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Some Conceptual Issues of Corporate Governance

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SOME CONCEPTUAL ISSUES OF CORPORATE GOVERNANCE*

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Foreword

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Corporate governance has become a central subject of debate among Asian policymakers in the aftermath of the 1997 Asian financial crisis. Economies that suffered major economic reversals have identified weaknesses in corporate governance as a principal cause of the crisis. However, the issue of corporate governance came into the public policy arena much earlier. In the United States the wave of hostile takeovers, leveraged buyouts, corporate restructuring, and acceleration in executive compensation led to intense business, media, academic, and policy discussions in the 1980s. In Europe extensive debates have been taking place for more than a decade on the relative merits of the Anglo-Saxon market-based governance model and the stakeholder relationship model. In Eastern Europe, transition economies that have recently privatized their state-owned enterprises are concerned about how these enterprises should be governed.

THE AGENCY PROBLEM

Corporate governance deals with ways of ensuring that suppliers of finance to corporations assure themselves of getting a return on their investment. The issue was first raised in the economics literature in the 1930s when economists looked at the implications of separation of ownership from control in modern corporations characterized by limited liabilities. It was suggested that once salaried managers are running companies owned by numerous dispersed shareholders, firms might no longer maximize profit for the benefit of shareholders. On one hand, shareholders and managers have different interests and objectives: shareholders want to maximize returns to their investment while managers may be more interested in empire-building. On the other hand, managers have to be given substantial amount of discretion in managing companies, but monitoring of managerial efforts by shareholders is usually imperfect and costly due to imperfect information. This is the so-called agency or moral hazard problem. It is now understood that such problems exist not only between shareholders and managers, but also between shareholders and creditors, and between controlling and minority shareholders.

MARKET COMPETITION

Market competition provides an effective mechanism to tackle these agency problems and to provide protection for shareholders and creditors. Market competition puts pressure on managers to act efficiently, otherwise they will soon be forced out of business. In fact, in a perfectly competitive world, market discipline could be a sufficient guarantee that managers act in the interest of investors. In reality, however, firms do not operate in a perfectly competitive world because of many market failures caused by economies of scale, externalities, information asymmetries, transaction costs, and so on. For instance, in product markets, some firms may enjoy monopoly power due to scale economies and therefore are inefficient as they could survive by exploiting consumers and seeking rents; in financial markets, the pervasive information problem may prevent market forces from functioning efficiently in allocating funds and monitoring their use. Market imperfection could also be a result of "government failure". In many emerging markets, government interventions such as directed credits, implicit and explicit guarantees, and state ownership seriously distorted incentive structures and weakened market discipline.

When markets are not perfect and market discipline is weak, government regulations become important in solving the corporate governance problem. Government regulations should provide legal protection for investors, which is usually embedded in corporate and securities laws. However, there are also other mechanisms which, by creating appropriate incentive structures, could mitigate the agency problem and reduce the cost of legal protection. These include ownership concentration, market for corporate control, and discipline by creditors.

OWNERSHIP CONCENTRATION

Shareholders are the residual claimants to the income and assets of companies. They bear the residual risk of companies and have control rights over them. The principal rights they have are voting rights during general annual meetings over key matters of corporate policy, such as appointment of the board of directors and mergers and acquisitions. Of fundamental importance for the enforcement of these rights is the strength of legal protection. However, the enforcement of shareholder rights also depends on the degree of shareholder involvement in corporate affairs, and their willingness to monitor managerial efforts. These in turn depend upon the extent to which shareholders believe their votes will matter.

It has been noticed that when corporate ownership is dispersed, such as in the US and the UK, the so-called free-rider problem may lead to weak shareholder monitoring. The argument is that a small shareholder would bear all the monitoring cost, while he or she could only share a small proportion of the benefit. The best strategy for small shareholders is therefore to vote upon the board of directors, and to bet that boards would act in their interests, rather than to be engaged in costly monitoring. Ensuring that boards act in the shareholders' interests requires that board directors have proper incentives. There is a large amount of empirical evidence suggesting that boards may act passively. In many countries insiders (e.g., executive managers) dominate boards. Boards of directors tend to be captured by management. These concerns have in recent years led to calls for the appointment of nonexecutive directors to boards as a means of ensuring that interests of outsiders (minority shareholders) are protected; for separating the role of the chief executive officer from that of the chairman of the board; and for setting up independent committees of remuneration, nomination, and auditing in the board.

