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Shareholder Value as Context for Investor Engagement

1.1. INTRODUCTION

The significance of capital for the growth of the firm has been recognized in economics at least since the publication of the first edition of Adam Smith's *The Wealth of Nations* in 1776. For Adam Smith, capital investment enabled the division of labour, increased productivity, and the growth of the firm (1976: Book 2). In Adam Smith's more colourful and evocative prose (1976: 360):

> [c]apital may be employed in four different ways: either, first, in procuring the rude produce annually required for the use and consumption of the society; or, secondly, in manufacturing and preparing that rude produce for immediate use and consumption; or, thirdly, in transporting either the rude or manufactured produce from the places where they abound to those where they are wanted; or, lastly, in dividing particular portions of either into such small parcels as suit the occasional demands of those who want them. . . . [U]nless a capital was employed in furnishing rude produce to a certain degree of abundance, neither manufacturers nor trade of any kind could exist.

Yet management writers have historically paid only limited attention to the behaviour of the providers of capital, the investors—much less attention than that paid to the behaviour of either management or labour. Investors have been the largely invisible ghost in the capitalist machine. This lack of visibility is reflected in mainstream management texts, the canons of conventional management knowledge. For example, organizational behaviour texts, such as Buchanan and Huczynski's (2004) or Mullins' (1996) do not mention investors, whilst Ackroyd's recent sociological study of industry (2002: 85–90) provides only a brief statement of the classic managerialist analysis of relations between investors and managers. Similarly, strategic management texts, such as G. Johnson, Scholes, and Whittington's widely used *Exploring Corporate Strategy* (2005), now in its seventh edition, pay no attention to investors. At the same time, the extensive literature on financial markets and financial decision-making has been more concerned with developing models of markets than with the empirical analysis of concrete sociological and behavioural issues arising from the relations between investors and managers of the companies in which they invest, although the recent growth of behavioural finance is changing this situation (Shleifer 2000; Smart, Megginson, and Gitman 2004: 361–7).

Historically, the major sociological research on the role of capital and the behaviour of investors has been by Marxists, beginning of course with *Capital* (1930) itself. Hilferding's work *Finance Capital: A Study of the Latest Phase of Capitalist Development*, originally published in 1910 in German and republished in a new English edition in 1981, remains a classic study. In the same Marxist tradition, Zeitlin's research (1974) in the USA in the 1970s examined the relationships between owners and managers, but from the perspective of class analysis rather than from the perspective of the theory of the firm. More recently, the French 'regulation' school (Boyer 2004; Aglietta and Reberioux 2005) has analysed 'circuits of capital'. The British interdisciplinary social science journal *Economy and Society* published a special issue on 'Shareholder Value and the Political Economy of Late Capitalism' in 2000. But such research has not been incorporated into mainstream management thinking—neither Hilferding nor Zeitlin appears in the International Encyclopaedia of Business and Management (IEBM), whilst investors do not appears in the IEBM volume 'Organizational Behaviour'.

One justification for the neglect of the role of investors in the management literature has been the belief that managers rather than owners determine the destiny of firms—the investor is a 'capitalist without function', in Marxist terms (Dahrendorf 1959: 44). The dispersal of investors identified by Berle and Means in 1932 in their study of *The Modern Corporation and Private Property* resulted in the separation of ownership from control, with owners marginalized. Managers were seen as securely in control of the corporation (Berle and Means 1932):

> the position of ownership has changed from that of an active to that of a passive agent. In place of actual physical properties over which the owner could exercise discretion and for which he was responsible, the owner now holds a piece of paper representing a set of rights and expectations with respect to an enterprise. But over the enterprise and over the physical property—the instruments of production—in which he has an interest, the owner has little control. At the same time he bears no responsibility with respect to the enterprise or its physical property. It has often been said that the owner of a horse is responsible. If the horse lives he must feed it. If the horse dies he must bury it. No such responsibility attaches to a share of stock. The owner is practically powerless through his own efforts to affect the underlying property.

Dispersed shareholders had neither the incentive nor the capacity to monitor the performance of managers or to exercise control over them: exit rather than voice was the most effective way of responding to dissatisfaction. The period between the 1920s and the 1970s was the classic period of 'managerial capitalism' (Marris 1964).

