



Universität
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Agency costs, Shareholders, Board of Directors

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Review – Lecture 1

- What is a corporation: private property of shareholders used to advance a common interest
- History
 - Royal charters: ecclesiastical, municipal & charitable
 - Merchant guilds (14th c). Colonial (16th c): E. India (1600), South Sea (1702), Commercial: Bank of England (1694)
- Attributes of the modern corporation
 - Separate entity with perpetual existence
 - Limited liability for corp obligations limited to corp property
 - Centralized management
 - Transferability of ownership interests
- Theory of the firm:
 - Coase: contracts and transaction costs
 - Pigou: regulation and externalities
- Corporate theories – contract, concession & communitaire models
- What is the Goal of Corporate Law

What is the Goal of Corporate Law



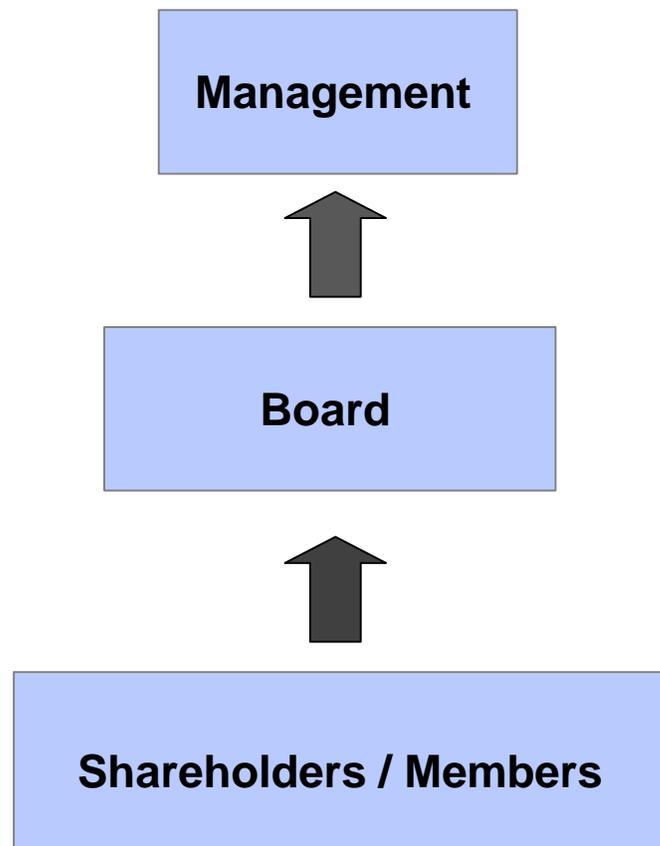
Key Points

- What is Corporate Governance
- Shareholders
- Principal-Agent Model
- Board of Directors