In most countries other than the US and the UK, corporate ownership is concentrated. In Germany, large commercial banks through proxy voting arrangements often control over a quarter of the votes in major companies, and also have smaller but significant cash flow stakes as direct shareholders. In smaller German companies, the norm is family control through majority ownership. In Japan, although ownership is not nearly as concentrated as in Germany, large cross-holding as well as share holdings by major banks are common. In most of the rest of the world, including continental Europe, Latin America, East Asia, and Africa, corporations typically have controlling owners, who are often founders or their offspring. Recent theoretical research has suggested that in a world where it is very costly to write and enforce a complete contract between shareholders and management, large shareholders could play an important role in monitoring management. It has been argued that the presence of a large shareholder could ensure the optimal balance between management and the providers of capital.

Concentrated ownership is however not without problems. A fundamental problem is the conflict between large controlling blockholders and powerless minority shareholders. Large shareholders may treat themselves preferentially. They may abuse controlling power for their own interests at the expense of those of minority shareholders and other investors. This could take the forms of paying themselves special dividends, exploiting other business relationships with the companies they control, and taking on excessively risky projects since they share in the upside while the other investors, who might be creditors, bear all the costs of failure. When large shareholders are banks, they may earn rents from their control over industrial firms. For instance, empirical studies have indicated that, controlling for other factors, Japanese firms with main banks paid higher average interest rates on their liabilities than did unaffiliated firms. A further problem associated with banks being controlling shareholders in nonfinancial corporations is that banks may become too soft in granting loans, terminating bad investment projects they invested, and pushing for liquidation.

Empirical evidence on the role of large shareholders in exercising corporate governance is accumulating. For instance, it has been found that, in Germany, large shareholders are associated with a higher turnover of directors, and block shareholders improve corporate performance. In Japan, firms with large shareholders are more likely to replace managers in response to poor performance than firms without them. In the US, large blocks of stock were traded at a substantial premium to the posttrade price of minority shares, consistent with the view that control rights are valued. Empirical studies also found evidence of an inverted "U" shape relationship between the degree of ownership concentration and profitability. A possible interpretation to this relationship is that as ownership concentration rises, agency costs decrease and hence profitability rises; but when ownership concentration rises to a certain limit, its costs outweighs its benefits, leading to a fall in profitability.

MARKET FOR CORPORATE CONTROL

Many economists believe that the market for corporate control is also a key part of a corporate governance system. The central mechanisms for the transfer of corporate control are mergers and takeovers. Takeovers are much more common in the US and UK where ownership is dispersed than in Continental Europe and East Asia where ownership is more concentrated. In certain periods since the 1980s, takeover activities became almost part of daily corporate life in the US and UK.

Many people view the market for corporate control as a means of improving corporate governance, by threatening managers with takeovers to keep them from abusing their power or misusing corporate resources. If managers were to abuse their positions or fail to perform well for any reason, stock prices of their companies would fall, attracting buyers who would acquire these companies and correct the abuses, including replacing bad management.

This whole line of reasoning is however not without controversy. There are a number of reasons why takeovers as a mechanism of disciplining managers may not be feasible. First, free-riding strategies on the part of shareholders in companies with dispersed share ownership could prevent successful bids. The argument is that shareholders of a target company, believing their own actions have a trivial, small effect on the probability of success of a particular bid, would have an incentive to decline the offer. They would accept the offer when the value of the bid fully reflects the value of the increased profitability that the acquiring company expects to bring about. But this would leave no incentive for the acquiring company to make a hostile bid in the first place. Second, even with concentrated ownership, informational problems may render the takeover mechanism ineffective. The insiders, or managers, are likely to know better about the performance of the company. Thus, when controlling shareholders in the target company are willing to sell their shares, it indicates that the acquiring company is paying too much; if they refuse to sell, it indicates that the acquiring company is paying too little. Takeovers will only be successful when the company taking over pays too much. Third, the incumbent managers are often well placed to take strategic actions that deter takeovers, including committing the company to long-term contracts with severe penalties for breach, and such devices as golden parachutes, poison pills, and changing the corporate charter to make takeovers more costly.

These considerations would suggest that takeovers are generally unlikely to take place in practice. However, available evidence tell a different story: takeovers do take place and, moreover, in waves. At the same time, it is also fairly widely agreed that takeovers in fact occur for a variety of reasons other than fulfilling its disciplining role. These include the pursuit of monopoly power, empire building, tax motives, and certain defensive and strategic considerations. There is an accumulated body of evidence that while takeovers may serve to discipline the management of target companies, they themselves could be major instances of nonvalue-maximizing behavior by the acquiring company's management (Shleifer and Vishny 1988).

