover bid is launched there is no guarantee it will be successfully completed. In the UK, for example, O'Sullivan and Wong (1998a) estimate that 18.7% of takeover bids made between 1989 and 1995 were ultimately abandoned while in a study of takeover activity in the 1980s Holl and Kyriazis (1996) find that 25.2% of their sample of takeover bids were unsuccessful. Takeover attempts may fail for a variety of reasons including, *inter alia*, successful defence by the target company, intervention by the regulatory authorities, rejection of the bid

by target shareholders, or voluntary withdrawal on the bidder's part. Once a bid is launched, the target company has to decide how to respond. In the case of agreed (or friendly) bids this is rarely an issue as both the target and bidder are likely to have agreed on the terms before the bid is announced and both parties will encourage target shareholders to accept the takeover. In the case of contested (or hostile) bids, however, resistance will involve the target pursuing some sort of defensive strategy either to ultimately defeat the bid or extract a higher price before eventually agreeing to the takeover. O'Sullivan and Wong (1998a) report that 26% of takeover bids launched in the period 1989–95 were resisted while Jenkinson and Meyer (1991) report a similar level of resistance for the period 1984–89. A number of researchers have investigated the impact of target resistance on bid outcome. O'Sullivan and Wong (1998b) report that 47% of bids resisted by the target's management in the period 1989–93 were subsequently abandoned while only 6% of agreed bids were unsuccessful. For the period 1980–89, Holl and Kyriazis (1996) estimate that the probability of a friendly bid succeeding was 0.958 compared to a probability of 0.609 for contested bids. Uncontested bids fail for a number of reasons including, *inter alia*, referrals to the Competition Commission on anti-trust grounds, disagreements about post-bid governance arrangements and target shareholder opposition.

It is clear, therefore, that the reaction of the target company is an important influence on the success of takeover bids. The significant likelihood of target resistance and the associated increased probability of bid failure focuses attention on two key issues in the takeover process. First, it is necessary to examine how target companies can seek to defend themselves against an unwanted bid. This focuses attention on the regulatory environment in which takeovers occur and the extent to which targets are free to use defensive mechanisms to fight off an unwanted approach. Second, it is important to try to understand why some bids are resisted and others are welcomed. Target resistance has been interpreted in two opposing ways in the literature; it may suggest either manager–shareholder alignment or management entrenchment. In the former case, management acts in the interests of target shareholders and opposes a bid in order to maximise shareholder welfare during the takeover process. In the latter case, target management acts to prevent the takeover bid from succeeding, for their own interests, even though it may be in the interests of the company's shareholders. A significant amount of research has focused on the potential for conflict between managers and shareholders surrounding takeover contests and the second part of this section reviews this literature in an attempt to identify whose interests are being served during takeover contests.

## Takeover Regulation and Target Resistance

From the target company's point of view, once it chooses to resist a takeover bid, it needs to consider the defensive strategy it wishes to pursue. The regulatory environment will heavily influence the strategy chosen. Almost all countries have some level of takeover regulation in place but the details vary considerably between countries (see Berglof and Burkart (2003) for a review of takeover regulation in Europe and the US). For example, even though the UK and the US possess broadly similar corporate ownership characteristics, the regulation of takeover activity differs considerably between the two countries. Takeovers in the UK are governed by *The City Code on Takeovers and Mergers*. The purpose of the code is to ensure fair and equal treatment of all shareholders involved with corporate takeovers and to provide an orderly framework within which takeovers are conducted. A key element of the code is to

ensure target shareholders make the final decision concerning a bid and that this decision is based on the provision of up-to-date information that must be available to all shareholders. An important consequence of this is that UK companies are relatively restricted in what they can do to defend themselves against unwanted bids. In particular, UK companies are not permitted to employ pre-bid takeover defences and once a bid is launched, shareholder approval is required for almost all defensive measures pursued. In the US, however, defensive tactics are within the business discretion of the board of directors and are widely used. For example, as noted by North (2001), many US companies have adopted anti-takeover provisions including: (a) supermajority provisions, (b) fair price provisions, (c) staggered elections for directors, (d) blank cheque preferred provisions, (e) restrictions on special meetings, (f) elimination of cumulative voting, and (g) poison pill plans. North (2001) also notes that a number of states have passed anti-takeover legislation and there is an increased willingness of the courts to apply the 'business judgement rule' which gives boards substantial freedom in responding to unwanted bids.

Despite the restrictions imposed by the *City Code*, UK companies are not powerless or unwilling to resist unwelcome bids. Sudarsanam (1995) discusses the main defences available to UK companies and the frequency of their use in the period 1983–89. The two most popular defensive tactics were profit reports (59%) and promises of increased dividends (45%). Profit reports/forecasts are popular in the UK as it is one of the few defence options where shareholder approval is not required. The underlying logic appears to be that such disclosures provide existing management with the opportunity to release new information on the company's prospects and consequently reduce any perceived mis-pricing of the company by the market. However, the available evidence suggests that the issuing of such forecasts has no significant impact on the eventual outcome of the bid (Brennan, 1999; Cooke *et al.*, 1998; Sudarsanam, 1995). It should be noted though that Brennan (1999) finds that companies issuing profit forecasts are often associated with revised bids. Cooke *et al.* (1998) summarise the position as follows: 'in conclusion, the characteristics of defence documents . . . do not materially affect the outcome of a hostile bid. This is consistent with a view that the defence is undertaken not to correct mis-pricing of the target's stock by providing additional information to shareholders to remain independent, but rather to drive up the purchase consideration and increase shareholders' wealth' (p. 136).

Other defensive strategies employed by UK companies are more obviously designed to defeat the takeover. Sudarsanam (1995) reports that 24% of targets in his sample enlisted the support of a 'white knight'. This is where a friendly company launches a counterbid for the target. In Sudarsanam's (1995) study, 37% of targets argued against the bid on anti-trust grounds hoping for an official referral of the bid by the Office of Fair Trading to the Competition Commission. Under the *City Code*, such a referral immediately terminates the bid pending an investigation. Targets may also pursue some sort of restructuring activity such as making a bid for another company or seeking to divest some underperforming elements of the business and promising improved performance as a result. In some instances such divestments may actually replicate the bidder's own publicised strategy for the target. Other defence strategies identified by Sudarsanam (1995) include using trade unions and employees to lobby against any rationalisation aspects of the bid, using advertising, and raising legal issues concerning specific aspects of the bid. In his empirical analysis of the impact of different defensive mechanisms on bid outcome, Sudarsanam (1995) reports that white knight support, support of unions and litigation help to defeat unwanted bids while divestments and advertising reduce the likelihood of a successful defence.

## Shareholder vs Manager Interests

### *Board composition*

Recent research on management's attitude to takeovers has focused on the governance relationship between shareholders and managers. Using this framework, a number of studies have examined whether board composition influences target management's decisions around a takeover bid as well as ascertaining the impact of any such relationship on shareholder wealth. O'Sullivan and Wong (1998a) report that boards resisting takeover bids are typically larger and comprise a higher proportion of non-executive directors compared to boards of friendly targets. Furthermore, O'Sullivan and Wong (1998b) find that boards resisting takeovers are more likely to have different individuals occupying the positions of company chairman and CEO. In the US, Cotter *et al.* (1997) also find that larger boards and boards with a majority of non-executive directors are more likely to resist takeover bids. Cotter *et al.* (1997) report that resistance by boards with a majority of independent directors generates higher returns for shareholders. In a Canadian study, St-Pierre *et al.* (1996) find that targets involved in hostile bids have a higher proportion of non-executive directors compared to friendly targets. A more indirect insight into the role of board monitoring in the context of takeover activity is provided by Brickley *et al.* (1994) who report a positive and significant stock market reaction when companies with a majority of independent directors adopt *ex ante* defensive mechanisms (poison pills in this instance). Brickley *et al.* (1994) also report a negative reaction when poison pills are utilised by companies with manager-dominated boards. These studies suggest that independent boards seek to pursue shareholder interests by resisting certain takeover approaches. Interestingly, O'Sullivan and Wong (1998a, b) in the UK and Cotter *et al.* (1997) and Brickley *et al.* (1994) in the US fail to find evidence that board composition has an impact on takeover outcome. It appears, therefore, that more independent boards may pursue shareholder interests by resisting takeover bids in order to increase the returns to shareholders but stop short of forcing the bidder to abandon the bid.

### *External blockholders*

In addition to the use of independent boards, the presence of large external shareholders may also influence the attitude of target managers to a takeover bid. According to Shleifer and Vishny (1986) large external shareholders may facilitate takeovers by selling their shares to bidding firms when incumbent managers are underperforming and unwilling to implement reforms. Therefore, we might expect managers in companies with significant blockholder ownership less likely to resist takeover bids for entrenchment purposes in the knowledge that such resistance is likely to be futile in the face of large shareholder opposition. We might also expect companies in which external blockholders own substantial proportions of equity to be administered in the interests of shareholders and consequently pursue shareholder objectives during takeover contests. In a UK study, O'Sullivan and Wong (1998a) find no difference in the ownership levels of external blockholders between hostile and friendly targets nor between targets that were successfully acquired and targets that retained their independence. In a Canadian study, St-Pierre *et al.* (1996) also fail to identify differences in the ownership of external blockholders between friendly and hostile bids.

A refinement to this area of research has been to distinguish between blockholders that are institutional shareholders and other blockholders. Institutional shareholders are interesting in the context of takeovers since they are unlikely to be affiliated with company management and consequently are more inclined to pursue shareholder objectives in takeover contests. In the

US, Raad and Ryan (1995) find that institutional ownership is greater in the case of hostile rather than friendly takeover targets while Duggal and Millar (1994) find that takeover success is positively related to the ownership of what the authors categorise as 'pressure-sensitive' and 'pressure-resistant' institutions. Sudarsanam (1995) reports that the presence of institutional shareholders increases the likelihood of a successful bid in the case of hostile takeovers in the UK. These findings are consistent with institutional shareholders resisting takeover bids in an attempt to maximise shareholder wealth but also seeking to ensure that the bid is successful. In a more recent UK study, however, O'Sullivan and Wong (1999) find that hostile targets with greater levels of both institutional ownership and unaffiliated blockholders are more likely to successfully resist a hostile bid. Even though this finding is at variance with Sudarsanam's (1995) study, it suggests a willingness of UK institutions to side with incumbent managers in contested bids. Indeed, Black and Coffee (1994) identify that a lower proportion of hostile bids are successful in the UK compared to the situation in the US prior to the introduction of poison pill defences. Black and Coffee (1994) suggest that the comparative ease with which managers in the UK successfully defend against unwanted bids is due largely to the presence of less aggressive institutional shareholders compared to their counterparts in the US.

### *Managerial ownership*

Management reaction to takeovers is also expected to be influenced by the degree of managerial ownership in the target company. Takeovers are expected to affect the wealth of managers and non-manager shareholders differently. While target shareholders may benefit financially from takeover premiums, managers may suffer both pecuniary and non-pecuniary losses if corporate control is involuntarily relinquished after a takeover. Thus, the decision of managers to accept or reject a takeover bid is likely to depend on the trade-off between the potential wealth gains of share ownership and possible losses of compensation, prestige and security following post-acquisition displacement. Baron (1983) suggests that target managers' preference for retaining control during a takeover may be influenced by the level of their share ownership in the firm. When personal financial gain, as a consequence of substantial managerial equity holdings, arising from a change of ownership are non-trivial and are likely to outweigh possible losses, incumbent managers are less likely to want to oppose a takeover attempt. Mikkelsen and Partch (1989) also argue that high levels of managerial ownership may encourage takeover activity if bidders incur lower transaction costs when negotiating with a smaller group of large shareholders compared to dealing with a large group of small shareholders. In a counter theory, Stultz (1988) demonstrates how high levels of managerial ownership may reduce the likelihood that a takeover bid will succeed. Stultz (1988) argues that high managerial ownership may discourage takeover attempts by raising premiums to such a prohibitive level that takeovers become unprofitable transactions for bidders. In this way entrenched managers may be capable of frustrating the takeover market and thereby successfully resisting unwelcome offers.

In recent years the influence of managerial ownership on managerial reaction and the eventual outcome of takeover bids has received a great deal of research attention. Overall, the evidence suggests that managerial ownership does play an important role in both management's reaction to and the ultimate outcome of takeover bids. Both O'Sullivan and Wong (1998b) in the UK and Song and Walkling (1993) in the US find that managerial ownership is significantly lower in hostile targets compared to friendly targets. Similar results are reported for the UK by Holl and Kyriazis (1997) and for the US by Raad and Ryan (1995), Buchholtz and Ribbens (1994) and Cotter and Zenner (1994). This evidence supports the contention that low levels of managerial ownership serve to hinder takeovers while the potential for takeover premiums

for managers means that friendly takeovers are associated with higher levels of managerial ownership. Since this evidence suggests that hostile takeovers only occur when managers possess low levels of ownership, a possible implication is that economically desirable takeovers are not attempted because bidders believe that managers possess sufficient equity either to hinder the bid's success or to make the takeover price uneconomic for the bidder. On the other hand, the finding of larger levels of managerial shareholding in targets of friendly takeovers suggests that bidders are unlikely to launch a bid in the absence of prior agreement with target management.

In respect of bid outcome, O'Sullivan and Wong (1998b) find that higher levels of managerial ownership increase the likelihood of takeover success. Similar results are reported for the UK by Holl and Kyriazis (1996) and for the US by Song and Walkling (1993), Duggal and Millar (1994), and Cotter and Zenner (1994). Of course, the positive impact of managerial ownership on takeover success is likely to be driven by the positive relationship between managerial ownership and friendly bids. Indeed, in the case of hostile bids, O'Sullivan and Wong (1999) and Sudarsanam (1995) find no evidence of managerial ownership influencing bid outcome. It appears, therefore, that managerial ownership influences the takeover process in different ways and at different stages, facilitating friendly takeovers but serving to hinder unwanted takeovers. Of course, what remains unclear is whether high levels of managerial ownership actually prevent disciplinary takeovers. For example, since hostile takeovers are perceived to play an important role in ensuring that managers in public companies pursue shareholder interests, this discipline may only occur in companies with low levels of managerial ownership. On the other hand, higher levels of managerial ownership in friendly takeover targets appear to confirm Baron's (1983) hypothesis that lower managerial ownership serves to focus managers' minds on the value of compensation and job retention while the positive association between large equity holdings and friendly bids suggests that the possibility of pecuniary gains may be the overriding motivation for managers possessing substantial equity holdings.

### *Size of target*

An additional influence on management's attitude to takeover bids relates to the equity value of the target. The principal-agent literature suggests that agency problems between shareholders and managers are likely to be exaggerated in large firms where ownership is widely dispersed (Berle and Means, 1932). We might therefore expect managers pursuing entrenchment objectives more likely to resist bids when the target is large since external shareholders are unlikely to possess sufficient (expensive) equity to effectively monitor managers (Demsetz and Lehn, 1985). The available empirical evidence provides some support for this argument. In the UK, O'Sullivan and Wong (1998b) and Powell (1997) find that hostile targets are significantly larger (measured by market capitalisation) than friendly targets. In the US, studies by Cotter *et al.* (1997) and Raad and Ryan (1995) also find that contested targets are significantly larger (measured by book value of total assets) than their friendly counterparts. Since the available evidence suggests that managers are more likely to resist bids in larger companies, it may be expected that a greater proportion of such bids fail. However, O'Sullivan and Wong (1998a) and Cotter *et al.* (1997) find that size does not influence bid outcome when all bids are examined. When looking at hostile bids only, though, O'Sullivan and Wong (1999) and Sudarsanam (1995) find that larger targets are more likely to be acquired. This suggests that while size allows managers more freedom to oppose a bid, larger targets are more difficult for managers to successfully defend. Presumably, the dispersion of shareholdings that allows managers to pursue their own interests in opposing unwanted bids is counterbalanced by managers' inability



to actively influence the way dispersed shareholders behave when deciding whether or not to accept a particular bid.

The evidence summarised in this section illustrates the rather complex governance environment in which takeovers operate. There is evidence that independent boards and active blockholders seek to ensure the maximisation of shareholder wealth in the takeover process. This is frequently achieved through initial hostility to bids but falling short of forcing abandonment of the bid. Managerial ownership is an important influence on managerial reaction. When managers possess significant equity in the target company, takeovers are more likely to be friendly while managerial resistance is associated with low ownership levels. The main concern in respect of managerial ownership relates to the possibility that high levels of managerial ownership may deter wealth-maximising acquisitions since the takeover market may not be able to discipline entrenched managers with significant ownership. It should be noted, though, that since the mid-1990s the incidence of hostile takeovers has decreased significantly. One possible explanation for this may be the general awareness and improvement in the internal governance of companies as a whole and a concerted effort on the part of policymakers and regulators to improve the incentives available to managers to encourage shareholder-oriented behaviour (Holmstrom and Kaplan, 2001).

## **POST-ACQUISITION PERFORMANCE**

If takeovers are motivated by governance objectives it is important to consider the impact of takeovers on shareholder wealth in both target and bidder companies. Research on the wealth effects of takeovers on target shareholders is usually ascertained through short-term event studies that analyse share market returns in windows of either (a) immediately prior to the bid announcement until the bid is completed or (b) a shorter timeframe typically including the day of the announcement as well as one day either side. Studies of the wealth effects on shareholders in bidder companies examine the short- and long-term utilising both event study techniques as well as more traditional measures of accounting performance. An emerging area of academic interest concerns the wider impact of takeovers, especially in relation to productivity, employment and wage levels in acquired companies. The following sections summarise the available evidence on takeover performance in each of these areas.

### *Target Returns Surrounding the Bid*

The empirical evidence on target returns surrounding takeover bids is unambiguous; takeover announcements generate significant positive returns for target shareholders. Studies of takeovers in the US by Dodd (1980), Asquith (1983), and Eckbo (1983) report two-day abnormal returns ranging from 6.24% to 13.4% around the bid announcement date. Over a one-month period, the positive returns are estimated at between 13.3% and 21.78% (Asquith *et al.*, 1983; Malatesta, 1983). Total abnormal returns from the announcement of a takeover bid through to outcome range from 15.5% to 33.9% (Asquith, 1983; Dodd, 1980; Weir, 1983). The gains to target shareholders are replicated in studies of takeovers in the UK. Franks *et al.* (1977) report abnormal gains of around 26% while Firth (1979, 1980) reports gains of 37% between months -4 and +1, and gains of 29% in the announcement month itself. In a study of 1900 takeovers between 1955 and 1985, Franks and Harris (1989) report gains of 23% in the announcement month alone, with overall gains between months -4 and +1 of 29%. Limmack (1991) reports overall gains of 37% in a study of 462 completed bids between 1977 and 1986.

Jarrell *et al.* (1988) provide an interesting insight on the time dimension of gains to target shareholders. Their study examines the returns to shareholders of 663 completed takeovers between 1962 and 1985. They estimate that the average shareholder gain was 19% in the 1960s, 35% in the 1970s and 30% in the 1980s. Bradley *et al.* (1988) report similar results in their study of 236 completed takeovers for the periods 1963–68 and 1981–85. Andrade *et al.* (2001) provide a more up-to-date summary of gains to target shareholders in a sample of approximately 2000 takeovers in the US between 1973 and 1998. Andrade *et al.* (2001) report average gains to target shareholders over this period of 16% (for the –1 to +1 day period) and 23.8% (for the –20 days to conclusion period). These returns are broadly consistent when the period is broken down into the three merger ‘waves’ (i.e. 1973–79, 1980–89 and 1990–98).

An interesting extension explored by Andrade *et al.* (2001) is to examine whether the returns to target shareholders are influenced by the choice of takeover financing. Their analysis finds that gains are greater when there is no equity financing, overall returns for bids involving equity are 20.8% compared to 27.8% in the case of non-equity purchases. This difference is replicated in the shorter event window with non-equity bids generating returns of 20.1% compared to 13% when equity is included. Andrade *et al.* (2001) explain this differential market reaction in the context of research on the impact of equity issues which is typically associated with share price reductions as investors associate equity issues with management’s view that the company’s stock is overvalued.

In addition to financing choice, a number of studies have examined the impact of other bid characteristics on target shareholder returns surrounding the bid. Of particular interest to this review is to ascertain whether returns to target shareholders are influenced by managerial reaction and governance characteristics. Huang and Walkling (1987) find higher (but statistically insignificant) returns to targets of contested bids. Cotter *et al.* (1997) find that the returns to target shareholders are higher when it possesses an independent board and in the case of resisted bids and bids for targets with poison pill defences the returns are greater when the board is independent. Cotter *et al.* (1997) also find that board independence does not impair the likelihood of a takeover bid being successful. Taken in its totality, the authors suggest that their findings are consistent with board independence maximising target shareholder wealth during the takeover process. In the UK context, Holl and Kyriazis (1997) find that initial resistance and the bargaining and negotiations that usually follow increased returns to target shareholders by a significant amount during the 1980s. In the US, Song and Walkling (1993) find that, in their subsample of contested bids, managerial ownership has a significant and positive impact on returns when the bid is ultimately successful.

## Bidder Returns Surrounding the Bid

Unlike evidence in respect of their target counterparts, the short-term impact of takeover bids on the wealth of shareholders in acquiring companies is generally mixed but mostly insignificant. Some studies report weakly positive returns, others show weakly negative returns and a number report no statistically significant impact. In the US, Dodd (1980) reports negative returns of 7.22% for bidders over the 20 days surrounding the bid announcement. Asquith (1983) reports no impact on the returns of bidders on announcement date. Mitchell and Lehn (1990) report returns of 0.14% over six days surrounding the bid and 0.7% abnormal returns for the period –5 to +40 days. Smith and Kim (1994) report bidder losses of 0.23% at announcement date and insignificant gains over the announcement to final offer period. Walker (2000) reports

negative bidder returns of 0.84% for the four-day period surrounding the bid. In the UK, Firth (1980) reports negative average cumulative residuals of 0.045 during the announcement month. Franks and Harris (1989) find that bidders earn around 1% abnormal returns during the announcement month and between 2.4% and 7.9% over the period -4 to +1 day (depending on which benchmark model is used). Holl and Kyriazis (1997) report significant negative returns of 1.25% for bidders two months after the announcement while Higson and Elliott (1998) report an insignificant impact on bidder wealth between announcement and conclusion of the bid. Sudarsanam and Mahate (2003) report negative abnormal returns of between 1.39% and 1.47% for the two days surrounding the bid.

In their review of US takeovers between 1973 and 1998, Andrade *et al.* (2001) report average announcement (-1 to +1 days) returns of -0.7% over the period with losses for each decade of 0.3% (1973-79), 0.4% (1980-89) and 1% (1990-98) respectively. A main source of concern arising from these findings is the apparent worsening of the announcement returns to bidders over time. Taking a slightly longer perspective (-20 days to completion), Andrade *et al.* (2001) report more negative results, overall abnormal returns for the three decades were -3.8% ranging from -4.5% in the 1970s to -3.9% in the 1990s. It should be noted, though, that Andrade *et al.* (2001) do not find the negative returns statistically significant. Consequently, they conclude that 'it is difficult to claim that acquiring firm shareholders are losers in merger transactions, but they clearly are not big winners like the target firm shareholders' (p. 111).

The relatively inconclusive evidence on bidder returns surrounding takeover bids has encouraged researchers to investigate bid characteristics in an attempt to see whether announcement returns are sensitive to different types of takeover. This has resulted in researchers relating bidder returns to such bid characteristics as the type of takeover, the method of payment, the relative size of the target and bidder and the industrial relatedness of the two companies. From a governance perspective, a potentially useful distinction is to isolate bids that are resisted by target managers in an attempt to ascertain whether takeovers of such firms provide more opportunity for wealth-enhancing restructuring. Dodd and Ruback (1977) find that tender offers earn positive abnormal returns of 2.83% during the announcement month while Bradley (1980) reports average returns of 4% to bidders in the case of tender offers. Both Jarrell and Bradley (1980) and Bradley *et al.* (1983) find significant positive abnormal gains to bidders involved in tender offers. However, Lang *et al.* (1989) fail to find any difference in returns to bidders based on opposed and unopposed bids while Jarrell and Poulsen (1989) report negative returns to bidders involved in tender offers. Distinguishing between tender offers and mergers, Walker (2000) reports no significant bidder gains from tender offers but significantly negative returns to bidders involved in mergers.

The evidence cited above suggests that bidders involved in contested takeovers may actually gain more (or suffer less) during the announcement period. However, a number of researchers report that tender offers and hostile takeovers are more likely to be financed by cash while uncontested takeovers are more likely to include a significant equity component (Agrawal *et al.*, 1992; Rau and Vermaelen, 1998; Travlos, 1987). At the same time a number of studies identify higher returns around announcement for bidders that choose to finance the acquisition with cash. For example, Travlos (1987) reports significantly negative returns for equity transactions while returns for cash bidders are not significantly different from zero. This result is broadly confirmed by Walker (2000) who reports that share offers generate returns for bidders that are insignificantly different from zero while returns associated with cash offers are significantly positive. Andrade *et al.* (2001) find that announcement returns between 1973 and 1998 were

consistently more negative when equity finance was involved regardless of whether the shorter or longer announcement window is used. Of course, what is difficult to establish, and remains unclear, is whether the slightly more positive returns for acquisitions financed with cash are due to the method of payment or the type of acquisition being undertaken?

In addition to type of merger and method of payment, returns to bidders may also be influenced by the joint characteristics of the target and bidder firms. In this respect a number of studies have explored the impact of the relative size of bidder and target as well as the industrial relatedness between the two companies. Asquith *et al.* (1983) find that acquisitions for targets of at least half the bidder's size yield returns 1.8% more than bids for smaller targets. In the UK, Franks and Harris (1989) find that bidders acquiring targets of between 50% and 100% of their own size exhibit significantly positive abnormal returns of 5.8% over a five-month period surrounding the bid. In a more recent study, Higson and Elliott (1998) report negative returns of -1.7% for bidders acquiring targets at least 25% of the bidder's size. One of the first studies examining the impact of industrial relatedness on bidder wealth was undertaken by Morck *et al.* (1990) who found weak evidence that related acquisitions impact positively on bidders. More recent work by Hubbard and Palia (1999) and Walker (2000) report better returns for bidders pursuing related as opposed to diversifying acquisitions.

## Long-run Bidder Performance

The longer-term post-acquisition performance of bidders has attracted a great deal of research. Much of this has been motivated by early studies suggesting that takeovers may be damaging to the long-term wealth of shareholders. This research has generally utilised either event study methodologies where the bidder's share price is compared to some market-related benchmark(s) or accounting studies where specific profitability measures are used. This section reviews the evidence in each of these research strands.

Early studies on the post-acquisition performance of bidders reported fairly consistent evidence of weaker performance. For example, in the US, Mandelker (1974), Dodd and Ruback (1977) and Langetieg (1978) all reported negative abnormal returns for periods ranging from 40 to 70 months after the acquisition. It should be noted, though, that none of the performance differences reported in these studies appear to have been statistically significant. In the UK, Firth (1980) reported slightly positive returns for successful bidders and slightly negative returns for unsuccessful bidders for the 36-month post-merger period. In neither case was the difference statistically significant. Asquith (1983) found negative and significant returns for bidders of both successful and unsuccessful takeovers but found the returns to unsuccessful acquirers to be less negative. This is broadly consistent with Dodd and Ruback (1977) but contrary to Firth's (1980) findings for UK acquirers. In a subsequent UK study, Limmack (1991) finds evidence that over the two-year post-bid period, unsuccessful bidders displayed less negative returns. The broadly negative returns for acquirers using a variety of benchmark models has been the overriding finding of subsequent studies both in the US and in the UK. Notable US studies reporting negative returns to bidders include Dodds and Quek (1985), Bradley and Jarrell (1988), Loderer and Martin (1992), Anderson and Mandelker (1993) and Mitchell and Stafford (2000). UK studies reporting negative returns include Barnes (1984), Franks and Harris (1989), Limmack (1991), Kennedy and Limmack (1996) and Gregory (1997). These studies have used a variety of benchmark models and have also covered varying lengths of time after

the acquisition. It should also be noted that in many instances the negative findings reported are not statistically significant (see Agrawal and Jaffe (2000) for a detailed description of individual study characteristics and findings).

Despite the overwhelming evidence of negative, or at best neutral, returns to shareholders in acquiring firms it is important to highlight instances where researchers report positive post-acquisition performance. For example, Dodd and Ruback (1977) report positive returns when the purpose of the acquisition is to clear up outstanding equity not already held by the bidder. Magenheim and Mueller (1988), Agrawal *et al.* (1992), Loughran and Vijh (1997) and Rau and Vermaelen (1998) report positive returns to bidders involved in tender offers. These findings are interesting as such takeovers may be viewed as disciplinary and we might expect more scope for efficiency improvements post-bid. Franks *et al.* (1988) report positive returns for UK bidders financing the takeover with cash. In a US study, Loughran and Vijh (1997) report significantly positive returns for cash transactions and significantly negative returns when the bid is financed by equity.

Researchers examining the post-acquisition performance of acquiring firms from an accounting perspective argue that any benefits of takeover will eventually appear in the firm's accounting records. One of the earliest studies of post-bid accounting performance was undertaken by Meeks (1977) who examined the performance of 233 companies making a single takeover between 1964 and 1972. Meeks (1977) finds that profitability increased in the year of the takeover but decreased in each of the five subsequent years. It should be noted that some researchers have pointed out that the elimination of multiple bidders may actually have biased Meek's (1977) findings as it might be expected that multiple bidders are more successful (Limmack, 2000). However, Meek's (1977) finding of poor post-acquisition performance is relatively consistent with earlier UK studies by Singh (1971) and Utton (1974). In a subsequent UK study, Dickerson *et al.* (1997) examine accounting performance surrounding 2941 UK acquisitions between 1948 and 1977. Unlike Meeks (1977), the authors include companies making multiple acquisitions. Dickerson *et al.* (1997) find that acquirers earn significantly lower rates of return than non-acquirers as well as their own earnings prior to acquisitions. The authors estimate that firm profitability reduces, on average, by approximately 2.04% per annum once they become acquirers. Furthermore, for every subsequent acquisition, the authors estimate that firm profitability reduces by a further 2.03% per annum.

Studies examining the post-acquisition performance of US acquirers have produced mixed results. Ravenscraft and Scherer (1989) examine target firm profitability over the period 1975–77 by utilising accounting data for 471 companies between 1950 and 1976 by the business segments in which the firms operated. Ravenscraft and Scherer (1989) find that the target lines of business suffer a loss in profitability following the merger. The authors suggest this evidence is consistent with mergers destroying value. Healy *et al.* (1992) examine post-merger operating performance for the largest 50 mergers between 1979 and 1984. They conclude that acquirers experience improvements in asset productivity, leading to higher operating cashflows relative to their industry peers. Interestingly, Healy *et al.* (1992) find that the post-acquisition performance of acquirers decreases after the takeover but is better than their sector counterparts. A recent study by Ghosh (2001) finds a post-acquisition difference between firms financing acquisitions with cash or equity. In particular, Ghosh (2001) reports that cashflows increase by about 3% per year following cash acquisitions and these improvements are due to increases in sales growth rather than cost reductions. Equity acquisitions, on the other hand, are associated with subsequent reductions in annual cashflows and sales growth, even though the decreases are

not statistically significant. Andrade *et al.* (2001) examine the post-acquisition performance of approximately 2000 US mergers between 1973 and 1998. The authors find that post-merger operating margins (measured as cashflow to sales) are improved relative to industry benchmarks. Andrade *et al.* (2001) conclude that ‘the combined target and acquirer operating performance is strong relative to their industry peers prior to the merger, and improves slightly subsequent to the merger transaction’ (p. 116).

## The Wider Effects of Takeovers

Even though the overwhelming interest in takeovers has focused on trying to ascertain the economic impact of bids on shareholders in both target and bidding companies, more recently researchers have sought to investigate the effect of takeovers on wider stakeholder groups. In particular, researchers are beginning to examine the impact of takeovers on productivity, employment and wage levels subsequent to takeover. An important contribution to the debate on the wider impact of takeovers was provided by Shleifer and Summers (1988) in which they argued that the high premiums paid to target shareholders may be explained by the *ex post* restructuring of employees’ ‘implicit contracts’ with their company. According to Shleifer and Summers (1988), employees are willing to make firm-specific investments in human capital in return for an implicit promise of job security which amounts to a return on their investment. However, following a takeover these employees become vulnerable to *ex post* renegotiation of implicit contract terms by management. For example, post-acquisition downsizing enables management to capture the future rents or income streams which would otherwise have accrued to employees, and to convert them into takeover premiums for the shareholders’ benefit (Deakin *et al.*, 2002). Shleifer and Summers (1988) argue that this type of wealth transfer is especially likely in hostile takeovers where new management is installed and a key party to the implicit contract, the incumbent management, is removed. Furthermore, as Deakin *et al.* (2002) observe, takeover regulation in both the UK and US appears designed to maximise shareholder interests at the expense of employee welfare.

Conyon *et al.* (2001) undertake a direct test of Shleifer and Summers’ (1988) hypothesis by investigating the impact on employment levels of a sample of 201 UK takeovers over the period 1983–96. The analysis includes both friendly and hostile transactions. Conyon *et al.* (2001) undertake their analysis in two stages. First, they make direct comparisons between the post-bid employment demands of friendly and hostile bids. This suggests that while friendly bids are associated with a slight increase in employment, hostile bids are associated with significant reductions and this is reinforced for a period of four years after the merger. Second, the authors estimate acquirers’ derived demand for labour model so as to control for output changes after acquisitions. This is particularly important in the case of hostile takeovers as such transactions are typically associated with significant *ex post* divestment of assets. With this control in place, Conyon *et al.* (2001) report that the derived demand for labour for both types of takeover reduces by approximately 7.5%. Crucially, however, the authors fail to identify a significant difference in the derived demand for labour between friendly and hostile transactions. They argue that the significant reductions in employment demand after hostile bids, which are not identifiable when output changes are incorporated, may be explained by the greater likelihood of substantial divestments by acquirers after a hostile takeover. Of course, the authors are not in a position to comment on employment effects of the divestment itself, further research

is needed to ascertain whether Shleifer and Summers' (1988) fears are substantiated at this second order control change.

In a further investigation of the effects of takeovers, Conyon *et al.* (2002) compare the productivity and wage effects of foreign and domestic acquisitions in the UK between 1989 and 1994. Both types of acquisition are found to result in significant increases in both real wages and labour productivity, though the greater increases relate to foreign acquisitions. The authors also compare firm-level employment levels before and after the acquisition and find no significant changes. This suggests that the increased productivity post-acquisition is obtained from more efficient use of labour rather than through downsizing. Conyon *et al.* (2002) find a difference between the two types of acquisitions in respect of wage rate, a significant increase in the case of foreign takeovers compared to a decrease in the case of domestic takeovers. The authors suggest that, in the case of domestic acquisitions, the reduced wage rate may be evidence consistent with Shleifer and Summers' (1988) suggestion that takeovers may allow for wealth transfers from employees to shareholders. Even though empirical research on the wider effects of acquisitions remains in its infancy, the few studies that have taken place have provided useful insights on the possible sources of gains from takeovers. The work cited here on increased productivity and greater employment efficiency presents a more positive view of the impact of takeovers than the more narrow financial studies that have, thus far, attracted the majority of interest.

The impact of takeovers on company performance has attracted a great deal of academic interest. From the perspective of shareholders in target companies, there is clear evidence of significant wealth gains arising from takeover bids. These gains appear to have been relatively consistent over the past three decades. There is emerging evidence that the size of shareholder gains may be influenced by certain bid characteristics. For example, takeovers financed by cash result in more positive returns than equity bids. Similarly, bid hostility, especially in the presence of more independent boards, generates higher returns. The impact of takeover bids on the wealth of shareholders in bidding companies is less clear. The large number of studies on the topic have produced inconclusive results. Studies of the impact of specific bid characteristics suggest that the announcement effects of cash-financed bids and bids resisted by target management may be more positive. Studies of the relative size of bidder and target companies provides some evidence that larger bids generate more positive returns while there is also some evidence that acquiring targets in related industries has a positive impact on bidder returns. Research on the post-bid performance of bidders has been undertaken using both stock market and accounting performance measures. Overall, the majority of studies suggest that bids have a negative impact on the long-run performance of bidders. With few exceptions, the overwhelming finding from stock market studies is bidder underperformance over a sustained period after the acquisition. This appears to hold regardless of which market model is used as a benchmark. Accounting studies are slightly more problematic to undertake since performance measures are, to a certain extent, utilising accounting data prepared by the company itself. The findings from the majority of studies that have been undertaken suggest that corporate efficiency does deteriorate after the acquisition. However, it should be noted that a few studies identify efficiency gains. A number of recent studies have sought to investigate the wider impact of takeovers, especially the effects on productivity and employment. The findings in this respect appear to be more encouraging with evidence of increased labour productivity. However, as hostile takeovers are associated with significant asset divestment more research needs to be undertaken to identify the employment effects of such divestment.

## **MANAGEMENT TURNOVER SUBSEQUENT TO TAKEOVER**

If takeovers are believed to perform an important governance role, one aspect of this might be the replacement of target managers once the takeover is completed. In a recent survey of corporate governance, Shleifer and Vishny (1997) suggest that the replacement of target management is one of the most consistent findings of takeover research. Shleifer and Vishny's (1997) observation is based on a stream of empirical research that has investigated the rate of managerial turnover experienced by managers in target companies subsequent to successful takeover bids. For example, Walsh (1988) compares managerial turnover in a sample of 55 target firms and a corresponding sample of non-targets. The turnover rate is significantly higher for the sample of acquired firms in the five years immediately following the takeover. In a subsequent study involving a larger sample, Walsh (1989) reports that managerial turnover is higher in the case of hostile compared to friendly bids. Walsh and Ellwood (1991) find a turnover rate of 39% for managers in successfully acquired targets within two years of the bid compared to a turnover rate of just 15% in non-targets. Walsh and Ellwood (1991) find no evidence that targets experiencing weaker pre-acquisition performance are more likely to experience a managerial change. Martin and McConnell (1991) report a turnover rate of 42% for CEOs of targets compared to 10% prior to the bid. However, Martin and McConnell (1991) find that targets replacing their CEOs have performed significantly worse than other firms in their industry prior to the bid. It should be noted that using the traditional hostile/friendly categorisation, Martin and McConnell (1991) find no difference in the rate of post-bid turnover of CEOs.

In the UK, Kennedy and Limmack (1996) find that CEO turnover is 40% in the first year after a successful takeover and 26% in the second year. This compares with turnover rates of 6% and 10% in the years immediately prior to the bid. Even though Kennedy and Limmack (1996) fail to find different rates of CEO turnover based on the mood of the bid (i.e. hostile or friendly), they find some evidence of a positive relationship between poor pre-bid performance by targets and subsequent CEO turnover. In a study focusing only on hostile bids, Franks and Mayer (1996) also report high levels of managerial turnover subsequent to the bid but find no relationship between the target's pre-bid performance and managerial turnover. Comparing post-acquisition turnover rates of hostile and friendly bids, Dayha and Powell (1998) report that turnover rates among all levels of executives are greater in the case of hostile bids.

In a recent US study, Kini *et al.* (2004) investigate post-takeover CEO turnover in the context of pre-bid performance, management reaction and internal governance characteristics. Kini *et al.* (2004) find evidence that CEO turnover is more likely to occur in targets with weaker pre-bid performance and more likely to occur if the bid was resisted by target management but less likely in targets with significant outside representation on the board of directors and with greater levels of ownership in the hands of blockholders. Interestingly, Kini *et al.* (2004) find that their findings only apply to takeovers occurring between 1979 and 1988 and not between 1989 and 1998. They explain this difference as consistent with takeovers in the earlier period having an important governance role while the stronger internal governance employed by firms during the 1990s may have reduced the need for disciplinary takeovers. This argument complements the conclusions of Mikkelsen and Partch (1997) who identify a decline in disciplinary pressure on top managers in the US between 1989 and 1994 compared to 1984 and 1988. Mikkelsen and Partch (1997) report that the inverse relationship between



firm performance and management turnover reported in previous studies had disappeared in the later period and they attribute this to the decline in the disciplinary impact of takeovers.

The main conclusions regarding top management turnover is that rates of change after takeovers are higher than either prior rates of turnover in targets or turnover levels in non-targets. There is some evidence that top management replacement is more likely subsequent to hostile bids. There is an increasing stream of evidence suggesting that post-acquisition turnover is influenced by the target's pre-acquisition performance. However, as suggested by Kini *et al.* (2004), the dynamics of the acquisition–turnover relationship may have changed during the 1990s as companies pursued alternative governance mechanisms (e.g. board independence, institutional activism and incentive-based compensation) to ensure managers pursue shareholder interests.

## THE CONSEQUENCES OF TAKEOVER FAILURE

As discussed in the section on the likelihood of takeover success, above, a significant number of takeover bids are not completed. Furthermore, the likelihood of takeover success is significantly reduced in the case of target hostility (Wong and O'Sullivan, 2001). This raises an interesting issue in the context of takeover governance, do takeovers have to succeed to play a governance role? This section tries to explore the potency of takeover threats as opposed to successful completions. It is useful to consider the governance role of abandoned bids in the context of other issues addressed in previous sections, especially the wealth effects of abandonment on target shareholders and the rate of management turnover in targets of unsuccessful bids.

One method of assessing market reaction to takeover abandonment is to examine the reaction of the target's share price to the termination announcement. In the US, Dodd (1980) finds that when a merger is cancelled by the target company, abnormal returns remain positive and above pre-bid levels. When abandonment is initiated by the bidder, target returns revert back to pre-bid levels. Bradley (1980) and Dodd and Ruback (1977) show that the market price of target shares does not return to pre-bid levels when a bid is cancelled. Bradley *et al.* (1983) demonstrate that this is due to an expectation that another bid will occur. Fabozzi *et al.* (1988) find that, in a sample of targets that do not receive a subsequent bid, all gains earned by target shareholders have disappeared at announcement of the abandonment. One year after the cancellation, target returns show no evidence of the bid's impact. Davidson *et al.* (1989) find that non-acquired targets that become subject to subsequent bids retain their gains but targets not subject to another bid revert to their pre-bid levels.

In the UK, significant negative stock returns to target shareholders are also recorded during cancellation announcements. However, it appears that the original gains do not completely disappear. Indeed, bid-related revaluations often persist for as long as two years after the abandonment (Firth, 1980; Limmack, 1991; Parkinson and Dobbins, 1993). One notable exception to this generalisation was reported by Franks and Harris (1986) who found that all announcement gains were lost when merger proposals are rejected by the Monopolies and Mergers Commission. It should be noted that such cancellations typically prevent synergistic mergers, thus the elimination of takeover gains is not surprising. The positive revaluation of targets (Limmack, 1991; Parkinson and Dobbins, 1993) and the positive post-abandonment returns to unsuccessful bidding firms (Firth, 1980; Parkinson and Dobbins, 1993) have often been quoted as evidence that defeating a bid is not necessarily detrimental to shareholders. Indeed, Limmack (1991) suggests that the bid process induces new information about the target that

results in a revaluation. It should be noted that Limmack (1991) finds that the improved returns by abandoned targets are mirrored by significant improvements in operating performance in the years after the cancellation. Abandoned targets not showing improved operating performance do not hold their bid-related gains. However, Ruback (1988) argues that, although original merger announcement gains to target shareholders may not be completely erased, the substantial decline in stock prices during announcements of termination is in itself a strong signal that failed bids are negatively perceived by the stock market.

To provide further insights into the costs of a failed takeover, a number of empirical studies have undertaken the task of monitoring the post-bid share price of failed targets and comparing them either with the offer premium or the pre-bid price. In the US, two prominent studies are frequently cited as testimony that allowing a target to preserve its independence is not damaging to the wealth of shareholders. According to Bradley (1980) and Kidder, Peabody and Company (1985), the post-abandonment share price of most abandoned targets was higher compared to the original price offered by bidders. Hence, the authors of these studies conclude that rejecting a bid may be regarded as a rational decision that is consistent with the shareholder interest hypothesis. However, the direct price comparison methodology employed by these studies has been criticised in a series of subsequent studies. Easterbrook and Jarrell (1984) and Pound (1986), for example, re-examine Kidder, Peabody and Company's (1985) sample by adjusting for stock market movements and incorporating the performance of other potential investments as a yardstick for evaluating what they perceive as the real impact of a takeover defeat. When these factors are taken into account, target shareholders suffered equity losses ranging from 15% to 30%. A number of subsequent US studies also provide evidence of significant losses for shareholders in abandoned compared to successful targets (Ruback, 1988; Ryngaert, 1988).

A number of researchers have proposed arguments suggesting that defeating a takeover attempt may not guarantee job retention for the target's managers. Jensen and Warner (1988), for example, argue that if acquisition attempts signal poor managerial performance, the presence of well-functioning internal governance mechanisms should lead to a higher incidence of managerial turnover even if the takeover bid is unsuccessful. Jensen and Warner (1988) also suggest that managers may be dismissed due to wealth-reducing defensive measures adopted during the course of the takeover contest. Hirshleifer and Thakor (1994) present a model in which boards of directors aggregate their information concerning managerial performance with that of potential bidders. In Hirshleifer and Thakor's (1994) model, unsuccessful takeover bids are followed by a high rate of management turnover because the takeover attempt conveys adverse information possessed by the bidder about the target's management.

Denis and Serrano (1996) hypothesise that managers are likely to be dismissed following unsuccessful control contests because of contest-related changes to the company's ownership structure and/or the composition of its board of directors. In their subsequent empirical analysis, Denis and Serrano (1996) find that outside blockholders frequently acquire significant holdings of target shares during the takeover contest and retain this shareholding after resolution of the bid, providing the incentive and ability to subsequently discipline underperforming managers. Denis and Serrano (1996) find that 34% of companies in their sample of abandoned targets experienced top manager turnover within two years of the failure of the bid. These turnovers are concentrated in poorly performing companies in which unaffiliated investors purchase large blocks of shares during the course of, or immediately following, the control contest. These outside blockholders often obtain board seats and are directly responsible for the removal of the incumbent managers. In contrast, managers of targets with no unaffiliated block purchases appear able to retain their positions despite poor pre-bid performance and the

use of value-reducing defensive tactics to block the proposed acquisition. Furthermore, companies with no post-bid management turnover are more likely to exhibit contest-related increases in blockholdings affiliated with the incumbent managers. Given that post-bid management turnover appears to be initiated by unaffiliated investors, not surprisingly, Denis and Serrano (1996) find that management changes are associated with significant increases in shareholder value.

In the UK, Franks and Mayer (1996) report similar results regarding management turnover in a sample of hostile bids, the rate of management turnover is greater in successfully acquired and non-acquired targets than a control group of non-targets. Franks and Mayer (1996) argue that the increased rate of management turnover subsequent to failed bids is consistent with the bid process releasing new information about the quality of target management and investors revising their assessments based on this. Agrawal and Walkling (1994) report that, in the US, target CEOs are more likely to be replaced when the bid succeeds than when it fails. Interestingly, Agrawal and Walkling (1994) find that 44% of CEOs in targets that successfully retain their independence after a bid hold no executive positions one year after the bid. This provides further support for the notion that takeover bids that eventually fail are still capable of performing a governance role.

The consequences of failed bids is an area of takeover research that has attracted relatively little attention as the vast majority of studies focus on successful acquisitions. The research that has been undertaken has shed some important light on the potential governance role of failed takeovers. For example, it is clear that all takeovers, regardless of eventual outcome, help to reveal new information about the target. Research appears to show that this results in a revaluation of the target by investors. In the UK, this revaluation appears to be positive. In some instances, especially where revaluations persist for many years after the abandonment, the long-term profitability of the targets improves. The successful defence of a takeover by management does not appear to guarantee management's own employment. Even though the few studies that have examined management turnover post-bid highlight a significant increase in turnover in the case of successful bids, the rate of management turnover in abandoned targets also appears to exceed what might be expected in non-targets prior to the bid. Consequently, despite the scarcity of research on abandoned bids, it appears that such bids also have an important governance role.

## **CONCLUSIONS**

This chapter has sought to review the evidence on the governance role of takeovers. This review was motivated by the suggestion that takeovers may play an important role in the governance environment in which companies operate. Writers such as Jensen (1986) and others have argued that takeovers play an important role in reconciling the interests of shareholders and managers in companies where other governance mechanisms either do not exist or exist but have failed to deliver shareholder objectives. In reviewing the literature in the area we felt it was appropriate to examine governance issues at each stage of the takeover process. If takeovers are believed to have a governance role it might be expected that takeover targets exhibit weaker pre-bid performance than firms not subject to takeover. Using accounting and stock market performance measures, the available evidence provides little support for this. Furthermore, when takeover targets are categorised between hostile and friendly, in the belief that hostile targets are more likely to be the subject of disciplinary bids, no consistent performance differences between

the two types of targets are identified. However, there is some recent evidence that targets with weaker pre-bid performance experience a greater level of management turnover after the bid. This suggests that, once the takeover occurs, actions are undertaken to correct for inferior performance. This also raises some questions as to the usefulness of the traditional hostile/friendly categorisation in seeking to distinguish takeovers motivated by governance objectives.

A significant number of takeover bids that are launched are not completed. An important impediment to the success of takeovers is resistance from target management. The existing literature suggests that such resistance may be in the interests of either shareholders or managers. A key objective of research in this area is trying to identify how governance characteristics influence managers' reaction to bids. A number of studies highlight the role of board independence in influencing target reaction to bids. Boards resisting takeovers appear to possess a greater proportion of non-executive members and such resistance appears to result in greater bid premiums for shareholders. It is also worth noting that such board-oriented resistance does not impede the likelihood of bid success. Studies investigating the role of large blockholders on managerial resistance provide no clear evidence that such shareholders play an important role. The most significant influence on target company reaction to takeovers is the ownership of managers. Significant managerial ownership provides somewhat of a dilemma for managers in the context of takeovers. On the one hand, successful takeovers are associated with an increased level of managerial turnover suggesting that managers might be inclined to resist bids to preserve their future employment. On the other hand, the presence of significant ownership also provides an opportunity for managers to earn significant bid premiums if the bid succeeds. Overall the empirical evidence is consistent with an increased likelihood of hostility when managerial ownership is low and a positive association between managerial ownership and friendly bids as well as bid success.

If takeovers are motivated by governance objectives it is important to consider the impact of takeovers on the wealth of shareholders in both the target and bidder companies. The impact on the wealth of target shareholders is typically measured through short-term event studies measuring the impact of a bid on the target's share price. The overwhelming evidence from this work is that takeovers generate very significant wealth gains for target shareholders. There is emerging evidence that the size of shareholder gains may be influenced by certain bid characteristics. For example, takeovers financed by cash and takeovers that are resisted, especially in the presence of more independent boards, appear to generate higher returns for target shareholders. The impact of takeover bids on the wealth of shareholders in bidding companies is less clear. The large number of studies undertaken on the issue have produced relatively inconclusive results. Studies of the impact of specific bid characteristics suggest that the announcement effects of cash-financed bids and bids resisted by target management may be more positive. Studies of the relative size of bidder and target companies provide some evidence that larger bids generate more positive returns while there is also some evidence that acquiring targets in related industries has a positive impact on bidder returns. Research on the post-bid performance of bidders has been undertaken using both stock market and accounting performance measures. Overall, the majority of studies suggest that bids have a negative impact on the long-run performance of bidders. With few exceptions, the overwhelming finding from stock market studies is bidder underperformance over a sustained period after the acquisition. Accounting studies are slightly more problematic to undertake since performance measures, to a certain extent, use data provided by the company itself. The findings from the majority of studies that have been undertaken suggest that corporate efficiency does deteriorate in the

years after the acquisition. However, a number of recent studies examining the wider effects of takeovers provide more promising results. In particular, studies identify increased productivity, more efficient use of labour and no evidence of significant job losses. However, hostile takeovers are frequently followed by significant divestment of assets and little is currently known about the employment impact of such divestment.

One of the most consistent findings of takeover research is the increased likelihood of managerial turnover subsequent to successful takeover bids. Rates of management turnover after takeovers are higher than either prior rates of turnover in targets or turnover levels in non-targets. There is an increasing stream of research suggesting that post-acquisition turnover is influenced by the target's pre-acquisition performance. However, as suggested by a number of researchers, the dynamics of the acquisition–turnover relationship may have changed during the 1990s as companies pursued alternative governance mechanisms such as greater board independence, blockholder activism and incentive-based compensation to ensure managers pursue shareholder interests.

Finally, a number of writers have suggested that takeovers do not have to be completed to provide a governance role. Even though there has not been much research on the governance implications of abandoned bids, the work that has been undertaken has produced some interesting findings. For example, failed takeovers reveal important information that typically results in a positive revaluation of the target by investors. This revaluation seems to persist for some time after the failure of the bid. Interestingly, the successful defence of a takeover by management does not guarantee management's own employment. Studies examining management turnover post-bid show that the rate of management turnover in abandoned targets appears to exceed what might be expected in non-targets prior to the bid. Consequently, despite the scarcity of research on abandoned bids, it appears that such bids also have an important governance role.

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# Governance and Strategic Leadership in Entrepreneurial Firms

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## INTRODUCTION

Entrepreneurial studies command an increasing share of management-related research. Attention to entrepreneurial firms, however, has not been accompanied by a concomitant increase in frameworks uniquely suited for conducting research in these domains. Shane and Venkataraman (2000, p. 217), for example, provocatively noted that entrepreneurial studies have not provided a framework to facilitate the discovery of empirical phenomena ‘not explained or predicted by conceptual frameworks already in existence in other fields’. Based on their summary of the current state of research, they encouraged management scholars to ‘join [them] in the quest to create a systematic body of information about entrepreneurship’ (p. 224).

Implicit in examinations of entrepreneurial firms is the role of organizational leaders, as these are the individuals responsible for the creation of goods and services and the leveraging of market opportunities. We provide what we hope is a modest step towards a systematic treatment of governance and strategic leadership in entrepreneurial firms. For us, this area of investigation provides a productive focus, as it allows us to concentrate on those individuals directly responsible for firm performance, chief executive officers (CEOs), top management team members (TMTs), and boards of directors (e.g. Dalton and Daily, 1998; Finkelstein and Hambrick, 1996). We also include discussion of another group uniquely relevant to entrepreneurial firms, venture capitalists.

We believe directed attention toward strategic leaders in entrepreneurial firms is especially promising, as the relationship between these individuals and firm performance may be most notable in this specialized organizational context. As noted by Daily and Dalton (1992a), entrepreneurial settings provide a venue where the impact of governance structures and strategic leadership are likely to be most pronounced. Consistent with that perspective recent research

has found that the board size/firm performance relationship is stronger for smaller, as compared to larger, firms (Dalton *et al.*, 1999).

While there are many angles that could easily be explored in the entrepreneurial literature, one of the more important foci is that which explores the antecedents to entrepreneurial firm performance. Consistent with this focus, our review of governance and strategic leadership will address those studies that have relied on performance as a dependent variable. Investigation of the intersection of governance/strategic leadership and firm performance promises to inform the ongoing debate regarding whether strategic leadership ‘matters’ (e.g. Day and Lord, 1988; Waldman *et al.*, 2001; see also Rowe, 2001, for direct application to the entrepreneurial context). At the crux of this debate is the extent to which firms’ leaders exert a significant influence on firm outcomes or whether these leaders ‘have minimal impact on performance’ (Day and Lord, 1988, p. 453). If, as previous research has suggested, leadership matters most in the entrepreneurial context, this should be evident from the general body of entrepreneurial firm research addressing the governance/strategic leadership/performance relationships.

## Defining the Entrepreneurial Firm

At the outset it is important that we define the boundaries of our review. The definition of an entrepreneurial firm has been the subject of considerable debate (see, e.g., Gartner, 1990; Low and MacMillan, 1988; Sharma and Chrisman, 1999). A cursory review of ‘entrepreneurial studies’ illustrates the multiple ways in which researchers have conceptualized the entrepreneurial firm. These range from a high-growth firm to an owner-managed firm to a founder-run business (see, e.g., Carland *et al.*, 1984; Daily and Thompson, 1994; d’Amboise and Muldowney, 1988; Handler, 1989; Kirchoff and Kirchoff, 1987, for excellent discussions of this issue). Inconsistency in the treatment of what constitutes an entrepreneurial firm may have clouded empirical and theoretical advances in the field as it is difficult to synthesize across studies where there is little commonality in firms’ defining characteristics.

Sharma and Chrisman (1999, p. 11) recently addressed this problem with their efforts ‘to systematize the use of terminology in the field of corporate entrepreneurship’. Their review focuses specifically on corporate entrepreneurship, yet it provides a fundamental step toward definitional consistency across entrepreneurial studies. Definitional consistency is important for theory development and for enabling researchers to aggregate empirical findings across studies, a central step toward building a base of knowledge applicable to entrepreneurial firms.

It is important, then, that we clarify the definition of entrepreneurial firms on which we will rely. Our review is consistent with the concept of independent entrepreneurship. Sharma and Chrisman (1999, p. 18) have defined independent entrepreneurship as ‘the process whereby an individual or group of individuals, acting independently of any association with an existing organization, create a new organization’ (see also Low and MacMillan, 1988, p. 141). For the purposes of determining whether a specific study is appropriate for our review, we elected not to adopt a specific selection criterion by which ‘new organization’ would be operationalized. Given the variability in how entrepreneurial firms are defined in prior research, only a small subset of the extant research that purports to examine entrepreneurial firms would be captured using any arbitrarily chosen age-related or other selection criterion. We prefer to be more inclusive in defining the domain of entrepreneurial firm research. Thus, we regarded any study in which the researchers defined their samples as comprised of independent entrepreneurial firms as appropriate for our review. More specifically, the studies on which we focus include those

relying on empirical tests of linkages between firm performance and elements of governance and/or strategic leadership, where the firm was created and operates outside the context of a previously established organization. Differences in how particular studies operationalize entrepreneurial firms are noted whenever such differences are judged as having significant theoretical import.

### **Delineating Firm Performance**

There is an additional area where a lack of consistency is apparent – what constitutes firm performance (e.g. Brush and Vanderwerf, 1992; Dalton *et al.*, 1980; Venkatraman and Ramanujam, 1986). Some researchers, for example, have suggested that sales growth ‘is the most important single indicator’ of entrepreneurial venture performance (Ensley *et al.*, 2000, p. 68; see also Chandler and Hanks, 1993, for related discussion). While we agree that sales growth is of fundamental importance to the entrepreneurial firm, our examination of the relevant literature suggests four central performance categories of interest. We would note that the organizing framework we propose represents four distinct, but not mutually exclusive, performance categories. The categories include: (1) the financial performance of the firm, including both accounting and market-based measures (e.g. Brush and Vanderwerf, 1992; Chrisman *et al.*, 1998; McDougall *et al.*, 1994; Murphy *et al.*, 1996; Zahra and Bogner, 2000); (2) the performance of the firm at the initial public offering (IPO) (e.g. Certo *et al.*, 2001a; Finkle, 1998; Prasad *et al.*, 1995; Stuart *et al.*, 1999); (3) the growth of the firm (e.g. Covin *et al.*, 2000; Ensley *et al.*, 2000; Ostgaard and Birley, 1996; Slevin and Covin, 1997; Weinzimmer *et al.*, 1998); and (4) the survival of the firm (e.g. Boden and Nucci, 2000; Westhead, 1995).

We would also note that our grouping of performance indicators in this manner does not necessarily suggest intra-category homogeneity. While it is true, for example, that the ‘financial performance’ category is comprised of commonly used variables, there is no consensus about what exactly constitutes ‘financial’ performance. Included in the category, for instance, are studies that have relied on return on assets (ROA), return of equity (ROE), return on sales (ROS), liquidity, gross sales, sales per employee, debt-to-equity ratio, and share returns.

Financial performance represents one of the more commonly accepted performance metrics. Interestingly, firm growth is a complementary, if sometimes conflicting, performance indicator *vis-à-vis* financial performance. While firm growth may be an overarching performance goal for an entrepreneurial firm, it sometimes comes at the cost of financial performance (e.g. profitability). Firm survival is another fundamental performance metric for the entrepreneurial firm given the high rates of business failure within the early stages of a firm’s development. We also include IPO performance as a special category of performance as it is unique to the entrepreneurial context. Many IPOs are guided by their founding entrepreneurs/entrepreneurial teams (Certo *et al.*, 2001a).

## **GOVERNANCE AND STRATEGIC LEADERSHIP DO MATTER**

An implicit assumption in governance/strategic leadership/performance relationships is that the choice of various governance structure options and leaders *could* be associated with firm performance (e.g. Dalton *et al.*, 1999). A key question driving this rationale is the extent to

which a firm's leadership can actually implement strategic change in order to enhance financial performance. As noted by Dalton and Kesner (1983, p. 736): 'This assumption is questionable, particularly in large organizations. The sheer number of persons involved, the complexity of the organization, and the variety of vested interests both inside and outside the company represent potential constraints to successful change strategies.' Finkelstein and Hambrick (1996) concur noting that the combination of ambiguity, complexity, and competing stakeholder demands in the large firm may compromise decision-making discretion and effectiveness.

The suggested constraints on leaders' ability to significantly impact firm outcomes are further emphasized in the literature on organizational crises and turnaround. A central theme is that organizational leaders exert a strong influence on organizational processes and outcomes primarily when the firm faces a crisis such as financial decline (see Daily and Dalton, 1998, for an overview). It is in this context that the need for effective leadership may become most apparent, as firms' leaders attempt to return the organization to financial stability (e.g. Daily, 1994; D'Aveni, 1990; Hambrick and D'Aveni, 1992).

Entrepreneurial firms may present an additional context where leadership/performance relationships are most salient. In contrast to the perspective that leadership is necessarily constrained in organizational settings, there are several aspects of entrepreneurial firms that facilitate leaders' ability to affect change and performance. It has been observed, for example, that CEOs and directors are less constrained by organizational systems and structures in smaller firms (Daily and Dalton, 1992a, 1993; Eisenhardt and Schoonhoven, 1990; Meyer and Dean, 1990). The size of the firm is also a factor in managerial discretion; specifically, officers are more likely to be influential in smaller firms (Finkelstein and Hambrick, 1996). Also, the smaller firm may facilitate power and more narrowly focus firms' planning, core knowledge, and environmental scanning processes (Baysinger and Hoskisson, 1990).

In the following sections, we provide overviews of the areas in which an examination of governance/strategic leadership in entrepreneurial firms may be productive. For instance, CEOs in these firms are often the individual who founded (or cofounded) the organization (e.g. McConaughy *et al.*, 1998). We also include venture capitalists in our review. While many entrepreneurial firms will not have exposure to venture capitalists, for those that do, venture capitalists can significantly impact firm performance. Also, venture capitalists are a relevant stakeholder for the entrepreneurial firm as they often impose various forms of governance on firms in which they hold equity (e.g. Bruton *et al.*, 1997). Consistent with the strategic leadership and governance literatures, then, we include overviews of CEOs/founders, CEO duality, TMTs, boards of directors, and venture capitalists.

As we discuss each of these topical areas, we will note relevant sample characteristic information. We do this to help place each study in the context of our review. The literature addressing governance/strategic leadership with firm performance provides relatively few studies; therefore, we have erred on the inclusive side. Where the sample is likely based on entrepreneurial firms, but there is some doubt, we provide sufficient context for the reader to make an independent judgment of the applicability of a given study.

## **CEOs/FOUNDERS**

While the literature reflects no consensus regarding whether corporate leadership 'matters', there is little disagreement that the most powerful executive position is that of CEO (e.g. Harrison *et al.*, 1988; Norburn, 1989; Pearce and Robinson, 1987). Attention to CEOs as distinct

from other top management members is, in part, attributable to their legitimate hierarchical status in the organization (e.g. Astley and Sachdeva, 1984; Hambrick, 1981). It is the CEO to whom all other organizational employees are ultimately accountable. As importantly, however, CEOs exert a unique influence on organizational processes and outcomes (e.g. Daily and Johnson, 1997; Pfeffer, 1992; Roth, 1995).

While the research examining the performance impact of CEOs in large firms is decidedly mixed in its conclusions (e.g. Daily and Johnson, 1997; Finkelstein and Hambrick, 1996), relationships of that kind may be most apparent in the entrepreneurial context, especially in the case of founder CEOs (e.g. Bruton *et al.*, 1997; Cooper *et al.*, 1994; Daily and Dalton, 1992a). Begley and Boyd (1986, 1987), for example, noted that CEOs of smaller firms tend to occupy a position of unique influence, serving as the locus of control and decision making. Also, there is a substantial body of research in entrepreneurship addressing the implications of leadership by founders versus non-founders (Chandler and Hanks, 1994; Daily and Dalton, 1992a; Rubenson and Gupta, 1996; Willard *et al.*, 1992). This may be a particularly interesting area of examination as there is rarely the equivalent question (i.e. Is the CEO the founder of the firm?) for larger, more mature firms.

Several studies have focused explicitly on the entrepreneur (e.g. Becherer and Maurer, 1997; Cooper *et al.*, 1994; Van de Ven *et al.*, 1984) or the founder (e.g. Begley, 1995; Chandler and Hanks, 1998; Ginn and Sexton, 1990) as a key determinant of performance. The entrepreneur/founder is, by definition, the individual (or one of the individuals) who created the business. Other studies have relied on the owner–manager (e.g. Chaganti and Schneer, 1994; Kotey and Meredith, 1997; Walsh and Anderson, 1995), the new venture CEO (e.g. Bruton *et al.*, 1997; West and Meyer, 1998), and the ‘lead’ entrepreneur, one of a team of founding entrepreneurs, who clarifies the firm’s vision and crafts the strategy for the team to execute (e.g. Ensley *et al.*, 2000).

Empirical investigations of the relationship between founders and firm performance comprise three categories. First, research has examined the relationship between whether the CEO is also the firm’s founder and firm performance. Also, research has focused on the relationship between founder personality characteristics, values and beliefs, skills, experience and education, and behaviors and decisions (Chrisman *et al.*, 1998) and firm performance. Lastly, there is some research combining elements from both categories. Each is reviewed in the following.

## Founder Status and Firm Performance

A small but important body of research has explored the direct impact of founder status on firm performance (e.g. Begley, 1995; Certo *et al.*, 2001a; Daily and Dalton, 1992b; Jayaraman *et al.*, 2000; Willard *et al.*, 1992). This research tests the assumption that founders matter by comparing the performance of founder-led firms with the performance of non-founder or professionally led firms. Begley (1995), for example, surveyed 239 CEOs whose firms were members of the Small Business Administration of New England. He reported that the founder-managed firms in his sample had higher ROA than the non-founder-managed firms. No differences were reported for additional performance variables – growth rate, debt-to-equity ratio, and liquidity. Similarly, in a study of 155 *Inc.* firms, Willard *et al.* (1992) found no differences between founder- and non-founder-managed firms across 11 different accounting- and market-based measures. Based on the premise that an organization’s demands of its general manager will evolve as the organization proceeds through its life-cycle (Flamholtz, 1986), Daily



and Dalton (1992b) examined whether founders had a positive effect on financial performance among firms with sales of less than \$10 million, and a negative effect for firms with sales greater than \$10 million. Relying on a sample of 186 small corporations, they, too, found no differences for price-earnings ratio, ROA, or ROE. In contrast, Jayaraman *et al.* (2000) analyzed stock return data for 47 founder-led firms and a matched sample of 47 non-founder-led firms. While they noted no significant main effect, they did find a positive relationship between founder status and a three-year stockholding period among the smaller and younger firms, as well as a negative relationship for founder status among larger and older firms. These results, in concert, provide little evidence of a positive relationship between founders and firm financial performance or growth of the firm.

An additional study included a focus on IPO firm performance. In an examination of 368 IPO-stage new ventures, Certo *et al.* (2001a) reported that founder-managed IPO firms experienced more underpricing (the difference between a firm's stock offering price at the time of an IPO and the stock's closing price the first day of trading) as compared to non-founder-managed IPO firms. Their finding suggests that the investment bankers who set the initial offer prices of founder-managed IPO firms discount such firms relative to non-founder or professionally managed firms, or that first-day investors particularly value the presence of a founder as the IPO firm's CEO and are willing to pay a premium over the opening stock price. We were unable to identify studies focusing on the founder/firm performance relationship that relied on firm survival.

## Founder Characteristics and Firm Performance

The vast majority of entrepreneurship research examining the founder/performance relationship has assumed that the CEO is the founder and explored the relationship between individual founder characteristics and firm performance (e.g. Chandler, 1996; Chandler and Hanks, 1994, 1998; Chandler and Jansen, 1992; Cooper *et al.*, 1994; Cooper *et al.* 1998; Doutriaux, 1992; Ensley *et al.*, 2000; Honig, 1998; Kotey and Meredith, 1997; Lin, 1998; Lussier, 1995; Murray, 1996; Rubenson and Gupta, 1992; Sapienza and Grimm, 1997; Westhead, 1995; Westhead and Birley, 1995; Westhead and Wright, 1998; Westhead *et al.*, 2001). The founder characteristics line of research represents the single most studied area that we identified, with the relationships between particular founder characteristics and firm performance a primary focus (e.g. Chrisman *et al.*, 1998; Cooper and Gimeno-Gascon, 1992; Low and MacMillan, 1988; Wortman, 1987).

Certain founder characteristic variables have yielded relatively consistent results with entrepreneurial firm performance. Parental background, education, experience, entrepreneurial orientation, and age are founder 'variables that have garnered impressive empirical or theoretical support' in terms of their acknowledged abilities to predict entrepreneurial firm performance (Sapienza and Grimm, 1997, p. 7). Even within this relatively limited set of variables, however, substantial variation in empirical results can be found. In an examination of 227 independent, high-technology start-ups, for example, Westhead (1995, p. 11) reported that 'founders with management experience in their last organization prior to start-up were more likely to be associated with a non-surviving business'. Conversely, the breadth and depth of a founder's managerial experience was found to be positively associated with venture sales and earnings in Chandler's (1996) study of 134 new ventures in the state of Utah. In contrast to both of these studies, Cooper *et al.*'s (1994) longitudinal study of 1053 new ventures representing all major

industry sectors and geographic areas in the US revealed no relationship between the level of a founder's management experience and firm survival or employment growth.

The results of this stream of research can be characterized as inconclusive and non-cumulative. In response to the diversity in findings, Chandler and Hanks (1994) have suggested that founder competence is a more promising predictor of performance than are founder characteristics. Of the founder characteristics having received significant research attention (e.g. personality characteristics, values and beliefs, skills, experience and education, and decisions and behaviors), research into founders' decisions and behaviors may prove most promising. Consistent with this view, Westhead and Birley (1995) observed that founder human capital variables were not predictors of employment growth among 408 new ventures in Great Britain. However, growth was strongly impacted by 'the *strategic decisions* which owner-managers make, such as the choice of industry and market niche, financing, suppliers, and customers' (p. 26, italics in the original). In short, founder effects on performance may manifest with research focusing on what founders 'do' rather than on what founders 'are'. Studies that rely on IPO firm performance also hold considerable promise, as this performance measure is not represented in this stream of research.

## Founder vs Non-founder Characteristics and Firm Performance

A third stream of founder effect research has explicitly defined and tested the posited linkage between founder status and firm performance. This research recognizes that differences in founder status are associated with differences in individual-level characteristics variables, and that these characteristics in turn affect performance. As such, this stream of research tests a key premise implicit in our review – that founders do matter to an entrepreneurial firm in ways that impact firm performance.

Chaganti and Schneer (1994) provide an example of empirical research in this area. Relying on a sample of 345 small firms operating in four northeastern states, they studied a series of research questions designed to explain entrepreneurial firm performance. Consistent with Begley's (1995) findings regarding the superior profitability of founder-led firms, results indicated that owner-started firms realized significantly higher ROA than both buyout and family firms. This finding was primarily attributable to the unique management patterns operating in firms employing this mode of entry. Based on their results, they concluded 'that performance and management patterns vary across mode of entry as does the effectiveness of strategic management patterns' (p. 244).

Two studies examined whether governance structure choices are mechanisms through which a CEO's founder status may influence firm performance (Daily and Dalton, 1992a, 1993). Daily and Dalton (1992a) explored the impact of founder status on several governance structure choices – CEO duality, number of outside board members, and percentage of outside board members – among *Inc.* 100 firms. These governance structure choices were also tested as predictors of firm performance (ROA, ROE, price-earnings ratio). No founder effects on the governance structure choices were observed, nor were any direct founder effects on firm performance reported. Conversely, relying on a sample of 186 small corporations, Daily and Dalton (1993) found that founder-led firms had greater incidence of CEO duality and lower numbers and percentages of outside directors. They also found that the board composition and size were significantly related to firm financial performance.

Walsh and Anderson (1995, p. 1) explored whether ‘the individuals who establish a small business differ from those who continue on the management of a previously established business; and (2) [whether] these differences affect the employment performance of the firm’. The results, based on a sample of 113 small firms operating in Ireland, revealed that firms’ founders, relative to non-founders, were significantly more innovative in their problem-solving styles. However, no relationships were uncovered between problem-solving styles and employment level or growth for either founder-led or non-founder-led firms.

Overall, research on the relationship between founder status and performance is relatively sparse and equivocal. Both main effects and contingent effects for the founder status/firm performance relationship have been noted. The majority of the research has focused on financial performance, with evidence of the positive impact of founders on entrepreneurial firm performance evident for financial performance, firm growth and firm survival. The relative scarcity of research in this domain, coupled with the equivocal findings, however, suggests the need for additional empirical exploration.

## CEO DUALITY

CEO duality (whether the CEO concurrently serves as board chairperson) constitutes a focus unique to publicly traded entrepreneurial firms. Competing theories characterize the CEO duality/firm performance literature (see, e.g., Dalton *et al.*, 1998, and Finkelstein and D’Aveni, 1994, for extended discussions). Many observers believe that the dual board leadership structure seriously compromises the independence of the board (Baliga *et al.*, 1996; Dalton *et al.*, 1998). Former Securities and Exchange Commission (SEC) commissioner Richard C. Breeden characterized CEO duality as the ‘George Patton model of governance – one person with all the authority’ (Dobrzynski, 1993, p. 69). The tenets of agency theory would suggest that such centralized leadership authority will lead to management domination of the board and result in poor performance (e.g. Eisenhardt, 1989; Fama, 1980; Fama and Jensen, 1983a, b; Jensen and Meckling, 1976; Shleifer and Vishny, 1997). Alternatively, organization theory and stewardship theory suggest that centralization of authority, as is found with the dual structure, will be associated with higher firm performance. Among the many benefits of CEO duality are clear lines of reporting authority, a centralized organizational spokesperson, and communication of strong firm leadership to external constituents (see, e.g., Dalton *et al.*, 1998; Donaldson, 1990; Finkelstein and Hambrick, 1996).

Relying on a sample of entrepreneurial firms, Daily and Dalton (1992a) examined the relationship between CEO duality and firm financial performance among *Inc.* 100 firms. For both accounting-based performance measures (i.e. ROA, ROE) and market-based performance measures (i.e. price–earnings ratio), they were unable to establish an association between CEO duality and financial performance. Similarly, in an examination of IPO-stage firms, Certo *et al.* (2001b) found no relationship between CEO duality and IPO underpricing. A related study relying on small corporations found no relationship between CEO duality and firm financial performance, whether relying on accounting (ROA, ROE) or market-based measures (price–earnings ratio; Daily and Dalton, 1993). These authors also found no relationship for firm growth.

In sum, the literature demonstrates no evidence of a CEO duality/performance relationship for entrepreneurial firms. As noted, the central concern with CEO duality is the potential for managerial domination of the firm. In an entrepreneurial firm where the CEO is often

the founder, this tendency would seem to be even more problematic. The entrepreneurship literature, however, does not sustain the proposition that CEO duality is systematically related to firm performance. This evidence, however, is based on a very small number of empirical studies.

## **TOP MANAGEMENT TEAMS**

TMT research experienced a renewal in the late 1980s following what Daily and Schwenk (1996, p. 185; see also Finkelstein and Hambrick, 1996; Hambrick, 1989) described as 'nearly two decades of relative inattention to the role of senior executives in corporate outcomes'. The preponderance of empirical work in this area has focused on TMT demography or TMT heterogeneity/homogeneity and the relationships with valued corporate outcomes such as innovativeness and firm performance (e.g. Kilduff *et al.*, 2000; Simons and Pelled, 1999). A focus of this work, too, is the impact, if any, that top managers have on firms' financial performance (e.g. Finkelstein and Hambrick, 1996; Thomas, 1988).

Much of the TMT work emanated from Hambrick and Mason's (1984) conceptualization of the upper echelons perspective. The central thesis of their work is that certain demographic profiles of TMT members will be associated with organizational outcomes such as strategies pursued and financial performance. They proposed that demographic variables such as executives' age, firm tenure, and educational background provide important insights into their cognitive predispositions. While TMT research has been criticized for its reliance on demographic variables that proxy for cognitive processes (e.g. Lawrence, 1997; Pettigrew, 1992), researchers continue to build on this tradition of integrating demographic with process variables (e.g. Pelled *et al.*, 1999; Waldman *et al.*, 2001).

Relatively little of the available TMT research has focused on TMTs in entrepreneurial settings (e.g. Weinzimmer, 1997). This is unfortunate, as West and Meyer (1998) have noted the importance of research focusing on teams, as compared to individual entrepreneurs (see also Gartner *et al.*, 1994; Kamm *et al.*, 1990). Many entrepreneurial firms rely heavily on a team-based approach to leadership (Eisenhardt and Schoonhoven, 1990; Ensley *et al.*, 2000; Feeser and Willard, 1990; Roure and Maidique, 1986). Reliance on a team provides access to a diversity of resources and skills not typically captured in a single entrepreneur (e.g. Aldrich and Zimmer, 1986; Cooper *et al.*, 1994).

In one of the few examples of empirical work in this area, West and Meyer (1998) investigated the relationship between TMT consensus and firm performance among entrepreneurial firms operating in high-growth industries. Their work is especially important as it incorporates the process-oriented approach, relying on primary data obtained via surveys and focused interviews. West and Meyer (1998, p. 397) noted that for the high-growth firm, disagreement among TMT members is likely to 'have a profound [negative] impact on firm performance'. Firm performance was measured as the sum of top managers' answers to three performance-related questions. One of these questions focused on performance relative to an ideal, with the remaining two questions focusing on performance as competitive advantage.

West and Meyer found that consensus on the CEO's articulated goals and means was negatively associated with perceived performance. These results held most strongly for secondary, as compared to primary, means and goals, as well as for firms in their early life-cycle stage. The authors noted that these results are opposite previous research findings and in contrast

to conceptualizations of the importance of consensus. These findings among entrepreneurial firms may differ from more traditional organizational settings for a variety of reasons. The authors propose that a central reason is that consensus on goals and means may be viewed as less important for firms where emerging growth opportunities, as compared to historical preferences of the CEO, are more salient (West and Meyer, 1998).

These findings may also illustrate the potential limitations of a CEO, as compared to a team, dominated approach to leading the entrepreneurial firm (West and Meyer, 1998). Should CEOs prove relatively narrow in their perspectives (e.g. Meyer and Dean, 1990), they may fail to seek the input of top managers. The loss of TMT perspectives on firm goals and means may result in a mismatch between the firm and its environment, leading to lower firm performance. Rather than attempt to force agreement among TMT members, the firm appears to be better served when a diversity of opinion is offered and multiple combinations of goals and means are considered. This conclusion is consistent with that of Ginn and Sexton (1990) who found that small business growth is significantly related to an owner's willingness to delegate decision-making authority.

In a related study relying on the demographic approach, Weinzimmer (1997) built on the concept of constructive conflict in an examination of the relationship between TMT characteristics and firm growth. Weinzimmer's sample included small firms and a control set of larger firms. While the sample is not a concise fit with our focus on entrepreneurial firms, given the paucity of entrepreneurial team/performance research, the focus on firm growth as the dependent variable, in conjunction with firm size, warrants its consideration. Weinzimmer found that functional heterogeneity among TMT members and TMT size was positively correlated with firm growth for the smaller firms, with functional heterogeneity positively related to firm growth for the larger firms as well. These findings suggest that large TMTs are more important, with respect to firm growth, for smaller firms. This is consistent with the anticipated benefits of the diversity of perspectives and resources that a team, as compared to a solo entrepreneur, can provide to the entrepreneurial firm. Similarly, Siegel *et al.* (1993) found that functionally balanced entrepreneurial teams were positively associated with entrepreneurial firm growth (see also Roure and Maidique, 1986).

Feeser and Willard (1990) also investigated the impact of TMT size on firm growth. While recognizing the potential downside to larger teams (e.g. slower decision processes), they proposed that larger TMTs would better enable firm growth. As we have discussed, larger teams have the potential to provide greater depth of skills, abilities and experiences. The authors focused on high-technology firms and compared *Inc.* 100 firms with a matched set of low-growth firms in the same industries. They, too, found strong support for the benefits of larger TMTs in relation to firm growth (see also Cooper and Gimeno-Gascon, 1992, who noted a positive relationship between founding team size and subsequent performance).

