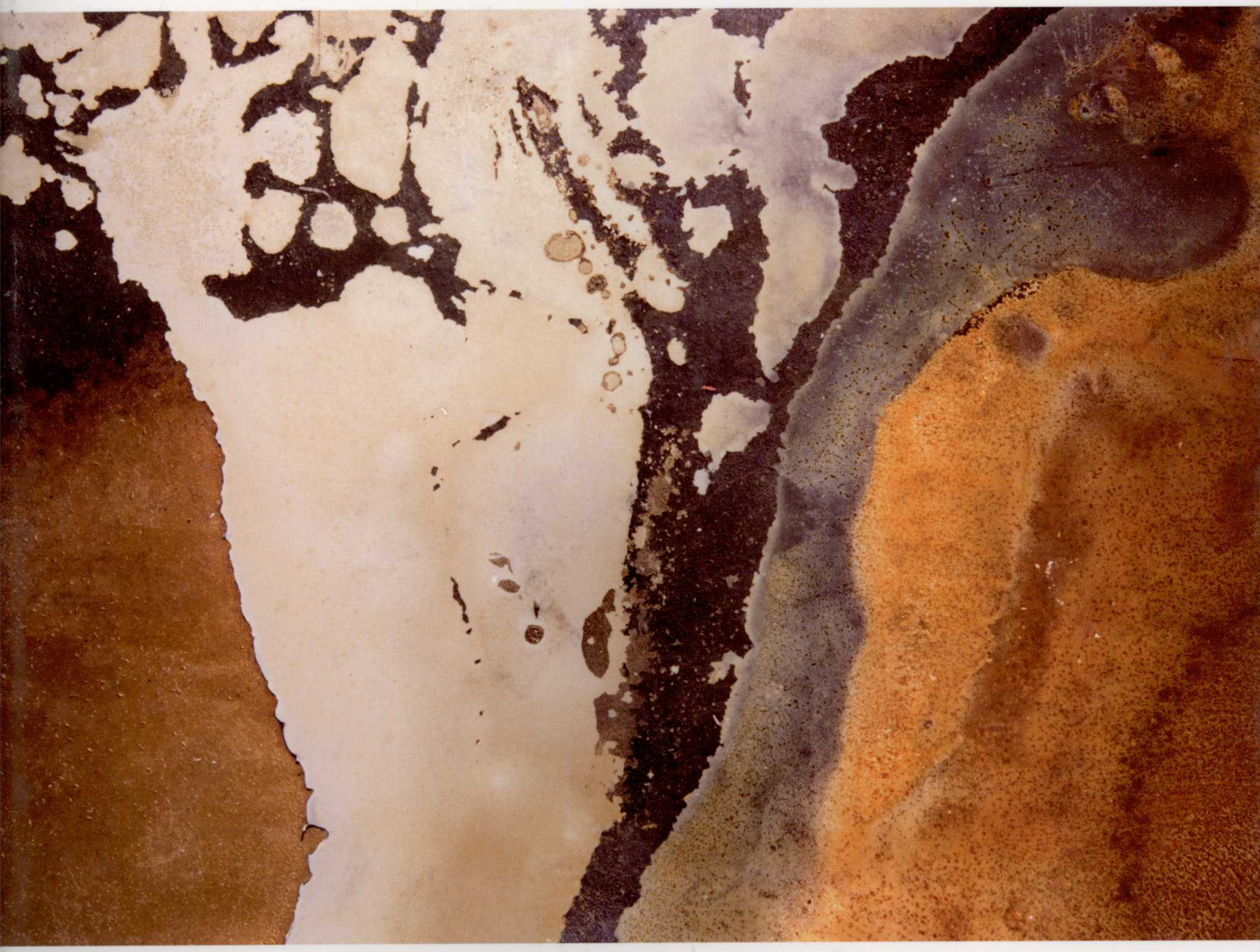
CORPORATE GOVERNANCE

A Synthesis of Theory, Research, and Practice



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The *Robert W. Kolb Series in Finance* provides a comprehensive view of the field of finance in all of its variety and complexity. The series is projected to include approximately 65 volumes covering all major topics and specializations in finance, ranging from investments, to corporate finance, to financial institutions. Each volume in the *Kolb Series in Finance* consists of new articles especially written for the volume.