DISCIPLINE BY CREDITORS

Creditors have some control rights in companies and hence are also important players in corporate governance. Creditors could influence major decisions of the companies and discipline bad management through a variety of controls they have when companies default or violate debt covenants. Their influence exists also because they lend short term and borrowers have to come back at regular, short intervals for more funds (Shleifer and Vishny 1997).

Debt comes in two principal forms: bank debt and market debt (i.e., corporate bonds). Bank debt typically takes the form of a bilateral relationship between a borrower and a lender, although this may be undertaken on a syndicated basis. Corporate bonds are fixedincome lending agreements between the issuing company and dispersed bondholders. Both borrowers of bank loans and issuers[7] of corporate bonds have certain contractual payment obligations, promising to make a prespecified stream of future payments to lenders. However, the creditors may also have some rights over corporate decisions made in solvent states. For instance, they could impose sanctions over the investment policy of a company, including mergers and acquisitions and spin-offs, and impose restrictions on overall level of borrowing of the company and, if the company is close to insolvency, on dividend payments and other decisions that may damage their security. If the borrower violates any covenant and, especially, defaults on a payment, the lender gets certain rights, such as the ability to repossess some of the firm's assets (collateral) or the opportunity to throw the firm into bankruptcy. It is generally believed that, by threatening that a failure by the borrower to adhere to the contract triggers the transfer of some control rights from managers to the lender, debt reduces costs arising from agency problems. For instance, creditors' threats may prevent managers from investing in poor projects, or force them to sell assets that are worth more in alternative uses. On the other hand, it is also well accepted that debt as a disciplining device has its costs. Its main costs are that companies may be prevented from undertaking good projects because debt covenants could keep them from raising additional funds; they may be forced by creditors to liquidate when it is in fact not efficient to do so. These concerns have naturally led researchers to look at the optimal choice of debt versus equity in a company's financial structure.

The effectiveness of debt as a mechanism of corporate governance depends on the quality of monitoring, on how difficult it is to renegotiate in default states, and on the extent to which creditors' rights are enforceable in the courts. Banks usually have much larger stakes in companies than dispersed individual bondholders and hence have stronger incentives to monitor corporate activities. On the other hand, bank debt is part of a bilateral relationship and, in default situations, renegotiations may be relatively easier, especially when banks are at the same time equity-holders of borrowing companies. Meanwhile, renegotiating with dispersed bondholders may be difficult, and the borrower might be forced into bankruptcy. It has been suggested that the difficulty of renegotiations, and the power of dispersed creditors, might explain why market debt is an extremely uncommon financing instrument. Market debt is used mostly in developed countries, such as the US, which has a strong investment banking ethos and well developed securities laws (Mayer 1990).

LEGAL PROTECTION FOR INVESTORS

The effectiveness of concentrated shareholding, the market for corporate control, and debt as a mechanism for solving agency problems and strengthening corporate governance hinges on a strong legal system for investor protection. Without a strong legal system in place, these mechanisms will either function poorly, or fail to function at all, or lead to agency problems of a different kind such that their costs might overweigh their benefits. Legal protection for investors involves specifying the legal rights of and requirements for investors, duties and responsibilities of corporate directors and managers, and restrictions on and prohibitions of certain trading activities. These are usually embedded in corporate laws and regulations. Legal protection of investors also requires that corporate laws and regulations be enforced effectively.

The actual forms of corporate laws and regulations differ considerably from one country to another. These depend on historical, cultural, political, and economic factors, on the development stage of a country's corporate sector and financial system, and also on whether a country has a civil law or common law tradition. In principle, different legal arrangements can be classified into the following clusters: securities market regulations; fiduciary responsibilities of directors and managers; and laws governing shareholder rights, takeovers, and corporate insolvency.

Securities Market Regulations

The basic objective of securities market regulations is to instill public confidence on the reliability and accuracy of information reported by companies and thereby protect investors' interest, maintain order in the securities market, and promote market efficiency.

These regulations usually cover (i) requirements for registration of companies and of securities offered or sold to the public; (ii) requirements for timely and accurate reporting and disclosure of financial information; (iii) restrictions on securities trading by certain groups of people (such as "insiders", i.e., controlling shareholders and managers); (iv) prohibitions against certain types of trading activities and behavior such as "fraud or deceit" or "manipulative or deceptive devices or contrivances"; (v) rules of the stock exchanges and membership requirements of associations of securities dealers; and in some countries (vi) restrictions on levels of shareholdings by financial institutions in nonfinancial corporations.