However, the issue of the relationship between investors and managers has been given a new urgency by the growth of a new form of capitalism associated with the 'shareholder value' approach to the corporate governance of the firm. The sharpened focus on shareholder value has been a major change in capitalist economies since the 1980s. The priority of shareholder value underpins both much recent finance theory, as the efficient capital market hypothesis, and much corporate practice. It has profound consequences for economic behaviour, and more broadly for society as a whole. Shareholder value involves managers giving priority to the interests of a single stakeholder, the investor, instead of seeking to balance the interests of multiple stakeholders, as in traditional theories of the firm, or to maximize managerial rewards, as in revisionist analyses (Marris 1964; Blair 1995; A. L. Friedman and Miles 2002). The succinct slogan of Mark Roe's book, *Strong Managers, Weak Owners* (1994), is no longer appropriate. In the confident words of Hansmann and Kraakman (2004: 33), 'there is no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value'. Similarly, 'enlightened shareholder value' has become the cornerstone of company law reform for New Labour government in the UK. For the Department of Trade and Industry (DTI), 'enlightened shareholder value' provides clarity of focus and a mechanism for rewarding risk takers, fostering innovation, and an entrepreneurial business culture. Froud et al. (2000: 104) gave the same weight to shareholder value, if with much less enthusiasm, in their analysis of 'financialization': '[t]he new forces of the capital market, via investment institutions and professional fund managers, are generally much more mobile and rapidly threatening [to managers] than the old forces of the product market via retailers and consumers'. In short, shareholder value is the dominant motif of a new form of capitalism, investor capitalism, which is supplanting traditional managerial capitalism in the USA and, to varying degrees, elsewhere (Useem 1996).

In the academic management literature, the relations between investors and managers have become primarily the province of finance specialists and lawyers, under the rubric of corporate governance (see Clarke 2004 for a valuable five-volume collection of papers). Both groups have focused on the means required to develop efficient capital markets and to maximize shareholder value. Issues addressed include the best means of protecting the interests of minority shareholders, clarification of the role of the board of directors as the guardian of shareholder interests, and the effectiveness of alternative means of aligning the interests of senior managers with those of shareholders (LaPorta et al. 1999; Prendergast 1999; MacAvoy and Millstein 2004).

This book addresses a broader range of issues, the overall behavioural and structural features of relations between investors and managers, not primarily market efficiencies, institutional arrangements, or corporate financial performance. Our orientation is thus sociological, rather than legal or financial. We view corporate governance as a means to an end: it is the institutionalized means for allocating authority and power within the enterprise. This parallels the conception of Gourevitch and Shinn (2005: 3), who view corporate governance as 'the authority structure of a firm'.

Our study focuses upon investors' relations with the management of the firms in which they invest, investor engagement. Such investor engagement may occur in any market-based business system. However, the likelihood and forms of engagement are closely linked with the institutions of corporate governance and the business system of which they are a part. The corporate governance regime may encourage and facilitate, or discourage and hinder, investor engagement. Corporate governance regimes prioritizing shareholder value encourage and facilitate investor engagement. The special status of shareholders in shareholder value corporate governance regimes reinforces incentives and provides the rationale for investor engagement. Shareholder value legitimizes investor engagement, a legitimation endorsed by corporate management itself (Useem 1993). Shareholder value also generates metrics by which investors can monitor the performance of corporate management and evaluate the effectiveness of their own engagement, using measures such as economic value added (EVA™, net operating profits after tax minus the required rate of return on capital employed)—what Froud et al. (2000: 80–110) referred to as 'financialization'. The rights, policies, and practices that support shareholder value provide a supportive context for investor engagement. On the other hand, stakeholder corporate governance regimes, in which the interests of employees, communities, the state, and customers are given weight, lack similar incentives or rationale for investor engagement. Corporate governance regimes, in turn, are linked to overall features of national business systems, as discussed in Chapter 7. Liberal market capitalist business systems provide a congenial ecology for the development of shareholder value corporate governance regimes, whilst coordinated market business systems do not. In short, investor engagement is nested in the institutions and practices of shareholder value corporate governance regimes and liberal market economies.

Our underlying theme is that shareholder value and investor engagement do make a difference to firm behaviour. Investor relations emerged as a recognized management function in the 1980s. The heightened sensitivity of senior managers to investor expectations and the priority given to managing investor relations is one aspect of the new relationship, discussed in Chapter 6. A second aspect of the new relationship is the primary concern of this book, the closer engagement of many investors with the firms in which they invest. Investors are more than the passive principals on whose behalf managers, as agents, act. But the extent to which investors engage with the firms in which they invest differs amongst types of investors and amongst firms. The changing situation of institutional investors is increasing investor engagement, with institutional investors acquiring the characteristics of 'universal owners' (Hawley and Williams 1997), locked into their current investments by the size and spread of their holdings. Where exit is difficult, engagement is more likely. As universal owners, large institutional investors, especially pension funds, have a strong interest in the quality of corporate governance, in minimizing the negative externalities of corporate activities, and in the overall corporate contribution to the economies to which their beneficiaries belong. Moreover, private equity funds and venture capital funds are also likely to be heavily engaged with the management of the firms in which they invest, particularly in the aftermath of the collapse of the dot-com boom. Such investors usually possess special knowledge of the sector in which they are investing and own a large proportion of the shares of the companies in which they invest, giving their engagement substantial leverage, as discussed in Chapter 5.