The small body of empirical research focusing on TMTs in entrepreneurial ventures yields valuable insights into the association between TMTs and entrepreneurial firm performance, as measured by firm growth. Cooper and Daily (1997; see also Ensley *et al.*, 2000) have noted that the concept of 'team' is particularly well suited for entrepreneurial research, as many entrepreneurial ventures will have been founded by a team, as compared to an individual. Entrepreneurial ventures with strong growth prospects are most able to accommodate multiple founders. As importantly, firms on a strong growth trajectory are more likely to require the multiple skills found within a team setting (e.g. Vesper, 1990). Establishing an effectively functioning TMT is therefore critical to the success of an entrepreneurial firm (Timmons, 1994). The consistent findings with regard to firm growth are encouragement for researchers

to expand consideration of performance indicators to include financial and IPO performance, as well as firm survival.

## **BOARDS OF DIRECTORS**

There is a distinguished tradition of conceptualization and research relating various aspects of boards of directors to a variety of corporate outcomes (see, e.g., Dalton *et al.*, 1998; Finkelstein and Hambrick, 1996; Johnson *et al.*, 1996; Zahra and Pearce, 1989). It would be fair to conclude, however, that the vast majority of boards of directors research has focused on large-scale, traditional organizations (e.g. *Fortune* 500 firms) as compared to entrepreneurial firms (Dalton *et al.*, 1998; Ranft and O'Neill, 2001).

A dominant focus in boards of directors research is the relationship between board composition and firm performance. The underlying premise of the vast majority of this research is that greater board independence will be positively associated with firm performance. This research is largely built on agency theory and addresses the role of the board in shielding shareholders from managerial self-interest (see, e.g., Fama and Jensen, 1983a; Jensen and Meckling, 1976). Independent directors, directors with no personal or professional relationship to the firm or firm management, are believed to be more effective in protecting shareholders' interests, resulting in higher firm performance (e.g. Dalton *et al.*, 1998). The entrepreneurial firm, where, as we have noted, the founder is likely to maintain a strong presence, may benefit from the external oversight provided by the independently structured board.

An additional area of investigation is the relationship between board size and firm performance. Here, the focus is primarily on the ability of directors to provide access to resources otherwise unavailable to the firm. This line of research is consistent with the resource dependence perspective (e.g. Pfeffer and Salancik, 1978; Provan, 1980). Greater numbers of non-management (often referred to as outside) directors provide the potential to create linkages between the firm and its environment. As noted by Pfeffer and Salancik (1978), firms with greater needs for effective linkages with the external environment should have larger boards. The entrepreneurial firm provides a context where larger boards may prove beneficial.

There is a growing body of literature devoted to examination of these relationships in entrepreneurial settings (e.g. Borch and Huse, 1993; Fiegener *et al.*, 2000; Fried *et al.*, 1998; Ostgaard and Birley, 1996; Rosenstein *et al.*, 1993; Stuart *et al.*, 1999). We identified several studies consistent with our focus on the relationship between the board and firm performance. As with the general body of literature (see, e.g., Dalton *et al.*, 1998, 1999), studies devoted to examinations of these relationships in entrepreneurial firms have yielded inconsistent findings.

Two studies have noted a positive relationship between boards and financial performance. Relying on *Inc.* 100 firms, Daily and Dalton (1992a) found a positive relationship between both the number and proportion of outside (non-management) directors and price-earnings ratio. Similarly, relying on a sample of small corporations, Daily and Dalton (1993) found a significant relationship between three aspects of boards of directors (number and proportion of outside, non-management directors and board size) and three indicators of firm financial performance (ROE, ROA, price-earnings ratio). These authors interpreted their board composition and board size findings as consistent with directors' service and resource roles (see, e.g., Johnson *et al.*, 1996, for an overview of board roles).

Finkle's (1998) examination of biotech firms undertaking an IPO revealed mixed support for the resource dependence perspective. He found no relationship between board size and

performance, as measured by the initial offering size or aftermarket performance, but did find that certain categories of affiliated directors were associated with a larger initial offering size. While Finkle interpreted these latter findings as consistent with agency theory, we believe that these findings may be a better reflection of the benefits of establishing linkages between the firm and its environment. Venture capitalist board members and directors associated with reputable underwriting firms were associated with larger IPO offering size.

In another examination of IPO-stage firms, Certo *et al.* (2001b) found independent, outside directors positively and significantly related to IPO underpricing. This is opposite the anticipated relationship. Because, as we previously noted, underpricing represents wealth that the initial shareholders fail to retain at the time of the IPO, this indicates a negative relationship with what would be considered traditional (financial) performance indicators. Based on these findings, the authors concluded that board composition does not serve as an effective signal of firm quality at the time of IPO. They further suggested that the presence of independent, outside directors appears to be more beneficial for underwriters' clients, and not the IPO firm's initial shareholders. Certo *et al.* (2001b) also found that larger boards were associated with less underpricing. As with the previously noted studies demonstrating a positive relationship between board composition and firm performance, the authors suggested that this board size finding is consistent with the resource dependence perspective. They suggested that investors may view larger boards as an indication that the IPO firm has access to a wider range of potential resources (e.g. access to capital and raw materials).

In another analysis, Rosenstein *et al.* (1993) surveyed CEOs of firms having received venture capital financing. A section of the survey asked CEOs to rate their firm's performance relative to competitors. The authors then analyzed this performance information in relation to the number of venture capitalists serving on the board. Contrary to the perspective that venture capitalists would bring a unique set of resources to the firm, the authors found no significant performance differences as a function of the number of venture capitalists on the board of directors. Other studies have also found no relationship between board composition and firm performance. Ford (1988), for example, surveyed CEOs and board members of *Inc. 500* (privately held, entrepreneurial) firms and found no relationship between outside board members' and CEOs' assessments of the importance of the board of directors with regard to the firm's overall success.

While the findings are mixed, these studies, in concert, suggest that boards of directors' composition and size are important for firm financial performance and that board composition is associated with the market's response at the time of IPO. It is interesting, then, that CEOs and board members do not necessarily perceive the performance benefits of the board, as indicated by the Rosenstein *et al.* (1993) and Ford (1988) studies. Given the relatively modest amount of work in this area, additional research attention suggests great promise for better understanding the importance of the board for entrepreneurial firm performance. Based on the absence of studies focusing on firm growth and survival, a focus on these performance indicators may prove especially informative.

## VENTURE CAPITALISTS

Venture capital has been one of the driving forces behind the successful commercialization and pace of introduction of unproven technologies over the past two decades (Barry, 1994; Jeng and Wells, 2000; Manigart and Sapienza, 2000). While venture capital plays a relatively

modest role in the overall scope of the formation and growth of entrepreneurial firms, venture capital financing fills an important void in start-up financing of high-risk ventures, as other forms of financing are often unavailable to these firms (Jeng and Wells, 2000; Sahlman, 1990). A venture capital firm serves the role of financial intermediary in a market where lenders and borrowers find it costly to get together. These costs are due to adverse selection and moral hazard problems, and the cost of administration, information gathering, and search efforts (Jeng and Wells, 2000). As demonstration of its importance, the venture capital industry has grown dramatically in the past two decades (Gompers and Lerner, 1996). Research in this area, however, had been largely descriptive and somewhat atheoretical (Sapienza *et al.*, 1996).

Survival rates of venture-backed firms are higher than for the general population of new ventures (70–80% vs 10–20%; Timmons and Bygrave, 1986). This is, in part, explained by the selectivity demonstrated by venture capitalists in funding less than 1% of proposals received (e.g. Hall and Hofer, 1993; Megginson and Weiss, 2001; Zacharakis and Meyer, 2000). Despite this selectivity, there is wide dispersion in the performance of venture-backed firms (e.g. Amit *et al.*, 1998; Dorsey, 1977; Huntsman and Hoban, 1980; Sahlman, 1990).

Many venture-backed entrepreneurial firms are neither clear successes nor failures. These become what are euphemistically referred to in the venture capital industry as the ‘living dead’ (Ruhnka *et al.*, 1992). The highest-ranking cause of living dead situations is management weakness (Ruhnka *et al.*, 1992). Replacing management, an action often initiated by venture capitalists, positively impacts performance in these firms. Such action is also consistent with the general propensity toward monitoring and control demonstrated by venture capitalists.

Venture capital involvement is especially relevant with respect to IPO firm performance. As noted by Sahlman (1990), the majority of returns for venture funds are earned on companies that eventually go public (see also Stevenson *et al.*, 1987). Venture capital involvement in an entrepreneurial firm can serve as a powerful signal to potential investors at the time of IPO (Barry *et al.*, 1990; Megginson and Weiss, 2001). Venture capital backing has been associated with lower underpricing and underwriter compensation (Megginson and Weiss, 2001). Not only do venture capitalists provide value through direct funding pre-IPO, they are also associated with lower IPO costs.

While not the focus of our review of governance/strategic leadership with firm performance, we would note (as indicated in the previous section) that venture capitalists not only commit capital, but also participate directly in the governance of their portfolio companies, *vis-à-vis* the board of directors (Barry *et al.*, 1990; Rosenstein *et al.*, 1993). One of the most significant actions a venture capitalist can take as a board member is to replace the CEO (Bruton *et al.*, 1997; Rosenstein *et al.*, 1993). Venture capitalists commonly structure their contracts such that they have the right to appoint and remove members of the management team (Gompers and Lerner, 1996). In one of the most extensive examinations of CEO dismissals by boards of directors on which venture capitalists serve, Bruton *et al.* (1997) found that replacing a CEO typically has a strong positive effect on performance. Their results are consistent with Ruhnka *et al.*'s (1992) finding of a positive performance effect when replacing CEOs of living dead firms. Lerner's (1994) examination of the impact of a change in CEO indicated that venture capitalist investors added 1.75 board members between financing rounds when the CEO was replaced, versus an average increase of only 0.24 between rounds in which the CEO was not replaced. Thus, the board-monitoring activities of venture capitalists appear to intensify as the need dictates. These research studies are consistent with the work of Barney *et al.* (1989) who found that high-agency and business risks were associated with the employment by venture capitalists of more elaborate governance structures for monitoring and control.



In a comprehensive review of venture capital in the early 1990s, Timmons and Sapienza (1992, p. 430) provocatively commented that ‘the area of venture capital research currently providing the greatest controversy is the issue of whether or not venture capitalist firms add value beyond the capital supplied’. The bulk of more recent studies comparing accounting or market data between venture-backed and non-venture-backed firms suggests that venture capitalists do, in fact, add value. However, the results of studies that have surveyed venture capitalists and entrepreneurs on their perceptions of value added (e.g. MacMillan *et al.*, 1989) have yielded inconsistent results. Also, there continues to be much debate on whether venture capitalists add value appropriate to their level of reward. Within the limited partnership legal structure of most funds, venture capitalists serve as general partners and traditionally put up 1% of the capital and receive 20% of the profits (Fried and Hisrich, 1992). The venture capitalist does appear to matter, but how much and at what price remains to be determined.

## **DISCUSSION: AN OPPORTUNITY LOST**

In our introductory section, we reviewed the continuing discussion of whether governance/strategic leadership in its several forms (e.g. CEOs, TMTs, boards of directors) is, in fact, associated with firm performance (Dalton *et al.*, 1998, 1999; Finkelstein and Hambrick, 1996; Rowe, 2001; Waldman *et al.*, 2001). The current state of the debate is nicely captured by Finkelstein and Hambrick (1996, p. 20; see also Daily and Schwenk, 1996, for an extended discussion): ‘As intuitively reasonable as it may seem, the idea that top executives hold great sway over organizational outcomes is not universally held.’ Conclusions of this ilk are largely based on evidence from large, mature firms. Our review proposed at the outset that relationships between governance/strategic leaders and firm performance should be more robust in entrepreneurial settings (e.g. Dalton *et al.*, 1998, 1999).

There are an imposing variety of theoretical rationales to sustain the perspective that entrepreneurial settings provide a more fruitful venue for governance/strategic leadership/performance relationships. One of the more compelling rationales involves the notion of managerial discretion. Hambrick and Finkelstein’s (1987) seminal work in this area suggests that it is the discretion of strategic leaders that will ultimately inform the decisions they make, the allocation of funds in support of those decisions, and the actual implementation of those initiatives. Without such discretion, strategic leaders are constrained, more imitative, less likely to pursue innovative strategies, and unlikely to marshal sufficient support from critical constituencies if they did (Hambrick *et al.*, 1993). Finkelstein and Hambrick (1996, p. 31) specifically noted that the size of the firm may be an important indicator of reduced executive discretion: ‘Large, mature firms . . . are not easily changed. Their top executives operate under severe inertial constraints.’ While Finkelstein and Hambrick did not specifically implicate entrepreneurial firms, it is generally true that entrepreneurial firms are significantly smaller than the large, mature firms on which the vast majority of organizational research is conducted. By extension, then, entrepreneurial firm leaders may operate under less severe constraints enabling them to more directly impact firm outcomes such as performance.

The view that entrepreneurial firm strategic leaders are less constrained by organizational systems and structures and may have far more latitude as compared to their larger-firm counterparts is sustained by empirical research (e.g. Baysinger and Hoskisson, 1990; Daily and Dalton, 1992a, b; 1993; Eisenhardt and Schoonhoven, 1990; Norburn and Birley, 1988; Reinganum, 1985). As we previously noted, there was also a recent meta-analysis of board size and financial

performance that provided an interesting, and entirely supportive, result underscoring a more pronounced effect for smaller firms. Dalton *et al.* (1999), relying on 131 samples ( $n = 20\,620$ ), reported a significant relationship between board size and financial performance. That effect, however, was much greater for smaller firms. For purposes of our review, that study is relatively coarse grained. The studies included in their 'entrepreneurial/small firm' category are not all entirely consistent with the definition of entrepreneurial firms on which we relied. Even so, it does suggest, based on many samples and a robust sample size, that some strategic leadership variables are, in fact, more highly related to performance for smaller firms. Some of these firms, as we have noted, will be small, *entrepreneurial* firms.

While the extant research is suggestive, much of it will not be directly applicable to the entrepreneurial setting. It is not surprising, then, that a consistent theme in extant entrepreneurial studies is the relative dearth of research examining the posited relationships between governance/strategic leadership and firm performance. At one level, this is surprising since a large body of conceptual/theoretical work underscores the importance of entrepreneurial firms to new market exploration, new product/service development, and job creation (e.g. Birley, 1987; Low and MacMillan, 1988; Reynolds, 1987; see also Gartner, 1985). Barring the inconclusive and non-cumulative research concerning the impact of founder characteristics on entrepreneurial firm performance, however, our review of this literature suggests that little attention has been focused on relationships between governance/strategic leadership variables and the subsequent performance of entrepreneurial firms. Given our argument that the entrepreneurial environment is exactly where these relationships are likely to be demonstrated, we find this to be an opportunity lost.

As our review of the entrepreneurial literature progressed, we identified a body of relevant empirical research. On a number of dimensions, however, this body of research presented some challenges in terms of its formal synthesis. Rather than relying on a narrative review, for example, we would have preferred to employ meta-analytical procedures that are nearly universally favored for synthesizing a body of research (e.g. Cooper, 1998; Hunter and Schmidt 1990, 1994; Lipsey and Wilson, 2001; Rosenthal and DiMatteo, 2001). Our review revealed several limitations to such an approach. Meta-analytical procedures require consistency across variables. We found, however, that the relevant entrepreneurial literature rarely relied on the same dependent variables. There was not a sufficient subset of studies relying on the same performance indicators (e.g. accounting-based measures, market-based measures, growth, survival, value of firm (or underpricing) at firms' IPO) and the same independent variable (e.g. founder/non-founder, board composition, TMTs) to allow their combination for meta-analysis. In the context of founder experience and performance, for example, Reuber and Fischer (1999, p. 30) recently noted their frustration with the lack of consistency to which we referred: 'there is a wide variety in the measures of experience and outcomes, in the moderating, mediating and control variables used, and in the values placed on particular kinds of experience', and that these factors have resulted in our current inability to confidently make claims about the importance of a founder's experience.

As importantly, our review also confirmed that there is very little consistency in the manner in which researchers have defined the 'entrepreneurial firm'. While we believe that the studies included in our review are largely consistent with our definition of an entrepreneurial firm as independent entrepreneurship (Sharma and Chrisman, 1999), we have also explicitly noted those few cases where the sample included in a given study may not have been as fully consistent with this definition as we would have liked. Our review, then, highlights the importance of developing consistency across studies in constructing research samples. Only then

can researchers begin aggregating the results of the general body of entrepreneurial research, whether that research addresses the governance/strategic leadership/performance relationships or otherwise.

### The Promise of Future Research

Our review also left us optimistic about the promise of future entrepreneurial research. The extant entrepreneurial research, for example, underscores the benefits of diversity among TMT members. This is a potentially important insight as the literature reflects an interest in the notion that many entrepreneurial ventures are team based, comprised of multiple founders (e.g. Ensley *et al.*, 2000; Weinzimmer, 1997). Even for those firms not founded by a team of individuals, the TMT may prove pivotal in the growth and success of the entrepreneurial venture. This is consistent with the resource dependence perspective. Our review indicates that this perspective may be especially applicable to entrepreneurial firms. This conclusion is based on research demonstrating positive relationships between outside directors, TMT members, board size, and venture capitalists and firm performance.

Dalton *et al.* (1999) have argued that it is the resource dependence role of high-ranking officers of the firm, board members, and other external linkages (e.g. venture capitalists), not the control role of these constituents, that accounts for the observed associations with firm performance. In the entrepreneurial firm, the resource dependence role may be even more critical than for larger, mature firms. The crucial issue may not be that firms' boards, or their investors, are able to control the policies, procedures, or practices of CEOs and their TMTs. Instead, it may be the ability of board members, venture capitalists, or high-ranking managers who can provide the firm with access, information, and resources that would otherwise be unavailable to it. Future research in the area of these resource dependence linkages may be particularly interesting, and productive.

Another promising area for future research is the inclusion of research designs not currently reflected in the literature or that have received little attention in the current literature. Longitudinal research designs, for example, are infrequently relied on for entrepreneurial research. We would hasten to note that this is a criticism that could easily be applied to organizational research in general (e.g. Schwenk and Dalton, 1991). The entrepreneurial domain, however, is particularly applicable for multi-period research. This would enable researchers to trace the development of a firm from its founding to its maturity. Also, these designs would enable researchers to employ sophisticated analytical techniques such as multi-period structural equations analysis. Such designs could not only provide a longitudinal perspective of the relationships of interest but could also inform the discussion of causality.

Researchers may also want to design studies that enable them to employ analyses that test the possibility that some of the strategic leadership/performance relationships are non-monotonic. The next generation of entrepreneurial research may be attentive to the potential for non-linear relationships. Perhaps both low levels and high levels of venture capital funding are dysfunctional. Perhaps board size and some elements of board composition (e.g. number of affiliated directors) have non-linear relationships with firm performance as well. Perhaps both low and high levels of founding team ownership at the time of an IPO constrain the performance of the firm at the time of IPO and beyond.

A focus on the resource dependence perspective would also support research that examines the transitional stages of the entrepreneurial firm. There is a strong tradition of research that

examines organizational life-cycles (e.g. Churchill and Lewis, 1983; Clifford, 1973; Hanks, 1990; Whisler, 1988). This research, in part, addresses the transition of a firm from entrepreneurial management to professional management (e.g. Daily and Dalton, 1992b). A basic premise is that entrepreneurial firms eventually outstrip the capabilities and resources of the founder (Flamholtz, 1986; Tashakori, 1980). If the transition from entrepreneurial management to some level of greater professionalization, with or without the guidance of the firm's founder, is inevitable for the entrepreneurial firm, attention to the resources that TMT and board members, as well as venture capitalists, can provide to assist in this transition promises to inform the importance of strategic leadership to entrepreneurial firm performance.

A venue where this type of transition may be most salient is for the entrepreneurial firm undertaking an IPO. At the time of an IPO an entrepreneurial firm will have to establish the abilities of firm managers to successfully guide the firm toward future success. Additionally, the IPO firm will be required to institute a board of directors if one is not already in place (see, e.g., Certo *et al.*, 2001b). Relying on signaling theory, recent research has demonstrated that larger boards are associated with less underpricing (Certo *et al.*, 2001b). We would also encourage researchers to extend such studies by employing resource dependence theory to investigate the potential resource linkages provided through TMT and board members and the relationship to longer-term IPO firm performance.

Future research may also benefit from examining various governance/strategic leadership categorizations in concert. Would the relationship between founder/non-founder and firm performance be different given various levels of venture capital exposure? Would high levels of venture capital have a tendency to constrain, along the arguments suggested by Hambrick and Finkelstein (1987), a firm founder's discretion to a different extent than that of a professional manager? What might be expected with a founder CEO, a high proportion of inside directors, and only modest equity holdings by venture capitalists? Is this a model of effective influence and focused attention to objectives or a recipe for managerial entrenchment and recalcitrance? Tashakori (1980), for example, found that venture capitalists favored replacing founders in order to facilitate the transition from an entrepreneurial to a professionally managed firm and enhance firm performance. Related to this, Certo *et al.* (2001a) found that investors discount the value of a founder-led IPO firm, as demonstrated by higher levels of underpricing. They also found that founder-led IPO firms with greater proportions of inside directors experienced less underpricing. This finding is suggestive of the importance of TMT diversity to offset any real or perceived limitations inherent in founder management.

## **CONCLUSION**

In conclusion, based on our review of the extant literature, we have identified several promising areas for furthering research addressing the relationships between governance/strategic leaders and entrepreneurial firm performance. These include: (1) the need for definitional consistency across entrepreneurial studies, (2) the reliance on theories not currently well reflected in extant research, most notably resource dependence theory, (3) the advancement of studies that enable the use of sophisticated methodologies enabling longitudinal research and tests of causality, (4) a focus on transitional stages of entrepreneurial firms and how governance/strategic leaders might facilitate effective transitions and firm performance, and (5) the consideration of combinations of governance and strategic leadership variables and how such combinations might facilitate entrepreneurial firm performance.

Our research agenda, while perhaps aggressive, is consistent with Shleifer and Vishny's (1997, p. 774) observations based on their review of corporate governance research: 'In writing this survey, we face a variety of still open questions . . . While the literature in some cases expresses opinions about these questions, we are skeptical that at the moment persuasive answers are available.' Across a vast literature of corporate governance in strategic management, finance, accounting and economics, Shleifer and Vishny (1997) concluded that researchers need to know a great deal more about such questions to objectively compare corporate governance systems. Our review of the entrepreneurial literature would suggest that this is the case with governance, strategic leadership and performance as well. We believe that the search for some of those answers may be particularly productive in the entrepreneurial environment. In the same spirit as Shane and Venkataraman (2000) to whom we earlier referred, we invite others to join us in empirically establishing the role of governance and strategic leadership in the success of the entrepreneurial firm.

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# Corporate Governance: The Role of Venture Capitalists and Buy-outs

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## INTRODUCTION

This chapter examines the contribution of the mechanisms involved in venture capital investments and leveraged management buy-outs to dealing with corporate governance problems in a wide variety of enterprise types. Both venture capitalists and leveraged and management buy-outs represent developments in capital markets that address the governance problems encountered therein. Leveraged and management buy-outs are a major subset of a range of corporate restructuring transactions, which also includes leveraged recapitalisations and cash-outs, employee stock ownership plans etc., and involve simultaneous changes in the ownership, financial structure and incentive systems of firms. Changes which typically have the effect of securing: first, a substantial reunification of share ownership and manager control; second, the partial substitution of various debt instruments for equity in the firm's financial structure; third, the introduction of increased incentives for investors and/or lenders to monitor senior managers; and fourth, the introduction of greater incentives at the peak tier of the managerial hierarchy and often at subordinate levels as well. These changes to existing corporate governance systems may be expected to enhance performance but may also introduce other governance problems and related issues, concerning in particular adverse selection and post-transaction monitoring.

Buy-outs and buy-ins taken together are a significant element of the UK market for corporate control, accounting for the majority of these ownership transfers in 2003 (CMBOR, 2004). Having developed primarily from the early 1980s (Thompson and Wright, 1995),<sup>1</sup> they remained important in both volume and value terms throughout the 1990s and beyond (Wright *et al.*, 2000b).

There is some considerable degree of overlap between specialist providers of funds to buy-outs (LBO Associations, Jensen, 1989) and venture capitalists (Sahlman, 1990). Both invest funds on behalf of other institutions and although there is a degree of heterogeneity in the

forms they take, both are often, especially in the US, organised as limited partnerships. Both cases involve relationship investment with management, managerial compensation is oriented towards equity and there are likely to be severe penalties for underperformance. The principal differences concern the nature of the relationship between investor and investee and that in investments by LBO Associations most of the funding required to finance an acquisition is through debt. Investments by venture capitalists, which may also involve buy-outs as well as start-ups and development capital, make greater use of equity and quasi-equity. As will be seen below, these differing relationships and financing instruments may be used to perform similar functions in different types of enterprise, so widening the applicability of the active investor concept within the Anglo-American system of corporate governance.

Venture capitalists have an important role to play in providing equity and quasi-equity funding for buy-outs and buy-ins, especially in the UK (CMBOR, 2004). Although buy-outs and buy-ins represent an important share of the investments made by venture capitalists (EVCA, 2003), these institutions will also be involved in the provision of funding and relational investor skills to early and development stage projects (Wright and Robbie, 1998).

This chapter examines the corporate governance issues involved in buy-outs and venture capital investments. The following section discusses theoretical issues, first relating to corporate governance problems in large organisations with diffuse ownership and the role played by the governance mechanisms involved in buy-outs. It then analyses the governance problems which may arise in privately held firms following the introduction of a buy-out or venture capitalist.

The second major section examines the empirical evidence relating to the effects of buy-outs and venture capitalists on various dimensions of firm performance as well as the effectiveness of the governance mechanisms which are involved. In the first instance, if buy-outs and venture capital investments represent, in principle, an enhancement on previous governance mechanisms then post-transaction improvements in performance may be expected. Alternatively, it may be the case that apparent improvements are merely a redistribution from other stakeholders in the firm. In terms of the effectiveness of new governance mechanisms, in the context of the general corporate governance debate, particular attention focuses upon the voice exercised by active investors.

## **THEORETICAL ISSUES**

This section first outlines the nature of governance problems which may be expected to give rise to conditions where buy-outs and venture capitalists may be appropriate. In particular, these problems concern the absence of voice-related, that is active, monitoring by investors and weaknesses in internal control mechanisms. Second, the nature of buy-outs and their expected contribution to enhancing performance are outlined. However, after a buy-out or venture capital investment has taken place new governance problems may be introduced and the third section discusses their potential nature.

### **Governance Problems in Large Organisations with Diffuse Ownership**

It has long been recognised, certainly since Berle and Means (1932), that a widely dispersed share ownership generates a monitoring problem, with individual shareholders having the

incentive to free ride rather than participate in decision making. The evolution of equity markets in the US and UK – although not necessarily in Japan or continental Europe – has intensified this problem by arrangements which have tended to lower the costs of *exit*, in the sense of Hirschman (1970), whilst further discouraging *voice*. Bhidé (1993) has demonstrated that stock market policy in the US – and somewhat similar arguments apply in the UK – has favoured maximum *liquidity*, i.e. the ease of making trades without more than a marginal disturbance on price, and *breadth*. He shows that the effect of regulations designed to protect outside investors from being disadvantaged in trading with insiders or financial institutions is to promote liquidity at the expense of penalising active investors. In the context of capital markets dominated by fund managers, this has had the effect of confining institutional investors to a passive role in governance, a position facilitated by the ease of partial or complete exit in a liquid market.

Outside the Anglo-American context, capital markets may place a much lower premium on liquidity and typically permit much more investor *voice* in corporate decision making. For example, in Germany and Japan very much smaller proportions of companies' shares are traded on open markets, whilst long-term cross-shareholding between firms and their trading partners and bankers are commonplace with consequent cross-representation on boards of directors (Kester, 1992). In Germany, banks also exercise considerable voting power as delegated proxies for their shareowning customers (Cable, 1985; Edwards and Fischer, 1994), and some European capital markets favour the separation of voting and non-voting equity claims, facilitating the operation of controlling blocks. In general, a more tolerant view of insider trading is taken in Japan and many European nations, some of which only introduced prohibitive regulation as part of the harmonisation of the European Community prior to 1992 (Bhidé, 1993). Weaker restrictions on insider behaviour, or less rigorous enforcement of such restrictions, encourage active investors rather than passive portfolio managers. France is an interesting case since large shareholders may exchange *exit* for *voice* by accepting board membership, on condition they cease short-term dealings in their firm's shares (Charkham, 1994, pp. 152–153).

Thus critics of Anglo-American corporate governance contrast its reliance on *exit*, backed by the sanction of hostile acquisitions, with the role played by investor and banker *voice* in Japanese and European firms. In the latter the concentration of equity ownership and especially equity voting power, the active participation of large investors and the important position of banks provide a continuing incentive for the monitoring of senior management.

## Failure of Internal Control Mechanisms

Restructuring transactions which developed in the 1980s pointed to a failure of firms' internal control mechanisms. In particular, it appears that the multidivisional (M-form) firm, which had become the dominant form of corporate organisation in the US and UK (Caves, 1980), was failing to deliver the shareholder benefits that its proponents, Williamson (1975) included, had anticipated. The M-form is characterised by a separation of operational decision making, located in profit-accountable divisions, from strategic planning and capital allocation which are the responsibility of corporate headquarters. Williamson (1975) hypothesised that such a structure enjoyed both corporate governance and informational efficiency advantages over its typical predecessors, the functionally organised firm and the holding company. As a governance device, the M-form was hypothesised to reduce managerial discretion by placing the *direct* control of most corporate resources in the hands of divisional managements who

were themselves remunerated by performance. The structure did not directly improve the peak tier agency problem, but Williamson (1985) suggested that since the M-form facilitated the absorption of acquisitions, an M-form population would intensify the threat of the takeover sanction on poor performance.

It was, however, via its informational advantages that Williamson saw the M-form contributing most to shareholder value. He argued that the internal capital market, created where profit-generating divisions remit cash to corporate headquarters which then reallocate investment funds back to finance divisional projects, enjoys substantial information transmission and monitoring advantages over its external counterpart. This generates the synergy for diversified M-forms.

Although the early empirical work was generally supportive of the M-form hypothesis (e.g. Steer and Cable, 1978), several caveats emerged: first, at least some of the apparent gains for introducing M-forms reflected abnormally poor performance *prior* to M-form adoption (Thompson, 1981); second, researchers continued to find significant coefficients for agency cost variables in regressions of performance on organisational form, suggesting that the M-form is at best an incomplete governance device (Cable, 1988); third, many M-forms lacked the control and/or incentive mechanisms described by Williamson (Hill, 1985); and fourth, whilst the M-form was clearly associated with conglomerate mergers in the 1970s the latter have increasingly become viewed as detrimental to firm performance (Hoskisson and Turk, 1990). Bhide (1993, 1994) argues that the comparative advantage of the internal capital market declined with improvements in the efficiency of external markets, weakening the case for diversified firms.

The failure of internal control systems may also be seen in situations involving innovation. Innovative activity typically involves high risk, unpredictability and long time horizons (Holmstrom, 1989). In large, integrated diverse organisations, obtaining reliable information on innovative activity may be prohibitively costly. Bureaucratic measures may be adopted to try to ensure performance but these measures may restrict experimentation and constrain innovative activity (Francis and Smith, 1995). Managers in the pre-buy-out situation thus face investment restrictions from headquarters, particularly where their firms are peripheral to the main product line of the parent company (Wright *et al.*, 2001). These restrictions reduce the freedom to respond to market developments and give rise to opportunities for a buy-out (Wright *et al.*, 2000a). Limitations on discretion and incentive alignment may be substitutes (Holmstrom and Milgrom, 1990). The loss of efficiency from restricting managerial discretion through tighter control may be outweighed by the benefits of providing the right incentives. It is likely to be difficult to provide the necessary equity incentives pre-buy-out for divisional management that directly relate to performance because of the need to maintain similar remuneration structures across the group and because equity typically relates to the group as a whole not to individual divisions.

## The Nature of Buy-outs

Buy-outs may be considered as devices which restore active governance and help resolve internal control problems by recreating many of the ownership, financial and incentive characteristics associated with newly emergent and/or bankrupt firms.<sup>2</sup> In a leveraged buy-out (LBO) a publicly quoted corporation is acquired by a specially established private company. The latter's equity is usually subscribed by a specialist LBO association; some institutional

investors, often with continuing dealings with the LBO association; and the management of the bought-out corporation. The principal equity subscribers are able to obtain substantial percentages of ownership because the bulk of the deal price – perhaps between two-thirds and seven-eighths – is met by borrowings. The same institutions may be involved as debt and equity subscribers – under a so-called ‘strip financing’ arrangement – or, alternatively, specialist institutions may be involved with debt instruments ranging from bank loans to ‘junk bonds’ (Jensen, 1989) and with covenants attached to the debt instruments (Citron *et al.*, 1997). The resulting private company is typically controlled by a small board of directors representing the LBO association and other major equity holders, with the CEO usually as the only insider on the board (Jensen, 1989, 1993).

The LBO, as described above, is a device for taking private an entire public corporation. The management buy-out, the dominant restructuring transactions in the UK, usually involves by contrast the acquisition of a divested division or subsidiary by a new company in which the existing management takes a substantial proportion of the equity. In place of the LBO association, MBOs usually require the support of a venture capitalist.

Since the transaction involves divisional divestment, the former parent may retain an equity stake, perhaps to support a continuing trading relationship. A management buy-in (Robbie *et al.*, 1992) is simply an MBO in which the leading members of the management team are outsiders. Such buy-outs as a generic concept have strong implications for corporate governance.

First, there is a substantial reconcentration of equity in the hands of insiders or with institutions with a close association with the new firm. Second, not merely do institutions (including venture capitalists) become motivated to act as monitors, normally by providing non-executive directors, but the process of going through the initial buy-out transaction ensures that the individuals concerned have a thorough knowledge of the affairs of the new company (Jensen, 1993) and thus the capacity to monitor. Third, the large-scale substitution of debt for equity in the financial structure of the new company substantially reduces managerial discretion and commits the management team to a repayment timetable. Together with the now significant management equity stake, vulnerable in the event of failure, this ‘bonds’ management to deliver on the performance plan agreed at the time of the buy-out. Fourth, most buy-out transactions are accompanied by a variety of incentive schemes. For example, in the UK many MBO deals allow the management’s final equity stake to reflect performance, according to a ratchet mechanism (Thompson *et al.*, 1992b), whilst employee shareholding schemes are not uncommon.

In situations involving the identification of opportunities for innovation, the problems relating to the restrictions of bureaucratic control noted above may be eased after the buy-out. Instead of obeying orders from headquarters that block innovation and investment in order to optimise the goals of the diversified parent company, the buy-out creates discretionary power for the new management team to decide what is best for the business, how to organise and lead the company, and how to set up a business plan that is most profitable for themselves and the firm (Wright *et al.*, 2000a, 2001). In these circumstances, the transaction may involve a financial structure with more moderate leverage that provides for greater discretion on the part of management whilst at the same time maintaining board representation by the private equity firm and covenants attached to the provision of external funds that require management to meet performance targets. The nature of the private equity firm may also be different from the traditional leveraged buy-out firm, with the balance of executives’ skills likely to involve more sector experience in addition to the typical narrower financial monitoring skills. In some



cases, management themselves may possess entrepreneurial skills that enable them to identify yet more radical innovative opportunities that were frustrated under the previous ownership regime (Wright *et al.*, 2000a, 2001).

### Expected Effects of Buy-outs

It has been widely suggested (DeAngelo *et al.*, 1984; Hoskisson and Turk, 1990; Jensen, 1986, 1989, 1993; Thompson *et al.*, 1992b etc.) that, taken together, these characteristics imply that the governance mechanisms in buy-outs coerce business units into a closer approximation to profit maximisation than occurs within a comfortably resourced quoted company. Apart from reducing direct expense preference behaviour by senior managers, which whilst it might be flagrant is rarely quantitatively important, the corporate restructuring present in buy-outs is likely to improve performance in four interrelated ways.

The first concerns increased management efforts towards cost minimisation. Buy-out activity is particularly concentrated in profitable but mature, low-growth industries. Enterprises therein, where the opportunities for growth in the core business are strictly limited, may find it particularly difficult to motivate managers with conventional reward systems. An LBO or an MBO for any cash cow division represent methods of injecting new incentives into potentially sclerotic businesses. The second relates to the reversal of *unprofitable diversifications*. Jensen (1986, 1989) has argued that mature businesses which generate *free cashflows* – i.e. funds in excess of those required for reinvestment in the core business – will tend to engage in unprofitable diversification rather than disgorge the cash in abnormally large dividends. Such diversifications may have agreeable consequences for managers – including increased firm size and therefore remuneration (see Conyon *et al.*, 1995) and lower earnings fluctuations – but not for shareholders. A debt-financed buy-out may be used to commit the firm to raise the (pre-interest) cashflow and hence reduce unprofitable investments and even to divest past diversifications to meet the terms of a debt repayment plan. The third concerns a reduction in *the response time for adaptation to market conditions*. A multiproduct firm with a satisfactory overall cashflow and a weak governance mechanism may experience considerable inertia in taking decisions to reorganise its activities in line with changing market conditions. For example, Jensen (1993) has argued that the largest US corporations have demonstrated a marked reluctance to disinvest in domestic manufacturing, in line with trends in productivity growth and world trade, provided that overall cashflows have been acceptable. A debt-laden entity, with active industry and strong incentives, is likely to accelerate the process of adapting to changes in underlying economic conditions. Fourth, where there is a trading relationship with a former parent, a divestment buy-out may have an increased incentive to perform where it is heavily dependent on its former parent and where the former parent retains an equity interest (cross-holding) (Wright, 1986). In such cases, the buy-out may mimic some of the relational investment characteristics of the Japanese keiretsu.<sup>3</sup>

Critics of buy-outs have argued that the apparent short- and/or medium-term gains for equity holders at least in part transfers from other categories of economic agent. The suggested losers include: *long-term equity owners*, as such a transfer would be consistent with a ‘short-termist’ reduction in avoidable expenditures, such as R&D or advertising, to boost the apparent profitability after a buy-out; *other stakeholders within the firm*, including the holders of senior debt in an LBO, who experience an increase in risk with no concomitant reward, and employees – at any level within the firm – who may find that their required performance breaches the

expectations held on joining the firms (Shleifer and Summers, 1988); and the tax authorities as, in general, debt interest is allowable against tax and hence restructuring transactions tend to reduce the firm's obligations.

## Governance in Privately Held Firms

Daily *et al.* (2002) in the previous chapter examined governance issues in entrepreneurial firms. In young and privately held firms the problems of diffuse ownership are absent as there is typically still a major ownership interest of the founders or their family (Hart, 1995). As such, corporate governance problems do not drive the need for change. However, founder managed firms may fail to adopt formal routines, including the delegation and decentralisation of authority and responsibility, because such steps may be seen by the founders as usurping their authority and legitimacy (Schulze *et al.*, 2001). These firms may experience an increased need for external finance, either to fund growth and or to enable ownership succession to occur whilst maintaining the firm as an independent entity, which may introduce governance problems. These problems may arise in the absence of the accompanying introduction of control devices either where former full owners remain as managers or former managers become part owner-managers but with a less than full ownership stake since they may have an incentive to engage in some degree of opportunistic behaviour (Jensen and Meckling, 1976). As with buy-outs, control devices can be introduced which give voice for venture capitalist investors (Sahlman, 1990) and an important monitoring role for bankers and other debtholders.

## Governance in Buy-outs and Venture Capital Investments

In both buy-outs and venture capital investments, the governance problems which may arise are sufficiently severe as to warrant further discussion. These issues relate to both pre- and post-transaction monitoring, both of which may influence the effectiveness of the newly introduced governance structures.

### *Pre-contracting problems*

At the time that a buy-out or venture capital investment is being considered, institutions are faced with a potentially adverse selection problem in that they are unable to gauge the managers' performance in the enterprise prior to deal completion (Amit *et al.*, 1993). Adverse selection issues also raise crucial problems in the potential effectiveness of post-transaction monitoring by institutional investors (Stiglitz and Weiss, 1981). To the extent that these problems lead investors to misjudge the situation, a deal and accompanying financial structure may be agreed which is inappropriate and possibly unviable. As a result, the control mechanism introduced by the commitment to meet the cost of servicing external finance may lead to suboptimal decisions. In addition, even if active investors are efficient in carrying out their governance role they may be faced with severe problems in effecting marked increases in performance.

In appraising potential investments, venture capitalists are faced with both uncertainty and an adverse selection problem. Uncertainty arises in relation to problems in forecasting future performance and the venture capitalist may attempt to address this problem by reference to available information on the sector and more general environmental data. Adverse selection arises as venture capitalists have to rely greatly on information about the state of affairs of the

enterprise which is supplied by the entrepreneur. Whilst the entrepreneur generally possesses an accurate understanding of the enterprise, there is no guarantee that this is conveyed in an unbiased and complete manner to the venture capitalist, giving the entrepreneur an asymmetric information advantage.

Early theoretical work by Cooper and Carleton (1979) and Chen *et al.* (1990) examined the role of contracts in multi-stage venture capital projects. Admati and Pfleiderer (1994) examine venture capital contracts relating to multi-stage venture capital investments by considering the possibility of asymmetric information, reflecting the problem that early stage venture capitalists become inside investors with greater information than subsequent investors.

Amit *et al.* (1993) point out that while the entrepreneur's familiarity with the industry, personal characteristics and track record can provide some insight for the venture capitalist these criteria are at best partial predictors of future success. These problems may vary between types of investment. In the case of a management buy-out proposal, financiers need to take funding decisions on the basis of observed managerial performance in post, expectations about whether improving managerial incentives will improve performance and management's willingness to take on the risk of a buy-out in order to secure the fruits of their human capital. Management buy-ins typically focus on enterprises which require turnaround and restructuring, but as the buy-in entrepreneur comes from outside there are problems of asymmetric information, both in relation to their true skills and because it has not been possible to observe the manager in post. In replacement and development capital situations it may be difficult to judge whether the entrepreneur's apparent previous performance will continue in the future where his/her equity stake is diluted by the introduction of venture capital. Amit *et al.* (1993) show that where venture capitalists are unable to assess private information about an entrepreneur's capabilities, low-ability entrepreneurs will accept the venture capitalist's price offer whilst high-ability entrepreneurs do not. Moral hazard problems are also raised since after the entrepreneur has been funded it may be difficult to distinguish between the effects of low entrepreneurial ability and adverse environmental conditions.

Hellmann (1998) provides an interesting and important theoretical explanation of why entrepreneurs may be prepared to provide venture capitalists with extensive control rights. Hellmann shows that investor control is more likely when entrepreneurs are more wealth constrained and less experienced and skilful. He suggests that entrepreneurs may self-select venture capitalists that have specialist monitoring and added value skills. Kirilenko (2001) provides a further development of earlier theories of the distribution of control rights in venture capitalists by relaxing the assumption that control is a binary variable. Kirilenko assumes that control is a continuous variable and that control rights are not proportionate to the number of shares held by venture capitalists or entrepreneurs.

In a management buy-out, investing institutions may be guided by incumbent management's deep knowledge of the business. This is not to say that management will necessarily have clear incentives to reveal truthful information since they may either wish to underplay problems in their anxiety to make the deal appear viable or overplay problems in order to reduce the transaction price. However, detailed probing may enable the venture capitalist to undercover major difficulties and approach an accurate assessment of the true state of affairs. In a buy-in, incoming management face similar problems to the venture capitalist. Management buy-in entrepreneurs may be able to reduce some of the problems of asymmetric information where they have detailed knowledge about the industry sector. In such cases they may be able to use personal networks to carry out informal verification about the state of the target enterprise.

### *Post-contracting governance problems*

In order for investors to engage in effective post-transaction monitoring to reduce moral hazard problems a key requirement is access to reliable information about the firm's activities. Whilst active investors may be faced with less severe moral hazard problems than arm's length shareholders, significant asymmetric information problems may remain. Sahlman (1990) indicates that venture capitalists and LBO Associations use various mechanisms to encourage entrepreneurs both to perform and to reveal accurate information. These mechanisms include staging of the commitment of investment funds, convertible financial instruments ('equity ratchets') which may give financiers control under certain conditions, basing compensation on value created, preserving mechanisms to force agents to distribute capital and profits, and powers written into Articles of Association which require approval for certain actions (e.g. acquisitions, certain types of investment and divestment etc.) to be sought from the investor(s) (Robbie and Wright, 1990). In addition to such structural mechanisms, the process of the relationship with the investee company is also an important aspect of the corporate governance framework. It has been pointed out that staging of investments can lead to myopia and overinvestment where initially entrepreneurs and subsequently first-round venture capitalists as insiders present misleading information to outsiders in an attempt to persuade them to invest. Admati and Pfleiderer (1994) show that a contract in which venture capitalists continue to maintain the same fraction of equity in the various rounds of financing a venture capital project can neutralise a venture capitalist's incentive to mislead. As will be seen below, the degree to which institutions may become involved directly in the process of corporate governance may vary both between LBO Associations and venture capitalists and between different types of venture capitalist.

In sum, the discussion in this section suggests that buy-outs and venture capital investments can involve mechanisms which make a contribution to dealing with governance problems associated with diffuse ownership and control. However, new governance problems may be introduced which result from adverse selection at the time of a transaction and post-transaction moral hazard.

## **EMPIRICAL EVIDENCE**

The evidence presented in this section covers two broad themes. The first addresses the effects of buy-outs and venture capital investments. If these forms of organisation in principle involve enhanced governance mechanisms, then improvements in various aspects of performance may be expected to be observed. The second reviews evidence on the apparent efficacy of the differing elements of the corporate governance framework introduced in buy-outs, with particular attention focused on the role of active investors in exercising governance through voice.

### **The Effects of Buy-outs**

In what follows, the results of an extensive set of studies relating to the impact of buy-outs on various dimensions of performance are reviewed. Apparent performance improvements may be the result of improved corporate governance mechanisms or they may simply be redistributions from other stakeholders or may follow from apparent underperformance prior to buy-out as a

result of the manipulation of accounting information by management. An issue is also raised about the time dimension of the role of corporate governance mechanisms in buy-outs and buy-ins. Although there is an argument that they pose a long-term challenge to the widely held company quoted on a stock market (Jensen, 1989), this is highly debatable. Accordingly, evidence on the longevity of buy-outs and buy-ins is also reviewed.

This review of the empirical evidence first addresses performance effects in terms of effects on share prices, operating performance and reductions in deferrable expenditures. The second set of empirical results covers evidence relating to the notion that in addition to or instead of performance improvements, buy-outs may involve transfers from other stakeholders, previous owners and taxation. Third, evidence relating to the longevity of buy-outs is briefly reviewed.

### *Antecedents and stock market responses*

US studies of the role of free cashflow in the decision to go private have produced mixed results. Lehn and Poulsen (1989) and Singh (1990) report that firms going private have greater free cashflow than firms remaining public. In addition, they found that public to privates (PTPs) exhibited lower sales growth. However, Kieschnick (1998) reworked Lehn and Poulsen's sample using a weighted logistic regression and found free cashflow and sales growth to be insignificant. In addition, Opler and Titman (1993) also find no evidence that, individually, either free cashflow or Tobin's Q influence the decision to go private. However, they do find that leveraged buy-outs are more likely to exhibit the combined characteristics of low Q and high cashflow than firms remaining public. Further, Halpern *et al.* (1999) also find no evidence to support the free cashflow hypothesis. Thus there is limited evidence that US PTPs exhibit excess free cashflow and poor growth prospects which suggests that going private is not being driven by the need to return free cash to the shareholders. Different governance structures may be associated with whether a firm is taken private in a management buy-out. A matched sample study of firms that remain listed and those that undertake a buy-out in the UK found that firms that go private through a buy-out are more likely to have higher CEO ownership, higher institutional ownership and more duality of CEO and chairman (Weir *et al.*, 2005). These firms did not have excess free cashflows or face a greater threat of hostile acquisition but they did have lower growth opportunities.

A series of studies (DeAngelo *et al.*, 1984; Kaplan, 1989a; Lehn and Poulsen, 1989; Marais *et al.*, 1989) have examined the share price response to 'going private' LBO deals and each finds, as expected, a large abnormal gain for the target's shareholders. The implied bid premium appears even larger than that found in conventional acquisitions: Kaplan (1989a) reports a median abnormal gain of 42% for 76 US buy-outs in the period 1980–86. Furthermore, since the assets pass to a new private owner there is no partially offsetting price movement for the acquirer. In part, the bid premium may reflect anticipated gains for divestment. Similar stock market studies of voluntary divestments by diversified companies (e.g. Hite and Vetsuypens, 1989; Markides, 1992) reveal small but significant positive announcement effects.

### *Operating performance and strategy*

Research on US LBOs indicates substantial mean improvements in profitability and cashflow measures over the interval between one year *prior* to the transaction and two or three years *subsequent* to it. A series of studies of early 1980s LBOs (Kaplan, 1989a; Kaplan and Stein, 1993; Muscarella and Vetsuypens, 1990; Smith, 1990) reports mean gains in the operating cashflow/sales ratio of between 11.9% and 55%. A subsequent study (Opler, 1992) using deals completed in the later 1980s reports a 16.5% gain in that ratio over a similar three-year

period. Smart and Waldfogel (1994) suggest these pre- and post-restructuring comparisons fail to control for firm-specific trends in performance. To isolate the shock effect of the buy-out they use a series of estimators which are adjusted for forecast performance. Their best estimates imply a median shock improvement in the operating income/sales ratio of 30% between the pre-LBO year and the second post-LBO year. A survey of 182 mid-1980s MBOs in the UK indicated that 68% showed clear improvements in profitability, compared with 17% that showed a clear profitability fall (Wright *et al.*, 1992). In this study and the American work (Kaplan, 1989a; Smith, 1990), improvements in working capital management, particularly credit management, appear to be an important identified source of improved performance. Asset sales also appear important in the US context (Liebeskind *et al.*, 1992). Wright *et al.* (1996a) examined the impact of full firm MBOs on accounting profits and concluded that firms experiencing an MBO generated significantly higher increases in return on assets than comparable firms that did not experience an MBO over a period from two to five years after buy-out.

Further studies have examined changes in strategy following buy-out and have shown that buy-outs are a means for focusing the strategic activities of the firm towards more related businesses (Easterwood and Seth, 1993) and that they are followed by a reduction in both diversification and the number of hierarchical levels of management that are related to improvements in profitability (Phan and Hill, 1995). Both Wright *et al.* (1992) and Zahra (1995) find that buy-outs are followed by significant increases in new product development and other aspects of corporate entrepreneurship.

### *Productivity*

The productivity impact of LBOs was examined by Lichtenberg and Siegel (1990) using a longitudinal database of 12 000 US manufacturing plants. They found that total factor productivity for plants involved in LBOs, 1981–86, rose from 2% above its industry control, to 8.3% over the first three years of post-LBO operation. However, the mean changes conceal considerable differences between yearly cohorts, the significant productivity gains occurring in the later years of their sample period. Wright *et al.* (1992) also found a variable productivity impact in their study of UK MBOs – the proportion of respondents citing productivity gains as the principal source of performance improvement halved (to 9%) between the early and mid-1980s.

More direct evidence is provided by Wright *et al.* (1996a) who analyse total factor productivity for each of years one to six following buy-out. They find a significant positive coefficient on the management buy-out dummy variable in each year. Amess (2003) examines total factor productivity (TFP) in buy-outs using a stochastic production frontier approach on a panel of UK manufacturing firms. He finds that MBOs have higher efficiency than non-MBOs in the two years before buy-out but not prior to that date, have higher efficiency in each of the four years following buy-out and do not have superior efficiency beyond the fifth year post-buy-out. Both these studies use measurements of TFP based on firm-level data which is potentially misleading. In the largest buy-out study to date, Harris *et al.* (2005) assess the total factor productivity (TFP) of plants before and after management buy-outs (MBOs), using a longitudinal dataset of approximately 36 000 UK manufacturing establishments. Some 4877 of these plants experienced an MBO during 1994–98. The results are in contrast to the US evidence of Lichtenberg and Siegel (1990) as they suggest that MBO establishments were approximately 2% less productive than comparable plants before the transfer of ownership. After the MBO, plants experienced a substantial increase in productivity of approximately 90%.

### *CAPEX and R&D*

Increased leverage may be expected to put pressure on management to reduce CAPEX and R&D. If the effect is to curb some negative net present value projects, as Jensen (1986, 1989) suggests, the result will be value enhancing. However, if managers are forced to abandon profitable opportunities the reverse holds. The US evidence strongly supports the view that capital investment falls immediately following the LBO (Kaplan, 1989a; Smith, 1990). Palepu (1990) notes that since this appears to hold for LBOs which subsequently return to a public listing, with large positive returns for investors, it is difficult to view the reduction in capital investment as damaging. The evidence on UK MBOs is rather different. Wright *et al.* (1992) report that asset sales are offset by new capital investment, particularly in plant and equipment.

Several studies (Lichtenberg and Siegel, 1991; Long and Ravenscraft, 1993; Smith, 1990) report that LBO firms reduce R&D spending, but that LBOs are very largely in low R&D industries, such that the overall effect is unsubstantial.

### *Transfers from other stakeholders, previous owners and taxation*

Following Shleifer and Summers (1988) it may be that restructuring transactions create opportunity to revise implicit labour contracts and so transfer value from employees to equity owners. However, evidence on the measurable dimensions of *employment and employee compensation* does not indicate any major transfers. Opler (1992), Kaplan (1989a) and Smith (1990) – but not Muscarella and Vetsuypens (1990) – report small increases in total firm employment following LBOs. Kaplan (1989a) and Smith (1990), however, report rather larger falls after an adjustment for industry effects – i.e. LBO firms failed to expand their employment in line with industry averages. Lichtenberg and Siegel (1990) report an 8.5% fall in non-production workers, over a three-year period, with production employment unchanged. (Their database excludes head offices, so that the total impact on non-production workers is probably even greater.) Lichtenberg and Siegel also report a decline in the relative compensation of non-production workers.

UK studies suggest that job losses occur most substantially at the time of the change in ownership. Wright *et al.* (1992) report an average 6.3% fall in total employment with an MBO, but note that the firms surveyed indicated a subsequent 1.9% improvement by the time of the authors' survey. In both US and UK *firm-level* studies the aggregate employment losses may be inflated somewhat by voluntary divestments.

The wealth of existing bondholders will be adversely affected if new debt, issued at the time of the restructuring, impacts adversely on the perceived riskiness of the original debt. Marais *et al.* (1989) fail to detect any such wealth transfer. However, a more detailed study by Asquith and Wizman (1990) reports a small average loss of 2.8% of market value. Those original bonds which had protective covenants actually showed a positive effect; whilst bonds without covenants experienced a significant negative reaction.

Purchasers of corporate assets, like buyers on any other market, may overpay or underpay on occasions. However, in MBOs and LBOs with significant insider participation, there is the possibility of systematic underpricing. This could be passive, where managers simply exploit asset prices which appear (to them) to be too low or it could be the result of some deliberate misrepresentation or concealment by them. Evidence on the former has been obtained from abnormal stock market returns for announced and then withdrawn LBOs. DeAngelo *et al.* (1984) report on substantial (25%) net cumulative prediction error and Marais *et al.* (1989) a much smaller one (7%). Smith (1990) argues that abandoned, hidden-information buy-outs should show the same subsequent performance gains as completed ones and hence the same market response, assuming the buy-out is solely motivated by insider information. She finds no

such evidence and hence concludes against the hidden information view. However, the stock market response appears to depend substantially on whether or not a subsequent bid occurs (Lee, 1992); whilst existing owners' returns are greater when competitive bids are received (Easterwood *et al.*, 1994).

Evidence of 'earnings management' prior to a management bid is somewhat contradictory: DeAngelo (1986) reports none whilst Perry and Williams (1994) find evidence of consistent falls in the last complete financial year prior to an announcement. Kaplan and Stein (1993) analyse the structure of MBO pricing across the whole 1980s. They suggest that deal prices rose with the level of leverage leading to 'overheating' and a sharp rise in the failure rate at the end of the decade. Thus if there were initial transfers from the pre-MBO owners, this trend was reversed across the period.

Since restructuring transactions typically substitute debt for equity they tend to reduce corporate tax liabilities. Kaplan (1989b) and Schipper and Smith (1988) suggest that tax savings do account for a small fraction of the value gains from LBOs – a finding underpinned by a significant correlation between estimated tax savings and the observed buy-out bid premium. Jensen (1989) suggest that the overall impact of LBOs on tax receipts is likely to be positive, with increased tax receipts for capital gains, operating income increases and interest income received.

### *Longevity*

If the new organisational forms created in buy-outs and buy-ins remedy corporate agency problems they might be expected to pose a long-term challenge to the widely held public limited company (Jensen, 1989). However, recent work (Kaplan, 1991; Wright *et al.*, 1994) in both the US and the UK indicates that the longevity of buy-outs is heterogeneous. Though the majority of buy-outs may be relatively long lived, a substantial proportion, particularly larger firms, either return to quoted status or are sold to third parties within a relatively short period. A significant proportion have also failed, the governance aspects of which are returned to below.

## The Effects of Corporate Governance Mechanisms

What is so far unclear from the evidence is the *relative* importance of the different elements in the corporate governance mechanisms present in buy-outs and venture capital transactions. It was noted above that typically these transactions had the effect of increasing managerial equity interest in the firm, increasing monitoring incentives in institutions, raising leverage and introducing performance-related contracts at different levels in the organisation. The first subsection briefly reviews the general effects of the corporate governance changes in buy-outs and venture capital investments compared to other forms of corporate restructuring. The second subsection discusses in turn the implications for corporate governance of evidence relating to adverse selection problems and post-transaction monitoring.

### *General*

Some indications of the effects of corporate governance mechanisms introduced in buy-outs and venture capital investments are given by comparing alternative organisational forms. For example, leveraged recapitalisations, which simply substitute debt for equity in quoted companies, have been shown to raise shareholder value (Denis and Denis, 1993) but they do not appear to have the same performance impact as LBOs, which also involve managerial ownership and



institutional involvement (Denis, 1994). Similarly, defensive ESOPs, in which leveraged employee share purchases are used to forestall takeovers, do not appear to perform as well as LBOs (Chen and Kensinger, 1988). Thompson *et al.* (1992b) regressed equity returns to investors on a number of governance devices, including leverage, ratchet contracts etc., and found that the management team shareholding size had by far the larger impact on relative performance in UK MBOs. Similarly, Phan and Hill (1995) found that managerial equity stakes had a much stronger effect on buy-out performance than debt levels for periods of three and five years following the transfer of ownership.

### *Investors' monitoring*

In the light of the previous discussion, the effectiveness of corporate governance mechanisms needs to be viewed both before and after the buy-out or venture capital transaction. Pre-transaction issues concern the ability of investors to deal with adverse selection problems through financial contracting. Post-transaction concerns involve the efficacy of monitoring devices in general, but also the more problematical cases of restructuring and failure. The ability of corporate governance mechanisms in buy-outs and venture capital investments to intervene in a more timely manner than in firms with non-active investors has been argued to be an especially important attribute. Monitoring also has a time dimension because of the objectives of both management and buy-out and venture capital investors. This section considers these issues in turn.

### Contracting

Venture capitalists are found to place most emphasis on very detailed scrutiny of all aspects of a business, typically including discussions with personnel and accessing considerably more information of an unpublished and subjective kind especially unaudited management projections (Wright and Robbie, 1996). However, informational asymmetries are likely to remain and contracting is used in an attempt to address this problem. Sahlman (1990) drew attention to the nature of the financial contracts used to govern the relationships both between venture capital firms and their funds providers and between venture capital firms and their investees. These financial contracts may specify information rights. Mitchell *et al.* (1995) find that the information needs of venture capitalists for monitoring purposes extend well beyond those generated by conventional accounting statements. Despite more detailed access, they find that information asymmetries still exist.

Kaplan and Strömberg (2001) find that the contracts adopted by venture capitalists allow them to separately allocate cashflow right, voting rights, board rights and other control rights. These rights are frequently found to be contingent on observable measures of financial and non-financial performance, especially for early stage investments. Voting and control rights tend to be allocated such that if an investee performs poorly the venture capitalist obtains full control. If an investee's performance improves, the entrepreneur is likely to obtain increased control, whilst if the investee does very well the venture capitalist is likely to get cashflow rights but reduced control rights. Venture capitalists tend to have greater control in early stage investments where the business has yet to generate revenues. Importantly, cashflow incentives and control rights mechanisms are complements not substitutes. Kaplan and Strömberg suggest that the allocation of control rights between the venture capitalist and the entrepreneur are central to financial contracts and note that despite the prevalence of contingent contracting, contracts are inherently incomplete. Fiet *et al.* (1997) suggest that the use of contractual covenants can align a new venture top management team's financial incentives with those of the venture capitalist

and the board of directors and reduce the level of dismissals of CEOs. However, actual dismissal covenants were found to be an ineffective means of preventing dismissal. The overall size of the board was also negatively related to the probability of entrepreneur dismissal; the number of venture capitalist board members is associated with a greater probability of dismissal.

### Post-transaction governance mechanisms

Post-transaction governance problems can be considered in relation to the nature and effectiveness first, of venture capitalists generally and second, in respect of the mechanisms involved in buy-outs and buy-ins. In other words, although active investors may be in place it is not clear how they may operate in order to be effective.

In respect of venture capitalists, Sapienza *et al.* (1992) provide evidence that there is less involvement in monitoring activities which are more developed and presumably less risky, such as buy-outs, buy-ins and development capital cases. MacMillan *et al.* (1989) show that differing levels of involvement in venture capital investments (e.g hands-on/close trackers versus hands-off/laissez-faire approaches) were not related to the nature of the operating business but to the choice exercised by the venture capital firm itself as to the general style it wished to adopt. There were, however, no significant differences in the performance of businesses subject to differing levels of involvement. Similarly, Elango *et al.* (1995) identify three levels of assistance by venture capitalists in their investees: inactives, active advice-givers and hands-on but point out that these are not primarily related to the stage of investment. However, there were major variations in the amount of time different venture capitalists spent on problem investees. Some venture capitalists tended to fire managers quickly in such circumstances, whilst others became closely involved in working with existing management. Barry (1994) cites evidence that venture capitalists intensify their monitoring activities as the need dictates.

Gomez-Mejia *et al.* (1990) found that CEOs view the venture capitalist's influence as positive in terms of financial concerns and boundary spanning activities. However, they found that venture capitalists' involvement in internal management issues is generally seen as negative. They conclude that CEOs and venture capitalists appear to hold opposite views about venture capitalists' contributions to the internal management of the firm. Rosenstein *et al.* (1993) find that the value added by venture capitalists was not rated significantly higher by CEOs than that of other board members. There was some evidence that larger venture capitalists provided significantly more value added, but that in such cases the venture capitalist frequently controlled the board. Entrepreneurs were found to value venture capitalists on their board with operating experience than those with purely financial expertise. Indications are that the general type of skills possessed by venture capital executives varies between types of venture capitalist, with those employed by captive funds (e.g. development capital subsidiaries of clearing banks) tending to be more financial skills oriented whilst those employed by independents tend to have greater industrial skills (Beecroft, 1994).

The study by Sweeting (1991) suggests that relationships need to be such that problems are revealed to the venture capitalist at an early stage rather than being left to fester and emerge as a surprise at a later stage. Fried and Hisrich (1995) also provide evidence of the importance of personal relationships in the governance of venture capital investments in the US and that formal power needs to be used sparingly to be effective. Sweeting (1991) finds that venture capitalists 'tend to leave well alone when there is confidence in what is going on and the people in charge, and, alternatively, they are concerned and proactive to put matters right when this is not so' (p. 18). Whilst venture capitalists may take control when things go seriously wrong, such action has to be exercised with care since, as Sweeting points out, to act precipitously

may destroy carefully nurtured relationships and commit the venture capitalists to unknown amounts of time to put matters right. Sweeting and Wong (1997) find that venture capitalists sometimes take a 'hands-off' approach to overseeing their investments and structure their deals in a way that is compatible with this approach.

Sapienza and Gupta (1994) found that high goal congruence between the CEO and venture capitalists is associated with less interaction in the venture capitalist–CEO dyads. They also found that less venture capitalist experience, earlier stage ventures, and greater geographic distance are associated with less venture capitalist involvement; however, venture capitalists' level of ownership is not related to the amount of interaction. Lerner (1995) found support for the geographical proximity idea with venture capitalists twice as likely to serve on the board if they are within five miles of the venture.

Closer involvement in monitoring by venture capitalists may not in and of itself lead to superior returns (Wright *et al.*, 2003). The way in which involvement is conducted and the development of relationship is likely to be crucial. Sapienza and Korsgaard (1996) use a procedural justice perspective to examine the relationships between venture capitalists and entrepreneurs. They found that timely feedback by entrepreneurs increases venture capitalists' trust and their commitment to entrepreneurs and also decreases monitoring. Busenitz *et al.* (1997) examined contractual factors that may impact perceptions of fairness in the venture capitalist–entrepreneur relationship and find that some governance mechanisms put in place at the time of funding and the background of the NVT do frame the perceived sense of fairness in the venture capitalist–entrepreneur relationship. Cable and Shane (1997) introduce a prisoners' dilemma logic to the venture capitalist–entrepreneur decision to highlight which factors are expected to be more salient to the entrepreneur and when certain factors will have their greatest influence on venture capitalist and entrepreneur decisions to cooperate with each other or defect.

Hellmann and Puri (2000) use archival and survey data of both venture-capitalist- and non-venture-capitalist-backed firms and find that the appropriateness of choosing an involved investor depends on product market strategy and that venture capitalists play different roles in different companies. Venture capitalists are found to have an impact on the development path of a start-up firm.

Venture capitalist firms may not invest alone but as part of a syndicate of venture capital firms and this can bring governance benefits. Brander *et al.* (2002) argue that the need to access specific resources for the *ex post* management of investments, rather than for the selection of investments, is a more important driver for syndication, based on their finding that syndicated venture capital deals have higher rates of return than stand-alone projects. Sorenson and Stuart (2001) have shown that the probability that a venture capital firm will invest in a distant company increases if there is a syndicate partner with whom they have previously co-invested, and if that syndicate partner is located near the target company. Jääskeläinen *et al.* (2002) show that the number of IPOs of portfolio companies of US venture capital managers increases when they manage more companies, up to a certain 'optimum'. This optimum can be increased through syndication. Wright and Lockett (2003) caution, however, that coordination in syndicates may delay governance actions. They find that to address these problems, syndicates typically involve the selection of reputable venture capital firms and powers that enable lead investors to take timely action and 'drag along' other syndicate partners.

Institutional influences between countries may influence the nature of monitoring by venture capitalists. Sapienza *et al.* (1996) find that although venture capitalists perform a similar post-deal role in different countries, venture capitalists in the UK put in effort at a rate more similar

to US venture capitalists than to their European counterparts; this is interesting given that later stage investing in the UK is comparable to elsewhere in Europe. In the Netherlands and France interpersonal roles are slightly more important than the networking roles; in the US and the UK, the interpersonal roles approach the strategic roles in perceived importance.

The nature of involvement in monitoring may be influenced by institutional factors related to whether or not a venture capital firm in a particular market is domestic or foreign owned. Whilst a foreign owned firm may to some extent adapt to local circumstances, it may also transfer some of its modus operandi to the market into which it internationalises. Pruthi *et al.* (2003) in their study of venture capital firms in India show that foreign venture capitalists, which were predominantly US owned, were significantly more likely than domestic venture capitalists to be involved at the strategic level whilst domestic venture capitalists were significantly more active at the operational level. Foreign venture capitalists placed significantly more emphasis on restrictions on additional borrowings and on monthly management accounts whilst domestic venture capitalists placed significantly more emphasis on specifying certain accounting policies and industry specialist board membership.

Similarities but also differences emerge in the operation of active investor governance in buy-outs and buy-ins. Sahlman (1990) in comparing LBO Associations with venture capitalists notes that executives in the former may typically assume control of the board of directors but are generally less likely than venture capitalists to assume operational control. UK evidence in buy-outs and buy-ins shows that board representation is the most popular method of monitoring investee companies with venture capitalists also requiring regular provision of accounts (Robbie *et al.*, 1992). However, evidence shows that there appears to be a greater degree of control exercised by institutions over management buy-ins than for buy-outs or other forms of investment. A much higher requirement for regular financial reports than for venture capital investments generally is indicated (Robbie *et al.*, 1992). Equity ratchets are also found to be more frequently used in buy-ins, reflecting the greater uncertainty about their future performance, but there is little difference between buy-outs and buy-ins in the extent to which institutions require board representation.

As for venture capital investments generally, evidence from buy-outs and buy-ins emphasises the importance of keeping the venture capitalists informed of developments through regular contact. Hatherly *et al.* (1994) show that on balance the relationship between financial institutions and management buy-outs involve partnership and mutual interest with devices to control agency problems generally being used in a flexible manner. However, there is case study evidence that, in smaller buy-ins in particular, institutions do not appear to have been as active in responding to signals about adverse performance as might have been expected (Robbie and Wright, 1995) and that relationships between entrepreneurs and investors had not developed to the extent that potential crises could be identified and understood by the venture capitalist. These problems reflect the high cost of monitoring and control in relation to the value of investments. Monitoring via non-executive directors who were not full-time employees of the venture capitalists frequently appear to be inefficient, particularly in problem cases requiring close supervision.

In larger buy-ins there is evidence of extensive and repeated active monitoring, as, for example, in the case of Isosceles/Gateway (see Wright *et al.*, 1994, for a detailed case study). This difference illustrates the comparative cost–effort–reward trade-offs involved in the active monitoring of large and small investments. Interviews with buy-out investors indicate that larger deals, partly with a view to eventual exit through stock market flotation, are increasingly

following the Cadbury Committee recommendations concerning board committees and the roles of non-executive directors (Chiplin *et al.*, 1995). Typically, it may be expected that a larger deal would include two independent non-executive directors, one of whom would be chairman, together with one director representing financing institutions.

### Restructuring and problem cases

Particular importance has been attached to the governance role of active investors in cases where buy-outs and other venture capital investments require restructuring (Ruhnka *et al.*, 1992). The extent and nature of action by institutions may depend crucially upon their judgement as to the causes of poor performance, the prospects for the success of restructuring action and costs–reward relationship involved in such actions. The authors' interviews with venture capitalists suggest that it is possible to identify two general types of problem cases: 'Living Dead' and 'Good Rump'. Living Dead investments essentially involve enterprises where the business collapses with little prospect of turnaround. Such investments risk involving a disproportionate amount of monitoring and control, especially if the enterprises concerned are small. Moreover, it may be difficult for the venture capitalist to implement change in such companies where management typically have a majority of the equity, until a pressure point arises which cannot be relieved by other funding sources.

The second category, 'Good Rump', is distinguishable from the first in that these firms are viewed as capable of being turned round, but the effects of restructuring have yet to be seen. Such cases may be underperforming because of general sectoral problems. In both cases the ability of active investors to effect change may be heavily influenced by whether they are controlling shareholders or not. A problem of enforcing restructuring is that it may be difficult to agree with other parties what form it should take. In smaller investments, since management are usually important majority shareholders great care is needed in taking action, with the principal strategy typically being to produce a consensus on necessary action. If institutions are a controlling shareholder, as is usually the case in larger buy-outs and buy-ins, making changes is theoretically straightforward. However, in cases with large syndicates of financiers, restructuring may be delayed or take a particular direction because of differences in the attitudes of syndicate members (Lockett and Wright, 2001).

An important issue in dealing with problem cases concerns whether or not to replace the CEO. Lerner (1995) found that the number of venture capitalists on the board goes up significantly at the time when there is CEO turnover. Bruton *et al.* (1997) examine the determinants of venture capitalists' decisions to seek dismissal and whether venture capitalists believe that such replacements make a significant and positive difference in the fate of the venture. They find that venture capitalists see the strategic activities as most crucial in dismissal decisions, whereas more operational types of failings are more easily overlooked. Further, they show that venture capitalists believe that the replacements have a significant net positive effect on performance.

Larger management buy-ins may be able to bear extensive restructuring, and it may be economical for institutions to invest the effort to undertake it, whereas the possibilities may be very limited for smaller cases. In small buy-outs and buy-ins, management may own the vast majority of the equity and a very small group of managers may carry out the major functions, thus making it difficult to remove underperforming management or enforce a trade sale. In larger buy-outs and buy-ins, no single manager may be indispensable and it may thus be easier for institutions to exert pressure to remove underperforming senior managers.

## Failure

In the limit, problems with governance structures in buy-outs may be expected to be closely associated with business failure. Following Jensen (1991), the governance role of higher leverage may mean that financial distress is signalled earlier than if an enterprise were funded substantially by equity. As a result, a firm which defaults on loan payments may still retain greater value, including going concern value and stand a better chance of being reorganised, than one which is finally forced to waive a dividend. However, where buy-outs are funded with excessive levels of debt they may not realistically be able to service it, leading to a greater probability of failure (Bruner and Eades, 1992). Kaplan and Stein (1993) in a study of larger US buy-outs provide strong evidence that excessive prices paid for buy-outs in the late 1980s meant that buy-outs took on higher amounts of debt and had an increased probability of failure or needed to be restructured, particularly if planned asset sales were not forthcoming, than buy-outs funded earlier in the 1980s. As in the US, larger UK buy-outs which entered receivership or were refinanced in the early 1990s also had markedly higher proportions of senior debt than those which did not experience such problems (Wright *et al.*, 1994).

The influence of governance factors on likelihood of failure, after controlling for firm-specific factors, was examined using logit analysis by Wright *et al.* (1996b). Using a large sample and a set of financial and non-financial variables a 92% correct classification rate was produced. Initial and start-up characteristics of MBOs, reflected in a number of key non-financial variables, demonstrate a strong ability to explain failure up to five years later. Thus, *ceteris paribus*, greater levels of restructuring undertaken expeditiously at buy-out are associated with survival whilst the need to deal with problems some time after buy-out are associated with failure. The shedding of labour in buy-outs is well documented (Palepu, 1990) and a significant positive association with delay in reducing employment and failure may reflect the superior performance of those buy-outs that are able to restructure and shed labour early in the life-cycle and have underlying strength in their product base. Direct investor monitoring was found not to be significant. Positive managerial motives for buy-out were associated with reducing the probability of subsequent failure. Buy-outs which raise funds from the wider body of employees had a lower probability of failure. Variables relating to the proportion of equity held by management and initiative being taken by management were weakly significant. However, it was found that leverage and size *per se* do not increase the risks of failure if the appropriate incentives and restructuring actions can be implemented and the enterprise is able to generate sufficient cashflow to service its debt. In an agency theory context, these findings are consistent with the control function of high levels of debt which place pressure on management to restructure and that variables which measure the taking of restructuring action at the time of the buy-out reduce the probability of failure.

## Longevity

Barry (1994) cites evidence that venture capitalists' governance may be biased where they have incentives to offer bad advice to their investees in the matter of premature IPO timing. Such a potential reverse principal-agent conflict may arise where venture capitalists seek a premature IPO in order to gain profile and report prior performance in the raising of new funds. Megginson and Weiss (1991), however, do show that there is less underpricing in venture-backed IPOs than in those without such finance, a finding consistent with a recognised role for venture capitalists as monitors.

Venture capital firms can influence the timing of the IPO decision by virtue of their board seats as well as their more informal role as advisors to management. Lerner (1994b) shows that seasoned venture capital firms appear to be particularly good at taking companies public near market peaks but rely on private financings when valuations are lower. Gompers (1996) provides an alternative perspective on Lerner's arguments by developing a model of venture capital grandstanding which demonstrates that new venture capital firms are willing to incur costs by taking companies public earlier than would maximise returns on those individual companies and earlier than would established venture capital firms. This behaviour acts as a signal to the market that the venture capital firm has the necessary skills to select investments that have a high probability of going public and hence of generating greater returns. This action is crucial as only good performers will be able to raise new funds. Brav and Gompers (1997) find that venture-capital-backed IPOs outperform non-venture-capital-backed IPOs using equal weighted returns and that venture-capital-backed firms do not significantly underperform benchmark market returns using factor asset pricing models but non-venture-capital-backed IPOs do.

A meta-analysis of short-run IPO underpricing which aggregates the findings from a number of studies finds that in contrast to expectations, venture-backed IPOs were positively associated with underpricing (Daily *et al.*, 2002). However, there is also evidence that the interaction of top venture capital firms and top underwriters has a stronger impact on IPO firm market capitalisation than the impact of venture capital backing in isolation (Lange *et al.*, 2001). Bradley *et al.* (2001) examine the effect on underperformance of IPOs after the end of the lock-up period following flotation and find that the negative effect is more pronounced for venture-backed IPOs. They attribute this effect to venture capitalists distributing shares to their limited partners on expiry of the lock-up and limited partners immediately selling the shares. There is also evidence that general partners (i.e. venture capitalists and leveraged buy-out financiers) relinquish control through open market sales rather than selling a strategic block, suggesting that corporate control considerations related to blockholders may not be of primary importance for these companies (Ritter and Welch, 2002). Jain and Kini (1995) show that venture-capital-backed IPOs have superior post-issue operating performance compared to non-venture-capital-backed IPOs over a three-year post-issue period. They also show that the extent of superior performance is positively associated with the quality of venture capitalists' monitoring.

Examination of the buy-out process suggests that for each transaction the interests of the three parties involved so that a buy-out can be completed – management, institutions and the company itself – influence the longevity of the buy-out form (Wright *et al.*, 1994). Institutions' desire for realisation in order to achieve their returns may influence the nature of corporate governance to achieve a timely exit. Buy-outs funded through closed-end funds may especially seek exit within a given time period. For example, some 30% of buy-outs completed in 1988 funded through closed-end funds have either floated or been sold by March 1995 compared with only 13.2% of buy-outs funded through other sources of finance (Chiplin *et al.*, 1995). In order to achieve timely exit, institutions are more likely to engage in closer (hands-on) monitoring of their buy-out investments and to use exit-related equity ratchets on management's equity stakes (Wright *et al.*, 1995).

Successful managers' desires for wealth diversification and career enhancement, and the enterprise's ability to compete successfully in changing markets in the longer term, also raise the potential for conflicts of interest and emphasise the life-cycle of the buy-out form. Meeting the interests of these parties also has implications for the appropriate governance structure in a particular buy-out. Both quantitative and case study evidence suggests that the greater the

degree of environmental dynamism and the greater the conflicts in the objectives of the parties which had to be suppressed at the time of the transaction to enable it to be completed, the more the governance structure has to be able to respond and be flexible (Wright *et al.*, 1994).

Holthausen and Larcker (1996) examine whether performance benefits are maintained when buy-outs return to market (so-called 'reverse buy-outs'). They find that while leverage and management equity falls post-IPO, they remain high relative to comparable listed corporations that have not undergone a buy-out. Pre-IPO, buy-outs' accounting performance is significantly higher than the median for the buy-outs' sector. Following the IPO, accounting performance remains significantly above the firms' sector for four years but declines during this period. Consistent with other studies, they find that the change is positively related to changes in insider ownership but not to leverage.

## CONCLUSIONS

The theoretical and empirical discussion in this chapter indicates that buy-outs and venture capital investments can make a considerable contribution to dealing with governance problems both in firms with diffuse ownership and control and in cases where previously entirely closely held firms sell at least part of their equity. The evidence reviewed indicates that such changes in the ownership and financial structure may yield large gains in shareholder value and operating performance, but that both pre- and post-transactional governance problems also need to be addressed.

It is also necessary to recognise that buy-outs and venture capital investments are heterogeneous phenomena, with apparently similar forms having differing governance implications: as evidenced by the insider–outsider distinction between an MBO and an MBI, where the latter involves an outside management team. Incoming managers (and their investors) in a buy-in are faced with potentially severe asymmetric information problems. To the extent that these problems lead managers and/or investors to misjudge the situation the restructuring contract effected may be inappropriate and possibly unviable.

The evidence presented in this chapter also has more general implications for the corporate governance debate. First, it suggests the need for a flexible approach to governance under which the forms adopted take account of such specific factors as the firm's product market and life-cycle circumstances. The governance debate can be said to have focused on the relative merits of *exit* and *voice* in reducing the agency costs of control. The innovations involved in the restructuring transaction would appear to recognise a role for enhanced voice, even in the context of exit-dominated capital markets. Second, the discussion of the monitoring problems of active investors suggests that even in cases where they have a major incentive to exercise voice, their ability to do so may be constrained by access to information, the nature of the relationship with the management of the firm being monitored and the effort–cost–reward trade-off involved in close involvement. Third, the evidence on the longevity of buy-outs and buy-ins suggests that governance structures are not necessarily fixed over time. As enterprises develop they may need to change their governance structure if value for shareholders is to be optimised.