Fiduciary Responsibilities of Directors and Officers

The role of these legal arrangements is to ensure that managers hired to run companies and board directors elected by shareholders to oversee managers will act in the best interest of the companies. A fiduciary is someone who has legal responsibility to care for something held in trust for someone else. Boards of directors are expected to formulate corporate policy, approve strategic plans, authorize major transactions, declare dividends, and authorize the sale of additional securities. They are also expected to hire, advise, compensate, and if necessary, remove management; to arrange for succession; and to determine the size of the board and nominate new members, subject to approval by shareholders. Fiduciary duties impose the responsibilities of loyalty and care on managers and directors. The duty of loyalty requires that the managers or directors avoid conflict of interest and refrain from self-serving transactions at the expense of the corporation. The duty of care requires each director and officer to act in good faith and in a manner he or she reasonably believes to be in the best interest of the corporation. Treating managers and directors as fiduciaries provides a mechanism for imposing sanctions if they fail to exercise their responsibilities to the corporation and shareholders, without necessarily requiring that all of those responsibilities be spelled out in precise detail in advance. Fiduciary responsibilities of directors and officers are usually specified in company laws.

Laws Governing Shareholder Rights

The basic shareholder rights, mostly specified in a company's laws, usually include the right to (i) secure methods of ownership registration; (ii) convey or transfer shares; (iii) obtain relevant information on the company on a regular basis; (iv) participate and vote in the annual general meeting, including electing members of the board and participating in making decisions concerning fundamental corporate changes such as amendments to articles of incorporation and extraordinary transactions such as mergers and dissolution; (vi) file derivative suits on behalf of the company; (vii) adopt resolutions making recommendations to the board of directors; and (viii) share in the residual profits of the company. Information on a company usually includes financial results of the company, major share ownership, members of the board of directors and key executives and their remuneration, foreseeable major risk factors, governance structures and policies, and company objectives and policies other than return to shareholders. Company laws also stipulate processes in which shareholders exercise their rights, mainly the annual general meeting and voting procedures, including notification of the dates and agenda of the meeting, voting, and counting methods. An important rule relating to voting method is the so-called "proxy voting" whereby shareholders vote in absentia. An important requirement for voting rights is the equal treatment of all shareholders of the same class. An important issue concerning these requirements and rules is whether or not they tilt the balance of power in favor of existing management and against outsiders and minority shareholders.

Laws Governing Takeovers

Legal arrangements for takeovers are usually contained in company laws or takeover codes. The basic objective of these arrangements is to ensure that the market for corporate control functions in a fair and transparent manner so that shareholders have ultimate influence over strategic corporate decisions and the rights of all shareholders are protected. Takeover is the major form of gaining control of a company without management approval. Laws governing takeovers usually contain rules and procedures for disclosing information relating to an acquirer's shareholding in a target company and the takeover plan, and the timing of information disclosure. The laws may also include restrictions on certain types of takeover defense including greenmail and poison pills. In addition, the stock exchange may set rules to ensure the protection of shareholder rights and the liquidity of the market. For example, in the UK Take-over Code, there is a compulsory bid rule whereby an investor who acquires over 30 percent of the shares of a company must bid for the remaining shares.

Laws Governing Corporate Insolvency

Bankruptcy provides a mechanism by which creditors can collectively settle their claims against an insolvent company in an orderly manner. It solves the creditors' coordination problem and allows the dispersed creditors to save the direct and indirect costs of a race to grab assets when a company defaults. It therefore provides effective protection for creditors, as without such a mechanism the cost of recovering debt by creditors on their own would substantially reduce the value of their claims and deter them from pursuit. This is particularly important for minority creditors. Bankruptcy is also an important mechanism to discipline company managers by imposing hard budget constraints. A further important function of bankruptcy is that it provides a forum for debt restructuring and an opportunity for an insolvent company to be reorganized. This is because there are cases where the immediate liquidation of an insolvent company is an inefficient response to insolvency, but one that may occur in the absence of judicial intervention. This could happen if costs of transactions among the company's creditors and between the creditors and the company's management are greater than the incremental value of a reorganized over a liquidated company. Giving the insolvent company a temporary right to continue the operation and to be free from efforts of creditors to enforce their claims may solve this premature liquidation problem.

