Essays on Corporate Governance

van Oijen, P.H.

Chapter 7
Summary and Conclusions

Over the last two decades, the subject of corporate governance has received an increasing amount of attention from academics. The reason for this is the recognition that the traditional, neo-classical micro-economic framework is inappropriate for understanding firm behavior. In that framework, the actions of all parties that are involved with the activities of the firm are completely guided towards firm value maximization. Such a narrow view of how companies operate is strongly at odds with the complex setting in which corporate decisions come about. The self-interest of parties that are closely involved with the firm, such as management, employees, shareholders and creditors, might lead to behavior that deviates from value maximization. Moreover, the interests of these stakeholders will frequently conflict with each other. For example, the decision to reorganize the firm by closing down inefficient factories might be in the interest of investors but can harm the wellbeing of management and employees. If the latter two parties are able to control the reorganization decision, the firm might abstain from a reorganization that would increase its market value.

As a consequence, one cannot simply presume that corporate policies will be directed towards value maximization. This observation is of great relevance for studying corporate finance. Most modern companies are large organizations. They are not run by investors but by managers. This so-called separation of finance and control exacerbates the potential for conflicts over corporate policies. When management supplies only a small amount of the funds that the firm requires, managerial objectives such as personal career concerns, prestige and perk consumption might dominate and define the policies that management prefers to carry out. If top-officers then effectively control the policy of the firm, the interests of investors will not be fully reflected in corporate decisions and value maximization can be seriously compromised. This might have severe repercussions for the ability of firms to finance their operations. The values of the different financial claims on the firm are strongly affected by the decisions that are taken within the company. Rational investors will therefore adjust the prices at which they supply capital to a level that properly compensates them for what they perceive as inefficiencies in corporate policies. Consequently, the cost of capital of the firm is increased and investment projects that are attractive from a (frictionless) economic perspective might not be initiated.

The corporate finance literature has recognized that there are several mechanisms that reduce such adverse consequences of conflicts of interests over corporate policy. One of these mechanisms concerns the capital structure of the firm, i.e. the debt-equity choice of the firm. By cleverly balancing the relative amounts of debt and equity (or by choosing for either debt or equity when the firm needs additional funding), the extent to which conflicts over corporate decisions will arise can be controlled. Recently, the literature has also analyzed the importance of the design of control rights that are attached to securities. This so-called security design approach recognizes that when firms finance themselves, they design a financial contract that specifies both the cash flow rights and the control rights of the investor that acquires the contract. If their contractual control rights are comprehensive enough, investors can use these to safeguard their interests. *Chapter 2* of this dissertation provides an extensive overview of both these strands of the corporate finance literature.

Financial contracts therefore offer the potential for a contractual solution to resolve conflicts over corporate policy. However, the scope of contracts to influence decisions is limited by their incomprehensive nature. Corporate decisions are typically not directly governed or dictated by detailed contractual arrangements. Contracts are incomplete in the sense that there will be many circumstances that are virtually impossible to capture in contracts. For example, the conflict about whether or not to reorganize, which we referred to earlier, is in practice never resolved by a contract that dictates the circumstances under which management should initiate a reorganization.

The incomplete nature of contracts implies that there exists substantial discretion in corporate decisions and that the actual policy of the firm will depend on the power of the different stakeholders to exercise control. This is precisely what corporate governance is all about. In its broadest sense, corporate governance refers to the way in which companies are directed and controlled. It looks at how and whether the interests of parties such as management, employees, shareholders and creditors are reflected in corporate policies (Charkham 1995). Because of the close relation between corporate decisions and the value of the securities of investors, it is obvious that corporate governance has implications for the efficiency of the capital markets. If the governance over companies is weak from the perspective of investors, the cost of capital at which firms can finance themselves will reflect this.

These observations have inspired academicians, policy makers and practitioners to scrutinize current governance practices. In most developed countries, serious efforts are made by these parties to obtain precise knowledge about the prevailing governance arrangements and their implications. This dissertation adds to this growing literature. The main part of our work consists of empirical analyses regarding corporate governance in the Netherlands. We thereby focus on firms that are listed on the Dutch stock exchange, i.e. on publicly held firms. To obtain precise information about the governance structures of these firms, we collect data on four different aspects. These concern the ownership structure of firms, the allocation of control rights over shareholders and corporate insiders (i.e. management and supervisory board members), the role of the supervisory board as an internal control mechanism and the ties between firms and banks. Chapter 3 of this dissertation reports and discusses the so-called Dutch system of corporate governance that emerges from these data.