## NOTES

1. See Wright *et al.* (1992) for discussion of their development in the UK and elsewhere.



2. Detailed descriptions of the characteristics of corporate restructuring transactions, which also include leveraged recapitalisations and cash-outs, are available elsewhere. (For example, in Jensen (1989) for US LBOs, Thompson *et al.* (1992b) for UK MBOs, Denis and Denis (1993) for leveraged recapitalisations, Chen and Kensinger (1988) for ESOPs and Robbie *et al.* (1992) for UK management buy-ins.) The main emphasis here is upon buy-outs and buy-ins, as these illustrate the widest range of governance mechanism changes and have attracted most empirical attention.
3. Critics of buy-outs have suggested that it is misleading to compare LBO Associations to the main board of Japanese keiretsu (Gilson and Roe, 1993) as argued by Jensen (1993). Though financial institutions play a large role in both buy-outs and keiretsu, the Japanese bank's role is embedded in a system of relational cross-holdings which includes industrial companies. The contractual governance structure among factors of production and its dependence on product market competition is critical to the keiretsu. In the absence of trading relationships described here such arrangements are absent from LBO Associations.

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# Explaining Western Securities Markets

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Mark J. Roe

## INTRODUCTION

How important is corporate law – and its capacity to protect minority stockholders from insider machinations – in building securities markets and separating ownership from corporate control? Quite important, according to most recent analyses, and maybe central. Without strong corporate law protections, securities markets, it is said, will not arise. And if corporate law is good enough in technologically advanced nations, ownership will be diffused away from concentrated ownership into dispersed stock markets.

This new perspective contributes to understanding the fragility of capital markets in transition and Third World economies, chiefly where even basic contract and property rights are weak. But it has been used – and I argue here it has been overused – to primarily explain the persistence of dominant stockholders and fragile securities markets in many of the world's richest nations in Europe and Asia. I say 'overused' because there is too much that is critical to ownership separation that corporate law *does not even seek to reach* in the world's richest, most advanced nations.

Two conceptual problems afflict the idea that corporate law is primary. Each is sufficient to render the corporate law argument, while still relevant, secondary, not primary.

First, current academic thinking lumps together costly opportunism due to a controller's self-dealing and costly decision making that inflicts losses on the owners. The former – self-dealing – corporate law seeks to control directly. The latter – bad decision making that damages shareholders – it does not. Other institutions control the latter, and their strength varies from firm to firm and from nation to nation. Yet owners tend to stay as blockholders – and ownership does not become diffuse, and securities markets remain weak – if stockholders expect that managerial agency costs to shareholders would be very high if ownership were fully separated.

Second, the focus on legal families is probably oversold. Civil law systems are said to overregulate, while common law systems, operating through wise judges, do not. The theoretical difficulty with this perspective is that American regulatory agencies (such as the Securities and



Exchange Commission) arose because common law institutions were thought to insufficiently regulate securities markets.

To recast our angle of vision from a national overview of the system to a micro-perspective, if ownership were not separate from control in a nation (or a firm), we cannot know whether separation was aborted because blockholder rampages are uncontrolled or because *managerial agency costs* would be far too high if ownership were separated. *Either* could have prevented separation. Or one alone could have, with the other not standing in the way. And the first is closely and directly affected by corporate law; the second is not.

Managerial agency costs come in two ‘flavors’, only one of which corporate law tightly controls. One flavor – machinations that transfer value to the controllers and managers, or ‘stealing’ – corporate law seeks to control. But the other – ‘shirking’, or pursuing goals other than shareholder value – corporate law largely leaves alone. If underlying economic, social, or political conditions make managerial agency costs very high, and if those costs are best contained by a controlling shareholder, *then concentrated ownership persists whatever the state of corporate law in checking blockholder misdeeds.*

I speculate on what underlying economic, political, and social conditions could make managerial agency costs persistently high. I also speculate on how a shrinking of these agency costs, plausibly now going on in continental Europe, could raise the demand to build legal institutions that facilitate separation. First, for ownership to be separated in the modern economy, distant shareholders seem to need, or at least do better if they have, some pro-stockholder institutions, such as transparent securities markets, aligning compensation systems, intermittent takeovers or other means to control managers, and shareholder primacy norms. (Enron and WorldCom failures show us how fragile these can be even in a nation, like the United States, that favors such institutions.) But some polities, unlike America’s, have been hostile to pro-shareholder institutions and don’t support them.

Second, some polities further open up the gap between managers and shareholders by encouraging managers to expand, to go slow in downsizing, to give employees more rights against firms that can be best mitigated for shareholders via concentrated ownership, and so on. When those pressures are strong, dominant stockholders stay in place to resist them. Some nations have pursued a vision of what makes for a just society in ways different from how they have been pursued in the United States. And, hence, it is no surprise that their corporate systems differ.

Third, in corporatist polities, owners and stakeholders have protected themselves by being concentrated enough to be national political players, because that’s where the economic pie is divided up (Faccio, 2002; Roe, 2000). Some of these pressures are in flux today, but their historical reality is quite concrete. The relationships fit some types of industrial production, especially where soft commitments and close working relationships between owners and workers are critical.

High-quality, protective corporate law is a good institution for a society to have. It lowers the costs of building strong, large business enterprises. It can prevent or minimize diversions engineered by dominant stockholders, and some institution that minimizes these is a necessary condition for separation to stay stable. It, or a substitute such as reputational intermediaries (DeLong, 1991; Miwa and Ramseyer, 2000) or stock exchange rules (Coffee, 2001; Mahoney, 1997; Roe, 2000), lowers the cost of ownership separation and seems to precede, or shortly follow after, ownership separation. But, among the world’s wealthier nations, corporate law does not primarily determine whether it is worthwhile to build those enterprises and their

supporting institutions. It is only a tool, not the foundation. With labor and political institutions in mind, we can better explain why some nations have deep separation and strong stock markets while others, about equally wealthy, do not.

## **THE ARGUMENT: CORPORATE LAW AS PROPELLING DIFFUSE OWNERSHIP**

Today's dominant academic and policy explanation of why continental Europe lacks deep and rich securities markets is the purportedly weak role of corporate and securities law in protecting minority stockholders, a weakness that is said to contrast with America's strong protections of minority stockholders. A major European-wide research network, leading financial economists, and increasingly legal commentators have stated so (Bebchuk, 1999; Becht and Röell, 1999; Coffee, 1999; La Porta *et al.*, 1998, pp. 1136–1137, 1999).

Leading economists showed that deep securities markets correlate with an index of basic shareholder legal protections. And 'protection of shareholders . . . by the legal system *is central* to understanding the patterns of corporate finance in different countries. Investor protection [is] *crucial* because, in many countries, expropriation of minority shareholders . . . by the controlling shareholders is extensive' (La Porta *et al.*, 2000, p. 4, emphasis added). According to Modigliani and Perotti (1998, p. 5), nations with deficient legal regimes cannot get good stock markets and, hence, 'the provision of funding shifts from dispersed risk capital [via the stock market] . . . to debt, and from [stock and bond] markets to institutions, i.e., towards intermediated credit'. And legal origin (civil law vs common law) is said to load the dice in the results.

While the academics are developing a theory and gathering data, international agencies such as the IMF and the World Bank have admirably promoted corporate law reform, especially that which would protect minority stockholders (Iskander *et al.*, 1999). The OECD and the World Bank have had major initiatives to improve corporate governance, both in the developing and the developed world (Nestor, 2000; OECD, 1999; Witherell, 2000).

These efforts by the international agencies are valuable at some level. They could well contribute to reaching their goals of more stable enterprises and better economic performance, especially in transition nations. But corporate law, and the reach of government policy makers through corporate law reform, has limits. And those limits are much closer than the policy makers and academic theory now discern. Here I demarcate those limits in the world's richest nations beyond which corporate law ceases to be primary. If the limits are close, and the cost of constructing corporate law high, then other development strategies may be seen as even more valuable.<sup>1</sup>

### **Protecting Minority Stockholders**

The basic law-driven story is straightforward. Imagine a nation whose law badly protects minority stockholders against a blockholder extracting value from small minority stockholders. A potential buyer fears that the majority stockholder would later shift value to itself, away from the buyer. So fearing, the prospective minority stockholder does not pay pro rata value for the stock. If the discount is deep enough and cannot be accurately priced (or if the

transfer diminishes firm value), then the majority stockholder decides not to sell, concentrated ownership persists, and stock markets do not develop.

To approach the problem from the owner's perspective, posit large private benefits of control. The most obvious benefits that law can affect are those that the controller can derive from diverting value from the firm to himself. The owner might own 51% of the firm's stock but retain 75% of the firm's value if the owner can overpay himself in salary, pad the company's payroll with no-show relatives, use the firm's funds to pay private expenses, or divert value by having the 51%-controlled firm overpay for goods and services obtained from a company totally owned by the controller. Strong fiduciary duties, strong doctrines attacking unfair interested-party transactions, effective disclosure laws that unveil these transactions, and a capable judiciary or other enforcement institution can reduce these kinds of private benefits of control.<sup>2</sup> The owner considers whether to sell to diffuse stockholders. With no controller to divert value, the stock price could reflect the firm's underlying value. But the rational buyers believe, so the theory runs, that the diffuse ownership structure would be unstable, that an outside raider would buy up 51% of the firm and divert value, and that the remaining minority stockholders would be hurt. Hence, they would not pay full pro rata value to the owner wishing to sell; and the owner wishing to sell would find the sales price to be less than the value of the block if retained (or if sold intact) (Bebchuk, 1999; La Porta *et al.*, 1997, 1998, 1999; Modigliani and Perotti, 1997, 1998).

Hence, the block persists. The controller refuses to leave control 'up for grabs' because, if it dips below 51% control, an outsider could grab control and reap the private benefits.

## The Attractions of a Technical Corporate Law Theory

The quality-of-corporate-law argument is appealing. Technical institutions are to blame, for example, for Russia's and the transition nations' economic problems. The fixes, if technical, are within our grasp. Humans can shape the results. Progress is possible, one could believe, if we can just get the technical institutions right. And, one might further believe, if we make these technical fixes, economic development will follow. And, as a descriptive matter, if we don't see ownership separation in Germany, France, and Scandinavia, it must be because a technical fix is missing, one we can provide as easily as downloading a computer program across the Atlantic Ocean. But if it turns out that deeper features of society – industrial organization and competition, politics, conditions of social regularity, or norms that support shareholder value – are more fundamental to inducing securities markets, we would feel ill at ease because these institutions are much harder for policy makers to control.<sup>3</sup> These institutions might change over time (and seem to have been changing in Europe), but they are not in the hands of a technocrat drafting corporate law reform.

As self-contained academic theory, there is little to quarrel with in the quality-of-corporate-law argument. It is sparse and appealing. Good corporate law lowers the costs of operating a large firm; it is good for a nation to have it because it seems to cost so little. But we need *more* to understand why ownership is not separate from control *even where core corporate law is good enough*. Where managerial agency costs due to potential dissipation are substantial, concentrated ownership persists *even if conventional corporate law quality is high*.

Given the facts that we shall develop in the third section – there are too many wealthy, high-quality corporate law countries *without* much separation – the quality-of-corporate-law theory needs to be further refined or replaced. This we do next in the second section of the chapter.

## CORPORATE LAW'S LIMITS

### How Managerial Agency Costs Impede Separation

Managers would run some firms badly if ownership were separated from control. Effective corporate laws constrain managers' *overreaching* but do much less directly to make them operate their firms well. A related-party transaction can be attacked or prevented where corporate law is good; judges examine these transactions and remedy them. But judges leave unprofitable transactions untouched, with managers – unless tainted by self-dealing – able to invoke corporate law's business judgment rule to deflect direct legal scrutiny.

Consider a society (or a firm) in which managerial agency costs from dissipating shareholder value would be high if ownership were separated but low if it were not, because a controlling shareholder can contain those costs. When high but containable by concentration, concentrated shareholding ought to persist *even if corporate law fully protects minority stockholders from insiders' overreaching*. Blockholders would weigh their costs in maintaining control (in lost liquidity and diversification) against what they would lose if managerial agency costs were high. Control would persist even if corporate law were good.<sup>4</sup>

This is a basic but important point, and it is needed to explain the data that we look at in the next section.

### Improving Corporate Law without Increasing Separation

The basic but often missed argument in the prior section – that variance in managerial agency costs can drive ownership structure, and that managerial agency costs can vary greatly *even if conventional corporate law is quite good* – can be stated formally in a simple model. High managerial agency costs can preclude separation *even if there is high-quality conventional corporate law*.

Let:

$A_M$  = the managerial agency costs to shareholders from managers' dissipating shareholder value, to the extent avoidable via concentrated ownership.

$C_{CS}$  = the costs to the concentrated shareholder in holding a block and monitoring (that is, the costs in lost liquidity, lost diversification, expended energy, and, perhaps, error).

When  $A_M$  is high, ownership concentration persists whether or not law successfully controls the private benefits that a controlling shareholder can siphon off from the firm. Further, let:

$V$  = value of the firm when ownership is concentrated.

$B_{CS}$  = the private benefits of control, containable by corporate law.

Consider the firm worth  $V$  when ownership is concentrated. Posit first that managerial agency costs are trivial even if the firm is fully public. As such, the private benefits of control, a characteristic legally malleable and reducible with protective corporate law, can determine whether ownership separates from control. Consider the controller who owns 50% of the firm's stock. As such he/she obtains one-half of  $V$  plus his/her net benefits of control.

(In this simple first model, the value of the firm remains unchanged whether it has a controlling stockholder or is fully public.) She retains control when the following inequality is true:

$$V/2 + B_{CS} - C_{CS} > V/2. \quad (1)$$

The left side is the value to the controlling stockholder of the control block: half the firm's cash flow plus the private benefits diverted from minority stockholders minus the costs of maintaining the block (in lost diversification and liquidity). The right side is the value he/she obtains from selling the block to the public. Equation (1) states that, as long as the private benefits of control exceed the costs of control, then concentrated ownership persists. Because corporate law can dramatically shrink the private benefits,  $B_{CS}$ , corporate law matters quite a bit in equation (1). This is the current theory<sup>5</sup> that we next amend.

We amend by introducing  $A_M$ , managerial agency costs from dissipating shareholder value in ways that a controlling shareholder would avoid. If those managerial agency costs are non-trivial, then the controller's proceeds from selling into the stock market would be  $(V - A_M)/2$ . Concentration persists if and only if

$$V/2 + B_{CS} - C_{CS} > (V - A_M)/2. \quad (2)$$

To rearrange: concentration persists if the net benefits of control ( $B_{CS} - C_{CS}$ ) are more than the controller's costs of diffusion ( $A_M/2$ ):

$$B_{CS} - C_{CS} > -A_M/2. \quad (3)$$

Or, further rearranging, concentration persists if:

$$B_{CS} + A_M/2 > C_{CS}. \quad (4)$$

Quality-of-corporate-law theory predicts that diffusion fails to occur when  $B_{CS} > C_{CS}$ , with corporate law the means of containing  $B_{CS}$ . That is correct but incomplete. Where  $A_M$  is high, diffusion does not occur *even if*  $B_{CS}$  is zero and corporate law perfect, because  $A_M$  could take over and drive the separation decision.  $B_{CS}$ , the controlling shareholder's private benefits, are relatively unimportant if  $A_M$  is very high. Only when  $A_M \rightarrow 0$  do legally malleable private benefits determine diffusion.<sup>6</sup>

These simple relations adapt to much complexity here. For instance, if the controller can no longer manage well, then the sign on agency costs,  $A_M$ , changes. Similarly, the relationships can absorb uncertainty. That is, most business decisions are made under uncertainty. The billion-dollar factory that turns out to have been a bad investment is not, if the decision to build was made by agents, necessarily an agency cost. Mistakes are not necessarily agency costs. Rather, if the agent was more likely than a sole owner to overestimate the probabilities of success (because the agent benefited even from moderately unprofitable expansion), then this 'extra' portion of mis-estimate (the *increased* probability of taking on the project, the increased investment in the project once started, and so on) becomes the agency cost that (astute) close ownership would reduce. According to Levinthal (1988, p. 182), 'It is not the industriousness of top management that is the issue, but the qualitative nature of the decisions they make.'

## Corporate Law's Limited Capacity to Reduce Agency Costs

One might reply that core corporate law when improved reduces *both* the controlling stockholder's private benefits ( $B_{CS}$ , by reducing the controller's capacity to siphon off value) *and*

managerial agency costs ( $A_M$ , by reducing the managers' capacity to siphon off benefits for themselves). And it does so, one might mistakenly then argue, about equally.

### *The business judgment rule*

This criticism, however, fails to reflect what American corporate law really does. Managerial agency costs are the sum of managers' overreaching (unjustifiably high salaries, self-dealing transactions, and so on) *and* their mismanagement (that is, the part of their mismanagement that a stronger owner would avoid). Economic analyses typically lump these two together and call them 'agency costs'. But agency costs come from stealing *and* from shirking. It is correct to lump them together in economic analyses *as a cost to shareholders* because both costs are visited upon shareholders. For example, Fama (1980) notes that agency costs come from 'shirking, perquisites or incompetence'. But it is incorrect to think that *law* (especially American corporate law) minimizes each cost (shirking and incompetence) to shareholders equally well.

The standard that corporate law applies to managerial decisions is, realistically, no liability at all for mistakes, absent fraud or conflict of interest (Bishop, 1968, p. 1095; Dooley and Veasey, 1989, p. 521). *But this is where the big costs to shareholders of having managerial agents lie, exactly where law falls silent.*

Conventional corporate law – the law of corporate fiduciary duties, which common law is said to be particular adept at – does little or nothing to directly reduce shirking, mistakes, and bad business decisions that squander shareholder value. The business judgment rule is, absent fraud or conflict of interest, nearly insurmountable in America. It insulates directors and managers from the judge, removing them from legal scrutiny. Most American analysts think that one wouldn't want the judge second-guessing managers on a regular basis.

### *Controlling shareholders*

One might refine this analysis by accounting for controlling shareholder error. But the costs of these errors are usually thought to be smaller than legally uncontrollable managerial error. True, similar legal doctrines (the business judgment rule) shield the controlling shareholder from lawsuits for a non-conflicted mistake. But, because the controlling stockholder owns a big block of the company's stock, it internalizes much of the cost of any mistake (unlike the unconstrained managers). A controller has some incentive to turn the firm over to professional managers if he realizes they would make the firm more profitable. (And, as I mentioned, in those settings where the controller would overall be worse than unconstrained managers, we then should get diffusion.  $A_M$ 's sign flips.)

## Even if Law Critically Affects Both

Still, one might reject the proposition that law is secondary in inducing good management for shareholders. Law affects those other institutions that indirectly control managerial agency costs (competition, compensation, takeovers, transparency, and so on), and one might believe *these* laws to be central to whether public firms can arise and whether ownership can be separated from control.

But, even so, the structure of my argument – of *corporate* law's limits – persists. The institutions and law that affect managerial agency costs of running the firm differ from the

institutions and laws that affect insider machinations. The two sets are *not* identical. If one society does better with one set than with the other, then the degree of diffusion should be deeply affected. Corporate law might minimize insider transactions in both nations, but the other laws in one might fail to reduce managerial agency costs from running the firm, or might even increase them.

That is, assume *arguendo* that corporate law, broadly defined, can, if ‘unleashed’, affect both private benefits and managerial agency costs. But, if other institutions *also* affect managerial agency costs, then corporate law could be perfect but these *other* institutions would determine the degree of ownership separation through their effect on managerial agency costs from running the firm. These other institutions might vary across nations and systematically determine, or affect, the degree of ownership separation across nations.

### The Difficulty of Seeing Legal Origins as Causal

Moreover, a theory based primarily on legal origins is weakened by the means of regulation in the United States. America uses a regulatory agency, the Security and Exchange Commission (SEC), as the primary regulator of stock markets. This agency, though, is not a common law mechanism. As such, it is unclear where the *legal* advantage, if it has any, arose for the United States as compared with continental European civil law nations. Perhaps civil law nations have to regulate less than they usually might, so as to effectively foster a securities market. But common law has to regulate more. (And the impression one has is that civil law nations actually regulate securities markets *less* than their emblematic level.) Civil law nations may simply have decided for reasons exogenous to the legal system – more about that in the next subsection – *not* to regulate securities markets, because for some reason – say, political – building good security markets was not a national priority.

### The Tight Limits to the Purely Legal Theory

Thus, the basic theory I propose here is that, first, if one observes persistent blockholding, one cannot *a priori* know whether the blocks persist because minority stockholders fear the controller or because they fear the *managers*, who might dissipate shareholder value if the controlling stockholder disappears. Even if better corporate law usually increases diffusion in rich nations with adequate but not outstanding corporate law (a proposition open to theoretical challenge, see Roe, 2003a, p. 181<sup>7</sup>), concentration might be due to high managerial agency costs in running the firm and have little to do with core corporate law’s constraints on insider machinations.

If distant shareholders fear unrestrained managers, the controller cannot sell stock at a high enough price and thus he/she keeps control to monitor managers or to run the firm.

Second, stock markets are regulated, not left to the unadorned common law. This is so even in common law nations. Indeed, common law nations may regulate stock markets more than civil law nations do. As such, a theory based on legal origins – that civil law regulates, while common law judges – is not *prima facie* convincing. Even today, when corporate structures go awry – think of Enron – and fiduciary duties fail, the systemic reaction, even in a common

law nation like the United States, is to regulate – think of Sarbanes-Oxley of 2002 – *not* to rely primarily on judge-made common law fiduciary duties.

## **DATA: POLITICAL VARIABLES AS THE STRONGEST PREDICTOR OF OWNERSHIP SEPARATION**

If a society's institutions do not promote shareholder value, or if a society adds institutions that raise managerial agency costs (because it wants managers to be loyal to a wider spectrum of interests than elsewhere), then ownership separation ought to be narrower than elsewhere.

### **Politics Can Increase Managerial Agency Costs**

In nations where labor institutions – whether via social democracy or corporatist power-sharing or other cooperative arrangements – are strong, one would expect managerial agency costs to shareholders to often be higher in firms that had ownership and control divided than in nations where such labor institutions were weaker.

Two channels would be in play, one through the firm and the other through institution-building. First, through the firm, the polity would tend to promote non-profit-maximizing expansion (and make it even harder to contract when firms' capabilities are misaligned with markets). And there would be more bargaining over the surplus, with some of that bargaining at the national political level and some inside the firm. Concentrated ownership would be relatively more profitable for shareholders than in other polities. Second, nations in which labor or the left held significant political power could be unwilling to build the institutions that facilitate distant shareholding, such as building good securities regulation, promoting profit-building institutions, facilitating shareholder control over (or influence on) managers, and enhancing shareholder primacy norms that induce managers to align themselves with stockholders, even those stockholders that cannot control the managers day to day.

If this is right, and one or both of these channels is strong, then one could hypothesize a basic model with testable implications. Greater labor protection should predict weaker ownership separation. Consider these results, in Table 11.1 and Figure 11.1, from OECD data indexing the level of job protection in the OECD.

With a small sample like this multiple controls are hard, and the small 'n' makes the econometric behavior here tricky. But consider the results when we control for two measures of corporate law, one the well-known La Porta *et al.* (1998) index and the other measure of the control premium in the world's richer nations from Dyck and Zingales (2002), see Table 11.2. Each legal measure standing alone predicts separation. But look at what happens when we combine the legal measures with the political one.

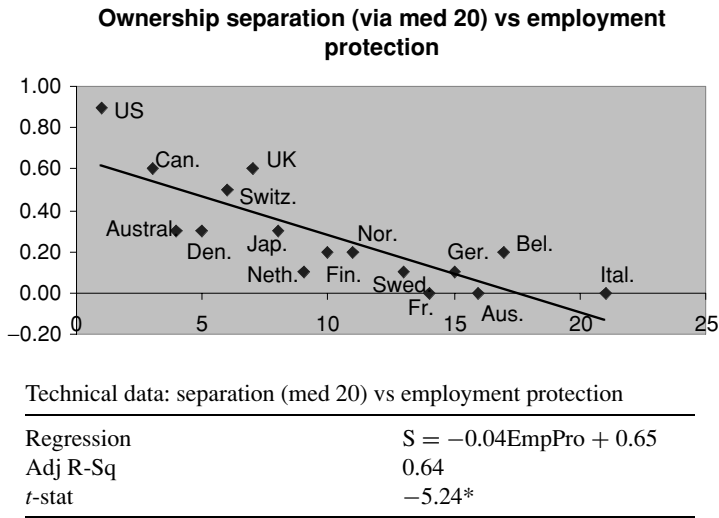
The bottom line: employment protection *strongly dominates the two measures of corporate law*.<sup>8</sup> Roughly, these results suggest that controlling insider overreaching – the type of costs of public firms that law can reach – gets us at most (only) half-way to making public firms viable. If the political environment impedes manager–shareholder alliances, the second type of agency costs to shareholders would rise, and ownership could not easily be separated from control, *even if controller machinations are contained*. In fact, in most of these 'models' law doesn't significantly increase the predictive power of left–right politics alone.<sup>9</sup>



**Table 11.1** *Employment protection and ownership separation*

Country	Employment protection	Widely held at 20% for medium-sized corporations (med 20)
Australia	4	0.30
Austria	16	0.00
Belgium	17	0.20
Canada	3	0.60
Denmark	5	0.30
Finland	10	0.20
France	14	0.00
Germany	15	0.10
Italy	21	0.00
Japan	8	0.30
Netherlands	9	0.10
Norway	11	0.20
Sweden	13	0.10
Switzerland	6	0.50
United Kingdom	7	0.60
United States	1	0.90

Source: Employment protection measures how strongly a nation’s law protects employees from being fired. (It is an inverse, relative measurement: a value of 1 means the employees are relatively not well protected; 17 means that they are well protected.) It aggregates specific employment rules in each nation in the OECD (OECD, 1994). Widely held measures the dispersion of stock in public companies. It is a nation-by-nation index, compiled by La Porta *et al.* (1999), of the portion of companies that are widely held in a slice of mid-sized firms in each nation. A company was classified as not being widely held if it has a stockholder owning 20% or more of the firm’s stock.



**Figure 11.1** *Employment protection as predicting mid-sized firms’ separation*

Sources: The x-axis is an index of employment protection compiled by the OECD (OECD, 1994); the y-axis is an index of ownership concentration in mid-sized public companies, compiled by La Porta *et al.* (1999). The data for both items are arrayed in Table 11.1.

**Table 11.2** Employment protection vs corporate law in predicting separation

Dependent variable: ownership separation in mid-cap companies					
Corp. law: La Porta	0.14 (3.69 <sup>***</sup> )			-0.03 (-0.57)	
Corp. law: control premium		-1.07 (-1.94 <sup>*</sup> )			0.43 (0.87)
Employment protection			<b>-0.04</b> <b>(-5.24<sup>***</sup>)</b>	<b>-0.03</b> <b>(-2.62<sup>**</sup>)</b>	<b>-0.05</b> <b>(-4.39<sup>***</sup>)</b>
R <sup>2</sup>	0.53	0.18	0.64	0.71	0.72

\* Significant at the 0.10 level  
 \*\* Significant at the 0.05 level  
 \*\*\* Significant at the 0.01 level

This table shows how well two determinants of ownership separation predict the dispersion results in Table 11.1. The dependent variable is the degree of ownership dispersion in the mid-cap companies in each nation, as listed in Table 11.1. The independent variables are employment protection and the quality of corporate law.

The third data column shows the labor index of employment protection (from Table 11.1) nicely predicting ownership dispersion. The labor predictor is robust to two measures of corporate law quality, one from La Porta *et al.* (1999, p. 492) and the other from Dyck and Zingales (2002). The first index of corporate law quality, from La Porta, indexes corporate law features that are thought to protect outside shareholders from insider overreaching; the second measures the premium paid for a control block above the trading value of minority stock. (A high premium suggests that small shareholders are poorly protected; a low premium that they're well protected.) The two indices of corporate law quality predict ownership separation in these rich nations, but they are not robust to adding the employment protection index. The latter strongly dominates corporate law in predicting the degree of ownership separation in the OECD, as is indicated in the third, bold-faced, row.

### Do Blockholders Increase or Decrease Value?

A pure law-driven theory would predict that increasing blockholding would decrease the value of minority shares. A pure managerial agency cost theory would predict the opposite. An integrative theory would look for both.

But bigger blockholders in many countries *increase* the value of minority stockholders' shares<sup>10</sup> (Roe, 2003b). This is not a relationship consistent with the legal theory. But it is one consistent with a managerial agency cost theory, that blockholders restrain managerial agency costs. And it is a result that fits with the political theory I have advanced, because for these countries in particular political and employment pressures are strong, and it is plausible that dominant stockholders are able to create more value for shareholders than do managers acting alone.<sup>11</sup> Overall, there are mixed results, some studies finding blockholders demeaning minority shareholder value, some showing them enhancing it, others showing offsetting effects. These overall results suggest that the legal theory again is insufficient in explaining the strength of ownership separation. Both effects – diversionary and agency cost – seem to be in play.

### And the Not-so-rich Nations?

One might observe that many poorer nations have decrepit corporate law institutions. This is true, and possibly weak corporate law is holding them back, but the coincidence of bad law and a bad economy does not tell us enough. To learn that, say, Afghanistan has poor corporate

law does not tell us whether its weak economy and low degree of ownership separation are primarily due to its weak corporate law or to its *other* weak institutions. If the other institutions, particularly the other property rights institutions, are decrepit, *these* may be the critical debilities preventing Afghanistan from developing wealth and complex private institutions that get it ready for public firms and ownership diffusion. Only then, when it gets that far, will we be able to tell whether weak corporate law holds it back. The omitted variable might be weak property rights institutions generally, with weak corporate law institutions just a visible and perhaps minor surface manifestation of the deeper weakness.

In any case, we are here focusing on the world's richer nations, not its poorer nations. Even if corporate law is the institution holding back the transition and developing nations – an unlikely hypothesis – the data indicate that it is not holding back every one of the richer nations from getting stronger securities markets and sharper ownership separation. Something else is.

Other data are consistent. There are too many studies showing that increasing blockholders in many countries *increase* the value of minority stockholders.

## CONCLUSION: POLITICS AND CORPORATE LAW AS EXPLANATIONS FOR SECURITIES MARKETS

We should be skeptical about a pure, or even a primarily, law-based theory or legal-origins theory for predicting ownership separation and stock market strength in the wealthy West. True, strong corporate law that protects distant stockholders is good to have. It is useful in building efficacious business enterprises and has utility in explaining some key aspects of corporate differences around the world, especially in transition and developing nations. For deep securities markets and strong ownership separation, nations probably need it or a substitute.

But the quality-of-corporate-law argument has limits, and these limits are probably much closer than is commonly thought. High-quality corporate law is insufficient to induce ownership to separate from control in the world's richest, most economically advanced nations. Technologically advanced nations in the wealthy West can have the potential for fine corporate law in theory, and several have it in practice, but ownership would *not* become separated from control wherever managerial agency costs are high. And managerial agency costs, unlike insider self-dealing, are *not* closely connected with corporate law. Indeed, American corporate law's business judgment rule has corporate law *avoid* dealing directly with managerial agency costs.

By examining a restricted sample of the world's richest nations, we can move toward two conclusions, one strong and the other weak. The strong one focuses on the richer nations in the wealthy West: studies that examine corporate law worldwide tend to overpredict the importance of corporate law in the world's richest nations. It seems almost intuitive that these nations – where contract can usually be nicely enforced – shouldn't have much technical trouble developing satisfactory corporate law or good substitutes. Some, by measurement, already have. If ownership still hasn't separated widely, then other institutional explanations are probably in play. The weak conclusion focuses on the world's transition and developing nations. We cannot conclude that improving corporate law is irrelevant there (because we have examined here only the restricted set of the world's richest nations). But we can offer the weak conclusion that the development agencies may do everything right in getting the corporate law institutions of these nations ready for ownership separation, and it is at least possible that no one comes to the party.

The quality of conventional corporate law does not fully explain why and when ownership concentration persists in the wealthy West, because core *corporate law does not even try to directly prevent managerial agency costs from dissipating a firm's value*. The American business judgment rule keeps courts and law out of basic business decisions and that is where managers can lose, or make, the really big money for shareholders. Non-legal institutions control these costs. In nations where those *other* institutions, such as product competition or incentive compensation, fail or do less well, managerial dissipation would be higher and ownership cannot as easily become separate from control as it can where dissipation is lower. Corporate-law quality can be high, private benefits of control low, but if managerial agency costs from dissipation are high, separation will not proceed. Even if we believed law to be critical to building these *other* institutions, the analysis would persist because *different* laws support the agency-cost-controlling institutions (anti-trust and product market competition; tax law and incentive compensation, and so on).

Moreover, the regulatory character of the means by which securities law is effected seem to run counter to the strengths of the common law system – it operates through rules and regulations, not common law, judge-made fiduciary duties. The SEC's regulatory character thus casts some doubt on the primacy of legal origins, that is, the idea that legal origins heavily affect the ability to protect minority stockholders.

Variation in other institutions could explain why managerial agency costs are not low enough. If other institutions induce managers, if untethered, to stray from shareholder profit-making, then shareholders would be less likely to untether the managers. When those other institutions are strongly in play, then corporate law – even corporate law writ large – no longer primarily determines the degree of separation.

A nation need not control insider machinations and motivate managers equally well; and, to the extent it does one better than the other, concentration and diffusion are deeply affected. The diffusion decision is based on the *sum* of private benefits of control and managerial agency costs. Even if traditional corporate law drives private benefits to zero, concentration should persist if managerial agency costs are high.

Data are consistent. Several nations have, by measurement, good corporate law but not much diffusion and hardly any separation. These nations also have a potential for high managerial agency costs if ownership and control were separated: relatively weaker product market competition and relatively stronger political pressures on managers to disadvantage shareholders. Political variables predict separation well, and they dominate corporate law quality in predicting separation in the wealthy West.

The quality of a nation's corporate law cannot be the only explanation of why diffuse Berle–Means firms grow and dominate. Perhaps, for some countries at some times, it is not even the principal one.

## NOTES

1. I do not address here *how* valuable those corporate law initiatives are. That is, if the advantages of securities markets can be cheaply achieved through other means, then those substitutes might make securities market development of secondary importance to general economic development. It is plausible that well-developed securities markets *reflect* economic development and only secondarily help induce it. The development agencies are pursuing securities market development as, one assumes, a means to general economic development, in the belief that it is a strong cause, not a minor reflection.

But if it is a reflection, then the agencies' efforts might go better into building the underlying foundations. (And the effort here in this chapter becomes one of explaining why we see, or don't see, strong securities markets, not in planning how to get them.)

2. Private benefits also arise from pride in running and controlling one's own, or one's family's, enterprise. On this, corporate law has little direct impact.
3. To be clear, I am not speaking simply of corporate law, but also securities law, and the quality of regulators and judges, the efficiency, accuracy, and honesty of the regulators and the judiciary, the capacity of the stock exchanges to stymie the most egregious diversions, and so on. Cf. Black (2000).
4. This section and its brief model draw on Roe (2002).
5. See Bebchuk (1999), who models the problem; see also Coffee (2001) and La Porta *et al.* (1997, 1998, 1999).
6. The best-developed model of the corporate law problem begins by assuming a population of firms that is more valuable when diffusely owned than when privately owned (see Bebchuk, 1999). As such, its author does not have to address managerial agency costs, since these are assumed away as central for the population under discussion. But it is on that assumption I say here where the critical calculus occurs in whether firms go public. (Not all other analyses of the relationship between corporate law and ownership diffusion confine their inquiry so adroitly.)
7. The idea is that when corporate law is 'passable' – neither excellent nor atrocious – then improving it could make distant shareholders *more* comfortable with a controller, and therefore *more* willing to buy minority stock. See also Roe (2000, 2002).
8. Indeed, it is robust even to having both legal indicators 'thrown' at it.
9. See Roe (2000a). Surely the correlation here does not prove the theory. And, even if the basic theory – a relationship between labor and ownership concentration – is right, other channels linking the two are possible. Visible ownership concentration might have provoked labor protection. Or the two may work hand in hand: high human capital industries might dominate in some nations, and they may fit well with concentrated owners (who can make soft deals better than can distant stockholders). The commonality between the footnoted relationships and the textually noted ones is that institutional protection of minority stockholders plays a secondary role in determining whether ownership is separated or stays close.
10. There's a possible exception for very large holdings going even larger.
11. Reality is more complex. First, distant shareholders might suffer through two channels. They might suffer the controllers' machinations, but the agency cost minimization may be so great that it exceeds the controllers' diversions of private benefits. Second, endogeneity might lead the low private benefits companies to have dominant stockholders, while the high private benefits companies build barriers to keep controllers out or they never go public. Nevertheless, the dominant observable effect is hard to reconcile with weak law primarily determining separation as opposed to being a secondary factor.

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# International Corporate Governance

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## INTRODUCTION

Jensen and Meckling (1976) apply agency theory to the modern corporation and model the agency costs of outside equity. In doing so, they formalize an idea that dates back at least as far as Adam Smith (1776): when ownership and control of corporations are not fully coincident, there is potential for conflicts of interest between owners and controllers. There are also benefits to separating ownership and control; otherwise such a structure is highly unlikely to have persisted as it has.<sup>1</sup> The conflicts of interest, however, combined with the inability to costlessly write perfect contracts or monitor the controllers, ultimately reduce the value of the firm, *ceteris paribus*. These ideas form the basis for research on corporate governance. How do entrepreneurs, shareholders, and managers minimize the loss of value that results from the separation of ownership and control?

The publication of Jensen and Meckling's model spawned a voluminous body of research, both theoretical and empirical. Through the 1970s and 1980s that research was largely focused on the governance of US corporations, and US-based corporate governance research continues to expand. By the early 1990s, however, research on governance in countries other than the US began to appear. At first, that research focused primarily on other major world economies, primarily Japan, Germany, and the UK. More recent years, however, have witnessed an explosion of research on corporate governance around the world, for both developed and emerging markets. The result is an extensive and still growing body of research on international corporate governance. Our task here is to survey that expanding body of literature.

We define corporate governance as the set of mechanisms – both institutional and market-based – that induce the self-interested controllers of a company (those that make decisions regarding how the company will be operated) to make decisions that maximize the value of the company to its owners (the suppliers of capital). Or, to put it another way: 'Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investments' (Shleifer and Vishny, 1997, p. 737).

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## *Corporate Governance*

The governance mechanisms that have been most extensively studied in the US can be broadly characterized as being either internal or external to the firm. The internal mechanisms of primary interest are the board of directors and the equity ownership structure of the firm. The primary external mechanisms are the external market for corporate control (the takeover market) and the legal system.

### Internal Governance Mechanisms

#### *Boards of directors*

Corporations in most countries have boards of directors. In the US, the board of directors is specifically charged with representing the interests of shareholders. The board exists primarily to hire, fire, monitor, and compensate management, all with an eye toward maximizing shareholder value. While the board is an effective corporate governance mechanism in theory, in practice its value is less clear. Boards of directors in the US include some of the very insiders who are to be monitored; in some cases they (or parties sympathetic to them) represent a majority of the board. In addition, it is not uncommon that the CEO is also the chairperson of the board. Finally, the nature of the selection process for board members is such that management often has a strong hand in determining who the other members will be. The primary board-related issues that have been studied in the US are board composition and executive compensation. Board composition characteristics of interest include the size and structure of the board: the number of directors that comprise the board, the fraction of these directors that are outsiders, and whether the CEO and chairperson positions are held by the same individual. Executive compensation research is fundamentally concerned with the degree to which managers are compensated in ways that align their interests with those of their companies' shareholders.

#### *Ownership structure*

Ownership and control are rarely completely separated within any firm. The controllers frequently have some degree of ownership of the equity of the firms they control; while some owners, by virtue of the size of their equity positions, effectively have some control over the firms they own. Thus, ownership structure (i.e. the identities of a firm's equity holders and the sizes of their positions) is a potentially important element of corporate governance.

It is reasonable to presume that greater overlap between ownership and control should lead to a reduction in conflicts of interest and, therefore, to higher firm value. The relationships between ownership, control, and firm value are more complicated than that, however. Ownership by a company's management, for example, can serve to better align managers' interests with those of the company's shareholders. However, to the extent that managers' and shareholders' interests are not fully aligned, higher equity ownership can provide managers with greater freedom to pursue their own objectives without fear of reprisal; i.e. it can entrench managers. Thus, the ultimate effect of managerial ownership on firm value depends upon the trade-off between the alignment and entrenchment effects.

Shareholders other than management can potentially influence the actions taken by management. The problem in the typical US corporation, with its widely dispersed share ownership, is that individual shareholders own very small fractions of an individual firm's shares and,

therefore, have little or no incentive to expend significant resources to monitor managers or seek to influence decision making within the firm. Moreover, the free-rider problem reduces the incentives for these disparate shareholders to coordinate their actions. However, individual shareholders who have more significant ownership positions have greater incentives to expend resources to monitor and influence managers.

As with ownership by managers, ownership by outside blockholders is not an unequivocally positive force from the perspective of the other shareholders. Blockholders can use their influence such that management is more likely to make decisions that increase overall shareholder value. These are the shared benefits of control; i.e. blockholders exercise them but all shareholders benefit from them. However, there are private benefits of control as well – benefits available only to blockholders. These private benefits can be innocuous from the perspective of other shareholders; e.g. a blockholder may simply enjoy the access to powerful people that comes from being a major shareholder. However, if blockholders use their control to extract corporate resources, the private benefits they receive will lead to reductions in the value of the firm to the other shareholders. Thus, the ultimate effect of blockholder ownership on measured firm value depends upon the trade-off between the shared benefits of blockholder control and any private extraction of firm value by blockholders.

In many countries, the government is a significant owner of corporations. Government ownership represents an interesting hybrid of dispersed and concentrated ownership. If we view the government as a single entity, state-owned corporations have very concentrated ownership. Unlike private blockholders, however, government ownership is funded with money that ultimately belongs to the state as a whole and not to the individuals within the government that influence the actions of the firm. In this regard, the ultimate ownership of state-owned companies is, in fact, quite dispersed. Over time, there has been a trend away from state ownership of corporate assets. The conversion from state to private ownership, termed privatization, provides an interesting setting in which to examine the effects of ownership on firm performance.

## External Governance Mechanisms

### *The takeover market*

When internal control mechanisms fail to a large enough degree – i.e. when the gap between the actual value of a firm and its potential value is sufficiently large – there is incentive for outside parties to seek control of the firm. The market for corporate control in the US has been very active, as have researchers interested in this market. Changes in the control of firms virtually always occur at a premium, thereby creating value for the target firm's shareholders. Furthermore, the mere threat of a change in control can provide management with incentives to keep firm value high, so that the value gap is not large enough to warrant an attack from the outside. Thus, the takeover market has been an important governance mechanism in the US.

As with other potential corporate governance mechanisms, however, the takeover market has its dark side for shareholders. In addition to being a potential solution to the manager/shareholder agency problem, it can be a manifestation of this problem. Managers interested in maximizing the size of their business empires can waste corporate resources by overpaying for acquisitions rather than returning cash to the shareholders.

*The legal system*

The literature that we term first generation international corporate governance research, and which we survey in the first section, is largely patterned after the existing US studies. Individual first generation studies generally focus on board structure, executive compensation, equity ownership, or external control mechanisms. The typical individual study examines one (or a small number of) non-US countries. This generation of international corporate governance research, and the US research on which it is patterned, is important and informative. However, it pays only scant attention to another external corporate governance mechanism, the legal system. Jensen (1993) acknowledges the legal system as a corporate governance mechanism but characterizes it as being too blunt an instrument to deal effectively with the agency problems between managers and shareholders. Practically speaking, studies that examine evidence from a single country provide little scope for studying the effects of legal systems, as all of the firms in such a sample are subject to the same national legal regime.

La Porta, Lopez-de-Silanes, Shleifer, and Vishny (LLSV) (1998) hypothesize that the legal system is a fundamentally important corporate governance mechanism. In particular, they argue that the extent to which a country's laws protect investor rights and the extent to which those laws are enforced are the most basic determinants of the ways in which corporate finance and corporate governance evolve in that country. This basic idea has spawned a growing body of research that examines differing legal regimes across countries. Such research allows for meaningful comparative studies of corporate governance. Given the interrelationships among the various corporate governance mechanisms, it also has the potential to provide a more complete understanding of the roles of firm-specific corporate governance mechanisms such as the board of directors and equity ownership. We term this line of research the second generation of international corporate governance research and survey it in the second section.

Comparisons of differing systems of corporate governance inevitably lead to certain obvious questions. Is there one 'right' system of corporate governance? If so, what are the characteristics of that system and are we observing convergence toward it? If there is not one right system of governance, what characteristics of countries or companies determine which systems are optimal for them? Several authors have tackled these important questions and we review their ideas and ours in the third section. The final section concludes.

Having indicated what we do in this chapter, it is incumbent upon us to point out what we do not do. Because numerous excellent surveys of the extensive US literature on corporate governance have been written over the years, we do not survey that literature here.<sup>2</sup> We do, however, briefly review certain papers and subject areas from the US literature to help frame and interpret the international evidence that we present.

Equity holders, of course, are not the only suppliers of capital to corporations and Jensen and Meckling (1976) also model the agency conflicts between shareholders and debtholders. Other than to acknowledge its existence, we do not deal with that particular agency relationship in this survey.

Finally, the traditional caveat for survey papers applies to this chapter as well. It would not be possible to give due consideration to all of the many excellent papers that have been written in the area of international corporate governance. The global scope of the topic makes this more true than usual: there are undoubtedly good papers written in languages other than English or published in outlets with which we are not familiar. We apologize in advance to the authors of each paper omitted. We have tried, however, to cover a broad spectrum of papers and the major topics in a way that will provide a representative view of what the literature has to say about international corporate governance.

## **FIRST GENERATION INTERNATIONAL CORPORATE GOVERNANCE RESEARCH**

The international corporate governance research that we label first generation is patterned after a large body of US research. In this section, we review the international evidence on internal control mechanisms, in particular the board of directors and equity ownership structure, and on the external market for corporate control.

The first generation of research on corporate governance mechanisms generally concerns itself with two questions regarding a particular mechanism. First, does that mechanism affect firm performance, where performance is typically measured by profitability or relative market value? Second, does that mechanism affect the particular decisions made by firms; for example, with respect to such issues as management turnover and replacement, investment policy, and reactions to outside offers for control?

### **Boards of Directors**

#### *Board composition*

In the US, the board of directors is charged with representing shareholders' interests. As such, it is the official first line of defense against managers who would act contrary to shareholders' interests. A considerable body of evidence addresses the effectiveness with which US boards protect shareholders' interests. Hermalin and Weisbach (2003) review this literature.

The board characteristics that have been most extensively studied are the relative proportion of outside directors and the size of the board. Hermalin and Weisbach summarize the US evidence as follows: (i) higher proportions of outside directors are not associated with superior firm performance, but are associated with better decisions concerning such issues as acquisitions, executive compensation, and CEO turnover; (ii) board size is negatively related to both general firm performance and the quality of decision making; and (iii) poor firm performance, CEO turnover, and changes in ownership structure are often associated with changes in the membership of the board.

The earliest non-US evidence on boards of directors comes from Japan. Kaplan and Minton (1994) examine the effectiveness of boards of directors in the Japanese system. In particular, they concentrate on the appointment of outside directors to Japanese boards, where outside directors are defined as individuals previously employed by banks or other non-financial corporations. They find that such appointments increase following poor stock performance and earnings losses, and that they are more likely in firms with significant bank borrowings, concentrated shareholders, and membership in a corporate group. As evidence that such outside directors are effective corporate governance mechanisms, Kaplan and Minton show that, on average, such appointments stabilize and modestly improve corporate performance, measured using stock returns, operating performance, and sales growth.

Wymeersch (1998) details extensively the makeup of European boards of directors. He reports that, in most European states, the role of the board of directors has not been prescribed in law. Thus, in many European countries shareholder wealth maximization has not been the only – or even necessarily the primary – goal of the board of directors. This varies across countries, with the British, Swiss, and Belgian systems being the most focused on shareholder welfare.

Boards of directors in Europe are most often unitary, as in the US. In some European countries, however, boards are two-tiered. A two-tiered structure is mandatory in some countries, e.g. Germany and Austria, and optional in others, e.g. France and Finland. Two-tier boards generally consist of a managing board, composed of executives of the firm, and a supervisory board. In Germany, representation of employees on the supervisory board, termed co-determination, is mandatory.

Until recently there have been few published papers that study the effectiveness of European boards of directors. Despite this lack of evidence, and despite the fact that the US evidence is somewhat open-ended regarding the effect of board characteristics on firm value, various European commissions have embraced the idea that appropriate board composition is important to good corporate governance. Codes of Best Practice have been issued in a number of European countries, starting with the UK in 1992. Common to most of these codes is a requirement for specified numbers or percentages of independent directors on the boards of firms in the country. The codes are typically voluntary in nature and the degree of compliance with them varies across countries. Wymeersch (1998) hypothesizes that compliance is more difficult on the continent than in the UK, due to the greater presence there of controlling shareholders who do not wish to see their influence reduced by the addition of independent directors to their companies' boards.

Dahya *et al.* (2002) address the effect on board effectiveness of the UK Code of Best Practice, put forth by the Cadbury Committee. Among other things, the Code recommends that boards of UK corporations include at least three outside directors and that the positions of chairperson and CEO be held by different individuals. While the Code is voluntary (as of the writing of this chapter), the London Stock Exchange does require that all listed companies explicitly indicate whether they are in compliance with the Code. If a company is not in compliance, an explanation is required as to why it is not.

Dahya *et al.* document that CEO turnover increased following issuance of the Code and that the sensitivity of turnover to performance is stronger following its issuance. These increases are concentrated among those firms that chose to adopt the Code. They further conclude that it is the increase in the fraction of outsiders on the board, rather than the separation of the chairperson and CEO positions, that explains the turnovers. These results are consistent with the findings of Weisbach (1988) for US firms, but inconsistent with the evidence reported by Kang and Shivdasani (1995), who are unable to document a definitive relation between the presence of outside directors and the sensitivity of CEO turnover to performance for Japanese firms. Franks *et al.* (2001) examine a sample of poorly performing firms in the UK and find that boards dominated by outside directors actually impede discipline of poorly performing managers.

Dahya and McConnell (2002) examine the effect of the UK's Code on appointments of new CEOs. They report that a firm's board is more likely to appoint an outside CEO after the firm has increased the representation of outside directors to comply with the Code. This result is consistent with the findings of Borokhovich *et al.* (1996) for the US. Based upon an event study of stock prices, Dahya and McConnell also report that appointment of an outside CEO is good news for shareholders.

As stated earlier, some Codes of Best Practice specify that the chairperson and CEO positions should be held by different individuals. There is relatively limited evidence on whether such a separation influences governance effectiveness. That evidence generally indicates that separating the two positions has no significant effect; i.e. it does not result in better firm performance or in better decision making by firms (see, for example, Brickley *et al.* (1997) for the US and Vafeas and Theodorou (1998) for the UK).

Evidence regarding the effectiveness of boards of directors elsewhere in the world is scattered. Blasi and Shleifer (1996) examine board structure in Russia in 1992–93 and then again in 1994. They report that most firms are majority-owned by insiders and employees and that the boards are solidly controlled by insiders. Most managers indicate resistance to outsiders on the board. Those board members that are outsiders are typically blockholders. Blasi and Shleifer note that a government decree urging that boards be composed of no more than one-third insiders has been ignored by all but a very few small Russian companies.

Hossain *et al.* (2001) examine the relation between firm performance and the presence of outside directors in New Zealand firms both before and after the 1994 Companies Act. This Act was issued in 1994 with the intention of enhancing the performance of New Zealand firms through better monitoring by boards. Hossain *et al.* find a positive relation; i.e. a higher fraction of outside directors leads to better performance. However, they find no evidence that the strength of that relation was affected by the Companies Act. Rodriguez and Anson (2001) examine the market reaction to announcements by Spanish firms that they will comply with the Spanish Code of Best Practice, which contains 23 recommendations that aim to strengthen the supervisory role of Spanish boards of directors. Rodriguez and Anson report that the stock prices react positively to announcements of compliance when such announcements imply a major restructuring of the board; this reaction is stronger for firms that have been performing poorly.

Consistent with the findings for the US, there is some evidence that boards with more outside directors in other countries are more likely to dismiss top management. Suchard *et al.* (2001) find that the incidence of top management turnover in Australia is positively related to the presence of non-executive directors on the board. Renneboog (2000) documents a similar result for firms listed on the Brussels Stock Exchange.

Also consistent with US evidence, there is some evidence of a negative relation between board size and firm performance in several other countries. Mak and Yuanto (2002) find evidence of an inverse relationship between board size and Tobin's  $Q$  in Singapore and Malaysia, while Eisenberg *et al.* (1998) document an inverse relation between board size and profitability for small and mid-size companies in Finland. Carline *et al.* (2002) find that board size is negatively related to operating performance improvements following UK mergers.

### *Executive compensation*

Among the tasks specifically assigned to the board of directors is that of determining the structure and level of compensation of the top executives of the firm. Murphy (1999) and Core *et al.* (2003) survey the existing evidence on executive compensation in the US. The compensation issue that is of greatest interest from a corporate governance perspective is the degree to which executive compensation aligns top executives' interests with those of their shareholders; i.e. the sensitivity of executive pay to performance. The US research surveyed by Murphy and by Core *et al.* supports several broad conclusions. First, the sensitivity of pay to performance in the US has increased over time. Second, the vast majority of this sensitivity comes through executive ownership of common stock and of options on common stock. Finally, stock options are the fastest growing component of CEO compensation in the US.

The non-US evidence on executive compensation has been relatively limited. Kaplan (1994) studies executive compensation in the US and Japan. He concludes that top executive compensation in both countries is related to stock returns and to earnings losses. The magnitude of that relation is quite similar in the two countries, though Kaplan points out that US managers own more stock and stock options than do Japanese managers. Conyon and Murphy (2000) compare

executive compensation in the US and the UK. They find that the level of cash compensation and the sensitivity of compensation to increases in shareholder wealth are much greater in the US than in the UK and attribute the difference largely to greater share option awards in the US.

Evidence on compensation has more recently expanded to include a greater number of countries. Crespi *et al.* (2002) study executive compensation in Spain and find some evidence of increased pay following increases in industry-adjusted stock price performance. This sensitivity of pay to performance, however, holds only in the subset of firms that have strong blockholders. Bryan *et al.* (2002) investigate the relative use of equity in the compensation mixes of firms in 43 different countries. They find that firms in countries with more equity-oriented capital markets and firms with higher growth opportunities use more equity compensation.

Overall, the empirical evidence on board structure and executive compensation around the world supports the more extensive US evidence. Smaller boards of directors are associated with better firm performance. The presence of outsiders on boards of directors does not affect the ongoing performance of the firm, on average, but does sometimes affect decisions about important issues. Codes of Best Practice that have been issued in many countries around the world generally seek to move boards toward greater representation by outside directors. The evidence to date on the effects of compliance with these Codes tentatively hints that having more outside directors alters board decisions within some, but not all, countries studied. The limited non-US evidence on executive compensation indicates that, to varying degrees, pay is sensitive to performance.

For many countries, there is only limited empirical evidence regarding issues related to the effectiveness of boards of directors and of the compensation plans they put in place; for some there is no evidence at all. These are useful avenues for further research. In addition, boards of directors and executive compensation cannot be viewed in isolation. The interrelationship between board composition, executive compensation, and other corporate governance mechanisms remains a fruitful area for research worldwide.

## Ownership and Control

Early corporate governance research in the US centered on the idea that corporations are owned by widely dispersed shareholders and are controlled by professional managers who own little or none of the equity of the firms they manage. Beginning in the late 1980s, however, research emerged that recognized that many US corporations do, in fact, have significant equity ownership by insiders or shareholders that own significant blocks of equity. Holderness (2003) surveys the US evidence on equity ownership by insiders and blockholders, where insiders are defined as the officers and directors of a firm and a blockholder is any entity that owns at least 5% of the firm's equity. He reports that average inside ownership in publicly traded US corporations is approximately 20%, varying from almost none in some firms to majority ownership by insiders in others. Mehran (1995) reports that 56% of the firms in a sample of randomly selected manufacturing firms have outside blockholders.

Holderness (2003) also surveys the US literature that examines the effects of insider and blockholder equity ownership on corporate decisions and on firm value. Recall from the Introduction that there are opposing hypotheses about these effects. Equity ownership by insiders can align insiders' interests with those of the other shareholders, thereby leading to better decisions or higher firm value. However, higher ownership by insiders may result in a greater

degree of managerial control, potentially entrenching managers. Similarly, the greater control that blockholders have by virtue of their equity ownership positions may lead them to take actions that increase the market value of the firm's shares, benefiting all shareholders. However, that same control can provide blockholders with private benefits, i.e. benefits that are not available to other shareholders. The private benefits enjoyed by blockholders potentially reduce observed firm value.

The US evidence regarding the effects of ownership structure on corporate decisions and on firm value is mixed. Morck *et al.* (1988) and McConnell and Servaes (1990) find that the alignment effects of inside ownership dominate the entrenchment effects over some ranges of managerial ownership. However, as inside ownership increases beyond some level, the entrenchment effects of inside ownership dominate and higher inside ownership is associated with lower firm value. In contrast, Himmelberg *et al.* (1999) use panel data and conclude that a large fraction of the cross-sectional variation in managerial ownership is endogenous. They suggest that managerial ownership and firm performance are determined by a common set of characteristics and, therefore, question the causal link from ownership to performance implied by the above-mentioned studies.

Holderness (2003) indicates that there have been few direct attempts to separately measure the impact of outside (i.e. non-management) blockholders on firm value. Mehran (1995) finds no significant relations between firm performance and the holdings of a variety of different types of blockholders, including individuals, institutions, and corporations. There is, however, some evidence that the formation of a new block or the trade of an existing block is met with abnormal stock price increases (see Barclay and Holderness, 1991, 1992; Mikkelson and Ruback, 1985). Overall, Holderness (2003) concludes that the body of evidence on the relation between blockholders and firm value in the US indicates that the relation is sometimes negative, sometimes positive, and never very pronounced.

While there is little strong evidence that blockholders affect the observed market value of firms, the US evidence does indicate that blockholders can enjoy significant private benefits of control. A number of studies document that block trades are typically priced at a premium to the exchange price, consistent with blockholders expecting benefits that are not available to other shareholders (see Barclay and Holderness, 1989; Chang and Mayers, 1995; Mikkelson and Regassa, 1991). The extent to which such private benefits lead to reductions in firm value remains an open question.

### *Ownership concentration around the world*

Of the various corporate governance mechanisms that have been studied in the US, ownership structure is the mechanism that has been studied most extensively in the rest of the world. As with other aspects of corporate governance, the early non-US evidence on ownership focused on Japan, Germany, and the UK.

Equity ownership in the UK has historically been much like that in the US. There are large numbers of publicly traded firms, most of which are relatively widely held. Equity ownership in Germany has historically been more concentrated than in the US. In addition, banks play more important governance roles in Germany and Japan. These distinctions led researchers to distinguish between market-centered economies (US and UK) and bank-centered economies (Germany and Japan).

Despite both being considered bank-centered economies, there are differences between the structure of equity ownership in Germany and Japan. Prowse (1992) indicates that financial institutions are the most important blockholders in Japan. It has been a common perception



that the same is true in Germany; however, Franks and Mayer (2001) find that other companies are the most prevalent blockholders in Germany, followed by families. German banks do, however, have more voting power than their equity ownership would suggest by virtue of the fact that they vote the proxies of many individual shareholders. Thus, financial institutions have significant amounts of control over firms in both Germany and Japan.

Beginning in the mid-1990s, studies of equity ownership concentration expanded to include countries others than the 'big four'. This body of evidence reveals that concentrated ownership structures are more typical of ownership structures around the world than are the relatively diffuse structures observed in large, publicly traded US and UK firms.<sup>3</sup> This generalization, however, masks important differences across countries with respect to the degree of ownership concentration and the identities of the blockholders.

Faccio and Lang (2002) examine western European countries and conclude that listed firms are generally either widely held, which is more common in the UK and Ireland, or family owned, which is more common in continental Europe. Blass *et al.* (1998) document high ownership concentration in Israel, with banks and affiliated institutional investors as the most significant non-insider holders. Xu and Wang (1997) document high ownership concentration in China, with ownership split relatively equally between the government, institutions, and domestic individuals. Valadares and Leal (2000) document high ownership concentration in Brazil, with the majority of blockholders being corporations or individuals.

Numerous non-US studies address the relation between ownership structure and firm performance. Kang and Shivdasani (1995) find that Japanese firms with blockholders restructure more quickly following performance declines than do Japanese firms without blockholders. They point out, however, that the response comes less quickly in Japan than in the US. Gorton and Schmid (2000) document that firm performance in Germany is positively related to concentrated equity ownership. Kaplan (1994), however, finds no relation between ownership structure and management turnover in Germany. Claessens and Djankov (1999) study Czech firms and report that firm profitability and labor productivity are both positively related to ownership concentration.

There are numerous potential types of large shareholders – other corporations, institutions, families, and government – and the evidence implies that the relation between large shareholders and value often depends on who the large shareholders are. Claessens *et al.* (1998), for example, examine firms in nine East Asian countries and find that the impact of ownership varies according to the identity of the blockholder. Ownership by corporations is negatively related to performance, while ownership by the government is positively associated with performance. They find no relation between institutional ownership and firm performance. Gibson (2003) studies firms in eight emerging market countries and reports that, while CEO turnover is more likely for poorly performing firms in the sample overall, there is no relation between CEO turnover and firm performance for the subset of firms that have a large domestic shareholder.

The effects on value of ownership by management have been of particular interest in international research. With respect to inside ownership in the UK, Short and Keasey (1999) document that the entrenchment effects of managerial ownership begin to dominate the alignment effects when management ownership is 12%. Because Morck *et al.* (1988) find that entrenchment dominates alignment beginning at 5% managerial ownership, Short and Keasey conclude that managers become entrenched at higher levels of equity ownership in the UK than in the US. They attribute this to better coordination of monitoring by UK institutions and less ability of UK managers to mount takeover defenses. Miguel *et al.* (2001) document a similar non-linear relation between inside ownership and firm value in Spain. Carline *et al.* (2002)

find that managerial ownership has a positive impact on performance improvements following UK mergers. Claessens and Djankov (1998a) find for Czech firms that managerial equity holdings have no effect on performance. However, they do show that firm performance improves with the appointment of new managers, particularly if the managers are chosen by private owners rather than by the government. Craswell *et al.* (1997) document only a weak curvilinear relation between inside ownership and performance in Australia; the relation is unstable across time and inconsistent over firm-size groups.

Less direct evidence on the relation between inside ownership and firm performance comes from studies of diversified firms. A large body of US evidence documents a diversification discount; i.e. diversified firms are worth less than the sum of the stand-alone value of the separate pieces of the firm (see, for example, Berger and Ofek, 1995; Lang and Stulz, 1994; Servaes, 1996).<sup>4</sup> Lins and Servaes (1999) measure the relation between concentrated ownership in the hands of insiders and the value of diversification for firms in Germany, Japan, and the UK. They find that inside owners have a positive effect on the value of diversification in Germany, but not in the UK or Japan. Chen and Ho (2000) study firms in Singapore and document that diversification has a negative effect on value only in firms with low managerial ownership.<sup>5</sup>

We indicated earlier that some governance researchers dichotomize economies into those that are market-centered and those that are bank-centered. Numerous studies address the impact of bank involvement on firm value. Morck *et al.* (2000) find that the relation between bank ownership and firm performance in Japan varies over the ownership spectrum; in particular, the relation is more positive when ownership is high. Gorton and Schmid (2000) report that the positive relation between ownership concentration and firm value for German firms is particularly strong where there is block ownership by banks. Xu and Wang (1997) document an overall positive relation between ownership concentration and profitability in Chinese firms; this relation is stronger when blockholders are financial institutions than when the state is the primary blockholder. Sarkar and Sarkar (2000) find that block equity ownership by lending institutions is positively correlated with firm performance in India. Blass *et al.* (1998) report that banks are significant blockholders in Israel. They conclude, however, that the benefits that the powerful role of banks have for shareholders are outweighed by the costs, e.g. the lack of an external control market.

The evidence from around the world indicates that the relation between ownership structure and firm performance varies – both by country and by blockholder identity. Overall, however, this body of evidence suggests that there is a more significant relation between ownership structure and firm performance in non-US firms than there is in US firms. Concentrated ownership most often has a positive effect on firm value. The important role that banks play in governance in non-US countries is particularly interesting given that US banks are prohibited from taking a large role in governing US firms. An interesting question is whether such prohibitions interfere with optimal governance for US firms – or whether other aspects of US governance reduce the potential value of bank involvement.

### *Ownership change via privatization*

The ownership studies reviewed above are primarily cross-sectional in nature. The relationship between ownership structure and firm performance can also be evaluated by examining firms that undergo a discrete change in ownership. A relatively dramatic example of such a change occurs when a previously state-owned firm is privatized, undergoing a relatively rapid transition from ownership by the government to ownership by private entities. Beginning in earnest in

the early 1980s in Britain, privatizations have spread around the world, generating increasing amounts of revenue for the governments involved over the past two decades.

Meggison and Netter (2001) provide an exhaustive review of over 225 studies regarding various economic aspects of the myriad issues surrounding privatization. We refer the interested reader to Meggison and Netter's excellent survey. Here we focus on a small subset of their studies as well as some studies not included in that survey to highlight the privatization findings that we consider most relevant.

The primary governance-related question addressed in the empirical privatization literature is whether firm performance increases when firms become privately owned. Meggison *et al.* (1994) examine 61 state-owned companies from 18 countries that were privatized over the period 1979–90. They report that, on average, privatized firms experience an increase in profitability, an increase in efficiency (measured as cost reduction per unit of production), and an increase in workforce employed from before to after privatization. Boubakri and Cosset (1998) focus on privatizations in developing countries. They compare 79 partially or fully privatized firms in 21 developing countries to various benchmarks and report significant relative increases in profitability, operating efficiency, employment levels, and dividends following privatization.

La Porta and Lopez-de-Silanes (1999) study 218 Mexican firms from a wide spectrum of industries that were privatized over the period 1983–91. They document a significant increase in profitability for these firms, due primarily to reductions in employment and the associated reduction in labor costs. Claessens and Djankov (1998b) conduct a large-scale analysis of 6354 newly privatized firms from seven Eastern European countries for the period 1992–95. Many of these firms became private by means of mass privatization schemes that transformed major sections of the Eastern European economy during the early 1990s. Using multivariate analysis, they conclude that privatization is associated with greater productivity and higher productivity growth.

Dewenter and Malatesta (2001) examine the relation between state ownership and performance cross-sectionally and over time. They look at *Fortune* magazine's largest industrial firms outside the US for the years 1975, 1985, and 1995; a sample that includes firms that are privately owned and firms that are state owned. After controlling for other factors, they report that state-owned firms are significantly less profitable than privately owned firms. State-owned firms also exhibit significantly greater labor intensity, as measured by employee to sales ratio. They observe, however, that the higher profits are not directly linked to privatization. Rather, the increase in profits seems to occur immediately prior to privatization. Thus, it is possible that governments choose to privatize firms that have become profitable. Alternatively, the prospect of future privatization may prod the company to improve performance.

The studies above represent a larger number of studies that address the effects of state vs private ownership on performance. Overall, the existing body of evidence implies that private ownership is associated with better firm performance than is state ownership. Also relevant to this survey are the related questions of whether the identity of the new owners and the size of their ownership positions matter. A smaller number of studies address these questions.

Governments do not always fully privatize and evidence suggests that performance is negatively related to their continued role in companies. Boubakri and Cosset (1998) find that performance improvement is greatest when governments relinquish voting control. Majumdar (1998) echoes these conclusions. He studies the performance of state-owned, privately owned, and mixed-ownership companies in India over the period 1973–89 and finds that privately

owned firms exhibit greater efficiency than state-owned or mixed-ownership firms and that mixed-ownership firms exhibit greater efficiency than state-owned firms.

A number of studies address the relation between performance and the presence of inside owners or foreign owners. Makhija and Spiro (2000) examine the share prices of 988 newly privatized Czech firms and find that share prices are positively correlated with foreign ownership and with ownership by insiders. Similar results are reported by Hingorani *et al.* (1997), who conclude that insider and foreign ownership mitigate agency problems through incentives that align the interests of managers and investors. In a study of 506 privatized and state manufacturing firms in the Czech Republic, Hungary, and Poland in 1994, however, Frydman *et al.* (1999) find that performance does not improve when ownership resides with corporate insiders, but does improve when outside (i.e. non-employee) owners are introduced. Frydman *et al.* (1996) study the ability of Russian privatization investment funds to effect change in the privatized Russian firms in which they invest. They conclude that domination by corporate insiders, particularly management, typically prevents the funds from accomplishing meaningful change.

Claessens and Djankov (1999) report that the presence of a significant foreign investor is associated with higher profitability in recently privatized Czech firms. D'Souza *et al.* (2001) study 118 firms from 29 countries that were privatized between 1961 and 1995. They find that greater foreign ownership is associated with greater efficiency gains post-privatization and that efficiency gains increase as government ownership declines. They also report a negative relation between employee ownership and profitability. Similarly, Boubakri *et al.* (2001) find that, in a study of 189 privatized firms in 32 developing countries, profitability and efficiency gains are associated with the presence of a foreign owner. They caution, however, that any positive effect of governance on value can only operate in an open competitive economy with respect for private property rights. In a study of the prices of privatized Mexican firms, Lopez-de-Silanes (1997) finds that prices are positively correlated with the presence of a foreign investor and with turnover in the CEO position.

There is some evidence that privatization is most valuable when it results in relatively concentrated private ownership. Claessens (1997) examines the mass privatization and voucher distribution schemes of the Czech and Slovak Republics in 1992–93. Under this scheme, 1491 private firms emerged from formerly state-owned enterprises. For a relatively modest price, individual citizens could buy points (or vouchers) with which to bid for these corporations. The companies were then sold through a five-round auction. As the auction process evolved, investment companies emerged that bought vouchers from individuals or individuals could exchange their points for shares in the investment companies. Investment companies ended up owning the largest fraction of shares. Indeed, individuals directly held shares in only 168 companies. Claessens regresses standardized share price against control variables and various measures of share ownership concentration. Both with prices from the original auction and with secondary market prices, he reports that share prices are highly positively correlated with ownership concentration. One interpretation is that dispersed ownership among heterogeneous small shareholders leads to less effective management oversight in firms that are newly privatized. In a later, more detailed, time-series study of 706 newly privatized Czech firms, Claessens and Djankov (1999) find evidence consistent with concentrated ownership leading to better performance in newly privatized firms. In particular, they report a positive correlation between ownership concentration and post-privatization profitability.

Meggison and Netter (2001) caution that there are numerous potential problems in carrying out empirical privatization research, including bad data, lack of data, omitted variables, endogeneity, and selection bias. Comparisons of state-owned to private enterprises require appropriate benchmarks, which can be difficult to identify. With these caveats in mind, however, the evidence to date from the empirical literature on privatization implies that the identity of owners and the size of their positions does influence firm performance. Ownership by insiders and by foreign investors is most often associated with better performance, while ownership by the government is associated with worse performance. There has been little or no evidence, however, regarding other aspects of the governance structures of newly privatized companies, such as board structure and executive compensation. Such firms, with their significant discrete changes in governance structure, remain a fruitful area for international corporate governance research.

### *The private benefits of control*

Equity ownership provides holders with certain rights to the cashflows of the firm. To the extent that large shareholders have both the incentive to monitor management and enough control to influence management such that cashflow is increased, all shareholders of the firm benefit. These are the shared benefits of control. Examination of the relation between equity ownership by blockholders and firm performance is essentially measuring whether there are any shared benefits associated with having large shareholders. However, there are potential private benefits of control as well, private in that they are available only to those shareholders who have a meaningful degree of control over the firm.

To the extent that control has value beyond the cashflow rights associated with equity ownership, there is an incentive to hold disproportionate shares of control. There are a number of ways in which shareholders can achieve control rights that exceed cashflow rights in a given firm. In the US, this is most typically accomplished through ownership of shares of common stock that carry disproportionately high numbers of votes. Several studies examine firms that deviate from one share/one vote in the US and find that superior voting shares trade at a small premium to inferior voting shares (see DeAngelo and DeAngelo, 1985; Lease *et al.*, 1983, 1984; Zingales, 1995). Such evidence is consistent with there being private benefits of control. Studies of voting share premiums around the world confirm the US evidence. The premium is larger in all other countries that have been studied than in the US, ranging from a low of 6.5% in Sweden (Rydqvist, 1988) to a high in Italy of 82% (Zingales, 1994). One interesting exception to the general pattern is in a very small sample of Mexican firms. Pinegar and Ravichandran (2003) examine firms that have American Depository Receipts (ADRs) on each of two different classes of common stock with differing voting rights. Of the 10 pairs of so-called sibling ADRs that they examine, five pairs are Mexican firms and for these five firms the superior voting shares trade at a discount, on average, to the inferior voting shares. Further analysis leads Pinegar and Ravichandran to conclude that control for these Mexican firms has shifted to creditors and competitors, eroding equity voting premiums.

Control in excess of proportional ownership can also be achieved through pyramid structures or by cross-holdings. In a pyramid structure, one firm owns 51% (for example) of a second firm, which owns 51% of a third firm, and so on. The owner at the top of the pyramid thereby has effective control of all of the firms in the pyramid, with an increasingly small investment in each firm down the line. Cross-holdings exist when a group of companies maintain interlocking ownership positions in each other. To the extent that the interlocking of their ownership positions makes group members inclined to support each other, voting coalitions are formed.

Consolidation of control via dual share classes, pyramids, and cross-holdings are common around the world. Claessens *et al.* (2000) examine firms in nine East Asian countries and find that voting rights frequently exceed cashflow rights, typically via pyramid structures and cross-holdings. The result is that in over two-thirds of the firms in these countries there is a single shareholder that has effective control over the firm. Faccio and Lang (2002) report that the use of dual class shares and pyramids to enhance the control of the largest shareholders is common in western Europe, though the resulting discrepancy between ownership and control is significant in only a few countries. For Brazilian companies, Valadares and Leal (2000) document that the vast majority of firms they study have some non-voting shares, while Lins (2003) finds that pyramiding is common.

Group ownership structures are common in a number of countries. In Japan they are termed keiretsu, in Korea chaebols, and in Russia financial–industrial groups. Groups are also common in India, Italy, and Brazil. Kantor (1998) reports that South Africa is dominated by five large groups – three of which are controlled by founders or their families. These groups often have control of individual firms within the groups, despite having made only minority cashflow investments in the firms.

In general, the international evidence indicates that the accumulation of control rights in excess of cashflow rights reduces the observed market value of firms. Lins (2003) examines 18 emerging market countries and documents that the uncoupling of control rights from cashflow rights is common and value reducing. Volpin (2002) reports that the sensitivity of top management turnover to performance in Italy is lower when controlling shareholders own less than 50% of the cashflow rights. Nicodano (1998) finds that the voting premium in Italy is higher when there are business groups involved. Lins and Servaes (1999) find that the diversification discount in Japan is concentrated in firms that are part of industrial groups. Lins and Servaes (2002) examine publicly traded firms in seven emerging market countries and observe a diversification discount only when firms belong to industrial groups or when management ownership is in the 10%–30% range. The discount is most severe when management control rights substantially exceed their cashflow rights. Joh (2000) finds in a sample of Korean firms that only those controlling blockholders that also have high cashflow ownership are associated with higher firm profitability. He finds that firms associated with business groups are less profitable overall. Gorton and Schmid (2000) document that bank control in Germany has a positive effect on firm return on assets when banks own the shares that they are voting, but has no impact on ROA when banks are proxy voting shares held by others.

Several studies address the effect of membership in a group on investment policies in companies within the group. In general, they find that investment is less sensitive to cashflow for firms that belong to groups than for firms in the same country that do not. Hoshi *et al.* (1991) find that Japanese firms with ties to large banks have lower sensitivity of investment to liquidity. Shin and Park (1999) show that investment by firms in Korean chaebols is less sensitive to firm cashflow than is investment by non-chaebol Korean firms. Perotti and Gelfer (2001) document the same for Russian firms that belong to financial investment groups, particularly those led by banks. While reliance on internal capital markets is not necessarily value reducing, evidence from the US implies that it more often does reduce value. Scharfstein (1998), Rajan *et al.* (2000) and Ahn and Denis (2002) present evidence consistent with the hypothesis that diversified firms invest inefficiently, investing too much in some business units or too little in others.

On a more positive note for group membership, Hoshi *et al.* (1990) present evidence showing that keiretsu membership in Japan reduces the costs of financial distress by mitigating the

free-rider and information asymmetry problems that make renegotiation with creditors difficult. Firms that belong to keiretsu, as well as non-keiretsu firms that have a strong tie to a main bank, invest more in productive assets and maintain higher revenues in financial distress than do other Japanese firms.

A number of conclusions can be drawn from the international literature on the ownership of publicly traded firms. First, ownership is, on average, significantly more concentrated in non-US countries than it is in the US. Second, ownership structure appears to matter more in non-US countries than it does in the US – i.e. it has a greater impact on firm performance. Overall, private ownership concentration appears to have a positive effect on firm value. Third, there are significant private benefits of control around the world, and they are more significant for most non-US countries than they are for the US. Structures that allow for control rights in excess of cash flow rights are common, and generally value reducing.

### The External Control Market

A vast literature on the takeover market in the US indicates that it is an important corporate governance mechanism, a ‘court of last resort’ for assets that are not being utilized to their full potential. Holmström and Kaplan (2001) review this literature. Several stylized facts stand out. Average announcement abnormal returns to target firm shareholders are positive, while average abnormal returns to acquiring firm shareholders are at best insignificantly different from zero and are, in most studies, significantly negative. The combined abnormal returns to a target and acquiring firm pair are relatively small, but significantly positive. Poorly performing firms are more likely to be targets of takeover attempts and the managers of poorly performing firms are more likely to be fired.

The takeover market in the UK is also active. Franks and Mayer (1996) examine UK hostile takeovers and find that they are followed by high turnover among members of the board of directors and significant restructuring. Target firms do not appear to be performing poorly before the acquisition bids, however. Carline *et al.* (2002) document average increases in industry-adjusted operating performance following UK mergers. Short and Keasey (1999) suggest that managers are less able to avoid being taken over in the UK than in the US due to the inability of UK managers to mount takeover defenses.

Firth (1997) reports that New Zealand’s takeover market is relatively unregulated and that there are a high number of takeovers relative to the size of the economy. The evidence is largely consistent with that for the US: average positive returns to target firm shareholders, average negative returns to acquiring firm shareholders, and an overall gain for the combined firms. He also documents a positive relation between takeover returns and the equity ownership of the acquiring firm’s directors.

Hostile takeover attempts in Germany have been rare, due presumably to the significant ownership concentration that characterizes the equity market. However, a number of authors present evidence that a German control market does exist, albeit one that is different in form from that of the US and the UK. Jenkinson and Ljungqvist (2001) assert that outsiders attempt to take control by seeking to acquire one or more blocks from existing blockholders. Franks and Mayer (2001) confirm these findings. Other evidence indicates that such changes in blockholder identity, and the turnover in board members that typically accompany them, are more likely following poor performance (see Franks and Mayer, 2001; Kaplan, 1994; Köke, 2001). Köke (2001) finds that changes in the blockholders of German firms are followed

by increased restructuring activity, particularly management turnover, asset divestitures, and employee layoffs.

In general, takeover activity does not appear to be an important governance mechanism around the world. Kabir *et al.* (1997), for example, find that hostile takeovers are relatively rare in the Netherlands, while Blass *et al.* (1998) indicate that there is only a very thin takeover market in Israel. Xu and Wang (1997) indicate that there is no active takeover market in China. This general lack of importance of takeovers is perhaps not surprising given the relatively high ownership concentration in most other countries.

The first generation of international corporate governance research provides an interesting look at governance in individual countries. Some recent work on international corporate governance is aimed at comparing governance systems across countries. The authors of these comparative governance studies examine numerous countries in a unified framework, seeking to understand the factors that explain differences in corporate governance around the world. We review this literature in the following section.

## **SECOND GENERATION INTERNATIONAL CORPORATE GOVERNANCE RESEARCH**

The evidence discussed in the previous section indicates that block shareholders are less common in the US than in most other countries. In addition, the presence of block shareholders is more likely to have a statistically significant effect on firm performance in countries other than the US. In general, the first generation of international corporate governance research does not directly address the reasons for the increased prevalence and impact of large shareholders outside of the US. There are, however, some hints. For example, Zingales (1994) hypothesizes that the premium on voting shares in Italy is much larger than in other countries because the law does not adequately protect the rights of minority shareholders, giving whoever controls a company greater scope to dilute minority shareholder rights.

Legal and regulatory issues play a relatively small role in the first generation of international corporate governance research. US research involving these issues consists primarily of studies involving some specific legal issues, e.g. state of incorporation and state anti-takeover statutes. The effects of the more general underlying system of corporate laws and regulations on corporate governance and firm value are not generally considered. This is perhaps not surprising, given that there can be little variability in such factors in a sample made up entirely of US firms. In addition, some researchers downplay the legal system as an effective means of corporate governance.

