PART ONE

Background and Perspectives on Corporate Governance

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CHAPTER 1

An Overview of Corporate Governance

H. KENT BAKER
University Professor of Finance and Kogod Research Professor, American University

RONALD ANDERSON
Professor of Finance and Gary Cohn Endowed Research Professor,
American University

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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

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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.

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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.

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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.

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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

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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.

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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.

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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.

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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.

Chapter 13: Board Subcommittees for Corporate Governance (Zabihollah Rezaee) Boards of directors often delegate their oversight responsibilities to board subcommittees. The three most common subcommittees are audit, compensation, and nominating committees. An audit committee, consisting of at least three independent directors, assists the entire board in overseeing corporate governance, internal controls, risk management, financial reporting, audit activities, and other oversight functions. The compensation committee, also comprising at least three independent directors, reviews, designs, and implements directors' and executives' evaluation and compensation plans. The nominating committee, consisting of at least three independent directors, commonly assists the full board in identifying and recommending candidates for nomination to the board of directors and to ensure a fair election process. The board of directors may also establish special committees for assistance in carrying out its advisory and strategic functions. Examples of special committees are corporate governance, financing, budgeting, investment, risk management, executive, litigation or investigative, and mergers and acquisitions.

Compensation, Ownership, and Turnover

Chapter 14: Executive Compensation: Incentives and Externalities (Phillip Geiler and Luc Renneboog) The classical framework on executive pay (including principal-agent, stewardship, and stakeholder theories) claims that remuneration contracts result from a market mechanism that is further corrected by several corporate governance mechanisms, such as good corporate governance rules, shareholder activism, shareholder coalitions, and top-management turnover. This chapter casts serious doubt on the effectiveness of this market mechanism. The available empirical evidence indicates that managerial self-dealing, the skimming of corporate profits by managers through compensation packages, and the existence of hidden compensation create a serious agency problem. In short, executive compensation often seems to be a mismatch with shareholder value creation.

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Chapter 15: Compensation Consultants and Executive Pay (Martin J. Conyon) This chapter provides a review of the recent literature on compensation consultants and executive pay. Six major pay consulting firms dominate the market. These firms advise client firms about executive pay and frequently supply other services such as actuarial work. Some evidence indicates that chief executive officer (CEO) pay is higher in firms using compensation consultants. The hypothesis that CEO pay is higher in firms whose consultants face potential conflict of interests, such as cross-selling of other services, is not as empirically robust.

Chapter 16: Corporate Governance and Ownership Structure (John J. McConnell, Stephen B. McKeon, and Wei Xu) Concerns about corporate governance arise because of the principal-agent conflict that can occur when control of the firm is separated from ownership. This chapter reviews the literature, both theoretical and empirical, that investigates whether ownership of a firm's shares influences the firm's performance and value, where the "who" of ownership refers to classes of shareholders including managers, atomistic outside shareholders, institutional investors, nonmanagement blockholders, and families. There appears to be consensus that there is likely to be an optimal allocation of shares among the various classes of

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shareholders (i.e., an optimal ownership structure exists), but there is no consensus as to what that allocation is or whether it can be identified empirically.

Chapter 17: The Effects of Management Turnover on Firm Performance (Mark R. Huson and Robert Parrino) This chapter summarizes the theory and evidence from the academic literature on the effects of management turnover on firm performance. This literature, which had its origins in the sociology and management literatures of the 1950s, has also received considerable attention in the accounting and finance literature in recent years. Overall, the evidence suggests that management turnover can affect performance. However, the potential magnitude of this effect varies with the circumstances surrounding the turnover, such as whether it is forced or voluntary, the characteristics of the new manager (including whether that manager is an insider or an outsider), and the opportunities for value-enhancing change. The effect of turnover on firm performance ultimately depends on the condition of the firm at the time of turnover, as well as the ability of the board to identify a high-quality replacement manager and its willingness to support changes in the real activities of the business.

Part Three: External Governance

Part Three examines external governance devices and is divided into four segments. The first part consists of Chapters 18 to 21, which examine nonexecutive shareholders such as blockholders, families, institutional shareholders, and other owners, as well as shareholder activism. The second part comprises Chapters 22 to 24 and focuses on nonequity stakeholders such as creditors, banks, and others. In the third part, Chapters 25 to 27 deal with the role of proxy contests and corporate takeovers. The fourth part, which consists of Chapters 28 to 30, examines the role that accounting, legal, and regulatory intervention play in corporate governance.