The influence of shareholder value philosophies differs amongst countries, with commitment to shareholder value more pronounced in the USA and Britain (the 'Anglo-Saxon liberal market economies', in Hall and Soskice's 2001 classification) than in mainland Europe or in Japan. However, there are perceptions of a general trend towards the international adoption of shareholder value philosophies and their associated practices, even in Germany and Japan (Dore 2000). There are several reasons for this trend, including the major expansion in international capital flows amongst capitalist economies following the abolition of capital controls in the late 1970s (see Aglietta and Reberioux 2005). Firms headquartered outside the USA have increasingly listed on the New York Stock Exchange (NYSE), accepting NYSE stringent listing requirements. As the world's largest economy—and only political superpower—the USA has influenced behaviour in other economies more than the reverse. Consequently, there has been increasing emphasis on common international forms of corporate governance, on standard accounting practices, and on shared conceptions of good business practice, heavily influenced by US conceptions.

Chapter 1 outlines shareholder value thinking as the context for investor engagement and undertakes three tasks. First, following this Introduction (Section 1.1), Section 1.2 presents the basic tenets of shareholder value, as developed mainly in the 1980s and 1990s. Then, Section 1.3 outlines the institutional preconditions which the literature has identified as fostering the development of efficient capital markets to maximize shareholder value. Section 1.4 discusses the reasons for the growth of shareholder value from the 1980s, relating its growth to broader changes in the economic and political environment. Section 1.5 concludes with a brief summary. The chapter focuses on developments in the USA and Britain, where commitment to shareholder value has been strongest.

1.2. THE THEORY OF SHAREHOLDER VALUE

Shareholder value corporate governance is a special application of agency theory. As Shleifer and Vishny (1997: 773) expressed it in their widely quoted *A Survey of Corporate Governance*, 'corporate governance deals with the agency problem: the separation of management and finance. The fundamental question of corporate governance is how to assure financiers that they get a return on their financial investment'. In agency theory, principals engage agents to operate on their behalf. An 'agency relationship [is] a contract under which one or more persons—the principal(s)—engage another person—the agent—to perform some service on their behalf that involves delegating some decision-making authority to the agent' (Jensen 2000: 85–6). The contracts between principals/investors and agents/managers may be implicit or explicit. However, such contracts are necessarily incomplete, since managers are required to use their best business judgement to enhance shareholder value, including responding constructively to unforeseen circumstances. Managers therefore receive delegated authority from investors. Investors, or more frequently their agents, monitor corporate performance, directly and indirectly, through 'reputational intermediaries' (Coffee 2006), to ensure that managers act in the investors' interests and maximize the return on the shareholders' assets. The overall objective of maximizing shareholder value provides the basis for establishing performance metrics, which indicate how well the organization is performing to investors and other external audiences, as well as motivating managers. As one shareholder value booster (quoted in Useem 1993: 130) enthused, '"public companies are not in business to reward creditors, inspire devotion of their employees, win the favour of the communities in which they operate, or have the best plants or products. These are all means to an end—making shareholders richer"'.

Agency theory provides the underlying theoretical rationale for shareholder value corporate governance. It rests ultimately upon a specific conception of the firm, in which the firm is viewed as a 'nexus of treaties' (Aoki, Gustafson, and Williamson 1990). According to Jensen (1998: 56), the corporate firm is '*a legal fiction which serves as a nexus for contracting relationships and which is also characterised by the existence of divisible residual claims on the assets and cash* *flows of the organization*' (emphasis in original). The firm is a particular type of market, 'the outcome of a complex equilibrium process' (Jensen 1998: 57), involving interdependences and exchange relationships between the parties. Following Oliver Williamson (1971, in Williamson and Masten 1999), firms are viewed as means of managing transactions and controlling transaction costs when 'market failure' occurs.

Constructing the institutions of shareholder value forms of corporate governance involves four elements directly relevant to investor engagement. The first element is defining and determining the interests of principals and their agents. As shown in Chapter 3, different types of investors and investors' agents have different types of interests, which affect their propensity to engage with the firms in which they invest. The second element is establishing the mechanisms for monitoring the performance of agents and disciplining perceived malfeasance. The different forms of engagement, the means of monitoring performance, and the measures taken to remedy unsatisfactory performance also differ. The third element is the process of moulding the perceived interests of principals and agents, to establish congruence between them. Both investors and managers seek to secure acceptance of the legitimacy of their definitions of interests, as discussed in Chapter 6. The fourth element is providing incentives for agents to maximize performance in the pursuit of principals' interests, for example through the development of share option schemes. In this conceptualization, relatively little attention is paid to the influence of corporate governance on the actual practices of management. In Williamsonian (1990) language, corporate governance is a means of protecting investors against moral hazard and minimizing the danger of senior managers pursuing 'self-seeking with guile'.

