Essays on Corporate Governance

van Oijen, P.H.

Chapter 1
Introduction and Outline

1 Introduction and Motivation

Corporate governance deals with the way in which parties that are stakeholders of the firm control corporate decisions. These stakeholders include management, investors and employees, but also more indirectly related parties such as consumers and suppliers. In the standard neo-neoclassical economic theory, there is no scope for studying corporate governance issues. Firms are treated as organizations in which all decisions are completely directed towards profit-maximization. No agency problems or coordination problems exist. According to this view, one can simply consider the firm as a single entity (i.e. as a production function) and neglect the presence of the many different parties that are involved in producing and selling the output.

The modern economist's view about corporations is that they are in fact complex organizations that cannot be represented by a single entity.[1] Managers, employees and financiers each have their own objectives and these may be quite different from profit maximization. Moreover, they are likely to disagree about the decisions that they prefer the company to make. Management may want to retain their positions even if they are not very suitable for the job. Even financiers might prefer the firm to deviate from firm value maximization. A bank that has a large amount of loans outstanding to a firm will be best of if this firm would direct its decisions towards maximizing the probability that the loans are repaid. Similarly, maximizing shareholder value is not always identical to maximizing firm value if the firm also has debt outstanding.

The existence of such conflicts of interests between different stakeholders implies that corporate decisions are not necessarily driven by profit maximization motives. In principal, these conflicts can be perfectly resolved by writing contracts that dictate that the actions of all the stakeholders should be solely directed towards maximizing the total value of the firm. Such comprehensive contracts, however, are prohibitively costly to write and to enforce. In real life, contracts are incomplete in the sense that there will be many corporate decisions about which contracts have little to say. To understand firm behavior we therefore need to

[1] See Berle and Means (1932), Jensen and Meckling (1976), Garvey and Swan (1994), Hart (1995a) and Prowse (1994) for more elaborate discussions of the shortcomings of the neoclassical theory of the firm.

study how and whether different stakeholders are able to exert control over these corporate decisions. This is precisely what corporate governance is all about.

In this dissertation, we present five distinct papers that contain original work on corporate governance. We thereby focus on governance issues that arise from external financing by the firm. In large companies, the financiers of the firm (i.e. the debt holders and shareholders) are not also the ones that are running the firm on a daily basis. Because the return on their investment will critically depend on the firm's policy, financiers will be concerned about the degree in which corporate decisions will reflect their interests and not just those of other stakeholders. Finance and corporate governance are therefore intimately related. Over the last fifteen years, the corporate finance literature has recognized this interdependency and much of the corporate finance literature is now directed towards studying how control over the company takes place. More recently, practitioners and policy makers have made considerable efforts as well to analyze corporate governance. In many developed countries, special corporate governance committees have been installed that report on current governance practices.

The objectives of all these efforts is to gather precise information about the differences in governance structures of firms, both within countries and between countries, and to determine the implications of such differences for corporate decisions. This dissertation tries to contribute to this research. It consists of both empirical and theoretical work on the intersection between corporate finance and corporate governance. In our empirical work, we study the basic governance characteristics of Dutch firms that are listed on the local stock market. We also analyze whether differences in the governance structures across these firms tend to affect the decisions that are made within the firm. Our theoretical work concerns a game-theoretical model that compares the costs and benefits of different governance structures and of an extensive survey of the relevant corporate finance literature.

2 Approach and Focus of Our Analysis

The main body of this dissertation consists of empirical work on corporate governance in the Netherlands. We collect data on the governance characteristics of Dutch firms and we look at some of the implications for corporate decisions. Our sample of firms consists of companies that are listed on the Dutch stock exchange. For describing the governance characteristics, we focus on four different aspects of these companies. The first one relates to the way in which the shares of a company are distributed across shareholders. We will refer to this as the ownership structure of the firm. Uncovering the ownership structure of the firm is important for several reasons. By determining how much of the shares of the firm are owned by corporate insiders, one can get an impression about the extent to which the wealth of corporate insiders is directly tied to the market value of the equity of the firm. If top-executives or independent directors (e.g. (supervisory) board members that are not also on the management board of the company) own a significant fraction of the shares, their decisions will have a close impact on their wealth. Ownership by these insiders can therefore align the interests of corporate decision-makers with (other) shareholders.[2] Another reason why the ownership structure of the firm may be important for corporate decisions is that concentrated ownership by outside shareholders might give these equity holders the incentives and the ability to monitor and control the firm.[3] A shareholder that only owns a minimal amount of shares has little to gain from such costly efforts. Both these observations suggest that the ownership structure of the firm may affect corporate decisions.