To learn about the consequences of the Dutch system of corporate governance, we concentrate on the probability that members of the management board or the supervisory board give up their positions. We relate these turnover probabilities to the performance of companies and to their governance characteristics. This enables us to assess whether corporate insiders in the Netherlands are held accountable for corporate performance and whether the governance structures of firms are important for enforcing turnovers. These issues are particularly interesting because it is often suggested that the Dutch system of corporate governance places so much power in the hands of insiders that they can insulate themselves from disciplinary forces. Our analysis, for which the results are presented in Chapter 3 and 4, will reveal whether or not these concerns are justified.

Besides focusing on whether or not corporate insiders give up their positions, we concentrate at the performance of companies. More precisely, we investigate whether differences in the governance structures of firms tend to have consequences for their performance. Such an analysis presents a strong but more indirect test for the relevance of the governance characteristics of companies for the decisions that are taken within firms. Chapter 5 of this dissertation reports the results of this part of our research. That chapter also concludes our empirical work on corporate governance in the Netherlands.

Chapter 6 of this dissertation presents a game-theoretic model where we analyze the effectiveness of monitoring in correcting managerial failure. The focus in that chapter is on the distance between the firm and monitoring parties. One might expect that from the perspective of firm value it will 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. In the last part of that chapter we investigate whether non-monitoring parties such as (small) shareholders are willing to intervene in the firm to correct monitoring failures.

The major results of these chapters are as follows. In *Chapter 3*, we find that share ownership tends to be rather concentrated in the Netherlands. In virtually all firms in our sample there was at least one shareholder that owned more than 5% of the shares in 1992. The average stake size of the largest shareholder was 28.5% in that year. Total ownership concentration, as measured by the sum of all blocks that are larger than 5%, was on average around 50% per firm. Compared to the UK and (especially) the US, these figures are rather high. In many other Continental European countries however, ownership is even more concentrated than in the Netherlands.

The major block owners are insiders (i.e. management and supervisory board members), financial institutions and non-financial companies. Insider ownership is on average quite large: In 1992, inside blockholders held 9.6% of the shares of their companies. In that same year, they owned more than 20% of the shares through blocks in 28 out of the 156 firms in our sample. Because only those blocks that exceed 5% are disclosed in the Netherlands, this figure even understates the importance of insider ownership.

Shareholder control rights are generally diluted in the Netherlands in the sense that in most firms much of the power of the shareholder meeting is transferred to corporate insiders. An important source for this is the widespread use of various takeover defenses. To protect themselves against hostile takeovers, firms issue golden shares, use binding nomination clauses for the appointment of the members of the management and supervisory board, limit the number of votes of single shareholders or strip the votes from the shares before issuing them. These defense measures not only deter hostile takeovers, they also have repercussions for the control rights of shareholders in the absence of a takeover attempt. Golden shares typically carry the exclusive right to appoint management or supervisory board members and are held by corporate insiders. Binding nomination clauses allow corporate insiders to propose two candidates for any vacancy in the management board or supervisory board. The shareholder meeting is then forced to elect one of these two candidates. The voting caps limit the number of votes that a single shareholder has on shareholder meetings. Finally, after stripping the votes from the shares these are kept at a trust that is (effectively) controlled by corporate insiders.

As a result of the last two defense mechanisms, total voting rights concentration was around 10 percentage points lower than total ownership (or cash flow rights) concentration in 1992. In that same year, 45% of the firms used trusts to control the votes of outside shareholders. In 25% of the firms, corporate insiders were ensured of at least 60% of the votes after stripping these from the shares of outside equity holders. The combined effect of insider ownership and the use of voting trusts implies that in that same year, in 60 out of the 156 companies a majority of the votes was directly controlled by the firm.

An additional source for the dilution of shareholder control rights in the Netherlands is the governance regime (in Dutch 'structuurregime'). Roughly speaking, firms are required to adopt the governance regime if they have more than 100 employees, a book value of equity of more than 12 million US Dollars and a council that represents the firm's employees. The regime dictates that the company must have a two-tier board structure. The supervisory board should then consist of members that are not also on the management board of the same company. The formal authority of the supervisory board is large because the governance regime also states that most of the formal control rights of the shareholder meeting have to be transferred to this institution. Under the regime, the supervisory board has the exclusive right to appoint and dismiss the members of both boards of the firm. The shareholder meeting only has to right to approve the annual accounts that are drawn up by the supervisory board and to start a legal procedure to object against the supervisory board candidates that are put forward by the supervisory board itself. 60% of the listed firms in the Netherlands operated under this regime in 1992.