Each *Kolb Series* volume is edited by a specialist in a particular area of finance, who develops the volume outline and commissions articles by the world's experts in that particular field of finance. Each volume includes an editor's introduction and approximately thirty articles to fully describe the current state of financial research and practice in a particular area of finance.

The essays in each volume are intended for practicing finance professionals, graduate students, and advanced undergraduate students. The goal of each volume is to encapsulate the current state of knowledge in a particular area of finance so that the reader can quickly achieve a mastery of that special area of finance.

Acknowledgments

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CHAPTER 1

An Overview of Corporate Governance

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INTRODUCTION

The importance of corporate governance became dramatically clear at the beginning of the twenty-first century as a series of corporate meltdowns arising from managerial fraud, misconduct, and negligence caused a massive loss of shareholder wealth. The firm's owners (shareholders) asked who, if anybody, is responsible for protecting and promoting the value of their investment. Yet governance issues and problems have a long and sometimes shocking history. Adam Smith (1776/1904, V.1.107) wrote in *Wealth of Nations*:

> *Being the managers of other people's money rather than their own, it cannot be expected that they [managers] should watch over it with the same anxious vigilance which [they would] watch over their own. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.*

Based on their seminal work, Jensen and Meckling (1976) can perhaps be credited with bringing governance issues to the forefront in the field of finance. In scholarly finance research, agency theory provides the general framework for analyzing managerial behavior. Agency theory in its simplest form proposes that the firm's owners (principals) hire managers (agents) and then delegate the firm's day-to-day operating decisions to these managers. The theory further assumes that both parties—owners and managers—seek to maximize their personal utility. In the case of shareholders, this translates into stock price (wealth) maximization. For managers, utility maximization does not necessarily translate into maximizing shareholder wealth. Managers, for instance, may prefer to focus on short-term earnings that correspond with their remaining tenure in the firm rather than long-term earnings growth that leads to shareholder wealth maximization. Similarly, managers may seek to adopt low-risk projects that impose little personal risk on their future employment prospects or wealth, even if these projects do not maximize the wealth of diversified shareholders.

Obfuscating or manipulating accounting reports appeared to be a particularly prevalent form of the agency problem during the first decade of this century. Managers of large and well-known companies such as Enron, WorldCom, and Tyco engaged in illegal reporting activities that led to a massive loss of shareholder wealth. Because shareholders in many countries are largely absentee owners and managers control firm operating decisions, managers can place their own interests before those of the shareholders, thus generating a principal-agent conflict. Shleifer and Vishny (1997) refer to the agency problem as the issues that financiers face in ensuring that managers do not expropriate or waste funds on unattractive projects but rather provide an appropriate rate of return on invested funds.

Academics and practitioners sometimes question the adequacy of the principal-agent model in describing and prescribing the manager-shareholder relationship. Agency theory focuses squarely on managers and shareholders and assumes these parties work toward their own best economic self-interest. Yet other models depict different managerial motivations and/or different parties to the relationship. Stewardship theory, for instance, contends that managers possess sufficient self-motivation to act in the best interests of all firm stakeholders (Davis, Schoorman, and Donaldson 1997). Stewards of corporate assets eschew purely self-serving behavior that harms the firm and instead focus on promoting group interests because they inherently seek to do a good job (Donaldson and Davis 1991). Stakeholder theory argues that many firm constituents, such as employees, customers, and suppliers, have important stakes in the firm and as a consequence, their interests should be considered along with those of shareholders (Freeman 1984). Critics of agency theory further argue that the model only considers economic outcomes and ignores the ethical dimensions of managerial decision making. Yet, despite the alternative models and criticisms, agency theory remains the central paradigm in the finance literature when examining managerial decision making and the relationship that managers hold with the firm.

How do shareholders control and monitor managers who seek to maximize their personal utility? The fraction or portion of the firm's outstanding equity held by managers constitutes an important control mechanism. Jensen and Meckling (1976) note that as managers hold an increasingly larger share of the firm's equity, they are less likely to pursue self-serving actions as they bear a larger fraction of the cost. Consequently, in firms where managers hold large equity stakes, managers' and shareholders' interests may be well aligned, thus providing strong incentives to maximize shareholder wealth.