The research that we term second generation effectively begins with the work of LLVS. In 'Law and Finance' (1998), they hypothesize that the extent to which a country's laws protect investor rights – and the extent to which those laws are enforced – are fundamental determinants of the ways in which corporate finance and corporate governance evolve in that country. Their empirical evidence indicates that there are significant differences across countries in the degree of investor protection, and that countries with low investor protection are generally characterized by a high concentration of equity ownership within firms and a lack of significant public equity markets. LLSV measure ownership concentration in each country by computing the total percentage equity ownership of the three largest shareholders for each of the 10 largest domestic, non-financial firms in the country. The median figure for the 49 countries



in the sample is 45%. The US figure of 20% is the lowest in the sample; only six countries are under 30%. LLSV assign each of the 49 countries to one of four general groups: common law countries, French civil law countries, German civil law countries, and Scandinavian civil law countries. They find that the laws in common law countries provide the strongest degree of protection for shareholders, while the laws in French civil law countries provide the least protection. Enforcement of the laws is stronger in the German and Scandinavian law countries than in the common law countries, with the weakest enforcement observed in French civil law countries.

Concentrated ownership may be a reasonable response to a lack of investor protection. If the law does not protect the owners from the controllers, the owners will seek to be controllers. LLSV (1998) point out that, in this situation, the agency conflict between managers and shareholders – the primary conflict around which most of the US corporate governance research has revolved – is not meaningful because large shareholders have both the incentive and the ability to control management. LLSV suggest, however, that highly concentrated ownership leads to an equity agency conflict between dominant shareholders and minority shareholders.

In addition to their insight about the agency problems between large and small shareholders, LLSV provide international corporate governance researchers with important data by developing objective measures of investor protection for each of the 49 countries in their samples. These overall scores are made up of variables related to specific shareholder and creditor rights, which measure the protection afforded by the law, and variables related to the rule of law, which measure the degree to which the existing laws are enforced. The variability in international legal structures – and the ability to measure it – provide greater opportunities for comparative corporate governance studies.

## Legal Protection and Economic Growth

One branch of the existing literature on the effects of legal systems on economies and on the firms within them is concerned with their effects on the availability of external finance and, therefore, on economic growth. Rajan and Zingales (1998) hypothesize that financial development facilitates economic growth. Consistent with this, they find that industrial sectors that need more external finance develop disproportionately faster in countries that have more developed financial markets. Wurgler (2000) examines investment by firms in 65 countries. Using the size of stock and credit markets relative to GDP as a proxy for financial development, he finds that firms in countries with developed financial sectors increase investment more in growing industries and decrease it more in declining industries.

LLSV (1997) hypothesize that better legal protection leads investors to demand lower expected rates of return and that companies, in turn, are more likely to use external finance when rates are lower. They compute three aggregate measures of the use of external finance and find that all three measures are highest in common law countries, where investor protection is greatest, and lowest in French civil law countries, where investor protection is weakest. Regression analysis indicates that the use of equity finance is positively related to shareholder rights. Demirgüç-Kunt and Maksimovic (2002) examine firms in 40 countries and document that the development of a country's legal system predicts firms' access to external finance.

Giannetti (2003) examines the effect of creditor rights and the degree to which they are enforced on the availability and use of debt for firms in eight European countries. She focuses primarily on unlisted firms, suggesting that their lack of access to international markets makes

them more subject to the constraints imposed by their own domestic markets. Giannetti finds that the ability of her sample firms to obtain loans for investment in intangible assets is positively related to the level of protection of creditor rights and the degree to which these rights are enforced; the same is true for access to long-term debt for firms operating in sectors with highly volatile returns.

Himmelberg *et al.* (2002) hypothesize that lack of investor protection forces company insiders to hold higher fractions of the equity of the firms they manage. These high holdings subject insiders to high levels of idiosyncratic risk, which, in turn, increases the risk premium and, therefore, the marginal cost of capital. Himmelberg *et al.* find results consistent with their hypotheses for firms in 38 countries. They document a negative relation between the degree of investor protection and the fraction of equity held by insiders, and a positive relation between inside equity ownership and the marginal return to capital.

Johnson *et al.* (2000) provide evidence that the degree of investor protection in a country also affects the way in which that economy's capital markets respond to adversity. They examine 25 countries during the Asian crisis of 1997–98 and find that the magnitude of decline in the stock market and the degree of depreciation of the exchange rate are negatively related to the degree of investor protection.

The results detailed above imply that strong economic growth requires developed financial markets and that strong investor protection is necessary if strong financial markets are to develop. Thus, studies indicate that investor protection laws and the degree to which they are enforced affect the size and extent of countries' capital markets and, with them, the level of economic growth.

The positive effects of investor protection on economies are echoed for the individual firms within them. LLSV (2000) find that firms in common law countries where investor protection is stronger make higher dividend payouts when firm reinvestment opportunities are poor than do firms in countries with weak legal protection. Dittmar *et al.* (2003) report that firms in countries with strong legal protection are less likely to maintain excess cash balances. They reject the possibility that their results are driven by the difficulty of raising needed external capital for firms in countries where investor protection is weak. Thus, the agency costs associated with free cashflow appear to be lower in countries with stronger investor protection. LLSV (2002) find that firms in countries with better investor protection have higher Tobin's  $Q$  ratios. Gul and Qiu (2002) relate LLSV's legal protection measures to information asymmetry for 22 emerging market countries, measuring information asymmetry based on the degree of importance that investors place on current vs future earnings. Their results indicate that greater legal protection is associated with lower levels of information asymmetry and, therefore, with less serious agency problems.

The relation between investor protection and financial systems has implications for the design of other aspects of governance. John and Kedia (2002) model the interactions between ownership structure, debt structure, and the external control market. Their model implies that optimal governance systems are, in part, functions of the degree of development of financial institutions and markets. There is evidence that individual firms within an economy do sometimes structure their own governance to overcome the deleterious effects that the lack of investor protection in their economy has on their ability to raise external capital. Durnev and Kim (2002) examine the quality of individual firm governance for firms in 26 countries using corporate governance scores compiled by *Credit Lyonnais Securities Asia* and *Standard and Poor's*. These scores are assigned based on a wide variety of firm characteristics, including characteristics related to disclosure, board structure, ownership structure, and accountability.

Durnev and Kim find that the quality of governance in individual firms varies greatly within countries; in particular, firms with better investment opportunities and firms that rely more on external finance have higher governance scores. Durnev and Kim also find that these firms are valued more highly. Klapper and Love (2002) examine firm-level corporate governance characteristics for emerging market firms and find that these characteristics matter more in countries that have weak investor protection.

There is evidence, however, that without underlying legal protection, individual company governance structures put into place when capital is needed to take advantage of investment opportunities do not necessarily survive when such opportunities disappear. Lemmon and Lins (2003) examine the response of firms in eight East Asian countries to the Asian financial crisis. They find that Tobin's  $Q$  falls further and stock price performance is worse for those firms in which minority shareholders are potentially more subject to expropriation. They conclude that ownership structure may be especially important in times of declining investment opportunities. Consistent with this, Mitton (2002) reports that East Asian firms that had higher outside ownership concentration experienced significantly better stock price performance during the crisis.

Fauver *et al.* (2003) present evidence on another means by which firms may be able to partially compensate for the negative effect of poor investor protection on the availability of finance. They analyze the effect of diversification on value for a sample of more than 8000 companies from 35 countries. They find that diversification has a more positive (less negative) effect on value for firms in countries with weaker investor protection and suggest that one interpretation of their results is that the internal capital market created by diversification is more valuable in countries in which investor protection is poor and external capital is less available.

Coffee (2001) suggests that social norms may also be an important determinant of the extent to which those in control of the firm take advantage of minority investors. He notes that the Scandinavian legal systems are considered to be relatively strong, despite the fact that they are more like other civil legal systems than they are like common law systems. He points out that Scandinavian countries have very low crime rates and hypothesizes that social norms in Scandinavia may discourage expropriation of minority investors. The fact that such expropriation is relatively low in the US, despite its high crime rate, leads Coffee to suggest the possibility that law and social norms are intertwined. In particular, he hypothesizes that the impact of social norms may be greatest when law is the weakest.

The first generation of international corporate governance reviewed in the previous section establishes that equity ownership within firms is much more concentrated in most countries of the world than it is in the US, and that this ownership concentration tends to have a positive effect on firm value. The results above offer an explanation for both findings – concentrated ownership is a rational and valuable response to a system that does not protect minority investors.<sup>6</sup> LLSV (1998), however, point out that there are costs to concentrated ownership as well; namely the potential agency conflicts between large shareholders and minority investors.

### Control vs Ownership: The Private Benefits of Control

If large shareholders benefit only from proportionate cash dividends and appreciation in the market value of their shares, there is no conflict between large shareholders and minority shareholders. The evidence in the previous section, however, establishes that there can also

be private benefits of control. Furthermore, the existence of such benefits leads investors in many countries to seek control rights that exceed their cashflow rights. While concentrated ownership is more often associated with increased value, control rights in excess of cashflow rights tend to be value reducing.

Dyck and Zingales (2004) measure the private benefits of control using the differences between the premiums for voting and non-voting shares for block control transactions in 39 countries. Like previous researchers, they find that private benefits vary greatly around the world and that they are quite significant in some countries. More importantly, they find that the individual voting premiums are negatively related to the degree of investor protection in the country; i.e. in countries where investors are less well protected by law, controlling shareholders can and do extract larger private benefits of control. Nenova (2003) studies 661 dual-class firms in 18 countries, using data for 1997. She isolates control benefits and vote values from stock prices and estimates that the private benefits that controlling shareholders extract from their control range from 0% of firm value in Denmark to 50% of firm value in Mexico. Nenova further finds that variables related to the legal environment explain 75% of the cross-country variation in the value of control benefits.

The second generation international corporate governance literature identifies at least two important ways in which controlling shareholders extract value from the firm. The first is termed tunneling, defined by Johnson *et al.* (2000) as transfers of assets and profits out of firms for the benefit of those who control them. They suggest that there are numerous ways in which tunneling can occur, that it happens even in developed economies, and that it is more likely to occur in civil law countries than in common law countries.

Tunneling is prevalent in firms in which excess control rights are achieved by pyramid ownership structures. La Porta *et al.* (1999) examine 27 wealthy economies and find that pyramids are the most common method by which controlling shareholders achieve control rights that exceed their cashflow rights. Recall that, in a pyramid structure, one entity owns a controlling interest in a chain of firms in such a way that the controlling shareholder of the firm at the top of the pyramid achieves effective control of all of the subsidiaries down the line, while actually owning an ever smaller portion of each firm. The controlling shareholder can extract value from the firms that are farther down the line by transferring resources of those lower level companies to the firms that are higher in the pyramid. This can be done in a variety of ways, e.g. by selling goods from higher level firms to lower level firms at inflated prices, or by selling goods from lower level firms to higher level firms at below-market prices.

Control of a firm also allows the controller to choose who the managers will be. Burkart *et al.* (2003) develop a model in which they assume that a professional manager is more capable of managing a company well than is an heir to the founder. Their model predicts that the equilibrium in legal regimes that protect minority investors will be widely held firms managed by professional managers, while weak shareholder protection regimes will tend to have family ownership with heirs as managers. Several authors present evidence that controlling shareholders – or their family members – often manage the firms they control. Claessens *et al.* (2000) find this to be true for nine East Asian countries, while Lins (2003) documents the same in his sample of firms from 18 emerging market countries. La Porta *et al.* (1999) find for 27 wealthy economies that controlling shareholders usually participate in management.

Of course, installing family members as managers is not harmful to minority shareholders if the managers installed are the best possible people to operate the firm. What evidence exists, however, demonstrates that this is not the case. The evidence in a number of US studies

indicates that CEOs that are family members are more entrenched and more likely to detract from performance. For example, Johnson *et al.* (1985) document a positive stock price response to the sudden deaths of founding chief executives; this result does not hold for non-founder chief executives. Morck *et al.* (1988) find that, among older firms, Tobin's  $Q$  is lower when firms are managed by members of the founding family than when they are managed by unrelated officers. Volpin (2002) finds that the sensitivity of top management turnover to Tobin's  $Q$  in Italy is lowest when controlling shareholders are the managers, when control is fully in the hands of one shareholder, and when controlling shareholders own less than 50% of the cashflow rights.

There is currently conflicting evidence on whether the problems associated with the presence of a controlling shareholder are alleviated by also having a large non-management shareholder. La Porta *et al.* (1999) indicate that it does not help for their sample of firms from 27 wealthy countries. Lins (2003), however, finds that outside blockholders reduce the valuation discount associated with managerial agency problems for firms from 18 emerging market countries.

Based upon currently existing second generation research, legal structure – in particular the degree to which investors' rights are protected – is important to the development of financial markets and to the structure of governance within firms around the world. The evidence discussed in the previous section indicates that equity ownership structure has a stronger relation to performance and value in non-US countries than it does in the US. The results presented in this section offer a possible interpretation of this finding. Demsetz and Lehn (1985) hypothesize that ownership is endogenous; i.e. firms will adopt the ownership structure that is most appropriate given the characteristics of the firm. If this is true, the uncertain relation between ownership and performance in the US may not suggest that ownership does not matter – only that different ownership structures are most appropriate for different firms. Under this view, the more significant relation between ownership and performance in some other countries may stem from their weaker legal systems. In other words, without strong protection of investor rights, firms do not have the luxury of developing optimal firm-specific governance systems. Concentrated ownership is a necessity, despite the fact that it creates its own set of problems. Consistent with this, Lins (2003) finds stronger positive relations between ownership and performance in countries with less legal protection and Durnev and Kim (2002) find that relations between governance quality scores and Tobin's  $Q$  are stronger in countries that are less investor friendly.

Do these results suggest that concentrated ownership is suboptimal in an overall sense, that its incidence would be greatly reduced if legal systems the world over provided strong protection of investors? Would corporate governance systems converge in such an environment? Are they converging in the current environment – and, if so, toward what are they converging? We turn to these questions in the following section.

## **CONVERGENCE IN CORPORATE GOVERNANCE SYSTEMS**

For as long as we have recognized fundamental differences in corporate governance systems across countries, there has been debate about which system is 'best'. Because the earliest non-US evidence was from Germany, Japan, and the UK, the early debate centered around these countries and compared the bank-centered governance systems of Germany and Japan to

the market-centered governance systems of the US and the UK. During the 1990s, the system of governance in Japan was compared favorably to that of the US. While the US system was heavily market-based, the Japanese system was more relationship-based. Proponents of the Japanese system characterized it as a superior substitute for the external control market, one in which managers were less subject to short-term pressures from the market. Critics, however, argued that the system entrenched managers, potentially protecting them from the value-increasing discipline of the market.

Shleifer and Vishny (1997) assert that good corporate governance systems are rooted in an appropriate combination of legal protection of investors and some form of concentrated ownership. The US and UK systems rely somewhat more heavily on stronger legal protection, while the German and Japanese systems are characterized by weaker legal protection but more concentrated equity ownership. Shleifer and Vishny downplay the debate about the corporate governance systems of these particular countries and characterize all four of them as having good corporate governance systems.

As corporate governance evidence from countries other than the 'big four' has grown in volume, the scope of the debate has expanded as well. Shleifer and Vishny (1997) argue that other countries lack the necessary legal protection to develop good corporate governance systems. In other words, while there is some room for variation in legal protection, there is a reservation level of legal protection that is required if an economy is to have an effective corporate governance system – and this reservation level is not met in many of the world's economies. Rajan and Zingales (2000) hypothesize that, while a relationship-based system of corporate governance can overcome some of the problems associated with the lack of investor protection, the long-run ability of firms to raise capital and allocate it efficiently will be better served by a market-based system. They emphasize that a market-based system can only be effective with transparency and strong legal protection of investors. Bradley *et al.* (1999) stress that a contractarian system of governance, such as that observed in the US, allows for greater flexibility and, therefore, allows firms to better adapt to dramatic changes. They cite the important role of law in dealing with aspects of the modern corporation that cannot be completely contracted upon.

It is likely that an evolution toward stronger legal protection for investors in many countries would lead to improved corporate governance systems and greater economic development. What is less clear is the likelihood of such an evolution occurring. Coffee (1999) hypothesizes that corporate evolution is likely to follow the path of least resistance and that evolution in corporate laws faces too many obstacles to be predicted. La Porta *et al.* (1999) and Bebchuk and Roe (1999) conjecture that the controlling shareholders of the world will fight to protect the private benefits of control that accompany their concentrated equity ownership. Attempts to improve laws protecting minority shareholders clearly threaten those private benefits of control. To the extent that controlling shareholders are influential people within economies, convergence to legal systems that are more protective of minority investor rights will be difficult. Stronger laws will expropriate value from controlling shareholders; thus, controlling shareholders will demand to be compensated for their losses.

Because the large number of changes in laws that are needed to bring about legal convergence are likely to be politically difficult, Coffee (1999) and LLSV (2000) put more store in what they term functional convergence. Functional convergence occurs when individual investors or firms adapt in ways that create stronger governance, despite a lack of appropriate legal structure. For example, investors can opt to invest their money in firms that are domiciled in more investor-friendly regimes. Firms in less protective regimes can bond themselves to

practice better corporate governance by listing on exchanges in more protective regimes or by being acquired by firms in more protective regimes. Coffee points to the significant number of Israeli firms that have effected their initial public offerings on NASDAQ in the US. Reese and Weisbach (2002) present evidence indicating that foreign firms that list in the US do so to protect shareholder rights. Doidge *et al.* (2001) examine firms at year-end 1997 and find that foreign companies listed in the US have greater Tobin's  $Q$  ratios than do firms from the same countries that are not listed in the US. They hypothesize that the firms that list in the US are better able to take advantage of growth opportunities and that their controlling shareholders cannot extract as many private benefits of control. Bris and Cabolis (2002) document that the Tobin's  $Q$  of an industry typically increases when firms in that industry are acquired by firms domiciled in countries that have stronger corporate governance systems.

Hansmann and Kraakman (2001) argue that there is a strong likelihood of convergence toward a single governance model. They assert that the basic corporate form has already achieved a great deal of uniformity; i.e. that economies are approaching a worldwide consensus that managers should act in the interests of shareholders and that this should include all shareholders, whether controlling or non-controlling. They believe that three principal factors drive economies toward consensus: the failure of alternative models, the competitive pressures of global commerce, and the shift of interest group influence in favor of an emerging shareholder class. They acknowledge that convergence in corporate law proceeds more slowly than convergence in governance practices; however, they expect that the pressure for convergence in law will be strong and ultimately successful.

Perotti and von Thadden (2003) stress the role of transparency in any convergence to a market-oriented system of governance. They hypothesize that lenders have less desire for transparency than do equity holders. Perotti and von Thadden believe, however, that increases in financial integration and product market competition around the world are likely to increase the returns to information gathering, thereby generating greater information revelation. Ultimately, this process will lead to reduced influence by banks and a convergence toward market-oriented financial systems.

What about convergence in corporate governance mechanisms other than the legal system? There is evidence of convergence in a number of areas. Shleifer and Vishny (1997) and Hansmann and Kraakman (2001) report that governance systems in Germany, Japan, and the US show signs of convergence toward each other. Large shareholders are on the increase in US firms, while board structure in Germany and Japan is moving more toward the US model of a single-tier board that is relatively small and has both insiders and a meaningful number of outsiders. Wojcik (2001) examines changes in ownership structure in German firms from 1997 through 2001. He reports that the level of ownership concentration fell significantly over this period, that cross-holdings began to dissolve, and that financial sector institutions declined in importance as blockholders. He concludes that German firms are, on average, moving toward the Anglo-Saxon system. The significant international incidence of privatizations represents a move toward the private ownership that characterizes the world's major economies.

Codes of Best Practice around the world are consistent with convergence toward an Anglo-Saxon governance structure. As discussed earlier, Dahya *et al.* (2002) and Dahya and McConnell (2002) report evidence of significant changes in board structure in the UK following code adoption there. However, evidence from some other countries is less favorable. Bianchi and Enriques (1999) report that attempts by the Italian government to increase protection of minority shareholders by fostering greater activism by institutional investors have not

been successful. de Jong *et al.* (2002) study firms in the Netherlands following a private sector initiative to promote change in the balance of power between management and investors. They find no substantive effect on corporate governance characteristics or on the relations between these characteristics and corporate value.

Liu (2001) reports that securities laws in Taiwan and China are increasingly influenced by the American common law model. In China such laws are meant to reduce asset stripping by directors and managers of state-owned companies, while in Taiwan it is minority expropriation by founders of family-controlled listed companies that the government wishes to curb.

In a more comprehensive study, Khanna *et al.* (2002) analyze 37 countries to determine whether globalization is leading firms to adopt a common set of the most efficient governance practices. They find *de jure* convergence – i.e. convergence in law – at the country level. Rather than converging toward any single system, however, they find convergence between various pairs of economically interdependent countries. They find no evidence of *de facto* convergence – i.e. convergence in practice. They conclude that globalization has induced adoption of some common corporate governance recommendations but that these recommendations are not being widely implemented.

Time will tell what the bottom line on the convergence of corporate governance systems around the world will be. Presumably, market forces will affect the extent to which convergence occurs; however, market forces are not allowed to operate unimpeded throughout the world. Convergence toward stronger legal protection of investors is likely to result in increased investment and growth; however, it is not clear whether or how quickly such convergence will occur. Convergence in other aspects of corporate governance – such as board composition and ownership structure – are evident in some places. Broad convergence may be hampered by the fact that there is not yet agreement on the factors that determine the optimal structures for individual firms.

## **CONCLUSION AND DIRECTIONS FOR FUTURE RESEARCH**

The literature on international corporate governance tells us much about corporate governance but the message in the information is far from clear or complete. Much more work remains to be done. Our understanding of the relationship between systems of governance and the value of economies and the firms within them is of increasing importance as emerging markets around the world look to the developed markets to decide how to set up their own economic and corporate governance systems.

In this chapter, we review existing international corporate governance research. The first generation of this research is broadly patterned after the large body of evidence on governance mechanisms in US firms. These first generation studies examine governance mechanisms that have been studied in the US – particularly board composition and ownership structure – for one or more non-US countries.

The first generation of international corporate governance research examines individual countries in depth and establishes that there are important differences in governance systems across economies. Early international research focused primarily on Germany, Japan, and the UK. Even across these very developed economies, significant differences in ownership and board structure were observed. As international research expanded into other countries, the



differences in corporate governance systems mounted. Of particular note are the very distinct differences in ownership structure across countries. The typical large US corporation, with its diffuse equity ownership structure and its professional manager, appears to be typical only in the US and the UK. Ownership concentration in virtually every other country is higher than it is in these two countries. In many countries, majority ownership by a single shareholder is common.

It is also common in many countries that major shareholders' control rights exceed their cashflow rights. The realities of ownership and control are such that the primary agency conflict in the US – that between professional managers and their widely dispersed shareholders – is relatively unimportant in many other countries. In its place, however, there is a different agency conflict, that between controlling shareholders and minority shareholders. Evidence suggests that the private benefits of control of companies can be significant and that they are value reducing.

The typical first generation international corporate governance study examines one particular country. Taken together, these studies reveal differences in governance systems across countries. Such a fragmented approach, however, does not yield much understanding of why we observe the differences we do. To be able to explain these differences, examination of many countries in a unified framework is required. This task is taken up in the second generation of international corporate governance research.

An important insight generated from the second generation research is that a country's legal system – in particular, the extent to which it protects investor rights – has a fundamental effect on the structure of markets in that country, on the governance structures that are adopted by companies in that country, and on the effectiveness of those governance systems. This insight, along with newly developed measures of the strength of countries' legal protection of investors, will continue to generate a rich body of comparative corporate governance studies.

Strong legal protection for shareholders appears to be a necessary condition for diffuse equity investment. The relatively diverse ownership of US firms can be attributed, at least in part, to the relatively strong legal protection available to potential investors in the US. The general lack of a relationship between ownership structure and firm value could simply mean that the strong legal protection in the US allows US firms to pick and choose among a menu of potential governance mechanisms to achieve optimal structures. In countries with weak protection, however, it appears that only ownership concentration can overcome the lack of protection.

While there is a large body of evidence on individual corporate governance mechanisms in the US, there is much less published evidence addressing the interrelationships among them and the factors that determine the optimal governance structure for a particular firm. In addition, the recent evidence on the importance of legal structure poses new questions even for the US. LLSV (1998) argue that, while protection of shareholder rights in the US is the strongest in the world, such protection is not particularly strong anywhere. Would greater protection in the US improve corporate governance, and with it firm values? Clearly there are limits to the value of protection. For example, a system in which shareholders have the right to approve or disapprove every decision made by managers would be neither practical nor valuable. But what are these limits? Does the US have an optimal level of shareholder protection, or is there room for improvement?

International governance structures are evolving as governments, private parties, and markets seek to strengthen their economies and firms. Such evolution will provide opportunities

for rich new data. For many countries, there is relatively little empirical evidence on governance mechanisms other than legal protection and ownership structure. Such issues as board structure, compensation, and changes in control have been extensively studied in the US, but have been studied much less – if at all – for many other world economies. This may reflect the dominant role of ownership structure in these economies, a dominance that appears to be driven at least in part by weaknesses in legal systems. Evolutions in legal structure provide for natural corporate governance experiments. What aspects of legal systems evolve? What are the effects of such changes on the role of other firm-specific governance mechanisms? What, ultimately, are the effects of such changes on the strength of economies and on the actions and value of companies within them? Answers to these questions will increase our understanding of the role of corporate governance throughout the world.

## NOTES

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1. Individuals are not necessarily endowed with both managerial talent and financial capital. The ability to separate ownership and control allows the holder of either type of endowment to earn a return on it. In addition, the ability to raise capital from outside investors allows firms to take advantage of the benefits of size, despite managerial wealth constraints or managerial risk aversion.
2. See, for example, Denis (2001) and Shleifer and Vishny (1997) on general corporate governance; John and Senbet (1998) and Hermalin and Weisbach (2003) on boards of directors; Core *et al.* (2003) and Murphy (1999) on executive compensation; Holderness (2003) on blockholders; Holmström and Kaplan (2001) on merger activity; and Karpoff (1998) on shareholder activism.
3. Dahlquist *et al.* (2003) present evidence that the existence of concentrated ownership of firms around the world explains some of the well-known home bias in equity ownership. Home bias refers to the overweighting of domestic stocks in investors' portfolios. This bias has typically been calculated utilizing a world market portfolio. Dahlquist *et al.* argue that large portions of the equity of firms with concentrated ownership structures are effectively unavailable to foreign investors interested only in portfolio diversification. The world market portfolio therefore overstates the amount of foreign stock available and, thus, overstates the extent of the observed home bias.
4. Several recent studies question whether the diversification discount is caused by diversification *per se* (see, for example, Campa and Kedia, 2002; Chevalier, 2000; Graham *et al.*, 2001; Maksimovic and Phillips, 2002; Whited, 2001). There is, however, little disagreement about the fact that the average diversified firm is valued less than a similar group of stand-alone firms.
5. These results contrast somewhat with those of Denis *et al.* (1997) for the US. Denis *et al.* find that firms with high inside ownership are less likely to diversify. Conditional on diversifying, however, the valuation effects of diversification are unrelated to inside ownership.
6. Esty and Megginson (2003) examine the impact of countries' creditor rights on the concentration of debt ownership in firms by analyzing 495 project finance loan tranches granted to borrowers in 61 different countries. In an interesting contrast to the results regarding equity ownership concentration, Esty and Megginson find that loan syndicates' average response to weaker creditor rights and poor enforcement of rights is to *decrease* debt ownership concentration. Because a larger number of creditors makes re-contracting more difficult, Esty and Megginson interpret their results as evidence that banks faced with weak protection of their creditor rights see deterring strategic defaults as their primary governance role.

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# Corporate Governance in Germany

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## INTRODUCTION

A corporate governance regime is usually defined as the amalgam of mechanisms which ensure that the agent (the management of a corporation) runs the firm for the benefit of one or multiple principals (shareholders, creditors, suppliers, customers, employees and other parties with whom the firm conducts its business). The mechanisms available to ensure economic efficiency are manifold and comprise: (i) the market for corporate control (both the hostile takeover market and the market for partial control), (ii) large shareholder and creditor (in particular bank) monitoring, (iii) internal control mechanisms such as the board of directors, various non-executive committees and the design of executive compensation contracts, and (iv) external mechanisms such as product–market competition, external auditors and the regulatory framework of the corporate law regime and stock exchanges.<sup>1</sup> Within this analytical framework the German regime is characterised by the existence of a market for partial corporate control, large shareholders, cross-holdings and bank/creditor monitoring, a two-tier (management and supervisory) board with co-determination between shareholders and employees on the supervisory board, a non-negligible sensitivity of managerial compensation to performance, competitive product markets, and corporate governance regulations largely based on EU directives but with deep roots in the German legal doctrine. Another important feature of the German regime is the efficiency criterion that corporate governance is to uphold. Whereas in Germany (and in many other continental European countries) the definition of corporate governance explicitly mentions stakeholder value maximisation, the Anglo-American system mostly focuses on generating a fair return for investors.<sup>2</sup>

A key characteristic of German business is its consensus-oriented egalitarian approach (*Soziale Marktwirtschaft*), often called ‘Rhineland capitalism’ (Schmid and Wahrenburg, 2003). This chapter provides an overview of the German corporate governance system. We describe the main theoretical models on the various alternative mechanisms and summarise the relevant empirical evidence on Germany. We also compare Germany to other countries to illustrate the peculiarities of the German case. We have made an effort to review all the

relevant literature. However, we do not claim that this survey is exhaustive. As a caveat it is important to notice that, although we have included some references to the legal framework, our approach is essentially based on economics.<sup>3</sup>

The structure of the chapter is as follows. The first section discusses the patterns of ownership and control and shows that control is not necessarily the same as ownership, as there are several mechanisms which cause deviations from the one-share-one-vote principle. In this section, we focus on large blockholder monitoring and the nature of control by different types of shareholders, paying special attention to industrial companies and banks. In the second section, we address other internal mechanisms, namely the board of directors and managerial remuneration. The third section deals with external mechanisms, i.e. the market for corporate control, changes in control concentration, creditor monitoring, and product–market competition. The recent regulatory evolution is presented in the fourth section. The final section concludes.

## OWNERSHIP AND CONTROL

### When Is Control Different from Ownership

The potential agency problems in large joint-stock corporations will be different depending on whether the one-share-one-vote principle is upheld or not. Table 13.1 summarises these cases. When diffuse ownership coincides with weak shareholder voting power, as in panel A, there may be serious agency conflicts between the management and the shareholders (Berle and Means, 1932). Monitoring the management may be prohibitively expensive for small shareholders as the monitor bears all the costs from his control efforts but benefits only in proportion to his shareholding (Demsetz, 1983; Grossman and Hart, 1980, 1988). As a consequence, only a large share stake provides sufficient incentives to monitor a company. On the one hand, diffuse control improves the liquidity of the stock and increases the company's exposure to the disciplining role of the market for corporate control. On the other hand, strong ownership and voting power come with low liquidity, but a large controlling shareholder reduces the likelihood that the managers will deviate from the maximisation of shareholder wealth. Given this trade-off, the question is whether either the voting power of large shareholders should be limited to avoid the expropriation of minority shareholders or whether concentrated voting power should be encouraged to curb managerial discretion (La Porta *et al.*, 1998; Shleifer and Vishny, 1997).

The two basic cases where ownership and control coincide are represented by panels A (dispersed ownership and control) and D (concentrated ownership and control) of Table 13.1. Most Anglo-American companies fall under panel A whereas most German firms fall under panel D. Firms from most other continental European and Japanese firms tend to fall under panel B. Table 13.2 provides a summary of recent evidence on control and ownership of German firms.

Edwards and Nibler (2000) and Franks and Mayer (2001) report that more than half of the listed German firms in their samples have an owner holding more than 50% of the equity (see also Correia da Silva *et al.*, 2004; Edwards and Fischer, 1994; Goergen *et al.*, 2004b; Lehmann and Weigand, 2000).<sup>4</sup> Furthermore, Edwards and Weichenrieder (1999) show that the actual proportion of voting rights exercised by the largest shareholder of listed German firms at the annual general meetings gives them a comfortable majority (54.84%). Control concentration

**Table 13.1** *Ownership and control*

		Control	
		Weak	Strong
Ownership	Dispersed	Panel A: Dispersed ownership and dispersed control	Panel B: Dispersed ownership and concentrated control
	Concentrated	Panel C: Concentrated ownership and dispersed control	Panel D: Concentrated ownership and concentrated control

Panel A: Dispersed ownership and weak control

- where: US, UK.
- advantages: (a) high potential for portfolio diversification and high liquidity; (b) existence of a takeover market
- disadvantages: insufficient monitoring; free-riding problem
- agency conflicts: management vs shareholders

Panel B: Dispersed ownership and strong control

- where: countries where a stakeholder can collect proxy votes, where shareholder coalitions are allowed, where non-voting shares are issued and where shareholding pyramids exist; e.g. in continental Europe.
- advantages: (a) monitoring of management, (b) portfolio diversification and liquidity
- disadvantages: (a) violation of one-share-one-vote, (b) reduced takeover possibility
- agency conflicts: controlling blockholders vs small shareholders

Panel C: Concentrated ownership and weak control

- where: any company with voting right restrictions; e.g. in some German firms
- advantages: protection of minority rights
- disadvantages: (a) violation of one-share-one-vote, (b) low monitoring incentives, (c) low portfolio diversification possibilities and low liquidity, (d) high cost of capital
- agency conflicts: management vs shareholders

Panel D: Concentrated ownership and strong control

- where: continental Europe, Japan, in any company after a takeover, in recently floated companies
- advantages: high monitoring incentives
- disadvantages: (a) low portfolio diversification possibilities and low liquidity, (b) reduced takeover possibilities
- agency conflicts: controlling blockholders vs small shareholders

*Source:* Renneboog (1998), Correia *et al.* (2004).

is also very high when measured by using an ultimate control criterion which tracks control throughout chains of direct stakes (Gorton and Schmid, 2000a, b) and by the Cubbin and Leech (1983) index (as applied by Köke, 2000). Ultimate control concentration is even higher in unlisted firms (see also Edwards and Nibler, 2000; Köke, 2003).<sup>5</sup>

Becht and Boehmer (2001, 2003) show that not only is there a high concentration of voting power in listed companies (82% of them have a large blockholder controlling ultimately more than 25% of the voting rights), but the largest shareholder often does not face other large shareholders (only 20% of these companies have more than two registered blockholders) and the average size of the second largest block (7.4%) is small (see also Edwards and Fischer, 1994; Edwards and Nibler, 2000). As many important decisions, such as modifications to the

**Table 13.2** *Ownership and control in Germany: recent selected studies*

Study	Sample year	Data source	No. of companies and sample definition	Block type	Largest block (mean %)	2nd largest block (mean %)
Gorton and Schmid (2000b)	1989–93	Saling Aktienführer, ed. by Verlag Hoppenstedt & Co., Darmstadt (various issues)	186 (1993 sample) firms from the largest 250 corporations that traded at the end of 1993 in at least one of the two-tier market segments: <i>Amtlicher Handel</i> or <i>Geregelter Markt</i>	Control rights	—	—
Franks and Mayer (2001)	1990	Hoppenstedt Stockguide and Commerzbank	171 quoted industrial and commercial companies (subset of the population of 477 quoted industrial and commercial companies in Germany in 1990)	Direct stake	—	—
Edwards and Weichenrieder (1999)	1992	Registers ( <i>Handelsregister</i> ) of annual general meetings	102 listed companies extracted from the 158 largest non-financial firms in 1992	Direct stake (or control rights?)	Owned: 46.30 — % at the general meetings: 54.84	Owned: 8.34 — % at the general meetings: 10.11
Edwards and Nibler (2000)	1992	Registers ( <i>Handelsregister</i> ) of annual general meetings	156 of the 200 largest non-financial firms in 1992	Direct stake	Owned: 47.0 — Listed: 80.0	Owned: 9.0 — Listed: 13.0

Lehmann and Weigand (2000)	1991–96	Commerzbank, Wer gehört zu wem?, Bayerische Hypotheken- und Wechselbank, Wegweiser durch deutsche Aktiengesellschaften, and Hoppenstedt's Börsenführer	361 firms from the mining and manufacturing sectors	Direct stake	– Listed: 73.40 – Unlisted: 97.87	—
La Porta <i>et al.</i> (1999)	1996	Hoppenstedt Aktienführer	20 largest listed	Direct stake	—	—
Becht and Boehmer (2001, 2003)	1996	BAWe (Hoppenstedt KSD)	430 population of listed companies on official market	Voting block	58.9	7.4
Faccio and Lang (2002)	1996	Commerzbank, Financial Times and Worldscope	690 publicly traded (financial and non-financial) corporations	Cashflow (CFR) and control rights (CR)	– CFR: 48.54 – CR: 54.50	—
Köke (2001)	1998	Hoppenstedt KSD	1519 manufacturing firms in the legal form of Kapitalgesellschaft	Ultimate control and direct stake	– GmbH: 89.44 – Non-listed AG: 83.23 – Listed AG: 57.66	—
Van der Elst (2002)	1999	Hoppenstedt Aktienführer BAWe	542 listed companies on official and regulated markets	Block official market; stake regulated market	46.1	8.2

Source: Adapted from Becht and Boehmer (2003).

firm's charter, mergers, and changes in the firm's capital usually require a supermajority of 75% of the votes, a shareholder with more than 25% of the votes has a blocking minority. Becht and Boehmer (2003, p. 10) look at the frequency of voting blocks in terms of their size and conclude that 'voting blocks are clustered at 25, 50, and 75%. [This] suggest[s] that block sizes are carefully chosen and control is an important issue for blockholders.'

In practice, however, a number of large German companies do not fit into panel D of Table 13.1, but fit into panels C and B. One reason for this is that the one-share-one-vote principle (Grossman and Hart, 1988; Harris and Raviv, 1988) is not necessarily upheld. In fact, as Table 13.3 shows, some German companies do not even have 'shares that are legal evidence of ownership' (Edwards and Nibler, 2000, p. 241). This is the case for the *Gesellschaft mit beschränkter Haftung* (GmbH), a private company with limited liability, the legal form of 15% of the German firms in 1994 (Van der Elst, 2002). According to Köke (2001), the average size of the largest shareholder in these companies is 89% and only 4% of GmbHs (approximately 400 000 in 1994) have dispersed ownership. As for those legal forms that allow the issue of shares and can therefore be listed, about 0.1% of the German companies in 1994 were public companies with limited liability (AGs) and 3.2% were partnerships with shares (*Kommanditgesellschaft auf Aktien, KGaA*), a legal form with at least one fully liable general partner (*Komplementär*) and a number of limited partners (*Kommanditisten*) whose liability is confined to their contribution.

Panel C of Table 13.1 represents the case where the concentration of voting power is lower than that of ownership. In this case, the deviation from the one-share-one-vote principle is caused by the use of voting caps designed to prevent large shareholders from exercising control. Voting caps may improve the protection of small shareholders against expropriation by large shareholders, but they certainly also entrench the management. Some examples of German firms that, until recently, had such voting caps in place are BASF (5%), Bayer (5%), Deutsche Bank (5%), Linde (10%), Mannesmann (5%), Phoenix (10%), Schering (3.51%), and Volkswagen (20%).<sup>6</sup> In the past, voting caps have been used in some cases to fend off a hostile raider. For example, Franks and Mayer (1998) show that in each of the three hostile takeover battles in Germany since WWII – this excludes the recent hostile bid of Vodafone plc for Mannesmann AG – voting rights restrictions were used. As a consequence, the voting power of several large share stakes was reduced from, for instance, 30% to 5%. In the cases of Feldmühle Nobel and Continental, the use of voting caps contributed to the failure of the takeover bid (see below). However, such voting-right limits are now prohibited (see the sections on external corporate governance mechanisms and the Third Act on the Promotion of Financial Markets, below).

Finally, Panel B of Table 13.1 shows that it is possible to have dispersed ownership with concentrated voting power. Although such a situation combines the benefits of control – increased monitoring – with those of dispersed ownership – risk diversification – there is also a danger that concentrated control will be exercised to extract private benefits from minority shareholders (Bebchuk *et al.*, 2000). The corporate law regimes in most continental European countries include a number of mechanisms that allow controlling shareholders to obtain a return on their investments that exceeds the financial return via private benefits of control (La Porta *et al.*, 1999). The mechanisms we consider are: (i) ownership pyramids, (ii) proxy votes, (iii) voting pacts, and (iv) dual class shares.

The most widely used mechanism to obtain control with a limited investment is ownership pyramids or cascades. These mechanisms enable shareholders to maintain control throughout multiple tiers of ownership while sharing the cashflow rights with other (minority) shareholders

**Table 13.3** *Main legal forms of business organisation in Germany*

	<i>Aktiengesellschaft (AG)</i>	<i>Kommanditgesellschaft (KG)</i>	<i>Gesellschaft mit beschränkter Haftung (GmbH)</i>
Description	Public company with limited liability	Partnership partly limited by shares	Private company with limited liability
% of total firms in Germany	0.1	3.2	14.4
Issue of shares representing ownership?	Yes	Yes	No
Listing?	Yes	Yes	No
Supervisory board ( <i>Aufsichtsrat</i> )	Yes	No	Yes, if more than 500 employees
Co-determination ( <i>Mitbestimmung</i> )	<ul style="list-style-type: none"> <li>– Full-parity co-determination: Coal, steel and mining firms with more than 1000 employees.</li> <li>– Quasi-parity co-determination: Firms with more than 2000 employees not subject to full-parity co-determination.</li> <li>– One-third co-determination: Firms not family owned with fewer than 500 employees registered before 10 August 1994 and firms not family owned with 500–2000 employees not subject to full-parity co-determination.</li> </ul>	<ul style="list-style-type: none"> <li>– Full-parity co-determination: Like AG.</li> <li>– Quasi-parity co-determination: Like AG.</li> <li>– One-third co-determination: Firms not family owned with 500–2000 employees not subject to full-parity co-determination.</li> </ul>	

*Source:* Prigge (1998) and Gorton and Schmid (2000b).



at each intermediate ownership tier. Thus, ownership pyramids reduce the liquidity constraints that large shareholders face while allowing them to retain substantial voting power.<sup>7</sup> Franks and Mayer (2001) and Köke (2001) show that German corporations are often controlled via such pyramids (see also Faccio and Lang, 2002; Gorton and Schmid, 2000a). However, their samples and definitions differ and so do some of their conclusions. Franks and Mayer (2001) find 33 pyramids in a sample of 38 firms (87%), of which 10 seem to be purely motivated by control because they involve a significant violation of the one-share-one-vote principle. Banks and families prevail at the top of these structures (with an average of 2.2 layers), which were defined on the basis of the presence of ‘at least one large shareholder holding more than 10% of shares indirectly through another company’. Köke (2001) reports cases of pyramids in 45% of a large sample of about 1500 firms, but the threshold that defines the chains or tiers is 50%. Following this criterion almost one out of two firms in the sample have a non-financial firm at the ultimate (second or third) level of the pyramid.<sup>8</sup> This supports our previous claim that a large part of the German business sector belongs to panel B. Interestingly, the GmbH is the most frequent legal form in the Köke sample (around 82% of the firms). Moreover, many of these GmbHs are part of groups of companies dominated by an AG: the so-called Konzerns.<sup>9</sup>

As mentioned above, it is possible that pyramids can lead to the expropriation of minority shareholders. Let us consider the examples. If a car producer requires car seats from a subcontractor, a large shareholding in the subcontractor can yield an important (strategic) advantage. The large shareholder will usually be represented on the subcontractor’s board and will thus be able to obtain private information on the firm’s cost structure or on supply contracts with competitors. The large shareholder could, for example, after obtaining such strategic information, renew negotiations about the price charged by the subcontractor for the car seats. Consequently, such transactions can lead to the creation of another kind of agency conflict, namely the oppression of minority shareholder rights. Let us consider one more example. Suppose that a shareholder owns 51% of the voting shares in firm A and that he also owns 100% of the equity of another firm, firm B. If firm A is a supplier to firm B, the controlling shareholder may be tempted to reduce the transfer price of goods sold to firm B. Profits are then maximised at the level of firm B which is fully controlled and owned by the large shareholder. At the same time, profits are not maximised at the level of firm A, which directly harms its minority shareholders.

Johnson *et al.* (2000) and Buyschaert *et al.* (2004) provide examples of these practices in France, Italy and Belgium. The former study argues that the use of a number of mechanisms to separate ownership and control may also have facilitated the expropriation of minority shareholder rights in Germany. Edwards and Weichenrieder (1999), for example, show that an increase in the largest shareholder’s control rights effectively harms minority shareholders. However, they claim that these negative effects may be somewhat compensated by the benefits obtained from greater monitoring of management when the largest shareholder is a non-bank firm or a public-sector body. Köke (2001) argues that in 10% of his sample, given that the cashflow rights of the largest shareholders amount to only 25% or less of their control rights, the ultimate shareholder ‘could hinder efficient monitoring’.

The second mechanism which gives control with limited cashflow rights is proxy votes. In the US and the UK, the management when making proposals to be considered at the annual general meeting normally solicit proxy votes for their support. In Germany, banks are the main exercisers of proxy votes because, as most shares are in the form of unregistered bearer shares,

holders normally deposit them with their banks, and banks are allowed to cast the votes from these shares (conditional upon the bank announcing how it will vote on specific resolutions at the general meeting and upon the lack of receiving alternative instructions by the depositors). For example, in the above-mentioned failed hostile bid for Feldmühle Nobel by the Flick brothers, voting restrictions were imposed thanks to a resolution supported by Deutsche Bank that eventually passed with 55% of the shares voted. However, Deutsche Bank only held a direct share stake of about 8%; the rest were proxy votes (Franks and Mayer, 1998).<sup>10</sup> Edwards and Nibler (2000) provide further evidence on banks' proxy votes for a sample of 156 listed and non-listed German companies in 1992. Their data show that banks typically control more voting rights via proxy votes than via their own stakes.<sup>11</sup> Moreover, they note that banks' proxy votes only affect the governance of AGs and KGaAs but not that of GmbHs. All in all, proxy votes seem to provide effective voting power to German banks (especially to the three largest ones: Deutsche Bank, Dresdner Bank and Commerzbank) mainly in large listed companies (see also Franks and Mayer, 2001; Prigge, 1998).

The third mechanism is voting pacts. Voting pacts enable shareholders to exert a much higher degree of control as a group than the members of the pact could individually. As pointed out by Franks and Mayer (2001), for example, in many German corporations a (hypothetical) coalition formed by the two or three largest shareholders could easily gain control;<sup>12</sup> see also Leech and Manjon (2002) and Leech (2001) for Spanish and British evidence on this, respectively. However, apart from the notable exception of Crespi and Renneboog (2002), there is little empirical evidence that long-term shareholder coalitions are formed in Europe because such coalitions may bring about substantial costs. For example, the regulatory authorities in the UK consider a long-term shareholder coalition as a single shareholder and, as a consequence, the coalition has to comply with all the regulations concerning information disclosure, mandatory tender offer, disclosure of strategic intent etc. According to Jenkinson and Ljungqvist (2001), corporate governance regimes like the German one in which multiple large shareholders exist, are both 'unpredictable and lacking in transparency. [Control] [b]attles often involve a protracted, and clandestine, shuffling of stakes between rival coalitions and the revising of pooling agreements [(voting agreements)]. Even large blockholders can find themselves, apparently without warning, as members of the suppressed minorities.' Most coalitions are usually formed on an ad hoc basis with a specific aim, such as the removal of badly performing management.

The fourth mechanism to separate ownership and control is dual class shares. Under a dual class regime, one class (B-shares) has fewer voting rights than the other one (A-shares). In the US, dual class shares have become an increasingly important concern to investors since the 1980s, when stock exchanges liberalised the originally restrictive policy on multiple and dual class shares. These shares are also commonly issued by European firms (from, e.g., Italy, Scandinavia, and Switzerland), but with large differences across EU member states both in terms of their use and the rights attached.<sup>13</sup> Non-voting shares are used by German firms, although they may not exceed 50% of the stock capital. Faccio and Lang (2002) estimate that the proportion of firms with dual class shares outstanding is 18% in Germany. Goergen and Renneboog (2003) demonstrate that the issuance of non-voting shares is very effective to forestall any change in control. The issuing of multiple voting shares was outlawed in Germany as of May 1998 and the grandfather clause was phased out on 1 June 2003 (Beinert, 2000, § 70). However, German firms, as well as firms from certain other countries, can still issue preference shares (*Vorzugsaktien*). This is risk-bearing capital without votes, but with special dividend rights (Goergen and Renneboog, 2003).<sup>14</sup>

## Monitoring by Blockholders

In the previous section, we have shown that most German companies have large controlling blockholders. The key question is: do blockholders enhance firm value? Value is expected to be created by the increased monitoring of the management by the large blockholders (see, amongst others, Admati *et al.*, 1994; Franks *et al.*, 2001; Kahn and Winton, 1998; Maug, 1998; Renneboog, 2000; Shleifer and Vishny, 1986; Stiglitz, 1985). There is an extensive literature investigating whether blockholders take corporate governance actions when increased monitoring is necessary (e.g. in the case of poor corporate performance or financial distress).<sup>15</sup> In addition, the incentives to correct managerial failure depend not only on the concentration of ownership or control, but also on its nature as specific classes of shareholders may value control differently.<sup>16</sup>

It should be noted, however, that concentrated ownership may also generate substantial costs. First, Demsetz and Lehn (1985), Admati *et al.* (1994) and Manjon (2004) claim that control by a large shareholder may result in reduced risk sharing. Second, as shown above, ownership concentration may reduce the market liquidity of all the shares (Becht, 1999; Bolton and von Thadden, 1998). Third, in highly leveraged companies, a large blockholder may push management to take excessive risks – especially if the company is performing poorly and the bankruptcy costs are high. In this case, risk-increasing investment projects may lead to the expropriation of debtholder wealth (Coffee, 1991; Jensen and Meckling, 1976). Fourth, Burkart *et al.* (1997) and Pagano and Röell (1998) point out that even when tight control by shareholders is efficient *ex post*, *ex ante* it may constitute an expropriation threat that reduces managerial incentives to exert effort and to undertake value maximising strategies (the so-called ‘overmonitoring’ effect). Fifth, although blockholdings are meant to mitigate the agency costs resulting from excessive managerial discretion, they can induce their own types of agency costs as the private benefits usually come at the expense of other shareholders or stakeholders.<sup>17</sup> These private benefits can, for example, be in the form of the squeeze-out of minority shareholders at a price below the value of their shares in a tender offer and the diversion of resources from security holders to entities controlled by a blockholder (Johnson *et al.*, 2000).

In fact, in the empirical literature, there is little evidence on the benefits from having large blockholders (Gugler, 2001; Short, 1994). Franks *et al.* (2001), for example, investigate whether the presence of blockholders in poorly performing British companies is related to increased board restructuring. They find no evidence of increased managerial disciplining in the wake of poor performance when large outside shareholders are present. The only consistent and significant finding relates to managerial entrenchment as managers with a substantial degree of control are able to ward off any attempts to remove them. Banerjee *et al.* (1997) investigate the governance role of French holding companies which constitute the dominant shareholder category in France and conclude that the presence of holding companies as major shareholders seems to reduce corporate performance and firm value. Similarly, Renneboog (2000) fails to find a monitoring role for blockholders in firms listed on the Brussels stock exchange, with the exception of controlling industrial and commercial companies which initiate board restructuring when the firm’s accounting and share price performance declines.

There have been a number of specific studies on the role of large shareholders in German firms (summarised in Table 13.4). The evidence is inconclusive. In a pioneering study on

**Table 13.4** *The impact of ownership concentration and bank presence on performances*

Study	Impact of ownership concentration/bank presence	Sample and period	Estimation method	Dependent variable	Main explanatory variables**
Thonet and Poensgen (1979)	-/	About 300 listed firms extracted from the universe of manufacturing firms for the years 1961–70	OLS, GLS	ROE	OC dummy, size, market share
Cable (1985)	+/+	48 firms extracted from the largest 100 in 1970	Weighted least squares	1968–72 average ratio of after-tax profits to capital assets	OC, BO, firm size and growth, public ownership, ratio of bank borrowing to total corporate debt
Gorton and Schmid (2000a)	+/+	Four cross-sections of AGs extracted from: (i) the list of the top 100 AGs of the year 1974; (ii) all non-financial firms listed in Saling Aktienführer 1976; (iii) the list of the largest manufacturing firms published in 1986 by the Frankfurter Allgemeine Zeitung; (iv) all non-financial firms listed in Saling Aktienführer 1987	Semi-parametric specification estimated by locally weighted regression year by year	MTB (log), ROE	OC, BO, co-determination, voting restrictions
Gedajlovic and Shapiro (1998)	-/	1030 medium to large-sized publicly traded from five countries (Canada, France, Germany, the United Kingdom and the United States) and 11 industrial sectors extracted from Worldscope-Disclosure 1991. Data from 1986 to 1991	Pooled OLS robust to heteroskedasticity	ROA	OC, firm size and growth, diversification and geographic scope

(Continued)

**Table 13.4** (Continued)

Study	Impact of ownership concentration/bank presence	Sample and period	Estimation method	Dependent variable	Main explanatory variables**
Edwards and Weichenrieder (1999)	-/	102 listed companies extracted from the 158 largest non-financial firms in 1992	OLS (White heteroskedastic correction)	MTB	OC, debt ratios, idiosyncratic risk, firm size, industry dummies
Goergen (1998)	ns	62 German firms that went public between 1981 and 1988 and were family controlled before their flotation	Generalised Method of Moments (GMM) as a system	Cashflow over book value of debt and equity, cashflow over market value of equity and book value of debt, CARs	OC by type of shareholder, performance from previous period
Edwards and Nibler (2000)	ns/ns	103 listed companies extracted from the 158 largest non-financial firms in 1992	OLS (White heteroskedastic correction)	MTB	OC by type of shareholder, debt ratios, voting rights controlled by banks by proxy votes, idiosyncratic risk, firm size, dummy indicating the worker representation in the supervisory board, industry dummies
Gorton and Schmid (2000b)	+ / +	Unbalanced sample (1987-92) from the largest 250 stock corporations that traded at the end of 1993 in at least one of the two-tier market segments: antilicher Handel or geregelter Markt	Semi-parametric specification estimated by locally weighted regression year by year	MTB (log)	OC (lagged), BO (lagged), firm size (lagged), dummy for equal representation in the board, industry dummies

Author(s)	Sample	Significance	Method	Control Variables	Findings
Lehmann and Weigand (2000)	361 firms from the mining and manufacturing sectors	-/+	Fixed effects (corrections for heteroskedasticity and first-order serial correlation)	ROA, ROE	OC, BO, board representation, firm size and growth, capital intensity, capital structure, market concentration
Agarwal and Elston (2001)	100 large listed and unlisted stock-held firms for the 1970–86 period	/ns	Fixed effects	Operating income over sales, growth and interest payments over debt	BO, debt, growth of sales, sales, capital stock to sales
Franks and Mayer (2001)	75 listed firms, 1990–94	ns/	Fixed effects	Board turnover	OC, earnings loss
Januszewski <i>et al.</i> (2002)	491 manufacturing firms operating in the period 1986–94	+/+	GMM	Productivity growth	OC, market competition, control dummy, shareholders, cross-shareholdings
Köke and Renneboog (2003)	1074 non-financial firms covering the years 1986–96	+/-	GMM	Productivity growth	OC, market competition, control dummy, dummies for type of shareholders, debt, financial distress

\* Note: '+' means positive effect of ownership-concentration/bank-presence on performance (or related variables), '-' means negative effect and 'ns' means no significant effect.

\*\* Note: OC stands for ownership-concentration measure and BO means bank's ownership measure.

listed companies, Thonet and Poensgen (1979) conclude that management-controlled firms outperform those controlled by outsiders in terms of the return on equity (ROE). Similarly, Edwards and Weichenrieder (1999), using a sample of quoted companies, and Lehmann and Weigand (2000), using a sample of both quoted and unquoted companies, find a significant negative relation between, on one side, control concentration and, on the other side, the market-to-book ratio and the return on assets (ROA). However, Kaplan (1994b), Goergen (1998) and Franks and Mayer (2001) find no significant impact of control on corporate performance and on board turnover in listed firms. Weigand (1999) and Edwards (1999) show that firms with high control concentration outperform more dispersed firms in terms of the ROA. However, Gedajlovic and Shapiro (1998) find inclusive results, using the ROA as their measure of performance. They find a non-linear relationship between ROA and control (which is negative at low levels of control but positive at high levels) and a positive impact on ROA from a reduction in strong managerial control (entrenchment). Köke and Renneboog (2003) conclude that the relation between strong ultimate blockholders and productivity growth is very limited. Strong blockholders reduce the negative effect of weak product market competition, but only in profitable large firms controlled by banks, insurance firms and the government. Finally, Cable (1985) and Gorton and Schmid (2000a, b) – focusing on bank control – seem to be the only studies reporting a consistently positive control–performance relationship. In contrast, Edwards and Nibler (2000) find such a positive relation only for individuals holding a minority stake and for foreign firms (see also Edwards and Weichenrieder, 1999).

Some studies focus on the monitoring effects of banks as large shareholders (Emmons and Schmid, 1998). Cable (1985), Gorton and Schmid (2000a, b), Lehmann and Weigand (2000) and Köke and Renneboog (2003), for example, find that banks as large shareholders improve corporate profitability. However, Edwards and Nibler (2000) report this effect only for the ‘3 big banks’. Interestingly, bank-controlled firms (or banks strongly influenced by other banks through, e.g., board representation) also seem to have higher survival rates (Elston, 2004). Conversely, Agarwal and Elston (2001) and Chirinko and Elston (1998) do not find statistically significant differences between the profitability of bank- and non-bank-controlled firms. In fact, firms whose ultimate owner is a bank or another financial institution appear to have lower productivity growth (Januszewski *et al.*, 2002).<sup>18</sup>

An important caveat that applies to most of these studies is the implicit assumption that it is control or ownership that influences corporate performance and not vice versa (Demsetz and Lehn, 1985; Himmelberg *et al.*, 1999).<sup>19</sup> Goergen (1998), who reviews the studies that explicitly address the direction of causality, shows that this conclusion may be premature and there may be a need for a reversal of the direction of causality between firm value and ownership or control in line with Kole (1996). However, most German studies claim that the characteristics of the German governance system make ownership and control exogenous (see, among others, Edwards and Nibler, 2000; Gorton and Schmid, 2000; Gugler and Weigand, 2003; Lehmann and Weigand, 2000).

It is apparent that control is valuable in Germany; controlling shareholders are likely to derive private benefits of control from large share stakes. Schmid and Wahrenburg (2003) show that the premium of voting over non-voting shares in Volkswagen hovered between 30% (1999) and 76% (2000). Nenova (2003) and Dyck and Zingales (2001) find that private benefits of control are significant for German firms. Edwards and Weichenrieder (1999) provide some empirical evidence that large blockholders enjoy private benefits of control (at the expense of minority shareholders). They show that the more control rights the largest shareholder holds,

the lower is the firm's market value. Conversely, firm value increases with the proportion of control rights held by the second largest shareholder. This suggests that the largest shareholder is able to extract private benefits of control when his control is uncontested whereas the presence of a second large shareholder redirects the focus of the firm towards the creation of firm value. A similar idea is put forward by Gugler and Yurtoglu (2003) in the context of dividend payout policies. In German firms, characterised by high control concentration, the conflict between the large controlling shareholder and the small minority shareholders is one of the main corporate governance issues. An increase in dividends reduces the funds at the disposal of the large shareholder and increases the market value of the firm. A decrease in dividends implies potentially more severe rent extraction and expropriation of small shareholders. Gugler and Yurtoglu find that the negative price reaction to dividend decreases is much more severe in firms with one controlling shareholder than in firms with several large blockholders.

To conclude, the German evidence on the link between corporate performance and control or ownership is inconclusive. Frick and Lehmann (2004) state that the relationship between ownership or control concentration and profitability has changed over time. In the 1970s and 1980s, there seemed to be a positive relation, which vanished or even turned negative in the 1990s.

## The Nature of Control

Not only does the degree of control matter, but so does the type of the controlling shareholder (Cubbin and Leech, 1983). As shown by Jensen and Meckling (1976), some types of shareholders may be better at monitoring poorly performing companies given their incentives and/or abilities. Similarly, different types of shareholders may be subject to different types of agency costs (Pagano and Röell, 1998; Zwiebel, 1995). Empirical evidence on the differences in incentives, abilities and costs in the governance of German firms can be found in, e.g., Gorton and Schmid (2000b), Lehmann and Weigand (2000), Januszewski *et al.* (2002), Köke and Renneboog (2003), Edwards and Nibler (2000) and Franks and Mayer (2001).

Table 13.5 compares the average sizes of the stakes held by the different types of shareholders in German firms to that in other European countries. The types of shareholders are: (i) institutional investors (banks, insurance companies, investment and pension funds), (ii) individuals or families, (iii) directors and their families and trusts, (iv) industrial and holding companies, and (v) the federal or regional governments. Germany is similar to most other continental European countries in the sense that the most important type of shareholder is holding and industrial companies, followed by individuals or families. In detail, in Germany the principal investors are, in order of importance, (i) holding and industrial companies, (ii) individuals and families, (iii) banks (although, as pointed out in the previous section, proxy votes can make them very powerful in the general meetings) and other institutional shareholders, and (iv) public authorities. We now turn to discussing each of these types in more detail.

### *Industrial and Holding companies*

The existence of share blocks held by other industrial companies is a documented feature of the German corporate governance regime (Prigge, 1998). In fact, about 80% of direct equity



**Table 13.5** Average cumulative percentage of voting blocks held by different classes of shareholders in Europe

Country	Sample	Control	Individuals or families	Banks	Insurance companies	Investment funds	Holding and industrial companies	State	Directors
Austria	600	(2)	38.6	5.6	0.0	0.0	33.9	11.7	0.0
Belgium	155	(2)	15.6	0.4	1.0	3.8	37.5	0.3	0.0
France	402	(2)	15.5	16.0	3.5	0.0	34.5	1.0	0.0
Germany	402	(2)	7.4	1.2	0.2	0.0	21.0	0.7	0.0
Italy	(1)	(2)	68.6	7.2	0.0	0.0	24.2	0.0 (4)	0.0
Netherlands	137	(3)	10.8	7.2	2.4	16.1	10.9	1.3	0.0
Spain	394	(2)	21.8	6.6	8.8	0.0	32.6	0.0	0.0
UK	248	(3)	2.4	1.1	4.7	11.0	5.9	0.0	11.3

*Notes:* (1) numbers for Italy refer to both listed (214) and large non-listed (about 8000) companies; for other countries only listed companies are taken; (2) both direct and indirect shareholdings are considered; (3) only direct shareholdings; (4) of the listed Italian companies about 25% are directly and indirectly controlled by state holdings; this is classified in the table under 'Holding and industrial companies'.

*Source:* Renneboog (2000) and Barca and Becht (2001). The table gives the average cumulative percentage of share blocks (above 5%) held by different types of shareholders. The figures reported are for the year 1996, except for Belgium (1994) and the UK (1993).

stakes in firms listed on the official market belongs to other firms (industrial firms, holding companies, investment firms and financial firms) (Becht and Boehmer, 2003). Moreover, there is evidence that German firms controlled by other companies tend to have higher levels of productivity (Januszewski *et al.*, 2002) and are less likely to be acquired if they are public corporations (Köke, 2002).<sup>20</sup>

Faccio and Lang (2002) show that Germany is the European country with the largest percentage of companies controlled by other firms. This phenomenon is also prominent in the German financial sector.<sup>21</sup> Table 13.5 shows that German holding companies and industrial companies control an average stake of 21% in other German listed firms, which is largely corroborated by Emmons and Schmid (1998) and Gorton and Schmid (2000b).<sup>22</sup> These large industrial shareholders may obtain substantial private benefits at the expense of other shareholders or stakeholders (Grossman and Hart, 1988) and cross-holdings may have an important negative impact on competition (Canoy *et al.*, 2001).

### *Families or individuals*

Table 13.5 also shows that individuals or families are one of the main shareholder categories in continental Europe (see also La Porta *et al.*, 1999).<sup>23</sup> In particular, Franks and Mayer (2001) have found that large-scale family control is especially pronounced in the largest German firms. This finding was also documented by Edwards and Nibler (2000) and Becht and Boehmer (2001). In 40% and 37% of their samples individuals or families control blocks of on average 57% and 20% (respectively) of the voting rights. In general, however, they are much more commonly found among small and medium-sized non-financial companies (Faccio and Lang, 2002; Köke, 2001).

### *Directors*

A particular category of individuals controlling share stakes is that of the directors, who are insiders and therefore possess superior information on the firms' prospects. However, Table 13.5 suggests that continental European managers are not shareholders of the firms they manage. Actually, hardly any information is known about directors' control in continental Europe for the following reasons: (i) the shareholdings of most directors are below the disclosure thresholds, (ii) although large family blockholders frequently appoint their representatives (which can be family members) to the board, the origin of board representation does not need to be disclosed publicly, and (iii) the use of intermediate investment companies further obscures directors' control. Whatever the reasons, we have found only two German studies presenting data referred to this category. First, Gorton and Schmid (2000b) show that the management owns at least 50% of the control rights in 8% of the firms in their 1992 sample. Moreover, 15% of the firms have a member of the management team as the largest shareholder. Second, Köke (2003) reports ultimate control measures for a sample of listed and unlisted firms for the years 1987–94. The average stake of the (executive and non-executive) directors and their families is 22.5% for the quoted firms and 12% for unquoted firms. These figures suggest that in a non-negligible number of German companies there is no separation between ownership and control because 'managers own' and 'owners manage'.

### *Banks and other institutional shareholders*

There is an extensive theoretical literature on the role and incentives of bank monitoring. Diamond (1984), for example, formulates a model that shows that delegation of monitoring to

banks is efficient as duplication of monitoring by small investors (creditors) can be avoided, provided the bank's lending portfolio is sufficiently diversified.<sup>24</sup> Krasa and Villamil (1992) study delegated monitoring by considering the role of the intermediary who is to satisfy the different portfolio preferences of both borrowers and lenders. They model the incentive structure of the monitor by determining what intermediary portfolio accomplishes optimal asset transformation between borrowers and lenders. Rajan and Diamond (2000) review the assumptions of Diamond (1984) and show that the bank's incentives to monitor are preserved provided that there is no deposit insurance and that the first-come first-serve feature of bank deposit contracts is maintained. In other words, it is the possibility of a bank-run that preserves the banks' incentive to monitor the firms.

However, as shown in Table 13.5, bank shareholdings in German – as well as other continental European – companies are generally small.<sup>25</sup> One reason for this may be the avoidance of potential conflicts of interest (Canoy *et al.*, 2001; Goergen and Renneboog, 2001). In Germany, for example, only 5.8% of the large voting stakes of 5% and more are held (directly as well as indirectly) by banks, resulting in an average of 1.2% of the votes (see Table 13.5). However, from what we have said above, it is clear that the influence of banks is understated if one just looks at their direct and indirect stakes and ignores their proxy votes.

Weigand (1999) shows that over the long run, firms controlled by universal banks outperform management-controlled firms. Other evidence on the impact of banks is given by Goergen *et al.* (2004b) who examine the flexibility of the dividend policy of German corporations. They find that bank control is associated with a higher likelihood to omit the dividend when the firm suffers a loss. This suggests that bank control mitigates informational asymmetry and reduces agency costs. In contrast, control by other types of shareholders does not influence the dividend decision. In widely held loss-incurring firms there is even a reluctance to cut the dividend which suggests that these firms are more prone to agency costs than firms with a controlling shareholder and therefore rely more heavily on dividend policy as a corporate governance mechanism.

As for the other types of institutional shareholders, insurance companies also seem to be important.<sup>26</sup> In sharp contrast with the UK and the US, however, other institutional investors (notably investment funds) do not hold significant stakes in German companies (Davis and Steil, 2001; O'Sullivan, 2000).<sup>27</sup> Empirical evidence from the firms listed on the German official market (*Amtlicher Handel*) shows that whereas 20 insurance companies hold shares representing around 17% of the market capitalisation, the rest of the institutional investors (excluding banks) barely reach 0.5% (Wójcik, 2002). Given the close links between insurance firms and banks in Germany, the importance of the former further reinforces the role of banks as controlling shareholders (Canoy *et al.*, 2001; Goldman Sachs, 2000).

In general, the lack of institutional blockholders (apart from banks) in Germany as well as of most continental European countries suggests that, in contrast to the Anglo-American countries, little shareholder activism is to be expected from these institutions.<sup>28</sup> Even in Anglo-American countries, there is not much evidence of monitoring by institutional shareholders and any monitoring seems to be limited to just a few large funds because most institutions prefer to avoid monitoring firms and gathering non-public information. If they were to possess such information, the insider trading legislation would curb their trading such that the liquidity of their investment portfolio would be reduced. Furthermore, the costs of actively monitoring the many firms included in the institutions' portfolios may also be prohibitive (Stapledon, 1996; Stapledon and Bates, 2002).

### Public authorities

Despite the large-scale privatisation programmes that occurred in Europe over the last decades (starting with the UK in the 1980s),<sup>29</sup> in many listed European firms the state is still one of the largest shareholders (La Porta *et al.*, 1999). In this respect, one has to take into account the privatisation of East German firms during the early 1990s (Dyck, 1997; Hau, 1998). Even when controlling for this specific privatisation process, the importance of public authorities as shareholders remains considerable, especially in large (GmbH and unlisted AG) firms (Faccio and Lang, 2002; Köke, 2001). As an illustration, in 1997 the value of their holdings in the firms listed on the official market or *Amtlicher Handel* was about 21% of the total market capitalisation. In 2001 the public investments represented only 14% of the market capitalisation (Wójcik, 2002).<sup>30</sup> In terms of the number of firms in which the government was the largest shareholder, figures range from 6% (Emmons and Schmid, 1998; Franks and Mayer, 2001) to 8% (Edwards and Nibler, 2000; Gorton and Schmid, 2000b).

In the next section we review the evidence on the other internal mechanisms of corporate governance: the supervisory board, management board turnover in the wake of poor performance and managerial remuneration.

## INTERNAL CORPORATE GOVERNANCE MECHANISMS

### Supervisory Boards

To the opposite of most western economies, Germany has a two-tier board with a management board (*Vorstand*) and a supervisory board (*Aufsichtsrat*).<sup>31</sup> The supervisory board represents the shareholders and employees. Baums (2000) compares the fiduciary duties (duty of care and loyalty) in German and UK corporate law and concludes that ‘the range of fiduciary duties in the English law system seems wider and more developed than in its German counterpart’ (p. 8). The German supervisory boards are dominated by representatives for the large shareholders. In large firms with more than 2000 employees, the 1976 Codetermination Act has created a system of quasi-parity co-determination. Employee representatives make up half of the supervisory board but the chairman who is a shareholder representative has a casting vote in case of a stalemate. Bankers are frequently elected to the supervisory board (even as chairmen) (Edwards and Nibler, 2000, p. 241). In small companies with more than 500 but less than 2000 employees, one-third of the supervisory board consists of employee representatives. Finally, full-parity co-determination by the shareholders and employees is limited to the steel and coal sector only (which are subject to the 1951 Montan Codetermination Act). The role of this co-determination system is currently the object of a debate in Germany. The only companies that are exempt from having a supervisory board with co-determination are those who can appeal to the constitutional freedoms of faith and free press (e.g. the publishing company Springer). The directors of German firms are usually appointed for a term covering the legal maximum of five years, although reappointment at the end of the term is possible.

There is little evidence that the co-determination system leads to superior corporate governance (Franks and Mayer, 2001). Firms with workers’ councils have a lower employee departure rate (by 2.4%), pay significantly higher wages (Jirjahn and Klodt, 1999) and have a lower wage differential between skilled and unskilled labourers (Hübler and Meyer, 2000).

All in all, there is evidence that workers' councils and employee representatives on the supervisory board unilaterally favour the interests of the incumbent workforce (Frick and Lehmann, 2004).

## Management Board Turnover in the Wake of Poor Performance

The disciplining of top management (and in particular of the CEO) has received considerable empirical attention.<sup>32</sup> The reason is that such disciplining is one of the few observable corporate governance actions by the board of directors. Most other governance actions or decisions by directors are not directly observable, as the minutes of the board meetings are not publicly available. However, good corporate governance cannot simply be equated to the dismissal of badly performing managers from the board for the following two reasons. First, poor (industry-corrected or business-cycle adjusted) corporate performance leading to managerial disciplining may be protracted past poor performance and hence also the result of failed past corporate governance. As such, the dismissal of poorly performing management may come too late.<sup>33</sup> Second, the success of the removal of the underperforming management should be considered along with the managerial alternative. For instance, Dherment-Ferere and Renneboog (2002) study how the French stock market reacts to the appointment of CEOs with different backgrounds. They find that whereas voluntary resignations do not cause share price reactions, the nomination of an external manager following the performance-related forced resignation of a CEO causes a strong significant increase in abnormal returns of more than 2%. The abnormal return at the promotion of an internal candidate to the post of CEO in a poorly performing firm is negative (1% on the day of the announcement), which presumably occurs because the internal candidate is held (partially) responsible for past poor performance.

For Germany, Kaplan (1994a) presents evidence that management board turnover is closely related to poor stock performance and earnings losses, but not to sales and earnings growth. In contrast, the turnover of the chairman of the supervisory board is more likely to happen when the firm's net income falls. In addition, poor stock performance also causes supervisory board dismissals. Three additional results are worth mentioning. First, the evidence is consistent with the view that the German corporate governance regime is based on a long-term perspective of the firm (Porter, 1992). Second, the sensitivity of executive turnover to firm performance in Germany is comparable to that in Japan and the US (Kaplan, 1994b; Kaplan and Minton, 1994). Third, neither large shareholders nor bank control seem to protect managers from the possibility of being dismissed when their companies perform poorly. These results call into question the view that in bank-based regimes, such as the German one, managers may be entrenched at the expense of minority shareholders (Coffee, 1991; Roe, 1993). The results in the Kaplan studies are not entirely supported by the Franks and Mayer study (2001). The latter documents that supervisory board turnover depends on corporate performance but only when there is a change in control. Supervisory turnover of firms which are incurring losses is not statistically different from that of firms generating profits although it is significantly higher when new blockholders acquire stakes in the poorly performing firms. The level of management board turnover provides a similar picture. Board turnover is higher for loss makers than for non-loss makers, but it is only statistically significant in the subsample for firms with stable holdings. These results suggest that block sales are not disciplinary in nature.

## Managerial Remuneration

Perhaps the simplest economic device to align managers' actions with the interests of shareholders (or, more generally, stakeholders) is a compensation contract that specifies the tasks and rewards of the executive directors for each outcome of corporate performance. However, an important limitation to the use of contracts as an internal governance mechanism is that they are necessarily incomplete (Tirole, 1999, 2001). In addition, managerial effort is unobservable such that a number of moral hazard problems may arise. The fact that managers are underperforming may remain undetected for some time whereas, in contrast, good managers may be paid less than they deserve (Grossman and Hart, 1983; Holmstrom, 1979). Fortunately, the optimal compensation scheme may be relatively straightforward to implement because, as shown by Holmstrom and Milgrom (1987), under certain conditions it simply boils down to a linear function of aggregate measures of firm performance (output, profits etc.).<sup>34</sup>

Table 13.6 compares CEO remuneration in Germany to the rest of Europe and the US. German CEOs are among the lowest paid in Europe. German CEOs earn on average a total remuneration of only \$454 979 as compared to \$696 697 for Belgian CEOs. Conyon and Schwalbach (1999, 2000a) show that when differences in tax rates are taken into account the variation across Europe is even larger. The pay package of German CEOs looks even more meagre when compared to their US counterparts. In terms of the importance of the basic compensation in the total pay package (47%), German CEOs are no different to their European counterparts, but are substantially different when compared to US CEOs (28%). In particular, German CEOs appear to have the highest total cash pay in Europe but have the lowest non-cash remuneration. This may explain why the total remuneration package of German executives is low compared to other European executives (Conyon and Schwalbach, 1999, 2000a). In the meantime, variable payment is increasingly adopted by large German firms (Tuschke and Sanders, 2003).

The influence of remuneration policies on the behaviour of German managers has recently been a matter of further systematic research (see, e.g., Kraft and Niederprüm, 1999). Elston and Goldberg (2003) investigate the monetary compensation of the members of the management and supervisory boards of German firms and confirm the results of Schmid (1997). First, although the size effect (positively) dominates the compensation equation, there exists a positive

**Table 13.6** *CEO remuneration in Germany as compared to the rest of Europe and the US in 2001/02*

	Pay components (as a percentage of total remuneration)				
	Total remuneration (\$)	Basic compensation	Variable pay	Benefits	Perquisites
Belgium	696 697	46	24	28	2
France	519 060	46	26	21	7
Germany	454 979	47	36	12	5
Italy	600 319	43	33	20	4
Netherlands	600 854	47	36	13	4
Spain	429 725	51	36	10	3
Sweden	413 860	46	25	27	2
UK	668 526	43	30	21	6
US	1 932 580	28	61	6	5

Source: Towers Perrin (2001–2002).

sensitivity of managerial pay to company performance in Germany. This relation is confirmed by Conyon and Schwalbach (2000b). Second, the Elston and Goldberg (2003) study shows that managers and directors of widely held firms receive a substantially higher monetary compensation than those of firms with large blockholders. Third, firms with monitoring house banks (which own an equity stake, are major providers of loan capital and frequently have board representation) generally pay managers and directors comparatively less than widely held firms. The adoption of stock-based compensation is investigated by Tuschke and Sanders (2003). They show that the relationship between the likelihood of adopting stock-based incentives and control concentration in listed German firms has an inverted-U shape with a maximum in the first quartile of control concentration.

In the next section, we review evidence on the external corporate governance mechanisms: the market for corporate control, block trades, creditor monitoring and product market competition.

## EXTERNAL CORPORATE GOVERNANCE MECHANISMS

### The Market for Corporate Control

The role of hostile takeovers is controversial. On the one hand, hostile takeovers are considered to be a device to keep managerial autonomy under check and to impose discipline by enabling the acquirer to reallocate the target's resources more profitably (Burkart, 1999; Grossman and Hart, 1980). On the other hand, there is little evidence that, in practice, the market for corporate control assumes these tasks. While poor performance only slightly affects the probability of a takeover, the main determining factor is size (see Comment and Schwert, 1995; Martin and McConnell, 1991; Morck *et al.*, 1988; Schwert, 2000, for the US, and Franks and Mayer, 1996, for the UK). In contrast, Franks *et al.* (2001) show that poorly performing UK companies are frequently drastically restructured via mergers and acquisitions which lead to the replacement of most of the directors.

Still, the role of the market for corporate control may be rather indirect. First, it is possible that the mere threat of a takeover raises efficiency *ex ante* (Scharfstein, 1988; Shleifer and Vishny, 1986). Second, companies shielded from the takeover market have lower share prices. The setting up of anti-takeover devices generally coincides with a reduction in share value (Jarrell and Poulsen, 1989; Karpoff and Malatesta, 1989; Ryngaert, 1988). This negative impact can be interpreted as evidence that shareholders fear that managers may take advantage of the increased lack of control by not maximising shareholder value. The fall in the share price may also reflect the reduction in the probability of the shareholders receiving a takeover premium.

In a survey paper on the economics of mergers and acquisitions, Burkart (1999) concludes that although managers shielded from the takeover threat do not behave like empire-builders they tend to become sluggish. For example, Bertrand and Mullainathan (2003) and Borokhovich *et al.* (1997) show that increased insulation from takeovers increases managerial salaries and lowers total factor productivity in US corporations. In addition, Garvey and Hanka (1999) provide evidence that anti-takeover legislation leads to fewer new investments and fewer disinvestments. All in all, it seems that the existence of an active market for corporate control is material.