Because of all these arrangements, the formal authority to appoint or dismiss management and supervisory board members is practically always transferred from the shareholder meeting to corporate insiders in the Netherlands. If a firm operates under the governance regime, this transfer is completely directed towards to supervisory board, which then formally controls the appointment and dismissal of the members of both boards.

We also examine whether ownership concentration and the degree in which the control rights of shareholders are diluted tend to be related with each other. We find that firms that rely the least on takeover defenses typically have a very large shareholder. They are also characterized by higher degrees of total ownership concentration. This suggests that concentrated ownership serves as a substitute for takeover defenses. With a controlling shareholder or with concentrated ownership, there is no need to rely on takeover defenses because the blockholders themselves can directly prevent that other parties obtain control over the company.

Practically all listed firms in the Netherlands are characterized by a two-tier board structure. In general, the supervisory board completely consists of members who or not also top-officers of that same company. We find that supervisory board members are more likely to leave the firm when corporate performance is poor. This suggests that the supervisory board is accountable for firm performance and that it changes its composition to cope with the new situation. This finding contrasts with the results of similar studies for other countries. The accountability of supervisory board members to stock price performance is also somewhat surprising because the composition of the supervisory board in the Netherlands is decided upon internally. It seems therefore that the formal insulation of the appointment process does not lead to a constellation where the positions of fellow board members are unquestionable. The chairman of the supervisory board, however, is undisputed in the Netherlands. After poor performance, there is no increase in the probability that the chairman leaves the firm.

We also analyze whether changes in the supervisory board composition are related to the ownership structure of the firm and to the different ways in which shareholder control rights are diluted. We find no evidence that outside block holders are important in enforcing supervisory board turnover. In addition, their presence does not lead to the appointment of new supervisory board members after poor performance. In all, these results suggest that large shareholders are not active in initiating changes in the composition of the supervisory board in the Netherlands. Our results do show however, that supervisory board turnover is significantly lower in firms that operate under the governance regime. This indicates that the composition of the supervisory board changes less frequently in these firms. A possible explanation is that the governance regime tends to result in an automatic stay of board members.

In the final part of Chapter 3, we briefly look at the ties between financial conglomerates and non-financial firms that arise from the credit relations between banks and firms and from supervisory board representation. Both these aspects provide a potential channel for banks to exercise control over companies. In 1992, 21 out of the 145 non-financial companies had a member of the management board of a bank/financial conglomerate on their supervisory board. The presence of these 'bankers' is associated with significant direct equity stakes but not with high levels of short-term bank debt over assets. It seems therefore that supervisory board representation by banks/financial conglomerates originates from the equity investments that these financial institutions make and not from their bank lending activities.

In *Chapter 4* we investigate to what extent managers in the Netherlands give up their positions in the management board if corporate performance is poor. This relationship is informative about the accountability of management in the Netherlands. Our analysis shows that poor recent stock price and earnings performance trigger large increases in the likelihood of management turnover. Hence, there is no evidence that management is not accountable for poor performance. The importance of stock returns in this respect contrasts sharply with the negligence of shareholder value that is suggested by the strong degree in which shareholder control rights are diluted. Also, the corporate performance-management turnover relation as well as the overall level of management turnover that we find is rather similar to those found for countries whose governance systems are different. Hence, the typical Dutch constellation of governance mechanisms tends to lead to similar dynamics in management turnover.

We then search for evidence on the importance of different governance mechanisms for enforcing management turnover. We first analyze whether the ownership structure of the firm affects management turnover. It turns out that outsider block ownership is unimportant for explaining management turnover after poor performance. The presence of large, outside shareholders is thus not vital for inducing management turnover. This conclusion continues to hold if we concentrate only on those outside blockholders that actually hold votes. Supervisory board block ownership and managerial block ownership are also irrelevant for the probability that management leaves the firm after poor performance. This suggests that the stance of the supervisory board towards management is not different if they own a significant fraction of the shares and that managerial block ownership does not entrench these top-officers.

