

Corporate Governance

"Anatomy of a Takeover"

Ethics of 1980s takeover wave: old but good!

1. go to the link:

<http://www.learner.org/resources/series81.html> (Ethics in America)

2. click on "Anatomy of a Corporate Takeover" VoD icon

3. click on sign-up here (if you are new to this particular service) and type your relevant information. It's FREE!

4. click on the relevant VoD icon again and you will be able to watch the video.

Historical perspective

- 70s: rising awareness that corporations being run by managers for the managers
 - Jensen and Meckling (1972)
- 80s: shareholder value movement:
 - Reagan-Thatcher deregulation: created new markets
 - Technological change
 - Jack Welch: sell under-performing assets
 - LBOs: look for under-performing companies
- 90s: provide managers with incentives
 - Options
 - Decline of hostile takeover market (state legislation)

- Increased sensitivity of pay-for-performance
 - Increased incentives to exert effort
 - Increased incentives to manipulate stock prices
- Corporate scandals
 - Fraud, "creative accounting," conflicts of interests: auditors, banks
 - Were they isolated events or systemic problems?
- Private equity & hedge funds
 - Investor activism

Why should we protect SHV?

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- Economic efficiency and growth depends on productivity
- The party most interested in improving productivity is the owner of the residual difference between output and inputs
 - Shareholders

Why should we limit SHV?

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- Universal norms: don't lie, don't cheat...
- Respect customers
 - Can't survive without them
- Respect employees
 - They are creating value for you
- Pay attention to community
 - You are one member

"Stakeholder" objective too diffuse?

- Management has too much leeway

Corporate Governance and Shareholder Value: Issues

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1. Shareholder rights and performance
2. Mechanisms for resolving agency problems: how well do they work?
 - Evidence
3. Securities fraud and stock price manipulation
4. What form of regulatory intervention?
5. The myth of independent oversight

Main CG mechanisms

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Main mechanisms

- Large shareholders: voice
 - Influence Board of Directors
 - Takeover market
- Regulation
- Private legal action
 - rare outside US; curtailed inside US

Gompers, Ishii and Metrick 2003

- Returns evidence
 - Good CG associated with high returns in 1990s (estimate: worst CG decile underperformed best CG decile by 0.71% a month!)
- Q (MV of assets/replacement cost) and shareholder rights
 - Positive but weaker association
- Capital expenditure and acquisitions negatively related to shareholder rights

TABLE VI
PERFORMANCE-ATTRIBUTION REGRESSIONS FOR DECILE PORTFOLIOS

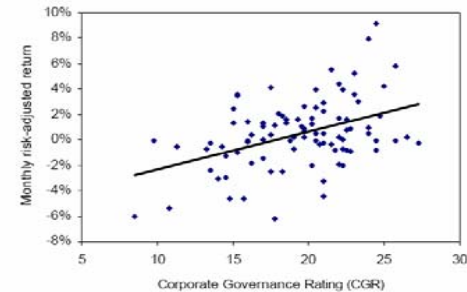
| | α | RMRF | SMB | HML | Momentum |
|----------------------------|------------------|------------------|-------------------|-------------------|-------------------|
| Democracy-Dictatorship | 0.71** (0.26) | -0.04 (0.07) | -0.22* (0.09) | -0.55* (0.10) | -0.01 (0.07) |
| $G \leq 5$ (Democracy) | 0.29* (0.13) | 0.98** (0.04) | -0.24** (0.05) | -0.21** (0.05) | -0.05 (0.03) |
| $G = 6$ | 0.22 (0.18) | 0.99** (0.05) | -0.18** (0.06) | 0.05 (0.07) | -0.08 (0.04) |
| $G = 7$ | 0.24 (0.19) | 1.05** (0.05) | -0.10 (0.07) | -0.14 (0.08) | 0.15** (0.05) |
| $G = 8$ | 0.08 (0.14) | 1.02** (0.04) | -0.04 (0.05) | -0.08 (0.06) | 0.01 (0.04) |
| $G = 9$ | -0.02 (0.12) | 0.97** (0.03) | -0.20** (0.04) | 0.14** (0.05) | -0.01 (0.03) |
| $G = 10$ | 0.03 (0.11) | 0.95** (0.03) | -0.17** (0.04) | -0.00 (0.04) | -0.08** (0.03) |
| $G = 11$ | 0.18 (0.16) | 0.99** (0.05) | -0.14* (0.05) | -0.06 (0.06) | -0.01 (0.04) |
| $G = 12$ | -0.25 (0.14) | 1.00** (0.04) | -0.11* (0.05) | 0.16** (0.06) | 0.02 (0.04) |
| $G = 13$ | -0.01 (0.14) | 1.03** (0.04) | -0.21** (0.05) | 0.14* (0.06) | -0.08* (0.04) |
| $G \geq 14$ (Dictatorship) | -0.42* (0.19) | 1.03** (0.05) | -0.02 (0.06) | 0.34** (0.07) | -0.05 (0.05) |