Shareholder value corporate governance arrangements may be institutionalized in different ways. However, the common feature is the establishment of a board of directors, usually combining senior corporate executives and external representatives of shareholders' interests, responsible for overseeing and supervising company managers, to ensure that shareholder value is maximized. Within the board, non-executive directors seek to ensure that management focus on shareholder value is maintained, chairing major committees of the board, including the audit committee and the remuneration committee, responsible for determining senior management remuneration. In Britain, although not in the USA, the chairman of the board is usually a non-executive director. Board structures and processes are thus designed to ensure that senior executives act on behalf of the interests of their principals, not in their own interests.

The priority of shareholder value is the foundation principle underlying the general theory of efficient capital markets, as developed in recent finance theory (Jensen and Meckling 1976; Jensen 1997). Capital markets are means of allocating resources from less to more profitable and thus more socially productive uses in a timely manner. According to Jensen (1997: 28), capital markets are more efficient in reallocating resources and reducing excess capacity than internal management decision-making and controls, and less disruptive than product markets: '[c]apital market and corporate control transactions such as the repurchase of stock (or the purchase of another company) for cash or debt creates exit of resources in a very direct way'. As an example, Jensen (1997: 28–9) cited the restructuring of the US oil industry in the 1980s:

> [w]hen Chevron acquired Gulf for $13.2 billion in cash and debt in 1984, the net assets devoted to the oil industry fell by $13.2 billion. . . . In the 1980s the oil industry had to shrink to accommodate the reduction in the quantity of oil demanded and the reduced rate of growth of demand. This meant paying out to shareholders its huge cash inflows, reducing exploration and development expenditures to bring reserves in line with reduced demands, and closing refining and distribution facilities.

Capital markets are efficient means of reallocating resources because they operate on transparent financial principles and are relatively immune from special interest influence by insiders, whether managers or employees, local communities, or politicians.

1.3. PRECONDITIONS FOR EFFICIENT CAPITAL MARKETS

The shareholder value corporate governance regime provides the institutional framework for the effective operation of capital markets. The development of capital markets which efficiently maximize shareholder value depends on establishing the appropriate institutional, legal, and cultural preconditions which foster effective corporate governance systems and align the interests of senior managers with those of shareholders. According to Gilson (2000: 3), there is a 'straightforward relationship' between the ability of capital markets to operate effectively and corporate governance, with corporate governance functioning as 'the corporation's equity contract, the set of rules that determines the terms of the stockholders' investment'.

1.3.1. Institutional Preconditions

The first set of preconditions relates to the integrity of information, the availability of adequate accurate information on corporate performance, and the means available to evaluate it (Gilson 2000: 6): '[e]quity investment requires good corporate governance, and good corporate governance requires the capacity to make credible disclosure of financial results. In the absence of effective financial disclosure, a country's capacity to support equity markets and, in turn, important kinds of industry, is compromised'. This involves timely access to accurate and credible information on corporate financial performance and enterprise strategies, as well as share price information. Effective corporate governance requires transparent accounting procedures, the preparation and presentation of financial statements according to generally accepted accounting standards, whose integrity is validated by independent auditors, and the application of full disclosure rules. Capital markets also require transparency regarding beneficial share ownership, to reduce the potential for market distorting trading by block holders or other major shareholders, especially problematic during merger and acquisition activity, as well as to restrict access to the private benefits of control.

The role of information intermediaries—auditors, analysts, financial advisers, and business media commentators—is central. The independent auditor is the guarantor of information integrity. However, the independence of auditors is not always complete. The US corporate scandals of the late 1990s, including the collapse of Enron and WorldCom, arose from the failure of auditors, and subsequently other information intermediaries, to provide honest evaluations of corporate financial performance. Particularly severe problems arose when audit firms were associated with management consultancies, as with Arthur Andersen and Accenture/Andersen Consulting at Enron, especially where consultancy fees were considerably higher than audit fees (Coffee 2003, 2006; Windolf 2004). Market efficiency and equity require that information should be accessible to all potential investors. However, there were systematic failures by information gatekeepers and reputational intermediaries in the USA in the late 1990s which undermined the integrity of the information available (Coffee 2006). The close relationships which developed between corporations and financial analysts in the USA in the 1990s, and between both and financial journalists, made unbiased assessments difficult (Coffee 2006).

1.3.2. Legal Preconditions

The first legal precondition for efficient capital markets is the protection of shareholder rights, especially the rights of minority shareholders. According to Black (2001: 783), 'there are two essential prerequisites for strong public securities markets. A country's laws and related institutions must give minority shareholders (1) good information about the value of a company's business;

and (2) confidence that the company's insiders (its managers and controlling shareholders) won't cheat investors ... through "self-dealing" transactions ... or outright theft'. Legal protection is required against self-dealing, either direct or indirect, whether by corporate management or by majority shareholders (Black 2001: 804).

