Under Construction Right Now. Do Not Use!

Corporate Governance

Confusion

- Good governance is not the same as good firm behavior (or good management).
- Good governance are the corrective mechanisms *if* the firm behaves badly.
- Good governance is costly—it does not come for free.

  Checks and balances have a real cost in terms of economic efficiency.

  For example, many CEOs argue against having an independent chairman of the board, because it would cost them time. This is an argument that governance is too costly, and not necessary, because they run the company well—that they believe worse corporate governance increases value, because the costs outweigh the benefits.

Theory

- Natural development *from* sole entrepreneur *to* investors vs. professional managers.
- Control rights.
- Spend \$10 to prevent \$1 of theft?
- “Fiduciary Duty”

How to "Steal"

Illegal:

- Theft.
- Fraud.
- Insider Trading.
- Transfer Payments.
- Bribes. (semi-legal).

Legal:

- Empire building.
- Perks.
- Executive Pay.
- Entrenchment.
- Friendship and Loyalty. Ethics + Workers
- Perverse incentives for MBOs.

Entrepreneurial Incentives

- Entrepreneur wants to avoid future conflict of interest to maximize proceeds.
  - necessarily incomplete.
  - limited in terms of strength over long time horizons.

Equity Protection

24-3

Once public and well-capitalized, the need to raise capital no longer matters — in fact, the opposite can happen. Bad managers may raise more capital by giving away existing shareholder wealth.

24-3B

Corporate board:

- CB sets agenda. board controls executives.
  EXCEPT, CEO is often CB!
- Very few independent directors. (Majority of corporations did not used to have a majority!!)
- Even presumably independent directors do not come from shareholders, but from past CEO/CB culture. (Plus, they often fill in gender, minority, and community representation roles—perhaps quite appropriately, as boards are usually *not* control organs, anyway.)
- Elections by slate.
- Over time, CEO controls board, not vice-versa.
- Function: Contacts, Connections, Relations.

These are generalizations. There are some great executives, great directors, and great boards.

24-3C

Takeovers, Proxy Contests, Shareholder proposals:

- Big in the 1980s.
- Minor importance today.
  - Greenmail.
  - Golden Parachutes.
  - More acquisitions. (Pufferfish strategy.)
  - Poison Pills. (Give rights to acquire more shares.)
  - "Fair Value Provisions" eliminate discrimination.
  - supermajority rules.
  - litigation.
  - scorched earth.
  - more shares issued
  - STAGGERED BOARD.
- LBOs: special form of takeover. MBOs: special form of LBOs. Faded away after the 1980s.

24-3D

Large Shareholders:

- can be benevolent. (in the US: public pension funds).
- limited: known by management, and insider trading restrictions.
- can be malevolent. (especially with founders;)

Many agency conflicts outside the US are more between large shareholders and small shareholders, than between management and shareholders. Pyramid holding schemes are very common. Dresdner bank owns 59.25% of its own shares!

24-3E

Legal Environment:

- Fiduciary Duty.
- Legal Suits.

24-3F

Ethics, PR, Norms, Reputation:

- Tremendous hiding of comp packages—often retirement related. (Grasso.)

A serious drag on effectiveness of corporations, but unlikely to cause collapse of capitalism. More likely to cause a competitive disadvantage internationally.

Debt

- Verification and active control not necessary. Default is almost mechanical.
- Mechanism works better outside US, than in the US.

What works? Where are we going? 24-5

- Historically, ethics and norms played a major role. Executives want to remain individuals of “character.”

  However, in the aggregate, norms and ethics have changed dramatically.
- P.R.
- Legal: Fear of directors about getting sued.

Sarbanes-Oxley

- is a great example of how *not* to do reform:
  - Great costs of compliance and administration.
  - Little good effect in the end given expense.
- Details:
  - Independent director strengthening.
  - Audit Committee. Rotation of auditors. ethics responsibility.
  - CEO signature.
  - Lawyers’ ideas of improvement, not economists’.
- Better Ideas:
  - Separate CB and CEO.
  - Change voting system to allow minority representation on board.
  - Insider trading to be pre-disclosed, not post-disclosed.
  - Tax financial disclosure.

- Do these changes through "safe harbor" provisions, not by forced law.

Side consequence: foreign companies are planning to leave U.S. financial markets.