Whether or not the firm operates under the governance regime, does not matter for the relation between performance and management turnover. Hence, the complete control that the supervisory boards formally have in these companies over the composition of the management board does not lead to different dynamics in the replacement of management. However, we do find that in firms that control a substantial amount of the votes of outside shareholders, poor performance tends to increase management turnover more so than it does in other firms. Obviously then, control over voting rights by the firm does not weaken the accountability of management for poor performance. The increase in the sensitivity of management turnover to performance suggests that governance mechanisms in these firms rely more heavily on corporate performance in enforcing management turnover. Perhaps this is due to a lower monitoring intensity under regular performance. We have no direct evidence that supports this explanation, however.

Our analysis further indicates that banks in the Netherlands exercise control when their loans are at stake. As the cash flow performance of the firm relative to its debt obligation worsens, supervisory board representation by banks leads to higher levels of CEO turnover. When focusing on the stock price performance of companies, we fail to find a similar effect. Because board representation is related to the equity stakes of banks and not to credit relations (see Chapter 3), it seems that banks use the power that originates from their equity investments to exercise control when the loan performance of the company deteriorates. Also, the probability that a large fraction of the management board leaves the firm after poor loan performance is positively affected by increases in short-term bank lending. We do not find such a relation when we consider supervisory board representation by banks. This suggests that banks are able to exercise control more powerfully through their credit relations than through their supervisory board memberships.

In *Chapter 5* we analyze whether the differences in the governance characteristics of firms affect their performance. We thereby primarily focus on the question whether concentrated ownership of shares leads to better firm performance. Such a positive influence will exist if monitoring by outside blockholders disciplines management or if insider block ownership improves the incentives of management and supervisory board members. Using a sample of 132 non-financial firms that are followed from 1992-1996, we find that the return on assets of a firm is indeed increasing in the fraction of shares held through blocks. This holds for both insider block ownership and outsider block ownership. Such a relation is not observed if we use Tobin's q or market-to-book of equity instead of the return on assets. However, these two performance indicators are higher in firms where outside blockholders own more than 10% of the shares than in firms that are characterized by a lower degree of outside ownership concentration. Our findings therefore suggest that both shareholder monitoring and the alignment of interests that results from insider ownership are relevant for Dutch firms. Nevertheless, the lack of consistency of our results implies that our analysis does not produce a clear-cut picture about the relation between the ownership structure Dutch firms and their performance.

We also examine the impact of the different ways in which shareholder control rights are diluted on firm performance. We observe that firms that operate under this regime display poorer performance. We consistently find this negative effect across our different performance indicators. The economic significance of this result is quite large. Controlling for the ownership structure of firms as well as for industry effects and other firm characteristics, the return on assets of these firms is around two percentage points lower. This suggests that the (formal) concentration of power in the hands of the supervisory board in these firms has a strong negative impact on corporate performance. Our analysis clearly indicates that firms that control a significant fraction of the votes by stripping these from the shares of outside shareholders perform no worse. Moreover, when excluding those blockholders whose shares do not carry voting rights, the relation between performance and block ownership that we documented before largely breaks down. Taken together, these findings indicate that control over its own votes does not insulate the firm from disciplinary forces such as shareholder monitoring.

Finally, we briefly look at whether the ties between banks and companies affect the performance of non-financial firms. Our measures of corporate performance were negatively related to the amount of short-term bank loans over assets. This is particularly true for Tobin's q, market-to-book of equity and return on equity. The effect is much milder when analyzing the return on assets. The pattern that we find is consistent with banks exercising control through credit relations, thereby enforcing conservative policies and extracting rents through the interest payments. We have no direct evidence, however, in support of this story.

Let us summarize the main findings of Chapter 3-5 and suggest some interesting topics for future research. We believe that Chapter 3 and 4 of this dissertation present some rather comforting results for the Dutch system of corporate governance. The sensitivity of supervisory and management board turnover to corporate performance indicates that those in control of Dutch companies are not deeply entrenched and that they are to a considerable extent accountable for poor corporate performance. Thus, the formal insulation of the composition of both these boards from parties outside the firm does not severely impair the accountability of these corporate insiders. Also, the importance of stock returns in explaining changes in board composition that we report is strongly at odds with the notion that shareholder wealth is subordinated to the interests of corporate insiders.

An interesting question that emerges from this part of our analysis is how these board turnovers are brought about in the Netherlands. There is no evidence that the presence of outside blockholders is important for initiating such changes in the composition of either the management board or the supervisory board. Are the members of these boards voluntarily leaving the firm when they learn that they may not be the right candidates for the seats they hold? If the answer to this question is yes, self-correction is an essential element of corporate governance in the Netherlands. Alternatively, it might be that the supervisory board plays a key role in enforcing turnovers in both boards. If this is indeed how changes in board composition are brought about, the supervisory boards seems to function as a largely independent governance institution that is characterized by a critical stance towards management as well as its own members.