> All non-controlling investors—large or small, shareholders or creditors—need their rights protecting.... Outside investors' rights are generally protected through the enforcement of regulations and laws.... Protected shareholder rights include those to receive dividends on pro rata terms, to vote for directors, to participate in shareholders' meetings, to subscribe to new issues of securities on the same terms as the insiders, to sue directors or the majority for suspected expropriation, to call extraordinary general meetings and so on.
>
> (LaPorta et al. 1999: 5–6)

Common law jurisdictions, such as in the USA and Britain, are seen as providing a firmer basis for developing equity markets than civil law jurisdictions, providing stronger protection for the interests of minority shareholders (LaPorta et al. 1997; LaPorta, Lopez-de-Silanes, and Shleifer 1998; Coffee 2001: 7). LaPorta et al. (1999: 11–12) suggested that common law jurisdictions provide more secure legal protection to shareholders than civil law jurisdictions because the judiciary has greater discretion in interpreting precedent in common law systems than in the more prescriptive regulatory environment of civil law systems. In common law systems, the judiciary is the protector of civil liberties, not the agent of state regulation. Explanations for the historical origins of different legal families are controversial and beyond the scope of this study. But the significance of legal family for the legal protection accorded to shareholders is clear (Gourevitch and Shinn 2005: 83–7).

The second legal precondition is support for effective means of monitoring and supervising the performance of corporate management. This has two aspects. The first is the legal regulation of corporate procedures, especially relating to the responsibilities and role of the board of directors, including the oversight role of non-executive directors. The role of non-executive directors has been the subject of extensive debate in both Britain and the USA. Hence, successive British commissions on company law reform—Cadbury 1992; Hampel 1998; Myners 2001; Higgs 2003—discussed possible changes in the law relating to directors' responsibilities and role, leading to revised company law legislation, currently (in May 2006) under parliamentary debate. Hitherto, reliance has been placed upon codes of practice, reinforced by the common law duty laid upon directors to act in the best interests of the company (P. Davies 2000). The performance of non-executive directors has been criticized from two directions. On the one hand, non-executive directors have been criticized for their perceived lack of independence, with substantial minorities of non-executives having links with corporate management (see Section 6.2). On the other hand, non-executive directors have been criticized for their lack of strategic awareness and for only limited involvement in the effective monitoring of managers. A particular concern has been with the role of non-executive directors on remuneration committees, where they have been seen as too compliant with senior management. The responsibilities of directors have been increasingly regulated, by law and by stock exchange rules, especially since the passage of the Sarbanes–Oxley Act in the USA in 2002. The second aspect is the legal regulation of information intermediaries, including disclosure and conflicts of interest (Coffee 2006).

1.3.3. Cultural Preconditions

The major cultural precondition is the creation of an environment of high trust, especially contractual trust. Trust, the expectation that agreements made will be adhered to, is fundamental to effective economic relationships (Sako 1992; Khalil 2003). Trust may be personal, based on knowledge of the character of the individual parties, or contractual, based on the acceptance of written commitments, underwritten by third parties and the legal system. Personal and contractual trust coexist. However, personal trust is an unsatisfactory basis for the efficient operation of markets, since the distribution of personal information is partial and asymmetric. Efficient capital markets work with contractual trust rather than personal trust, reflecting the requirement for transparent and widely distributed information. The low levels of contractual trust are a major reason for the failure to develop effective capital markets in post-Soviet Russia, despite the high incentives provided by potentially very profitable resource rich enterprises. The absence of trust undermines the potential for rule enforcement and gives rise to mafia-type means of enforcing compliance (Radaev 2002). Similarly, low levels of trust reinforce tendencies towards corruption, recognized by the World Bank as a major reason for the patchy development of equity markets in developing and post-socialist economies (Raiser 1998; Kornai and Rose-Ackerman 2004).

1.4. THE RISE OF SHAREHOLDER VALUE CAPITALISM

The international dominance of shareholder value philosophies was not inevitable, but reflected specific historical circumstances. The rise of shareholder value was rooted in broad changes in social and political values, most fundamentally in the view that the allocation of economic rewards through competitive markets is both more efficient and fairer than their allocation through politics and administration (Dore 2000: 4–5). Shareholder value originated as a response to the declining profitability of US firms in the 1970s (Fligstein 2001). It grew beyond a financial market technicality to become a broadly based economic and social analysis, even a social movement for some (G. F. Davis and T. A. Thompson 1994). Indeed, Jensen (2000) spoke of a 'third industrial revolution' in his work extolling the efficiency of capital markets, whilst Froud et al. (2000: 85) referred to a 'quasi-religious element of shareholder fundamentalism'.