| | Percentage of firms with governance provisions in | | | |
|-------------------------------|---|------|------|------|
| | 1990 | 1993 | 1995 | 1998 |
| Delay | | | | |
| Blank check | 76.4 | 80.0 | 85.7 | 87.9 |
| Classified board | 59.0 | 60.4 | 61.7 | 59.4 |
| Special meeting | 24.5 | 29.9 | 31.9 | 34.5 |
| Written consent | 24.4 | 29.2 | 32.0 | 33.1 |
| Protection | | | | |
| Compensation plans | 44.7 | 65.8 | 72.5 | 62.4 |
| Contracts | 16.4 | 15.2 | 12.7 | 11.7 |
| Golden parachutes | 53.1 | 55.5 | 55.1 | 56.6 |
| Indemnification | 40.9 | 39.6 | 38.7 | 24.4 |
| Liability | 72.3 | 69.1 | 65.6 | 46.8 |
| Severance | 13.4 | 5.5 | 10.3 | 11.7 |
| Voting | | | | |
| Bylaws | 14.4 | 16.1 | 16.0 | 18.1 |
| Charter | 3.2 | 3.4 | 3.1 | 3.0 |
| Cumulative voting | 18.5 | 16.5 | 14.9 | 12.2 |
| Secret ballot | 2.9 | 9.5 | 12.2 | 9.4 |
| Supermajority | 38.8 | 39.6 | 38.5 | 34.1 |
| Unequal voting | 2.4 | 2.0 | 1.9 | 1.9 |
| Other | | | | |
| Antigreenmail | 6.1 | 6.9 | 6.4 | 5.6 |
| Directors' duties | 6.5 | 7.4 | 7.2 | 6.7 |
| Fair price | 33.5 | 35.2 | 33.6 | 27.8 |
| Pension parachutes | 3.9 | 5.2 | 3.9 | 2.2 |
| Poison pill | 53.9 | 57.4 | 56.6 | 55.3 |
| Silver parachutes | 4.1 | 4.8 | 3.5 | 2.3 |
| State | | | | |
| Antigreenmail law | 17.2 | 17.6 | 17.0 | 14.1 |
| Business combination law | 84.3 | 88.5 | 88.9 | 89.9 |
| Cash-out law | 4.2 | 3.9 | 3.9 | 3.5 |
| Directors' duties law | 5.2 | 5.0 | 5.0 | 4.4 |
| Fair price law | 35.7 | 36.9 | 35.9 | 31.6 |
| Control share acquisition law | 29.6 | 29.9 | 29.4 | 26.4 |
| Number of firms | 1357 | 1343 | 1373 | 1708 |

Indicators of "good" CG used by GIM; (see Quarterly Journal of Economics Article)

Drobtz, Schillhofer & Zimmerman 2003

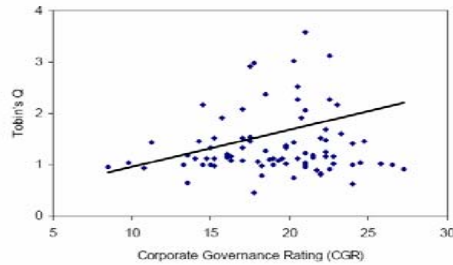
Figure 2: Corporate governance rating and risk-adjusted returns



CG & performance: Germany (2)

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Figure 1: Corporate governance rating and firm valuation