Building upon Jensen and Meckling's (1976) notion that managerial equity stakes alleviate the principal-agent problem, scholars of agency theory developed various incentive systems to align the interests of managers and shareholders. These systems or devices include stock option grants, restricted stock grants, long-term incentive payouts—generally, any monetary mechanism that provides managers with incentives to increase shareholder wealth. Via these wealth-sharing mechanisms, shareholders bear a cost but the cost may be justified if managers create more wealth than they receive. Yet recent history suggests that in many instances, the share of wealth received was insufficient to resolve the principal-agent conflict.

Beyond systems seeking to align managers' interests with those of the firm's owners, shareholders seek to control managerial behavior and actions through monitoring. Boards of directors arguably represent shareholders' most important monitoring device (Fama 1980; Fama and Jensen 1983). Boards have a fiduciary responsibility to represent the best interests of shareholders. In carrying out their function, boards undertake the duties of hiring, firing, and compensating top-level managers. Further, directors review and in many cases have final approval rights before managers can proceed with corporate actions. Understanding the importance of boards of directors in protecting shareholder interests, business scholars provide various prescriptions on board composition. Directors, for instance, should not simply be cronies of the top management team. Rather, board members should be independent of managers, bring knowledge and business acumen to discussions, and pursue actions that increase shareholder wealth.

Managers also confront monitoring and oversight from other firm constituents. Bondholders, an important provider of firm capital, seek to directly control managerial actions through covenants in lending contracts. Bondholders can indirectly control managers by varying the rate charged to firms for the use of their capital. Corporate charters, bylaws, and internal control procedures affect managers' behavior by explicitly defining permissible actions. Federal and state legislative bodies influence managerial actions by establishing legal strictures. Federal oversight also comes through regulatory bodies such as the Securities and Exchange Commission (SEC) and the Commodities Future Trading Commission (CFTC). Accounting procedures established through the Financial Accounting Standards Board (FASB) and other regulatory bodies seek to ensure that managers provide timely and relevant firm-level information, thereby allowing shareholders and other investors to make informed decisions. All of these strictures, regulations, and regulatory bodies affect managerial behavior and actions and influence the principal-agent conflict. However, the interests of some of these constituents may not necessarily be aligned with those of shareholders, thereby creating another level of conflict within the firm.

Corporate governance covers the broad array of systems, processes, and procedures that seek to regulate the relationship between managers and shareholders in particular and among all firm stakeholders in general. The chapters in this volume focus primarily on the relationship between managers and shareholders and, in some instances, between controlling shareholders and minority shareholders. Many classifications exist to describe corporate governance. Governance can be defined as internal or external to the firm. It can be described as being international or domestic. Governance can also be defined as to whether it seeks to provide appropriate managerial incentives or managerial oversight or monitoring. These classifications, among others, accurately and aptly define the multiple and varying dimensions of the subject.

Despite the growing interest in corporate governance, many questions still exist. The goal of this book is to provide a comprehensive view of the shareholder-manager relationship and to examine the current state of governance mechanisms in mitigating the principal-agent conflict. As a result, the book may help to improve public understanding about corporate governance and may contribute to the continuing debate surrounding this topic. Although the concepts and principles of governance apply to a broad range of organizations, the focus of the book is narrowed to address the governing of for-profit, publicly owned businesses whose main concern is to improve shareholder welfare and value. The sheer volume of work written on the subject makes the prospect of surveying corporate governance a daunting task. Consequently, the book primarily focuses on research conducted since Jensen and Meckling's (1976) treatise on the theory of the firm.

This book should be of interest to academics, managers, business students, regulators, and others interested in corporate governance. In fact, anyone wanting to gain a better understanding of the multiple facets of corporate governance for academic or applied purposes should find this book to be useful given its scope and currency. In particular, this volume should provide useful insights in educating business students and training current managers. For example, the book is appropriate as a stand-alone or supplementary book for undergraduate or graduate level courses in corporate governance. To this end, each chapter contains a series of discussion questions and guideline answers to help reinforce key concepts.

STRUCTURE OF THE BOOK

The book consists of 30 chapters divided into four main parts. These chapters are written by recognized scholars in the field of corporate governance who offer multiple perspectives. A brief synopsis of each part and chapter follows.