A recent study of the European domestic and cross-border mergers and acquisitions market shows that the market for corporate control in Germany is very limited (Goergen and

Renneboog, 2003). The main reason is that, as shown in previous sections, the vast majority of firms have a large controlling shareholder. In addition, pyramiding (with multiple layers of financial holdings sandwiched between the ultimate investor and the target firm) and cross-shareholdings<sup>35</sup> hinder takeover attempts (Jenkinson and Ljungqvist, 2001; Prigge, 1998). Another reason is that the legal and regulatory corporate governance framework in Germany has been lagging behind that of other countries in terms of disclosure, transparency and shareholder protection (see McCahery and Renneboog, 2003, and the section on recent evolution of corporate governance regulation, below).<sup>36</sup> Finally, the following takeover codes and legislation have created further barriers to takeover activity:

- (a) Taxation: Prior to 2002, the capital gains resulting from sales of equity stakes by corporations and financial institutions were taxed at the corporate tax rate (see the section on recent evolution of corporate governance regulation, below).
- (b) Court actions by dissenting shareholders: Prior to 2002, (minority) shareholders disagreeing with decisions taken at the annual general meeting could block these decisions, even though they had been approved by a qualified majority of 75% of the votes,<sup>37</sup> for long periods of time.
- (c) Board entrenchment: The management board is legally entrenched; only the supervisory board (balanced by the co-determination of shareholders and employee representatives) can remove the members of the management board who are usually appointed for a term covering the legal maximum of five years (Beinert, 2000, § 373). In other words, a new large (controlling) shareholder cannot remove the management board instantaneously (unless their contract comes to expiration). Furthermore, the supervisory board is also legally entrenched: the representatives of shareholders and employees have contracts for up to five years (with the option of renewing them). Consequently, a new controlling shareholder may not be able to obtain immediate control over the supervisory board. Whereas in some countries, staggered boards are common, this practice is infrequently used in Germany.
- (d) Proxy voting: Shareholders depositing their shares with their bank frequently grant permission to the bank to exercise their votes. Although, in principle, banks have to ask permission and state how they intend to vote on specific proposals, this was not common practice prior to KonTraG of 1998. The importance of proxy voting is confirmed by Schmid and Wahrenburg (2003) who claim that in quoted German corporations with a dispersed ownership structure, the large German universal banks (taken together) control the majority of the votes on the annual meetings.
- (e) Registered shares: Whereas most shares in German firms are bearer shares, some firms (mainly in the insurance industry) have issued registered shares (*vinkulierte Namensaktien*). Such shares are a very effective anti-takeover device as they can only be transferred with the approval of the directors.
- (f) Voting restrictions, multiple votes and non-voting shares: Voting restrictions could cap the percentage of voting rights any one shareholder could exercise. However, the Third Act on the Promotion of Financial Markets (*Drittes Finanzmarktförderungsgesetz*) of 1998 put a stop to the introduction of such voting restrictions. The grandfather clause for existing restrictions ended on 1 June 2000. The 1998 law also banned the issue of multiple voting rights, although a grandfather clause was created for such shares outstanding. The grandfather clause ended on 1 June 2003. However, German firms are still allowed to issue non-voting shares, but only for a maximum of 50% of the total equity issued.



The following comparative figures highlight the almost complete absence of disciplining by the market of corporate control in Germany. Whereas during the period 1984–89 there was an annual average of 40 hostile bids per annum in the UK (Jenkinson and Mayer, 1994), only three hostile takeovers (Feldmühle Nobel in 1988–89, Hoesch in 1990–91 and Continental in 1991–92) have occurred in Germany since WWII (Franks and Mayer, 1998). Hence, one can conclude that there is no active market for corporate control in Germany. This conclusion is supported by Franks and Mayer (2001) and Köke (2003), although Jenkinson and Ljungqvist (2001) show that there exists a market for partial control stakes which is frequently hostile (see next section).

### **Block Trades and the Market for Partial Control Stakes**

In the US, transfers of control by means of block sales are on average accompanied by positive abnormal stock performance (Holderness and Sheehan, 1988; Sudarsanam, 1996). In fact, Barclay and Holderness (1989) show that the price reaction is positive regardless of the price paid for the share block. The main reason for the positive market reaction is that changes in control may improve corporate governance, especially when the firm is performing poorly and is in need of a substantial reorganisation (Barclay and Holderness, 1991). When performance is poor, shareholders without a distinct interest in monitoring are expected to sell their shares, while those with strong monitoring abilities may increase their stakes in order to reinforce their position as (major) shareholders. Consequently, under such circumstances, block transactions giving the purchaser control over the firm may trigger a more favourable market reaction than those transactions that do not confer control to the purchaser. Holderness and Sheehan (1988) provide evidence on this conjecture for the case of the US. They also find that the market reaction is more favourable to block transfers that are accompanied by a tender offer on all shares outstanding. In addition, the market reacts more positively to block transactions in those firms that subsequently experience a full acquisition (Barclay and Holderness, 1992). Still, Sudarsanam (1996) concludes that, even when no takeover occurs, the benefits of control concentration outweigh the costs.

Jenkinson and Ljungqvist (2001) provide some empirical evidence on the existence of a market for large share stakes in Germany. They find that 64 German companies (out of all the listed firms in 1991) are potentially vulnerable to a hostile attack (given their control structure and lack of takeover defences). Moreover, they identify 17 cases of hostile stakebuilding among the 2511 changes in control that occurred over the period 1988–96 and involved German firms as targets. Franks and Mayer (2001) also find evidence of turnover of share stakes over the period 1988–91, with new shareholders emerging in 22% of the companies and old shareholders disappearing in 13% of the companies. Still, Franks and Mayer stress the differences between the Anglo-American markets for corporate control and the German market for partial control. First, the German market permits price discrimination between sellers of share blocks and other investors and, second, the overall gains from mergers as reflected in the bid premiums are low in relation to those in the UK and the US. According to Köke (2003), the motive behind a large part of the German block trades is the acquisition of control over the target firm. Finally, for the period 1980–95, Boehmer (2000) reports 715 purchases of at least 50% of the votes outstanding by 127 acquiring firms (through direct or indirect shareholdings or other contractual arrangements) in the corporations listed on the Frankfurt official market. Part of such purchases can be considered as hostile and be motivated by a disciplining effect (Jenkinson and Ljungqvist, 2001).

These transactions are accompanied by significantly positive cumulative abnormal returns (CARs) earned by the target firms' shareholders (Boehmer, 2000). However, the bid premium paid to the selling shareholders is small compared with the US and UK and non-selling shareholders do not obtain abnormal returns (Franks and Mayer, 2001). Poorly performing GmbHs, with high leverage and a non-financial owner, are among the most common targets. These acquisitions are usually done for reasons of horizontal or vertical integration. Conversely, AGs with strong ultimate owners are less likely to be sold, even if performance is poor, when the owners are individuals or families, or financial institutions. For these public AG companies, moreover, the impact of control concentration on the probability of being acquired shows an inverted-U-shape form (Köke, 2002). In a follow-up study, Köke (2003) qualifies this finding: ownership dispersion as well as tight shareholder control increase the probability of a change in the ultimate owner of the firm provided that control is not concentrated in the hands of directors and provided that creditor control is weak. Goergen and Renneboog (2003) find that, for a sample of initially family-controlled German firms that have recently gone public, size, the presence of the founder (or her family) among the shareholders, and the issue of non-voting shares decrease the probability of a transfer of control whereas growth and the level of risk of the firm increase the probability.

However, it is less clear whether this market for share blocks is really acting as a substitute for a market for corporate control. Köke (2002) shows that, typically, poorly performing firms are more likely to be acquired. However, Franks and Mayer (2001) find no evidence of high board turnover in targets that were performing poorly and thus argue that these block purchases are not disciplinary in nature. Conversely, Jenkinson and Ljungqvist (2001) find some evidence of post-contest management turnover in 7 of the 17 cases of stake building analysed and a certain enhancement in the performance of the target companies. Still, they stress that the bidder seems to be motivated by strategic investments (overcapacity, market power etc.) rather than disciplining 'wayward managers'. Similarly, Köke (2003) reports management turnover, assets divestitures (only in listed firms) and layoffs (also only in listed firms) following control changes, but no significant changes in performance. More importantly, he shows that both control changes and tight shareholder control determine CEO turnover, but the new shareholders only exert a disciplining effect when past corporate performance has been poor. Goergen and Renneboog (2003) find that the control structure of the bidder has an impact on the link between control changes and past performance. They show that the probability of being (partially) taken over by a bidder who has concentrated control increases if past performance was good whereas the probability of being taken over by a widely held bidder decreases. Finally, Boehmer (2000) concludes that, especially when the bidder is a non-financial minority blockholder, changes in control tend to increase the value of the acquiring firm.

## Creditor Monitoring

An important characteristic of some corporate governance regimes (in particular the German one) relates to the lending relationships (Deeg, 1998; Vitols, 1998). Shleifer and Vishny (1997) argue that large creditors fulfil a role similar to large shareholders because these creditors have large investments in the firm and therefore a strong incentive to monitor the firm's management. High gearing can be considered as a bonding mechanism for the management (e.g. Aghion and Bolton, 1992; Berkovitch *et al.*, 1997) such that high executive turnover is positively

related to high gearing. Denis and Denis (1995), for example, infer creditor monitoring from the fact that high leverage combined with managerial control improves shareholder returns. In contrast, Edwards and Nibler (2000, p. 260) suggest that 'German banks do not play a role in the governance of large listed firms which is distinct from their position as one of several types of large shareholder'.

In Germany, the banks owning shares in listed firms are frequently also the main bank, *Hausbank*, of these firms. Each type of the *Hausbank's* claims (debt versus equity) may require a different optimal decision process in the wake of financial distress. When there is a danger of bankruptcy and the bank faces a refinancing demand by the firm, its creditor claims may encourage the bank to make the firm file for liquidation whereas the equity claims may lead the bank to revolve its loans. Such conflicts of interest may even be exacerbated by the fact that in Germany (as in Belgium, France and Italy), intricate control-based networks (which may also comprise banks) exist such that banks' decisions may be influenced by the objectives of the network/conglomerate.

Rajan and Zingales (2003) state that relationship-based financing performs better when markets and firms are smaller, when legal protection is weaker, when there is little transparency, and when innovation is mostly incremental rather than revolutionary. Large creditors, especially in bank-based economies such as Germany, typically have a variety of control rights and therefore sufficient power to monitor. Consequently, bank monitoring may act as a substitute to alternative corporate governance devices. A disciplinary change in control is then expected to be less profitable and hence less likely to occur given the bank's monitoring. Köke (2003) analyses corporate governance in the German bank-based economy and confirms that non-market monitoring devices play a larger role because hostile control transactions are rare and because other constituencies such as large creditors typically have considerable power.

The long-term lending relationships give banks considerable power, which is frequently strengthened by bank representation on the supervisory board of the firm. One reason why bank influence is particularly strong is that historically German banks have acted as so-called house banks, providing long-term loans to long-term clients (Edwards and Fischer, 1994). Köke and Renneboog (2003) provide empirical evidence that German firms exposed to tight creditor control operating in competitive markets experience higher productivity growth, especially if these firms are performing poorly or are in financial distress. Lehmann and Neuberger (2001) and Edwards and Fischer (1994) also document that banks intervene in case their corporate client runs into financial distress. However, Agarwal and Elston (2001) are not convinced about the firms' benefit from increased access to capital, as their interest payments to debt ratio are also significantly higher. This suggests that German banks engage in rent-seeking activities.

Jenkinson and Ljungqvist (2001, pp. 430–431) 'identify another important role of banks, namely their role in assisting companies pursuing a strategy of hostile stakebuilding. [...] [B]anks play a pivotal role in building, brokering and concealing stakes. In contrast, it is striking how few examples [they] find of banks actively *defending* target companies from a hostile stakebuilder. Such behaviour may, of course, be compatible with the view that banks actively monitor German companies [...]. However, it is important to recognise that this role is performed not by the companies' *house banks* [...], but by the banks assisting the predator.'

## Product Market Competition

Ever since Adam Smith's celebrated book, economists have argued that product market competition provides incentives for the efficient organisation of production. A number of theoretical models have addressed this issue (see Aghion and Howitt, 1997, and Allen and Gale, 2000, for a review) and supportive empirical evidence also exists (see, e.g., Nickell, 1996; Nickell *et al.*, 1992). In particular, intense competition in the product market may reduce managerial slack through at least four different channels (Hermalin, 1992, p. 361): income (Hart, 1983), risk (Scharfstein, 1988), information (Holmstrom, 1979, 1982; Nalebuff and Stiglitz, 1983) and value of managerial actions (Hart, 1983; Scharfstein, 1988). Under certain conditions the basic insight that competition improves management performance holds, i.e. the income effect dominates. Ultimately, however, the combined result of these four effects is ambiguous, 'indicating that there is no definitive theoretical relationship between the level of competition and executive behavior' (Hermalin, 1992, p. 361).<sup>38</sup>

Unfortunately, the empirical evidence on the interaction between product market competition and corporate governance is scarce (Klette, 1999). The evidence suggests that both product market competition and the level of corporate governance boost firm performance. In a pioneering study, Nickell *et al.* (1997) analyse the productivity growth of UK manufacturing firms and find that the degree of market competition and shareholder control are associated with high productivity growth. Moreover, they conclude that competition (and debt) may be a substitutive mechanism to internal control. Following the same econometric methodology, two recent studies – Januszewski *et al.* (2002) and Köke and Renneboog (2003) – provide evidence on German firms.

First, Januszewski *et al.* (2002) present evidence of a positive (negative) effect of product market competition on productivity growth (the productivity level). Their results also show that control concentration has a positive effect on productivity growth and that this effect is even larger in firms facing intense product market competition, i.e. competition and tight control are somehow complements. In contrast, financial control has a negative impact on productivity growth. Second, Köke and Renneboog (2003) analyse two samples of firms: one from a market-oriented system of corporate governance (the UK) and the other from a bank-based system (Germany). This allows them to compare the differences in the impact of alternative governance devices. Notably, whereas in poorly performing and distressed German firms bank-debt concentration is associated with high productivity, in the UK this effect is only observed for firms with strong outside blockholders. In both countries, however, market competition enhances productivity growth.

## THE RECENT EVOLUTION OF CORPORATE GOVERNANCE REGULATION AND STOCK EXCHANGE STRUCTURES

The importance of all of the above corporate governance mechanisms as well as their interactions should be studied within a country's specific regulatory context. For example, strong shareholder protection reduces the danger of expropriation of minority shareholders. Consequently, the development of legal corporate governance rules (e.g. mandatory bid rule in the

case of takeovers) and self-regulation (e.g. corporate governance codes of best practice) should be priced by the markets. La Porta *et al.* (1998, 1999, 2000) have developed a new line of research which explains the differences in corporate governance systems by the level of legal protection of minority shareholders and the degree of capital market development. La Porta *et al.* find that common law systems tend to offer better protection both against the expropriation of shareholders by the management and the violation of the rights of minority shareholders by large shareholders than civil law systems. Likewise, creditor protection – measured by creditor rights indices which are based on bankruptcy law and the regulation regarding financial distress – is strongest in common law countries and worst in French civil law countries. The Scandinavian and German countries are somewhere in between. The implication of La Porta *et al.*'s work is that countries should move towards the more efficient common law system based on transparency and arm's length relationships.<sup>39</sup>

Other studies show analogous correlations (Beck *et al.*, 2003; Levine, 1999). For example, the level of shareholder protection relates inversely to the size of the premium over the market price paid for a majority voting block – higher premiums are paid in countries with weak protection (Zingales, 1994). Furthermore, there is a direct connection between strong shareholder protection and the volume of IPOs. What these studies tend to confirm is the comparative advantage of countries that protect investors' interests. Recent empirical work by La Porta *et al.* (2000) and Beck *et al.* (2000) finds that firms operating in jurisdictions with strong shareholder protection have a higher growth potential, as measured by Tobin's Q. Consistent with this evidence, Drobotz *et al.* (2003) relate the protection of shareholder rights to the long-run performance of a cross-section of German firms. They construct an index based on five categories of corporate governance rules and provide evidence that better shareholder protection leads to higher firm valuations (measured by the price earnings ratio and the market to book ratio). In general, these studies document a positive effect of better corporate governance protection on financial market development.<sup>40,41</sup>

## Changes in Corporate Governance Regulation

Since 1990, important new laws have been passed in order to promote the financial markets (*Finanzmarktförderungsgesetze*) by increasing transparency and by creating a level playing field in the market for corporate control: e.g. the Securities Act of July 1994 (*Wertpapierhandelsgesetz*), the revised Restructuring Act of 1995 (*Umwandlungsgesetz*), the Antitrust Law (*Gesetz gegen Wettbewerbsbeschränkungen*), the revised German Stock Corporation Act, and the Takeover Act of 2002 (*Unternehmensübernahmegesetz*).

### *Share stake disclosure and insider trading: the Securities Trading Act (1994)*

This Act applies to all companies with headquarters in Germany and traded on an EU stock exchange (and not just a German one) and deals with the disclosure of information on the company's shareholder structure and with insider trading regulation. Prior to 1995, little was known about the shareholder structure of German firms as the Stock Corporation Act stipulated that shareholders only had to report their stakes if they exceeded the thresholds of 25% and 50%, respectively. The Securities Trading Act, which became effective on 1 January 1995, states that stakes above the thresholds of 5%, 10%, 25%, 50% and 75% of the voting rights (be it from above or below) need to be disclosed to the Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*) which then makes this information public. However, disclosure

requirements beyond those stipulated in the Securities Trading Act can be imposed by the stock exchanges. These requirements differ by market segment: the General Standard and the Prime Standard segments (for the recent changes in stock exchange structure, see below). In addition, this Act labels insider trading as a criminal offence (Schmid and Wahrenburg, 2003).

### *The Antitrust Act*

This Act tests whether business combinations lead to the extraction of monopoly rents on the market for goods and services. The Act defines a business combination in the wide sense: a business combination does not just cover mergers and acquisitions, but also acquisitions of share stakes of 25% and above.

### *The revised Restructuring Act (1 January 1995)*

The Act is an important piece of legislation. First, it allows for tax-efficient restructuring and, second, it ensures that restructuring is not delayed as a result of law suits by minority shareholders. Beinert (2000, § 325) states that corporate restructuring (mergers, break-ups and spin-offs, transfers of assets and changes in legal status) can take place at book value (without revaluation). Consequently, capital gains taxation on asset revaluations (write-ups) can be avoided. A requirement for a corporate restructuring is the fiat by a qualified majority of at least 75% of the voting capital represented at the annual general meeting. However, the Stock Corporation Act generally allows (minority) shareholders to challenge such restructuring in court even though it has been approved by a supermajority. Such court actions may delay the restructuring for many years. The Restructuring Act supersedes the Stock Corporation Act: the shareholders who feel disadvantaged can still sue the firm for damages but cannot stall the restructuring any more.

### *The Third Act on the Promotion of Financial Markets (Drittes Finanzmarktförderungsgesetz) of 1998*

This Act bans the introduction of voting restrictions and grants a grandfather clause for existing restrictions which was phased out on 1 June 2000. The 1998 law also bans the issue of multiple voting rights, although a grandfather clause was created for existing multiple votes. However, since 1 June 2003, multiple voting shares are no longer permissible. It should be noted that German firms are still allowed to issue non-voting shares, but only for a maximum of 50% of the total equity issued.

### *The Takeover Code (14 July 1995, revised 1 January 1998) and the Takeover Act (1 January 2002)*

In 1995, the Takeover Code was introduced as a (voluntary) code of conduct for firms involved in a merger or acquisition. The code called for mandatory takeover bids as soon as a party had acquired control (50% of the votes or 75% of the votes present at the latest shareholders' meeting). Still, the code had a limited impact because it was not followed by several of the largest German firms and there were numerous violations of the code by its signatories. As a consequence of the failed code of conduct, a new takeover law (the Takeover Act) became effective on 1 January 2002. A mandatory tender offer needs to be made as soon as an investor acquires 30% of the voting rights. This mandatory bid is likely to have an impact on the large block trades (even hostile ones) which were common prior to 2002 (Jenkinson and Ljungqvist, 2001; Köke, 2000, 2004). On the one hand, the takeover law invokes the principle that the

target management should take a neutral stance in a takeover attempt. On the other hand, paragraph 33 of the Act obliges the management to take any actions in the best interest of the corporation, such as anti-takeover measures. The defensive measures that are allowed are: actions that can dilute the share stake of the bidding investor (a new equity issue to friendly parties while excluding pre-emption rights, share repurchases), a pac-man defence (counter-bid on the bidder's shares), selling the crown jewels, and soliciting bids from white knights. All the measures, apart from the last one, need the approval of the supervisory board. However, shareholders representing 75% of the votes at least can give the management full discretion to set up any anti-takeover action (for a renewable period of 18 months).

The Takeover Act does not allow restricted tender offers (in case a shareholder has acquired at least 30%) but admits conditional tender offers.<sup>42</sup> Another important change in takeover law regards squeeze-out rules. Whereas in the past minority shareholders could stall a merger or acquisition by fighting a squeeze-out in the courts, the Takeover Act states that the shares of the residual minority shareholders can be transferred to a shareholder holding at least 95% of the equity. In this case, the minority shareholders who are 'squeezed out' will no longer be able to stall the takeover process, but can ask for a cash compensation in the courts if their rights are violated. Finally, paragraph 33 of the Takeover Act also renders golden parachutes offered by the bidder to the target's management/directors illegal. This rule will prevent the payment of huge amounts of severance pay, such as those to Klaus Esser and the other directors of Mannesmann in the takeover battle by Vodafone.

### *Capital gains tax*

Since 1 January 2002, capital gains tax has no longer been incurred on divestitures of equity stakes (capital gains realised by financial institutions and corporations were taxed at the full corporate tax rate). Prior to that date, many corporations and financial institutions retained their equity positions in German companies rather than sold them. Consequently, this change in tax law may enlarge the market for large voting blocks (Becht and Boehmer, 2003, p. 4).

### Recent Codes of Best Practice

The recent codes of best practice (the Cromme Code (26 February 2002, amended on 21 May 2003), the *Bericht der Regierungskommission Corporate Governance* (10 July 2001), and the German Panel on Corporate Governance (July 2000)) do not recommend more stringent corporate governance principles than those already introduced by the legislative changes over the period 1995–2002. In fact, the main contribution of these codes is a structured summary of the regulatory changes in terms of disclosure and transparency, the duties of the management and supervisory board, remuneration contracts,<sup>43</sup> the formation of committees etc. The codes recommend that firms should allow remote access for shareholders to the general meetings using modern communication media (e.g. the internet).

In terms of accounting standards, the historical accounting conventions of the German Handelsgesetzbuch (HGB) demand less disclosure than, e.g., the US-GAAP rules of the Federal Accounting Standards Board. However, over the past few years, many German firms have voluntarily adopted the GAAP rules of the IASB (International Accounting Standards Board) (Tuschke and Sanders, 2003).<sup>44</sup> EU-listed companies will have to report their consolidated financial statements according to the IASB standards by no later than 2005.

## Stock Exchange Developments

During the price run-up of the 1990s, many new stock exchanges or new market segments were created in order to float small and medium-sized firms, predominantly from the high-tech, internet and telecoms sectors. In 1997, Germany set up the *Neuer Markt*, one of the Euro New Markets (along with the *Nieuwe Markt* in Amsterdam (AMEX), the *Nouveau Marché* in Paris, the *Nuovo Mercato* in Milan and the EuroNM Brussels). The firms listed on the *Neuer Markt* had to follow IAS or US-GAAP (as specified in the Rules and Regulations *Neuer Markt*, FWB 9). However, although the *Neuer Markt* experienced a remarkable growth until 2000, blatant violations of insider trading legislation, of share stake lock-in agreements and share price manipulations by several firms forced it to close down in 2002/3 (Goergen *et al.*, 2004a). The different market segments – *Amtlicher Handel* (the official, most liquid market), the *Geregelter Markt* (second-tier market) and the *Neuer Markt* – were restructured on 1 January 2003 to form the General Standard and Prime Standard market segments. Small and mid-sized companies, which meet minimum listing requirements (from the former *Amtlicher Handel* and the *Geregelter Markt*) and do not target international investors, are listed on the General Standard market segment. Companies following the international accounting standards (IFRS or US-GAAP) and disclosure rules are listed on the Prime Standard segment. The *Neuer Markt* firms were included in the latter.

## CONCLUSION

This chapter presents an overview of the German corporate governance system. The German system is characterised by the existence of a market for partial corporate control, large shareholders and bank/creditor monitoring, a two-tier (management and supervisory) board with co-determination between shareholders and employees in the supervisory board, a non-negligible sensitivity of managerial compensation to performance, a disciplinary product–market, and corporate governance regulations largely based on EU directives but with deep roots in the German codes and legal doctrine. Another important feature of the German system is the efficiency criterion that corporate governance is to follow. Whereas in Germany (and in many other continental European countries) the definition of corporate governance explicitly mentions stakeholder value maximisation, the Anglo-American system mostly focuses on generating a fair return for investors. We discuss the governance role of large shareholders, creditors, the product–market and the supervisory board of directors. Furthermore, we focus on the importance of mergers and acquisitions, the market in block trades, and the lack of a hostile takeover market. Given that Germany is often referred to as a bank-based economy, we pay particular attention to the role of the universal banks (*Hausbanken*). Voting control in Germany has often been eroded by ownership pyramids, the issue of non-voting shares, the application of voting restrictions (recently abolished) and the issue of multiple voting rights (recently abolished). Proxy voting also gives the banks' voice a disproportional vote on the general meetings.

This chapter shows that the relationship between ownership or control concentration and profitability has changed over time. In the 1970s and 1980s, there seemed to be a positive relation. However, this relationship vanished or even turned negative in the 1990s. There is also no clear answer to the question whether banks play a positive monitoring role in German firms. However, their positive contribution is less ambiguous in financially distressed or poorly performing companies. This can be attributed to the banks' importance as creditors. Köke



(2003) confirms that non-market monitoring devices play a larger role because hostile control transactions are rare and because other constituencies such as large creditors typically have considerable power. The long-term lending relationships give banks considerable power, which is frequently strengthened by bank representation on the supervisory board of the firm.

There is little evidence that the German co-determination system leads to superior corporate governance. Moreover, German CEOs appear to have the highest total cash pay in Europe and the lowest non-cash remuneration (although variable payment is increasingly adopted). Although there is a positive sensitivity of managerial pay to performance in Germany, the size effect (positive) dominates the compensation equation. Importantly, the pay-for-performance relation is influenced by large shareholder control: in firms with controlling blockholders, the CEO receives lower total compensation (compared to widely held firms) and the pay-for-performance relation is no longer statistically significant. When a universal bank is simultaneously an equity-holder and provider of loans, the pay-for-performance relation is lower than in widely held firms or blockholder-controlled firms.

The market for corporate control in Germany is very limited due to the fact that the vast majority of firms have a large controlling shareholder. Furthermore, pyramiding (with multiple layers of financial holdings sandwiched between the ultimate investor and the target firm) and cross-holdings hinder takeover attempts. Finally, the takeover codes and legislation have created further barriers to takeover activity: among others, court action by dissenting shareholders, board entrenchment, proxy voting, voting restrictions, multiple votes and non-voting shares.

However, since 1995, several regulatory initiatives have increased transparency and accountability. The rules on insider trading and anti-trust have been strengthened. For example, the revised Restructuring Act no longer allows minority shareholders to stall restructuring for many years. Moreover, voting restrictions and multiple voting shares are no longer permitted. More importantly, the Takeover Act imposes that a shareholder who acquires at least 30% of the equity has to make a tender offer for the remaining shares. The Takeover Act obliges management to take the interest of the company at heart, but paradoxically also allows the use of anti-takeover devices.

Finally, we would like to emphasise the scarcity of empirical studies on the advantages and disadvantages of the German corporate governance system. Given the current public debate on the best corporate governance system, and the thrust of national and cross-national policy-making institutions towards adopting the Anglo-American model, there is a pressing need for further research.

## NOTES

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1. Another important corporate governance device is the dividend policy (Correia da Silva *et al.*, 2004): a high payout policy precommits managers to generate sufficient cashflows and to pay them out to the shareholders. As such, a dividend payout policy can be a substitute governance mechanism to the ones listed above. However, in this chapter, it is not our intention to give an exhaustive account of all the possible governance mechanisms as we want to focus on the main devices applicable to German firms. For a more exhaustive overview of corporate governance devices, see, e.g., Becht *et al.* (2002). McCahery *et al.* (2002) review the debate on the optimal corporate governance system and the convergence of corporate governance regimes.

2. However, shareholder-value principles are progressively being introduced in German listed firms – see, e.g., Tuschke and Sanders (2003).
3. A discussion of the different legal approaches to corporate governance can be found in, e.g., Blair (1995) and Hopt *et al.* (1998).
4. Van der Elst (2002) reports a slightly smaller figure of 48.5%. The difference in results may be due to the fact that Van der Elst looks at ultimate voting blocks rather than direct stakes.
5. Incidentally, shareholdings are also *geographically* concentrated: ‘The four core *Länder* of North-Rhine Westphalia, Bavaria, Baden-Württemberg and Hesse accounted for almost 90% of the market capitalisation of the (...) companies in both 1997 and 2001. (...) In terms of cities, München, Hamburg and Frankfurt were decidedly in the lead’ (Wöjck, 2002, p. 889).
6. These examples are taken from Faccio and Lang (2002). See also Gorton and Schmid (2000a) for more examples from the 1970s and the 1980s.
7. For instance, if shareholder X owns 51% of the voting equity of firm Y which in turn owns 51% of the voting equity of firm Z, there is an uninterrupted control chain which gives shareholder X absolute majority control at each tier. Still, the cashflow rights of shareholder X in firm Z amount to only 26%.
8. It is important to bear in mind that Köke (2001) uses the Cubbin and Leech (1983) index to define ultimate control.
9. ‘The general characteristic of a *Konzern* is that at least one legally independent company is under centralized control exerted by the parent company. The law distinguishes between three *Konzern* categories: (1) integration, where the dominating company holds 100% of the integrated dependent company’s shares; (2) contractual groups of companies (*Vertragskonzern*), where dominating and dependent companies enter into a contract of domination (*Beherrschungsvertrag*), in most cases in connection with a profit transfer agreement (*Gewinnabführungsvertrag*); and (3) groups of companies based on actual dependence (*Faktischer Konzern*), where the relation between dominating and dependent companies is not subject to one of the types of contracts mentioned above. The *faktische Konzern* is the clearly predominating category, and the *GmbH* is the most common legal form of business organization for dependent companies’ (Prigge, 1998, pp. 952–953).
10. Edwards and Fischer (1994) argue that banks have traditionally supported voting restrictions in Germany because their access to proxy votes made them more powerful in the general meetings as the voting restrictions did not apply to proxy votes.
11. Gorton and Schmid (2000a) present analogous results from 1975 and 1986 data.
12. Edwards and Nibler (2000), however, argue that it is unlikely to happen if these large shareholders are banks.
13. As shown by Goergen and Renneboog (2001), for example, they no longer exist in listed UK companies as the result of an active dissuasive policy by the London Stock Exchange during the early 1990s.
14. A special case of a multiple voting share is the so-called ‘golden share’, which gives one or more shareholders (e.g. the government) a veto right in certain clearly defined situations. The Italian and Spanish governments, for example, hold golden shares in firms privatised during the early 1990s (e.g. Telecom Italia and Repsol). However, the *Treuhand* (the privatisation agency) does not seem to have employed them in the privatisation of eastern German firms (Dyck, 1997; Hau, 1998).
15. Even in the context of managerial compensation schemes, the role of blockholders is apparent. For example, Mehran (1995) shows that equity-based compensation is used less extensively in US firms with stronger outside blockholders suggesting that blockholder monitoring is a substitute for equity-based compensation contracts. In contrast, Crespi *et al.* (2002) find managerial compensation contracts related to share price performance are complementary to outside blockholdings in Spanish firms. In other words, it seems that in Spain one needs a strong blockholder to impose such contracts. In companies without outside blockholders, the managerial compensation contracts are based on accounting performance (which is subject to managerial control and can thus be manipulated). A similar result is reached by Renneboog and Trojanowski (2003) for the UK in a simultaneous equation system on managerial compensation and turnover.

16. See, e.g., Jensen and Meckling (1976). The thesis that different classes of shareholders have different abilities to extract control rents is empirically supported for the US by, e.g., Demsetz and Lehn (1985), Barclay and Holderness (1989, 1991) and Holderness and Sheehan (1988).
17. Zwiebel (1995) argues that private benefits of control can be extracted even if a company has multiple large shareholders. He claims that these benefits may be divisible and that parties can enjoy them accordingly to their relative control. Beyond some threshold, the control by large blockholders will not be challenged as it may be difficult to build up share blocks of a similar size. Unchallenged control may encourage the extraction of private benefits of control at the expense of dispersed small shareholders.
18. Moreover, 'acquisitions do not increase bidders' firm value more when financial institutions have partial control over the bidder group, but do decrease firm value when they have full control. [Therefore], there is little empirical support for the widespread contention that German banks provide efficient monitoring. [More precisely, bank involvement is beneficial if the institution holds the second- or third-largest stake, but not if it holds the largest stake' (Boehmer, 2000, pp. 137, 145).
19. Recent studies by Bhagat and Jefferis (2002), Borsch-Supan and Köke (2002) and Coles *et al.* (2003) discuss at length the econometric problems that arise in the estimation of these models.
20. However, Köke (2003) 'finds no evidence that complex ownership structures deter control purchases'.
21. This kind of relationship has also been observed in other European countries and seems to be related to the consolidation trend affecting the financial services industry all over the world (Goldman Sachs, 2000; Walter and Smith, 2000).
22. The average of 21% hides the fact that the ownership stakes are high: industrial shareholders hold average share stakes of 40% or more in 52% of the German companies.
23. The higher importance of family control in Austria and Italy (see Table 13.5) can be explained by the fact that the samples for the two countries consist of both listed and unlisted companies. Still, even after excluding the unlisted Italian firms, a majority of the listed Italian companies is family controlled.
24. Hellwig (2000) generalises Diamond's results by allowing for risk-averse banks.
25. It is interesting to note, however, that the German data analysed by Gorton and Schmid (2000) from the 1970s and 1980s suggest that bank shareholdings were not that small in the past.
26. Köke (2001) shows that institutional investors have a strong preference for listed firms. See also Deeg (1998) and Vitols (1998) on the role of German banks in small and medium-sized firms.
27. Pension funds are largely lacking as institutional investors; the reason may be that '[t]he German pension system currently does not involve public funds but rather leaves pension contributions under control of either the government or the employer' (Boehmer, 2000, p. 121).
28. Bratton and McCahery (1999) question whether the Anglo-American style of institutional shareholder activism would lead to improved corporate results in continental Europe because, in their opinion, a minimum level of takeover activity is a precondition of relational engagement between institutional shareholders and managers.
29. Gorton and Schmid (2000a), for example, show the decline in the participation of German and foreign governments as (largest) ultimate owners of German firms between the 1970s and the 1980s.
30. Becht and Boehmer (2003), in contrast, report that the government holds only 2.35% of the votes on the official market during 1996–98.
31. The Netherlands also has a two-tier system with a *Raad van Bestuur* (management board) and a *Raad van Commissarissen* (supervisory board). In France, corporations have the choice between a one-tier board and a two-tier system; but more than 95% of the listed companies have opted for a unitary board (Dherment-Ferere and Renneboog, 2002).
32. Several papers examine whether top management dismissal is followed by improvements in corporate performance. Denis and Denis (1995) document performance increases following forced CEO turnover in the US. However, Renneboog (2000) and Franks *et al.* (2001) do not find evidence of a significant improvement over the two-year period following the CEO's replacement for Belgian and British firms, respectively.
33. In fact, there is evidence in the UK that managerial disciplining only takes place when firms are in the lowest quintile of stock price performance and are incurring accounting losses (Franks *et al.*, 2001).

34. Supportive evidence of the Holmstrom–Milgrom model can be found in Garen (1994) and Kraft and Niederprüm (1999).
35. If the mutual equity stakes exceed 25%, restrictions will be applied on the votes cast at the annual meeting: see Beinert (2000, §382).
36. For a discussion of the recently proposed takeover legislation by the European Commission, see McCahery and Renneboog (2003) and Berglöf and Burkart (2003).
37. Schmid and Wahrenburg (2003) state that, whereas the decisions at shareholder meetings are usually taken with a simple majority, qualified majorities of 75% of the voting capital are needed for amendments to the articles of association, removal of shareholder representatives from the supervisory board, control agreements and profit transfer agreements, and mergers or acquisitions. In addition, such a qualified majority is needed for granting the management full discretion to take anti-takeover measures for a period of 18 months. A supermajority of 75% of the voting capital is also needed to cancel the pre-emptive rights with which shareholders are endowed when the firm does a seasoned equity offering (Beinert, 2000, §365).
38. Ambiguous results also arise out of the models of Horn *et al.* (1994), Meyer and Vickers (1997) and Schmidt (1997).
39. Some argue that the framework developed by La Porta *et al.* (1998, 1999, 2000) is too limited (Berglöf and von Thadden, 1999). In particular, by emphasising the importance of dispersed ownership, the approach of La Porta *et al.* only appears relevant to the context of developed countries. Others argue that there have been significant changes over the last 20 years in the patterns of finance in developing markets. The differences in corporate and legal rules cannot easily account for the differences in financial arrangements in emerging markets (Glen *et al.*, 2000).
40. Lombardo and Pagano (2002) find that better legal institutions influence equity rates of return and the demand for equity finance by companies. They also show that the imposition of legal limits on transactions with companies related through ownership cascades can preserve the income rights of minority shareholders and lead to a reduction in managerial benefits. Better legislation – via class action suits or voting by mail – leads to a reduction in the legal and auditing costs that shareholders must bear to prevent managerial opportunism. The authors conclude that the size of these effects on the equilibrium rate of return is increasing in the degree of international segmentation of equity markets.
41. However, some argue that the conclusions that can be drawn from these studies are limited because the direction of causality between the legal system and financial structure may run in the opposite direction, viz. financial structure prompts transformations taking place in the legal regime (Bebchuk and Roe, 2000; Bolton and von Thadden, 1998).
42. A restricted offer is an offer applying to, e.g., 40% of the shares. A conditional offer is a bid for X % of the shares which will be purchased provided that the bidder gets at least Y% of the shares.
43. The Cromme Code was amended on 21 May 2003. The amendments consisted in improving and clarifying the Code’s recommendations in terms of managerial remuneration and its disclosure.
44. Examples of German firms using IASB standards are Addidas-Salomon, Bayer, Deutsche Bank, Dresdner Bank, Henkel, Hochtief and Wella (see <http://www.iasb.org/> for further examples).

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# Network Opportunities and Constraints in Japan's Banking Industry: A Social Exchange Perspective on Governance

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## INTRODUCTION

The importance of the banking industry to Japan's economy can hardly be overemphasized. Despite the development of the equity market in Japan over the years, debt financing still comprises more than 70% of total external sources of funds among Japanese firms in the 1990s (Aoki *et al.*, 1994). The importance of the banking industry to Japanese firms is not limited to a pure lender–borrower relationship. Unlike their counterparts in the United States, which are prohibited by the Glass–Steagall Act from holding equity stakes in other firms, Japanese banks are allowed to maintain equity holdings of up to 5% in firms,<sup>1</sup> a majority of which are also their clients. Additionally, these bank equity holdings of client firms tend to be fairly stable over the years, with the intent to foster long-term client relationships. Many authors suggest that close bank–firm relationships lead to increased corporate governance efficiency and long-term investment horizon among Japanese firms (e.g. Sheard, 1994a), which is thus widely regarded as a crucial factor leading to a great number of Japanese firms becoming among the most competitive global firms. Concomitantly, many Japanese banks, such as Dai-ichi Kangyo Bank or Sumitomo Bank, have also grown into giant corporations themselves, consistently ranking among the largest banks in the world.<sup>2</sup>

However, the Japanese economic miracle came to an abrupt halt when its economic bubble burst at the beginning of 1990s after the Nikkei Index peaked on 31 December 1989 (Johnston

**Table 14.1** Major banking problems or failures in Japan since 1995

1995	Hyogo Bank
1996	Taiheiyo Bank Hanwa Bank
1997	Kyoto Kyoei Bank Hokkaido Takushoku Bank
1998	Midori Bank Long-Term Credit Bank of Japan Nippon Credit Bank
1999	Kokumin Bank Koufuku Bank Tokyo-Sowa Bank Namihaya Bank Niigata-Chuou Bank
2001	Ishikawa Bank
2002	Chubu Bank
2003	Resona Holding Ashikaga Bank

Source: Spiegel and Yamori (2004) and various news sources.

and McAlevey, 1998). By 2002, the gross public debt in Japan reached 140% of its GDP (*Economist*, 2002). The onset and persistence of such an economic downturn not only severely affected many Japanese firms, but also appeared to cast major doubts on the validity of the argument that Japan's bank-centered governance system creates efficiency. Japanese banks could not prevent many of their client firms' precipitous fall, nor have they been able to help them devise means to resolve their significant problems. Worse still, notwithstanding their salient positions in the Japanese economy, many banks have been operating in a crisis mode themselves due to the large number of bad loans. For instance, Nippon Credit Bank and Hokkaido Takushoku Bank, two large Japanese banks, had to undergo major restructuring, and Hanwa Bank, a regional bank, was in fact liquidated (*Economist*, 1996a; Rowley, 1997). Japan's once heralded banking system was even described by the popular press as a 'sick banking system' (*Economist*, 1996b). Table 14.1 lists the major bank problems and failures in Japan in recent years.

In light of the current situation in the Japanese economy, the widely embraced efficient bank-centered corporate governance proposition seems unable to furnish satisfactory answers. Although the received literature, which is largely premised on agency theory arguments, recognizes the relational nature of bank-client relationships, the conclusion that such relationships facilitate efficient corporate governance may have been premature. Although bank-client relationships may facilitate monitoring as this literature suggests, there may be other aspects of this social system that reduce its economic and monitoring efficiency.

We offer a different perspective to understand Japan's banking industry, one that recognizes the complex, rich social relationships that define Japan's bank-centered systems. We view these bank-centered systems as social exchange governance networks, focusing on embedded social elements such as roles, power, reciprocity, expectations, and obligations. An

explicit incorporation of these social elements into network structures allows us to uncover the underlying, complex relationships among exchange parties. Whereas many network studies focus on the opportunities created by relational ties, network constraints may also reduce firms' flexibility or responsiveness. Such a social exchange approach towards networks may provide a different lens through which to understand Japan's business topography, allowing us to recognize both the upsides and downsides of bank–firm relational ties.

Unlike their counterparts in the United States, banks in Japan, in addition to being lenders, may implicitly serve as 'insurers' for their affiliated firms against bankruptcy (Caves and Uekusa, 1976). To the extent that banking networks in Japan have heterogeneous characteristics, we propose that banks' strategic actions and hence performance are likely to vary in accordance with network characteristics. We focus on two kinds of network governance characteristics: institutional properties and structural properties. Institutional properties refer to the regulative, cognitive, and normative elements (Scott, 2000) that define the banking networks whereas structural properties are concerned with banks' position in the banking network, as well as the banking network's configuration and substructure. When the Japanese economy is growing, banks benefit substantially by facilitating network members in business expansion, in turn boosting banks' incomes. Nevertheless, when the Japanese economy is contracting, some banks may be tightly constrained by their network ties and thus are unable to pressure their network members for restructuring because the banks are expected to fulfill their social obligation as *insurers* and stand behind financially distressed network members. As such, bank performance would be negatively affected in the contracting economy.

Our primary purpose in this manuscript thus is to offer a fresh perspective for examining how the governance role of banks in Japan influences client firms and their strategic actions and bank performance. In the following sections we first provide a brief overview of the extant theoretical approaches to studying Japan's main bank system. We then proceed to use a social exchange approach as an underlying conceptual foundation to develop a theoretical perspective for understanding the role of banks in Japan that differs from the extant governance literature. Building on such a theoretical foundation, we explore how Japan's banking network characteristics can explain banks' strategic actions and performance during the 1980s and 1990s. Finally, we discuss how this perspective may offer new insights for the study of Japan's ailing economy, the current reform in other Asian countries, as well as network research in international business studies.

## **JAPAN'S MAIN BANK SYSTEM**

The main bank system involves a highly intensive set of mutual relationships between a bank and its clients. Main bank relationship does not have an explicit legal or regulatory basis, but is an 'informal set of regular practices, institutional arrangements, and behavior that constitute a system of corporate finance and governance, especially for large industrial firms typically listed on the stock exchange' (Aoki and Patrick, 1994, p. xxi). Main bank relationships are not limited to those between major banks and large firms. Almost all firms in Japan have maintained a main bank relationship (Aoki *et al.*, 1994; *Shukan Daiyamondo*, 1987) and most banks serve as the main bank in varying degree for some firms (Aoki *et al.*, 1994). Although some main banks have close keiretsu relationships with their client firms, firms not explicitly affiliated with a keiretsu such as Sony and Honda still maintain a main bank relationship.

Japan's main bank system represents a prime example of what banking theory in the finance literature (e.g. Allen and Gale, 1995) refers to as relationship banking,<sup>3</sup> as opposed to transactional banking prevalent in countries such as the United States or United Kingdom. While maintaining arm's length relationships with client firms, transactional banks provide bank loans and have very limited involvement in client firms' internal management. By contrast, while making 'additional financing in a class of uncontractible states in the expectation of future rents over time' (Aoki and Dinc, 2000, pp. 20–21), relationship banks maintain long-term relationships with client firms, often furnishing both equity and debt financing, sitting on the board of directors, as well as actively participating in corporate restructuring when necessary (Dewenter and Hess, 1998).

Few scholars interested in international corporate governance would fail to note that Japan's governance system is different from that of the United States or the United Kingdom. In the Anglo-Saxon system, corporate governance is mainly enforced by a myriad of internal mechanisms such as boards of directors, or when internal mechanisms fail, the external market for corporate control may replace the management team through a tender offer (Walsh and Seward, 1990). This combination of governance mechanisms has triggered numerous involuntary corporate takeovers or created pressure for voluntary downscoping of many firms in the United States, especially during the late 1980s and early 1990s (Hoskisson and Hitt, 1994). In comparison, corporate governance in Japan rests primarily on the main banks. Because of close bank–client relationships, Japanese banks may possess incentives and means to ensure efficient corporate governance in their clients. This predominant line of thought (e.g. Aoki *et al.*, 1994; Hoshi *et al.*, 1994; Teranishi, 1994) suggests that Japan's bank-centered corporate governance system reduces information asymmetry, agency costs, as well as restructuring costs.

Close bank–client relationship is likely to reduce the problem of information asymmetry (Aoki, 1994; Hoshi *et al.*, 1991) because main banks gather large amounts of information regarding client firms' operations and are familiar with the managers through stable, long-term relationships. Banks often assign directors on client firm's boards to enhance the quantity and quality of information about firm management. Furthermore, main banks usually hold membership on presidents' councils in horizontal keiretsus, where additional firm-specific information is exchanged. Moreover, bank involvement can mitigate the agency problem to the extent that banks are willing to bear the costs of keeping informed about their client firms' actions (Diamond, 1984). In addition to serving as lead lenders, main banks in Japan often hold equity stakes in the client firms. Because of their significant stakes in the client firms, main banks have the incentive to closely monitor the borrowers' actions. When a client firm is in financial distress, the main bank usually leads the rescue effort and shoulders the lion's share of the associated costs (Aoki, 1994), which may avoid potential conflicts among investors as to the best course of action (Hoshi *et al.*, 1991). Besides, the main bank should be more knowledgeable in implementing rescue actions owing to its intimate knowledge of the firm (Hoshi *et al.*, 1994).

To the extent that these benefits operate as theorized, banks in Japan would be able to foster superior efficiency through improved corporate governance, in turn contributing to banks' own performance. However, neither the firms nor their main banks have been faring well in the recent years. As a matter of fact, the banking industry has been among the hardest hit during Japan's current economic recession. This scenario signifies that there are major theoretical inadequacies as proposed by the predominant line of thoughts on Japan's bank-centered corporate governance system. We argue that the benefits of such a governance system, as summarized above, represent normative theory. The actual role of Japanese banks appears

to be more complex from what is described by this body of work. We offer a social exchange approach suggesting that banks may not serve as efficient governance monitors.

## **A SOCIAL EXCHANGE APPROACH TO JAPAN'S BANKING NETWORKS**

Banks in Japan usually maintain a network of close, long-term relationships with many firms. These network relationships enable banks to monitor members' business decisions; however, it does not necessarily imply that banks would or could act as effective governance watchdogs all the time. Close networks are often characterized with stable behavioral norms that prescribe or constrain members' actions. Member relationships are thus infused with thick elements of social exchange that sustain ongoing relations, rather than characterized by arm's length economic exchange to capture immediate profits. We conceptualize Japanese banking networks as social exchange networks, where stable social norms shape the exchange relationships among members. As such, we contend that banks' actions are unavoidably influenced by their social relations with members, thereby constraining their role as governance monitors.

The following subsection offers a brief overview of social exchange theory, especially highlighting some of the salient elements that characterize social exchange actions.

### **Social Exchange Theory**

Social exchange is defined by Blau (1964) as voluntary exchange actions that are motivated by the returns they are expected to bring from others. Social exchange theorists (e.g. Blau, 1964; Emerson, 1972a, b; Homans, 1961, 1964) conceptualize a social structure as a configuration of social relations among actors involving the exchange of valued items (tangibles or intangibles). What is implied is that exchange is 'a two-sided, mutually contingent and mutually rewarding process' (Emerson, 1976, p. 336). The goal is to use exchange relations as basic units of analysis for understanding complex social structures. Social exchange is murky, involving many emergent social elements, such as reciprocity, obligation, power, and role, which complicate the exchange process. However, these social elements are crucial for understanding the incentives and outcomes of an exchange.

The norm of reciprocity, acting as a 'starting mechanism' in initiating social interaction and as a 'system-stabilizing mechanism' in maintaining a stable social system (Gouldner, 1960), is defined as the interlocking duties which people owe one another and occurs with 'definite social ties or coupled with mutuality in non-economic matters' (Malinowski, 1932, p. 39, quoted in Gouldner, 1960, p. 169). Exchange actors depend on reciprocity to sustain stable exchange patterns. Failing to reciprocate benefits runs the risk of undermining the established social relations within the system. In a similar vein, an actor who provides rewarding items to another actor obligates the second actor to furnish back so as to discharge its *obligation* (Blau, 1964). Coleman (1990) likens such an obligation to a 'credit slip' held by the sending actor to be redeemed by the receiving actor's performance. To the extent that actors depend upon each other in social exchange, such dependence also provides the basis of *power* (Emerson, 1962). In essence, actor B depends on actor A (or symmetrically, A has power over B) when actor B finds the resources possessed by actor A valuable and has no alternative means of obtaining



them. However, one does not have power without the others' concurrent dependence. This subtle 'interdependent' relationship leads Blau (1964) to suggest that dispensing valuable resources can strengthen power because it increases affection and sustains loyalty. When rigid social norms create expectations for actors to fulfill their obligations, actors can be said to perform their *role* in a social system. Role theory explains roles by 'presuming that persons are members of social positions and hold expectations for their own behaviors and those of others' (Biddle, 1986, p. 67). Each actor is constrained to perform a specific role in accordance with a pre-written 'script'.

Premised on a social exchange approach, the following subsection provides a different perspective for understanding Japan's banking networks.

### Strategic Actions of Japan's Banking Networks

Amidst the prevalent view that keiretsu affiliation increases governance efficiency, Caves and Uekusa's (1976) study has found that the profitability of firms with close bank affiliation is lower than firms without close affiliation. Similar findings are obtained in subsequent studies (e.g. Nakatani, 1984; Weinstein and Yafeh, 1995, 1998). Additionally, Weinstein and Yafeh (1998) found that close bank–client relationships increase the availability of financial capital to the clients, but the cost of capital is in fact higher. The authors interpret these findings as an indication that although the close bank–client relationships create value, the banks – not the clients – capture most of the created value. On the other hand, when members encounter financial troubles, banks are more willing to support them (Morck and Nakamura, 1999; Suzuki and Wright, 1985). A well-documented example is Sumitomo Bank's rescue of Mazda in the 1970s. One of the former executives of the Sumitomo Bank was quoted as saying, 'We are always prepared to help out when a member firm is in trouble. *We won't allow any group member companies to go into business failure*' (Sheard, 1985, italics added). This implies that the main bank was then prepared to do anything to rescue an affiliated firm, regardless of whether it is an optimal action.

Main banks appear to be more like *insurers*. The trade-off for bank protection is higher cost of bank borrowings, much akin to an insurance premium. Viewed from a social exchange perspective, such a trade-off represents a valued exchange between voluntary parties, which may explain why affiliated firms are willing to incur higher costs of capital. In accepting the premiums, main banks also incur future liabilities when the clients are in financial trouble. Viewing the main banks as insurers also allows us to understand why banks had 'inappropriately' infused additional capital in mismanaged affiliated firms without demanding severe corporate restructuring efforts for a prolonged period of time until recently when they themselves were also in dire circumstances (Bremner and Thornton, 1999). If banks fail to fulfill their social obligation as expected by other members in the banking networks, they risk ruining the reciprocity norms established within the network, eventually undermining the integrity of the network. They may also lose collective support and hence power, jeopardizing their legitimate positions as network leaders. Corresponding with the 'one-set' principle characterizing Japanese networks (Gerlach, 1992), whereby there is usually only one major firm 'designated' for each line of business, the main bank's role as the network insurer also prescribes its scripted action.

When the economy is growing, most firms in Japan prefer to expand their business, given their growth-oriented mind-sets (Abegglen and Stalk, 1985; Kono, 1984). As pointed out by

Myers and Majluf (1984), information asymmetries between managers and investors increase the cost of external financing and, therefore, the amount of firm investment tends to be constrained by the availability of internal funds. However, close bank–client relationships can overcome these information problems, thereby allowing more efficient financing of ventures that show signs of potential growth. Indeed, several studies have reported that firms with strong bank ties demonstrate a much smaller sensitivity to internal funds than independent firms regarding capital investments (Hoshi *et al.*, 1991), R&D investments (Miyajima *et al.*, 2002), and foreign direct investments (Belderbos and Sleuwaegen, 1996). As such, supported by bank capital, network firms have the ability to venture into new product or international markets which have growth prospects.

Also, due to the availability of bank rescue, opportunistic members may be eager to pursue risky projects, which is a classic problem of moral hazard (Milgrom and Roberts, 1992). An alternative view is that some member firms may simply be prone to take higher levels of risks under a false sense of security and capability afforded by network collaboration. The most vivid example is perhaps the massive domestic and foreign real estate portfolios held by a large number of non-real estate Japanese firms. Banks actually may be less vigilant in overseeing members' actions when their lending decisions are based not only on the borrowing member's capability but also on network collateral (expecting other members would support the borrowing firm) or collective capability of the network. To the extent that banks are expected to act as network insurers, their primary role is to support firm growth and rescue firms, if necessary, from financial distress. In this regard, banks played their part in fueling the bubble economy in the late 1980s by providing capital for members to expand feverishly, possibly in return for increased profits themselves. Indeed, many banks were themselves engaged in significant expansion during the bubble economy. For instance, Japanese banks' high-profile foreign expansion in the United States in the 1980s has been well documented, such as the investments by Sumitomo Bank in Goldman Sachs and Bank of Tokyo in Union Bank (Kester, 1991). And yet, when the bubble economy burst in the early 1990s, banks had kept providing capital for many failing members for an extensive period of time rather than pressuring for major restructuring or even bankruptcy filings in the 1990s.

However, banking networks in Japan are not homogeneous. We examine below how the different characteristics of Japan's banking networks affected banks' strategic actions and relative performance differentially. We also examine how Japanese bank networks respond in growing vs contracting economies.

## **OPPORTUNITIES AND CONSTRAINTS IN JAPAN'S BANKING NETWORKS**

Because of additional opportunities afforded through network ties, some banks' performance was *positively accentuated* when the economy was growing in Japan (1980s). Conversely, network relational ties also imposed additional constraints on some banks' actions and *negatively accentuated* their performance when the economy was contracting or in a low growth mode in Japan (1990s). We suggest that the characteristics of Japan's banking networks can be defined by their institutional and structural properties, which affect banks' and client firms' strategic actions, and subsequently, bank performance. Figure 14.1 provides the overall conceptual framework.

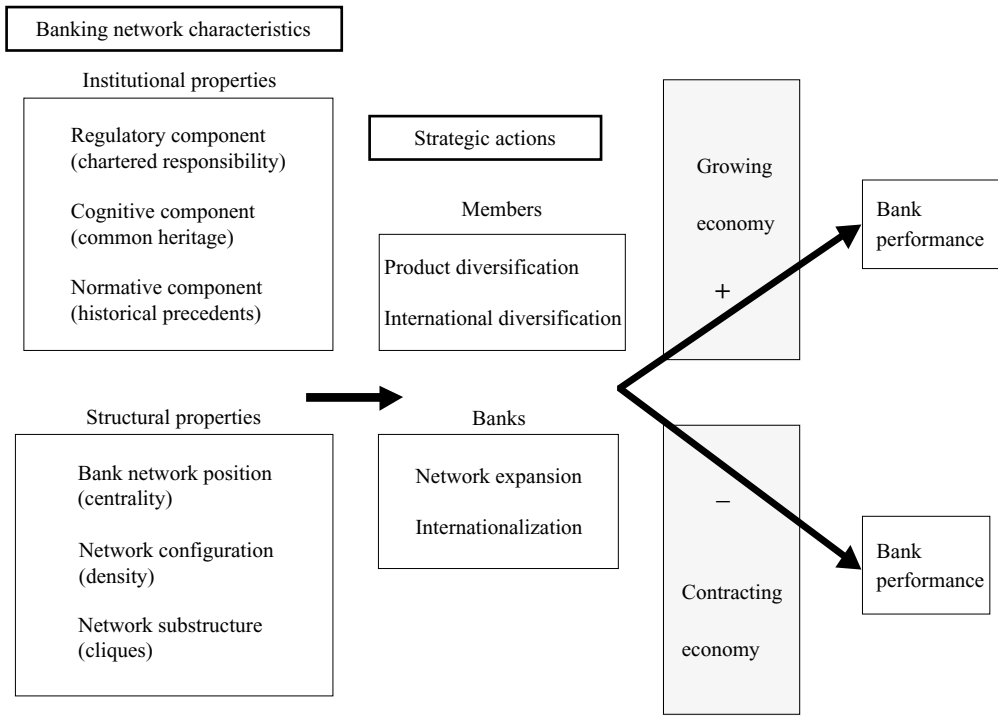


Figure 14.1 Conceptual model

### Institutional Properties

The exchange relationship we propose between banks and their clients involving higher costs of bank capital and insurance protection is not a formal contract (Ramseyer, 1994). Such an implicit contract is, in fact, what characterizes a typical social exchange action (Blau, 1964). Effective social exchange is unlikely to take place without sufficient mutual understanding of appropriate behaviors. No member firm would be willing to pay higher costs of bank capital (premium) without assurance that it can ‘file claim and get paid’ when necessary. Stated slightly differently, banks cannot enjoy the premiums when key social elements that guide exchange behaviors are lacking in the network. Therefore, institutional properties of bank networks are likely to affect the prevalence of social exchange, hence banks’ actions and performance. We focus on three institutional properties: chartered responsibility, common heritage, and historical precedence, corresponding to Scott’s (2000) three pillars of institutional environments, regulatory, cognitive, and normative, respectively.

#### *Chartered responsibility*

Japan has been widely described as a bank-centered economy whereby the role of banks in Japan is deeply ingrained into its business system. To understand Japan’s banking system, it is necessary to note that its current structure is largely an outcome of governmental policy. During the post-war period, banks’ primary role was simply to recycle deposits into cheap loans to help

recover from the devastated post-war economy. Subsequently, they were expected to support national economic growth. To better meet the needs for different types of bank services, banks in Japan were formally separated into serving different segments of the economy. A number of banking laws (e.g. Banking Law of 1981, Long-term Credit Bank Law of 1952) were enacted for governing the licensing and business scope of city, regional, long-term credit and trust banks (Duser, 1991). City banks are full-service commercial banks which are headquartered in major cities such as Tokyo or Osaka and have nationwide branch networks (Aoki, 1994) and mainly provide short-term loans. Prominent banks such as Mitsui Bank or Fuji Bank belong to this category. Maintaining their presence mainly in specific regions of the country, regional banks are smaller banks that often serve smaller, regionally based clients. Long-term credit banks were created to specifically provide long-term loans to large industrial companies, and unlike many city banks they have no keiretsu affiliation. There are three long-term credit banks in Japan: Industrial Bank of Japan, Long-term Credit Bank of Japan, and Nippon Credit Bank. Similar to long-term credit banks, trust banks, such as Mitsubishi Trust and Banking or Chuo Trust and Banking, are also providers of long-term capital. Many trust banks, such as Mitsubishi Trust and Banking, actually belong to major keiretsu networks, supplementing the loans provided by the city bank of their group.

Mandated by their respective chartered responsibility, this regulatory component represents institutional pressure for the banks in their respective networks to fulfill their expected social obligations. Aware of banks' different chartered responsibilities, members also expect banks to perform their assigned roles. Owing to banks' chartered responsibility, members have a higher degree of confidence about banks' commitment to support them and expect that banks were created to complement their growth. When the Japanese economy was expanding in the 1980s, many firms were eager to expand into different industries or foreign markets. Because diversification into new product markets or less familiar countries carries higher levels of risk and financial resources, firms that were associated with banks that are primarily chartered with promoting and supporting long-term national economic growth were more likely to pursue product or international diversification, as these expansion projects often involve longer pay-back periods. Thus, banks with chartered responsibility to primarily provide long-term loans would be more likely to encourage member firms to pursue higher levels of product and/or international diversification than would other banks in a growing economy.

To the extent that members were actively expanding their business in the bubble economy, these banks would also tend to find their business booming. Therefore, broadening their ties with additional members would represent an attractive strategy. Moreover, because many of their clients were expanding overseas, these banks were also likely to aggressively internationalize their business, including setting up overseas offices or providing international leasing and project financing, to serve their long-time members or develop new overseas clients. Thus, banks with chartered responsibility primarily to provide long-term loans are more likely to pursue higher levels of internationalization and/or expand their network size compared to other banks in a growing economy.

When the economy was expanding, the performance of banks with chartered responsibility can be boosted through expansion by clients and the banks themselves. Although these banks benefited from the growing economies of the 1980s, owing to their chartered mandates, these banks were also limited in their flexibility in adjusting their portfolios, thereby lengthening risk exposure due to the long-term nature of their loans. In comparison, banks that focus on short-term loans could more easily restructure their lending portfolios if necessary. To the extent that a larger proportion of their members pursued more risky diversification projects,

long-term loan providers would suffer from more severe financial stress when the economy was contracting in the 1990s that put many high-risk members into financial crises. Furthermore, some trust banks served as syndication partners with the city banks to provide loans to clients. Given their mandate, it is likely that trust banks might have to shoulder higher levels of risky lending by extending a larger proportion of long-term loans. Coupled with their traditional weaker credit analysis that mainly relied on the city banks (Packer, 1994), these banks were also likely to face more bad loans in the contracting economy of the 1990s. In summary, banks with chartered responsibility to primarily provide long-term loans would have better performance than other banks in a growing economy but worse performance than other banks in a contracting economy.

### *Common heritage*

Common heritage is likely to foster higher levels of trust and shared values among a group of firms. It can originate from kinship ties, cultural affinity, symbolic identities, or geographic proximity. Network relationships developed from these thick ties, which are instilled with a high degree of cognitive element (Zucker, 1983), facilitate social exchange between members. Due to common heritage, members share and understand similar stories, myths, tales, or metaphors with one another, providing powerful ingredients for building and maintaining close relations (Bateson, 1972; Orr, 1990). Network members expect and are expected by other members to conform to the existing cognitive expectations shared within the network.

Japan has been widely described as a network economy (Gerlach, 1992). The most prominent keiretsu (business networks) have been in existence for a long period of time. Three of the six largest horizontal keiretsu, Mitsui, Mitsubishi, and Sumitomo, date back to the Meiji era in the early years of this century and grew into prominence around WWI when the businesses were actually part of a zaibatsu (or a family conglomerate). The zaibatsu were broken up after WWII, but the firms which once belonged to the same zaibatsu subsequently re-established a multiplicity of ties with one another. Group identities in these three keiretsu are very strong, with many members using the same group name and logo (Miyashita and Russell, 1994). In comparison, the other three major horizontal keiretsu, DKB (Dai-Ichi Kangyo Bank), Fuyo, and Sanwa, are relatively less closely affiliated and fewer members adopt the same group name or logo. Although the roots of the Fuyo keiretsu and the DKB keiretsu can be loosely traced to the zaibatsu era, they were formally developed much later after WWII and are perceived as less contributory to the development of modern Japan (Miyashita and Russell, 1994).<sup>4</sup>

Another common heritage that distinguishes bank–client relationships is geographic proximity. Most of the big city banks are located either in Tokyo (Kanto region) or Osaka (Kansai region), the two major political and business centers in Japan (Aoki *et al.*, 1994). Both regions tend to retain a strong sense of historical identity. An example is that two major Kansai firms, Nomura Securities and Daiwa Bank, despite their major presence in Tokyo, still maintain their headquarters in Osaka (Miyashita and Russell, 1994). Although lacking historical identities as distinctive as some keiretsu banks, large long-term credit banks, such as the Industrial Bank of Japan, have been established for a substantial period of time and likewise serve as main banks for many firms (Packer, 1994). In many respects, these banks have also maintained strong common heritage with many clients.

To the extent that a higher degree of common heritage is shared among banking network members, member firms would have more confidence and support in expanding their business portfolios. Banks are more likely to internalize their social role as network insurers and would

not hesitate to stand behind network members when needed. To the extent that network members plan to diversify into unfamiliar grounds, they would also believe that their banks would fulfill their obligation to assist them. In this regard, we would expect to see these firms engaged in more product and/or international diversification during the 1980s. Thus, banks sharing higher degrees of common heritage with members would provide member firms the opportunity to pursue higher levels of product and/or international diversification than would other banks in a growing economy.

Given a higher degree of common heritage, banks would feel more secure to expand their business domestically or globally. With high levels of collective support from members and a sense of security resultant of network solidarity, banks sharing high degrees of common heritage with members would be encouraged to explore newer business opportunities and increase its network boundary. Moreover, the strong ties present in these social exchange networks might induce the banks to admit more network members in the growing economy with the view that these new members would be assimilated into the banking networks. To the extent that banking networks are in competition with one another, a larger banking network empire would certainly enhance its competitive power, which drives further expansion. As a consequence, banks sharing higher degrees of common heritage with members would pursue higher levels of internationalization and/or expand their network size compared to other banks in a growing economy.

Banks having strong common heritage with members are likely to have a higher degree of legitimacy to collect insurance premiums due to their 'taken-for-granted' social positions in the network (Suchman, 1995). In return, members have stronger social expectations of these banks to support them in times of financial difficulty and thus are more ready to pay an insurance premium. As such, these banks were likely to achieve better performance than other banks during the growing economy in the 1980s. However, as non-disputed leaders and insurers in their networks, these banks are expected to honor the implicit social exchange contract by standing solidly behind their members in financial distress and taking a disproportionate burden to turn them around. Failing to do so would damage the bank's credibility as an insurer and thereby hurt the solidarity and trust embedded in the network. As such, they may feel that such behavior would reduce future business opportunities with network members. Thus, banks having strong common heritage with members are less likely to abdicate their social obligations, and, as a consequence, they would encounter considerable financial stress during the major downturn in the Japanese economy in the 1990s. In short, banks sharing higher degrees of common heritage with members would have better performance than other banks in a growing economy but worse performance than other banks in a contracting economy.

### *Historical precedents*

Over the decades, there are incidences where main banks were involved in restructuring troubled firms. For example, Mitsui Bank brokered the merger between Mitsui Chemical and Toyo Koatsu (another Mitsui member firm) when Mitsui Chemical was in trouble in the 1960s. A more recent case was Sanwa Bank's involvement in supporting Daikyo Inc. in the early 1990s when Daikyo Inc. had suffered a major loss due to rapid increase in unsold apartments (Sheard, 1994b). The institutional role of a bank as a credible insurer would be more difficult to establish if the bank has never been involved in any rescue effort. Worse still, if there were incidences where a bank had abandoned its failing members, the norms of reciprocity and trust in the network would become fragile. However, because social exchange is an implicit contract (Blau, 1964), there is no formal document that specifies *ex ante* the terms and conditions of the

support. Under these circumstances, what guides proper behaviors often hinges on established social norms. The exact origin of any social norm in a network is difficult to pinpoint; it is more likely that norms are institutionalized through a gradual process of consistent behaviors that obtain a high degree of consensus in the social system (Coleman, 1990). Therefore, a bank that has consistently provided specific support to members in similar situations would over time develop a social norm that would shape members' expectations. In a similar vein, if a bank has consistently supported failing members in the past, it would be difficult not to provide similar support in the present, even though the number of failing members is large. Because a bank that treats its members differentially would raise objections from members who often expect distributive justice (Homans, 1961), shirking its social obligation would risk a bank's legitimacy as the network leader. In this light, a bank that has maintained credible historical precedents of providing support to members would over time establish a social norm within the network.

Such a normative element constitutes a blueprint that, over time, comes to prescribe proper behaviors and social obligations. Firms affiliated with banks that have built up a historical record of supporting failing firms would trust that they would receive the same kind of support in needy times. With this peace of mind, members would be more ready to increase their levels of risk taking by diversifying into different industries or foreign markets. Thus, banks with historical precedents of providing support to financially distressed member firms would thereby encourage member firms to pursue higher levels of product and/or international diversification than would other banks in a growing economy.

Banks that have maintained a historical record as credible insurers are likely to have more opportunities to expand their business, because their reputation would easily draw more followers. In the growing economy of the 1980s, many firms would be seeking credible banks that can provide support, and a historical record of rescuing failing firms would represent one of the best credentials for a bank engaged in a social exchange relationship. Therefore, banks with historical precedents of providing support to financially distressed firms would pursue higher levels of internationalization and/or expand their network size compared to other banks in a growing economy.

To the extent that banks have a record of supporting distressed firms and, as a result, enjoy more support from current members and more easily attract new ones, they should be able to achieve impressive performance in a growing economy during which many firms were in need of capital for expansion. A credible bank that can provide help, if necessary, would obviously be an attraction. Therefore, banks with historical records of providing support to members would grow significantly during an expanding economy since many firms were in need of capital for expansion. As such, this would increase the performance of the bank during this period.

However, maintaining such a reputation involves tremendous costs particularly during an economic downturn. Some banks might have provided support for inefficient or even failing firms without demanding significant overhaul; it is only until recently that many member firms have been forced by the government to restructure (Bremner and Thornton, 1999). On the other hand, from the members' perspective, these banks were merely adhering to the social norms of their banking networks by providing financial support in needy times. This perspective is in line with the view that norms that were a benefit may become a pathological rigidity over time (Leonard-Barton, 1995), tying the hands of the banks to push for much needed restructuring efforts in the 1990s. As such, the banks that built a reputation of benevolent supporters by rescuing financially distressed clients in the past would suffer to a greater extent as the economy declines and demands for corporate restructuring increases. Taken together,

banks with historical precedents of providing support to financially distressed firms would have better performance than other banks in a growing economy but worse performance than other banks in a contracting economy.

In addition to the institutional properties, the structural properties of a network also affect the social exchange relationships among members in a network. In the following, we will examine how the structural properties of Japan's banking networks gave rise to opportunities and constraints in the growing and contracting times of Japan's economy.

## Structural Properties

Social network researchers have developed a multitude of concepts to describe an actor's position in its network or patterns of linkages characterizing the network (Scott, 1991; Wasserman and Faust, 1994). The structural properties of the bank-centered networks signify the associated opportunities and constraints. Network structures are posited to embody substantive, fundamental meanings in social relationships and help increase our understanding of many behavioral and social phenomena. Granovetter (1985) states that in order to understand social actors' behaviors, one must look into the relational system in which they are embedded. As such, the purpose of network analysis is to study the positions of the actors and structure of the network for assessing their influence on network opportunities and constraints (Wasserman and Galaskiewicz, 1994).

We propose a number of network concepts to describe a bank's structural position in its network (centrality), network configuration (density), and network substructures (clique). Based on these structural properties of the banking networks, we seek to understand their impact on a bank's strategic actions and subsequent performance.

### *Centrality*

Centrality refers to an actor's position in the network relative to others. Three types of centrality are commonly discussed in the social network literature, each of which describes a different aspect of an actor's social structural position in the network. These three centrality concepts are degree, closeness, and betweenness, corresponding to an actor's number of direct ties to other actors, independent access to others, and control over other actors, respectively (Wasserman and Faust, 1994). Degree of centrality captures whether an actor is well connected with others. More direct contacts signify increased access to resources and sources of information. On the other hand, direct contacts also indicate potential demand for assistance from other actors. Closeness centrality captures an actor's capability to independently contact other actors in the network. A central actor can reach other actors by means of fewer intermediaries and is therefore less dependent on other actors to reach some specific actors. However, intermediaries may also act as buffers in case of trouble. Without buffers, an actor would always have to confront all other actors' direct demands and challenges. Betweenness centrality captures the frequency with which an intermediary actor is positioned between other pairs of actors. An actor who has a high degree of betweenness centrality is considered a broker and is supposed to obtain additional flow of information and resources (Burt, 1992). Likewise, we also expect that this actor will face pressures and demands from many actors who would utilize it to achieve their goals.

Centrality is often used to identify the most important, or prominent, actor embedded in the network (Wasserman and Faust, 1994). An actor is prominent if the ties of the actor render the actor especially visible to other actors in the network (Knoke and Burt, 1983). In this regard, a



bank that has a high level of centrality implies that it is a more prominent actor in the banking network. A prominent, or well-connected, bank has access to and control over additional flow of resources and information. A bank with high centrality in the banking network is likely to marshal and control more resources, including financial capital, directly from a larger number of members. Compared to a less centralized bank in other banking networks, a well-connected bank leader is likely to provide stronger confidence as well as concrete support for members to expand their business or support them during bad times. The ability to obtain resources more directly from members increases the speed of funding to members that were often engaged with intense competition with other firms to enter in new product or international markets. In contrast, a less centralized bank would experience trouble in providing the sufficient resources for the members, harming the ability of the members to expand in new markets. In addition, a highly visible, centralized bank in its network would find it more difficult to shirk its social obligation in fulfilling the insurance role during hard times. Consequently, members would feel more confident to the extent that their banking networks have more centralized banks in place. Banks with high centrality would have members pursuing higher levels of product and/or international diversification than would other banks in a growing economy.

Not only do banks that have high centrality in their networks enjoy more followers due to the bank's superior resources and information, but they also have the ability to quickly obtain resources from their large number of direct ties with network members. Besides, direct ties allow the bank to obtain first-hand, high-quality information about new product or international markets more efficiently. The visibility and status associated with high centrality in their network enhance the bank's attractiveness to clients, furthering its resource and information advantages. Thus, armed with more resources, richer information, and higher status, banks with high centrality in their networks would be more ready in a growing economy to conduct business in foreign markets and to expand its network. Consequently, banks with high centrality would pursue higher levels of internationalization and/or expand their network size compared to other banks in a growing economy.

Banks with high centrality are likely to reap major benefits during the growing economy in the 1980s, in that they can draw a larger number of followers, as well as command resources more easily. Even secondary banks in the network, such as the trust bank, may also be able to command significant benefits due to its broker position in the network, providing crucial links between the city bank and the members. However, high centrality is a double-edged sword. Although a centralized bank may have more power in marshalling resources, the exercise and maintenance of its power requires fulfilling its social obligation (Blau, 1964). During the current recession, a bank that has high centrality is expected by all other members to take the lead role in providing financial support, thus stretching its resources to many troubled firms. Besides, their high visibility within the networks would make them a prime target for assistance, making it difficult for them to resist providing support for failing members.

In the case where a bank does not have many buffers (i.e. maintaining many direct contacts with members), its social obligation as an insurer would be in high demand in the contracting economy. To the extent that the main network bank has some trust banks or smaller banks in the network to act as buffers, then the main group bank may have some relief because it could share some of the burden with secondary banks in the network. This may also explain why some of the trust banks, which may have high betweenness centrality, have incurred more severe financial loss in recent years. In short, banks with high centrality would have better performance than other banks in a growing economy but worse performance than other banks in a contracting economy.

### *Density*

While the use of centrality seeks to capture a bank's position in the network, density refers to a network's overall configuration. Density describes the general level of linkage among the actors in a network where a 'complete' network has all the actors connected to all others and directly linked to one another (Scott, 1991). It is empirically defined as the ratio of the number of linkages that actually exists in the network to the total number of possible linkages for the network. In other words, density of a network informs us about the levels of interconnectedness of a relational network. Scholars claim that high network density leads to information and resource sharing and trust-based governance (Coleman, 1990; Uzzi, 1997). Dense networks facilitate faster and more efficient flows of resources, information, and status because of many interconnections and shared routines among the actors. Because dense networks function as 'closed' systems, trust and shared norms develop more easily and they serve as an effective governance mechanism that facilitates effective sanctions on deviant actors (Coleman, 1990; Larson, 1992; Uzzi, 1997).

Dense networks can economize on search, deliberation, and governance costs within the network, thereby facilitating economic transactions and alleviating resource constraints of individual members (Rangan, 2000). A bank that operates in such a network would find that resource flow tends to be efficient and social contacts among members high. Members find it easier to obtain resources and support within the network, lessening the need to search or deal with firms and financial institutions outside the banking network. High network density may also provide a sense of solidarity or security for members, making them feel powerful or less worried about failures. For instance, keiretsu in which members are interwoven by various ties, including equity, debt, trade, and personnel, can serve as a risk-sharing mechanism (Nakatani, 1990). When a member falls into financial distress, the main bank usually arranges a collective or group-wide rescue operation. As explained earlier, Sumitomo Bank organized a group-wide effort to rescue Mazda Motor in the 1970s. As such, Sumitomo Bank provided emergency financing and mobilized other member firms to offer supply and sales support (Pascale and Rohlen, 1983). This feeling of togetherness may have provided impetus for members to engage in more business expansion in the growing economy in the 1980s. Because of a heightened level of consensus among members for expansion, banks in the network are likely to make loans to more members to expand their business. As a result, banks operating in high-density network would have members pursuing higher levels of product and/or international diversification than would other banks in a growing economy.

As the density level increases, information and resources flow across member firms more rapidly with numerous directly connected conduits. Therefore, when a bank operates in a dense network, it can usually leverage its leadership position to promote increased benefits throughout the network and raise levels of cooperation and resource flows. Similar to the members, banks operating in high-density networks may be subject to a sense of security or capability fueled by a high degree of social consensus or social bond. This may, in turn, induce the banks to expand their own business either domestically or internationally in the 1980s in order to leverage the strength of their network connections to capture additional opportunities. Thus, banks operating in a high-density network would pursue higher levels of internationalization and/or expand their network size compared to other banks in a growing economy.

The same processes by which dense networks enable efficient resource flows and facilitate rapid growth may reduce the members' ability to adapt (Uzzi, 1997). In the dense network, problems tend to spread to all members of the network rapidly, as do resources and information. For instance, in the presence of high levels of intragroup trading, the financial difficulties of

a member would ripple through the network, thereby developing into a widespread problem within the network, causing the banks to immediately suffer severe hardship. Strong commitment to the network, backed by shared norms of reciprocity and cooperation, intensifies social pressure upon members to perform their expected roles. Due to the feelings of obligations and friendship, the bank and members with ample resources feel obligated to offer assistance to weaker members (Gedajlovic and Shapiro, 2002; Lincoln *et al.*, 1996). Indeed, the social aspects of exchange relationship may supersede the economic imperative. Therefore, banks operating in a high-density network would have better performance than other banks in a growing economy but worse performance than other banks in a contracting economy.

### *Cliques*

Because actors tend to interact more with actors who are similar in certain aspects and tend to form more intensive relational ties with one another, the network creates substructures called cliques. Cliques are defined as densely connected subgroups of ties within the network (Doreian, 1979). A network characterized with a large number of cliques would find that there are pockets of intense ties scattered all over the network landscape but interaction between these pockets of ties, or cliques, would be less intense. Cliques exhibit unique norms and cultures within a network and actors in a clique tend to share a greater degree of homogeneity such as common value and identity with one another. The existence of cliques indicates the existence of intensive subnetworks within a network that allow for extremely high levels of consensus and collaboration within the cliques. Indeed, the clique itself represents the dense network, which facilitates the flow of resources, information, and status and is governed by shared norms, and collective monitoring and sanctions. At the same time, organizing across cliques for coordination and cooperation is facilitated because they still share broader common ties than between networks.

Clique members in a banking network would share very strong social norms with one another and, accordingly, be able to obtain significant support within the clique. At the same time, clique members would also be able to collaborate with other cliques within the network as they still share a high degree of similarity with one another. Furthermore, banks probably prefer to work with very identifiable cliques. To the extent that clique members share resources, information, and status under efficient governance mechanisms, banks can economize on the costs of searching, evaluating, and governing clients by working with very identifiable cliques. They can expand the scope of their businesses without incurring the extra costs of managing redundant relationships inside the clique. Put differently, by working with the cliques, banks can replicate the efficiency and benefits of the brokers in the network with multiple structural holes (Burt, 1992). Therefore, clique members would enjoy the increased level of support from other clique members, as well as support from the banking network as a whole. In the growing economy, high levels of resource availability and support enable members to expand their business. Besides, clique members are likely to have higher propensity to act together. Therefore, a collective effort in entering into new business arenas would increase the incentives to engage in new business expansion. When one member contemplates diversifying into a certain market, there is a strong likelihood that its move would be shared and supported by its clique members. In short, banks operating in a network with cliques would have members pursuing higher levels of product and/or international diversification than would other banks in a growing economy.