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Mechanisms for resolving agency problems

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1. Large Shareholders
2. Minority Shareholder Activism
3. Boards
4. Executive Compensation
5. Litigation
6. External Certification (Audit, Ratings)
7. Hostile Takeovers (CH, D, UK, US)₁₄

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1. Large Shareholders

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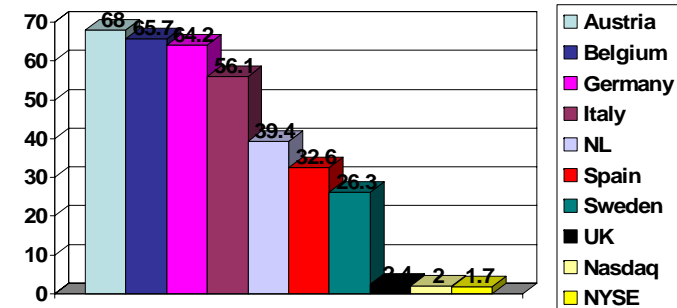
- most of the time shareholder actions operate through the board of directors
- corporate law and securities regulations impose limits on large shareholder powers
- concentrated ownership is the norm outside the US:

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Percentage of listed companies under majority control

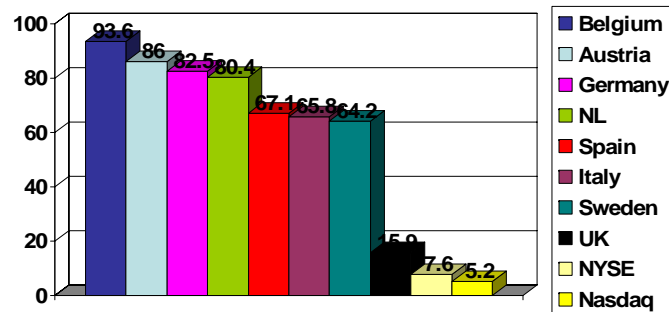
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Source : country chapters in Barca and Becht (2001)
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Percentage of listed companies with a blocking minority of at least 25%

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Source : country chapters in Barca and Becht (2001)

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Large Shareholders: Evidence

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Link between ownership dispersion, voting control and corporate performance:

- profit rates and returns on assets not significantly related to a control dummy
- “hump-shaped” relationship between concentrated ownership and Q
- possible reverse causality: from performance to ownership concentration
- family firms outperform (Anderson & Reeb)

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2. Minority shareholder activism

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Why institutional investors often cautious: banks and insurance companies

“A bank is not just a shareholder, but also has the firm as a client. For insurers the same applies. That distinction between roles is not easy to make. Moreover many firms have no understanding for such a distinction” R. Maatman, lawyer for ABP, NL

“You are in a difficult position if you want to present a new contract to the management board whilst you have voted against one of their proposals the day before.” D. Brilleslijper, Delta Lloyd, NL

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Shareholder activism (2)

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- Fund managers have same conflict
e.g. Fidelity pressured in Hewlett-Packard vote, USA
- 401(K) business at stake
- Pension funds
Company pension funds controlled by management who discourage attacks on peers

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SIPA Shareholder activism (3)

This leaves independent, public or nonprofit sector-related pension funds as actors (Calpers, TIAA-CREF)

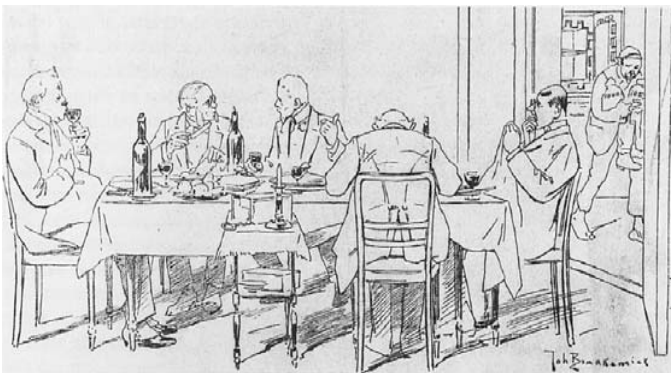
How did they do?