The second aspect that we focus on when describing the governance characteristics of companies is the way in which control rights are formally allocated over different stakeholders. Dutch firms rely heavily on all kinds of takeover defenses. They frequently strip the votes from the shares or issue so called 'golden shares' to corporate insiders. These golden shares often carry the right to control the appointment of insiders or to veto major decisions. In addition, some firms are legally required to adopt a special governance regime called the 'structuurregime', which severely curbs the voting rights of shareholders. As a result of these arrangements, control over major decisions such as mergers or the appointment of management and non-executive board members is transferred from (the general meeting of the) shareholders to corporate insiders. The firm thus formally dilutes the control rights of shareholders and this may influence corporate behavior.

The third aspect that we concentrate on is the internal control imposed by the supervisory board.[4] In practically all the firms that are listed on the Dutch stock exchange, management and supervision are strictly separated through a two-tier board structure. The power of these supervisory boards is potentially very large. The dilution of the control rights of shareholders that we just referred to often results in a transfer of control rights from shareholders to the supervisory board.

The fourth aspect that will be central in our analysis concerns the different ways in which banks or, more generally, financial conglomerates are involved with firms. In the

[2] On the other hand, the corporate finance literature has identified various reasons why insider ownership might intensify conflicts of interests between shareholders and corporate insiders. For example, risk aversion of managers that own a substantial amount of the shares may induce conservative corporate strategies. Also, insider ownership may entrench management because it gives them voting power.
[3] With outside shareholders we mean shareholders that are not members of the management or supervisory board.

Netherlands, banks/financial conglomerates are not only allowed to supply loans but they can also hold large equity stakes in the firm. In addition, as we will see, they are sometimes represented on the supervisory boards of listed firm. Such ties between firms and banks might be important for corporate decisions because they potentially lead to control by banks.

These four aspects of the governance structures of companies are central in much of the global debate on corporate governance. The reason for this is that if we focus on these four characteristics, we observe dramatic differences in the way financial systems are shaped. Ownership of shares in most Continental European countries is far more concentrated than in the US and the UK.[5] Compared to these last two countries, the control rights of shareholder are relatively weak in Continental Europe.[6] We also observe substantial differences between the role of banks in the financial systems across countries. For example, the relative importance of bank loans versus bond financing varies dramatically from country to country.[7]

These observations suggest that governance structures are rather heterogeneous across countries. To determine to what extent such differences translate into disparities in corporate policy or in firm performance is a complex and delicate task that can only be accomplished by a vast amount of research. The empirical work in this dissertation contributes to this quest. We not only derive the governance characteristics of Dutch listed firms but also investigate the implications for corporate decisions and firm performance. We thereby focus on four topics. The first one concerns the incidence that management and supervisory board members leave the firm. Such departures can be informative about the accountability of these corporate insiders, especially if we relate them to corporate performance. If those that are responsible for corporate policy are also (held) accountable for the consequences, we expect that the probability of observing a turnover is decreasing in the performance of the company.

Accountability will be of immediate relevance when studying turnovers in the management board. These members are closely involved with corporate policy on a daily basis so that if a management board member leaves the firm after poor firm performance, there is probably a relation with the achievements of this manager. In this sense, turnovers of supervisory board members might be less directly interpretable as accountability. Nevertheless, if we find that poor corporate performance is accompanied by the departure of supervisory board members, this suggests that there is a response within the board to the

[4] In the corporate finance literature, the board of directors or the supervisory board is generally considered to be a corporate insider. Hence, control by these institutions is frequently referred to as 'internal control by the board'.

[5] See for example Franks and Mayer (1990, 1997b), La Porta, Lopez-de-Silanes and Shleifer (1998) and Becht (1997).

[6] See, La Porta, Lopez-de-Silanes, Shleifer and Vishny (1997a, 1998) and Demirgüç-Kunt and Maksimovic (1998).

[7] Mayer (1988), Gorton and Schmid (1996) and Thakor (1996).

performance of the company. The fact that such a response then leads to a departure of board members suggests a certain degree of responsibility within the board. We therefore also interpret this as a sign of accountability of the board.