There are six major sets of reasons for the growth of shareholder value as the driving force of capitalist development. The first set of reasons is financial, the steps taken to revive US business profitability in the late 1970s. The second set of reasons is political and relates to changes in the political environment, with the political success of Mrs Thatcher in Britain and President Reagan in the USA. The triumph of Thatcherism in Britain and Reaganism in the USA led to an emphasis on market liberalism, with deregulated markets for capital as well as for products and labour, and fewer restrictions on business. The third set of reasons is economic and related to changes in the structure of the economy, including the changing position of labour. The emphasis on shareholders' rights was made possible by, and reinforced, a change in the distribution of power in society, with the decline in the power of organized labour. Alongside growing income inequality and decline in the percentage of gross domestic product (GDP) allocated to labour, the growth of shareholder value reflected the reduced capacity of organized labour to define and to defend employees' interests. The fourth set of reasons relates to comparative international economic performance and the poor performance of coordinated market economies in the 1990s. The relative decline of collectively oriented coordinated market economies, both in Continental Europe and in Japan, following on the earlier collapse of socialist economies, reinforced the attractiveness of liberal market shareholder-oriented capitalisms. Britain's apparent success in creating flexible labour markets, reducing unemployment, and achieving faster growth than other European countries, without inflation, increased European respect for shareholder value and liberal market capitalism. The fifth set of reasons relates to the internationalization of capital flows, especially the internationalization of the portfolio investments of US mutual funds, and the fund managers' pressures for acceptance of their interpretations of good corporate governance. The final set of reasons is academic, associated with the wider development of corporate finance as an academic specialism, and growing the popularity of rational social choice theory and institutional economics amongst American social scientists. In the 1990s, agency theories of the firm and institutional economics provided the most popular frameworks for analysing organizations, as in the widely quoted work of Oliver Williamson (1975, 1985) and subsequently John Roberts (2004).

The fundamental origins of shareholder value lay in corporate responses to the 'accumulation crisis', to use the Marxist term, in the USA in the late 1970s, and the subsequent corporate restructuring through mergers and acquisitions. US corporations experienced a decline in profitability in the 1970s, following the 1973 oil crisis. Inflation led to high interest rates, and to low stock prices, with stock price levels falling below asset values. US manufacturing failed to match Japanese increases in productivity, and Japanese imports grew rapidly, especially of cars and consumer electronics. There was major excess capacity in manufacturing. The crisis was viewed as primarily a financial crisis, and financial measures were taken to resolve it. The measures taken involved rationalization, restructuring, downsizing, and mergers and acquisitions, as well as refinancing. The means to achieve this reorganization included both traditional and new forms of restructuring and financial engineering. Corporate strategies included divestment of non-core activities, to sharpen focus and to reduce the 'diversification discount' (J. Roberts 2004); horizontal mergers and acquisitions, to eliminate spare capacity, reduce competition, and increase market share; stock repurchase, to increase share prices through reducing supply; and increased debt through the issue of high-yield bonds (junk bonds). Such strategies reflected the financial conception of the firm in a new era (Fligstein and Shin 2005). Financial reorganization was especially likely in firms with a chief executive officer (CEO) with a financial background and with institutional investors represented on the boards of directors (Fligstein 2001: 164).

The financial engineering associated with the boom in merger and acquisition activity in the 1980s and the growth of shareholder value was facilitated by political changes. The deregulation agenda promoted by President Carter in the USA in the late 1970s was accelerated by President Reagan, including new merger guidelines issued by William Baxter in 1981, which relaxed the conditions under which mergers were subject to antitrust restraints. President Reagan's reductions in corporation tax also encouraged corporate share acquisitions. The simultaneous programme of privatization, deregulation, and market liberalization undertaken by Mrs Thatcher's Conservative government in Britain encouraged similar trends. The privatization of utilities, beginning on a large scale with British Telecom in 1984, was explicitly designed to broaden the basis of share ownership, with discounted prices and preferential allocations for individual shareholders, as well as to raise revenue and 'roll back the state' (Vickers and Yarrow 1988: 188–90; Riddell 1991: 87–112). Privatization led to a massive increase in the number of shareholders in Britain, a national opinion poll survey in April 1986 indicating that 14 per cent of the population, almost six million people owned shares (Vickers and Yarrow 1988: 189). The accelerated disposal of council houses (municipally owned property), was also designed to build a 'property owning democracy'.

Labour was incapable of mustering support for counter-definitions of corporate transformation. First, this weakness was partly due to changes in the structure of employment and in the labour market, which increased the organizational difficulties of labour, and partly to political changes. The decline in large-scale manufacturing, the growth of service sector employment, and the reductions in the size of firms (if not of corporations) created major difficulties in recruitment for trade unions (TUs) (Martin 1992: 173–7). Recruitment was more difficult in the new economy. TU membership declined, as retiring members were not replaced. Declining membership created organizational difficulties for TU leaders, as well as weakening their claims to define the legitimate interests of workers. Second, both Republican administrations in the USA and Conservative administrations in Britain followed antiunion policies. The strong stance taken by the Reagan administration against air traffic controllers in the 1981 strike, which eventually resulted in the destruction of the Professional Air Traffic Controllers' Union (PATCO) marked a symbolic end to the New Deal consensus between capital and labour (Kochan and Katz 1988). In Britain, the 1984 coal miners' strike, eventually broken by strong government action, marked a similar end to the post-war industrial relations system. Conservative governments passed a succession of increasingly restrictive laws on TU activity, beginning with the 1980 Employment Act (Dunn and Metcalf 1996).