- negligible impact on corporate performance irrespective of form or aim of shareholder proposals
- but measurement problems: timing, simultaneity, backdoor impact

SIPA 3.The board of directors

- The board:
 - selects the CEO,
 - monitors management,
 - votes on important decisions (mergers, CEO remuneration, capital structure decisions)
- In theory: CEO like executive branch of government and board like legislative branch
- In practice: more like a 'rubber stamp assembly'?

SIPA A board of directors, C19



SIPA Boards

Most regulatory efforts focus on its independence

- extent of monitoring a function of the board's "independence"
- board appointments determined through negotiations between existing board and CEO
- as firm does better CEO's bargaining power grows and independence of board diminishes: gradual erosion of the effectiveness of boards over time
- minority directors who oppose management dismissed;
- directors only vote against management if evidence of mismanagement is overwhelming
- boards only intervene in crises

- board composition and corporate performance (stock returns) are “not related” in the US, but:
- independent boards protect bidder shareholders against overbidding
- independent boards are more likely to remove CEOs following poor performance

Main economic rationale for current structure of executive pay:

tie CEO compensation to performance and thereby align managers' and shareholders' objectives

Alchian and Demsetz (1972) & Jensen and Meckling (1976): Manager should be a residual claimant

Agency theory: tradeoff between risk-sharing and incentives

Jensen and Murphy (1990): median CEO earns 'only' \$3 for every \$1000 increase in share value. Huge increase in use of options over last decade.

Modern agency theory of executive pay, Holmstrom and Tirole (1993):

- Stock-based compensation:
 - Stock price an unbiased estimate of fundamentals
 - Induces managers to focus on long-run value
 - performance measure that cannot be manipulated easily

Executive compensation: optimal contracting or extraction of rents?

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- Bebchuk, Fried and Walker (2002): CEO pay in the US cannot be rationalized on the basis of agency theory
- most CEO compensation contracts in the US do not optimally:
 - correct for common shocks through market indexing,
 - set the strike price on stock options,
 - limit the CEO's ability to unwind their stock holdings

Executive compensation: optimal contracting or extraction of rents? (2)

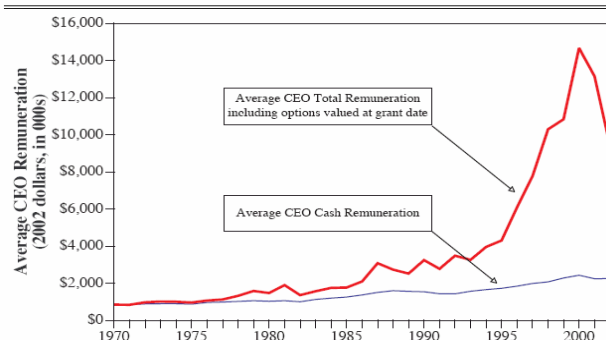
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- US compensation practice reflects a failure in corporate governance
- It is a form of managerial rent extraction:
 - managers pretend that their pay is performance-based,
 - but they are insulated from stock price volatility through the repricing or reloading of options
 - managers go through this pretence to 'camouflage' their rent extraction

CEO Pay Trends

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Figure 1 Average Cash and Total Remuneration for CEOs in S&P 500 Firms, 1970-2002



Jensen et al., 2004

Top-five compensation as a proportion of earnings

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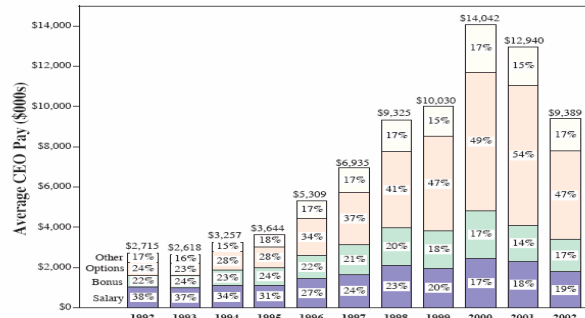
| Period | Aggregate compensation to aggregate income |
|-----------|--|
| 1993-1995 | 4.8% |
| 1994-1996 | 4.4% |
| 1995-1997 | 4.7% |
| 1996-1998 | 4.9% |
| 1997-1999 | 5.3% |
| 1998-2000 | 5.4% |
| 1999-2001 | 7.2% |
| 2000-2002 | 12.1% |
| 2001-2003 | 10.3% |