Part One: Background and Perspectives on Corporate Governance

The remaining nine chapters of Part One consist of two parts. The first part comprises Chapters 2 through 7, which provide an overview of corporate governance. These chapters offer a brief history of corporate governance, explore corporate governance systems, discuss corporate best practices, and review the relationship between corporate governance and firm performance in both a domestic and an international context. The second part consists of Chapters 8 through 10, which examine the separation of ownership and control. These chapters emphasize the role of agency theory and other approaches to corporate governance.

History, Systems, Best Practices, and Empirical Evidence

Chapter 2: The Financial Determinants of American Corporate Governance: A Brief History (Lawrence E. Mitchell and Dalia T. Mitchell) This chapter is a preliminary exploration of the interdependence of finance and the rules of corporate governance. It argues that the surviving rules and norms of corporate governance, among many that jurists articulated throughout the twentieth century, were primarily those that reflected the financial realities of their times. Finance drove the reconceptualization of New Jersey corporate law at the turn of the twentieth century, which in turn facilitated the great merger wave that catalyzed the intertwined movements for federal incorporation and antitrust reform. Finance made the attempts of the 1920s and 1930s to restrain corporate power ineffective and shaped public understanding of the form and function of the board of directors during the mid-century age of managerialism. Finance led to the broad acceptance of the monitoring board and the norm of shareholder value in the last decades of the twentieth century. The current financial crisis illustrates some of the consequences of the law's deference to finance.

Chapter 3: Corporate Governance Systems (Christian Andres, Andre Betzer, Marc Goergen, and Daniel Metzger) Hicks (1969) and Chandler (1977, 1984) were the first to propose a typology of capitalist systems. Their typologies are based on the world's largest economies and the ways these economies finance and govern their companies. Since then, more general typologies have been advanced that propose particular factors to explain the differences in corporate governance across the world and ultimately the differences in economic growth. These typologies can be classed into two broad schools: (1) hierarchies of institutional settings, and (2) the "varieties of capitalism" literature, which is centered on the notion of complementarity. The former school includes several theories arguing that differences in corporate governance are due to differences in the quality of law, politics, and electoral systems, and the ways companies are financed. This chapter reviews these classifications and examines how they fit with the empirical evidence on national corporate governance characteristics.

Chapter 4: Corporate Governance Best Practices (Alex Todd) Chapter 4 introduces the concept of *aspirational corporate governance* (ACG). ACG proves a context and formal framework that boards might employ to guide corporate governance improvements for any organization regardless of its business objectives, control structure, or legal context. The ACG framework can be used to diagnose and design corporate governance principles, systems, and practices appropriate for the complexities of sustaining a self-regulating governance structure. ACG allows organizations to adapt through innovation to create new possibilities for delivering value in a complex, uncertain world.

Chapter 5: What's Wrong with Corporate Governance Best Practices? (Christopher Søren Shann Turnbull) This chapter critiques corporate governance practices widely promoted as being *best* for publicly traded corporations. The criteria used to identify good governance are those that minimize the involvement of regulators or lawmakers with such corporations. The different drivers of corporate evolution in Europe and the United States explain the development of some of the counterproductive practices in Anglophone countries. These include directors obtaining inappropriate powers, and conflicts of interest for directors and auditors. These intrinsically flawed practices have become enshrined as best practices in governance codes, governance metrics, regulations, securities exchanges, and the law. This chapter uses the natural laws of requisite variety, identified by mathematicians who founded the science of governance in the 1940s, to explain why current practices are not best. Natural laws explain why the communication and control architecture of corporations and corporate regulators do not permit executives, directors, or regulators to directly monitor or control on a reliable basis the complex workings of modern firms without co-regulators.

Chapter 6: The Effect of Corporate Governance on Performance (Sanjai Bhagat, Brian Bolton, and Roberta Romano) Corporate governance is the set of processes that provides an assurance to outside investors of a fair return on their investment.

This chapter focuses on the empirical evidence of the relationship between corporate governance and performance. While the findings in the earlier literature are mixed, the recent literature documents that better governance is sometimes related to certain measures of performance. First, better governance as measured by several academic indexes and stock ownership of board members is positively correlated with accounting measures of operating performance. Second, none of the widely used governance measures—indexes or individual board characteristics—are correlated with future stock market performance. Third, given poor firm performance, the probability of disciplinary management turnover is positively correlated with stock ownership of board members. Better-governed firms, as measured by the academic and commercial indexes, are less likely to experience disciplinary management turnover in spite of their poor performance. The evidence provides a strong argument for considering dollar ownership of the board members as a corporate governance measure.