By analyzing turnovers at the top-level of the company, we can also obtain more knowledge about the importance of the governance characteristics of firms. This brings us to the second topic that is central in our empirical research, which concerns the question of whether or not there is evidence that (outside) investors exert control over Dutch firms. In this respect we investigate whether the presence of large shareholders is important for explaining management and supervisory board turnover. As we already stated, if a shareholder owns a significant fraction of the shares she potentially has the incentives and ability to monitor and control the firm. If blockholders indeed monitor the firm, they may be responsible for initiating changes in the composition of the management or supervisory board. Similarly, we check whether banks tend to exert control over the composition of the management board. We also provide a more indirect test for the relevance of investor control in the Netherlands by linking the performance of companies to both the presence of large shareholders and to the ties between firms and banks.

The third topic relates to assessing the consequences of block ownership by management or supervisory board members. More specifically, the incentives to maximize shareholder value might be improved as the stakes of these corporate insiders increase. We directly test for the relevance of this incentive effect by relating performance to insider performance.

The fourth topic that we concentrate on concerns the importance of the voting rights of shareholders for corporate governance in the Netherlands. We are particularly interested in investigating whether control over votes by the firm and the existence of the special governance regime ('structuurregime') that we referred to earlier have implications for corporate decisions. By stripping the votes from their shares, many firms control a significant fraction of the votes of outside shareholders. Management might then become entrenched because shareholders completely loose their formal control rights. We therefore analyze whether management is less accountable to poor performance in these firms and whether performance is negatively affected by such a separation of voting rights and cash flow rights. Similar conjectures concerning a negative influence on corporate governance have been put forward by opponents of the special governance regime. Firms that operate under this regime have to transfer most of the control rights from the shareholder meeting to the supervisory board. The rights of shareholders are then severely curbed. By examining the effect of the governance regime on management turnover, supervisory board turnover and corporate performance, we will be able to learn more about the relevance of these conjectures.

This dissertation also consists of two theory-oriented chapters. The first one is a literature review that discusses some recent advances in the theory of corporate finance. It thereby highlights how research in corporate finance has evolved from capital structure theory to corporate governance. The second one presents a model that describes different corporate governance constellations and that allows us to assess the optimality of alternative corporate governance systems. That chapter adds to recent insights of the theoretical literature that intensive monitoring and control over agents such as top-executives of companies might in fact be inefficient in terms of firm value. In the next section, we provide a more detailed description of all these chapters.

3 Outline of the Dissertation

The remainder of this dissertation consists of five more chapters. Chapter 2 provides the literature survey while Chapter 3, 4 and 5 contain the empirical work on the governance of Dutch listed firms. The sixth chapter then presents the theoretical model that we just referred to. In all of these chapters, the focus is on the control aspects of corporate finance. We now briefly outline each of these chapters.

Chapter 2 is called "Why Finance Matters: From Capital Structure Theory to Corporate Governance". It provides an overview of the theoretical literature from the perspective of the information and agency problems that are associated with corporate financing. The purpose of this chapter is twofold. First, it aims at highlighting how the method of financing (i.e. the mixture of funding sources and the design of financial contracts) matters for the ability of firms to finance their activities. The second goal of this chapter is to show that corporate governance and corporate finance are intimately related.

We start that chapter with a discussion of the more traditional capital structure literature, which offers some basic insights in the debt-equity choice that a company faces. We then move on to the more fundamental security design question as we derive the basic characteristics of optimal financial contracts under various assumptions. The final two sections of Chapter 2 deal explicitly with control aspects of financing, which directs the discussion towards the governance aspects of corporate finance.

In *Chapter 3* we provide a comprehensive overview of the Dutch system of corporate governance for firms that are listed on the local stock market. We focus on the four governance characteristics that we identified earlier: (1) the ownership structures of these firms, (2) the way in which the control rights of their shareholders are diluted, (3) the design of internal control and (4) their ties with banks/financial conglomerates.

We first analyze the precise nature of the separation of ownership (of shares) and control in The Netherlands. To this end, we construct the ownership structure of Dutch listed firms. The shareholders of these firms are required to disclose their holdings if these exceed 5% of the shares of a firm. We collect these ownership data and classify the disclosing shareholders. This gives an indication of the degree in which ownership is concentrated and sheds a light on the importance of insider ownership as well as the identity of the major blockholders.