In situations where a bank operates in a network with distinctive cliques, this structural property holds important implications for the bank. The existence of cliques can alleviate

network leaders of their day-to-day coordination and organization, as they need only to identify the local leader of a clique and easily transmit its message across all clique members. For example, the existence of vertical keiretsu affiliated with a horizontal bank-centered keiretsu can be identified using the clique concept. Toshiba vertical keiretsu is a member of Mitsui (or Sakura now) bank-centered network, but has a very strong independent status. The firms belonging to the Toshiba group are likely to form a clique with one another, fostering and sharing very similar culture and expectations. In good times, Toshiba is likely to rely on its banks for its financial capital and willing to pay premium to gain group access. Although it is likely that some of the more powerful clique members usually gravitate toward clique activities, they are also eager to join the bank-centered networks for crucial information and higher status. The importance of bank-centered membership may be underscored by a comment from a senior executive of an independent, family-controlled company called Suntory, 'We must be in a keiretsu to compete effectively' (Miyashita and Russell, 1994, p. 196). Access to critical resources, timely information, and network insurance protection are often valuable. The case of Mazda, discussed above, reveals that even a large automotive manufacturing group needed the assistance of the main bank. Therefore, banks that operate in networks characterized with cliques may actually benefit from the individual strengths of each clique and maintain critical links with major clique members. This ability to connect with clique members also facilitates banks expanding into new markets to service powerful clique members. To the extent that there are several distinctive cliques in a network, a bank can also serve as a powerful broker linking these relatively independent cliques with one another, benefiting from the information or resource flow among the cliques. When smaller banks in the network are part of a clique, their opportunities to expand along with clique members would also be complementary. Thus, banks operating in a network with cliques would pursue higher levels of internationalization and/or expand their network size compared to other banks in a growing economy.

Distinctive cliques have the potential to operate efficiently and thus contribute significantly to banks' performance in good times. On the other hand, the presence of powerful cliques also poses a constraint on the banks, as common social expectations among the clique members for the banks' assistance exert strong pressure on the banks to provide financial support, succumbing to the collective pressure of cliques. Besides, financial troubles in these powerful cliques often snowball into major financial rescue or restructuring on the part of the bank, requiring a large amount of resources. Moreover, resistance to bank pressure to perform necessary restructuring would be stronger when clique members share common thinking and act collectively to support each other's demand. Thus, banks operating in a network with cliques would have better performance than other banks in a growing economy but worse performance than other banks in a contracting economy.

## **IMPLICATIONS AND CONCLUSION**

Based on a social exchange approach, we examine the institutional and structural properties of banks' relational ties that are likely to have significant impact on banks' performance. We emphasize both network opportunities and constraints and propose that close bank-client networks have yielded opposite performance outcomes between the growing economy in the 1980s and the contracting economy in the 1990s in Japan. The extant view of banks in Japan as efficient governance monitors does not match the reality of the current financial troubles faced by the banks themselves as well as their clients. Although the extant view correctly

recognizes the relational nature of Japan's banking industry, it fails to capture the intricate, sticky relations between banks and their clients in Japan, or, more generally, between long-term, close exchange partners. While Aoki *et al.* (1994) have called the Japanese main bank system a nexus of relationships, our arguments developed above may suggest that it can more aptly be described as a *nexus of social exchange contracts*. Using a social exchange approach in conceptualizing banks as networks insurers who maintain implicit contracts with their member clients, we have a better understanding of the role of banks in Japan and the reasons why many banks in Japan are now facing financial hardship themselves, while at the same time they have resisted pressuring their member clients to restructure for a prolonged period of time. If we understand the social role of banks in Japan, we would not picture them as governance monitors failing their duty. To a certain extent, it is the banks' unflinching commitment to its role, as network insurers, which has led them and their member clients into the current abyss of financial distress.

### Implications for Policy Makers in Japan

Japan's banking industry has undergone the 'Big Bang', a government-led deregulation plan with intent to overhaul Japan's financial system. The rationale behind the Big Bang is that the risk of financial intermediation is disproportionately borne by the banks and, as such, should be dispersed among various domestic market sectors and players, both domestic and international (Banker, 1997). However, the financial reforms had not led to the economic recovery that the government had hoped for (Khanna and DiLorenzo, 2002). While a major reform of Japan's financial system is much needed to help reinvigorate the banking industry as well as Japan's overall economy, it is important to realize that Japan's business system is institutionalized with thick social structural relationships that are often resistant to change. When a network of relations is built on historical and structural ties, the constraints against radical, external pressure for change are often significant. This was evidenced by the regrouping of the pre-war zaibatsu into keiretsu networks despite external force to break up these relations. A top-down reform aimed at the financial system should be viewed as a first step in deregulating Japan's business system.

Compared to many other countries, Japan cannot be regarded as a highly regulated economy. However, the intricate, implicit networks of relationships among firms may, in fact, pose higher barriers to competition than regulation. In this regard, a higher degree of competition in the Japanese economy should be encouraged. Moreover, the much-heralded bank-centered corporate governance system also needs significant reform. While close bank-client relationships contribute to tremendous growth opportunities for many firms in Japan, these relationships may also (1) compromise banks' incentives and ability in monitoring and controlling firm actions, (2) lead to inappropriate strategic actions for both the banks and their client firms, as well as (3) constrain efforts in carrying out necessary restructuring in the banks and their client firms. We should learn from the current experience that sound corporate governance requires a combination of internal and external mechanisms. Japan's almost sole reliance on bank-centered governance is a dangerous path. It is difficult to maintain efficient corporate monitoring and governance where board members have extensive interests tied with other member firms, an external market for corporate control is virtually non-existing, or where overdominance by one type of owner (i.e. the bank) exists. In this regard, governance reform such as more independent directors or the development of an active external market for corporate control would

be necessary. The sole reliance on close bank–client relationships as the dominant governance mechanism is likely to fail.

In recent years, many Japanese banks have begun to initiate major restructuring efforts, such as through merging with one another. For example, Industrial Bank of Japan, Fuji Bank, and Dai-Ichi Kango Bank have merged to become Mizuho Bank; Sumitomo Bank and Sakura merged to form Sumitomo Mitsui Bank. With banks increasingly engaged in restructurings, coupled with government's effort in financial deregulation, the banking sector reform in Japan calls for deinstitutionalization, i.e. 'the process by which deeply entrenched practices give way to new innovations' (Ahmadjian and Robinson, 2001, p. 622), of close bank–client relationships. The regulatory reform such as the Big Bang would trigger deinstitutionalization. Technical and economic pressures due to economic downturn, poor performance, or increased competition may provide the impetus for adopting practices diametrically opposed to long-held values and traditions. However, given that close bank–client relationships have spread and persisted as a result of historical, institutional, and social factors illustrated above (DiMaggio and Powell, 1983), regulatory changes alone may not be sufficient to induce banks and firms to abandon time-honored practices and adopt new ones instead. In this context, foreigners that are free from existing historical, institutional, and sociological ties tend to behave according to technical and economic imperatives (Khanna and Palepu, 2000). Shinsei Bank is a case in point. Shinsei Bank started when New York-based Ripplewood Holdings took over Long-term Credit Bank in 2000 and renamed it. Unconstrained by local tradition and practices, Shinsei Bank acted contrary to the traditional Japanese banker's approach. When struggling retailer Sogo asked for a fresh infusion of cash after defaulting on its loans in 2001, Shinsei refused to provide additional loans, letting Sogo go into bankruptcy. In addition to cutting off debtors with no realistic chance of paying back their loans, Shinsei has reduced its dependence on low-margin corporate lending for which Long-term Credit Bank was created and expanded into the more profitable fee-based services such as investment banking and securitization of debt. Three years after the takeover, Shinsei Bank has emerged as a different kind of bank with high profit and better future prospects. If the success of Shinsei Bank can serve as a model for other local banks, the traditional banking model may become deinstitutionalized and the new banking model more broadly diffused (Bremner, 2003). In fact, the transition of Japan's banking system provides an excellent setting to examine a deinstitutionalization process which has not received a great deal of research attention (Ahmadjian and Robinson, 2001; Scott, 2000).

## Implications for other Asian Economies

Japan's experience may serve as an example for other Asian economies that are currently experiencing economic downturn. Although relationships may provide an avenue for better information and resource flows within the group, the dark side of intimate relationships may eventually undermine the very foundation of efficient governance. Evidence from the Korean bank sector did challenge the value of durable bank–firm relationships. Bae *et al.* (2002) found that adverse shocks to banks during the 1997–98 period had a negative effect not only on the value of banks themselves but also on the value of their clients' firms. While close relations may create trust, trust does not necessarily lead to appropriate strategic actions and outcomes. Sometimes these relations would lead to collusive behavior or, recently in Japan and many other Asian economies, corruption and 'crony capitalism'.

As most economists agree, stifling competition often seems to lead to negative welfare for the society at large. Moreover, as we have begun to learn from the experience in the past few years from many Asian economies, including Japan, competition-reducing behaviors may also lead to collective failure among interconnected firms. Therefore, our manuscript helps highlight the opportunities as well as constraints a firm faces in a close network of relationships, where each firm is expected to perform its obligation or reciprocate the benefits, without proper consideration as to what should be the 'best' course of action. Group collaboration sometimes may provide a false sense of security. With the expectations of support from the banking network, there may also be a moral hazard problem where member firms are less conservative with their strategic actions. With loyal clients, even the banks may be less conservative in expanding their business and extending loans to member clients, hence fueling the bubble economy of the late 1980s in Japan. Other Asian economies that are now contemplating reform in their business systems, as well as advocates of Japan's governance system in the United States, should all take heed of what we have witnessed in Japan over the last decade.

## Conclusion

By adopting the social exchange approach, our manuscript contributes to broadening the perspectives on corporate governance where agency theory has served as a dominant theoretical frame of reference. While focusing on the potential conflicts of interest between principals and agents, agency theory at least implicitly assumes that principals and agents – free from social, institutional, and historical contexts – are ready to behave as dictated by economic motivations and incentives. However, principals and agents do exist in social, institutional, and historical contexts, and such embeddedness as well as economic considerations influence their behavior. As a consequence, prescriptions based on agency theory – although they may be technically rational – may otherwise be socially or institutionally unacceptable. Taking social and institutional embeddedness seriously, along with economic factors, would enrich our understanding of corporate governance and its ramifications.

The social exchange perspective suggests that firms with close ties to banks are less likely to take the necessary restructuring efforts. This may be the case in particular when restructuring efforts require drastic changes that disrupt existing social relationships. In the study of management buy-outs in Japan, Wright *et al.* (2003) reported that firms affiliated with keiretsu were slow to initiate management buy-outs for corporate restructuring, compared to firms unaffiliated with keiretsu and foreign firms. Although the close relationships with banks may provide stability necessary to institute a long-term orientation, they may breed inertia that retards appropriate corporate restructuring and transformation. As such, the Japanese setting may provide an excellent setting to further explore the effects of social embeddedness on corporate restructuring and their consequences.

We by no means claim that economic factors are unimportant in understanding corporate governance and its ramifications. In a comparative study of large Japanese and US firms, Kaplan (1994) found strikingly similar relationships among firm performance, top executive turnover and compensation in both countries: top executive turnover increased significantly with poor stock performance and earnings losses; executive compensation increased with high stock returns and earnings. These findings suggest that economic factors likewise play a crucial role in influencing top executive turnover and compensation across different corporate governance

systems and supposedly across different levels of social embeddedness. Economics factors such as firm performance may exert greater influence on firm action when the governance mechanisms are less socially embedded. Unfettered by thick social and institutional ties, the firm has latitude of pursuing the action dictated by economic imperatives. By contrast, social factors may dominate firm action with respect to the governance mechanisms when strong ties to social and institutional relationships exist. Indeed, some governance mechanisms are more embedded than others. How differing degrees of social and institutional embeddedness moderate the effects of economic and social factors awaits further conceptualization and systematic empirical analysis.

Our manuscript also contributes to the study of networks in international business. The prevalence of relational networks in many countries has been noted by many researchers. However, a lot of these studies have largely focused on one or limited aspects of these networks and have yet to adequately capture the complex properties that characterize many of these networks. Although our primary concern in this manuscript is Japan's banking networks, the conceptual framework developed here, emphasizing both the institutional and structural properties of networks, represents a more integrative approach to the study of business networks. Business networks often exhibit various characteristics that defy an easy conceptualization. By incorporating both the institutional and structural arguments of networks in a conceptual framework, our manuscript can serve as a guide for future theoretical and empirical research on networks in international business studies.

## NOTES

1. Banks were originally allowed to own up to 10%; however, the Revised Anti-Monopoly Act of 1977 required banks to reduce their equity holdings to no more than 5% by 1987.
2. As a further illustration, seven of the top 10 banks in the world in 1987, ranked by asset size, were Japanese banks (Glasgall, 1988).
3. Other examples include Germany and the Netherlands.
4. Because of the prolonged recession and bank crisis, there has recently been a wave of mergers among banks. In 1999, Sakura Bank (main bank of the Mitsui group) announced a merger with Sumitomo Bank (main bank of the Sumitomo group). In the same year, Dai-Ichi Kangyo Bank (main bank of the Dai-Ichi Kangyo group), Fuji Bank (main bank of the Fuyo group), and Industrial Bank of Japan announced a comprehensive consolidation of three banks. Although these bank mergers blur the boundaries of the horizontal keiretsu, it remains to be seen whether such bank mergers will bring qualitative changes into the bank–client relationships.

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# Analysing Change in Corporate Governance: The Example of France

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Mary O'Sullivan

## INTRODUCTION

Corporate governance is broadly concerned with the distribution, exercise and implications of corporate control. Who controls corporate decisions? What types of decisions do they make? What are the implications of these decisions for different interest groups or stakeholders?

In this chapter, I focus on the case of France to reflect on the characteristics and determinants of change in systems of corporate governance in the late twentieth century. Discussions of globalisation, with particular attention to the global integration of financial markets, have prompted widespread concern with systemic change in corporate governance. There has been particular interest in the question of whether continental European systems of corporate governance, often described as insider systems, can survive in a world in which they are increasingly subject to the pressure of financial markets that are dominated by outsiders, portfolio investors without strong relationships to particular enterprises.

The case of France is important to contemporary discussions of corporate governance. Over the last 25 years the relationship between the corporate economy and the financial markets in France has undergone several dramatic changes. For some commentators, these changes constitute a systemic shift in French corporate governance from an insider to an outsider system in which the dictates of financial markets, especially the demands of foreign institutional investors, strongly influence corporate actions. In this regard, the French system is often contrasted with other insider systems in continental Europe where change has been more tentative. It is, therefore, crucial to understand to what extent systemic change in corporate governance has occurred in France, how that process has taken place, and its implications for the stakeholders of French corporations.

There are different ways to approach the empirical analysis of national systems of corporate governance. A structural approach, which seeks to relate patterns in corporate governance to the characteristics of particular institutions or mechanisms, dominates research in the field.

Research on structures of corporate ownership occupies a particularly prominent role in the financial literature on corporate governance. An alternative approach emphasises the importance of both structure and agency in an evolving process of corporate governance. For addressing corporate governance from a financial perspective, such an approach focuses on the interaction between corporate strategies and the financial system. In this chapter, I use both of these perspectives as bases for analysing changes in French corporate governance in the last 25 years.

First, I discuss the empirical evidence on the ownership structures of French corporations and emphasise a number of major changes that have occurred over the last quarter of a century. Of particular importance is the marked decline in the role of the state as a shareholder in French corporations, the subsequent creation and unwinding of cross-shareholding relationships and the growing importance of foreign shareholders in the ownership structures of French listed corporations. However, I also point to evidence of important continuity with family ownership proving to be highly persistent through the 1990s.

Second, I analyse the interaction between French corporations and the financial system over the last 25 years with a particular focus on the way in which French enterprises have relied on financial institutions to fund their expansion. One important development has been the diminution of the central role of the state in the financing of the French corporate sector. There has also been a major change in the interaction between private companies and the financial system, especially in the 1990s, with a major increase in these companies' reliance on equity issues as a source of external finance as well as in the role of market, as compared with intermediated, debt. The restructuring of the boundaries of private enterprises, through spin-offs and acquisitions, played a crucial role in driving share issues not only for cash but also in exchange for the shares of other companies. New debt financing by French companies, especially in the late 1990s, was also motivated to an important degree by the financing of acquisitions.

There are important implications of the changes in the ownership and financing of French corporations that I document for the governance of these enterprises. There have been significant developments in the distribution of corporate control in the French corporate economy but it remained firmly in the hands of insiders into the new century. However, there has been an important change in the way that insiders have exercised their control. In particular, they have used it as the basis to pursue strategies to greatly expand the international presence of the companies that they run. It is, as yet, difficult to say what the consequences of their actions will be for the stakeholders of French corporations but there is suggestive, if inconclusive, evidence of changes in the distribution of returns towards financial interests and senior executives at the expense of the workforce, especially French employees. Finally, I consider whether a shift from insider to outsider control is likely to happen in France as an unintended consequence of managerial action and argue that it will do so only under quite specific conditions that are confined to a small number of cases.

In conclusion, I consider the role of structure and agency in the process of change that I described. Despite its prominence in the literature on corporate governance, ownership structure, by itself, does not take us far in explaining the most important recent developments in French corporate governance. I suggest that there are other structural characteristics that may do a better job of explaining change in French corporate governance. The role of industrial structure certainly merits further exploration in explaining the propensity of French corporations to pursue strategies of external growth. In addition, the social structure of the French corporate economy – the exaggerated hierarchies in French corporations that accord enormous power to the PDG and the networks that bring these top managers into close contact with

each other – may also be factors in explaining why French managers systematically favoured foreign expansion through external growth in the 1990s.

## **UNDERSTANDING SYSTEMS OF CORPORATE GOVERNANCE**

Empirical research on corporate governance is predominantly concerned with relating patterns in corporate governance to the structural characteristics of particular institutions or mechanisms that are deemed to influence the relationship between corporations and their stakeholders. Analysis of corporate governance from the perspective of financial interests focuses on institutions such as share ownership, investor rights, takeover rules and board composition as critical determinants of patterns of corporate control. An extensive body of evidence has now been generated based on this structural approach to the analysis of corporate governance.

Empirical work on comparative-historical patterns of corporate ownership is particularly prominent in this stream of research. Concern with patterns of corporate ownership goes back a long way to the classic analysis of *The Modern Corporation and Private Property* by Adolph Berle and Gardiner Means (Berle and Means, 1932). The world that Berle and Means described was one of diffuse ownership in which shareholders exercised little control over the ‘princes of industry’ who ran the corporations in which they held shares. From this perspective, the challenge in improving corporate governance was to determine how to make corporate managers accountable to shareholders and/or other stakeholders.

The view of the US corporate economy outlined in *The Modern Corporation* was initially the conventional one in the literature on corporate governance. However, recent studies have challenged its generality in showing that the diffusion of share ownership is the exception rather than the rule (LaPorta *et al.*, 1999). In most countries, corporate ownership and, specifically, the cashflow and voting rights of which ownership is comprised, is highly concentrated. Patterns of concentrated ownership are evident in many developing countries but they are also a feature of most developed economies.

A series of empirical studies by the European Corporate Governance Network has provided us with a particularly detailed picture of European patterns of corporate ownership (Becht and Mayer, 2001; see also Faccio and Lang, 2002). They show that ownership tends to be highly concentrated in continental Europe but the way it is concentrated and, in particular, the relationship between cashflow and voting rights, is quite different across countries (Becht and Roell, 1999). Evidence of concentrated ownership has stimulated thinking on corporate governance to move in new directions with scholars arguing that governance problems take a different form when corporate ownership is concentrated than when it is diffused. In particular, conflicts between majority and minority investors are deemed to be more important than those between shareholders and managers.

As research on patterns of corporate ownership has developed, there have been attempts to link these patterns to characteristics of other institutions that influence corporate governance. In particular, an influential body of empirical research has been developed that advocates a ‘law and finance’ perspective. It suggests that there are important links between the characteristics of corporate ownership, legal institutions and financial markets in different countries. These characteristics are seen to be highly complementary, that is, to form an integrated system of corporate governance. Systems of corporate governance characterised by diffuse corporate

ownership, strong legal protection for minority investors and developed financial markets are contrasted with systems in which there is concentrated ownership, weak legal protection for minority investors and underdeveloped financial markets (LaPorta *et al.*, 1999).

The underlying assumption behind all of this work is that the structure of ownership plays a crucial role in determining the distribution, exercise and implications of corporate control. However, there is little empirical research that shows that a link actually exists between ownership patterns and the control of corporations. Indeed, rather than analysing the relationship between ownership and control, most of the empirical research that addresses the implications of ownership for corporate activity has tested for a reduced-form relationship between ownership and performance. The results of these studies are ambiguous and, as yet, there is no clear evidence that a strong relationship exists (Bøhren and Ødegaard, 2003; Gugler, 2001). When the term 'control' is used in the literature on ownership structures it tends to refer to voting rights. While these rights may give shareholders influence over specific corporate decisions, such as mergers and acquisitions, they do not necessarily imply systematic influence over corporate decision making.

The structural approach is therefore open to criticism from alternative ways of analysing corporate governance. Some scholars have challenged the relevance of ownership structures for determining actual patterns of corporate control. Instead, they have argued that other social structures, both inside and outside the firm, exert a more important influence on the actual control of corporations (Fligstein, 1990; Fligstein and Brantley, 1992). In short, this line of criticism argues that in taking a structural approach to the analysis of corporate governance, we had better be sure that the structures that we analyse are the ones that really matter to corporate control.

Another, more fundamental, criticism can be made not only of the research on ownership structure but, in general, of structural approaches to the analysis of corporate governance. The argument here is that social structures, whatever form they assume, do not determine behaviour in a mechanical way. Economic agents are heterogeneous and, in particular, they differ in terms of what they want, what they understand, and how they seek to achieve their objectives; in short, they are strategic actors. In the context of corporate governance, shareholders may differ from each other, as well as other financial stakeholders, even if they display similar structural characteristics (e.g. majority shareholders). Similarly, managers may differ in ways that are important in determining corporate behaviour.

Critiques of structural arguments for their neglect of the importance of agency have been made by many social theorists. These critiques do not necessarily lead to the argument that action is voluntaristic, that structure does not matter at all, only that it matters differently when agency is taken seriously. The analysis of Anthony Giddens, the scholar who has gone farthest in the critique and rehabilitation of the concept of structure in social theory, is particularly instructive on this issue. He argues that agents need financial and other resources in order to act and that social structures determine the extent to which they have access to these resources. Furthermore, actions also follow certain norms or rules that are generated by social structures even if they are not wholly determined by them (Giddens, 1976, 1979).

From the perspective of corporate governance, ownership of corporate shares or other forms of access to financial resources may allow some agents to act in ways that are not possible for others. Furthermore, when managers or shareholders take action, they may exhibit certain patterns of behaviour that can be understood in terms of structural characteristics. For example, executives of companies with concentrated shareholding may be less willing to use equity finance to expand if, through the dilution of the shareholding structure, it diminishes the control of existing shareholders.

If we need to take account of the way in which structure influences action it is also important to recognise that the exercise of agency may itself transform structure. Concentrated shareholders may dilute their holdings leaving managers fully exposed to the pressure of market forces. Or managers may, in pursuing an acquisition strategy, bring about a transformation of the ownership structure of the corporation that they run.

This line of reasoning leads to the study of corporate governance as an unfolding process in which agency interacts with structure over time rather than as a system of institutions that can be defined by particular characteristics at a point in time. To paraphrase Giddens, structures of corporate governance are both the medium and outcome of the practices that constitute governance systems.<sup>1</sup> As a result, what is determinant and what is outcome is often difficult to decide. Moreover, in taking account of the interaction between agency and structure, allowance must be made for the inherent uncertainty of the outcome of the governance process as well as the time that it takes to unfold.

Financial analyses of corporate governance that take seriously the role of agency and structure in corporate governance focus on the ongoing interactions between corporate actors and the financial system. While corporations use the financial system in a variety of ways, their reliance on that system for financing their development is particularly important. It is, after all, for their role in providing finance to corporations that shareholders are attributed a role, for some scholars a predominant role, in the governance of corporations. Therefore, we need to understand which firms seek funds from the financial system, the strategies that they are pursuing that lead them to do so, as well as the implications of their reliance on the financial system.

In principle, there could be all kinds of relationships between the findings from the two different approaches that I have described to the study of corporate governance. They may well be complementary; structural analyses may allow us to recognise change but not to explain how it occurs and the interactive approach can fill in the gap. However, it is also possible that one type of explanation takes precedence over another. Changes in the relationship between the corporate sector and the financial system may determine ownership structures; for example, in their analysis of the origins of diffuse ownership in the UK, Franks *et al.* (2004) emphasise the importance of the issuance of equity to facilitate acquisitions in the process through which shareholdings were diluted. Alternatively, ownership structure may determine the relationship between the corporate sector and the financial system; for example, the law and finance perspective claims that diffuse ownership is a prerequisite for active financial markets at least to the extent that legal protection for external investors is provided.

There is no way to determine the relationship between the findings from these two different approaches in the abstract. Instead, they must be used to study a particular case of corporate governance to see how they relate to each other in explaining the facts of that case. This is what I do for the French system of corporate governance for the period from the late 1970s to the turn of the twentieth century.

## **THE OWNERSHIP AND FINANCING OF FRENCH CORPORATIONS**

For France, as for most countries, empirical research on corporate governance is dominated by studies of ownership structures. I begin with a summary of that research to highlight the



changes and continuities in the structure of corporate ownership in France in the last quarter of the twentieth century. Of particular importance is the marked decline in the role of the state as a shareholder in French corporations, the subsequent creation and unwinding of cross-shareholding relationships and the growing importance of foreign shareholders in the ownership structures of French listed corporations. However, there is also evidence of continuity with family ownership proving to be highly persistent through the 1990s.

Then I turn to an analysis of the evolving interaction between French corporations and the financial system. Here again there is evidence of major change. One aspect of that change has been the withdrawal of the state from its central role in the financing of the French corporate economy. In relinquishing that role, the state made room for the private sector to supply French corporations with the funds that they wanted. It also provided a direct stimulus to the stock market from the mid-1980s as a result of its extensive restructuring of the scope of the public sector through privatisation.

There has also been a transformation in the way in which corporations in the French private sector interact with the financial system. Despite an improvement in their profitability and, as a result, greater access to internal resources, French corporations have remained highly dependent on external finance. However, there has been an important change in the mix of external finance that they use with an increase in the importance of equity issues as well as in the role of market, as compared with intermediated, debt.

A major restructuring of the boundaries of French corporate enterprises, rather than an expansion of internal investment, played a dominant role in driving these changes. Spin-offs and acquisitions were crucial to the recent growth in share issues for cash and in exchange for the shares of other companies. Debt refinancing was also an important motivation for stock issuance but, even then, some of this financial restructuring was related to external growth, being undertaken to stabilise an acquirer's finances following an acquisition or to bolster them in anticipation of one. Moreover, new debt financing by French companies, especially in the late 1990s, was motivated to an important degree by the financing of acquisitions.

Large firms dominated these developments. As far as the equity markets are concerned, transactions by the largest listed French corporations accounted for about 90% of the total amount of money raised through share issues on the Bourse in the last 25 years; medium and small listed companies, even at the peak of their issuance activity in the late 1990s, together represented only 10% of the total proceeds raised on the Bourse. Similarly, the increase in debt finance in the late 1990s was driven by the largest listed corporations and state-owned enterprises.

## The Structure of Corporate Ownership in France

The extensive involvement of the French state in the ownership of business enterprises is typically regarded as one of the defining features of French post-war capitalism. The desultory performance of the French economy in the 1920s and 1930s convinced many commentators that extensive family control of French industry was holding back the development of the economy through underinvestment and a lack of entrepreneurship. Thus, when de Gaulle promised, through a programme of nationalisation, to bring about 'the eviction of the great economic and financial feudalities from running the country', his views reflected a widespread scepticism in France of the economic efficacy of family control.

The programme of nationalisation that began at the end of WWII targeted two types of company. First, enterprises that provided elements of the basic infrastructure deemed necessary

for the reconstruction and further development of the French economy came under government control. Second, enterprises that had been controlled by the enemy, by collaborators, and by the Vichy regime were brought under the direction of the state. In the beginning of the Fifth Republic, a number of other enterprises were nationalised and new public enterprises were created in the aerospace and computer industries as the government sought to rationalise some industries and to build up others. By 1976 the state held a majority of shares in 40 of France's top 500 companies and minority shares in 13 others (Morin, 1986).

However, the most ambitious programme of nationalisation in post-war France was yet to come. It began under the Mitterrand government in 1982 and brought the state's involvement in the enterprise sector to its peak. At its conclusion, the state owned 100% of 13 of the 20 largest French industrial firms and held a controlling block in many others. It was also in control of the country's leading financial enterprises as well as a large number of smaller French banks.

The role of the state in the ownership of French corporations dramatically changed shortly afterwards. In 1986, the right-wing government of the time launched the country's first major programme to transfer corporate assets from the state to private hands and set in motion a wave of privatisations that have continued right up until the present day. A list was drawn up for the privatisation law of 1986 that contemplated the sale of 65 enterprises by February 1991 (Goldstein, 1996).<sup>2</sup> In 1986 and 1987 a number of the best-performing state enterprises were sold in public share offerings. By the time the privatisation programme was stalled by the stock market crash of 1987, 31 enterprises had been sold off and €10.7 billion had been raised in the process (Goldstein, 1996, p. 463).

When the Socialists came to power again in 1988, they did not attempt to reverse earlier privatisations. Rather with the introduction of the '*ni-ni*' policy – neither nationalisation nor privatisation – they declared a moratorium on policies to transform the equity ownership of French corporations. As a result, there were no privatisations in 1989 and 1990. Michel Rocard's Socialist government did, however, allow a number of transactions among French nationalised corporations, and between these companies and foreign acquirers, which effectively diluted the state's direct equity stake in the French corporate economy (see Goldstein, 1996, p. 465, for an explanation). From 1991, the sale of up to 49% of nationalised companies was permitted, the reduction of state ownership continued still further and the government once again turned to the public markets to liquidate some of its industrial and financial holdings (Schmidt, 1996).

In 1993, the new right-wing government, under Edouard Balladur as Prime Minister, officially launched a second major privatisation programme. Notwithstanding the sell-offs of the mid-1980s, the French state remained a very important shareholder in the French economy; in 1993, the three largest French companies by sales were state owned as were four of the top 10 companies and 15 of the top 50 (Goldstein, 1996, p. 458). A list of 21 companies to be transferred from public to private ownership was drawn up – 12 of these companies had been on the 1986 list (Schmidt, 1996, p. 191) – and it included most state-owned enterprises with the exception of the utilities, the railways, defence companies and the Caisse des Dépôts (Goldstein, 1996, p. 467). Alain Juppé's government continued with Balladur's programme although major difficulties were encountered with some proposed sell-offs.

In their campaign for the June 1997 election the Socialists promised to end the sell-off of state assets. Once in power, however, Jospin's government adopted a very different approach. From June 1997 to the end of 1999, the Socialists sold off state enterprise assets worth €25.5 billion,<sup>3</sup> thus surpassing the total amount generated by the privatisations conducted by the Balladur and Juppé governments from 1993 until June 1997 ('Privatisations: le gouvernement s'oriente vers une pause en 2000', *Les Echos*, 19 November 1999, p. 6).

The privatisation programme led to a major transformation in the structure of ownership of the French corporate sector. Moreover, the way in which successive French governments conducted the privatisation process meant that they influenced the structure of ownership of these companies even when they were transferred to private hands. Specifically, the process created a *noyau dur* for the privatised companies. Somewhere between 15% and 30% of the shares of privatised companies were sold to a limited number of shareholders, usually other companies that had industrial or financial ties with the privatised entity, that were intended to comprise a stable shareholding nucleus. Shares were sold to these stable shareholders through private placements and a premium (somewhere between 2.5% and 10%) to the public offer price was charged. Most of these core investors made a formal commitment to hold their shares for about two years after privatisation but it was widely believed that they would hold them for longer than that (Morin, 1998; Schmidt, 1996, p. 158).

The story of nationalisation and privatisation is not the only one that needs to be told to understand the structure of corporate ownership in France. Another important theme is the persistence of family ownership especially in certain sectors such as retailing, automobiles and tyres, luxury goods and some high-technology industries (Chadeau, 1993). Based on data for 1997 and 1998 on the ultimate ownership of 607 listed French companies, Faccio and Lang calculated the percentage of firms controlled by different types of owners at the 20% threshold. They found that 64.8% of them were controlled by a family as compared with only 14% which were widely held.<sup>4</sup> These figures compare to the averages for their sample of 13 Western European countries of 44.3% and 36.9% respectively. France, with its highly concentrated ownership structure in which families play a central role, is most similar to Germany, Austria and Italy. It is least like the UK, which had the highest percentage of widely held firms at 63.1% and the lowest percentage of family-controlled firms at 23.7% (Faccio and Lang, 2002).

The decline in the role of the French state as an owner of French listed companies is reflected in the figure of 5.1% for French listed companies controlled by the state. While that figure is slightly higher than the average of 4.1% for the 13 countries it is considerably lower than the figure of 10.3% reported for Italy which had a similar history of state ownership to France. The effect of privatisations can also be seen in the data: an analysis of ownership structures by size of company reveals that 60% of the 20 largest French listed companies, most of them privatised enterprises, are widely held, which is considerably higher than for all other countries except the UK, Sweden and Ireland (Faccio and Lang, 2002). Cross-shareholdings are not identified in the analysis because the 20% threshold is too high to pick up stakes that were typically less than 5% but other studies have documented their importance in the mid-1990s (Morin, 1986).

However, in the late 1990s, these cross-shareholding networks began to unravel. The process was initiated in the wake of the merger, in December 1996, of Axa, the leading French insurance company, with one of its competitors, UAP. The transaction created a veritable financial powerhouse with shareholding links to many of France's most important companies. Shortly after the merger, however, the newly created company announced that it would sell off its holdings in a number of important French corporations including Crédit National (12.4%), Schneider (7.1%), and Suez (6%). Only the holdings that Axa-UAP regarded as strategic to its core business, namely, BNP (12%) and Paribas (9.76%), were to be maintained (Morin, 1998). Other large French companies followed Axa's lead in unwinding their cross-shareholdings and, by the end of the 1990s, many of the ownership ties that had been put in place to protect French corporations from unwelcome scrutiny by outsiders had come undone.

In parallel, an extremely rapid incursion of foreign institutional investors took place on the French stock market. Foreign ownership had increased as a result of the privatisation process

and by 1994 was already at 25% of French listed shares compared to 10% in 1985. It increased to 30% by 1997, then jumped to nearly 35% by 1999, and to 40% by 2000 (Banque de France, 2004). Foreign participation in the shareholding structures of large, listed French companies was even higher than the average (Morin, 2000).

In contrast to these changes in ownership, the importance of families in French corporations seems to have survived through the late 1990s. Indeed, an analysis of the ownership structures of the 250 French listed companies included in the SBF 250 stock market index suggests that the importance of family ownership actually increased between 1993 and 1998. The study focused on the prevalence of patrimonial firms, defined as 'companies where individuals or families are identified as major ultimate shareholders with at least 10% of equity'. The results showed that patrimonial firms increased in importance during the period from 48% to 57% of the total number of SBF 250 firms and from 32% to 35% of their aggregate market capitalisation (Blondel *et al.*, 2002).

## The Financing of the French Corporate Sector

When WWII ended, concern about the backwardness of French industry persuaded the state that it was not enough to try to usurp family control by nationalising key enterprises. It was believed that other steps had to be taken to upgrade France's technological capabilities if the country was to become a modern industrial power. The state's control over the allocation of credit by financial institutions was one of the most important tools that it used to influence the restructuring and development of the French economy.<sup>5</sup>

Essentially, the French government placed restrictions on the overall expansion of credit in the economy thus limiting the capacity of the banks to lend to business and other sectors of the economy. However, in cases where the government wanted to encourage particular activities it did so by making an exception to credit restrictions for the relevant borrowers. Besides the use that it made of credit controls, the state also established a number of agencies that could make subsidised loans to specific sectors and businesses to meet what were seen as their special needs (Loriaux, 1991). The overall effect of these interventions by the state in the financial sphere was a high dependence by French enterprises on debt for financing their investment. As Elisabeth Bertero described it: 'the French financial system [was] an overdraft economy, or an extreme version of a bank-based system, if we emphasise firms' capital structure' (Bertero, 1994).

From the early 1980s, there was a dramatic change in the relationship between the enterprise sector and the financial system in France. First, the government assumed some of the private sector's debt as a result of its nationalisation programme. Second, the profitability of French enterprises improved dramatically from 1982 on, thus increasing their self-financing capacity. Finally, the major programme of financial liberalisation that began in France in the late 1970s, and gained serious momentum from the early 1980s, led to a change in the mix of external finance that French companies used.<sup>6</sup>

The combined effect of these changes is reflected in the evolution of the sources of finance used by French corporations from 1978 to 2002. Although internal financing was rather weak from 1978 to 1985, accounting for no more than 14% of value added and as little as 9.8% in 1981, it improved sharply in the late 1980s reaching a peak of 19.3% in 1988. Thereafter, it declined unsteadily to reach 16% in 2002 with the largest decline occurring in the last three years of this period.

French corporations' reliance on external finance has changed substantially over the last 25 years (Banque de France, 2002). They were heavily dependent on external finance from 1978 to 1984 but that dependency fell sharply in 1985 with the demise of the overdraft economy. However, corporations' resort to external finance rebounded shortly afterwards and remained high until the early 1990s. It declined from 1993 to 1997 but then rose dramatically in the late 1990s to reach an all-time high for the entire period.

There was a dramatic shift in the mix of external finance used by French companies over the last 25 years. In the late 1970s and early 1980s companies depended almost entirely on debt finance and, more precisely, intermediated finance. Share issues played a growing role from the mid-1980s accounting for between 5% and 7% of value added from 1985 to 1995. From 1996 to 2002 their importance expanded still more to between 6% and 15% of value added. As far as debt finance is concerned, its importance was volatile from 1985 on but in the late 1990s it increased rapidly to reach very high levels. There was a change in the type of debt used during the period with a greater reliance on market debt – bonds and commercial paper – at the expense of intermediated debt.

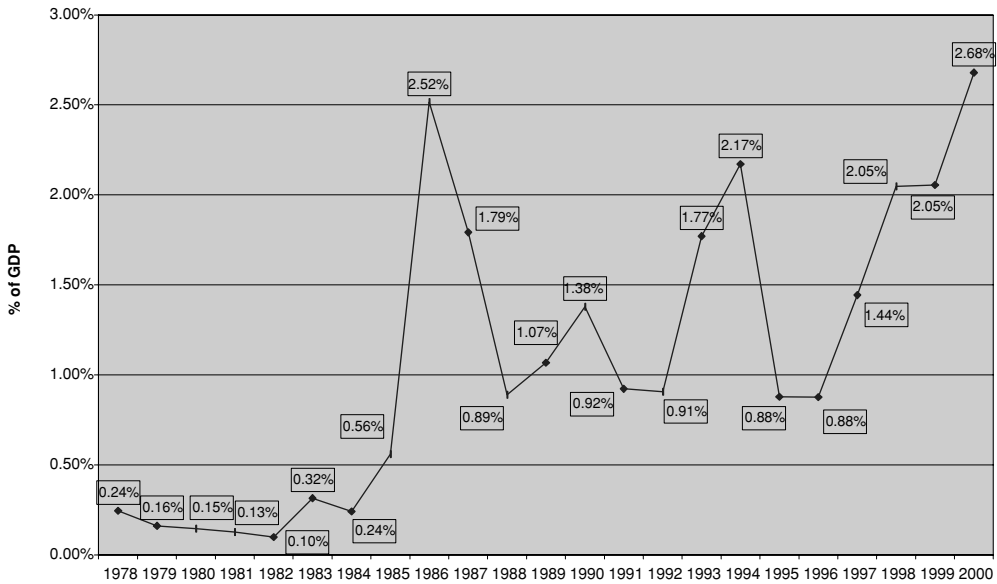
On the face of it, it is strange that external finance remained so important for French enterprises. The strengthening of their financial positions meant that their capacity to finance their capital expenditures from internal sources was high from 1984 on, coming close to 100% in many years. It is clear, therefore, that the use of external finance did not follow internal investment needs. Instead, the external financing of French enterprises seems to have been driven by the growing importance for French corporations of acquisitions and investments as uses of their funds (Banque de France, 2002).

While the aggregate data are suggestive of such a link, they cannot show that the trends towards an increased use of external finance and a growth in acquisitions and investments were related. It is possible that they were simply coincident with some companies increasing their reliance on the financial system for external funds and others using their own surplus funds to invest in external growth. Certainly, there were important developments on the French financial markets, such as privatisations and initial public offerings, which were not obviously related to acquisition activity.

Therefore, a more detailed analysis is required of the changes in the use of the financial system by French corporations. An additional, and more significant, benefit of a disaggregated analysis is that in permitting the identification of the companies that used the financial system, it allows us to study the strategies that they were trying to pursue in doing so as well as the results of their reliance on external funds to achieve their strategic objectives. I focus on listed companies in the discussion that follows in part because of greater data availability but, more importantly, because their financing activity played a crucial role in driving the changes described above. In the following sections, I present and discuss evidence on trends in stock issues for cash and in exchange for shares by French listed companies as well as developments in their debt financing.

### *Trends in public share issues for cash by French listed corporations*

To raise capital, French companies can issue shares domestically or on foreign markets. There are three regulated stock markets in France: the Premier Marché (PM), the Second Marché (SM) and the Nouveau Marché (NM). I analyse stock issuance activity on all three of these markets. To do so, I rely primarily on statistics on public share offerings provided in the yearbooks issued for each year from 1975 to 2000 by the Société des Bourses Françaises



**Figure 15.1** Proceeds from public share offerings by French listed companies as a percentage of GDP

(SBF),<sup>7</sup> better known under its commercial name, ParisBourse<sup>SBF</sup> SA, which is responsible for the organisation and operation of all three markets.

I also discuss developments in foreign listings by French companies and the financing role that they have played for corporations that have listed abroad. French corporations have sought listings on a variety of foreign stock exchanges including the US exchanges, the London Stock Exchange, and the EASDAQ. Of these, the US exchanges are by far the most important<sup>8</sup> and, in my discussion, I focus on listings by French corporations on the New York Stock Exchange (NYSE) and the NASDAQ.

Figure 15.1 plots the total cash proceeds raised by French listed companies through public share issues on the Bourse during the 23-year period from 1978 to 2000. The French stock market reached an important turning point in 1985 with all subsequent years registering higher levels of public share issues than had been seen until then. However, the annual figures are volatile and only in the last five years of the century was there a steady rise in stock issuance by listed companies albeit from a rather low point in activity in the mid-1990s. In 2001, there was a decline in the proceeds raised from €37.6 billion in 2000 to €30.5 billion but they remained above the previous peak of €27.8 billion in 1999.

In the SBF statistics, public share offerings by listed companies in France are divided into a number of major types of issues: privatisations of state-owned companies; initial public offerings by privately held companies; offerings by already listed companies (seasoned offerings) of shares and share-like instruments (mostly convertible bonds); public sales of listed shares and a residual category described as ‘other’ which includes shares issued as payment for dividends, shares issued on behalf of employees and the exercise of subscription warrants. I focus on the three most important types of transactions in terms of cash raised: privatisations, IPOs and issues of shares and convertible debt by already listed companies.

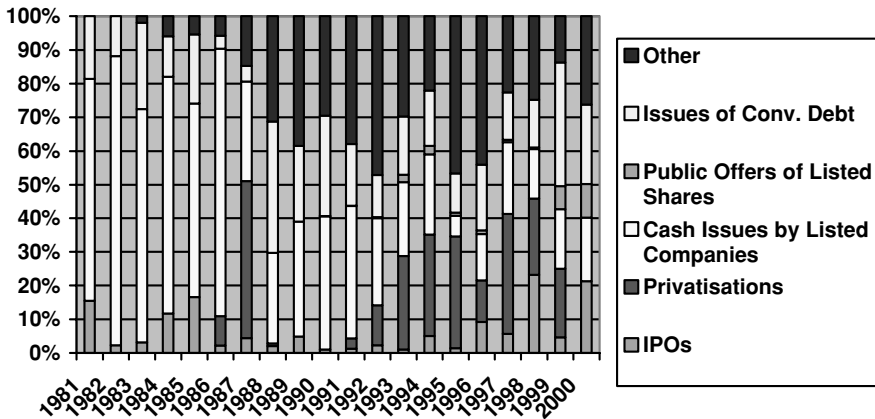


Figure 15.2 Breakdown of public share offerings by listed companies in France

*(i) Privatisations*

From the launch of France’s privatisation programme in 1986, the sale of state-owned companies played an important role in driving the total proceeds from share issues on the French Bourse. During the 15-year period from 1986 to 2000, privatisations accounted for 17.6% of the total proceeds of public share issues by French listed companies. As Figure 15.2 shows, they reached their highest level of relative importance in 1987 when they represented nearly half of the total proceeds raised through public stock issues by domestic companies as well as in 1994, 1995, and 1997 when they represented more than 30% of these proceeds.

An analysis of the uses of the monies raised through privatisation makes it clear that the political momentum for the transfer of ownership from state to private hands was closely linked to its role in shoring up state finances. Of the €10.8 billion received from privatisations from 1986 to 1988, €7.0 billion (65%) was used to pay off the state debt and €3.8 billion was paid in subsidies to enterprises that remained in government ownership. Of the €16.6 billion raised from 1993 to 1995, €12.2 billion (74%) was used to finance the current expenses of the state and €4.3 billion was paid in subsidies to state-owned enterprises (Air France, Bull, Crédit Lyonnais, GAN etc.) (Juvin, 1995). The receipts from privatisations conducted since 1996 were used primarily to finance equity loans, grants and contributions to public enterprises (‘La gauche aura tire pres de 100 milliards de francs des privatisations’, *Les Echos*, 11 February 1999, p. 18).

In short, the vast majority of the money raised through privatisation-related public share offerings in France was raised by and for the French government rather than for the enterprises that were privatised. Even when some money went to other enterprises, in the form of subsidies, it was directed to them by the government rather than the financial markets. As Hervé Juvin noted in his analysis of the financial repercussions of privatisation in France:

The most compelling reason for the privatisations was the state’s budget deficit. In one way or another, every privatisation resulted in a flow of capital from the private sector into the coffers of the state. The primary motivation for the privatisations was financial – the need to fund the current financial requirements of the government and to pay off the state debt – rather than ideological. The modernisation and development of the French financial markets served the dual role of financing the public debt and facilitating the sale of public enterprises much more than the will to finance the private sector. (Juvin, 1995, translated from the original French by the author)

**(ii) Initial public offerings**

The initial public offering (IPO) is the capital-raising transaction most readily associated with the stock market. However, IPOs have never dominated the proceeds from French share issues. In the years prior to 1986, they accounted for at most 15% of the total proceeds of public share issues. From 1986 to 1995 they were never higher than 5% of overall proceeds and they usually amounted to less than that. From the mid-1990s, their relative importance increased and during the period from 1996 to 2000, they accounted for 15% of the proceeds raised through public share offerings. However, in absolute terms, the value of the proceeds raised in IPOs on the French stock market reached unprecedented levels in the last five years of the century; they amounted to an average annual amount of €3.47 billion from 1996 to 2000 which compares with annual averages of €385 million for 1991–95, €378 million for 1986–90, €208 million for 1981–85 and a mere €25 million for 1976–80.

The number of French companies going public, as well as the proceeds raised in IPOs, also soared in the late 1990s. From 1996 to 2000, the average number of companies going public in France each year was 72, more than five times what it had been during the period from 1991 to 1995. Although the number of IPOs per annum was quite high during the 1980s – at 20 from 1981 to 1985 and 40 for 1986 to 1990 – it was still much lower than the late 1990s.

Until the early 1980s the Premier Marché (PM) was the only option available for French companies seeking a domestic listing. Companies quoted on the PM had to have a minimum market capitalisation of €750–800 million and upon listing they were required to sell at least 25% of their total equity to the public. To facilitate listings by smaller, less-established companies, two new markets were introduced in France in the 1980s and 1990s. The Second Marché (SM) was founded in 1983 to encourage medium-sized companies to list their shares. Companies listing on the SM were required to have a minimum market capitalisation of only €12–15 million and a public float of 10% of their equity. In March 1996 the Nouveau Marché (NM) was established to serve the needs of high-growth companies and its listing rules were explicitly modelled on America's NASDAQ. Issuers on the NM could list if they had a minimum capital of €1.5 million and at least 20% of that capital had to be held by the public on listing. Moreover, 100 000 shares of the capital, or shares with a total value of €4.5 million, had to be offered to the public when the company listed of which 50% had to represent a capital increase.

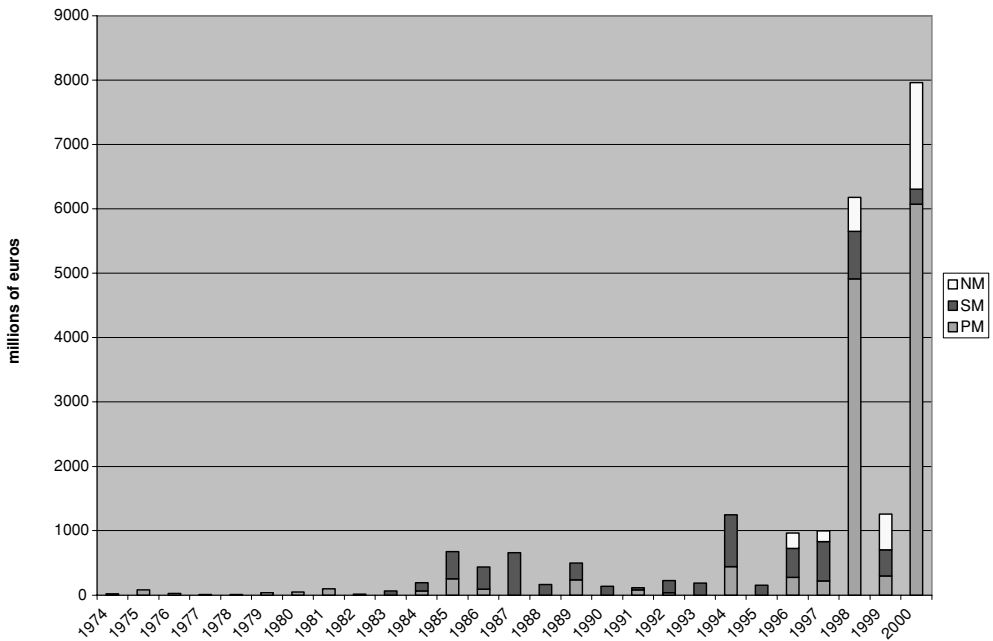
Despite the introduction of these two new markets, transactions on the PM dominated the proceeds raised through IPOs by domestic companies on the French stock markets. For the entire period from 1974 to 2000 the PM accounted for 59% of the total cash raised in IPOs compared with 27% and 14% for the SM and NM respectively. As Figure 15.3 shows, the dominance of the PM was actually greater in the late 1990s than earlier; transactions on the PM represented 68% of all IPO proceeds for the period from 1996 to 2000 compared with 14% for the SM and 18% for the NM.<sup>9</sup>

It is commonly assumed that IPOs are undertaken for the purpose of financing investment by the company going public. However, data on the intended uses of proceeds by French companies completing IPOs suggest otherwise. Certainly, the notion that companies use their IPOs to raise capital for new investment turns out to be problematic as a comprehensive description of activity on the PM.

A list of all the IPO transactions on the PM in which cash was raised<sup>10</sup> is provided in Table 15.1. Although they are few in number they account for 100% of all cash raised in IPOs on the PM and 77% of money raised in all IPOs on the French stock market (PM, SM, and NM) for the period from 1991 to 2000. An analysis of each of these transactions shows that in none of the IPOs undertaken during the 1990s was the primary motivation for the IPO the raising of



## Corporate Governance



**Figure 15.3** Breakdown of value of proceeds of IPOs by market

**Table 15.1** Domestic initial public offerings (excluding privatisation) on the Premier Marché, 1991–2000

Year	Company	Money raised EUR million	Description
1998	Alstom	3779.0	Spin-off
2000	Vivendi Environnement	2361.5	
2000	EADS n.v.	2308.5	
2000	Wanadoo	1710.0	
1998	Rhodia	1128.9	Spin-off
2000	Euler	479.5	
2000	Completel Europe n.v.	476.0	
2000	Liberty Surf	450.5	
2000	Trader.com n.v.	390.0	
2000	Elior	350.7	
1999	Neopost	233.1	
1997	ISIS	219.4	Spin-off
2000	Oberthur Card Systems SA	217.0	
2000	Coface	169.6	
1994	Coflexip	123.6	Spin-off
2000	Kaufman & Broad	118.0	
1994	Technip	64.5	Spin-off
1999	Business Objects	64.4	
1992	CBC (Compagnie Générale de Batiment et de Construction)	38.9	Spin-off

Source: Author's analysis of data from Année Boursière, various years.

capital for the listing company. In some cases, all of the proceeds of the IPO were paid, not to the company going public, but to the previous owners of the businesses. In other cases, such as Neopost and Business Objects, in which the listing company did raise capital for its own purposes, it represented only a minority of the proceeds of the public offering; the primary motivation for these IPOs was also to liquidate the stakes held by existing shareholders in the listing company (O'Sullivan, 2003).

In 2000, however, there were signs of a broadening of IPO activity on the PM. Even if some IPOs still served the purposes of liquidating shareholders, in most cases a much higher proportion of the IPO proceeds went to the listing companies. Particularly notable was the allocation of the IPO proceeds in the largest transactions of the year – the offerings by Wanadoo, Vivendi Environnement and Liberty Surf – where the listing companies received the vast majority of the proceeds raised in their IPOs. However, closer scrutiny of the IPO by Vivendi Environnement suggests that it was really driven by the imperatives of its parent company's restructuring plans rather than its own capital-raising needs. Vivendi transferred a huge amount of the debts of the Vivendi group to Vivendi Environnement and the IPO did little to help the newly listed company meet the enormous financial burden that it inherited.

The year 2001 saw the return of spin-offs undertaken for the direct benefit of the parent company rather than the newly listed entity. The sale of shares in Orange by France Telecom dominated the year's activity raising a massive but disappointing €6.9 billion for the beleaguered parent. Alcatel also spun off its cable business in the IPO of Nexans and absorbed all of the proceeds for its own purposes.

The identity of the companies using IPOs to spin off parts of their businesses suggests an important connection between transactions to retrench and extend corporate boundaries. Alcatel, France Telecom, Vivendi and Rhône-Poulenc (renamed Aventis subsequent to its merger with Hoechst) were all engaged in, or recovering from, major acquisition programmes at the time of their spin-offs. In some cases, there was an even more direct relationship between IPO and acquisition activity. JC Decaux went public in 2001 and retained most of the proceeds of the transaction to refinance the debt it had assumed in pursuing an aggressive strategy of external growth and to fund future acquisitions. For companies going public on the NM, moreover, the use of the proceeds of their IPO to fund external growth was a common strategy (O'Sullivan, 2003).

### ***(iii) Seasoned offerings of share and share-like instruments***

Issues of shares and share-like instruments by already listed companies overwhelmingly dominated capital raising by French companies on the Bourse until the mid-1980s. They amounted to 94.6% of all cash raised through share issues from 1976 to 1980 and 87.5% from 1981 to 1985. As share issuance activity picked up their share declined to 61.9% from 1986 to 1990 and about 40% in the 1990s but they still remained the most important category of public share issue. The vast majority of the proceeds of these types of issues benefited large companies listed on the PM; their seasoned offerings of stock and convertible debt amounted to more than 91% of the proceeds of all such offerings from 1991 to 2000. The SM accounted for about 6% of the total and the NM for just over 2%.

The largest 15 seasoned issues of shares from 1991 to 2000, which accounted for more than 50% of all such issues during that period, are shown in Table 15.2. The largest 15 issues of convertible debt from 1993 to 2000, which accounted for 48% of all convertible issues, are shown in Table 15.3. Information on the intended uses of the proceeds of these issues, which is shown in these tables, reveals that seasoned issues of shares and convertible debt were

**Table 15.2** Fifteen largest public seasoned share offerings for cash, 1991–2000

Year	Issuer	Proceeds (€ millions)	Purpose
2000	Axa	3694.6	Acquisition
1999	Vivendi	2730.3	Acquisition
1997	GAN	1674.3	Recapitalisation
1990	UAP	1600.7	Acquisition of Victoire?
2000	Bouygues	1507.3	General investment including acquisitions
2000	Alcatel	1402.5	Acquisitions
1993	Machines Bull	1303.4	Recapitalisation
1994	Eurotunnel	1111.0	Recapitalisation
1997	Rhône-Poulenc	1067.1	Acquisition
1998	Valéo	1036.7	Acquisition
1994	EuroDisney	907.1	Recapitalisation
1996	Axa	900.1	Purchase of its own shares
1992	Ciments-Français	761.3	n.a. (complicated deal involving Paribas and Italcementi – see earlier draft)
1994	Paribas	631.6	Investment
1993	Générale des Eaux (Vivendi)	630.1	Acquisitions & debt refinancing
1998	Cap Gemini	572.2	Acquisitions

Source: Année Boursière, 1991–99; Autorité des Marchés Financiers, 2000; articles in *Le Point*, *La Tribune*, *Les Echos*, *Financial Times*.

**Table 15.3** Fifteen largest public seasoned convertible debt offerings for cash, 1993–2000

Year	Issuer	Proceeds (€ millions)	Purpose
1999	Vivendi	2850	Acquisition
1998	France Telecom	2,031	Acquisition
2000	Lafarge	1727	Acquisition
1999	Vivendi	1700	Debt refinancing (acquisition related)
1999	Axa	1524	Acquisition
2000	ST Microelectronics	1094	Investment including acquisitions
1999	PPR	1000	Debt refinancing (acquisition related)
1999	ST Microelectronics	768	General Investment
1994	Alcatel	762	Debt refinancing
2000	Thomson Multimedia	800	Investment especially acquisitions
2000	Havas	700	Debt refinancing (acquisition related)
1996	Havas	644	Debt refinancing
1995	Sanofi	624	Investment especially acquisitions
1993	BSN	610	Acquisition
1994	Peugeot	604	Debt refinancing

Source: Année Boursière, 1991–99; Autorité des Marchés Financiers, 2000; articles in *Le Point*, *La Tribune*, *Les Echos*, *Financial Times*.

primarily undertaken to fund acquisitions and/or to recapitalise the issuing company through the reduction of debt rather than to raise capital to finance internal investment. Acquisitions overwhelmingly dominated as an intended use of the proceeds of these issues from the mid-1990s on and, in the second half of the decade, to the extent that debt was refinanced it tended to be acquisition-related debt.

### *Public share offerings for cash by domestic companies on US stock exchanges*

By the end of 2000, a total of 18 French corporations had listed American Depository Receipts (ADRs) on the New York Stock Exchange (NYSE) and a further 14 had ADRs on the NASDAQ. ADRs, also called American Depository Shares, are receipts for the shares of a non-US-based company that are held in trust by a US bank. They entitle the holder to all dividends and capital gains on the underlying shares but the shares, and the votes attached to them, are held in trust for the ADR holder by a US bank. It should be noted, however, that ADRs are convertible into the underlying shares at the holder's request.

Some of the stock issues by French corporations on foreign stock exchanges are captured in the statistics compiled by the ParisBourse. Specifically, when a French company conducts a global offering on the ParisBourse, that is, when it simultaneously offers shares in Paris as well as New York or London, the French statistics capture the total amount. However, 18 issues occurred without any transaction showing up in Paris so they are additional to those discussed above. Data on the proceeds raised in these transactions show that while the monies were sometimes significant for the particular companies involved, especially those listed on NASDAQ, they amounted to a modest amount relative to the total amount of cash raised by French companies on their domestic stock markets.

Among the issues on the NYSE, in three cases – Compagnie Générale de Géophysique (CGG), Groupe AB SA and Alcatel – the primary motivation for their IPOs seems to have been to raise new capital. The remaining transactions, even when they involved some capital raising by the listing company, were not motivated primarily by it. For example, when Groupe Danone listed on the NYSE in 1997, the company's PDG, Franck Riboud, emphasised that 'the objective of the listing on the exchange was not to raise capital'. Rather, he said, the operation allowed the group to show that it 'plays with the big boys'<sup>11</sup> and that it had global ambitions ('Danone a fait son entrée a la Bourse de New York', *Europe Agro-Industrie*, 5 December 1997). Similarly, Gerard de la Martiniere, the president of Axa, noted that '[w]e don't have any capital-raising project in mind for the moment'. Instead, he claimed that '[w]e want to develop the awareness and visibility of Axa and the listing in New York is an important part of that policy' ('L'assureur vient d'enclencher le processus pour son entrée au grand marché américain', *Les Echos*, 29 May 1996, p. 18). SCOR's listing on the NYSE occurred to provide its major shareholders with access to a liquid market in which to unwind some of their shareholdings in the company. Finally, the recent listings by Publicis Groupe SA and Vivendi Universal were entirely motivated by their respective mergers with Saatchi and Saatchi and Seagram.

In two of the French corporate ADRs listed on the NASDAQ, Alcatel Optronics and Havas Advertising, the attractions of using ADRs as a currency for exchange was also the main motivation for listing. However, most of the other French listings on NASDAQ were undertaken for the purpose of raising capital. Coflexip was the first French company to be listed in New York without a listing in Paris. Its president, Christian Marbach, claimed that, in listing in New York: 'our target is not individual investors who have money but pension funds that have

a long-term vision for our sector'. The total proceeds from the company's IPO amounted to approximately €85.4 million; 60% of the total went to Elf Aquitaine and 1'Institut Français du Pétrole (IFP) for the sale of some of their holdings in the company and the other €33.5 million was paid to Coflexip ('Industrie parapétrolière: La Coflexip préfère la Bourse de New York à celle de Paris', *Le Monde*, 10 December 1993). Another five companies – Business Objects, Flamel Technologie, Ilog SA, Edap-Tms SA, and ActivCard SA – also completed significant capital-raising transactions through their IPOs on the NASDAQ.<sup>12</sup>

### *Trends in share issues in exchange for shares by French listed corporations*

The discussion above highlights the major importance of acquisitions in motivating issues of shares and convertible debt for cash by French companies. That phenomenon is linked to the recent dramatic expansion in their use of external growth, including overseas acquisitions, as a strategy for expansion. The first phase of the increase in M&A transactions occurred between the late 1980s and the beginning of the 1990s. French corporations embarked on a race to consolidate their strategic positions when, with the passage of the Single European Act in 1986, the pace of European integration seemed likely to accelerate (for a detailed account, see Schmidt, 1996, pp. 358–368).

A lull in M&A activity followed from 1992 to 1994 but, in 1995, there was a resurgence in the number of deals concluded. From then until the end of the century, the total value of M&A transactions involving French companies reached unprecedented highs driven not so much by a greater number of deals as by an enormous increase in the average deal value. While there has been an expansion in the value of all types of deals involving French companies, the increase was most dramatic for deals in which French companies were acquirers rather than targets.

In concluding M&A deals, especially domestic deals, there was a growing tendency to rely on share-for-share exchanges. By the end of the 1990s, French companies displayed a marked preference towards the end of the 1990s for exchange offers as opposed to cash offers in concluding their very largest deals. In contrast to the clear trend towards shares as the preferred medium of exchange in domestic transactions, however, moves in that direction were slower in the case of foreign acquisitions. With some notable exceptions, such as Vivendi's acquisition of Seagram, French companies have paid for many of their largest foreign acquisitions in cash, a fact that explains their aforementioned tendency to appeal to the share or convertible debt markets to finance these purchases.

Especially when target companies were based in the US and the UK, the main reason for the lesser reliance on shares was the reluctance by, and in some cases inability of, shareholders of these companies to accept shares of French companies as payment for M&A transactions. Cross-listing on the NYSE or the NASDAQ was a way around this problem. As the PDG of Havas Advertising, Alain de Pouzilhac, put it: '[i]f you want to have what they call a "currency", which is a currency that counts, you have to be quoted in the United States... If we hadn't done it [listed in New York] we would not have acquired Snyder because French paper cannot be exchanged for American paper and then we would have had to pay cash. It is, therefore, indispensable to be listed in the United States if you want to expand through share exchanges' ('Alain de Pouzilhac, PDG d'Havas Advertising', *La Tribune*, 13 November 2000, p. 22).

### *Trends in debt issues by French listed corporations*

For understanding trends in debt issues by French listed corporations, it is in principle possible to complete a similar analysis of bond issues to that which I have undertaken for share issues. However, there is limited value in such an exercise since, in raising debt, companies rely not only

on bond issues but also on intermediated debt. The importance of market-based debt instruments in the total indebtedness of French non-financial enterprises substantially increased in the last 25 years. Bonds increased from an average of 6.5% of these companies' total indebtedness from 1978 to 1982 to 11.5% from 1986 to 1992 and reached a level of 14% in the last years of the century. The importance of commercial paper also increased from zero in 1984 to 4% of total debt from 1989 to 1998 before rising to 7% at the end of the 1990s. Although debt owed to financial intermediaries declined from two-thirds to one-half of total indebtedness, it still remained the most important source of debt for French non-financial enterprises.

Unfortunately, firm-level data for intermediated debt are not readily available, making it impossible to study companies' debt-raising transactions and their stated purposes in the way that I have done for share issues. However, it is possible to analyse trends in, and determinants of, debt levels using data from companies' financial accounts. In a recent article, Claude Picart, a statistician at INSEE, the French national statistical office, used these data to show that the debt levels of different types of French-based companies displayed considerable variation from the middle of the 1990s. In contrast to the debt increase from 1989 to 1993, which was experienced by all major categories of French non-financial enterprises, there was a marked differentiation in the trends in leverage in the late 1990s.

Listed companies, especially the most liquid ones which are included in the SBF 120 index, as well as state-owned enterprises experienced a major increase in debt levels. In contrast, there was a gradual reduction in the indebtedness of other types of non-financial enterprise in the late 1990s. As a result, by 2000, SBF companies and state-owned enterprises accounted for 52% of the indebtedness of non-financial enterprises compared with only 30% of their aggregate value added (Picart, 2003, p. 213).

Based on data from INSEE's database of financial accounts for the 98 non-financial companies in the SBF index, Picart found that rising indebtedness was not confined to the two or three large corporations that have recently become the target of unwelcome media attention in France; in fact, 39 of these 98 groups more than doubled their debt levels. Moreover, rising indebtedness was strongly associated with the growing propensity by French companies to expand, especially internationally, through external growth; companies that internationalised most in the late 1990s were those that experienced the most rapid increase in indebtedness (Picart, 2003).

## **IMPLICATIONS FOR FRENCH CORPORATE GOVERNANCE**

In this section I consider the implications of my analysis of changes in the ownership and financing of French corporations for the governance of these enterprises. There have certainly been important developments in the distribution of corporate control in the French corporate economy but it remained firmly in the hands of insiders through the 1990s into the new century. However, there was an important change in the way that insiders exercised their control. In particular, they used their strategic power to greatly expand the presence of their companies in international markets. It is, as yet, difficult to say what the consequences of their actions will be for the stakeholders of French corporations but there is suggestive, if inconclusive, evidence of changes in the distribution of returns towards financial interests and senior executives at the expense of the workforce, especially French labour.

Even though insiders largely remained in control of the French corporate economy into the new century, it is still possible that an unintended consequence of their heavy reliance on financial markets to pursue external growth will be a loss in control to outsiders, especially outside financiers. I consider whether a shift from insider to outsider control is likely to happen in France in the near future. I argue that to the extent that it occurs, it will do so under very specific conditions that apply only to a small number of cases. Moreover, if we look at what has happened in the few cases in which these conditions have already been satisfied, it is apparent that, even then, the assumption of control by outsiders is not automatic.

## The Distribution of Corporate Control

The most important and clear-cut change in the distribution of corporate control in France stems from the marked decline in the role of the state in the French corporate sector. That change occurred in part as a result of the massive transfer of ownership of corporate enterprises from the public to the private sector through successive privatisation programmes. It also resulted from the systemic change in the financing of French enterprises that led to a decline in the capacity of the state to directly influence the allocation of financial resources to business enterprises.

The way in which the state withdrew from its involvement in the French enterprise sector had important implications for the subsequent control of French corporations. In this regard, its behaviour with respect to the ownership and financing of newly privatised enterprises was somewhat paradoxical. On the one hand, in instituting a system of cross-shareholding, it provided the top managers of privatised enterprises, who were typically appointed to their positions by the state, with considerable protection from the demands of purely financial interests. However, in absorbing the proceeds of the privatisations for government purposes, it restricted the financial autonomy of privatised companies, thus increasing the likelihood that they would have to return to the financial markets to get access to capital.

Ironically, one of the ways that privatised enterprises bolstered their treasuries in the late 1990s was by unwinding their cross-shareholdings. As to why they waited until then to do so, part of the explanation can be found in trends in French share prices. The performance of the CAC40 index was uninspired from the end of the 1990s until the middle of 1996. However, from the beginning of September 1996 the index took off from a level of about 2000 and continued its upward climb, almost uninterrupted with the exception of a sharp decline in late summer 1998, to nearly 7000 in early September of 2000.<sup>13</sup> As a result, the value of the shares that French companies held as part of cross-shareholding networks soared and, correspondingly, companies' incentives to liquidate them rose.

At around the same time, the financial needs of these companies dramatically increased. A worldwide wave of mergers and acquisitions got underway from the mid-1990s in several of the industries in which French companies were prominent. To the extent that large French companies wanted to bolster their competitive positions, through consolidation at home and expansion abroad, they needed access to funds to support their external growth. One ready source of funds was available from the liquidation of their cross-shareholdings.

From this perspective, the fact that Axa was a first mover in unwinding its cross-shareholdings is no surprise. External growth had long been a crucial element in its strategy for expansion and, in the 1990s, the company became committed to an aggressive programme of overseas acquisition. Shortly after its merger with UAP, Claude Bébéar, Axa's chief executive of the combined company, emphasised that, in allying with UAP, '[w]e have decided to become

a global actor'. In fact, Axa's global ambitions were already apparent prior to the merger; it raised capital earlier in the 1990s from the equity and bond markets that was explicitly intended to fund its international expansion ('Axa in Ffr2.3 billion issue of convertible bonds', *Financial Times*, 4 April 1995, p. 32). The liquidations of its extensive cross-shareholdings at the time of a rising market provided the insurer with a further source of funds to strengthen its position in the rapidly consolidating global insurance industry.

Faced with similar incentives, other large French companies followed suit in liquidating their holdings of shares in privatised enterprises. In unwinding the cross-shareholding network that the state had established, top managers of privatised enterprises gained greater strategic autonomy for themselves. As a result, as the 1990s unfolded, these men looked less and less like servants of the French state and more and more like tycoons such as Bernard Arnault and François Pinault and even Claude Bébéar, who had largely built up their own business empires.<sup>14</sup> It was these types of men who were largely in control of the destiny of the French corporate sector towards the end of the twentieth century. It was the pursuit of their ambitions to become global leaders through strategies of external growth, strategies financed by a heavy reliance on external finance, which brought the financial markets to greater prominence in French capitalism than they had previously attained in the post-war period.

My interpretation of changes in the distribution of control of large French corporations is different from that advanced by other scholars based on an analysis of changes in corporate ownership in France. Michel Goyer, for example, argues that '[t]he transformation of the French system of corporate governance is nothing short of impressive: in less than a decade, France shifted from an insider to an outsider model' (Goyer, 2001). He emphasises, in particular, the growing role of foreign investors, 'composed primarily of Anglo-American mutual and pension funds' and argues that '[o]n some critical indicators of corporate governance – related to the internal decision-making process and business strategy – French corporations have gone to great lengths to meet the preferences of Anglo-Saxon institutions investors' (Goyer, 2001). Of particular importance, he argues, is French companies' shift from conglomerate strategies to a focus on their core competences.

In a similar vein, Morin speaks of a revolution in French corporate governance: '[d]irectly inspired by the American "shareholder value" model, the largest French groups are going through a managerial revolution' (Morin, 2000). He goes on to say that the CAC40 companies are now forced to obey the diktat of financial markets, in other words, that 'the largest French firms are subject to Anglo-Saxon management and return on capital norms' (Morin, 2000).

My analysis of the changing interaction between the corporate sector and the financial system suggests problems with the timing and chain of causation underlying these accounts. French managers were already engaged in massive restructuring before the unwinding of cross-shareholding networks and the most important incursions of foreign shareholders; based on my account, these developments were instruments rather than causes of change. For example, in contrast to Goyer who claims that firms sold their cross-shareholdings 'in an effort to convince foreign investors that they would be responsive to shareholder concerns', I have argued that French firms did so because it suited them to do so at the time since valuations were relatively high and they wanted the cash to pursue their global ambitions. In short, the chain of causation runs from managerial action to changes in shareholding patterns rather than the other way around.

There is no question that French companies' use of financial markets to fund their external growth has brought them into much closer contact with portfolio shareholders, especially



foreign institutional shareholders, than was previously the case. The unwinding of cross-shareholding relationships eliminated some large, friendly shareholders. At the same time, companies' reliance on equity markets to fund their growth, at least for some companies, led to a further dilution of their ownership structures. However, as shareholder activists are well aware, a change in ownership towards a more diffuse shareholding structure does not automatically lead to an increase in the control exercised by portfolio shareholders over corporate activity.

The greatest concern among proponents of shareholder activism in France, as in other countries, is the passivity of portfolio shareholders and their lack of real influence over corporate decision making. Since foreign shareholders are even less likely than domestic shareholders to exercise their voting rights, French companies have tended to be even more insulated from the influence of portfolio shareholders than their US and UK counterparts. Moreover, in some cases, these companies have taken active steps, such as the award of double voting rights to long-term shareholders, to limit the voting power of outsiders.

One result of the fact that shareholders, even dissatisfied shareholders, do not necessarily express their views on particular corporate decisions in an unambiguous way is that French managers have been able to manipulate the rhetoric of shareholder value for their own purposes. They have been able to claim to deliver 'what the shareholders want' because what that is tends to be quite ambiguous. For several years, Jean-Marie Messier, the notorious former CEO of Vivendi, was highly effective at creating the space to pursue his own strategic actions by claiming to be responsive to his shareholders' interests.

The events surrounding Vivendi's acquisition of Seagram are illustrative. When Messier announced that he was in talks to acquire the Seagram company, Vivendi's share price fell 10% in one day ('Vivendi chief bets on his ability to create media empire', *New York Times*, 15 June 2000, p. C4). One analyst was quoted by *Les Echos* as saying that he had not met one Vivendi investor who was favourably disposed towards the deal. In the short term, he claimed, the deal destroyed value and the promises for the future of the group were still highly uncertain ('Les marches restent sceptiques sur la fusion Vivendi-Seagram', *Les Echos*, 17 July 2000). On 5 December 2000, the day of Vivendi's extraordinary general meeting in which the deal was put to a vote of the shareholders, the climate surrounding the deal was described in *La Tribune* as 'uncertain' with Vivendi's share price having declined 50% from its highest point that year and 13% since the announcement of the merger ('Vivendi-Universal entre de plain pied dans la réalité', *La Tribune*, 5 December 2000).

In fact, the deal received 'le oui' from shareholders represented at the meeting. Indeed, not only did they approve the deal but they did so with an overwhelming majority of 94.97%. Little wonder that Messier was jubilant and addressed the Vivendi shareholders in the following terms: 'your exceptional mobilization is the strongest and finest response to the narrow corporatist views that we've seen since the project was announced, and to the irritable skepticism so typical of the French when faced with such a bold move' (text of Jean-Marie Messier's address to Vivendi's Extraordinary Shareholder Meeting, 5 December 2000, [www.vivendi.com](http://www.vivendi.com)).

However, by then sufficient numbers of Vivendi's shareholders had voted 'no' with their feet to substantially drive down the price of Vivendi shares. Moreover, those who voted in favour of the deal did not represent a majority even of the shareholders that remained. Only 39.6% of shareholders were present or represented at the meeting that approved the deal. Although that proportion was a substantial increase on the usual representation at shareholder meetings in France – Messier noted that four or five times as many shareholders as usual had voted at the meeting on 5 December – it still represented only a minority of Vivendi shareholders.

Nevertheless, it provided Messier with the apparent support that he needed to go forward with the acquisition.

The example of Vivendi suggests that a greater diffusion of share ownership, in and of itself, does not imply a serious contestation of insider control even when a particular strategic action, such as an acquisition, is highly controversial. Most strategic actions are much less controversial and, as a result, they are less subject to the scrutiny of outsiders. In these cases, portfolio shareholders are less likely to be able to effectively contest managerial control because they are so reliant on insiders for judgements of the merits of these actions. Nevertheless, the case of Vivendi and, in particular, the fact that Messier was ultimately subjected to sufficient pressure to resign his post, also suggests that there are limits to insiders' scope for strategic manoeuvre. However, as I shall argue below, the conditions under which these limits are imposed are quite restricted and to date, at least in the French case, the role of portfolio shareholders in constraining managerial excesses has been limited.

In analysing developments in the distribution of control in the French corporate economy, I have focused on what has happened in large, established companies. There can also be a change in corporate control through a decline in the relative importance of these large enterprises in the corporate economy. Certainly, the rhetoric that accompanied the development of financial markets in France often linked their expansion to improved opportunities for small and medium-sized enterprises and, in the late 1990s, to the rise of a 'new economy' in France. However, the evidence that I have presented clearly shows that financial flows from the financial system to the corporate economy were dominated by large French enterprises. That is not to say that these developments did not benefit smaller companies<sup>15</sup> only that they reinforced rather than undermined the dominant role that large firms play in the French enterprise sector.

## The Exercise of Corporate Control

The most striking characteristic of recent developments in corporate governance in France has been the marked change in the way in which French executives exercised their control. From the middle of the 1990s, they have used it to expand to a much greater extent than before through external growth especially acquisitions of foreign companies. The value of mergers and acquisitions of foreign firms by French companies increased from 0.6% of Gross Domestic Product (GDP) in 1995 to 1.5% in 1997 and 6.1% in 1999 before reaching a peak of 12.9% in 2000. It declined in 2001 and 2002 to 4.5% and 2.4% respectively but still remained well above the level of the mid-1990s (UNCTAD, 2003).

One way to observe the extent of this activity is through an analysis of the French companies on UNCTAD's list of the top 100 transnational companies in the world. There were eight French companies on this list in 1993 but the number was 13 in 1997 and 2003. Moreover, most members of this group of French companies increased the extent of their internationalisation faster than their average counterpart and thus moved up the ranks of transnational companies.

Growing internationalisation was not confined to the few French companies that have made it to the ranks of the top 100 TNCs. In a recent article, Lise Dervieux documented the trends in internationalisation for the 32 non-financial companies in the CAC40. She presented evidence of a marked increase in the internationalisation of these companies from 1997 to 2002. During this period, foreign sales increased from 56% to 65% of total sales for her sample of companies. Foreign employment increased from 50% to 65% of total employment and the foreign share of fixed tangible assets rose from 45% to 68%. The growing share of international operations

in these companies' total activity reflects a dramatic expansion in their foreign operations compared to slow growth and even a decline in their levels of activity in France (Dervieux, 2003).

## The Implications of Corporate Control

What are the implications of corporate control in France today and how has that changed from the past? The answers to these questions turn on two major issues. First, is the total pie to be split among the stakeholders of French corporations bigger or smaller as a result of the way in which corporate control was distributed and exercised from the middle of the 1990s? Second, has there been a shift in the distribution of that pie among different stakeholders in French corporations?

Arguably, it is too early to judge the performance implications of the strategies that French companies have pursued from the middle of the 1990s but I can at least point to some early indicators of trends in profitability. Starting with an analysis of profitability of the companies of French origin that appear on the list of the top 100 TNCs it is apparent that profitability trends are quite differentiated. For most of these companies, there is no evidence of any marked improvement or deterioration in performance in recent years. However, three companies – Vivendi, Alcatel and EDF – experienced a major deterioration in their net profits. The profitability of Suez also declined but only in the last year, 2002, for which we have data.

In each of these cases, the losses sustained were directly attributable to external strategies for growth being driven to an important degree by extraordinary (non-recurring) items, primarily the write-off of premia paid in acquisitions that subsequently appeared to be unjustified. These results are in accordance with evidence presented by Picart (2003) on recent developments in the profitability of all French non-financial companies included in the SBF 120. It shows that the four most indebted groups in France experienced a dramatic decline in performance in 2001 and that it was linked to the write-off of goodwill from acquisitions. The profitability of the other companies in his sample, taken as a group, also fell in 2001, albeit to a lesser extent, and the decline also seems to have been related to extraordinary write-offs.

