The Neglected Role of Justification under Uncertainty in Corporate Governance and Finance

Hill, C.; Pacces, A.M.

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Claire Hill

Alessio M. Pacces

More from: Claire Hill , Alessio M. Pacces

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A big corporate governance debate today concerns the so-called short-termism of publicly held companies. In response to actual and anticipated pressure from activist hedge funds, companies, some say, harm shareholders and the greater society insofar as the pursuit of short-term results undermines the maximization of long-term value. According to others, activists rightly keep management on their toes. Both camps seem to have a point.

In our paper, we argue that we cannot know whether there is a general short-termism problem in corporate governance. Because the right time horizon for a company is not known, managers complaining about activist hedge funds' short-termism might well reflect long-termism, ie, postponing the realization of failure. However, hedge fund activism creates a short-term bias because of the need for relevant actors, including management, to justify their decisions. This short-term bias cannot be efficient for every company at every point in time.

We introduce a novel conceptual framework. We define justification cost as the cost of suboptimal managerial choice resulting from accountability. Accountability prompts managers to act with a view to justification. Managerial action that can be justified tends to be more conventional, yield results that are demonstrable in the short term, or both. The need for justification reduces the traditional agency cost of monitoring the agent, because conduct such as tunnelling or empire building is harder to justify. But the most justifiable actions are not always those that are best for shareholders. Actions chosen because they are justifiable limit an agent's downside risk: underperformance can then be attributed to bad luck. Managers may be tempted to make decisions they can justify, whether or not those decisions are best for the shareholders. As a result, justification may also increase agency costs. We call this form of agency cost justification cost to distinguish it from traditional agency cost. On this perspective, accountability becomes excessive when it increases justification cost to a larger extent than it decreases traditional agency cost.

Justification cost is likelier to exceed traditional agency cost in the presence of Knightian uncertainty. When uncertainty is relatively small, justification-minded actions are the best agents can do to pursue the principal's interest. But sometimes, conventional actions and focus on short-term results lead to the neglect of long-term profit opportunities to avoid uncertainty. This may be value-destroying in industries where innovation is discontinuous rather than incremental. Importantly, the relevance of uncertainty in particular industries changes over time.

The short-term bias stemming from hedge fund activism is efficient in contexts of vigorous competition and incremental innovation, but may be inefficient when uncertainty is higher, for instance in situations of discontinuous or radical innovation. Large shareholdings cannot remedy this bias. Because the portfolios of the majority of institutional investors are indexed, institutional investors do not have incentives to screen idiosyncratic choices. Moreover, even dominant shareholders have become unable to fend off activist hedge funds.

We argue that corporate law should enable companies to adapt the balance between managerial discretion and accountability by way of dual-class shares. Such shares allow voting rights and cash flow rights to be disproportionate. The management can secure leeway simply by holding super-voting shares in a sufficient proportion as to outvote the holders of the remaining, lower-voting shares. Securing leeway in this fashion is increasingly common for IPO companies.

Introducing dual-class shares is more complicated for companies that are already listed. Dual-class recapitalizations with super-voting stock are prohibited by the exchange rules in the U.S., and are not a viable technique to enhance the voting rights of the management or the dominant shareholders in other European jurisdictions.

We contend that companies that are already listed should be able to introduce control-enhancing mechanisms, such as dual-class shares, under the following rules. Firstly, managers or dominant shareholders should be allowed to issue super-voting stock to themselves. Secondly, non-controlling shareholders should have veto power. This veto is crucial to enable a negotiation over the price of managerial leeway. Thirdly, by default, the control enhancement should be temporary, ie, expire in a number of years. Our solution fares better than other proposals to deal with hedge fund activism, such as general curbs of the latter, loyalty shares, and mandatory sunset of dual-class shares.

Claire A. Hill is a Professor at the University of Minnesota Law School

Alessio M. Pacces is a Professor at Amsterdam Law School and Amsterdam Business School