Bebchuk-Grinstein 2005 estimates

CEO Pay Trends: components

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Figure 3 Average Remuneration for CEOs in S&P 500 Firms, 1992-2002

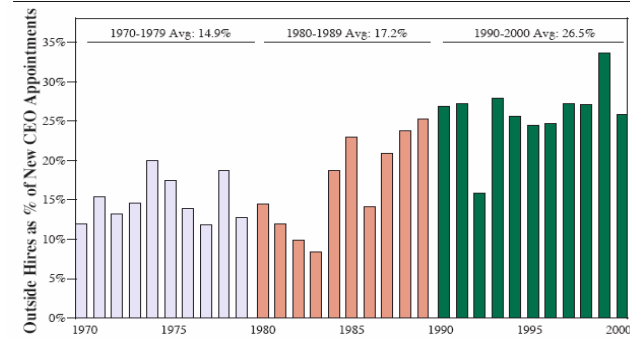


Note: Average pay levels (in 2002-constant dollars) based on ExecuComp data for S&P 500 CEOs. Total remuneration (indicated by bar height) defined as the sum of salaries, bonuses, benefits, stock options (valued on date of grant using ExecuComp's modified Black-Scholes formula), stock grants, and other compensation.

CEO outside hires

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Figure 4 Outside Hires as Percentage of New CEO Appointments in Large US Firms, 1970-2000



CEO tenure has fallen

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- 1970s: 18.2 years
- 1980s: 17.2 years
- 1990s: 14.1 years

II. Explanation of compensation trends

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- Bebchuk et al. (2002, 2004)
 - Incompatible with "arm's length" bargaining leading to optimal contracting
 - Practices inconsistent with optimal contracting
 - "Managerial power" view
 - Executives influence their own compensation, maximizing rents subject to "outrage" constraints
- Jensen et al. (2004) similar (more nuanced) view
 - Detailed practical advice for boards & policy

SIPA Option explosion: causes

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- Awareness of need for equity-based compensation (Jensen-Murphy 1990)
- Disclosure and tax rules
 - options not expensed
 - 1994 tax act: any pay above \$1 mn must be performance-based to be deductible for corporate tax purposes
- “Low perceived cost” explanation
 - no cash outflow
 - lower-level employees also paid in form of options

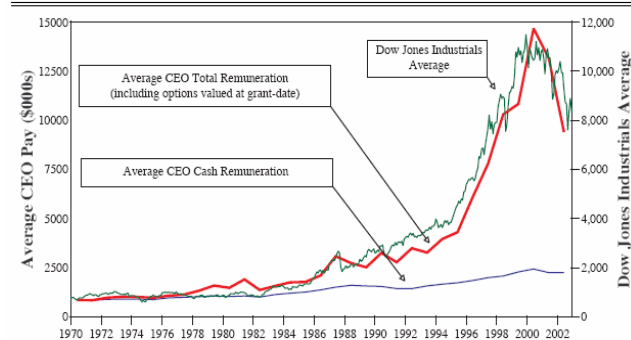
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SIPA Remuneration and stock prices [JMW 2004]

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Figure 5 Dow Jones Industrial Average Cash and Total Remuneration for CEOs in S&P 500 Firms, 1970-2002



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SIPA CEO Pay relative to hourly workers

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SIPA Corporate Crises of 2001-ff.

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- 25 largest bankruptcies in 2001 – 2002.
- Executive pay explosion
 - 52 executives and directors > 10M, 31 > 25M, 16 > 50M, 8 > 100M.
 - Ken Lay (CEO, Enron), 247 M, Gary Winnick (CEO, Global Crossing), 512M.
- Challenge to standard “agency” view of executive compensation.
- Popular view: rent extraction by CEO's.
- Need better governance.

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Recessions catch what the auditors miss.

J.K. Galbraith

- Securities fraud
- Stock price manipulation

- Perverse incentives
“In the bubble, the carrots (stock options) became managerial heroin, encouraging a focus on short-term prices with destructive long-term consequences. ... It also encourages behavior that actually reduced the value of some firms to their shareholders - such as making an acquisition or spending a fortune on an internet venture to satisfy the whims of an irrational market.”