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Nonexecutive Shareholders

Chapter 18: Corporate Monitoring by Blockholders (Isabelle Dherment-Férère and Luc Renneboog) This chapter compares the ability of different corporate governance regimes to discipline poorly performing management. The analysis suggests that the German corporate governance system best assumes this disciplinary role. German corporations, as large shareholders and as new blockholders, remove underperforming management. Pyramid ownership structures do not hinder the exertion of control power by the ultimate blockholders. In addition, when a firm has contracted a substantial amount of debt with the German universal banks, managerial disciplining occurs more frequently. Although poor performance is correlated with higher managerial turnover, no evidence exists that disciplining is taking place by large blockholders in the United Kingdom. Executive directors who own large stakes seem to be entrenched in the firm even in the wake of poor performance. In the Belgian corporate governance system, corporations and nonexecutive directors assume the monitoring and disciplinary role. In contrast, the French system does not seem to be adept at removing poorly performing executive directors. The CEO dominates the board and little evidence suggests that board structure and composition are related to disciplining underperforming management. Furthermore,

control by holding companies and the government entrenches the management of poorly performing French firms.

Chapter 19: The Governance of Family Firms (Morten Bennedsen, Francisco Pérez-González, and Daniel Wolfenzon) In the past decade, corporate governance research has documented that families control most publicly traded firms around the world. This finding has triggered a considerable body of research that seeks to understand the governance of family firms and their impact on firm performance. This chapter critically examines this literature. The chapter highlights the fact that the main governance issue facing family firms is balancing the benefits associated with having a controlling family with the challenges this structure imposes on minority shareholders. Common governance mechanisms are less likely to be effective whenever control and decision rights are concentrated around a family. The chapter emphasizes the crucial role of family governance in the allocation of resources and reviews recent studies that seek to understand the impact of family characteristics on firm decisions and performance. The chapter also discusses some of the most important topics for future research.

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Chapter 20: Institutional and Other Shareholders (Chris Mallin) The global financial crisis has placed increased emphasis on the role of institutional shareholders such as pension funds, insurance companies, and mutual funds. In addition, the spotlight has fallen on other shareholders including hedge funds, private equity, sovereign wealth funds, and banks. In response to the increasing expectation for institutional shareholders to act as owners rather than simply holders of shares, they are becoming more engaged with the companies in which they invest. Institutional shareholders' engagement is facilitated by the various tools of governance: constructive dialogue, (proxy) voting, shareholder proposals (resolutions), and focus lists. The effectiveness of shareholder engagement is still open to discussion. Yet there have been notable victories such as *say on pay*, whereby investors can vote on remuneration committee reports, resulting in various companies amending their executive remuneration packages.

Chapter 21: The Politics of Shareholder Activism (Donald Nordberg) Shareholder activism is an exercise of power that may be benign or threatening to the interests of corporate management, boards, and other shareholders. The complexity of the relationships among management, boards, and others helps explain the difficulties directors face in pursuing shareholders' interest. What arises, particularly in relation to the growth of hedge fund activism, is greater dispersion of shareholder interests and growing questions about the legitimacy of how those interests are acted out in the political landscape of corporation governance. This chapter offers a framework to examine the stance that shareholders take when exercising or not exercising their power. Anticipating the expression of shareholder power involves assessing their intentions along three dimensions: (1) their attitude toward an individual stock (buy, hold, or sell), (2) their approach to activism (docile, walkers, or activist), and (3) their investment horizons (long-term, short-term, or *perverse*—where shareholders' economic interests do not coincide with their holdings).

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Nonequity Stakeholders

Chapter 22: Executive Behavior: A Creditor Perspective on Managerial Ownership (Ronald Anderson, Sattar Mansi, and David Reeb) Using relational and adversarial models of managerial behavior, this chapter examines how creditors, an important corporate stakeholder, regard executive ownership. Based on creditors' unique claims on firm assets, the chapter argues that agency and stewardship models of managerial behavior offer differing predictions on the role of executive stock holdings. Using a sample of S&P 500 firms, the analysis indicates that creditors are particularly concerned with executive ownership, suggesting these important stakeholders view executive equity stakes as an important governance device. Further analysis reveals that during the late 1990s and early 2000s (a period of heightened governance interests), creditors placed incrementally greater emphasis on managerial ownership as a mechanism to protect their investments in the firm. These findings suggest that creditors perceive managerial ownership as an agency-theoretic governance device rather than a stewardship mechanism that fosters managerial commitment and promotes group interests. Overall, the analysis indicates that managerial ownership influences executive behavior.

Chapter 23: Governance of Banking Institutions (Renée Birgit Adams) This chapter documents some little-known features of bank governance involving bank boards and describes regulation and laws that are likely to influence bank governance. It also describes how organizational form and activities of banks may influence bank boards and provides some new evidence on these influences. The chapter points out some potential problems with the measurement of CEO compensation and ownership structures in banking. A main conclusion is that applying governance standards developed from the study of nonfinancial firms to banks is unlikely to improve bank governance.