The laws governing corporate insolvency are usually contained in bankruptcy laws or company laws. These laws set rules relating to (i) the initiation of bankruptcy, (ii) the timing of bankruptcy, (iii) the management of the company during bankruptcy, (iv) who decides initially whether the company should be reorganized or liquidated, (v) the bankruptcy liquidation procedure and seniority of different classes of claims, (vi) treatment of secured creditors in reorganization, (vii) the reorganization plan, and (viii) protection of insolvent companies in reorganization. There are substantial differences in these rules across countries. An important issue is whether the law is biased in favor of debtors or creditors. The US bankruptcy law is sometimes labeled as favoring debtors. It has two principal procedures: Chapter 7, which deals with liquidations and, Chapter 11, which deals with the reorganization of insolvent firms. Chapter 11 offers a distressed company and its management protection from creditors while a reorganization plan is being drawn up. It has been argued that Chapter 11 creates incentives for management to seek debtor-in-possession protection from creditors, thereby protecting managers from the full consequences of poor decisions and making poor decisions more likely. In contrast, bankruptcy laws in the UK, France, and Germany have often been labeled as being creditor-oriented. Although there are procedures for reorganization in bankruptcy laws in the three countries, in no procedure does management retain control of a distressed company; in the event of insolvency the receiver or administrator becomes the manager of the company. There is no mechanism for debtor-in-possession restructuring. This has led some scholars to argue that the UK system is biased toward premature and inefficient liquidation. However, since the mid-1980s, the focus of bankruptcy laws in these countries has also been shifted away from exclusively protecting creditors' interests toward a balance between protecting creditors and saving distressed firms.

A TAXONOMY OF CORPORATE GOVERNANCE

A great deal of the discussion on corporate governance has focused on the differences between the Anglo-Saxon market-based model and the German-Japanese relationship-based model. In the UK and US, ownership of equity and debt is dispersed. Corporate governance is exercised by portfolio investors through the enforcement of shareholder and creditor rights and through the market for corporate control. The sole purpose of governance structures is the protection of shareholder value. In Germany and Japan, on the other hand, ownership of equity and debt is concentrated. Banks and large family interests are important in the governance structure. Also substantial cross-holdings of shares exist between companies. The Anglo-Saxon model of corporate governance has come under criticism for some time (Mayer 1990). It has been argued that the Anglo-Saxon model forces management to pursue short-term objectives, and that the German and Japanese models of corporate governance are consistent with superior long-run performance and encourage long-term investment. However, recent experience of many East Asian countries, which have basically the relationship-based corporate governance system and have been hit hard by the financial crisis, and examples of failure of Japanese as well as German banks in acting as effective monitors of companies have cast serious doubt on these criticisms.

The nature of corporate governance reflects the nature of a country's financial system, as they are two sides of the same coin. The Anglo-Saxon model is based on a market-oriented or arms-length financial system. The German-Japanese model is based on a relationship-oriented financial system. Table 1 summarizes the key characteristics of these two models.

The different types of corporate governance place different demands on the general legal environment and enforcement of property rights. The arms-length or market-based system places great emphasis on courts enforcing shareholder rights over assets. The relationship-based model places greater emphasis upon enforcement through the trust embodied in the relationship itself. But this does not apply to minority shareholders who will rely upon the legal system for protection. It has been argued that weak legal systems and poor protection of minority shareholders cause concentrated ownership structures. However, the argument could be reversed: the relationship model with its prediction of concentrated ownership structure could be the cause of low levels of minority shareholder protection and judicial enforcement, due to economic and political power of large controlling shareholders in some countries. Hence there are arguments both ways: the type of finance could determine the level of legal enforcement and, on the other

Table 1: Characteristics of Relationship-based and Market-based Finance

	Type of Financial System	
	Relationship Finance	**Arm's-length Finance**
Share of control-oriented finance	High	Low
Financial markets	Small, less liquid	Large, highly liquid
Share of all firms listed on exchanges	Small	Large
Ownership of debt and equity	Concentrated	Dispersed
Investor orientation	Control-oriented	Portfolio-oriented
Shareholder rights	Weak	Strong
Creditor rights	Strong for close creditors Weak for arms length creditors	Strong
Dominant agency conflict	Controlling vs. minority investors	Shareholders vs. management
Role of board of directors	Limited	Important
Role of hostile takeovers	Very limited	Potentially important
Role of insolvency	Potentially important	Potentially important

hand, the degree of legal enforcement could determine the type of finance used. This is consistent with the view that high ownership concentration is typically both a symptom and a cause of weak corporate governance. Ownership concentration is symptomatic of weak corporate governance because it is a means for shareholders to monitor and control management when shareholder protection systems are weak. It is a cause of weak corporate governance because it may lead to more risk-taking behavior and to the abuse of minority shareholders. In addition, controlling shareholders are a potential source of pressure to delay improvements in disclosure and governance, as these improvements may erode their corporate control and insider benefits.

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