Corporate Governance

Corporate governance is the framework within which corporations exist

- it focuses on the relationships among officers, directors, shareholders, stakeholders, and regulators
  - reflects both the decision rights within the firm and mechanisms to make managers work in interest of SHs
- primary issues
  - corporate control
    - the power to make investment and financing decisions
      - this control resides with the parties having sufficient voting power to force decisions
      - commonly imposed by installing sympathetic management team
  - corporate governance issues
    - the mechanisms via which SHs control or oversee managers
      - structure of the Board of Directors, voting rights, proxy fights are actions that shareholders can take to influence corporate decisions
Corporate Structure

- The issue of corporate control is part of a broader issue of corporate architecture
  - this is the financial organization of business
  - in the US corporations have the following structure
    - shareholders
      - widely disperse with small ownership shares, but a key group of founders/managers often hold a functionally controlling block
        » shareholders with more than 5% must report to SEC on Form 14D
    - Board of Directors
      - a board, elected by the shareholders to represent them in overseeing the operation/running of the firm
        » in the U.S the BoD have a legal fiduciary responsibility to SHs
    - Officers of the firm
      - these are the managers of the firm, appointed by the Board of Directors
        » often many of the managers will come from the Board of Directors
        » these are known as “inside” directors

Corporate Control

- Lets start with how corporate control works in a freely functioning market
  - the issue is to try to change who controls the decision rights within the firm
    - this is related to gaining control of the assets, by acquisition or some other means
  - methods
    - mergers and acquisitions (M&A)
    - leveraged buyouts (LBOs)
    - management buyouts (MBOs)
    - spin-offs and carve-outs
    - conglomerates
    - private equity partnerships
Mergers

- Mergers are the most common form of change in corporate control
- Mergers face a variety of difficulties
  - Antitrust law scrutiny
    - To insure that market power is not too concentrated
    - Done by national regulators (Dept of Justice and/or FTC in US)
      - Enforce laws such as Sherman Act, FTC Act, and Clayton Act
- Form of acquisition
  - Merger - a true combination of two firms
    - One firm assumes all assets and all liabilities of the other
    - Requires more than 50% of both firms' SHs to agree
  - Buy target's stock in exchange for cash, shares, or other securities
    - Acquirer gains control of all assets of the target firm by dealing with shareholders
  - Purchase of some or all of the assets of target firm
    - Ownership of assets is transferred and payment is made to selling firm rather than its shareholders
    - Target firm does not immediately cease to exist

Global Merger Activity

Source: Are companies getting better at M&A, McKinsey Quarterly 12/06, data from Dealogic
Methods for Takeovers

- Most mergers are negotiated by the firms’ top management and BoD
  - these are known as friendly takeovers
    - most common in US and (almost) exclusive form outside US
- hostile takeovers
  - acquiring firm goes around target management directly to SH
  - two methods
    - proxy fight - acquiring firm seeks support of target SH at the next annual meeting
      - a proxy is the right to vote someone else’s share
    - tender offer - make financial offer directly to target SH
      - if enough shareholders tender their shares, the acquirer gains control
- tender battles are complex
  - arguments often over who needs protection: SH or management
    - should management be given tools to protect their positions against unwelcome predators?
    - should managers hold an auction to obtain highest price for SH?
    - should acquirers be required to explain what they will do with firm?

Takeover Defenses

- Management have come up with many ways to protect against unwanted takeovers
  - shark repellent measures
    - staggered BoD terms so new SH gain immediate control
      - would have to alter the corporate charter
    - supermajority
      - require higher % of SH votes (80%) to approve merger
    - fair price rule
      - mergers not allowed unless fair price is paid (based on rules)
  - poison pills
    - existing SH are issued rights, which if there is significant purchase of shares by a bidder, can be used to purchase additional shares in the firm at very low price
  - why would management/stakeholders resist a takeover
    - bidder must offer premium over current market price
    - to get a higher price or for fear of losing jobs
    - management at target are often offered golden parachutes
    - generous payouts (bribes?) if they lose their jobs
Buyouts