Chapter 24: Corporate Governance: Nonequity Stakeholders (Marc Goergen, Chris Brewster, and Geoffrey Wood) Shareholders are not the only stakeholders in an organization. This chapter examines the influence of other stakeholders in a range of contexts, focusing particularly on employees. An influential strand of the finance literature focuses on the nature and extent of shareholder rights vis-à-vis employees. Unlike most of the current literature on the topic, which relies on a limited number of case studies and/or broad macroeconomic data, this chapter draws on evidence from a large-scale survey of organizations to highlight the complex nature of corporate governance regimes and how they are affected by the relative strength of unions and collective representation at the organizational level. The chapter looks at employment security and training and development across regimes. It also notes differences between societal institutions, legal traditions, political parties, and electoral systems across countries and indicates some limitations of the mainstream finance and economics literature along with the value of alternative socioeconomic approaches.

Proxy Contests and Markets

Chapter 25: Proxy Contests (Peter G. Szilagyi) Chapter 25 provides an overview of the role and effectiveness of proxy contests in corporate governance. Proxy

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contests have traditionally been viewed as an expensive and inefficient alternative to takeovers in forcing changes in corporate control. Indeed, until recently, proxy contests were relatively infrequent, waged mostly by individuals, and generally failed to improve corporate performance. However, a new wave of successful contests emerged in the 2000s, dominated by hedge funds seeking governance arbitrage and using innovative campaign strategies. Whether this new wave will be sustained in the long run depends on the SEC's new voting and proxy access rules that favor shareholders but are likely to reduce dissident incentives to initiate proxy contests.

Chapter 26: Corporate Takeovers and Restructurings (Mike Stegemoller) An important component of a well-functioning corporate governance system is the indirect external governance of takeovers and restructuring activities. Alongside the motives of creating synergies and taking advantage of market mispricing, takeovers act as a market for corporate control in which managers risk being replaced if they underperform, thereby mitigating the principal-agent conflict. Restructuring events such as subsidiary sales, spin-offs, equity carve-outs, and targeted stock issuances reduce agency problems by revealing information about the performance of subsidiary managers and relieving information asymmetries about the parent firm. Consequently, while there are different motives for takeovers and restructurings, both lead to massive changes in internal governance. Thus, examining these changes provides information about governance.

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Chapter 27: Corporate Takeovers and Wealth Creation (Marina Martynova and Luc Renneboog) This chapter analyzes the expected synergies of mergers and acquisitions as reflected in the short-term wealth effects around the takeover announcement. Takeovers are expected to create synergies as their announcements trigger statistically significant abnormal returns of 9.13 percent for the targets and 0.53 percent for bidding firms. The characteristics of the targets and bidding firms and of the bid itself are able to explain a significant part of these returns: (1) *deal* hostility increases the target's return but decreases the bidder's returns; (2) the private status of the target is associated with higher bidder's returns; and (3) an equity payment leads to a decrease in both bidder and target returns. A comparison of the UK and continental European M&A markets reveals that the takeover returns of UK targets substantially exceed those of continental European firms, while UK bidders earn significantly lower announcement returns than continental European ones.

Accounting, Legal, and Regulatory Intervention

Chapter 28: Corporate Governance and Accountability (Renee M. Jones) This chapter describes the sources of corporate governance standards for American corporations and analyzes the accountability mechanisms designed to ensure that corporate officials act faithfully in the management of corporate affairs. The chapter focuses on the financial reporting system, under the U.S. securities laws, that forms the foundation of the accountability system, and discusses structures and rules designed to ensure the integrity of financial reporting. The roles of the SEC, accounting and auditing regulators, and the board of directors are examined. Special emphasis is given to the Sarbanes-Oxley Act of 2002, which aimed to correct perceived

weaknesses within the system. The chapter concludes that U.S. corporate governance systems are sound in design but that problems in enforcement prevent the regime from effectively constraining abuses and excesses of corporate leaders.

Chapter 29: Corporate Governance Rules and Guidelines (Zabihollah Rezaee) The past decade has witnessed a move toward global financial markets and the cross-border flow of capital. Public companies worldwide form the basis of the global economy. Recent financial crises and the resulting global economic meltdown are rooted in a variety of factors including failure of market correction mechanisms and ineffective corporate governance. General perception is that subsidizing or bailing out troubled companies and their executives does not serve the economy, whereas better accountability and more effective and efficient corporate governance rules and guidelines should improve the global economy. Corporate governance rules and guidelines presented in this chapter are intended to promote a corporate culture and environment within which companies can operate to generate sustainable performance while protecting the interests of all stakeholders.