Besides the examples of companies with major losses that I have already mentioned, as well as several other examples such as Alstom and Rhodia, there is as yet no evidence of a major and systematic change in the fortunes of French listed corporations that might be attributed to the expansionary strategies that they have pursued from the middle of the 1990s. However, as I have already said, it is really too early to judge their results since only the most egregious examples of failure would show up so quickly. Moreover, I have made no attempt to control for industry and other factors that might affect profitability besides corporate strategy. All I can say based on the evidence currently available is that, with the exception of a few cases, there is no 'smoking gun' that suggests a clear change in the size of the pie that French corporations have available to them for distribution to their stakeholders.

Returns to stakeholders are influenced not only by the scale of resources that corporations generate but also by the way in which they allocate them. In scholarly discussions, several types of distributional changes have been highlighted in the French enterprise sector. One is a shift of resources in favour of capital and away from labour in the distribution of the value added of French enterprises (Askenazy, 2003). Second, growing executive compensation has raised concerns about a shift in relative compensation for different types of employees. A third

development is a growing pressure on the returns to French stakeholders, as well as investments in French activities that may affect their future returns, as companies use resources more intensively to support their foreign operations (Picart, 2003). Assessing the extent to which there is a demonstrable link between these outcomes and the developments in corporate control that I have described is certainly a subject that merits further treatment but it goes beyond the scope of this chapter.

## Will Outsider Control Emerge as an Unintended Consequence of Insider Strategies?

To argue, as I have, that insiders precipitated the crucial changes that made financial investors more prominent in the French system of capitalism is not to say that these insiders can control what happens from there. It is possible that French corporate executives' increased use of the financial markets for facilitating their expansionary strategies will have the unintended consequence of diminishing their control over the French corporate economy. It is true that, in courting financial markets to persuade them to underwrite their strategies of external growth, French corporate executives were willing to countenance 'investor-friendly' changes in corporate governance that have outlived the strategies themselves. In this regard, scholars have emphasised the importance of the succession of reports on corporate governance that have been produced in France from the middle of the 1990s – the Vienot reports (I and II) and the Bouton Report – that seek to define 'best practices' with respect to board composition and other formal dimensions of corporate governance.

There is no question that French companies have made significant efforts to comply with these recommendations; for example, France scores much higher than either x or y in terms of board independence (Goyer, 2001, p. x). However, it has yet to be shown that formal 'independence' translates into actual independence of French boards and, more generally, that conformity to governance codes changes the distribution and/or exercise of corporate control. If these developments are to provide the basis for a greater contestation of control from outsiders than has heretofore been the case in France, they are likely to be effective only to the extent that there is substantial momentum from outside financial interests behind them. Therefore, the central question that needs to be addressed about the future of corporate control in France is whether such momentum is likely to be forthcoming. Put differently, to what extent are outside financial interests likely to gain greater influence over French corporations on the basis of their ownership or financial relationships with French corporations?

As far as ownership relations are concerned, while it is true that a greater diffusion of share ownership in and of itself is unlikely to make a major difference to the ongoing exercise of control, that diffusion may well matter to the extent that it has made some French companies vulnerable to takeover threats. Two recent hostile takeover bids have made this threat to large French companies seem very real. In July 2003, the Canadian company, Alcan, launched a hostile bid to secure control of P  chiney. Shortly afterwards, in January 2004, Sanofi-Synth  labo, the French pharmaceuticals company, announced a hostile bid to acquire Aventis, its much larger counterpart.

Both bids were ultimately successful and they highlighted the fact that the threat of takeover is a serious one for some major French companies. Indeed, in early 2004 *L'Expansion* ran an article in which it highlighted the vulnerability of a number of prominent French companies to such a threat ('Alerte OPA! Le retour des manoeuvres', *L'Expansion*, 1 March 2004, p. 94).

Nevertheless, as I have noted, many large French companies still have a concentrated ownership structure and, therefore, are not as vulnerable to takeover threats as companies like P  chiney and Aventis. Moreover, the question of whether we are likely to see the wave of hostile takeover activity that would be necessary to systematically threaten the autonomy of French companies is an open one.

Historically, such waves have occurred when financial raiders abound as they did in the US and the UK in the 1980s. In France, there are few examples of financial raiders who systematically seek out companies that are undervalued by the financial markets. Most takeover activity has been undertaken to achieve industrial objectives. Therefore, the likelihood of a wave of takeovers depends less on what is happening in financial markets and more on the extent of consolidation in the industries in which French firms are prominent. If that is true, then, as I suggest below, an analysis of industrial structures may shed more light on corporate governance than an analysis of ownership structures.

A shift in control over French corporations could also occur as a result of a high dependence on the financial markets to sustain their operations. To the extent that they really need these markets to fund their ongoing operations, it seems reasonable to expect that these companies would have to comply with at least some of the demands of investors. In this way, the autonomy of insiders would be compromised. While this seems like a plausible scenario, there are very few cases in which it has actually happened in France.

First, there is little evidence of a systematic increase in the financial fragility of French corporations even if the scale of their internal resources has declined recently. The non-financial enterprise sector continued to generate internal resources on a scale that was almost sufficient to fund its ongoing capital investments. As I have emphasised, in resorting to financial markets on a massive scale in the 1990s, French corporations did so largely to fund acquisitions. These large ticket expenditures are usually seen as a more discretionary form of investment than ongoing commitments to existing operations and, therefore, easier to defer in the face of financial constraints. Moreover, given the slowdown in global M&A activity, French companies' expenditures on acquisitions have dramatically declined across the board.

However, even if French companies exercise considerable discretion over the extent of their *future* mergers and acquisitions, some of them are in a precarious financial position as a result of their *past* reliance on aggressive strategies of external growth. In Table 15.4 I show the companies with particularly high debt levels among France's largest 100 listed corporations.<sup>16</sup> While many of these companies are on the list because of the financing demands associated with funding their acquisition activity, this is not true in all cases especially for some of the state-owned enterprises. Moreover, some of France's most active acquirers do not appear on this list either because their profits are sufficient to allow them to comfortably service their debt and/or they relied more heavily on equity than debt to fund their external growth and/or they have already forestalled the problems associated with excessive debt by selling some of the overseas assets that they acquired in recent years.

Asset sales have also been undertaken by firms that remain on the list of French corporations with high levels of indebtedness. All of these firms are in the throes of major restructuring operations. In some cases, the PDG, or another senior executive, has lost his job to 'take responsibility' for the strategic decisions that plunged the company into financial crisis. Shareholders have applied considerable pressure for the removal of top managers in these companies but so far only in the case of Eurotunnel, a company with a long history of hostility between shareholders and managers, have enough votes been marshalled to fire a senior executive at the shareholders' meeting.

**Table 15.4** France's most indebted large listed companies

Company	Gearing	Interest cover (times)
Alstom	1290%	-3.37
Geodis	460%	1.52
Penauille Polyservices	342%	0.98
CEA-Industrie	331%	0.86
Finatis	311%	2.41
Autoroutes du Sud de la France	290%	1.63
SNCF Participations	246%	2.30
France Telecom	238%*	2.29*
Suez	217%	2.34
Rhodia	211%	1.62
Véolia Environnement	190%	2.81
Thales	182%	2.14
Alcatel	168%	-2.64
Lagardere SCA	150%	1.20
Lafarge	148%	2.58
Fimalac	134%	2.28
Faurecia	131%	1.93
Air France	130%	1.03
Provimi	115%	2.34
Vivendi Universal	113%	1.78

\*2003

Source: Author's analysis based on Amadeus database.

Indeed, even in cases of serious financial difficulty, it is striking how little influence outside financial interests gained in the process of resolving the crises that these companies faced. Vivendi is perhaps the most interesting example since its financial problems were so serious, reportedly bringing the company to the brink of bankruptcy. Messier, its flamboyant chief executive, was pressured out of office in late 2000. The Bronfman family, the company's largest shareholder since its acquisition of Seagram, had tried to remove Messier earlier and to replace him with Edgar Bronfman, Jr, but they were unable to get the approval of the board to do so. The momentum to remove and replace Messier ultimately came from quintessential insiders to the French system who 'persuaded' him to resign.

Claude Bébéar, often described as the godfather of French capitalism, was a particularly important player even though he initially had no formal relationship to Vivendi Universal. He apparently recommended that Jean-René Fourtou, the former CEO of Rhône-Poulenc and a personal friend, replace Messier and then provided his assistance in securing the cooperation of the financial community in recapitalising Vivendi. In reflecting on the reasons for Vivendi's survival, Fourtou remarked that '[w]ithout my credibility as ex-PDG of Rhône-Poulenc and that of Claude Bébéar, the former president of Axa, we would not have obtained the necessary funds from the banks to save the company from bankruptcy... We each had a list of bankers to call and we did not hesitate to rely on the weight of Aventis and Axa to convince the banks to lend us the funds' ('Le président de Vivendi Universal s'est expliqué devant la commission des finance', *Le Figaro*, 27 September 2002). Given the resilience of the inside control of the French managerial elite even in the case of Vivendi we cannot assume that financial interests will necessarily gain control even in times of financial distress.

## **THE ROLE OF STRUCTURE IN CORPORATE GOVERNANCE**

Having considered the characteristics of the change that has occurred in French corporate governance, I turn, in conclusion, to consider the role of structure in the analysis of corporate governance. The first phase of the changes that I described involved the withdrawal of the French state from the ownership and financing of corporate enterprises. Political scientists have already analysed these developments to understand how and why the decisions that led to these changes were made within the relatively stable context of the state bureaucracy (Loriaux, 1991). Less attention has been devoted to analysing the interaction between structure and agency that led prominent French corporate managers to aggressively pursue strategies of external growth and to rely so heavily on financial markets to achieve their objectives.

Notwithstanding the emphasis on ownership in structural analyses of corporate governance, patterns of corporate ownership do not predict these industrial and financial strategies. However, I point to alternative structural arguments that may shed more light on the changing interactions between the French corporate economy and the financial system. In particular, I emphasise the role of industrial structure as well as the social structure of the French corporate economy as potential explanations for the propensity of French companies to expand so aggressively through external growth.

### **Corporate Ownership and Control**

As I have noted, ownership structure plays a privileged role in the empirical analysis of corporate governance. However, it does not bear a clear-cut relationship to the strategic actions – the reliance on external growth, especially foreign acquisitions, and the use of external finance to fund that growth – that have played a central role in bringing about a major change in the relationship between corporations and the financial system in France. Indeed, for some companies the direction of causation appears to go the other way, from strategy to ownership structure.

With respect to the industrial strategies pursued by French corporations, we find a heavy reliance on external growth, and foreign acquisitions in particular, by firms with very different ownership structures. In Table 15.5 I present data on the ownership structures of some of France's most acquisitive companies in 1997 and 2002. They reveal a heterogeneous mix including state-owned enterprises like France Telecom, widely held companies such as Alcatel, Danone and Vivendi, as well as closely held corporations like LVMH and PPR. Most of the companies, including Aventis, Axa, Cap Gemini, Carrefour, Suez and Valeo, are somewhere in between with at least one shareholder holding more than 10%, but less than 40%, of the voting rights. Clearly, there is no particular type of ownership structure that predisposes companies to pursue these types of industrial strategy.

It is possible that it is not the industrial strategy that a company pursues but the way it is financed that is influenced by ownership structure. There is certainly evidence of such a link for the state-owned enterprises that racked up large debts in funding overseas expansion in recent years. The cases of France Telecom and EDF are illustrative. They funded their aggressive programme of acquisitions largely through debt. They did so because, on the one hand, the government was unwilling to invest in these companies<sup>17</sup> and, on the other hand, the state

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**Table 15.5** *Ownership structures of a sample of large acquisitive French corporations*

Company and Shareholders	% of shares		% of voting rights	
	1997	2002	1997	2002
<i>Alcatel</i>				
Caisse des Depots et Consignations Group		5.91		6.14
Employees		0.92		2.57
Société Générale		0.90		1.64
Alcatel Subsidiaries		3.35		—
Treasury Stock		2.00		—
Public		86.48		89.65
<i>Aventis</i>				
Groupe Kuwait Petroleum		13.50		13.50
Société Générale	3.00		3.00	
AGF	2.50		2.50	
BNP	1.50		1.50	
Credit Suisse	0.70		0.70	
Fiat	0.70		0.70	
Axa	0.50		0.50	
CDR Participations	0.40		0.40	
Autocontrôle	0.05		0.05	
Public	90.65	86.50	90.65	86.50
<i>Axa</i>				
Mutuelles Axa of which	25.90	20.47	37.80	33.15
– Mutuelles Axa	3.50	2.78	5.00	4.45
– Finaxa	22.40	17.69	32.80	28.70
BNP	7.70	—	6.60	—
Employees and Agents	—	4.06	—	4.26
Autocontrôle	3.90	1.69	—	—
Public	62.50	73.78	55.50	62.59
<i>Cap Gemini</i>				
Wendel Investissement (formerly CGIP)	30.00	11.10	30.00	11.10
Serge Kampf	16.00	5.70	16.00	5.70
Paul Hermelin	—	0.10	—	0.10
Public	54.00	83.10	54.00	83.10
<i>Carrefour</i>				
Groupe Familial Halley	—	11.46	—	18.39
Familles Badin-Defforey-Fournier	—	5.15	—	5.98
Groupe March	5.14	3.27	7.16	5.28
Société de Noyange	18.57	—	28.82	—
Employees	2.40	2.98	3.01	3.03
Autodetention	1.81	0.60	—	—
Public	72.08	76.54	61.01	67.34
<i>Groupe Danone</i>				
	Apr 1999		Apr 1999	
Eurazeo	5.36	3.97	8.61	3.88
Worms & Cie	4.89	1.26	6.44	2.43
Caisse des Depots et Consignations Group	—	2.50	—	2.42

(Continued)



## Corporate Governance

**Table 15.5** (Continued)

Company and Shareholders	% of shares		% of voting rights	
	1997	2002	1997	2002
FCPE «Fonds Groupe Danone»	—	1.28	—	2.03
Autocontrôle and Subsidiaries	7.13	5.86	—	—
FINDIM Investissements	2.21	—	4.22	—
Axa	1.42	—	1.49	—
Public	78.99	85.13	79.24	89.24
<i>France Telecom</i>				
French State		56.59		61.53
Autocontrôle		8.03		—
Employees		3.10		3.37
Public		32.28		35.10
<i>LVMH</i>				
Groupe Arnault	44.09	47.70	59.22	64.42
Autodetention	—	4.34	—	—
Autocontrôle	—	0.59	—	—
Public	55.91	47.37	40.78	35.58
<i>Suez</i>				
	1 Sep 1997		1 Sep 1997	
Groupe Bruxelles Lambert	10.70	7.20	12.60	12.50
Employees	0.70	4.00	0.70	4.50
Credit Agricole	6.10	3.30	10.50	5.70
CDC	3.10	3.20	4.40	3.80
Cogema	3.10	2.30	2.80	2.80
CNP Assurances	2.10	1.60	1.90	1.40
Caixa	—	1.50	—	1.40
Sofina	—	1.00	—	0.90
Fortis	2.20	—	2.00	—
Axa	2.00	—	1.80	—
Autodetention/ Autocontrôle	1.70	1.30	—	—
Public	68.30	74.60	63.30	67.00
<i>PPR</i>				
Artemis	42.50	42.20	58.10	57.00
Guilbert-Cuvelier	—	2.50	—	3.70
PPR	—	4.70	—	3.70
Employees	—	0.80	—	0.70
Public	57.50	49.80	41.90	38.60
<i>Valeo</i>				
Wendel Investissement (ex-CGIP)	20.18	9.40	18.65	15.96
CDC	6.79	7.87	8.19	9.82
Franklin Resources Inc.	—	12.84	—	11.53
Autodetention	—	0.74	—	—
Public	73.03	69.15	73.16	62.69
<i>Vivendi</i>				
	Jan-1999		Jan-1999	
Bronfman Family	—	4.23	—	4.23
Phillips	—	3.58	—	3.58
Liberty Media Group	—	3.49	—	3.49

**Table 15.5** (Continued)

Company and Shareholders	% of shares		% of voting rights	
	1997	2002	1997	2002
Employees	2.42	1.65	3.38	1.65
CDC	—	1.78	—	1.78
Citigroup Inc.	—	1.69	—	1.69
Société Générale	0.66	1.45	0.78	1.45
Cie de Saint Gobain	6.28	1.15	11.51	1.15
UBS Warburg	—	0.91	—	0.91
BNP Paribas	—	0.79	—	0.79
PEG Vivendi Environnement	—	0.69	—	0.69
Seydoux	—	0.27	—	0.27
Axa	1.68	0.04	1.99	0.04
Canal+	—	0.01	—	—
Alcatel	3.39	—	4.68	—
BNP	0.70	—	1.28	—
Autodetention	2.51	0.04	—	0.04
Public	82.36	78.24	76.38	78.24

*Source:* Author's analysis based on annual reports.

refused to permit the dilution of its stake that would result from an issue of new shares by these companies (Douste-Blazy and Diefenbacher, 2003).

There are echoes of similar behaviour by dominant shareholders in the private sector. The cases of LVMH and PPR suggest that closely held firms may favour a heavier reliance on debt than equity in order to maintain their control. While these companies have issued equity to finance their external growth, they have done so to a lesser extent than many of their counterparts. Moreover, when they have conducted such issues, the major shareholders have participated in these issues in proportion to their shareholdings thus maintaining their controlling stakes.

However, while this account makes some sense for these two companies, it does not seem to apply to all tightly held corporations. Even for the small sample of companies in Table 15.5, it is apparent that some companies that were rather closely controlled in 1997 have allowed their capital structure to become much more diluted since then. Cap Gemini is an illustrative example. In July 1997, Serge Kampf and Wendel Investissement together controlled 46% of the voting rights of this company. Based on a shareholders' agreement, they had agreed to act in concert with respect to the restructuring of the company. However, in November 1997, that agreement was concluded. From then on, both shareholders permitted the dilution of their stakes in Cap Gemini so that by the end of 2002 their combined share of the voting rights of the company was 16.8%. The dilution occurred primarily as a result of stock issues conducted by the company in 1998, 1999 and 2000 to raise cash for acquisitions and in exchange for the shares of other companies.

The experience of Cap Gemini, as well as that of Axa, Carrefour and Valéo, suggests another possibility with respect to the relationship between ownership and strategic action, that is, that the strategies that firms pursue may determine their ownership structures. In some cases, the issue of equity for cash and in exchange for the shares of other companies led to the dilution of

the stakes of major shareholders and, therefore, to a diffusion of share ownership as occurred in the cases of Cap Gemini, Valéo and Axa. As a result, portfolio investors – outsiders with no relationship to the corporations in which they held shares – became more prominent in the shareholding structures of these companies. In the case of Carrefour, share issues for cash and in exchange for shares led to some dilution but through one of its largest acquisitions, that of the French company Promodès, it also acquired some new family shareholders.

That the strategies that French companies pursued may have influenced their ownership structure has also been suggested as a possible explanation for the particularly rapid rise in foreign ownership that took place in the late 1990s. French corporations' overseas acquisitions, when they occurred through an exchange of shares, automatically resulted in a major increase in foreign ownership. In particular, they brought US and British institutional investors into the ownership structures of French corporations since they were the major shareholders in the companies that the French acquired (Banque de France, 2004).

That ownership structures may be an outcome rather than a cause of corporate strategies has also been suggested by Franks *et al.* (2004) who attribute the transformation of UK corporate ownership from a concentrated to diffuse structure largely to mergers and acquisitions. However, while the phenomenon is clearly relevant in the French case, it is important to note that owners did not necessarily sit back and let this happen. As I have already pointed out, some companies, such as LVMH and PPR, managed to limit the dilution of their ownership structures without holding back their external growth. Moreover, large shareholders often protected their voting power even as the percentage of shares that they held declined. In the case of Valéo, for example, its major shareholder, Wendel Investissement, maintained its share of voting rights at 15.96% in 2002 compared to 18.65% in 1997, a decline of only 14% compared to a much sharper drop of 53% in the percentage of shares that it held. A similar phenomenon also occurred at Axa, Carrefour and Suez although to a lesser extent.

The complex interaction between ownership structures of French corporations and the industrial and financial strategies that they pursued suggests that it is misleading to focus solely on ownership structures in analysing corporate governance. It also calls into question the existence of mechanical relationships between ownership structure and financial activity since, at least in France in the 1990s, companies with concentrated ownership were active participants in debt and equity markets. That is not to say that ownership does not matter at all but its implications for corporate control can only be understood by considering it in the broader context of the interaction of corporations with their environment, especially the financial system.

### What Other Structures Matter to Corporate Governance?

While there may be no obvious relationship between ownership patterns and strategic actions, it is possible that alternative structural arguments may work better. A leading candidate in accounting for the recent behaviour of French corporations is industrial structure. Specifically, the technological, market and competitive characteristics of particular industries may have played a significant role in inducing French corporate managers to expand through acquisition.

Many of the French companies that pursued aggressive strategies of external growth in the late 1990s did so against a backdrop of global consolidation in their industries. Leading examples include telecommunications equipment and services, pharmaceutical, retailing, insurance

and utilities. In other words, they may have pursued external growth because it seemed to make sense given the 'logic' of their particular industry. From this perspective, we would expect that their competitors in other countries would respond in a similar way in response to the same logic.

The case of the telecommunications equipment industry is illustrative. The dominant competitive strategy in that industry was established in North America from the mid-1990s and it relied heavily on acquisitions. The acquisitive efforts of the French telecoms giant Alcatel in the late 1990s were clearly designed to respond to the competitive challenge that its North American competitors had created (Carpenter *et al.*, 2003).

The game software industry is another good example. It was originally dominated by US and Japanese publishing companies that perform functions that are similar to music publishers in financing and marketing the development of games. However, in the 1990s, a number of small and medium-sized French companies, including Infogrames, Ubi Soft and Titus, propelled themselves into the top 20 global publishing companies in the industry based on aggressive strategies of external growth (Larrue *et al.*, 2003).

And there are several other examples. Together they suggest that analyses of industrial structure and dynamics may provide important insights into recent changes in corporate governance in France. The relationship between industrial characteristics and corporate governance has only recently begun to be explored (in addition to the studies cited above, see Froud *et al.*, 2002; Jurgens *et al.*, 2002). The evidence that these studies have already generated suggests that industrial structure is useful for explaining recent acquisition activity. However, even when account is taken of industrial structure some strategic discretion remains.

For example, in the case of the telecommunications equipment industry, Siemens, the leading German competitor in this industry, did not respond to North American competition in the way Alcatel did (Carpenter *et al.*, 2003). Similarly, in the game software industry, British game companies largely stayed away from the big league despite having a highly creative base of software developers that seemed to be an excellent foundation for a global publishing strategy. Indeed, the differences in the strategies pursued by the French and British competitors in this industry led some commentators to talk of the 'Britsoft paradox' and the 'French touch' (Larrue *et al.*, 2003).

These examples suggest that there may be important national structures that interact with industrial structures in shaping strategic action. In fact, sociologists have argued that the social structure of the French corporate economy systematically influences the decisions of French corporate managers. Bauer and Bertin-Mourot (1995) contend that the exaggerated hierarchies of French corporations, in which enormous power is accorded to PDGs, systematically breeds a bias towards external growth rather than internal development on the part of the senior executives.

Social structure may also matter in another way. The educational ties that bind French elites have long been the subject of interest among sociologists of French capitalism. Although there have been some diversification in educational backgrounds among younger French managers, the most senior ranks of executives in France's largest companies continue to be dominated by graduates of ENA and Ecole Polytechnique with some having attended both schools ('Grandes Ecoles: Les nouvelles filières de l'élite', *Le Point*, 2003). Some scholars have suggested that their common educational background gives French executives a shared outlook on the problems confronting the French corporate economy and, to the extent that this is true, it might explain why so many French managers saw internationalisation through external growth as an imperative in the 1990s.

## CONCLUSION

In this chapter, I have used two approaches to corporate governance, a structural and interactive approach, to analyse what has happened to the French system of corporate governance in the late twentieth century. My analysis suggests that there is little evidence of a systemic shift from insider to outsider control of the French corporate economy. However, insiders used their control in rather different ways in the 1990s specifically to pursue aggressive strategies of external growth, especially on international markets, based on a heavy reliance on financial markets. There is suggestive evidence that these developments have had consequences for stakeholders of French corporations and, especially for the balance between financial interests and employees, between top executives and lower-level employees and between overseas and domestic operations in the distribution of corporate value added.

I have also used my analysis of corporate governance in France to reflect on the merits of structural and interactive approaches for studying corporate governance. The dominant structural approach focuses on ownership but I show that ownership patterns do not predict the strategic behaviour that seems most important in the French case. I suggest that there are structural characteristics that may be more useful in analysing corporate governance. Specifically, the role of industrial structure merits further attention as does the social structure of the French corporate economy.

It is also possible that some of the strategic actions pursued by French corporations in the 1990s may have a more subjective explanation. Cases like Axa under Claude Bébéar, Cap Gemini under Serge Kampf, PPR under François Pinault, and LVMH under Bernard Arnault certainly suggest that the specificities of dominant personalities may also be an important part of the recent story of French corporate governance. Unfortunately, most of the accounts of these individuals' roles in the transformation of their enterprises suffer from an excessively voluntaristic approach to strategic action that ignores the way in which structures facilitate and constrain that action. In future research, therefore, there is a need not only to extend structural analyses of corporate governance but also to integrate them with analyses of the more subjective characteristics of particular corporate executives.

## NOTES

1. Social structures are 'both the medium and the outcome of the practices which constitute social systems' (Giddens, 1981).
2. The TV station TF1 was also to be privatised according to conditions set out in a separate law.
3. The amount includes the proceeds from the sales of Crédit Lyonnais (Ffr35 billion) and GAN (Ffr26 billion) although the total proceeds are often quoted by the government as Ffr106.5 billion which excludes these two transactions ('Privatisations: le gouvernement s'oriente vers une pause en 2000', *Les Echos*, 19 November 1999, p. 6).
4. By which they mean a family, an individual, or unlisted firm.
5. The state also became centrally involved in the overhaul of France's science and technology infrastructure and, in general, in a revamping of what is often described as the 'national system of innovation' (Chesnais, 1993).
6. Among the most important changes that were introduced were the removal of the post-war division of labour in the financial system as banks, insurance companies, and other financial companies were permitted to compete directly with each other by the 1984 Banking Act; the removal of subsidised credits in 1984 and the subsequent elimination of quantitative credit restrictions; as well as the reform

- and reorganisation of the French stock exchanges (for detailed discussions of the structure of France's post-war financial system and its recent evolution, see Bertero, 1994; and Loriaux, 1991).
7. On 22 September 2000, the SBF merged with the Amsterdam and Brussels Exchanges to form Euronext, a European stock and derivatives market. Euronext operates three subsidiary holding companies in each of the three member countries but centralises certain functions.
  8. Seven French companies – Alstom, Compagnie de St-Gobain, Danone, Euro Disney SCA, Lafarge, Thomson-CSF, and Total Fina Elf – 'had listings on the London Stock Exchange at the end of 2000. A much larger number of French companies – 22 in total – were listed on EASDAQ but 17 of these listings were dual listings with the ParisBourse. All statistics relevant to these companies' activities on the stock market are, therefore, captured in the French statistics used above. One company, EDAP TMS, has a dual listing on the EASDAQ and the NASDAQ and will be dealt with in the analysis of US listings. Four French companies – ActivCard SA (data security), Espace Production International SA (building and construction), Global Graphics SA (industrial machinery and equipment), and Swan SA (computer software) – went public on the EASDAQ only and raised significant amounts of capital (€11.0 million, €10.7 million, €22.2 million and €11.7 million respectively) in their IPOs (author's analysis of EASDAQ, *Primary Market Statistics*, 30 January 2001).
  9. If we analyse the relative importance of the three different markets in terms of the numbers of companies going public we get a different impression; for the entire period from 1974 to 2000, the PM accounted for only 7% of the 758 French companies that went public during this time compared with 72% for the SM and 21% for the NM.
  10. The details above relate to new listings of private companies on the Premier Marché in which capital is raised. It should be noted that many companies that list for the first time on the PM do not raise capital. These companies can be split into two groups: those that have already been listed on the Second Marché and transfer from that market to the PM and those formed from companies that were already listed on the PM.
  11. Literally 'joue dans la cour des grands'.
  12. The remaining companies – Dassault Systèmes, Genset, InfoVista SA, Transgène SA, and Wavcom SA – listed on NASDAQ as part of global offerings from Paris. These transactions are included in the statistics reported above. No information was available in the Anglo-American or the French press on the circumstances surrounding LVMH Moët Hennessy's listing on NASDAQ.
  13. From then it went into an almost uninterrupted freefall until March 2003.
  14. Both Arnault and Pinault inherited their businesses but they built them from medium-sized family companies into the sprawling operations that they have become today. Bébéar took over Axa when it was a regional mutual company and brought it from there to national, and then global, prominence.
  15. For evidence on the use by smaller companies of the French financial markets, again to fund external growth, see a case study of the French game software company by Larrue *et al.* (2003).
  16. Defined as those with gearing (long-term liabilities + short-term loans ÷ shareholder's equity) of 100% and higher and interest cover (net profit before interest + interest paid) of 2.5% or lower.
  17. Notwithstanding the European restrictions on state payments to industrial enterprises, it is legitimate for governments, like any other shareholder, to make investments in a state-owned enterprise in expectation of a financial return (Dousté-Blazy and Diefenbacher, 2003). In the case of France Telecom, moreover, the state could easily have provided funds for investment by allocating some of the proceeds of its privatisation to the company.

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# Ownership and Control of Chinese Public Corporations: A State-dominated Corporate Governance System

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## INTRODUCTION

The last few years have witnessed a proliferation of comparative studies of corporate governance and financial systems around the world, which has, in turn, prompted significant advancements in the theories of corporate governance that had been developed predominantly from the Anglo-American experience. Portrayal of the global landscape of corporate ownership and control (e.g. Barca and Becht, 2001; Claessens *et al.*, 2000; Faccio and Lang, 2002; La Porta *et al.*, 1999) serves to reveal that the traditional image of dispersed ownership structure (Berle and Means, 1932) characterised by ‘weak owners and strong managers’ (Roe, 1994) is rather an exception than a rule outside the US and UK. Particularly, a large proportion of companies in East Asia and continental Europe are found under the ultimate control of families, the state, and occasionally widely held financial institutions, with managers on many occasions affiliated with large shareholders.

These newly established empirical regularities have arguably reoriented the main research agenda for corporate governance mechanisms in the rest of world, since the core concern is no longer the traditional version of agency costs – the ‘management bias’ (Becht and Mayer, 2001), with potential moral hazard conducted by the management who are in effective control of the firm (Jensen and Meckling, 1976; Shleifer and Vishny, 1997). Rather, it gives way to the conflict of interests between controlling blockholders and minority shareholders, or the

'private control bias' (Becht and Mayer, 2001), which leads to potential fund diversion and asset expropriation by dominant shareholders (Denis and McConnell, 2003; La Porta *et al.*, 2000). Hence there is increasing literature exploring the complicated relationship between concentrated ownership structure and corporate performance (e.g. Bebchuk *et al.*, 2000; Claessens *et al.*, 2002; Cronqvist and Nilsson, 2003; Holderness and Sheehan, 2000).

Among the burgeoning literature that has tremendously advanced our knowledge of the global corporate governance systems, there is, however, an embarrassing omission of in-depth analyses of the Chinese context, especially considering China's continued blossoming as one of the world's major economic powers. In concrete terms, few comparable works have so far been undertaken to document the *ultimate* ownership and control patterns of more than 1100 Chinese public corporations. Lack of hard data and accurate understanding of the ultimate ownership and the associated pyramid structure has been a major impediment to producing otherwise rigorous and illuminating studies in extant literature of Chinese corporate governance. Moreover, despite the sea change of the Chinese corporate sector and capital market during the last 15 years,<sup>1</sup> there is so far no systematic account of, and no serious exploration into, the dynamic aspect of corporate control, i.e. the evolution of ownership and control that has been intensively studied in the US, UK, and Germany (e.g. Denis and Sarin, 1999; Franks *et al.*, 2003; Goergen and Renneboog, 2003). Hence it is fair to say that few aspects of China's economic transition and emergence into the world economy have been so poorly understood than its stock market and the associated corporate governance system, though it has a large potential for 'throwing off its emerging status to become the biggest and most vibrant in Asia' (Walter and Howie, 2003, p. 242).

In this chapter we advance the broad research agenda of comparative corporate governance by examining the performance impacts and evolution of ownership and control mechanisms in Chinese publicly traded companies. After a brief description of the institutional environment concerning China's state-dominated capital market and corporate governance system, we present research findings on two key aspects of corporate China: namely, the ultimate and intermediate control structure of Chinese listed companies and its significant performance implications, and the evolution of ownership and control in Chinese companies during the last decade, with reference to the recent literature on the determinants of ownership evolution and privatisation. The chapter concludes with the potential contributions of China-based studies to the general development of corporate governance research and suggested avenues for future research.

## OVERVIEW OF THE CHINESE CORPORATE GOVERNANCE SYSTEM

It is virtually impossible to understand the emergence of the Chinese state-dominated corporate governance system without putting it into the broader context of China's 1990s economic reform. Unlike the big-bang mass privatisation approach adopted by the Eastern European and Former Soviet Union (EEFSU) countries, the Chinese government, consistent with its gradualist and evolutionary reform strategy, has explicitly pursued a '2-R' policy – *retain* government control of large and medium-sized state-owned enterprises (SOEs) that operate in strategic sectors and *retreat* from state control of small enterprises that operate in highly competitive markets. With regard to the restructuring of large SOEs, corporatisation and stock

**Table 16.1** *The development of China's stock market, 1992–2003*

Year	Number of listed firms	Equity capital raised (billion RMB)	Market capitalisation (MC, billion RMB)	MC/GDP (%)
1992	53	5	104.8	3.93
1993	183	27.64	353.1	10.2
1994	291	9.98	369.1	7.89
1995	323	8.55	347.4	5.94
1996	530	29.43	984.2	14.5
1997	745	85.61	1752.9	23.44
1998	851	77.8	1950.6	24.52
1999	949	89.68	2647.1	31.82
2000	1088	154.09	4809.1	53.79
2001	1160	118.21	4352.2	45.37
2002	1224	77.98	3832.9	37.43
2003	1287	81.96	4245.7	36.38

*Note:* The RMB exchange rate is strictly pegged to the US dollar. The specific exchange rates are as follows: Year 1992, US\$ 1 = 5.75 RMB; 1993, US\$ 1 = 5.8 RMB; 1994–98, US\$ 1 = 8.3 RMB; 1999–2003, US\$ 1 = 8.28 RMB.

*Source:* *China Securities and Futures Statistical Yearbook 2003*; China Securities Regulatory Commission (<http://www.csrc.gov.cn>).

flotation are the key measures used in the hope of transforming the SOEs into real modern business organisations while maintaining controlling state shares. Besides, the stock market has become a convenient vehicle for tapping household savings to finance the distressed SOE sector, not least because the cost of bank financing is escalating as the frail state banking system has deteriorated over the last decade. As a result, it is not surprising that the Chinese government seems so enthusiastic to promote the rapid expansion of the domestic stock market, which is further demonstrated in Table 16.1.

The overwhelming state dominance of the Chinese corporate governance and capital market is aptly summarised by the following comment by foreign investment bankers: ‘the stock market is operated by the state, regulated by the state, legislated by the state, and raises funds for the benefit of the state by selling shares in enterprises owned by the state’ (Walter and Howie, 2001, p. 4). Apart from the government-controlled regulatory framework that is in contrast with the administratively independent regulatory bodies in the US and UK, the state monopolises the access to equity finance in the sense that it has the final say on which firm is qualified to raise equity funds through initial public offerings (IPOs). Consequently, there is no surprise that the domestic equity market is primarily populated by a large number of former SOEs, though the face value of state shares account for less than 50% of total shares subscribed in the public companies. Another distinct feature of Chinese public corporations is the significant constraint on the tradability of corporate stocks, among which nearly two-thirds cannot be freely traded on the equity market.

As shown in Table 16.2, stocks on the Chinese stock market can be classified into two broad categories according to their tradability on secondary markets. Non-tradable stocks include state shares, legal person shares and employee shares,<sup>2</sup> while the tradable counterpart is composed of A-, B-, and H-shares. A-shares are equity stakes sold through IPOs to domestic

## Corporate Governance

**Table 16.2** Aggregate distribution of the official shareholding classes in Chinese publicly listed companies (%)

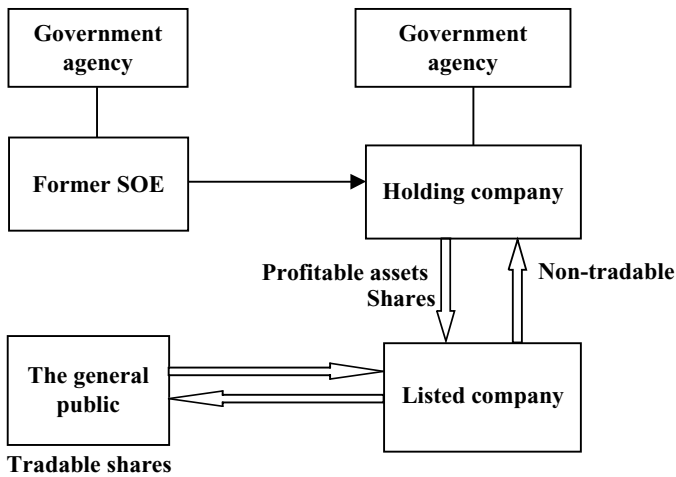
	1997	1998	1999	2000	2001	2002	2003
Total non-tradable shares	65	66	65	64	65	65	65
State shares	32	34	36	39	46	47	47
Domestic legal person shares	30	27	25	23	17	17	16
Overseas legal person shares	1	1	1	1	1	1	1
Employee shares	2	2	1	1	0.5	0.3	0.2
Total tradable shares	35	34	35	36	35	35	35
A-shares	23	24	26	28	25	26	27
B-shares	6	5	5	4	3	3	3
H-shares	6	5	4	3	6	6	6
Number of listed companies	745	851	949	1088	1160	1224	1287

Source: China Securities Regulatory Commission (<http://www.csrc.gov.cn>).

The table reports the aggregate distribution of the officially defined shareholding classes in all of the Chinese public corporations. *State shares* are stocks held by government agencies, such as state asset bureaus and government authorised institutions. *Legal person shares* are owned by domestic/overseas institutions, be they enterprises or other economic entities enjoying legal person status. *Employee shares* are offered to workers and managers of a listed company usually at a substantial discount. *A-shares* are the ordinary equity shares mostly held and traded by retail/institutional investors in RMB on the domestic stock exchanges. *B-shares* refer to those that were once exclusively traded by foreign investors denominated in foreign currencies until 2001, when domestic investors can also hold these shares. *H-shares* concern the shares issued by Chinese corporations to foreign investors through listings on the Hong Kong Stock Exchange.

retail or institutional investors and traded in the secondary market. B-shares refer to those traded in foreign currencies (US dollars in Shanghai Stock Exchange and Hong Kong dollars in Shenzhen Stock Exchange) by overseas and domestic investors.<sup>3</sup> The H-shares in the general sense concern those issued by Chinese PLCs to foreign investors through listings on the Hong Kong Exchange. With respect to the official definition of the non-tradable part, state shares are held by government agencies or state-authorised organisations at either the central or local levels, whereas legal person shares are those owned by domestic institutions and enterprises with legal person status.<sup>4</sup> However, it is virtually impossible to understand the subtle difference between the two categories without a further scrutiny of the incorporation and listing process of Chinese companies.

To the extent that a majority of Chinese listed firms are transformed from former state enterprises, Figure 16.1 illustrates the typical restructuring process of an SOE in preparation for public listing.<sup>5</sup> It is dubbed 'carve-out' listing in the sense that the former SOE carves out a portion of profitable physical assets to establish a new company for flotation. In return for the assets injected, the parent SOE receives non-tradable state or legal person shares in the new company, which is then listed on equity markets by selling new tradable shares (A-, B-, or H-shares) to the general public. Since the post-restructuring state and legal person shares are not tradable on the secondary market, it in principle prevents a rapid dilution of state ownership, which was precisely designed to assuage the ideological concerns from conservatives within the communist party especially in the early 1990s.



The figure illustrates a typical restructuring and listing process of a Chinese SOE. Originally the former SOE was supervised by the government agency prior to corporatisation. As a result of restructuring, the SOE is transformed into a holding company, which in turn carves out its profitable assets for the establishment of a new corporate entity. The holding company receives controlling non-tradable shares for the injection of profitable physical assets. When the new company obtains the approval for a public offering, it receives cash from the general public in return for the issuance of tradable shares.

**Figure 16.1** *The ‘carve-out’ listing of a Chinese SOE*

Against this general institutional background, we examine in the subsequent sections two intimately related issues that are perceived to be of central relevance to the reform of China’s corporate governance and financial system. First, an unprecedented large-scale empirical survey is undertaken to identify the ultimate shareholding structure and its associated stock pyramids, through which a new analytical framework of state corporate control mechanism is established to assess the performance variations induced by different classes of control agents in the middle of the state pyramids. Second, we document the evolution of the shareholding concentration and ultimate control of Chinese public firms in the last decade, which is indicative of the prospects for a mixed ownership structure in the Chinese corporate sector. Meanwhile, we attempt to provide some preliminary explanations of the evolution pattern in line with the existing corporate control theory and China’s reform experience.

## **ULTIMATE OWNERSHIP, INTERMEDIATE SHAREHOLDING CLASSES, AND THEIR RELATION TO CORPORATE PERFORMANCE**

Recent empirical studies of corporate ownership structure have provided a detailed account of various means controlling shareholders can use to maintain and extend de facto control in their downstream firms. Among them, the widespread pyramid shareholding structure is employed by controlling shareholders to create a set of hierarchical control chains, in which an intermediate corporate agent is controlled by another one, whose controlling shares in turn

lie, directly or through several such similar chains, in the hands of the ultimate dominant shareholder group. So the immediate ownership data from the public corporations is not, in principle, adequate to present an accurate picture of the exact control pattern in these firms, and the tracing of ultimate shareholding structure is crucial to our understanding of the ownership and control in modern business corporations.

While the moral hazard of ultimate controlling shareholders when using pyramid as a device of separating cashflow rights and voting rights and its pernicious effect upon corporate performance have been well documented (Bebchuk *et al.*, 2000; Claessens *et al.*, 2002),<sup>6</sup> there is little work investigating, theoretically or empirically, whether there are any significant performance impacts induced by *qualitatively* different pyramidal structures. For example, do different types of shareholding identities in the intermediate control chain tend to be associated with different performance of downstream firms, even given the *identical* ultimate controlling shareholders?

In this section, we attempt to shed light on the issue through presentation of our findings on the complex effect of different pyramidal structures on the performance of Chinese state-controlled public corporations. While considerable state control over especially large firms has been found in a number of West European and East Asian countries in La Porta *et al.* (1999), Claessens *et al.* (2000), and Faccio and Lang (2002),<sup>7</sup> China, the world's largest employer of government agencies to control public corporations, is unfortunately not included in any of their datasets, partially due to, we believe, the paucity of information disclosure and the unique institutional environment. Nevertheless, the Chinese reform context provides a particularly rich field for examining the disaggregated and varied performance effects of a certain controlling shareholder class such as state, not least because the vast magnitude of government control over a large number of public companies in a large country ensures substantial internal variations within the broad category of state control.<sup>8</sup>

## The Ultimate Shareholding Structure of Chinese Public Corporations

We begin by identifying the ultimate shareholding structure of Chinese companies in respect of the types of ultimate controllers and then the classes of intermediate agents used by the state as a control instrument in the Chinese-style pyramid. According to established practice (Claessens *et al.*, 2000; Faccio and Lang, 2002; La Porta *et al.*, 1999), an ultimate controlling shareholder can be identified via a pyramid structure in which at least one firm lies between the downstream public corporation and the ultimate owner in the chain of 20%/10% voting rights.<sup>9</sup> Although information about top 10 shareholders of the public companies is required to be disclosed in China, most of the largest shareholders of the public corporations themselves are not quoted on the stock market, hence in principle they have no obligation to disclose their own shareholding information to the public,<sup>10</sup> thus resulting in a major obstacle to the identification of the exact ultimate shareholding structure. This may partly explain why previously so few studies have followed this approach. It is also due to the uncritical reliance on the Chinese official shareholding classification (Table 16.2), whose deficiencies will be elaborated shortly.

Fortunately, however, Chinese publicly traded firms were required by the China Securities Regulatory Commission (CSRC) to disclose details of their ultimate controlling shareholders, for the first time in 2001, despite the varying qualities of the actual disclosures. Then, for a small number of firms whose controlling shareholders' final identities were still unclear from their annual reports in 2001, we have identified the real behind-the-scenes controllers through

a careful study of their company IPO prospectus and other relevant information with assistance from securities analysts and information provided by our own survey of the top shareholders of firms. Moreover, since our empirical study on the performance effects of intermediate shareholding classes concerns company-level data in the period 1997–2000, we further identify the ultimate controlling shareholders in these firm-years. It would be straightforward if the firms in question did not experience transfer of control during 1997–2001, but for those which did experience, we use a combination of the methods mentioned above to trace the former ultimate controllers.<sup>11</sup>

The summary findings of our survey shown in Table 16.3 reveal for the first time the identity of the ultimate controlling shareholders in Chinese public corporations and how these ultimate controllers use different classes of shareholdings as a ‘control instrument’ to direct the listed companies. The shareholding structure in Chinese public corporations is still characterised

**Table 16.3** *Who ultimately controls China’s listed companies by the end of 2001?*

Status of the largest shareholder of a publicly listed company	Number of companies as percentage of the total number listed	Average controlling stakes held by the largest shareholder
State as the ultimate controlling shareholder		
Direct control:		
Government departments/agencies	9.0% (102 firms)	38.1% (16.5%)
Indirect control:		
State-controlled institutions (SCIs)	72.6% (825 firms)	49.1% (16.7%)
In which of SCIs:		
(1a) State-controlled publicly listed firms	2.6% (30 firms)	52.9% (19.2%)
(2a) State-owned enterprises (SOEs)	58.9% (668 firms)	49.4% (16.5%)
(3a) State-controlled unlisted companies	10.0% (114 firms)	46.6% (17.2%)
(4a) State-owned academic institutions	1.1% (13 firms)	43.7% (14.7%)
Total state-controlled companies	81.6% (927 firms)	47.9% (17.0%)
Non-state firms/families as the ultimate controlling shareholder		
(1b) Non-state-controlled publicly listed firms	0.2% (2 firms)	19.1% (10.4%)
(2b) Unlisted collective firms and TVEs	4.8% (54 firms)	41.5% (17.9%)
(3b) Unlisted domestic private firms	12.8% (145 firms)	33.9% (13.8%)
(4b) Unlisted foreign private firms	0.7% (8 firms)	36.8% (17.5%)
Total non-state-controlled companies	18.4% (209 firms)	35.9% (15.4%)
Grand total of number of firms in the sample	100.0% (1136 firms)	45.7% (17.4%)

The table reports the classes of intermediate and ultimate controlling shareholders in Chinese publicly listed companies by the end of 2001. Theoretically, being the largest stockholder in a company does not necessarily mean absolute control of the firm if there exist sufficient large stakes held by the other large shareholders, but the situation is less likely to appear in Chinese corporations in which the largest shareholder always owns a sufficiently large number of shares, as shown in the table, to guarantee control. The controlling stakes are the sum of all the voting rights directly held by the largest shareholder and those by its subsidiaries in a particular listed company. Brackets beside the percentage of shares are standard deviations of the largest shareholdings. State-owned enterprises (SOEs) here indicate firms that are 100% owned by a single government department/agency. Comparative to SOEs, various state-controlled agencies have fractions of stakes in state-controlled unlisted companies, and it even could be the case that some domestic or overseas non-state companies hold some minority shares in the firms. TVEs, township and village enterprises, are a transitional form of rural collective firms in China.



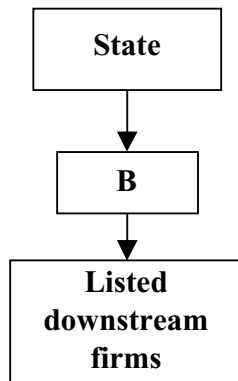
by state predominance, in that the state retains ultimate control of 81.6% of public companies at the end of 2001. Table 16.3 clearly shows that the state exercises its ultimate control via a state pyramid scheme with two broad patterns: (1) government direct control of 9% of the public companies, and (2) government indirect control of 72.6% of the public companies. Within the category of government indirect control, intermediate companies used in the control chain include: SOEs (58.9% of the total firms), state-controlled unlisted companies (10%), state-controlled publicly listed companies (2.6%), and state-owned academic institutions (1.1%). On the other hand, private forces already control over 200 public companies on the Chinese stock market via their own pyramidal structure. Among them, 147 companies are controlled by domestic private firms, which are in turn in the hands of individuals or families; 54 companies are found under the control of urban collective firms and Township and Village Enterprises (TVEs) in the rural sector. Although we lack exact data, anecdotal evidence implies that, on many occasions, private firms choose to register themselves as a 'collective' to avoid unfavourable treatment by the government in China's unique transitional environment. Finally, due to China's policy constraint, there is little involvement by foreign capital on the domestic capital market: only eight listed firms are indirectly controlled by foreign firms.

The identification of ultimate controlling shareholders in Chinese public companies leads us to question the common practice of regressing firm performance on the ownership class of state shares vs legal person shares, which are based on the Chinese official classification shown in Table 16.2. We believe that such a classification is misleading for the study of the complex relationship between shareholding classes and performance of state-controlled public firms for at least two reasons. First, it is unclear if these legal person entities are ultimately controlled by the government or by the private sector. If it is taken as granted that they are state-controlled institutions, as Sun *et al.* (2002) and Sun and Tong (2003) assume, data misspecification arises since Table 16.1 shows that there were as many as 209 non-state-owned public companies in 2001 whose controlling shareholders are also designated 'legal persons' by the official classification. Even if the extent of such misspecification is limited because of the smaller number of non-state-controlled firms before 2000, which will be shown in the ownership evolution section below, it is still strange to group legal person shares into an independent shareholding class in parallel with state shares, because they too are also controlled by the state. Second, although it is tempting to equate state shares to shares held by government agencies and legal person shares to those held by state-controlled companies (Qi *et al.*, 2000). Sun and Tong, 2003), its validity has been belied by our empirical case studies (Liu and Sun). That is, shares held by some state-controlled firms are also called 'state shares' instead of 'legal person shares', suggesting a far more blurred distinction between the two classes than one might at first imagine.

## The Performance Effects of Intermediate Shareholding Classes

An application of the 'pyramid' concept to the context of Chinese corporate reform enables us to examine the agency problem of the ultimate owner in using different classes of intermediate shareholdings, denoted by Box B in Figure 16.2, as 'controlling instruments' to direct public companies.

A specific class of intermediate control agent represents the economic status of the controlling shareholder of a downstream firm. For example, the direct government shareholding



The figure shows a simplified version of a state pyramid shareholding scheme, where state, as the ultimate controller in the top box, can employ different types of intermediate control agents in Box B as controlling shareholders for different downstream firms.

**Figure 16.2** *A simplified version of the state pyramid*

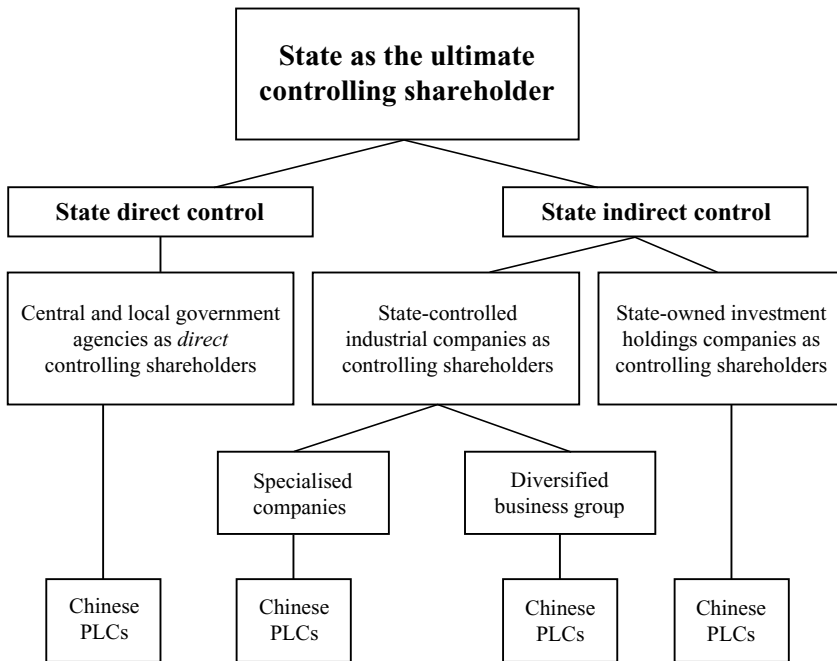
implies that a government department is chosen to be the proxy of the state to control the firm, so that Box B is a government department. Alternatively, the ultimate owner can choose a commercial-oriented firm as ‘the controlling shareholder’ to act on behalf of the owner in monitoring the firm. In this case, Box B is a company. If a firm has (1) an ultimate owner and (2) a controlling shareholder that is an intermediate institution or company chosen to act on behalf of the ultimate owner, then agency problems will arise in the pyramid control chain. Since an intermediate shareholding class represents a certain degree of competence and motivation in corporate control and monitoring, a certain level of business expertise, and a certain type of advantage in providing resources to its controlled firms, the quality of control will be expected to vary among different classes of intermediate controlling shareholders in face of different constraints and incentives imposed by its ultimate owner – the state.

Following this line of reasoning, if an intermediate shareholding class is given under the ultimate state control, we can assess which shareholding class has the least agency costs relative to others by comparing the performance of downstream listed firms under different intermediate control. For most Chinese public companies with identical ultimate ownership of the state, this means that such performance comparisons will reveal information concerning a hierarchy of efficiencies of different control mechanisms applied by the Chinese government in reforming its corporate governance system. Therefore, the Chinese state-controlled listed companies are the focus of our nested performance comparison.

To empirically test our theoretical conjectures, we need a concrete classification of various intermediate control agents that bears economic relevance. Figure 16.3 provides the one that characterises the different pyramidal mechanisms taken by the state to retain the ultimate control.

### *State direct control vs indirect control*

First of all, a performance comparison can be made on a broad classification between state direct control and state indirect control. The former means that the state uses government departments, such as state asset management bureaus, to hold controlling voting shares directly.



The figure illustrates the complicated pyramid structures and the associated intermediate shareholding classes the state can use to exercise its ultimate control. The various intermediate control agents include government departments/agencies, investment holdings companies, and industrial firms, which can be further classified as specialised firms and diversified business conglomerates.

**Figure 16.3** *The Chinese-style state pyramid*

Alternatively, the ultimate state control of listed firms can be achieved by a corporation or institution acting on behalf of the intermediate controlling shareholders. Theoretically, it may be plausible to argue that the shorter the delegation chain between ultimate principal and downstream agent, the less efficiency loss arising from such agency problems, thus making direct control outperform indirect control. However, such a claim does not consider the potential differences in the capability and incentives of monitoring downstream managers between government bureaucrats and SOE managers. If SOE managers in intermediate controlling firms have more technical capabilities and financial or political incentives to better monitor their subsidiary managers, the alternative hypothesis would be that the latter shareholding class outperforms the former.

### *Investment holding companies vs industrial companies*

Second, within the category of state indirect control, the Chinese government employs two types of domestic institutions: investment holding companies vs industrial companies. With the gradual progress of enterprise reform in China, it becomes less and less popular for various government departments to be directly involved in enterprise management. Investment

holding companies are established and solely owned by local governments to hold controlling financial stakes in firms that were previously and directly controlled by their state asset management bureaus.<sup>12</sup> So compared with direct decentralisation of economic powers to traditional industrial SOEs, they actually created a new species of corporate agents to act on behalf of themselves to monitor downstream listed firms. Then the potential difference in their respective competences of monitoring downstream listed firms, if any, should be reflected in performance variations of their subsidiaries.

### *Diversified business groups vs specialised firms*

Finally, with respect to the scope of businesses in which the industrial holding companies are engaged, the group of industrial companies are further divided into two classes: specialised firms and diversified conglomerates. The former means that the business of the intermediate holding company is horizontally similar to its owned or controlled downstream firms. In contrast, if the business or industry that a shareholding company operates is different from its downstream firms, it is then defined as a business-diversified shareholding class. This distinction is of a particular interest to the recent debate on whether group affiliation and diversification add value to member firms in emerging markets.<sup>13</sup> Little empirical evidence, however, is available in the Chinese context and we attempt to contribute to the debate by examining whether affiliation with a state-controlled diversified industrial group makes a difference to downstream corporate performance.<sup>14</sup>

Table 16.4 is drawn from our empirical nested performance comparison (Liu and Sun, forthcoming), with the estimation results confirming our theoretical conjecture that the performance variations in downstream listed firms are associated with different types of intermediate control agents under the identical ultimate ownership.

First, the results reported in Table 16.4 clearly show that profitability measured by ROE in companies under state indirect control is higher than the direct control group by around 8% on average. In effect, it is suggested that the identity of the intermediate control agent matters more than the mere length of delegation chain. The additional 8% agency cost imposed on state directly controlled companies arguably indicates that, compared to managers in government-controlled enterprises, government bureaucrats themselves are less capable or motivated to effectively perform the role of supervising the downstream listed firms.

The reasons for the inferior capability can be briefly discussed as follows. First, relative to SOE managers in intermediate holding companies, government officials lack sufficient business expertise and information for efficacious monitoring of the management in downstream companies, exacerbating the ‘insider control’ problem prevalent in transitional economies<sup>15</sup> (Aoki, 1995; Qian, 1996). Second, the incentives of government officials are less aligned to the pursuit of pure profitability of downstream listed firms than those of intermediate SOE managers for personal promotion in the political–bureaucratic regime. Factors influencing personal promotion are obviously much more diverse for local bureaucrats than SOE managers, such as the overall growth rate and social stability of enterprises under their jurisdiction, which may lead them to sacrifice the profitability of certain firms for their private interests. In contrast, considering that their own promotion prospects might be influenced by the performance of the firms they once controlled, intermediate SOE managers might have more incentives to monitor their affiliated public corporations on the basis of profitability.

Second, Table 16.4 shows that public companies under the control of investment holding firms on average underperform by more than 4% than those controlled by industrial firms.

**Table 16.4** Estimation of performance effects induced by different intermediate shareholding classes

Dependent variable ROE	State as ultimate owner			Private as ultimate owner
	Direct vs indirect	Investment vs industrial	Diversified vs specialised	Diversified vs specialised
Comparison groups				
Intercept	0.178*** (5.5)	0.092 (1.6)	0.150*** (5.9)	-0.044 (1.2)
Intermediate ( $D_j$ )	-0.081* (1.9)	-0.041* (1.8)	-0.053*** (3.6)	0.042* (1.9)
Takeover	0.008 (1.3)	0.001 (0.1)	0.004 (0.4)	0.059*** (4.0)
Duality	-0.011 (1.6)	-0.007 (0.8)	-0.005 (0.6)	0.004 (0.2)
Shareholding concentration: 1 if $C_1 \geq 30\%$ , otherwise 0	0.012*** (2.0)	0.0142** (2.1)	0.011* (1.8)	-0.002 (0.1)
Tradable shares	-0.034 (1.4)	-0.031 (1.2)	-0.023 (0.9)	-0.009 (0.2)
Insider shares	0.048 (1.2)	0.032 (0.6)	0.061 (1.2)	0.109 (1.2)
Sales growth	0.029*** (3.7)	0.029*** (3.1)	0.031*** (3.1)	0.035*** (2.7)
Industry profit margin	0.001 (0.3)	0.0014 (0.3)	0.005 (1.3)	0.013 (1.5)
ROE <sub>t-1</sub>	0.096*** (3.2)	0.022 (0.7)	0.045 (1.2)	0.082** (2.0)
Year 1998	-0.023*** (4.8)	-0.023*** (4.2)	-0.022*** (3.8)	-0.062*** (5.0)
Year 1999	-0.041*** (8.5)	-0.040*** (7.1)	-0.039*** (6.8)	-0.072*** (5.7)
Year 2000	-0.051*** (9.1)	-0.054*** (8.3)	-0.053*** (7.9)	-0.085*** (6.1)
Firm dummies included ( $\chi^2$ : $\sum \text{firm}_i = 0$ for $H_0$ )	1468 [0.005] (777 firms)	1313 [0.005] (670 firms)	1247 [0.005] (619 firms)	358 [0.005] (145 firms)
Auto[1]: $\rho_{t-1}$	0.320 (0.64)	0.793 (1.1)	0.415 (0.8)	-0.223 (1.6)
Standard error ( $\sigma$ )	0.062	0.062	0.060	0.069
R <sup>2</sup>	0.455	0.451	0.476	0.588
No. of observations	1923	1541	1385	356

Notes:

- (1) The regression equation is  $Y_{it} = \alpha_i + T_t + D_j + \beta X_{it} + \varepsilon_{it}$ , where firm performance  $Y_{it}$  is measured by return on equity (ROE), which is the net profits divided by equity capital,  $D_j$  is the dummy variable representing different intermediate shareholding classes,  $\varepsilon_{it}$  is random stocks assumed to satisfy the Normal distribution  $N(0, \sigma^2)$ ,  $\alpha_i$  represents the cross-sectional dummy used to control for other firm-specific time-invariant effects, and  $T_t$  is the year dummies that attempt to capture macroeconomic shocks or market conditions at time  $t$ .
- (2) The  $X_{it}$ s are control variables that are used to eliminate potential spurious correlations between  $Y_{it}$  and  $D_j$ , including the *takeover dummy* (1 if a firm experiences a control transfer, 0 for pre-takeover time), *duality dummy* (1 if board chairman and CEO are the same person, 0 otherwise), *ownership concentration dummy*, the proportion of *tradable shares* in the total shares outstanding, *insider shares* (the proportion of shares held by board directors, managers and employees), the growth of sales revenues, and the *industry profit margin*.
- (3) The likelihood ratio statistic is applied to test the firm fixed effects, and since  $H_0$  is rejected then firm dummies are included in all estimations to capture the firm fixed effects.
- (4) T-statistics are reported in parentheses, and p-values are in square brackets.
- (5) \*Significance at the 0.1 level, \*\*significance at the 0.05 level, and \*\*\*significance at the 0.01 level.
- (6) Since our panel data are short, we only test the first-order autocorrelation on the basis of Arellano and Bond (1991):

$$y_{it} = \sum a_i D_i + \sum a_t T_t + f(\mathbf{X}, \beta) + \theta y_{it-1} + \rho_{t-1} \hat{\varepsilon}_{it-1} + u_{it} \text{ where } \hat{\varepsilon}_{it} = \rho_{t-1} \hat{\varepsilon}_{it-1} + u_{it} \quad u_{it} \sim N(0, \sigma^2)$$

The underperformance, we believe, lies in the fact that managers in investment holdings companies neither have enough information nor the required expertise to exercise effective control of their subsidiaries, apart from the common incentive problem inhabited in all kinds of state-controlled shareholders. Specifically, staffs in these holding companies are more likely to be dominated by former government bureaucrats rather than SOE managers, and our conjecture

is that on many occasions these companies are little more than an additional layer of bureaucracy placed between government state asset management bureaus and downstream business enterprises.

The empirical result we have established is supported by anecdotal evidence of the diverging performance of listed firms ultimately controlled by the Shenzhen municipal government and the Shanghai government. While the former chooses to delegate around two-thirds of local state assets to the aforementioned Shenzhen Investment Holdings Company, the latter adopts a much more decentralised approach by assigning control rights to a variety of industrial holding companies as intermediate agents roughly based on industry lines. And it seems no coincidence that by 2001, public companies in Shanghai exhibit superior performance to their counterparts in Shenzhen.

Finally, the result we present in Table 16.4 lends unambiguous support to the superior performance induced by the diversified business groups as intermediate controllers.<sup>16</sup> For further investigation, we then conduct the same regression analysis for private controlled public companies, i.e. the last column of Table 16.4. Quite interestingly, we get the opposite result that affiliation with private diversified groups has a negative performance effect. Such a striking disparity may be reconciled by realising that, in the same market environment, state-controlled conglomerates in China are generally quite large and highly diversified under the direction of the central government, whereas private business, though developing quickly, is still at the initial stage of development especially during the time interval 1997–2000 that we examine.<sup>17</sup> Thus it is not difficult to understand that, while large government-directed diversified groups can offer more to their affiliates than unaffiliated downstream firms probably by overcoming market failures through intragroup resource sharing, diversification in private firms fails to yield pay-offs high enough to counterbalance the agency costs of group affiliation.<sup>18</sup>

Moreover, the better performance observed in the companies controlled by state diversified companies should be particularly attributable to the capability of the management. Because of the enterprise-restructuring programme that encouraged the good to take over the bad, introduced in the late 1990s, the Chinese government has been keen to support the expansion of highly competitive state-owned firms via takeover of less efficient firms in order to have them under good management control for efficiency improvement. That is, smart management raises efficiency in stage one, and then the government selects efficient firms to expand in stage two.<sup>19</sup> Where to expand is believed to be subject to the influence from the mixed interests of government and management. Apparently, efficient industrial companies under state ownership tend to expand to different markets and becomes a large industrial conglomerate group to let its controlled firms benefit a lot from economies of scope in intragroup resource sharing. Thus, good management and economies of scope are the main explanation to the superiority of the diversified shareholding class for state firms.

All in all, our nested performance comparison among three pairs of ownership classes – state direct control vs state indirect control, investment holding companies vs industrial firms, and diversified business groups vs specialised companies – exhibits consistent and statistically significant evidence that the least inefficient intermediate control agent ranked by our study is diversified industrial conglomerates in the indirect state control chain. This finding provides implication for the reform of corporate control mechanisms in China, even absent the policy choice of mass privatisation.

## THE EVOLUTION OF OWNERSHIP AND CONTROL AND ITS DETERMINANTS

Modern theories of corporate governance and finance have long recognised the potential endogeneity of corporate ownership and control structures, and substantial efforts have been devoted to the exploration of their economic, legal, regulatory and sociopolitical determinants (e.g. Demsetz and Lehn, 1985; La Porta *et al.*, 1999; Roe, 1994; Shleifer and Vishny, 1997). First, ownership concentration and control can be largely influenced by firm characteristics such as profitability, size, risk, growth, and industry affiliation, which has been verified by several empirical analyses using the US and German data (Demsetz and Lehn, 1985; Demsetz and Villalonga, 2001; Goergen and Renneboog, 2003). For instance, poor performance or greater growth potential may be responsible for triggering a less concentrated shareholding structure, inasmuch as the founding owner wishes to release financial burdens or trade shares for further growth.

Second, the new 'law and finance' literature spearheaded by La Porta *et al.* (1998, 2000) postulates a positive correlation between ownership concentration and the degrees of investor protection that are, in turn, determined by a country's legal and regulatory system. That is to say, if small investors are vulnerable to substantial expropriations by large shareholders, the status of a controlling shareholder confers enormous private benefits relative to dividends solely arising from its cashflow rights. Hence concentrated ownership and control will be persistent in countries with poor investor protection, whereas diffuse ownership is more common in a regulatory environment committed to protection of minority shareholder rights.<sup>20</sup>

In the light of the Chinese institutional environment discussed in the 'Overview', above, due attention also needs to be paid to the share issue privatisation (SIP) literature for understanding and predicting how the ownership and control of these partially privatised companies evolve. In fact, SIP, which uses stock markets as an effective instrument for ownership transformation, represents one of the most classic approaches of the worldwide privatisations over the last two decades (Jones *et al.*, 1999; Megginson and Netter, 2001). While government ownership has been diluted during the SIP process, which more often than not involves a sequence of partial sales,<sup>21</sup> whether the state has finally relinquished corporate control varies across existing empirical studies. While large sample studies tend to suggest a positive answer (Jones *et al.*, 1999), the persistence of state control is manifest in a number of small sample works. For example, Boubakri *et al.* (2004) document the relative reluctance of governments in Asian developing countries<sup>22</sup> to relinquish corporate control after SIPs, compared with a control sample of firms collected from other developing countries. Gupta (forthcoming) also notes that up to 1999 the Indian government had never sold a majority ownership stake in its SIPs. More crucially, sole reliance on direct ownership data runs the risk of underestimating the magnitude of state control, since immediate institutional shareholders of privatised firms can be ultimately controlled by the state via complex stock pyramids even absent direct government ownership. This is precisely what Bortolotti and Faccio (2004) have indicated through tracing the ultimate control of a sample of 141 privatised companies in OECD countries. They find that even at the end of year 2000, the state still exercises ultimate control in about 30% of sample firms.

In view of the relevant literature, we contribute in this section our preliminary research findings on the evolution of shareholding concentration and control over the first decade of Chinese public corporations, which is the first piece of empirical evidence presented in the

Chinese context as far as we are aware. Furthermore, we delve into the potential key institutional and economic factors that affect the government's decision on control transfer.

## The Change of Shareholding Concentration and Corporate Control

Before turning to the detailed empirical results, it is worthwhile to make a brief introduction to the institutional background of share trading regulation in China. As mentioned in the 'Overview', above, and especially Table 16.2, Chinese listed companies are characterised by a highly segmented shareholding structure, in which a majority of stocks cannot be transacted on the equity market. In effect, this was deliberately designed by the government in the early 1990s to forestall the loss of corporate control,<sup>23</sup> since private forces cannot follow common practice in developed markets by acquiring listed companies via market purchases or tender offers. However, this does not mean that the non-tradable part of stocks is completely illiquid, because they can change hands through an off-market negotiated block transfer.<sup>24</sup> In particular, various state agencies that act as owners of state and legal person shares can elect to dilute their non-tradable shareholdings through the off-stock-exchange avenue, subject to approval by their superior government departments and final endorsement at the central government level.<sup>25</sup> On the other hand, private firms can take the chance to become new controlling shareholders of the listed companies through the purchase of non-tradable share blocks, which is sometimes dubbed 'backdoor listing', compared to the narrow access to the state-controlled IPO process that discriminated severely against private firms throughout most of the 1990s. In short, the unique segmented shareholding structure in principle does not preclude the change of ownership concentration and corporate control, but it definitely reduces the speed of ownership transformations.

The foregoing discussion of the regulatory/legal and economic determinants can give an immediate clue to the shareholding concentration of Chinese companies: owing to the highly inefficacious investor protection in the Chinese legal and regulatory system, it would be straightforward to expect a sustained concentrated ownership structure, even if the tradability constraint is removed in future. Actually, it can be seen from Table 16.3 that up to 2001 the average largest control stake of all Chinese listed firms still amounts to 45.7%. It is unwise, however, to treat the legal/regulatory determinant as the deterministic one, as it cannot explain the intra-country variation of shareholding concentration across different listed companies, and this is exactly what the economic interpretations can remedy.

Table 16.5 reports both the cross-section and the panel data fixed-effect regression results reflecting the firm-specific determinants of shareholding concentration of state-controlled public corporations. Specifically, the estimation results suggest that the dilution of state shareholdings is predicted by higher levels of lagged sales revenues, which could act as a proxy for higher growth prospects perceived by the state controlling shareholders in the next period. So to finance business growth, the state trades some of its cashflow rights provided that corporate control is still maintained.<sup>26</sup> Besides, we find a significantly positive correlation between shareholding concentration and the contemporaneous industry profitability, which indicates that the state may retain more ownership claims in profitable industries. Finally, the negative coefficient sign with the year 2000 dummy in panel B implies a significant policy change in favour of private investments on Chinese industries.

When it comes to the evolution of corporate control, particularly the extent to which the government has surrendered its control to the private after one decade of SIPs, we make every endeavour<sup>27</sup> to trace the origins of the non-state-controlled listed firms identified as of year-end



**Table 16.5** The determinants of shareholding concentration in Chinese state-controlled public companies

	1997	1998	1999	2000
Panel A: Cross-section regressions of the largest shareholdings				
Return on equity ( $t - 1$ )	0.111 (1.1)	0.100 (1.0)	0.293 (2.7)**	0.111 (0.5)
Sales growth ( $t - 1$ )	-0.050 (2.0)**	-0.038 (1.8)*	-0.059 (2.9)**	-0.047 (1.7)*
Industrial profit margin ( $t$ )	0.002 (0.9)	0.001 (0.6)	0.003 (2.5)**	0.003 (1.5)
Takeover	NA	-0.227 (1.3)	-0.051 (2.9)**	-0.048 (2.0)**
Intercept	-0.114 (0.6)	-0.227 (1.3)	-0.210 (1.4)	-0.871 (3.1)**
Standard error	0.162	0.161	0.159	0.238
$\bar{R}^2$	0.10	0.14	0.14	0.10
$X^2 H_0$ : homoscedasticity	[0.845]	[0.102]	[0.715]	[0.048]
No. of observations	359	382	516	396
Panel B: Panel date fixed-effect estimations				
	The largest shareholdings		Shareholding concentration	
Return on equity ( $t - 1$ )	0.045 (0.8)		0.032 (1.1)	
Sales revenues ( $t - 1$ )	-0.014 (1.2)		-0.027 (5.9)**	
Industrial profit margin ( $t$ )	0.003 (2.0)**		0.002 (2.7)**	
Takeover	-0.017 (1.1)		-0.011 (1.8)*	
Year 1998	0.066 (1.5)		0.001 (0.2)	
Year 1999	0.001 (0.1)		-0.006 (1.5)	
Year 2000	-0.066 (4.7)**		-0.025 (4.4)**	
Intercept	0.637 (2.4)**		0.777 (8.1)**	
Firm dummies (789)	Included		Included	
Standard error	0.128		0.046	
$\bar{R}^2$	0.58		0.91	
No. of observations	1656		1656	

Notes:

- (1) Firm-level data include all Chinese public companies with the state as the ultimate controlling shareholder over the period 1996–2000. Observations with suspicion of profit exaggeration and other outliers are removed from the regressions.
- (2) Dependent variables: *largest shareholdings* represent the proportions of shares held by the largest state-controlled stockholders; *shareholding concentration* is measured by the Herferndihl index (the sum of the squared shares of each of the top 10 shareholders), and the higher index means a higher degree of ownership concentration.
- (3) Independent variables: *return on equity ( $t - 1$ )* is the net profit divided by equity capital with one year lagged; *sales growth ( $t - 1$ )* is the rate of sales revenue change with one year lagged, while *sales revenues ( $t - 1$ )* are those in logarithm with one year lagged; *industrial profit margin* is the average profit rate of the industry to which a particular company belongs; *takeover* is a dummy variable valued by 1 for control transfer and its subsequent time period, otherwise 0.
- (4) T-statistics are reported in parentheses, and p-values for chi-square statistics are in square brackets.
- (5) \*\*Marks significance at the 0.005 level.

2001 in Table 16.3, with the aim of answering the crucial question on the control evolution in China – where do these non-state companies come from? It is found that the 209 non-state-controlled listed firms shown in Table 16.3 have three origins: direct IPOs, takeovers through the backdoor listings mentioned above, and management/employee buy-outs (MBOs).

Table 16.6 shows the number of non-state firms that directly went public through the state-regulated IPO process with a breakdown of years and subtypes. It can be easily realised from a

**Table 16.6** *Non-state firms listed through the state-controlled IPO process by the end of 2001*

	Private	Collective	Foreign	Total IPOs	Ratio (%)
1990–92	1			54	2.0
1993	3	1	2	123	4.9
1994	1	5	1	110	6.4
1995	1			24	4.2
1996	7	8	1	203	7.9
1997	6	6	1	206	6.3
1998	4	3	1	105	7.6
1999	3	11	1	96	15.6
2000	11	9		137	15.0
2001	11	2		78	16.7
Total	48	45	7	1136	8.8

The table reports the proportion of non-state-controlled listed companies as of year-end 2001 that are directly floated on the domestic equity market through the state-regulated IPO process. In line with the categories used in Table 16.3, ‘private’ means those controlled by listed and unlisted domestic private firms, ‘collective’ indicates those by unlisted urban collective firms and TVEs, and ‘foreign’ designates those by unlisted foreign private firms. The fourth column shows the total number of IPOs allowed by the state in given years, and the ratio of non-state-controlled IPOs to the total number is calculated in the last column.

comparison with the total IPO numbers that non-state IPOs were tightly constrained until 1999, when the government seemed to relax the restrictions. But despite that, yearly non-state IPOs only account for about 15% of total public offerings. Hence there is still serious discrimination against private firms, while SOEs in general enjoy preferential access to equity financing at least up to the start of this century. What is more, eagle-eyed readers may have discerned two opposite trends in the numbers of private and collective IPOs during the 1990s – the rise of the private and the fall of the collective. We suspect two contributing factors are responsible for the contrast. First, due to ideological reasons, it was extremely difficult to directly float private firms on the market during the first half of 1990s. As a result, they disguised themselves as collectives to gain access to a listing. Second, a substantial proportion of collective firms such as urban collectives and rural TVEs have been gradually privatised since the late 1990s, so the private force has finally dominated the non-state sector at the turn of the century.

When private firms cannot get floated on the market through the discriminating IPO channel, they resort to the backdoor listing discussed above. Table 16.7 reports the number of non-state firms that have gained their listing status through off-market takeovers. Apart from 14 companies acquired that were originally non-state-controlled, 86 are privatised by state-controlled largest shareholders giving up their controlling stakes to non-state firms, a great majority of which are private ones. And it can be recognised from the table that the first two control transfer events happened in 1994 and took off in 1998. In addition, government relinquished its control to firm insiders – management/employees – in six companies as early as 1997, which is shown in Table 16.8. Combining Tables 16.6, 16.7, and 16.8 then yields an accurate picture of the origination of the 209 non-state firms: 92 (86 + 6) companies are under the ultimate control of private ownership because of the voluntary government retreat, while the others managed to be floated through the IPOs.

**Table 16.7** *Non-state firms listed through takeovers by the end of 2001*

Acquiree	State			Private/Collective	
	Private	Collective	Foreign	Private	Collective
1994	2				
1995					
1996	4				
1997	8	1		1	
1998	15	1	1	2	1
1999	16			3	
2000	16	2		3	
2001	18	2		4	
Total	79	6	1		14

The table reports the number of non-state-controlled companies, as of year-end 2001, that have gained their listing status through takeover of existing publicly traded firms. Non-state firms can either take over state-controlled listed firms or extant private/collective ones; the second to fourth columns report the numbers of state-controlled listed firms that were acquired by private, collective, and foreign firms respectively each year; and the last two columns show the numbers of those gaining the equity market access through acquisition of private/collective listed companies.

**Table 16.8** *Non-state firms listed through management/employee buy-out of holding companies by the end of 2001*

Acquiree	State		Collective
	Management	Employee	Management
1997		1	
1998			
1999		1	1
2000	1		
2001	3		2*
Total	4	2	3

The table reports the number of listed companies that became non-state-controlled as of year-end 2001 through the management/employee buy-out of holding companies of the public firms. The two middle columns show the number of state listed firms that were bought by the management and employees, and the last column shows that of companies whose controlling shareholders are collective firms when listed but were later bought out by the management. The two year-2001 companies with an asterisk mean that only when the ultimate shareholders were required to disclose at the end of 2001 did we realise that the once collective parent firms had been completely privatised, so we can only conclude that the exact time of the two management buy-outs falls between the IPO date and 2001.

## Why Government Is Reluctant to Relinquish Corporate Control

The slow and at best partial SIPs in China documented in previous sections lead us to wonder whether the Chinese-style SIPs necessarily imply a gradual erosion of state control over listed companies in order to obtain more and more equity finance. Or does it merely imply the persistence of government control with a modest degree of ownership diversification, the motives of which are yet to be adequately explored? In this subsection, we argue that the potentially dramatic deviation of cashflow rights from control rights induced by the pyramid structure plays a critical role in explaining why the state does not have to sacrifice its effective control in return for a reasonably large amount of equity finance.

Actually, the control-enhancing role of stock pyramids is well recognised in theory (e.g. Bebchuk *et al.*, 2000; Claessens *et al.*, 2002) and empirically identified in a large number of Asian and continental European public corporations to ensure that their ultimate controllers, especially founding families, can retain control (Bortolotti and Faccio, 2004; Claessens *et al.*, 2000; Faccio and Lang, 2002; La Porta *et al.*, 1999). And we suspect that the Chinese government may wish to emulate the Asian and European family firms by playing the same game.

To put it a little bit more formally, consider a sequence of  $n$  ( $n \geq 2$ ) firms in a pyramidal control chain, in which the ultimate controller holds a fraction of  $S_1$  of the shares in company 1, company 1 holds a fraction  $S_2$  of the shares in company 2, and so forth.