- Buyouts differ from M&A in several ways
  - done by group of investors rather than another firm
    - large fraction of purchase price is debt financed
      - hence the term leveraged buyouts
      - often some of the debt is very risky, (i.e., "junk")
    - the asset being bought becomes a private asset
      - it is privately controlled by owners and often once reorganized and rationalized, taken public later in IPO
  - buyouts are typically of two forms
    - leveraged buyouts (LBOs) are done by partnership of private investors
    - management buyouts (MBOs) are when the group is led by (some) existing firm management
  - buyouts can be used to gain control of specific assets
    - MBOs are often done on unwanted divisions of larger companies
    - in US in 1980s LBOs were more often of entire firms

Spin-offs and Carve-outs

- Spin-off
  - a new independent company created by detaching part of a parent company’s assets
    - existing SHs receive shares in the newly independent firm
      - they can then hold or sell these shares if not interested
    - these are not taxed as long as parent shareholders receive 80% of shares in new company

- Carve-out
  - a spin-off—except that shares in separated asset are sold to new shareholders in public offering
  - typically spin-offs are seen by the market as good news
    - value is potentially created by widening investor choice
    - focus makes it easier to measure performance
    - separate securities make it possible to create right incentives for managers
  - to understand how these create value we must understand conglomerates
Conglomerates

- Conglomerates are a portfolio of different businesses within a single corporation
  - conglomerate mergers were very common in the 60’s and 70s
    - US saw a spin-off craze in 80’s and early 90s
    - most mergers are now between firms in related (same) business
  - conglomerates are very common in other (developing) countries
- pros and cons of conglomerates
  - diversification of businesses stabilizes income and reduces risk
    - but SH can diversify more easily than firms can
      » some gains to firm diversification cannot be replicated by SH
  - good management is fungible
    - but knowledge of the details of the industry are important
  - conglomerate creates large internal capital market
    - free cash flow from mature divisions could invest in other divisions
    - but internal market lacks rigor of external market evaluation
      » allows unprofitable cross subsidization

Financial Architecture of Conglomerates

- For a conglomerate to be successful it must focus on the incentive issue of corporate governance
  1. make sure divisional management has performance targets and incentives as strict as if they were separate firms
  2. operate the internal capital market in as rigorous a fashion as the external markets
- these are difficult things to do
  1. market values of divisional performance cannot be observed within a conglomerate
    » market prices are valuable signals
  2. an internal capital market is difficult to separate from politics and internal bargaining
    » typically capital providers (SH’s) do not have active voice in internal market
- the net result is the average US conglomerate is ~10% less valuable than the breakout value of its businesses
Conglomerates Outside the US

- While disappearing in the US, conglomerates are very common elsewhere
  - a significant percentage of Korea's GDP is from its large conglomerates called "chaebols"
  - conglomerates very common in Latin America

- why are conglomerates common outside US?
  - size
    - it is difficult to be large and focused in small markets
    - size means access to int'l markets and more political power
  - underdeveloped local capital markets
    - internal capital market may be preferable to underdeveloped external markets
    - important issues besides liquidity include regulation, information efficiency, strong legal environment
    - evidence that markets are stronger in "common law" countries
  - history
    - large companies are often given role of rescue investors

Corporate Governance

- The rules by which control within the firm is distributed, managed and regulated
  - these have been in the news most recently because of the corporate scandals
    - largely in US but also elsewhere
    - the primary issue in most of these cases was the issue of management behavior
      - arises from the separation of ownership and management
      - separation of ownership and management creates incentive for managers to work for their own interest rather than that of the firm
  - relates directly to issues of incentive given to managers
    - incentives of managers influenced most directly by their compensation contracts
    - manager that are not controlling owners work for shareholders
    - since the early 1980s US shareholders have asked managers to focus on maximizing firm value
      - to do this contracts were written to align incentives
Incentive Contracts

- Tie managers’ compensation to value of firm
  - stock based compensation
    - rise of options rather than shares as “costless” compensation
    - options created huge upside and no additional downside to taking risky steps to increase firm value
      - creates incentives for management to be more aggressive in actions to increase market value
  - large equity price rises in late 1990’s created incentives to pump up firm value, cash in the options, and run
    - thus there was a huge increase in expected value to value increasing activity and no change in the expected punishment
      - little evidence of SEC enforcement of securities laws
      - Boards and Shareholders didn’t care if stock price kept going up
    - result was an increase in aggressive actions to increase value of firm
      - including illegal actions

Where was the Governance?