Chapter 30: Economics Aspects of Corporate Governance and Regulation (Valentina Bruno and Stijn Claessens) Country-level investor protection and other corporate governance rules can help alleviate agency problems and overcome contract incompleteness, encouraging better firm performance. However, firms already adopt governance practices voluntarily and, as such, the implicit and explicit costs of any rule may exceed its benefits. This chapter provides a survey of the relevant theoretical and empirical literature on this issue. Not surprisingly, in light of the complex interactions between corporate governance rules and firm practices with various externality effects, the literature argues for both positive and negative aspects of existing and new country rules. This review also makes clear that many issues remain unanswered due to methodological and data limitations. Nevertheless, a key finding of this survey is that corporate governance and related rules cannot be considered in isolation from other country-specific economic and institutional factors.

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Part Four: Answers to Chapter Discussion Questions

Part Four gives readers answers to the discussion questions presented at the end of each chapter.

SUMMARY AND CONCLUSIONS

As this book suggests, corporate governance is a multifaceted subject. In broad terms, corporate governance refers to the way in which a corporation is directed, administered, and controlled. Corporate governance also concerns the relationships among the various internal and external stakeholders involved as well as the governance processes designed to help a corporation achieve its goals. Of prime importance are those mechanisms and controls that are designed to reduce or eliminate the principal-agent problem. Good corporate governance is important because it not only provides the cornerstone for the integrity of corporations,

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financial institutions, and markets, but also is central to the health and stability of world economies.

The current financial crisis has highlighted many corporate governance failures. As a consequence of high-profile collapses of corporations since 2001, heightened attention has focused on the corporate governance practices of modern corporations. As Kirkpatrick (2009, 1) notes:

> *... the financial crisis can be to an important extent attributed to failures and weaknesses in corporate governance arrangements which did not serve their purpose to safeguard against excessive risk taking in a number of financial services companies. Accounting standards and regulatory requirements have also proved insufficient in some areas. Last but not least, remuneration systems have in a number of cases not been closely related to the strategy and risk appetite of the company and its longer-term interests.*

The financial crisis required governments to make massive interventions in their financial systems. For example, the U.S. federal government passed the Sarbanes-Oxley Act in 2002 as a means of restoring public confidence in corporate governance. The financial crisis also led the Organization for Economic Co-operation and Development (OECD), which consists of the governments of 30 democracies, to update the *OECD Principles of Corporate Governance* (OECD 2004) and to provide an analysis of the role of corporate governance in the financial crisis (OECD 2009). The current turmoil in economies throughout the world suggests a need to reexamine the adequacy of corporate governance. This book provides a challenging and comprehensive synthesis of the myriad of theoretical and practical issues that arise from the debate on how to create effective corporate governance.

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ABOUT THE AUTHORS

H. Kent Baker is a university professor of finance and a Kogod Research Professor in the Kogod School of Business at American University. He has held faculty and administrative positions at Georgetown University and the University of Maryland. Professor Baker has written or edited 10 books including *Survey Research in Corporate Finance: Bridging the Gap between Theory and Practice* (Oxford University Press, 2010); *Behavioral Finance: Investors, Corporations, and Markets* (John Wiley & Sons, 2010); *Dividends and Dividend Policy* (John Wiley & Sons, 2009), and *Understanding Financial Management: A Practical Guide* (Wiley-Blackwell, 2005). He has more than 230 publications in academic and practitioner outlets, including in the *Journal of Finance, Journal of Financial and Quantitative Analysis, Financial Management, Financial Analysts Journal*, and *Harvard Business Review*. Professor Baker ranks among the most prolific authors in finance during the past half century. He has consulting and training experience with more than 100 organizations and has presented more than 700 training programs in the United States, Canada, and Europe. Professor Baker holds a BSBA from Georgetown University; MEd, MBA, and DBA degrees from the University of Maryland; and two PhDs, an MA, and an MS from American University. He also holds CFA and CMA designations.

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Ronald Anderson is a professor of finance and real estate and the Gary Cohn Endowed Research Professor in the Kogod School of Business at American University. He currently serves as the chair of the Department of Finance and Real Estate. He worked as corporate executive and engineer for Schlumberger Limited for over 11 years in the United States, Europe, Africa, and South America. Professor Anderson's research focuses on the relation between managers and shareholders, and also upon the firm's other investors and their interaction with firm managers and shareholders. He is perhaps best known for his work that examines the relationship between founding-family ownership and firm attributes in publicly traded companies. His research has appeared in such journals as the *Journal of Finance, Journal of Financial Economics, Administrative Science Quarterly, Journal of Financial and Quantitative Analysis,* and *Journal of Accounting and Economics*. Professor Anderson's consulting focuses on helping founding families improve corporate governance practices and assisting families in corporate matters such as succession, acquisitions, and project valuation. He received his BS in engineering and an MBA from the University of Pittsburgh, and a PhD in finance from Texas A&M University.

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