Chapter 7: International Corporate Governance Research (Diane K. Denis) Research in international corporate governance establishes that legal systems and corporate ownership structures vary systematically across countries. Such differences have important implications for countries and for the individual firms within them. Country-level governance systems impact the development of financial markets and, therefore, the ability of individual firms to raise the financial capital needed to undertake profitable investment opportunities. Firms can partially overcome weak country governance through firm-level governance mechanisms and access to an increasingly globalized financial system, but should do so only if the benefits exceed the costs. Governance reforms have been common during the past 10 years. The goal of future reform should be systems of laws that provide for vibrant markets in which countries and firms can choose governance systems that maximize value.

Separation of Ownership and Control

Chapter 8: Agency Theory: Incomplete Contracting and Ownership Structure (Iain Clacher, David Hillier, and Patrick McColgan) This chapter discusses and highlights some of the key issues concerning agency relationships and the costs that arise from them. The two main agency relationships considered are those between professional managers and outside shareholders and between controlling and minority shareholders. Depending on a corporation's ownership structure and the institutional environment in which it operates, one of two agency relationships will dominate. The goal of corporate governance is to mitigate the costs arising from agency relationships. Thus, an understanding of agency theory and the factors that exacerbate agency relationships is important for the efficient allocation of corporate resources.

Chapter 9: Theories and Models of Corporate Governance (Thomas W. Joo) Chapter 9 is a brief historical survey of American legal theory's leading models of the corporation, with emphasis on the contemporary theory of contractarianism. Legal theory must be understood within the historical context that shapes its normative goals and underlying normative assumptions. Theorists should not simply apply this insight retrospectively to others' work, but should expressly consider and discuss it in formulating and presenting their own future theories.

Chapter 10: Unfettered Agents: The Role of Ethics in Corporate Governance (Donald Nordberg) The theory and practice of corporate governance potentially point to substantial and even catastrophic risk if the agents of shareholders (senior management) are left unfettered and free to choose their own direction. From the 1930s to the present day, corporate collapses point to the need for mechanisms to control managers. Critics of the principal-agent approach argue that agency theory and its solutions do not singularly hold the answer because the theory takes an economic rather than ethical view of behavior. This chapter explores the main theoretical perspectives that have contributed to knowledge of corporate governance: agency, stewardship, and stakeholder. The chapter sets these perspectives against three competing views of ethics, pitting utilitarian against deontological views, and then shows how the renewed interest among philosophers in virtue ethics in recent years might help better explain boardroom decisions.

Part Two: Internal Governance

Part Two consists of seven chapters, which review and investigate governance systems that work internally to the firm. This section also contains two parts. The first part includes Chapters 11 to 13, which examine the boards of directors, while the second part consists of Chapters 14 to 17, which review the role of compensation, equity ownership structure, and turnover as internal control mechanisms.

Boards of Directors

Chapter 11: Board Composition and Organization Issues (Matteo Tonello) This chapter examines the composition of boards of directors in today's U.S. public companies. The topics covered include size and diversity, professional backgrounds, independence and affiliations, age restrictions and retirement policies, and limits to serving on multiple boards. The chapter describes practical organizational issues, including the formation of standing and special committees, the adoption of classification structures, leadership assignments, attendance policies, executive sessions for outside directors, and other operational matters. The discussion of major legal standards and best practices is accompanied by current statistical data based on proxy statement analyses and a survey of corporate members of The Conference Board, the New York-based independent research organization.

Chapter 12: Board Diversity (Daniel Ferreira) This chapter discusses some of the research findings concerning board composition with an emphasis on the demographic characteristics of board members. The chapter starts with a discussion of how economics and management scholars differ in their theoretical analyses of board diversity. These theoretical perspectives are then used to uncover the costs and benefits of board diversity. After a brief overview of the empirical literature, the case of gender diversity in the boardroom is discussed in greater detail. Implications for research, business practice, and policy are briefly summarized.