- In 2000 stock prices fell sharply
  - with lower prices many activities to inflate value collapsed
  - others were pressed harder to do things to keep value up
  - suddenly we were questioning how these activities could have gone on
  - blame all around
    - complicity between management and auditors in reporting information to shareholders
      - auditor had incentive to keep firms happy as they made more money on consulting services than auditing
    - boards of directors that were too friendly to management and or caring only of insiders not outsiders
      - lack of independence and effort on the part of boards
    - shareholders not exercising the full extend of their corporate governance responsibilities
      - need to realize that agents act in accordance with their incentives
US Response

- The US has seen a marked increase in attention to corporate governance issues
  - compensation issues
    - reduced reliance on options and discussion of appropriate reporting
      - Microsoft now to use restricted stock rather than options
      - SEC discussing appropriate charge to income for options
        » options are valuable even when issued out of the money
    - Legislation: Sarbanes - Oxley 2002
      - managers are liable for accuracy of info in financial statements
      - creation of Public Company Accounting Oversight Board (PCAOB)
        » new regulatory arm to audit the auditors
      - increase in penalties for white collar crimes
      - restrictions on soft payments from firm to managers
      - rules to give more power to small shareholders to question management and propose board members

Impact of Sarbanes-Oxley

- Sarbanes-Oxley has been controversial
  - big problem has been costs relative to benefits and change to corporate incentives
    - costs
      - cash costs of Sec 404 compliance higher than anticipated
        » developing internal control systems cost more due to large demand
        » auditing firms charged more to certify
      - indirect costs were significant
        » greater risk to officers and board members increased compensation costs and fees for legal and insurance
        » qualified board members harder to find
      - incentives and opportunity costs
        » managers less like to take risky ventures, hoard more cash
        » money diverted to compliance reduces investment and growth
      - impact on US markets
        » promote private equity
        » shift of US listing to foreign markets
    - recently the PCAOB softened requirements on auditors
Governance Around the World

- Differences in corporate governance around the world arise largely from two issues
  - the degree of the separation between ownership and management
  - the role that outside creditors (banks) can play in corporate decisions
    - in turn these lead to some fundamental differences in the way business environment is structured
      - the form of owner oversight on managers
      - the nature of the market for corporate control
  - taken together, these issues go a long way to understanding differences in corporate governance around the world

Separation of Ownership and Management

- While it is a basis of most financial theory, it is not really very common
  - in the US, managers are often substantial owners
  - outside the US, lack of separation is even more common
    - ownership is often much more concentrated
      - equity ownership is generally dominated by families and large institutional investors
  - explanations for this
    - lack of any type of external equity markets to pool funds for anonymous investors
    - historical reasons
      - ownership is less concentrated in countries where the industrialization (therefore large corporations) was proceeded by democratization (individual rights)
        - for example, the U.S., U.K.
Overview of Differences in Financial Architecture

- **Differences in the role of banks**
  - concentration of banking power
    - in the US, banking is more competitive than abroad
      - the result is a large number of banks with little market power
    - abroad there are often a few large banks, often state supported
  - bank regulation
    - US commercial banks are more regulated than banks abroad
      - commercial banks are prohibited from holding equity in firms
      - eliminates US banks from being shareholders
      - while they may be credit provider to the firm, they have no role in providing protection to minority shareholders
    - outside US, banks often are allowed both to lend to and invest in firms (these are called universal banks)
      - banks can act as custodians of others' shares and vote them
        - this mean banks can be large SH with significant decision rights

Concentration of Ownership

- **Due to less developed equity markets abroad**
  - financing is often obtained from other firms
    - this leads to large “cross holdings” of equity where firms will own significant shares in other firms
      - this is in lieu of outside individual investors
    - in some countries, this cross holding is done via firms within the same family
      - there are a series of firms all of which have cross holdings in one another
        - while this does not help raise equity, it does reduce influence of outside shareholders
  - this phenomenon, together with banks ability to hold equity means that outside the U.S. ownership is much more concentrated
    - often more than 80% of equity is held by friendly firms or banks
      - this equity is in “friendly hands” making hostile takeovers and changes in management oversight is virtually impossible
Shareholder (Stakeholder) Oversight