We then address the dilution of shareholder control rights in The Netherlands. This dilution arises from the adoption of takeover defenses by firms and from the particular governance laws in this country (in Dutch: 'structuurregime').

After that, we take a close look at how internal control is designed through the board of directors. Almost all firms that are listed in the Netherlands have a separate supervisory board. We investigate whether the performance of the company is important for the probability that supervisory board members leave the firm. Also, we check whether the ownership structure of the firm and the allocation of control rights over different stakeholders are important in explaining supervisory board turnover.

Finally, we concentrate on the role of banks in financing firms and their potential to exert control over firms. The Dutch financial regulators recently allowed the formation of financial conglomerates. As a consequence, most banks are engaged in investment banking, offer mutual funds and provide insurance services. These financial conglomerates are important shareholders, supply bank loans and represent themselves on the supervisory board of firms. We present data on these ties between financial conglomerates and listed firms to get an impression about the control potential of Dutch 'banks'.

Chapter 4 is titled "Management Turnover and Corporate Performance in the Netherlands". It is often claimed that management in the Netherlands does not care sufficiently about shareholder value and that the overall degree in which shareholder control rights are diluted is an indicator of that. Some even argue that management in the Netherlands is entrenched and that they largely control their own positions. To investigate these conjectures, we present a basic test that reveals to what extent management is (held) accountable to corporate performance. We analyze whether poor stock price performance and poor earnings performance increase the probability that the CEO or other members of the management board leave the firm. If management would not be very concerned about shareholder value, we expect that poor share price performance only has a small or negligible effect on the probability that management board members retain their positions. Also, to further investigate whether the accountability of management to corporate performance suggests managerial entrenchment, we compare our results with those found for countries with corporate governance systems that are considerably different from 'the' Dutch system.

We then examine whether the governance characteristics of individual firms affect the relation between performance and management turnover. If large shareholders are vital for enforcing turnovers in the Netherlands, the presence of blockholders will be important for the probability that top-executives leave the firm. We also search for evidence that banks exert control by enforcing that management board members leave the firm and analyze whether corporate control over votes reduces the accountability of management in terms of a lower response of management turnover to poor performance.

In *Chapter 5* ("Corporate Governance Mechanisms and Firm Performance in the Netherlands"), we use the governance data presented in Chapter 3 and examine whether differences in corporate performance can be explained by differences in the governance structure of companies. Using four different proxies for corporate performance, we exploit the cross-sectional variation in both the ownership structures of the firms and in the control rights shareholders. This helps to answer the questions whether the presence or identity of large shareholders matters for the performance of companies and whether the dilution of shareholder control rights has direct implications for the value of the firm.

Chapter 6, which is titled "Monitoring, Shareholder Activism and the Correction of Managerial Failure", presents a theoretical model that focuses on the effectiveness of monitoring in correcting managerial failure. We explicitly recognize that control over large, publicly owned companies is often best characterized by a framework where agents monitor agents on behalf of principals. This hierarchical setting not only arises because monitoring takes place by designated parties such as independent board members or the supervisory board, but also because oversight by large shareholders is not identical to monitoring by principals. These shareholders are often corporations themselves and thus serve as agents of their own shareholders.

To capture this hierarchical nature of monitoring of management, we focus on the behavior of a monitor whose task consists of detecting and correcting managerial failure and whose actions are driven by her reputation of being a capable monitor. We thereby concentrate on the distance between the firm and monitor. One might expect that from the perspective of firm value it would be optimal to ensure that monitoring takes place from a minimal distance to the firm. Our analysis however shows that this is not necessarily the case. We also investigate whether non-monitoring parties such as (small) shareholders are willing to intervene in the firm to correct monitoring failures.

4 Concluding Remarks

The main objective of this thesis is to obtain some fundamental insights in the governance structures of Dutch listed firms and to analyze whether differences in these structures tend to affect corporate decisions and performance. Investigating these issues is not only interesting from an intellectual point of view. Corporate governance is about control over corporate decisions, and therefore about firm behavior. Deficiencies in the governance system may have adverse consequences for the economy. If investors perceive that their interests are insufficiently safeguarded by current arrangements, they will raise their required rate of return when offering funds to the company. As a consequence, firms might be unable to make investments that have positive value from an economic point of view. This thesis therefore presents a serious attempt to contribute to our knowledge about the efficiency of the Dutch financial system to allocate capital to the corporate sector.