The decline of collective labour organization and collective bargaining and the growth of human resources management (HRM) echoed and reinforced market rhetoric. The publication in 1984 of the initial Harvard Business School volume on HRM (Beer et al. 1984) symbolized a transformation in the management of employees within the firm. Explicitly antiunion policies were increasingly common in the USA, if still rare in Britain. Employment relations came to be defined in terms of individual rather than collective relationships, with managerial conceptions of employment relations in individualized rather than collective terms coming to be endorsed by employees as well as managers. Human capital theory rather than collective bargaining came to form the basis for earnings differentials: earnings differentials were justified by the possession of different individual human capital endowments rather than differences in collective bargaining power, or even institutionally recognized skills (Lazear 1998). The language of human capital theory resonated with the language of maximizing shareholder value. Employees wished to optimize their returns on their investment in skills, just as investors wished to optimize their returns on their financial investments.

The fourth set of reasons for the growth of shareholder value relates to differences in national economic performance. The US economy recovered from the Japanese threat in the early 1990s, leading to the long stock market and consumer boom between 1992 and 2001. US self-confidence returned, buttressed by the triumphalism associated with the collapse of communism and the perceived impending 'end of history' (Fukuyama 1992). The USA experienced significant increase in employment levels and acceleration in economic growth (Boyer 2004). At the same time the British economy revived, so that by 2000 the level of unemployment in Britain was substantially below that of its major European competitors. The achievements of the US and British economies were seen as reflecting the strengths of liberal market capitalism. In the 1990s, the German and French economies were perceived as failing, with higher unemployment and lower rates of economic growth than in the USA and Britain. Similarly, the continuing Japanese recession indicated the limitations of the Japanese form of coordinated welfare capitalism: failures in corporate governance, the absence of effective control rights for residual claimants, were believed to have led to the 'widespread misallocation of capital that mired Japan in excess capacity and liquidity problems' (Morck and Nakamura 2000: 1).

The perceived dynamism of the US and British economies was linked specifically to the role of its venture capital markets. In the USA and, to a lesser extent, Britain, venture capital markets were seen as major enablers for the creation of dynamic new technology companies. Venture capital markets provided a means for financing innovation in 'high technology' industries, especially the information technology (IT) sector. The innovation 'wave' of the 1980s and 1990s was associated with entrepreneurial, risk-taking firms, creating a dynamic IT sector, financed by venture capitalists attracted by high-potential rewards. 'Silicon Valley' was viewed as the epitome of this process. The high profits associated with the rapidly expanding computer software industry, and the subsequent 'dot-com' Internet stocks boom, appeared to provide justification for the ideology of the risk-taking entrepreneur as hero, especially in the USA. Venture capital markets were absent or ill-developed in Germany or France. The success of the USA in reviving its innovation capability, especially in information and communication technologies, and the rapid expansion of Internet-based companies, led to a long stock market boom (Boyer 2004). New production concepts were developed in the USA, which claimed to combine the efficiency and cost effectiveness of just-in-time systems as developed in Japan with the flexibility of decentralized production systems—so called Wintelism, named after the chief executive of Nike (M. A. O'Sullivan 2001*a*: 221–4). High-value and high-visibility brand name firms based in the USA, such as Nike in footwear and Dell in computers, retained responsibility for product design and development, whilst manufacturing was outsourced to wherever production costs were lowest.

The fifth set of reasons for the spread of shareholder value relates to the expansion in the flow of international capital, especially between the USA and Europe. The international flow of capital was a powerful means of transmitting commitment to shareholder value. Three aspects were especially important. First, US and British funds, both mutual funds and pension funds, increased their levels of investment overseas after 1980, with the liberalization of capital export controls. By 1999, US institutional investors' assets overseas amounted to $19,279 billion, whilst UK institutional investors' assets amounted to $3,264 billion; 51 per cent of US assets and 68 per cent of UK assets were held in equities (Gourevitch and Shinn 2005: 106). Japanese overseas investment, at $5,039 billion, was much less likely to be invested in equities, only 19 per cent (Gourevitch and Shinn 2005: 106). The level of foreign penetration, measured as the percentage of the total market capitalization of listed firms held by foreign investors, reached 36.1 per cent in France, 35.0 per cent in the UK, and 23.6 per cent in Germany in 2000 (Gourevitch and Shinn 2005: 105). The fund managers responsible for such investments had clear conceptions of good corporate governance, with an emphasis on transparency, the rights of minority shareholders, and the role of independent directors. Their conceptions were institutionalized in the metrics used by ratings agencies such as Standard and Poor's to construct corporate governance indices. Second, fund managers exerted pressure for standardizing national reporting requirements and accounting procedures, in line with the requirements of the US Generally Accepted Accounting Principles (GAAP) or the International Accounting Standards Board (IASB). Third, non-US corporations which listed on NYSE were required to meet the associated listing requirements, including the expanded requirements introduced following the Enron scandals and the Sarbanes–Oxley Act 2002.