The analysis in Chapter 5 suggests that monitoring by outside blockholders and (positive) incentive effects from insider ownership are important for corporate decisions in the Netherlands. In our opinion, further research is needed to establish whether these are indeed the underlying mechanisms for the relations that we report. Up to this date, the amount of research in the Netherlands in this area has been very limited. A fruitful approach for future research would be to search for more direct evidence that insider block ownership and shareholder monitoring affect corporate decisions. This may be accomplished through case studies, questionnaires and interviews.

We consistently find evidence that banks exercise control in the Netherlands. Their credit relations with firms and their presence on supervisory boards have implications for management board turnover. Also, the relation between the amount of short-term bank loans that companies rely on their performance suggests that banks are able to enforce conservative corporate policies and to extract rents. Whether banks indeed play such an adverse role is an interesting question for future research.

Chapters 3-5 provide no disturbing evidence concerning the consequences of corporate control over votes. Our results with respect to the governance regime, however, are somewhat less comforting for the Dutch system of corporate governance. The strong negative impact of this regime on the performance of companies that we report in Chapter 5 begs the question in what respect corporate decision making tends to be different in these firms. Does the concentration of formal control rights in the supervisory board lead to inertia in corporate decisions and to consensus driven supervision? Or do the supervisory boards in these companies attach more weight to the interests of other stakeholders? More research is needed to be able to answer these questions.

Chapter 6, which is called "Monitoring, Shareholder Activism and the Correction of Managerial Failure", provides a theoretical model that stresses the limits of the effectiveness of monitoring in correcting managerial failure. The set-up of our model recognizes that monitoring by parties such as the board of directors, the supervisory board and large shareholders is often best characterized as a situation where agents monitor other agents on behalf of principals. Supervisory board members or independent board members are unlikely to behave as if they are the sole shareholder of the firm. Large shareholders are in fact mostly companies (either financial or non-financial) instead of individuals. The representatives of these companies are therefore agents themselves who act on behalf 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.

Our analysis points at the existence of a trade-off between the proximity of the monitor and the preservation of her future objectivity in evaluating corporate policy. Close and intrusive monitoring of management facilitates a timely recognition and correction of managerial failure. At the same time, it creates a situation where the monitor and management become jointly responsible for corporate policy. The need to intervene then indicates that the monitor has failed to capitalize on her proximity. This distorts the incentives of the monitor to intervene in the firm whenever managerial failure persists over time. Close and intrusive monitoring therefore reduces the incentives of the monitor to speak out against managerial policies and introduces a lack of objectivity in monitoring. As a result, it can be optimal to increase the distance to a level where early recognition of managerial failure is impossible. Intervention in corporate policy by the monitor then no longer suggests a monitoring failure, providing complete objectivity.

We then focus on the scope of control by non-monitoring parties, i.e. shareholder activism, to correct for the negative effects of a lack of objectivity in monitoring. Our analysis reveals that shareholder activism does not necessarily provide a viable substitute for the objectivity of the monitor. Outsiders might be reluctant to interfere because they are uncertain about whether or not managerial failure has been timely corrected by the monitor. This uncertainty is exactly the reason why a lack of objectivity can occur. The lack of substitutability between the objectivity of the monitor and control by non-monitoring parties is therefore inherent to the incentive problem of the monitor. We further show that the probability of observing shareholder activism can easily be highest when the need to correct the monitor is low. Hence, shareholder activism that is driven by concerns about the objectivity the monitor might be the least frequently observed in governance systems where objectivity is low.

These results contrast strongly with the notion that more monitoring and control over the agent will be beneficial for the principal. Chapter 6 therefore points at a cost of arranging close and intrusive monitoring by agents such as supervisory boards and large shareholders. The close involvement of these parties in monitoring managerial policy may create a tendency to support inefficient managerial policies. This suggests that agency problems are not necessarily more efficiently controlled in governance systems where agents are closely involved in monitoring corporate policy. Moreover, our analysis suggests that shareholder activism might be less frequently observed in a system where objectivity in monitoring is relatively low. This might explain why shareholder activism is not an essential element of corporate governance in Continental European countries and in Japan.