- In all countries there is an oversight mechanism
  - allows shareholders and/or stakeholders to oversee decisions of the management
    - insure that management acts in owners’ best interest
  - in the US this is done by the Board of Directors
    - typically 12 members elected by the shareholders
      - big issue is number of insiders versus outsiders
  - elsewhere these boards may be all management or contain representatives of creditors and labor
    - in Germany there is a 2 tier structure
      - management board of only managers and supervisory board of outside directors representing SHs, creditors and employees
    - in Japan, the supervisory board is comprised mostly of the firm’s managers and managers of related firms and banks

Financial Architecture Abroad

- In Germany and Japan, we see a much closer link between banks and corporations
  - in Germany and Japan, there are a relatively small number of large banks
    - these banks are not prohibited from taking equity stakes in the firms to which they lend
      - bank managers have seats on the board of directors
    - also banks often hold individuals’ shares in the firm and vote the shares for the investors
      - often a bank may be close to a majority shareholder in a firm
    - this allows a closer relationship between creditors and shareholders and makes banks large shareholders
  - also, the late development of equity markets means that other equity is often held by other firms
    - thus there is extensive “cross-holding” of shares in these countries by other institutions or wealthy families
Comparison of Different Systems of Corporate Control

- In the U.S. and U.K there is a market based system of corporate control
  - banks play almost no role in corporate control as they are prohibited from owning or voting stock
  - but with the resulting disperse share ownership an active market for corporate control exists
  - parties that believe they can manage assets more effectively than existing management can purchase them
    - this is the market for corporate control – mergers and takeovers
    - if they are successful, they become wealthy and the economy becomes more efficient
    - if they fail, they lose and existing stakeholders lose as company fails
  - there is both an up and a down side to this system

Bank-based System of Corporate Control

- Germany
  - German banks control equity of firms in 3 ways
    - through direct ownership for their own account and trusts
    - by actively voting the shares of their banking clients
    - by acting as investment bankers to the firm
      - they effectively control the market for equity issues and control a large block of shares (sometimes more than 30%)
  - management reports to supervisory board
    - board consists of non-managers of the firm
    - SH vote for just over 50% of seats on supervisory board
      - banks and family have the most votes
        - they control the method by which shares are voted
        - vote for friendly outside directors
    - workers get to elect the remaining representatives
      - difficult to make decisions that impose pain on workers
Equity Culture in Germany

- Historically, equity not important in Germany
  - bank are main providers of credit and equity
  - only a small percent of German firms are publicly listed
    - just 20% of total corporate sales are by exchange traded firms
      - large publicly traded firms are called Aktiengesellschaft (AG)
    - the majority of German firms are small- to medium sized firms
      - these are called Mittlestand
      - they are typically run and controlled by a single family
    - corporate governance is not an issue for these firms as the owner and manager are the same
  - however, with mass privatizations there is a growing equity class in Germany
    - this will put pressure on the old style governance system
      - individual investors will want action if performance of firms lags
      - but poor performance and collapse of Neuer market has slowed growth of interest in equity as investment

Governance in Japan

- Japan also has bank system of governance
  - but banks are less powerful than in Germany
    - they act more as a corporate partner rather than major SH
  - most banks in Japan are aligned with (owned by) a group of integrated firms
    - these corporate conglomerates are called keiretsu
      - these vertically and horizontally integrated firms all share cross holdings and cooperate rather than compete
      - major keiretsu in Japan are Mitsubishi, Mitsui, Sumitomo, Dai-Ichi, Fuyo, and Sanwa
    - in a keiretsu, no firm can hold more than 5% of another firms stock
      - but many groups have 20 – 50 companies in them
        - this allows large block holdings of equity to prevent takeovers
    - management of firms are overseen by managers of affiliated companies
Impacts on Market for Control

- Large block shareholders and underdeveloped markets mean weak corporate control market
  - can’t mount a takeover if majority of equity is in friendly hands
  - hostile takeover also difficult due to regulations and rules
    - Germany requires 75% SH vote to approve takeover and does not allow golden parachutes
- how do outside shareholders press for change when performance lags
  - question management at shareholders meetings and vote against management nominated directors
- minority SHs are becoming increasingly active in pressing management to pursue value maximization
  - in US this is being driven by institutional investors, like CALPERS, pushing for more outside directors, more disclosure of info, and tighter linkage of executive pay and firm performance
  - SH activism is also increasing outside US