The final set of reasons for the spread of shareholder value thinking is academic, the growth of corporate finance as an academic discipline and the widespread popularity of agency theories of social action, and institutional economics specifically, amongst American management scholars. Scholars such as Michael Jensen (1997, 1998, 2000), in a succession of papers beginning in the 1970s, played a major role in developing corporate finance, and linked its development with the efficient capital market hypothesis and shareholder value. Oliver Williamson's work (1964, 1970, 1975, 1985) on transaction cost economics, beginning with the publication of *The Economics of Discretionary*

Behavior: Managerial Objectives in a Theory of the Firm in 1964, proved highly influential in organizational analysis, leading to the development of institutional economics (Carroll and Teece 1999). This involved analysing organizational behaviour in terms of transaction cost economics, in which corporate structures are ultimately determined by the search for the best means of economizing on transaction costs. Economic activities are coordinated via markets, except in specific, limited circumstances, since lower transaction costs can be achieved through markets than through organization (or 'hierarchy'). Coordination through organization occurs only when markets fail. There is an obvious congruence between the emphasis of institutional economics on economizing transaction costs through markets and the emphasis of financial economists on efficient capital markets. Williamson (1996: 173) himself identified the similarities: 'TCE [transaction cost economics] and AT [agency theory] both work out of a managerial-discretion set up. They also adopt an efficient-contracting orientation to economic organisation. And both argue that the board of directors in the corporation arises endogenously'.

1.5. CONCLUSION

This introductory chapter has outlined the major features of shareholder value thinking and provided a brief account of the factors which have contributed to its growth since the 1980s. Realizing shareholder value has always been a major preoccupation of senior managers in capitalist systems, as Marxists have long emphasized. However, between the 1920s and the 1970s, the wide dispersal of share ownership and the separation between ownership and control allowed senior corporate managers the discretion to accommodate a wide range of interests (most centrally their own), not only those of shareholders. The New Deal consensus in the USA, and Keynesian social democracy in Britain, underwrote conceptions of the firm which incorporated the interests of a wide range of stakeholders, including organized employees. Since the 1980s, beginning in the USA, senior managers have given higher priority to shareholder interests, with maximizing shareholder value becoming the dominant corporate objective. Linked to this objective, institutional and legal reforms aimed to create efficient capital markets. Measures taken to achieve this included company law reforms and administrative measures to enhance the protection of shareholders' interests, to foster transparent corporate reporting systems, and to ease capital flows. The extent of the reforms designed to achieve these objectives differed amongst countries, but the direction of the changes was uniform.

The growth of shareholder value as the exclusive criterion for corporate performance had its roots in the accumulation crisis of US corporations in the late 1970s. The crisis led to a decline in the profitability of US corporations. The remedies for the crisis included extensive financial and organizational restructuring, with a massive expansion in the number and size of corporate mergers and acquisitions. The shareholder value form taken by the new means of financial engineering were encouraged by political changes, the success of liberal market reforms associated with President Reagan in the USA and Mrs Thatcher in Britain, and the weakness of labour. The poor economic performance of coordinated market economies, such as Germany and Japan in the 1990s, with slower growth and higher unemployment than in the USA and Britain, enhanced the international prestige of liberal market economies and further encouraged the international spread of shareholder value thinking. The flow of institutional investment, especially of US mutual and pension funds, provided a major channel through which shareholder value thinking was disseminated. Finally, the normative implications of shareholder maximization were consonant with the implications of both efficient capital market theory and institutional economics, which formed the dominant strand of organizational analysis in the USA in the 1990s, when US business schools provided the internationally accepted definition of advanced management thinking.

Shareholder value involves a radical simplification in the conception of the firm. Yet it has widespread ramifications. At the least, it is a powerful legitimating rationale for management practice, providing a template against which practice may be evaluated. Substantively, it has formed the basis for much company law reform and corporate practice, especially regarding corporate governance and mergers and acquisitions. The remainder of this book examines investor engagement in detail, in the context of the growth of shareholder value. Drawing upon an extensive literature and case studies of institutional investors and private equity–venture capital funds, the book documents the shape of investor engagement and the impact which investors have upon management practice.