It can be shown that the ultimate controller is able to exercise effective control over each firm in the pyramidal chain, including the company  $n$ , if and only if,

$$S_i \geq S_i^* = Z_\alpha \sqrt{\frac{\pi_i H_i}{1 + Z_\alpha^2 \pi_i}} \quad i = 1, 2, \dots, n$$

where  $S_i^*$  is the so-called ‘critical control level’<sup>28</sup> beyond which the control of the largest shareholder in company  $i$  is no longer contestable (Cubbin and Leech, 1983). And it is a function of  $\pi_i$ , the probability of shareholders exercising their vote at company  $i$ ’s shareholder meeting,  $H_i$ , the Herfindahl index of shareholding concentration in company  $i$ , and  $Z_\alpha$ , the  $z$ -value such that  $P(z \leq Z) = \alpha$  for a Normal distribution with  $\alpha$  being the probability of winning the vote at a shareholder meeting.

With regard to the cashflow rights, however, the fraction of cashflow rights/ownership claims ultimately held by the ultimate controller in the downstream company  $n$ , in this scenario, turns out to be

$$S = \prod_{i=1}^n S_i$$

For example, assuming that the ultimate controlling shareholder owns 50% of shares at each tier of the pyramid, which guarantees that its control is not diluted through the pyramid, its cashflow rights over the downstream company  $n$ , however, are drastically reduced to  $(0.5)^n$ . Even if  $n = 2$ , the ultimate controller can only contribute 25% of capital but get 100% of control over downstream companies. And, generally speaking, the longer the pyramidal control chain, and the smaller the  $S_i$ , the greater separation between control rights and cashflow rights. The following case of the Sinopec Group also serves to illustrate the point very well.

The original China Petroleum and Chemical Group Company was a large integrated solely state-owned business group under the direct supervision of the central government. Shown in Figure 16.4, the 10 downstream companies were traditionally all the solely owned subsidiaries,

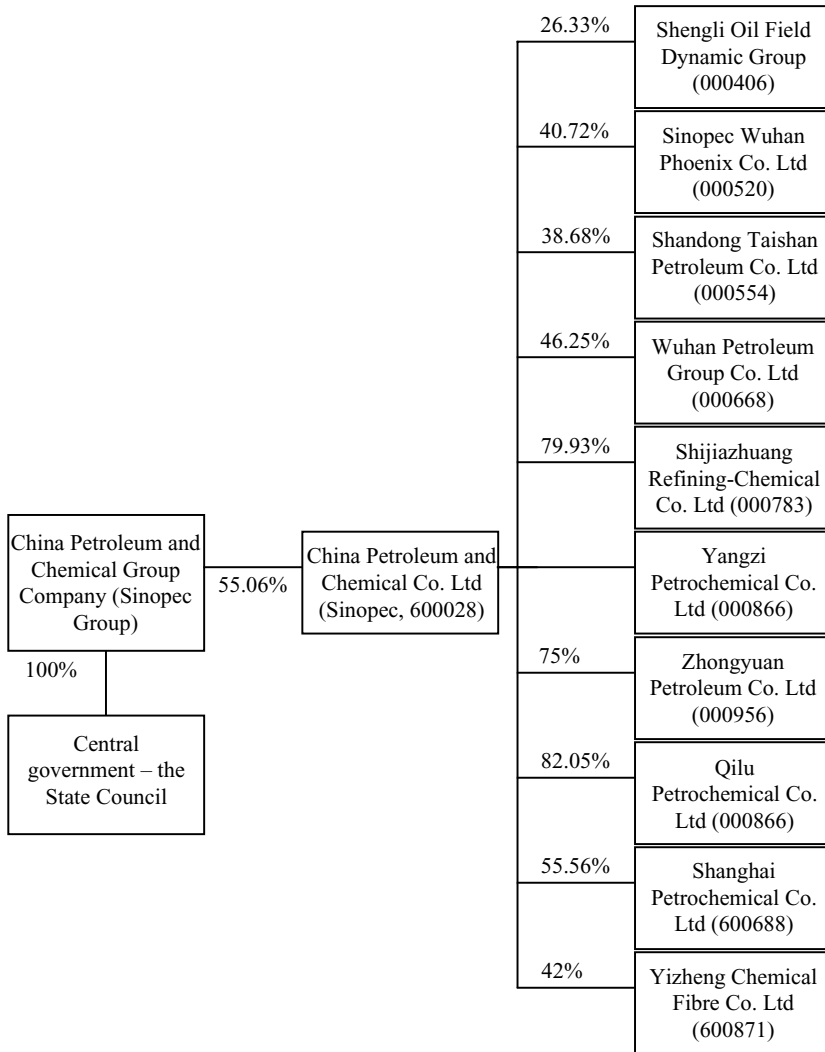


Figure 16.4 The pyramid structure of the Sinopec Group

but later they respectively were floated on China’s emerging stock market from 1993 to 1999, with the old group company taking the controlling stakes, which was the first ownership dilution. The years 2000 and 2001 witnessed a more radical separation between control rights and cashflow rights: Sinopec, established on the core businesses of the old group (now known as Sinopec Group), was floated in Hong Kong, New York and London in October 2000, and afterwards in Shanghai in August 2001. At the end of 2002, the group company still held 55.06% of cashflow rights in the quoted flagship Sinopec. Moreover, as illustrated in Figure 16.4, it has replaced the old group company as the controlling shareholder of the 10 publicly listed subsidiaries. Therefore, the cashflow stakes of the state in the 10 downstream companies have been further diluted while its ultimate control is unaffected.

As an extreme case, Shengli Oil Field Dynamic Group (000406) was once 100% owned by the group company, but after its flotation in 1996, the group only retained 26.33% of its shares. And after 2000, the ultimate cashflow rights dwindled further as the Sinopec Group, representing the central government, now only holds  $26.33\% \times 55.06\% = 14.5\%$  of shares in the company. Nevertheless, it would be erroneous to believe that the state control of these firms has significantly declined as well,<sup>29</sup> because the unique mechanism of state pyramid structure largely guarantees that the state can ultimately wield nearly 100% of power on these firms with a much smaller amount of capital invested. So, it transpires that it is the government non-controlling ownership stakes, not the control rights, that have been effectively traded for equity finance.

Although the control-enhancing role of stock pyramids may give ample incentives for the government to adopt a rather opportunistic approach to the control issue, i.e. trading limited ownership stakes for cash without loss of the substantial rents of corporate control, it is unwise to assert that the current state dominance in Chinese listed firms will endure. This is due to the premise of our previous analysis that corporate control itself must be sufficiently valuable in the first instance. As the controlling shareholder of a public corporation, the government distinguishes itself from minority shareholders not only in the greater dividends/cashflow claims deriving from its larger shareholdings, but also in the considerable control 'rents/premiums' that could be exclusively captured (Bebchuk, 1999). This leads us to believe that the state would surrender its control when a listed firm, for whatever reason, has deteriorated into such a financially distressed position that the corresponding government agency and bureaucrats can neither collect profits based on their ownership claims nor capture significant control rents from the limited corporate resources.

## **CONCLUDING REMARKS**

The notion of ownership and control, and their complex interrelationship with corporate performance and behaviours, have long been a topic under intensive discussion in economic literature dating back to Berle and Means (1932). Moreover, the ownership and control issue tends to remain in the limelight of contemporary research on corporate governance systems, which are believed to have a crucial bearing not only on firm and industrial competitiveness, but also on the efficiency of financial systems and overall economic growth across the globe. With respect to China, the last 25 years of gradualist economic transition and integration into the world economy have resulted in a sea change in the country's industrial sector, where the corporatisation of former SOEs and the rise of the non-state sector are here to stay. At this critical juncture, this chapter has undertaken an assessment of the first decade of development of Chinese corporate governance and capital market, with special reference to the static and dynamic aspects of ownership and control.

In concrete terms, we have dissected the state-dominated corporate governance system in two dimensions. First, we provide a novel analytical framework to investigate the hypothesised performance variations in association with different classes of intermediate shareholding agents within the state pyramid. After controlling for other potential effects on performance, in particular firm-specific effects, our research finds a significant pattern of performance variation among Chinese public corporations. From a policy perspective, this finding provides the Chinese government with critical insights into how to choose a relatively efficient shareholding structure to retain its ultimate control at a situation where market competition is imperfect.

Furthermore, we argue that our approach has general relevance to the study of concentrated ownership, because the same conceptual framework may be naturally applied to other types of ultimate controlling shareholders such as banks or families. Future research may be designed to examine if there is any disparity of major corporate decisions and policies in downstream listed companies that can be attributed to different classes of intermediate shareholdings. In other words, do firms under the control of different intermediate agents tend to behave differently in some certain aspects, such as managerial turnover and compensation, debt policy, dividends policy, investment decision etc.? Understanding of these delicate behavioural differences, once achieved, would provide some more *exact* explanations for the performance variations observed.

Second, we provide an exploratory study of the evolution of ownership and control and its economic and regulatory determinants in line with the state-of-the-art corporate governance literature, and hope to extend the cutting-edge research to the Chinese context. Particularly, we find that better growth prospect in state-controlled public companies would lead the government to dilute its shareholdings to finance further expansion for growth, though effective corporate control is largely retained, if not further bolstered, by widespread stock pyramids. Regarding the transfer of corporate control, we manage to trace down the origins of the private-controlled listed firms which comprise direct IPOs, takeovers and MBOs. Consistent with some of the SIP studies in other developing and developed countries, the Chinese government so far employs the stock market to trade *limited* ownership stakes, rather than *de facto* control, for finance. However, more research needs to be done in identifying the specific factors that affect the state's decision on control transfer. In particular, rigorous theoretical models based on the explicit specification of the pay-off function of Chinese government bureaucrats are in order to pinpoint the key conditions under which full privatisations could be triggered. And they should be in turn tested against the stylised fact in China: the performance-driven pecking order of control transfer. That is, the least profitable firms are in the top priority of full privatisation, whereas the government keeps a firm grip on the most profitable ones.

The Chinese experience documented in this chapter, we believe, is of particular interest to the construction of efficient corporate governance in both emerging markets and transition economies. And our research findings reported in the chapter, we hope, can help lay a good foundation for the policies to be formulated to reform the current inefficient state-dominated corporate governance system, as well as complement the broader research enterprise of international corporate governance systems to a significant extent.

## NOTES

1. The Chinese stock market was established at the start of the 1990s, with the Shanghai Stock Exchange beginning operation in December 1990 and the Shenzhen Stock Exchange in July 1991.
2. It should be noted that non-tradable does not necessarily mean non-transferable, since state and legal person shares can be transferred among various institutions subject to government approval, but the crucial point here is that after the transfer these shares still remain non-tradable on the market. Employee shares are offered to workers and managers of a listed company usually at a substantial discount. They were initially not tradable until they had been held for a minimum of six to 12 months and the company concerned had filed an application of market transaction to the Securities Regulatory Commission.

3. The separation of A- and B-shares is due to the inconvertibility of RMB in China's capital account.
4. For the negligible percentage of shares held by overseas institutions (overseas legal persons), a substantial part of them are actually Chinese firms registered in Hong Kong or other tax-friendly jurisdictions.
5. For an informative description of the share types and listing process of the Chinese firms from a practitioners' perspective, see Walter and Howie (2003, Chapters 4 and 5).
6. Specifically, firm value has been found negatively related to the difference between the ultimate controlling shareholder's control/voting rights and cashflow rights/financial stakes in its downstream public company, which is a rough proxy for the relative magnitude of the controller's distorted incentive for entrenchment and tunnelling.
7. For instance, La Porta *et al.*'s (1999) sample shows that 70% of large corporations in Austria, 45% in Singapore, and 40% in Italy and Israel are under ultimate state control by using the 20% cutoff level. With the same cutoff criterion but samples less biased to large firms, Claessens *et al.* (2000) found 23.5% of public companies in Singapore and 13.4% in Malaysia state-controlled, while Faccio and Lang (2002) identified that state-controlled companies constitute more than 15% of their Austrian and Finnish sample.
8. Presumably, we might observe less variation of such control mechanisms from government-controlled companies in city-states and small countries mentioned in note 7. But for a country like China, pervasive state control of downstream public companies may need a far more complicated pyramid structure, at least for technical reasons.
9. The Chinese corporate law does not permit multiple classes of voting rights, so shareholding rights and voting rights are interchangeable in Chinese companies.
10. This is even much more severe than the case of West European firms documented by Faccio and Lang (2002), subsequently evidenced by Table 16.1, that only 32 Chinese companies in the intermediate control chains are themselves floated on the market.
11. One of the tips for such identification is that, according to the Chinese regulation, if state-controlled shareholders of public companies wish to transfer/sell shares to other identities, they have to file an application and obtain the final approval from the Ministry of Finance, whereas there is no such requirement for private-controlled shareholders.
12. For example, the Shenzhen Investment Holdings Company and its subsidiary collectively control 68.19% of the voting rights in the Guangdong Sunrise Group Co. Ltd (Stock Code 000030), a publicly quoted company in real estate business. Directly supervised by the Shenzhen municipal government, the investment holding firm also owns controlling stocks in another 16 companies listed in the Shenzhen Stock Exchange and three companies listed in Hong Kong, ranging from telecommunication industry to pharmaceutical and petrochemical industries.
13. See Khanna (2000) for a succinct survey.
14. Keister's (1998) study on Chinese business groups at the early period 1988–90 is the only empirical work of which we are aware. However, it was focused on within-group organisational characteristics and did not contain a comparison with non-group firms. Moreover, the diversification at the group level was not addressed in that paper.
15. Casual observations of the board structure in Chinese public corporations where government agencies act as the largest shareholders reveal that government bureaucrats take only one, or even no, seat on boards with the remainder filled with inside managers. So it is not unreasonable to conceive that most information about the downstream firms the bureaucrats get is through reading reports in their own offices from subsidiary managers.
16. Similar empirical findings in other emerging markets can be found in Khanna and Palepu (2000a, b), who demonstrated the extent to which Indian and Chilean firms can benefit from group-level diversification.
17. In our sample, quoted industrial companies under state ownership are larger than the private ones by 1.7 times in terms of sales.



18. Here we do not deny the validity of a more cynical interpretation grounded on the rent-seeking view, especially considering the Chinese social-political context. That is, only these large state-diversified groups can reap substantial benefits via the policy favours granted by the government, in contrast to the absence of such political connection in the private diversified firms.
19. In our sample, only 16% of the state-owned industrial companies are diversified, which is relatively small in terms of specialised ones.
20. Bebchuk (1999) devises a simple model showing that when private benefits of control are large, an initial state of dispersed ownership structure is not a stable equilibrium, and a concentrated one will finally dominate. A countervailing argument is raised by Franks *et al.* (2003), who hold that the British experience is not consistent with the aforementioned story. Investigation of the ownership evolution of a unique dataset of British firms reveals that ownership was rapidly dispersed at the first half of the twentieth century when effective investor protection was not in place. They alternatively suggest that informal relations of trust played an important part in the dispersion.
21. For example, Jones *et al.* (1999) find that only 28.9% of firms in their large SIP sample sell more than 50% of capital in the initial sale.
22. Chinese firms are not included in their sample.
23. The institutional arrangement was quite useful for assuaging communist leftists' ideological concerns about the dilution of state ownership, especially considering the political atmosphere precisely after the 1989 Tiananmen Square event.
24. Since there is no market price for these non-tradable shares, the transfer price is then determined by a bargaining process between sellers and potential buyers. In practice, the price is far lower than that of its tradable counterpart, and only a little higher than the net assets per share.
25. It could be a very time-consuming process that takes one year or so, and there is no guarantee that the initial share block transaction would not be overturned by the higher layers of governments.
26. Space limits prevent us from elaborating the reasons why governments, especially the local ones, are so keen to promote the business growth of the firms under their jurisdiction. For an institutional analysis of the phenomenon, see Liu *et al.* (forthcoming).
27. The detailed procedure is similar to those elaborated in 'The ultimate shareholding structure', above.
28. It is worth noting that the critical control level can be far less than the 50% common sense if the shareholding distribution in the *remaining* investors of company *i* is dispersed enough. As a matter of fact, an equity holder who has only 10% of the total shares may well be the de facto controller of the firm if all other investors' shareholdings are far less than 1%. Hence in theory the separation between cashflow rights and control rights arises even absent the pyramid structure.
29. One may have doubts on the control power of the Sinopec Group on Shengli Oil Field Dynamic Group (000406) with only 26.33% of voting rights in hand. A further examination of the firm, however, reveals that the ownership distribution of the remaining shareholders is highly dispersed, since the total shareholdings from the second to the tenth investor only amount to 12.64%. Applying the aforementioned criterion of 'critical control level', we can see meagre control contestability in the firm.

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# Corporate Governance in Transition Economies

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## INTRODUCTION

Extensive privatisation has now occurred across many transition economies through a variety of methods. Differing approaches to privatisation have major implications for the subsequent nature of governance structures. Essentially, the three principal objectives of privatisation concern the speed with which it takes place, the need for acceptability and accountability in the process and the impact on efficiency (Wright *et al.*, 1993, 1994). Political factors have often played a major role in both the pace and form of privatisation adopted in a particular country. These political influences have meant that the importance attached to the establishment of corporate governance mechanisms in privatised enterprises has varied considerably. The need for the political acceptability of privatisation has often meant greater emphasis has been placed on the need for accountability and/or speed in the sale process. For privatisation policy to be implemented successfully, there is a need to balance the three objectives of accountability, speed and efficiency.

As the process of transformation has become more developed and some countries become well advanced in their accession to the EU, the emphasis of policy is shifting. In particular, increasing attention begins to focus on the issue of ensuring enhanced enterprise efficiency, though, of course, political factors may still place severe constraints on actions designed to deal with this problem. This changing emphasis brings consideration of corporate governance issues to the fore.

The development of appropriate corporate governance mechanisms in transition economies is distinguished from the economies of the West by the initial complete absence of the necessary prerequisites of an appropriate legal infrastructure and financial institutions in an environment where incumbent management and employees have entrenched rights within enterprises. Legislation had to be enacted which for the first time introduced Western-style property rights, financial reporting requirements and bankruptcy laws. This legislation is now generally in place throughout much of CEE, though the effectiveness of its enforcement varies between

countries and the associated institutions have taken longer to develop. At the same time, social justice arguments have frequently meant that incumbents generally acquired substantial equity stakes on privatisation in the enterprises in which they are employed. Given these conditions and the changing emphasis on seeking efficiency improvements in enterprises, the governance problem in transition economies becomes one of identifying how one might move towards a structure which will better enable efficiency benefits to be delivered.

The aim of this chapter is to discuss the nature of governance problems in CEE and to analyse the potential for the various elements of a corporate governance framework to resolve these difficulties. Given the heterogeneity of countries and governance problems in CEE, the approach adopted is based on the issues involved with examples of experience in particular countries being introduced as appropriate. The following section outlines the nature of corporate governance in the various types of approaches to privatisation adopted in transition economies. The third section discusses in turn the role of the various parties available in principle to undertake corporate governance. The fourth section presents a review of the evidence on the effects of different forms of governance; this section places a special emphasis on employment levels and strategies towards human resources, a crucial enterprise asset in CEE, concluding with an examination of the impact of governance on restructuring strategies and on management learning. A final section presents some conclusions.

## **CORPORATE GOVERNANCE AND DIFFERING PRIVATISATION APPROACHES IN TRANSITION ECONOMIES**

The important elements of a governance framework are discussed in detail elsewhere in this volume. An important issue concerns the comparative strength of voice and exit in the governance process. In transition economies, governance problems in privatised firms may be widespread given the general absence of financial institutions with sufficient expertise to undertake close monitoring. Further problems may result from the importance given to wider employee share ownership and the importance of buy-outs with a 'give-away' element. This can mean reduced pressure to meet financing commitments, greater likelihood of managerial entrenchment behaviour, problems of diffuse ownership and actions to meet the short-term objectives of employees.

The relative strengths of corporate governance in the various types of privatisation observed in CEE are summarised in Tables 17.1 and 17.2, which highlight the importance of voice and exit governance mechanisms. Given the general absence of external monitoring, of the ability to exit through share sales in a situation of weak stock markets and markets for corporate control, of weak product market competition and bankruptcy laws,<sup>1</sup> corporate governance is likely at least in the short term to rely heavily on the voice of insiders. This means that the employee and management buy-outs listed in Table 17.2 have often been used in CEE privatisations in contrast with the more conventional Western privatisation vehicles considered in Table 17.1. Nevertheless, the governance characteristics of management and employee buy-outs in Table 17.2 can be expected to vary with the circumstances. It may be expected that corporate governance will be weaker the more privatisations are of the 'give-away' type and the wider is employee ownership. The rationale for this view is developed further below. However, before analysing the potential contribution of the various elements of corporate governance

**Table 17.1** *Alternative privatisation approaches and governance I*

Type of privatisation	Governance by individual shareholders	Governance by financial institutions and industrial partners	Indirect governance (through share sales)
Absentee shareholders:			
Trade sale	Medium	Medium	Quite high
Flotation	Low to medium	Low to medium	High
Mass voucher schemes (without mutual funds/institutional shareholders)	Insignificant	Insignificant	High if shares immediately tradable
Holding company/mutual fund voucher schemes	Low	High, if capable institutional managers available	Low in long term

**Table 17.2** *Alternative privatisation approaches and governance II – incumbents (buy-outs)*

	Governance by individual shareholders	Governance by financial institutions/ industrial partners
<b>(a) ‘Conventional’ buy-outs</b>		
(Shares bought out of individual savings or ‘hard’ credit)		
MBO	High. Managers motivated by job preservation, share of profits and fear of losses to ‘voice’ effective control, but – free riding within management teams? – little opportunity to sell shares, except through internal market?	High in principle where financial institutions impose vertical control. Individual managers must repay ‘hard’ credit. In the region such control may be absent because of undeveloped financial system
EBO	Quite high. Employees voice effective control, but – free riding throughout workforce? – little opportunity to sell shares	As above
<b>(b) ‘Give-away’ buy-outs</b>		
(Shares bought out of enterprise savings, or ‘soft’ credit either by managers and employees directly or indirectly through citizens’ vouchers)		
MBO	Quite low. Managers gain from job preservation and enterprise profits, but no personal financial sacrifice through ownership of shares if enterprise makes losses	Quite low as default on loans common yet refinancing is (almost) automatic
EBO	Quite low. Free-rider issues will exacerbate the problems with ‘give-away’ MBOs, see above	Low, as above

mechanisms to contribute voice to the monitoring process, the following section presents some evidence on the extent and nature of governance in privatised enterprises in CEE.

An emerging theme across transition economies has been the use of employee-slanted buy-out methods to achieve the quick privatisation of the majority of large manufacturing firms, typically experiencing financial difficulties. On the other hand, the sale of stakes in the state's 'crown jewels' – resource-based firms and 'strategic' stakes in high-tech firms – has generally proceeded more slowly, using auctions, placements etc., which place more emphasis on securing maximum sale proceeds. This tendency is noted below for individual countries.

## **CORPORATE GOVERNANCE IN TRANSITION ECONOMIES**

The nature of privatisation in transition economies varies considerably between and in some cases within countries, reflecting the relative importance of the privatisation objectives identified earlier which in turn are conditioned by political and economic contexts (see, for example, Frydman *et al.* (1993) and Estrin (1994) for outlines of varying privatisation programmes). This section and the next provide a flavour of the variety of types and the governance issues they raise, but with an emphasis on the issues which may be raised in attempting to enhance governance in companies which are privatised as independent entities and especially the widespread cases in CEE where insiders hold significant equity stakes.

### **Hungary**

In Hungary, there are indications that management- and employee-owned groups chiefly had to share ownership with the SPA, the Hungarian State Holding Company, local governments, commercial banks, and on occasion with outside investors who retained a very small ownership proportion generally left over from the period of transformation. In most cases, the only significant minority shareholder was the SPA, mainly due to the requirement that a proportion of shares be set aside for holders of compensation certificates (SPA, 1994). Banks providing finance typically rarely took equity stakes, and when they did, their shareholdings were generally modest. Ownership involvement by a foreign firm often concerned cases where the foreign partner took part in the initial transformation of the company. Whilst wider employee ownership has developed, shareholdings have tended to be concentrated amongst management, since the rules for share subscriptions have tended to weight ownership towards managers and long-serving employees through a system of points reflecting the number of years at the company, position and salary, or simply the amount of money that management was willing and able to invest.

Evidence also indicates that the ability of employee shareholders in buy-outs involving ESOPs to engage directly in governance was constrained since supervisory and ESOP management bodies were typically dominated by the firm's managers. Evidence from detailed case studies of 17 Hungarian buy-outs (Karsai and Wright, 1994) shows that though employees as a group often had significant equity stakes, management played the dominant role. Employee owners were typically, because of their low and diffuse equity stakes together with lack of expertise, unable to exercise an effective supervisory role. The banks, which provided finance

to most of these companies, also preferred management to occupy a dominant position as a condition of extending the loan. Employment was known to have increased in only one enterprise. In the seven cases where redundancies occurred, the reduction in employment varied between 10% and 31%.

By 2002, 12 years after the commencement of large-scale privatisation in Hungary, the process was still incomplete. In 2002, plans were still being announced for the privatisation of the power firm MVM, the Malev airline, the Dunaferri steel company, the national broadcasting firm Antenna Hungaria, the shipping company Mahart, and Babolna in agriculture. Declarations of intent have also been announced in relation to the Hungarian postal service and the railway network.

## Poland

In respect of post-privatisation governance in Poland there is evidence that the ownership structure of leased firms has become more concentrated with time, mainly in the hands of outsiders but also with managers who often buy shares from employees. However, the tradability of shares has usually been limited. In 18 enterprises monitored by Dabrowski *et al.* (1993), the founders and employees had priority in buying shares and the sale to outsiders had to be accepted by management, supervisory boards etc. Nevertheless, this monitoring of a group of enterprises observed some increase in the extent of share trading over time, primarily because of the termination of employment, with outside investors becoming more involved. According to another survey of 142 enterprises (cited in Filatotchev *et al.*, 1996b), up to December 1992, 13.5% of all shares changed owner. Generally, the increasing share of outside investors and that of managers indicate that constraints on the tradability of shares are being progressively eased.

Interesting evidence on post-privatisation changes in Poland is available from a survey completed in June 1993 of 110 of the 200 enterprises established prior to the end of 1991 and which had subsequently leased the assets of previously state-owned enterprises (see Jarosz, 1994a, b, for full details). This evidence shows that as compared with the period before privatisation (i.e. beginning of 1990) employment by June 1993 had been reduced significantly. In 21% of companies employment was more than halved, in 40% of companies it fell by more than 31% and less than 50%, and in only 9% of companies it increased. Moreover, reductions in employment in lease-buy-outs exceeded that for the economy as a whole. Between January 1992 and June 1993 employment in the Polish economy fell by 6.93% whereas in lease-buy-outs it fell by 10.91% (Jarosz, 1994a, b). The study also shows that from the end of 1991 real wages in leased enterprises first rose by 4.6% and then fell to 10% below the starting level by the first half of 1993. In contrast, the enterprise sector as a whole saw real wages initially increase by 18.1% before falling to finish the period an eighth below the level seen at the end of 1991. The same survey shows that wages increased more in those companies where the reduction of employment was greater. The main weakness of the Polish leased enterprises seems to be a lack of capital and low investment and their main strength the strong support from their employees.

The mass privatisation programme in Poland began in 1993, but by 2002, the state still retained a controlling stake in over 2000 firms. These included three important banks, a large insurance firm, virtually all the steel industry, and KGHM copper and silver mining. Whilst some of these firms may be seen to represent the 'crown jewels' of Polish industry, a number of large loss makers remain in state hands, and the privatisation process has virtually stalled.



## Russia

Russian evidence suggests that although employees may have significant equity stakes, their involvement in boards of directors and other control mechanisms is generally very low (Filatotchev *et al.*, 1996a; Gurkov and Asselbergs, 1995). Indeed, a substantial majority of workers in privatised Russian firms believed senior managers were the dominant owners of the enterprise, even where workers owned significant shares (Lissovolik, 1997). Earle *et al.* (1996) show that management and executive boards, followed by managerial shareholders, have the greatest influence on decisions regarding sales, production, employment, social benefits, investment etc. However, employee ownership was found to be consistently greater than for other actors except management, with workers being moderately influential over the allocation of profits, especially in employee-owned firms.

In the early stages of the transition process, employee board representation appeared to have declined between the year prior to privatisation and one year afterwards. In contrast, employee participation in decision making increased a little after privatisation in terms of formal and informal consultations, particularly in terms of formal consultation with workers' assemblies on strategic issues. Employee representation on boards seems to have declined in Russia between 1995 and 1997 (Wright *et al.*, 2003b). Corresponding increases in representation were most notable in respect of outside private individuals, management, corporations and investment funds. Board representation by banks remained unchanged at a low level. About one-third of privatised enterprises had external private individuals on their supervisory boards and approaching a quarter had corporate representatives. Where they did have board representation, employees were the second most important stakeholder representative, on average holding 2.7 seats compared to management's 3.3. By comparison, investment funds hold 2.5, corporations 2.3, outside private individuals 2 and banks 1.5.

Despite their low levels of equity holdings, the evidence (Filatotchev *et al.*, 1996b) suggests that outsiders were represented on boards or otherwise present as active investors to a greater extent than their shareholdings would indicate. In most of the authors' sample of 171 privatised Russian firms there were no active or passive outside investors, but in three-tenths of cases, private individuals were involved in control, and in almost a quarter of cases other firms. Banks and the state property fund also fulfilled an active role, notably as directors and to a lesser extent as chairmen of the privatised enterprises. Representation by investment funds, whilst present in some cases, was not as evident as these other stakeholders.

Gurkov and Asselbergs (1995) find that acquisitions of controlling interests by financial institutions were viewed more acceptably than acquisitions by strategic partners. They adduce the reason for this difference to be that it was more feasible to obtain agreements to long-term financial investment from financial institutions, whereas foreign strategic partners were likely to introduce massive corporate restructuring and major shifts in product mixes to meet Western requirements. Freinkman (1995) argued that large Financial-Industrial Groups (FIGs) emerged in Russia which may have been able to contribute to both the rate of enterprise restructuring and patterns of corporate governance for privatised firms through investment in them.

Estrin and Wright (1999) synthesised the results from nine separate studies in Russia covering the period 1994-97. They found that insider ownership of privatised firms fell over time from a peak in 1994 of 69% to a low in 1997 of 52%. Among insiders there was a decline in employee ownership and an increase in managerial ownership (Estrin and Wright, 1999). Extending Estrin and Wright's analysis to take into account subsequent studies showed that this trend broadly continued through 2000 (Table 17.3). The problems here relate to differences

**Table 17.3** *Equity ownership by stakeholders in privatised unquoted Russian firms, 1993–99: a comparison (% of share of ownership)*

Owners	Earle <i>et al.</i> <sup>1</sup> (%) (1994)	Buck <i>et al.</i> <sup>2</sup> (%) (1994)	Blasi <i>et al.</i> <sup>3</sup> (%) (1996)	Jones <sup>4</sup> (%) (1996)	Wright <i>et al.</i> <sup>5</sup> (%) (1996)	Buck <i>et al.</i> <sup>6</sup> (%) (1997)	Aukutsionek <i>et al.</i> <sup>7</sup> (1997)	Filatovchev <i>et al.</i> <sup>8</sup> (%) (1999)	Dolgopyatova <sup>9</sup> (%) (1999)	Bureau of Economic Analysis <sup>10</sup> (2000)
Insiders	69	66	58	59	59	55	52	46	42	53
Managers	21	19	18	13	12	16	15	14	11	18
Employees	48	47	40	46	47	39	37	32	31	35
Outsiders	20	14	32	27	31	39	39	47	50	42
Large	—	11	26	15	23	26	25	28	30	23
Small	—	3	6	12	8	13	14	19	20	19
State	11	20	9	14	10	6	7	7	8	6
Sample (no. of firms)	214	171	357	111	314	105	139	150	200	350

*Notes:* Years in brackets refer to date of survey, share ownership represented as percentage held by each group of shareholders. Large outside shareholders refer to institutional and corporate investors, small outside shareholders are individuals.

*Sources:*

1. Earle *et al.* (1996).
2. Buck *et al.* (1996). Includes enterprises privatised through State Privatisation Programme and lease-buy-outs.
3. Blasi *et al.* (1997). Figures do not sum to 100 in original due to rounding errors and missing data. Includes enterprises privatised through State Privatisation Programme.
4. Jones (1998).
5. Wright *et al.* (1998). Includes enterprises privatised through State Privatisation Programme and lease-buy-outs.
6. Buck *et al.* (1999).
7. Aukutsionek *et al.* (1998).
8. Filatovchev *et al.* (2001).
9. Dolgopyatova (2000).
10. Aukutsionek *et al.* (2003).

in sample coverage of different forms of privatisation and the difficulties involved in obtaining representative samples in transition economies.

An alternative approach is to examine changes over time in the same sample of privatised firms, either by identifying the changes retrospectively or by resurveying firms. A synthesis of the available studies is presented in Wright *et al.* (2003b) which generally showed an overall decline in insider ownership but with management's stake increasing whilst employees' stakes fall. In those studies relying on resurveys, there may be a selection bias where enterprises not responding to subsequent surveys may be those where the share distribution has changed most, e.g. through a sale of the business. Similarly, studies taking a sample of enterprises in a later year and looking backwards at changes in ownership over time may also involve selection biases relating to (a) the inclusion only of surviving independent firms and (b) the inclusion of firms that were not privatised at the start of the period.

Jones (1998) and Aukutsionek *et al.* (1998), who use changes in panels of privatised firms, found mixed evidence of changes in the importance of insiders as dominant shareholders, with managers appearing to be more likely to take a dominant role than employees. Jones (1998) noted that the method of privatisation was important, with voucher privatisations in Russia displaying greater changes in ownership than was the case for leasehold buy-outs.

Russian evidence suggests that managerial purchases of shares from employees have already been extensive, and it appears to be aimed at entrenching management's position rather than to overcome employee resistance by concentrating holdings to enable management to restructure (Filatotchev *et al.*, 1999a).

Ten years after the mass privatisation programme in Russia began in 1992, followed by piecemeal privatisations after 1994, the sale of government stakes in Russia's richest firms is still incomplete. Though the process has accelerated after 2002, the sale of the state's remaining 5.9% stake in Lukoil was delayed in August 2002. The 2003 programme included the partial or full privatisation of more than 1000 of Russia's premier firms. These included Slavneft, Svyazinvest, and the metal producer MMK. Nevertheless much remains to be done, and the state still fully owns 9500 enterprises, plus large stakes in another 3500 companies, estimated to be worth in total \$60 billion (EBRD, 2002, p. 190).

## Ukraine

Evidence from Ukraine (Filatotchev *et al.*, 1995a) showed a substantially greater ownership role for employees and lower involvement by outsiders than was the case in Russia. There were indications that in these enterprises employees had much greater formal and informal involvement in the governance process than was the case in Russia and that post-privatisation actions, whilst involving some restructuring and employment reduction, also saw continued emphasis on the social assets of enterprises and in increasing real wage rates. By 2002, the Ukrainian privatisation programme was nowhere near complete, and new delays were announced for large-scale privatisations such as the power distribution firms, Ukrtelecom and a number of other 'strategic' stakes.

## Czech and Slovak Republics

The approach to large-scale privatisation in the Czech and Slovak republics primarily, but not exclusively, involved a voucher scheme where individuals could bid directly for companies or

indirectly through buying shares in Investment Privatisation Funds which in turn bid for shares in companies. Unlike the variants available under the Russian voucher privatisation, insiders in the Czech and Slovak programmes were not granted special preferences, although management could propose a privatisation project where they perceived it would be possible for incumbents to place their voucher points in their own firm to sufficient extent as to effectively create a worker buy-out (Takla, 1994).

## Bulgaria

Evidence from Bulgaria on transformation in enterprises which were converted to joint stock companies but which remained state owned showed that governance structures remained largely ineffective, with boards being largely passive and managerial remuneration not creating incentives to restructure, though informal mechanisms may have gone some way to constrain managers (Peev, 1995). However, the competencies of individual managers were found to be very important in determining whether restructuring took place. Rock and Klinedinst (1997) reported from their study of enterprises in Bulgaria in 1992 that in cases where workers gained majority control of enterprises, participation in decisions increased dramatically.

Progress with Bulgarian privatisation has generally been slow and in 2002 plans were still being discussed for the privatisation of about 440 majority state-owned firms, of which many were monopolies. These included Bulgartabac, BTC telecoms and the Vazor arms group.

## POST-PRIVATISATION GOVERNANCE

In the light of the previous evidence relating to governance mechanisms in privatised firms in CEE, this section discusses the potential contribution of the various stakeholders to enhancing the governance of such enterprises (Wright *et al.*, 2003b). The following stakeholders are discussed in turn: insider ownership, banks, domestic and foreign companies and non-bank financial intermediaries (such as investment funds, wealthy individuals and venture capitalists).

### Insider Ownership

It may be argued that employee participation in share ownership in newly privatised enterprises will have strong positive effects on efficiency and innovation. Employees may participate in decision making, imposing a strong collective monitoring on management's activities together with mutual monitoring (Ben-Ner, 1993). Employees and management will be closely united, stimulating efficiency and innovation. However, there may be severe difficulties in persuading employees to act in a manner which maximises the longer-term shareholder value (Buck *et al.*, 1994).

Compared to conventional shareholders, employee owners who are unable to freely sell their shares may prefer the firm to take decisions which benefit them in the short term, such as through higher payouts of profits in the form of higher wages and the maintenance of employment, and corresponding lower levels of investment. Employees can benefit in the short term from higher job security and remuneration whilst the benefits from investment programmes are only felt in the longer term. With virtually all their human and financial capital tied up in one enterprise,

employee shareholders may seek to reduce risks by voting for excessive product diversification by the firm.

Employee owners of a firm may be tempted to transfer their ownership rights to outside 'core' investors, since dispersed, internal ownership makes it difficult for them to exercise the control component of their rights, given the costs of mutual monitoring and the lure of the free ride. Moreover, employees may wish to exchange their shares for cash in order to purchase consumer goods and may especially want to do so where the company faces difficulties or has ambitious restructuring plans, and is unlikely to provide a dividend or significant realisable gain in share price for some time. Hence, employee ownership may slowly be eroded as individual employees find ways of selling their shares.

It also needs to be borne in mind that equity ownership is only one part of the overall governance process. Corporate governance also involves the control of the dominant decision makers in an enterprise by other stakeholders. A crucial role is thus assigned to the provision of investable funds, direct monitoring by active investors and the indirect control exerted by creditors. In general, enterprises involved in significant insider ownership in CEE may be expected to differ markedly from those in the West with consequent implications for their ability to effect efficiency improvements. If employees are majority equity holders but managers own only minority stakes, they may have little incentive to effect enterprise restructuring. In the absence of other forms of governance, managers and employees may form a coalition of entrenched interests resisting reform. Unless managers in a particular enterprise are dominant and market oriented, and employees are correspondingly compliant, the extent of market-based transformation may be limited.

## **Banks**

Theory in the West places considerable emphasis on the role of the providers of debt and the need to service this form of finance as hard constraints on the behaviour of managers (Jensen, 1986). Failure to meet interest payment provides an early warning signal that rectifying action is required. Debt providers are viewed as introducing mechanisms such as debt covenants and requirements for the supply of regular financial information which places pressure on management to perform. Whilst these mechanisms help minimise the risks of default, after meeting debt repayments companies which are excessively leveraged may have little cashflow available to engage in new profitable investment.

In both Poland and Hungary, for example, where privatisation may have involved the purchase of businesses, there may be considerable commitment either to service external borrowing or meet instalment payments. However, there are a number of problems in the operation of such commitment mechanisms. The first concerns the nature and role of the banks. Banks may, in principle, exercise control not only through examining the accounts of the client firm, but also by stipulating in loan contracts their information and control rights concerning the firm's operation and financial affairs. However, until bank privatisation is fully implemented, state-owned banks are heavily involved in the financing of buy-outs in Hungary and Poland, the same party which is the seller and which has been unable to monitor enterprises in the past. In other words, after privatisation of enterprises, the banks may still have neither the staff nor the expertise to exert effective corporate governance.

The second difference is that income streams may be considerably less stable than in mature sectors in the West. Third, many enterprises, especially those using leasing approaches to

transformation, may have few assets which can be used as collateral. Fourth, the enterprises are likely to have significant investment needs. Banks are unlikely to be keen to extend their credits and provide fresh cash for investment and restructuring purposes without there being considerable collateral available from, say, real estate. Problems with obtaining reliable financial information on which to base a decision and doubts about the value of assets and uncertainties concerning whether real estate actually belongs to a particular enterprise may also make banks cautious in their assessment of the amount of collateral available. In Hungary, evidence from the authors' survey of buy-outs, as noted earlier, suggests that the value of the security demanded usually amounted to one and a half times the total value of the loan. The ESOP law regulated collateral requirements including detailed rules concerning the bank lien over the property of ESOP groups, the compulsory utilisation of dividends for loan repayment, and responsibility for the management of the firm's assets.

A fifth difference is that enterprises in CEE are faced by high interest rates and difficulties in obtaining long-term debt beyond that available with subsidies. Banks are highly constrained in their ability to fund long-term investments of companies because of undercapitalisation, maturity mismatch arising from the lack of long-term savings and high levels of bad debts generated both under the former regimes as well as from poor lending decisions during the transition period. A further problem is the crowding out effect resulting from the difference between the security of company loans and state securities. Even within these generally problematical conditions, pure buy-outs may be viewed by the banks as a greater credit risk than other enterprise lending. Evidence from a survey of the nine main commercial banks in Warsaw shows that management and employee buy-outs with exclusive insider ownership are generally rated as greater credit risks than those enterprises which have been able to attract foreign or strategic investors (Solarz, 1994).

There are, however, some mechanisms that provide a limited means of alleviating these problems. In Hungary, for example, the need to provide collateral was reduced by a change in SPA policy in 1993 which meant that only 50% of the shares plus one could be sold to incumbents in a buy-out. With the passage of the MRP (ESOP) law, collateral requirements also became more regulated as it contained detailed rules concerning the bank lien over the property of ESOP groups. In early 1993, a new institution was established to offer guarantees for ventures which though promising could not provide the necessary guarantees. The Credit Guarantee Co. Ltd was authorised to assume risk up to HUF 100 million and up to 80% of the required collateral. Since this institution became involved, the level of collateral has dropped from one and a half times the size of the loan to just 70%. Although a generally available scheme, most of this new institution's early clients were employee groups, the introduction of the scheme removing one of the largest obstacles to the granting of finance for buy-outs. There was a danger, however, that this process would reinforce the practice of using personal contacts and political influence in obtaining finance, with less emphasis being placed on an enterprise's income-earning potential or its ability to provide property guarantees (Voszka, 1992).

In Poland, the leasing procedure required that the downpayment could not be lower than 20% of the capital of the privatised state enterprise. Transfer of ownership occurred after all of the capital and interest had been repaid. As a result, companies were deprived of the possibility of using assets as collateral in taking long-term credits though attempts were being made to address this issue through earlier transfer of ownership rights.

Russian enterprises, in contrast, were not exposed to any significant additional debt as a result of privatisation. Although the voucher auction did not bring any fresh cash into the company, the banking system may have filled this gap and provided much needed finance for

restructuring purposes. However, Russian banks were aware of the problems with corporate governance within newly privatised companies. As a result, banks were reluctant to provide privatised Russian companies with long-term credits as long as corporate governance problems had not been solved and focused on short-term lending. The provision of long-term financial resources to industrial organisations with governance structures which were inadequate in the new market environment inevitably increased systemic risk within the fragile system of Russian commercial banking.

The above discussion indicates that whilst highly leveraged privatisations may be appropriate for enterprises with stable cashflows and low investment needs, this may not be the case for those enterprises such as many in CEE where these conditions do not hold. Moreover, in the absence of banking reforms and enforcement of bankruptcy in CEE, the role of banks in enforcing the exit of unprofitable enterprises may also be weakened.<sup>2</sup>

### Domestic and Foreign Companies

The presence of an outsider with a significant equity stake provides for direct influence in the direction of the company. In addition, because such parties also tend to have a significant trading relationship with the bought-out company making the bought-out company typically more dependent on the equity partner than vice versa, an extra element of governance is introduced. Such an asymmetry of dependence provides an incentive to improve performance, especially where the equity partner has access to alternative trading relationships where the other party fails to perform satisfactorily. In addition, there is also evidence that such relationships are transitory since attempts are likely to be made to broaden customer and supplier bases, so as to reduce dependence. Despite the possibilities of such arrangements in CEE, certain major problems remain.

An important precondition for a long-term commitment is the existence of mutual trust between the parties involved. Foreign firms may also be reluctant to become involved unless they can obtain majority control, which insiders may be unwilling to cede. Employee owners may be unwilling to enter such a relationship where they perceive that the other party may want to close capacity etc. Similarly, the incoming party may be reluctant to become involved where an unacceptable level of uncertainty exists about conditions inside the enterprise. There are also indications, for example from Hungarian experience, of the vulnerability of CEE enterprises to exploitative behaviour by enterprises from outside the region. For example, whilst there may appear to be attractions in a bilateral agreement whereby a foreign firm takes a partial equity stake and agrees to buy a given level of orders at a guaranteed price in return for which the CEE enterprise purchases foreign capital equipment, enforcement of the foreign enterprise's part of the contract may be especially difficult. In Poland, foreign firms and domestic legal persons have not been allowed to participate in the initial privatisation, except in regions with high unemployment.

It was, perhaps, not surprising that in Russia where employee owners and outside firms became involved in joint ownership, there had previously been a long-standing relationship between the parties involved (Khaykin *et al.*, 1993). Similarly, the buy-outs interviewed by the authors in Hungary, where external firms had become involved in equity ownership, had frequently had a relationship with the enterprise from at least the time of transformation into a commercial enterprise. A further route to develop trust was provided by the Russian privatisation legislation whereby 20% of the shares of an enterprise could be acquired through

an investment tender rather than an open auction. Hence it was possible to achieve a joint arrangement whereby a prospective outside investor reached an agreement with incumbent management and employees on issues concerning job security, salary levels, distribution of ownership and profits, and amount and type of investment to be contributed by the outside investor. Having established a relationship at the privatisation stage, the outside investor could subsequently secure agreement to increase its shareholdings either by direct purchases from incumbents or, perhaps less threateningly, through increasing the capital of the company. Over time the proportion of shares acquired in this way could become a controlling one, though the continued importance of incumbents indicated that they are likely to retain a significant equity stake. In order to maintain management incentives and to ensure that new funds were used for investment it was often appropriate to increase a company's share capital and persuade a new investor to contribute new funds for investment, rather than management selling their shares.

The efficiency of such joint arrangements would depend upon the degree of product market competition. Contrary to Hungary and Poland, in Russia it proved impossible to enact, let alone enforce, a regulatory framework to enhance competition at the start of the privatisation process.<sup>3</sup> As a result, governance structures which involve industrial partners may serve to bolster the already inefficient structures rather than to undertake restructuring, with this kind of corporate governance structures becoming more rigid over time and resembling features of the former system. There is also a fear that the creation of such joint arrangements may hide questionable financial interests of the old nomenclature and even criminal connections.

## Non-bank Financial Intermediaries and Individuals

Non-bank financial intermediaries include a number of institutions, such as pension funds, investment funds and venture capital funds. The way in which these institutions may become involved in active corporate governance varies considerably depending upon regulatory frameworks, incentive schemes and the skills of fund managers (Frydman *et al.*, 1993) and which range from long-term relationships where institutions prefer constructive intervention to disposing of a holding to short-term perspectives.

### *Private investment funds*

Control by a private investment fund introduces the opportunity to split up an enterprise or to strip it of its assets, and may be especially attractive where there are substantial city centre land and buildings which can be redeveloped. Such a prospect may become feasible as markets in land and buildings become established and make assets of this kind valuable after a long period in which they have been ignored or undervalued in accounting statements. Such restructuring may perform an important function in reallocating them to more productive uses than previously.

Whether investment funds will be able to exert effective corporate governance is debatable, at least in the short to medium term. Such funds are not homogeneous. Pistor *et al.* (1994) identified four overlapping types in Russia. The 'restructuring' group came closest to effecting voice-oriented corporate governance, and could, in principle, exert pressure to restructure which could include ejecting insiders from positions of control. They found little evidence that investment funds had been proactive in effecting dismissals. Ejecting insiders was difficult unless funds could persuade the body of employees to reject incumbent management. Hence, it was possible that by working with management rather than adopting a hostile stance changes



could be effected. The problem, however, was that, as with 'managerialists', the second group, funds could become more concerned with bolstering managerial entrenchment than effecting independent corporate governance.

The third group, 'traders', can be viewed as effecting corporate governance through exit. By attempting to identify enterprises whose shares can be traded easily the funds may provide a degree of monitoring and information creation which may be important for future allocation of investment. However, Pistor *et al.* (1994) noted that a high degree of trading by investment funds could be the result of the undervaluation of Russian enterprises during the early stages of privatisation, meaning that large profits could be generated from the windfall gains available by simply selling the stakes acquired on privatisation. In turn this raised the opportunity cost of restructuring and reduced the incentive to become an active investor. Given the overlapping nature of 'restructurers' and traders, a high level of trading also raised problems for the level of commitment of funds to a hands-on relationship with a newly privatised company. It was also questionable whether such intermediaries had adequate monitoring skills to deal in detail with the vast numbers of privatised enterprises. Moreover, if individual managers running such intermediaries did not have their own wealth exposed to loss, they could not be particularly concerned about value maximisation. The fourth group, 'rent seekers', were motivated by the ability of enterprises to continue to obtain credits from the state and could particularly benefit if the government maintained soft budget constraints.

The extent to which investment funds in Russia could contribute finance for investment in the companies in which they had an equity stake was also debatable. The fact that banks could typically be significant shareholders in voucher funds meant that they could be important agents for channelling investment funds into Russian firms. Pistor *et al.* (1994), however, showed that share sales may be encouraged by severe cash constraints on the funds, raising doubts about their ability to set aside adequate amounts for the follow-on finance which often would be required for post-privatisation enterprise restructuring. Hence there appeared to be at best little evidence that investment funds were actively contributing to the long-term growth of enterprises.

Parker (1993) drew attention to the governance shortcomings in the Czech and Slovak privatisations. Investment Privatisation Funds, which were initially intended to have a minor role, emerged in principle as being able to exert an influence over management, though their limitation to holding no more than 20% of the equity of a particular company may have restricted their effectiveness. By the end of the early stages of voucher privatisation, Investment Privatisation Funds controlled some 37% of all voucher points placed with six such funds being particularly dominant and having the power to demand management and employment changes (Takla, 1994).

In Poland, National Investment Funds (NIFs) were established with the purpose of restructuring enterprises in their portfolios. The remuneration schemes for the managers in NIFs were designed to give them appropriate incentives to effect profitable restructuring. However, as yet it remains to be seen how effective these organisations have been in practice.

Therefore, it appears that a combination of two problems, unstable governance and an urgent need for investment finance, can only be solved with the introduction of investors who are closely involved in the process of strategic and operational decision making in newly privatised companies and with a serious financial commitment to the business. Hence, the emphasis of the process of external funding of privatised companies in CEE has to be shifted from debt to equity financing with core investors exercising a higher degree of monitoring and control in privatised enterprises.

### *Wealthy individuals*

Wealthy individuals, initially external to the enterprise, may also have had a role to play in the governance and finance of privatised companies in the countries of CEE. They may have become involved either in a main controlling and ownership capacity (a management buy-in) or in a minority active investor role (so-called informal venture capitalists or 'business angels'). In the West, management buy-ins may also typically involve formal venture capital funding in the purchase of the business. Business angels as informal venture capitalists are often seen as bringing the advantages associated with a longer investment horizon than conventional venture capitalists as well as perhaps being more flexible as to the degree of involvement in governance that they seek (Freear *et al.*, 1992). There are general problems with both management buy-ins and business angels concerning their identification and matching to individual enterprises, which relates to compatibility and acceptability between the parties involved as well as the wealth and expertise levels of the business angels (Robbie *et al.*, 1992). These issues apply both in the West and in CEE but may be particularly severe in the latter.<sup>4</sup>

However, private individuals have had an active governance role in a significant minority of Russian buy-outs. In the Uralmash Heavy Engineering Amalgamation in Russia, where the workers collective acquired 50% of the shares on privatisation, a fifth of the shares were unexpectedly acquired by the private company 'Bioprocessor', owned by one of Russia's wealthiest individuals. It was agreed that 'Bioprocessor' would not interfere in operational decision making in Uralmash but that its senior managers would take seats on the board of directors of Uralmash.

### *Venture capitalists and private equity firms*

Venture capitalists and private equity firms can, in principle, for small and medium sized firms, help to solve the dual problem of an inadequate system of corporate governance and a lack of long-term finance for restructuring and investment in CEE.

Venture capitalists and private equity firms, as with other investors, may be faced with serious adverse selection problems in investing in CEE since difficulties are posed in screening the capabilities of management who typically have not operated in a market environment before. Venture capitalists and private equity firms, through close monitoring, may be faced with less severe moral hazard problems than arm's length shareholders, but significant asymmetric information problems may remain, particularly in CEE where information systems are typically underdeveloped. Moreover, it is also important to bear in mind that incumbent management may wish to select an investor who does not want to exert close monitoring. In CEE there are, however, as with the banking system, concerns about the availability of appropriate managerial expertise, at least in the short to medium term. In principle, venture capitalists and private equity firms can use various mechanisms to encourage entrepreneurs both to perform and to reveal accurate information, such as staging of the commitment of investment funds, using convertible financial instruments which may give financiers control under certain conditions, basing management's compensation on value created and developing relationships of trust between venture capitalists and management.

Evidence from Hungary, Poland and Slovakia shows that venture capital and private equity firms in CEE have utilised a range of methods to monitor investees (Wright *et al.*, 1999). Similar to the position found in developed Western markets, considerable importance has been attached by investors to the provision of monthly management accounts by investees, commentaries on the accounts, board membership by the venture capital firm, limits to managerial discretion on investment expenditure and restrictions on additional borrowings, asset disposals and

ownership change without the venture capital firm's consent. Venture capitalists in the more developed venture capital markets in Hungary and Poland have been significantly more likely than those in Slovakia to require direct access to investees' accounting systems, frequent board meetings and regular meetings with the venture capitalist. There have also been indications from this study that venture capital firms that were part of banks or were public sector owned were likely to be less actively involved in monitoring.

EVCA figures show that the value of venture capital and private equity investment in CEE in the period 1998 to 2002 amounted to €1.3 billion. Annual amounts invested increased two and a half times between 1998 and 2000, from €158 million to €396 million. A decade ago, private equity deals principally involved the privatisation of SOEs or the funding of start-ups. As transition has progressed, private equity deal sources have shifted to expansion capital opportunities, buy-outs, non-core business unit spin-offs, and transactions involving the consolidation of sectors across the region (Wright *et al.*, 2003a). Businesses that were privatised and had undergone thorough westernisation and restructuring, as well as businesses that have grown over the last decade from a start-up, present significant opportunities for private equity investment. Western corporations selling operations in CEE that they have previously acquired are now a noteworthy part of the private equity market. As in Western Europe, these divestments may be the subject of management or investor led buy-outs funded by private equity firms. Much as in the West, listed CEE corporations are under pressure to rationalise holdings built up in the initial transformation period and return cash to investors or reinvest in the core business. For many listed corporations in CEE with little or no free float of shares, the rationale for remaining quoted is absent. This is particularly true in Poland and Romania where early privatisation strategy and market access resulted in a relatively large number of companies being listed. In all these cases, private equity firms can provide enhanced incentives, more management, much needed capital for growth and active corporate governance. The development of transition involving the entry of foreign-owned private equity firms in the region, the development of managerial expertise, increasing availability of debt finance, improved access to financial and other information, enhanced contract enforcement especially in the EU Accession countries, the introduction of specific legislation relating to venture capital and private equity firms, and the development of takeover and stock markets have all enhanced the scope for this form of corporate governance in the economies of CEE compared to a decade earlier.

## The State

A major thrust of transition has been to reduce the role of the state. However, there may be a continuing role for the state in corporate governance (Wright *et al.*, 2003b). For example, the Russian state's direct ownership stakes in firms may provide an opportunity to exercise 'voice' directly through involvement in the firm's corporate governance mechanism. In Russia, the state still holds substantial proportions of company equity in the military-industrial complex (MIC) and primary and telecommunications sectors. For example, in the largest firm in Russia, Gazprom, the state remains the largest single shareholder in the firm. In this kind of case, the state could ensure that firms comply with its own regulations and directives in a situation where there is weak enforcement of enacted legislation. As a significant shareholder, the state may be able to act as an insider to put pressure on management to undertake needed reforms.

However, there are also questions about the capacity of state bureaucrats to act as a model shareholder in terms both of their skills and the extent to which they are open to pressure to collude with management (and other stakeholders) and be passive regarding pressure to reform. Nevertheless, there are signs that the state is trying to play a more proactive role in Russian firms. At Gazprom's 2001 AGM, the state won six of the 11 seats on the company's board of directors and allowed a simple board majority to replace top managers at any time rather than the previous requirements for unanimity. A month before the 2001 AGM, the CEO was replaced by Alexei Miller, a personal aide of Russian President Putin.

## **STUDIES OF THE EFFECTS OF DIFFERENT OWNERSHIP AND GOVERNANCE FORMS**

### **Productivity and Profits Performance**

In their meta-study covering all transition economies, Djankov and Murrell (2002) considered all forms of industrial firms and not just privatised ones. From 24 studies in 20 countries, they categorised 11 different ownership dummy variables. Their overall finding for the FSU was that, using the (negative) performance association with state ownership as a benchmark, manager and employee ownership appear to have opposite and countervailing associations with productivity performance, with managers having, on balance, a positive, and employees a negative, association. In firms that did not distinguish managerial from employee ownership, the net outcome was positive for all insiders, as for managers. For the whole of CEE, however, the association of manager and employee ownership with performance was insignificantly different from state ownership. They find consistent evidence that one of the most effective ownership types is foreign ownership, particularly in terms of improving total factor productivity and promoting enterprise restructuring.

Productivity performance data suggest that no one ownership form has been consistently associated with higher productivity in transition economies (Table 17.4). Arguably, this should not be surprising in the context of a wide range of different contingencies faced by firms, including firm size, industrial classification, national institutions, privatisation policies etc. In addition, attention must be paid to quality considerations in the studies surveyed, notably whether studies use large stratified samples (e.g. Jones and Mygind, 2000; Mygind, 1997), or robust specifications that address the problem of selection bias (e.g. Earle and Telgedy, 2001; Frydman *et al.*, 1999b; Jones, 1998).

Selection bias may mean that managers and other employees may use their inside information to 'cherry-pick' the best enterprises and to use insider information to understate the true value of the enterprise by under-reporting pre-privatisation revenues. In these circumstances, it is not clear whether subsequent increases in productivity and performance are due to the effects of management incentives or to the distortion of initial information. Frydman *et al.* (1999b) tested for this selection bias problem, as well as several others, by contrasting the pre-privatisation performance of managerially controlled firms in the Czech Republic, Hungary and Poland with that of firms controlled by other types of owners, finding no ownership-related bias in the selection of firms for privatisation. They found that in contrast to outsider-controlled firms, insider-controlled firms post-privatisation did not show increases in revenues and productivity.

**Table 17.4** Comparisons of effects of different ownership forms on productivity and performance

Study	Country	Findings
Mygind (1997)	Estonia	Productivity higher in EO, MO and minority IO (no figs)
	Latvia	Productivity higher in IO than SOE (no figs)
	Lithuania	Productivity higher in EO, MO, minority IO (no figs)
Jones and Mygind (2000)	Estonia	EO weak sig. positive association with total factor productivity in 1994 only; MO not sig. FO sig. positive association with 1994 and 1995; domestic individuals (1994) and no majority (1994/95) also sig. positive
	Latvia	MO weakly sig. positive association with total factor productivity in 1994 only, FO not sig., domestic (individual) ownership and cases of no majority sig. positive effect
Smith <i>et al.</i> (1997)	Slovenia	EO positive almost sig. association with total factor productivity; 1% increase in ownership → in added value of 1.4% in EO, 3.9% in FO
Earle and Telgedy (2001)	Romania	Labour productivity growth increases: FO -0.16-0.30; MEBO 0.05-0.07; labour productivity: FO 0.27-0.42; MEBO 0.11-0.16 (depending on specification)
Rapacki (1995)	Poland	Net margins: MEBO (3.7%), capital privatisations (2.9%); SOEs (2.5%); profit/costs: MEBOs (7.4%); capital privatisations (7.2%); SOE (5.1%)
Vaughan-Whitehead (1997)	Ukraine	Sales/employee ratio: EO 20% → 23%; SOE 11% → 13%; leasehold 21% → 18%; other joint stock 4% → 5% (1993-94)
Estrin and Rosevear (1999a, b)	Ukraine	MO, WO not significantly related to profitability; sales adjust better in IO
Jones and Mygind (2000)	Lithuania	Ownership no sig. association with total factor productivity
Jones <i>et al.</i> (1997)	Bulgaria	Using stochastic production frontiers, private ownership sig. positive association with efficiency, but worker or employee controlled, codetermination, and cooperative ownership not sig.
Anderson <i>et al.</i> (2000)	Mongolia	IO no significant association with value added/employee, sales/employee
Earle (1998)	Russia	After controlling for selection bias in initial OLS regressions, only OO significantly associated with productivity improvements
Djankov (1999a)	Georgia, Moldova	MEBOs higher productivity than voucher BOs, which did not restructure more than SOEs
Djankov (1999b)	Russia, Ukraine, Georgia, Moldova, Kyrgyz, Kazakh	No sig. link between labour productivity growth (sales/employee) ownership type; MO, EO beneficial to increasing labour productivity at low levels of ownership and also high levels for MO; FO always positive association with labour productivity growth at any ownership level
Rock and Klinedinst (1997)	Bulgaria	Labour productivity falls in EO and SOE

Table 17.4 (Continued)

Study	Country	Findings
Frydman <i>et al.</i> (1999b)	Czech Republic, Hungary, Poland	Labour productivity increases in OO 9%; IO falls 8% (1990–94)
Jones (1998)	Russia	Firms remaining with EO reduce labour productivity 17% compared to SOE; SOE becoming MO reduce labour productivity 73% p.a.; EO becoming MO reduces labor productivity 31%

Note: OO, outsider ownership; EO, employee ownership; MO, manager ownership; MEBO, management employee buy-out ownership; IO, insider ownership; FO, foreign ownership. Studies selected where there are comparisons between different ownership forms.

Jones (1998) pointed out that, with considerable changes in ownership structures following privatisation (see below), there is also a need for studies of productivity to include specifications relating to ownership and control transitions. Using specifications that emulate Frydman *et al.* (1999b), Jones found for Russian data that the privatisation effect on productivity was much weaker. When ownership transitions were incorporated, firms that remained employee owned experienced falls in labour productivity of 17% per annum compared to state firms. Where managers remained as dominant owners, productivity was insignificant but costs fell substantially relative to state firms. However, formerly state-owned firms that became owned by managers during the period to 1996 performed less well, especially where managers had high levels of influence, suggesting entrenchment behaviour (Filatotchev *et al.*, 1999). Former employee-owned firms that became bank owned showed the greatest increases in productivity. Djankov's (1999b) study of six newly independent states in FSU suggests that increasing ownership by managers post-privatisation was beneficial to labour productivity and asset sale restructuring.

In a study covering Russian firms over the period 1992 to 1997, Yudaeva *et al.* (2003) found that after controlling for selection bias, foreign-owned firms were approximately 2.7 times more productive in terms of total factor productivity than domestic ones. However, they noted that the productivity of foreign-owned firms was negatively affected by the slow progress of reforms in the regions where they operated. They failed to find evidence that either the size of the foreign ownership stake or the size of the foreign-owned firm was associated with performance differences. There was support for the importance of human capital as foreign firms working in regions with better-educated labour were more productive.

A number of studies have focused on the effects of emergent concentrated (dominant) owners on corporate performance. In the Russian oil industry in particular, holding companies such as Sibneft, Tyumen Oil Company (TNK) and YUKOS are fixing the borders of their empires through intra-holding consolidations, mergers and share swaps. These holding companies have two common features: ownership is concentrated and outside shareholders, at different stages and to various degrees, have suffered equity dilution. In addition, many industries in Russia have also experienced the rapid development of holdings by trading companies etc.

Some authors argue that these variations on the theme of the holding company provide a form of industrial organisation that may create a private, internal capital market through developing long-term relations between other members of the group in which banks play an important role (Johnson, 1997). The ability of the holding company to capture the benefits from control ensures a steady supply of financing (Modigliani and Perotti, 1997). Following the agency framework

developed by Jensen and Meckling (1976), a number of authors link these incentives with equity ownership by controlling shareholders that enhances their interest in the non-distortionary distribution of dividends. Other things equal, ownership concentration should lead to lower expropriation and, as a result, countries with poor investor protection would typically exhibit more concentrated control of firms than do countries with good investor protection (La Porta *et al.*, 2000). In addition, Bebchuck (1999) develops a rent-protection theory of corporate ownership structure, suggesting that when private benefits of control are large in countries with weak legal protection, concentrated ownership is the only viable arrangement.

However, some authors suggest that concentrated ownership replaces the traditional 'principal–agency' problem with a new set of costs associated with a 'principal–principal' relationship. In other words, in companies with dominant owners, the agency costs of managerial opportunism may be replaced by the costs associated with opportunistic behaviour by majority owners at the expense of minority shareholders. This research is particularly important for countries with relatively low protection of minority investors and where expropriation of minority shareholders by the controlling shareholders is extensive. This expropriation may take various forms, such as related-party transactions, use of transfer pricing, asset stripping and other forms of 'tunnelling' of revenue and assets from firms (see La Porta *et al.*, 2000, for an extensive discussion). As a result, the primary agency problem in this context is not the failure of professional managers to satisfy the objectives of diffused shareholders, but rather the expropriation of minority shareholders by controlling shareholders (La Porta *et al.*, 2000; Shleifer and Vishny, 1997). For example, Filatotchev *et al.* (2001a) provide empirical evidence that in Russia, ownership concentration is negatively associated with investment and performance, and these findings are supported by more recent research by Aukutsionek *et al.* (2003) that is based on a longitudinal survey of 150 manufacturing firms.

## Governance and HR Strategies

Earle *et al.* (1996) found in Russia that wages were lowest in worker-owned enterprises. A survey of Russian enterprises by the International Labour Organisation (ILO), conducted in 2000 and analysed by the present authors, shows that there is no significant association between employee ownership and wages for managers, skilled and unskilled workers. Bonuses for managers and skilled workers were, however, found to be significantly higher when employee ownership was high, and similarly for two categories of workers' benefits. Similar results were found in a survey of Ukrainian enterprises in 2000 by Buck *et al.* (2001), who report that employees and managers did sacrifice short-term profitability to promote employee benefits, higher wages, training etc. as immediate sources of employee utility. Higher wages were also associated with higher levels of insider ownership. Buck *et al.* (2001) also showed that higher spending on social benefits for employees (either on the old Soviet model of welfare provision or on patterns proposed by new, high-commitment human resource management) was associated with improved firm performance. Cost-cutting HRM strategies were found to have a consistently negative influence on performance in the context of the FSU.

This study provides a contrast with earlier evidence from ILO surveys in the mid-1990s that show relatively low wages in employee-owned firms compared with other forms of ownership, although employee-owned firms did tend to pay substantial productivity bonuses, social benefits and profit sharing (Vaughan-Whitehead, 1997).

Mygind (1997) found from a large sample in Estonia that employee and management ownership were associated with downward flexibility of wages. In contrast, in Lithuania, wage levels were generally higher in employee and manager-owned firms. Evidence has suggested that in Polish management–employee buy-outs, wages initially rose faster than in other firms, especially in larger firms, but were subsequently controlled (Filatotchev *et al.*, 1996b; Jarosz, 1994a; Nuti, 1997). Similarly, in Hungary, Latjai (1997) found in his study of six buy-outs that wages increased in the year of privatisation but had subsequently been controlled.

## Governance and Employment Performance

Generally in the initial period following privatisation (usually one to two years) management and employee ownership was followed by a reduction in employment. There were mixed results regarding whether this was less than under other non-insider ownership forms, but on balance, insider ownership appeared to lead to less reduction in employment than ownership by outsiders, but greater decreases than in SOEs (Table 17.5).

In Russian privatisation buy-outs, non-managerial employees did not seem to have been responsible for either blocking or promoting restructuring (Earle *et al.*, 1996). Evidence from a sample of 314 Russian enterprises privatised during the voucher programme and surveyed in 1996 suggested that changes in employment were strongly positively correlated with changes in sales rather than the form of buy-out, i.e. voucher buy-out vs purchase buy-out (Filatotchev *et al.*, 1999b). However, Aukutsionek and Kapelushnikov (1996) found in their survey of privatised Russian enterprises that about 60% suffered from labour hoarding as enterprise directors saw they had a social responsibility to employees; this share was only slightly below that for state-owned enterprises.

Using data from 541 Ukrainian enterprises surveyed in 1994–95 by the ILO, Vaughan-Whitehead (1997) found that the highest fall in employment was experienced by employee-owned firms and leasehold enterprises. This decline was greater than that found in the ILO's survey of Ukrainian firms in 1993–94 when employee-owned enterprises had one of the lowest falls in employment. Vaughan-Whitehead found that employee-owned firms tended to delay lay-offs more than other ownership forms, preferring to seek alternative forms of restructuring. Results from a sample of privatised enterprises in Russia, Ukraine and Belarus surveyed in 1998 also indicated that, contrary to expectations, employee ownership was not significantly related to employment (Buck *et al.*, 1999). Managerial equity ownership, but not non-managerial employee ownership, was significantly negatively related to employment reduction, providing some indication of entrenchment behaviour. Outside institutional shareholders in these three FSU countries were found to have an insignificant impact on changes in employment levels (Filatotchev *et al.*, 2000). In the Baltic states, Mygind (1997) reported lower reductions in employment in employee-owned firms in Estonia and Latvia but a greater reduction in insider-owned firms in Latvia.

## Restructuring

Filatotchev *et al.* (2000), in a study of manufacturing firms in Russia, Ukraine and Belarus, found that managerial ownership was associated with a reluctance to take necessary



**Table 17.5** Comparisons of effects of different ownership forms on employment changes after privatisation

Study	Country	Sample	Employment effect
Frydman <i>et al.</i> (1999b)	Czech Republic, Hungary, Poland	209 privatised and SOEs	IO firms lay off fewer workers than OO firms
Anderson <i>et al.</i> (2000)	Mongolia	211 privatised firms	IO reduced employment by less than OO firms
Mygind (1997)	Lithuania	484 large manufacturing, construction and trade firms	Employment fell less in EO and more in OO
Jones (1998)	Russia	111 privatised and SOE firms	Employment grew faster in majority employee-owned firms; where majority EO remained dominant, employment grew faster than SOE
ILO (1994)*	Ukraine	311 all types of ownership	Employment falls in all categories, but EO less than others: EO – 4%, SOE – 8%, leasehold – 11%, Other JSC – 12% (1993–94)
Earle <i>et al.</i> (1996)	Russia	439 all types of ownership	No effect of EO or MO on change in employment 1992–94
Filatovchev <i>et al.</i> (1996a, b)	Russia	171 privatised firms	After 1 year, 6.5% increased employment, 38% reduced employment by > 10%; 27% reduced employment by up to 10%
Filatovchev <i>et al.</i> (1999b)	Russia	314 privatised firms	Change in employment associated with change in sales not form of buy-out (voucher vs MEBO)
Estrin and Rosevear (1999b)	Ukraine	150 random samples	Ownership type no effect on employment adjustment after controlling for age of capacity, exporting, energy/cost, barter, employment size
Buck <i>et al.</i> (1999)	Russia, Ukraine, Belarus	97 privatised firms	Greater MO significantly reduces employment but not greater EO or OO after controlling for industry decline, country, employment size and sales/employee
Mygind (1997)	Latvia	5585 across all ownership forms	Employment fell more in IO firms than in SOEs
Mygind (1997)	Estonia	666 stratified random sample plus SOEs and foreign-owned firms	MO firms increased employment 9% – 13%; EO stable; FO increased 40%; others declined
Vaughan-Whitehead (1997)	Ukraine	541 all types of ownership	Employment falls in all categories, EO greater fall than SOE or other JSC; EO – 10%, SOE – 9%, leasehold – 13%, other JSC – 8% (1994–95)
Buck <i>et al.</i> (2001)	Ukraine	1232 all types of ownership	Employment falls in all categories, EO greater fall than SOE or other JSC; EO – 5%, SOE – 2%, leasehold – 7%, other JSC – 4% (1999–2000)

*Note:* IO, insider owned; EO, employee owned; MO, manager owned; OO, outsider owned; \* quoted in Vaughan-Whitehead (1997). Studies selected where there are comparisons between different ownership forms.

(employment and capital) downsizing actions. Employee-dominated firms were significantly less likely to involve managerial turnover than outsider-dominated firms but significantly more likely to do so than manager-dominated firms (Filatotchev *et al.*, 1999b). Using qualitative restructuring indices, Estrin and Rosevear (1999b) found that, consistent with Russian studies, ownership type in Ukraine was not related to performance, measured in terms of management and labour restructuring and financial restructuring following privatisation, although product and input restructuring was found to be stronger in insider-owned than outsider-owned firms.

Filatotchov *et al.* (2001b) extended Earle *et al.*'s (1996) finding that employee-owned and outsider-owned firms in Russia export significantly more than firms with other forms of ownership. They focused on exporting as a percentage of total sales as a key strategic outcome, since this exposes firms to the need for improved quality control. They showed that, whilst ownership structure had an insignificant direct association with performance, governance did affect mediating strategies, and different strategies were in turn related to performance. For example, managerial ownership was positively related to a product strategy that focused on domestic rather than export markets, and to a strategy of product diversification through firm acquisition. In turn, these strategies were negatively associated with export performance. In each of these studies, between-country variations were insignificant. If confirmed elsewhere, these findings of managerial ownership apparently holding back necessary downsizing strategies and export-oriented strategies may have serious implications for conventional measures of performance.

Interestingly, the influence of outsiders through board representation may have as important an impact as equity ownership on some aspects of restructuring in the FSU. Despite majority managerial control, outside board representation in FSU enterprises tended to be positively associated with presence of a foreign partner and export-oriented product development (Filatotchev *et al.*, 2001b). Increases in outside control were negatively associated with external acquisitions and positively associated with managerial turnover.

Substantial levels of employee ownership in enterprises may not afford a significant degree of decision control in the face of acute business crisis or the effect of their control may be neutral in retrenchment terms. The unresponsiveness of restructuring to employee ownership may have been because of employees' apathy and social immobility (Bim, 1996), the give-away nature of the share distribution process (i.e. low stakeholder legitimacy), restrictions on share sales that gave employees little incentive to act as shareholders or because of the generally low level of employee representation on boards or strategic decision-making bodies.

Comparative evidence of the effects of buy-out mode on restructuring by Djankov (1999a) relating to Georgia and Moldova showed that enterprise restructuring was faster in companies purchased by insiders at realistic valuations, principally managers, than in cases where enterprises were given away through voucher schemes that also favoured insiders. Djankov (1999a) found that productivity, asset sales and renovations were significantly greater in the 'purchased buy-out' cases, whilst voucher buy-out cases did not restructure to any greater degree than SOEs. These findings suggested that insiders' incentives to restructure decreased when they perceived ownership as a windfall gain.

Further insights into the impact of privatisation type were provided by Barberis *et al.*'s (1996) study of Russian shops. In their sample of 353 shops providing ownership structures, they found that, after adjusting for selection bias, in the 52% of the sample that were MEBOs, there was no evidence that equity incentives had promoted greater restructuring in terms of renovations, longer store hours and lay-offs. In contrast, shops that had been subject to MBIs or

other forms of outside ownership did experience significant restructuring. Barberis *et al.* (1996) argued that these findings suggest that human capital skills may matter more than incentives. However, using data from the Czech Republic, Hungary and Poland, Frydman *et al.* (1999a) found no evidence to support this argument but instead suggest that certain ownership types provided the incentives that allow entrepreneurship to manifest itself in performance.

## Governance and Learning

Filatotchev *et al.* (2003) suggest that in order to enhance the post-privatisation performance of firms in transition economies, there is a need to consider the complementarities and substitution effects associated with corporate governance regimes and management learning. They suggest that the restructuring of firms in transition economies may not only be constrained by a lack of effective governance mechanisms, but also by a managerial unwillingness and/or lack of ability to undertake change. When managers fail to respond to the adverse effects of rapid economic and social change, effective corporate governance can significantly influence strategic flexibility in terms of managerial ability and willingness to undertake restructuring (Hoskisson *et al.*, 1994; Johnson, 1996). But governance problems may arise if monitoring is inadequate or because managers have too much ownership. If this is the case, ability to change depends on managers' knowledge and learning capacity that directly affects the quality and timing of their strategic decisions. These factors may vary considerably between firms privatised through different routes. Firms privatised through 'give-away' schemes are highly unlikely to have efficient corporate governance systems and their learning capacities are limited by a leadership inherited from the past. As a result, prospects for proactive restructuring are rather uncertain. The privatisation of domestic institutions and firms may see relatively weak governance traded off for low managerial learning. Privatisation buy-outs with relatively high learning capacity, where good entrepreneurial managers do exist, may be traded off for weak governance. Organisations privatised through divestments to foreign partners or other strategic investors are more likely to have a higher degree of strategic flexibility, owing to relatively higher levels of corporate governance efficiency and learning capacity. Here, high learning and absorptive capacity produce a positive complementarity with high efficiency governance. This suggests that insider ownership is not necessarily associated with entrenchment and a lack of restructuring; in entrepreneurial buy-outs, weak governance may be compensated by a relatively high learning capacity of managers. By the same token, outside control may not necessarily promote restructuring if it is not followed by an increase in managerial capacity to change, as may happen in outside privatisations to domestic financial institutions and holding companies.

## CONCLUSIONS

This chapter has examined the problems of governance and its impact in CEE. A number of options for addressing the problems of governance were analysed. The development of venture capital firms with their associated governance and finance attributes was seen to be a particularly important means of providing a flexible system of monitoring managers.

A common feature of evidence from differing CEE countries is that after privatisation there has been a decline in share ownership by employees as a whole, with a corresponding increase in

managements' and outside investors' stakes, though the change in the comparative holdings of outsiders varied between countries. In Russia, in a comparatively short time since privatisation, acquisitions of substantial equity stakes by management and by outsiders, especially private and institutional investors and industrial groups, was evident. Investment funds appeared not to be active in monitoring. In Poland the decline in employee ownership and rise in share ownership by external investors was more in evidence than the increase in managerial equity stakes. In Hungary, in contrast, little movement in ownership structures was observed, though there appeared to be a modest increase in the concentration of managerial shareholdings and a corresponding reduction in employee and outsider holdings. Increases in management equity holding may have some positive impact on corporate governance, especially if managers have to borrow to fund the purchase of shares and are constrained to improve performance in order to be able to repay loans. However, they may still face governance problems where the widespread diffusion of shareholding through employee ownership remains. In addition, it needs to be borne in mind that increasing managerial share ownership does not involve the introduction of new finance for investment.

Newly privatised companies, however, suffer from the combination of three problems: inadequate systems of corporate governance, variable quality of entrepreneurship and lack of external finance. The longevity of initial forms of privatised firms will largely depend on the particular shape and structure of the evolving financial systems in CEE and on the economic power of newly emerging institutions (investment funds, venture capitalists etc.). There remains a need for the state to create an adequate regulatory environment, to ensure that the newly established relations between recently privatised companies, financial and non-financial stakeholders and lending institutions will ensure economic efficiency improvements and promote corporate restructuring and technological modernisation. However, as with corporate governance systems generally, there is a need to balance the appropriate monitoring of managerial behaviour with the promotion of entrepreneurial actions which will contribute to improving innovation and efficiency. In underdeveloped market systems as in CEE, it may be as important to emphasise measures to enhance entrepreneurial skills as it is to develop good governance systems. Given the barriers to developing institutional voice mechanisms discussed earlier in this chapter, this last point assumes major importance.

## NOTES

1. Whilst in theory it may be preferable to introduce and implement a full panoply of market-oriented institutional and regulatory frameworks which promote product market competition and enforce hard budget constraints through bankruptcy, in practice there are likely to be political constraints which make this unfeasible until a later stage in the transformation process has been reached (see Filatotchev *et al.*, 1995b, for discussion).
2. For discussion of the role of bankruptcy as a corporate governance device in CEE, see Frydman *et al.* (1993), Wright *et al.* (1993) and Aghion *et al.* (1994). Note that the state of development and implementation of bankruptcy legislation varies considerably between countries.
3. Though attempts are being made with the help of foreign anti-trust agencies to establish such a working regime.
4. In the Neue Länder of Germany, for example, the Treuhandanstalt (THA) introduced a scheme to promote management buy-ins but despite receiving several thousand enquiries was able to complete very few transactions (Wright *et al.*, 1993).

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