Michael Jensen, *The Economist*, November 16, 2002

- Incentives for stock price manipulation
“... the options craze created an environment that rewarded executives for managing the share price, not for managing the business. Options gave executives strong incentives to use accounting tricks to boost the share price on which their compensation depended.”
 Arthur Levitt, ex-SEC chairman (2002)
- Value of option grants increased ninefold from 1992 to 2000
- Enormous growth in earnings restatements
 - 1991: 0; 1992: 6; 1993: 5; ...; 1997-2000: 700

- Bonus contract incentives drive accounting decisions
- Equity-based compensation (options) predicts “discretionary accruals”
- Equity-based compensation and option exercise predicts SEC accounting enforcement actions
- Executive option holdings predict accounting restatements
- Timing of disclosures around option grants suggests selfdealing
- Exercise decisions and insider sales predict accruals

SIPA Example of selfdealing

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The Perfect Payday, WSJ 18 March 2005



<http://online.wsj.com/article/SB114265075068802118.html>

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SIPA Shareholder litigation

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- Main beneficiaries are lawyers
- Amount recovered small (~5% of maximum dollar loss)
- Disciplinary effect:
 - Executive turnover somewhat higher
 - Financial losses to managers minimal
 - No admission of guilt: almost all cases settled out of court
 - D&O insurance taken out by company

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SIPA Recent legal reforms discourage securities class action litigation

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- 1998 securities class actions to be brought only in Federal courts: curtails jurisdiction shopping
- **1995 Private Securities Litigation Reform Act**
 - Discourages frivolous litigation
 - e.g. reduced liability for unknowing parties (outside directors), limits on attorney's fees, shift of defendant's legal fees to plaintiff if suit is baseless, lead plaintiff requirements
- 1994 Supreme Court decision
 - Curtails liability of "aiders and abettors"
- 1991 statute of limitations (1 year from discovery, 3 years from offense; 2, 5 years since Sarbanes-Oxley)

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SIPA Policy Responses cont'd

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- OECD Principles (1999) & ongoing review
 - OECD Roundtables: Asia, Russia, Brazil
- 40+ Corporate Governance Codes in the European Union
 - All member states (except L)
- Sarbanes-Oxley Act
- NYSE, NASDAQ & Conference Board proposals
- SEC proposal: shareholder democracy

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SIPA Sarbanes-Oxley Act 2002

- Auditor and analyst independence
- Personal certification of reports by CEO and CFO
- Forfeiture of compensation following restatements
- Ban on loans to officers and directors
- Enhanced disclosure requirements
- Certify internal controls
- Whistleblower protection

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SIPA Responses to Sarbanes-Oxley

(Protivi survey)

- New procedures governing external auditor's non-audit services: 72%
- Board and board committee changes (membership and/or charter): 40%
- Internal audit department
 - Evaluating financial reporting process: 45%
 - Adjusting procedures for catching problems: 39%
 - Evaluating disclosure process: 37%
 - Adding staff/compliance training: 20%

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SIPA Summary of US trends

- Less scope for private enforcement through securities class action litigation
- Strengthened accountability of management and monitors:
 - Directors
 - Auditors
- Encourage whistleblowers
- More powers of enforcement for public agencies (undo years of neglect)
 - SEC, etc.
- More disclosure
 - Pay (expensing of options), accounts, CG, procedures

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SIPA But who monitors the monitor?

Government agencies

- SEC under enormous political pressure
 - accounting and financial services lobbies are top Congressional donors
 - e.g. Levitt's unsuccessful battles regarding accounting standards
- Regulatory competition (Spitzer & other state attorneys) can counteract danger of regulatory capture

SIPA Other monitors & conflicts of interest

- Auditors
 - Make money from non-audit services
 - Reappointment depends on current board and management
 - Self-regulating profession: rules and safe harbors
 - Limited terms and proscribed non-audit services in some countries
- Board
 - Reciprocal appointments (*e.g.* NYSE: Grasso-Langone)
 - Shareholder access (nominations)
- Large potential activist shareholders
- Whistleblowers