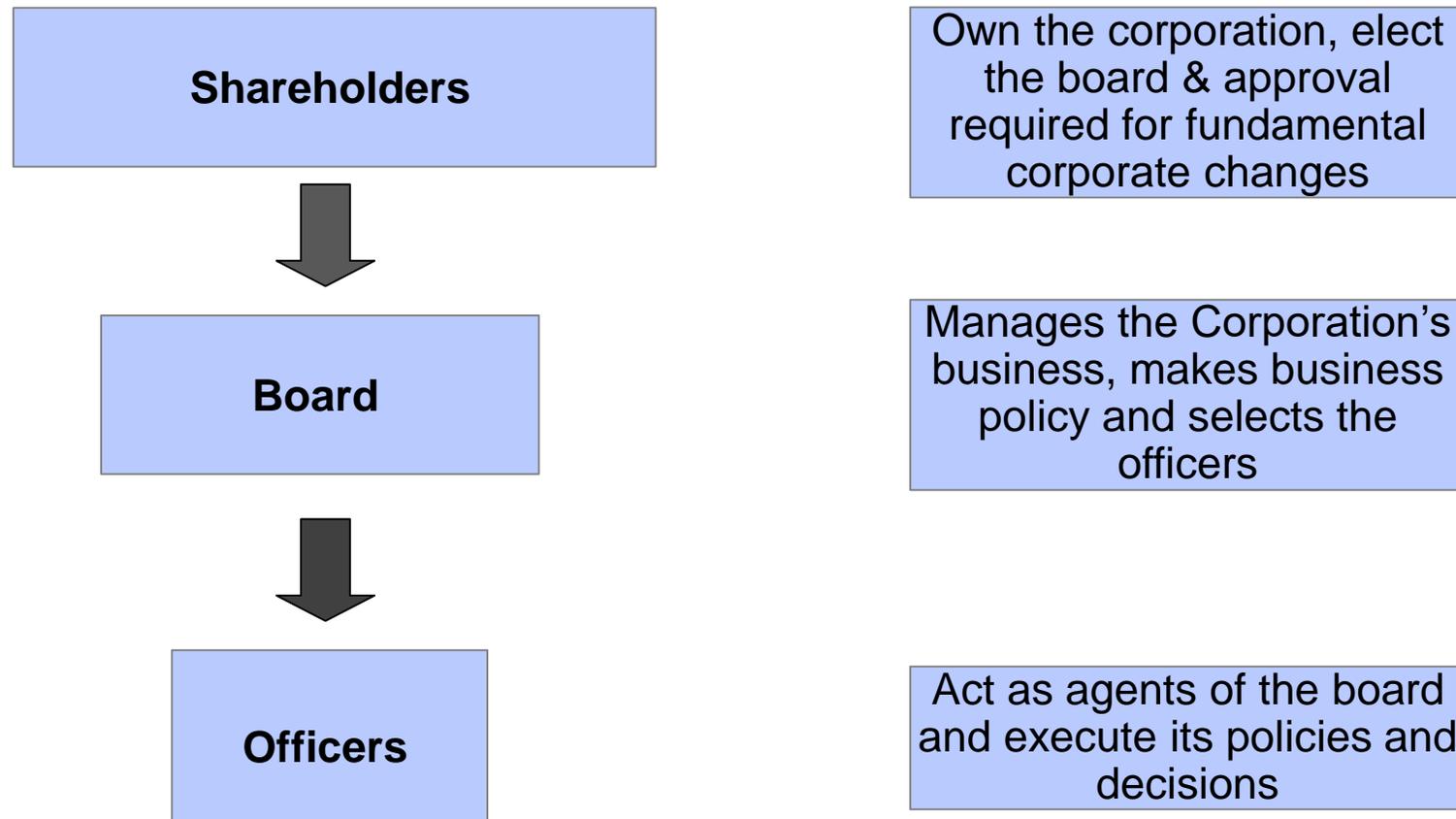
Corporate Governance

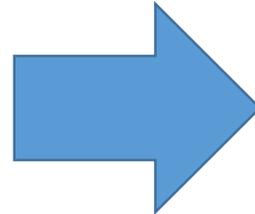
- **What it is:**
 - a system of rules, policies, and practices that dictate how a company's board of directors manages and oversees the operations of a company.
 - **Principal – agent model**
 - **Fiduciary duties of a director**
 - a **duty** to act in the best interests of the company.
 - a **duty** to act within the powers conferred by the company's memorandum and articles of association.
 - a **duty** not to fetter one's own discretion.
 - a **duty** to avoid a conflict of interest, and.
 - a **duty** not to make unauthorized profit.
- **Key principles:**
 - **transparency, accountability, and security.**
- **Poor corporate governance:**
 - at best, leads to a company failing to achieve its stated goals
 - at worst, can lead to the collapse of the company and significant financial losses for shareholders.

The Company's Pyramid Model of Corporate Governance

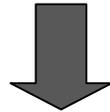


The Company's Pyramid Model of Corporate Governance

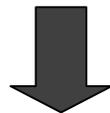




Shareholders



Board



Officers



Management

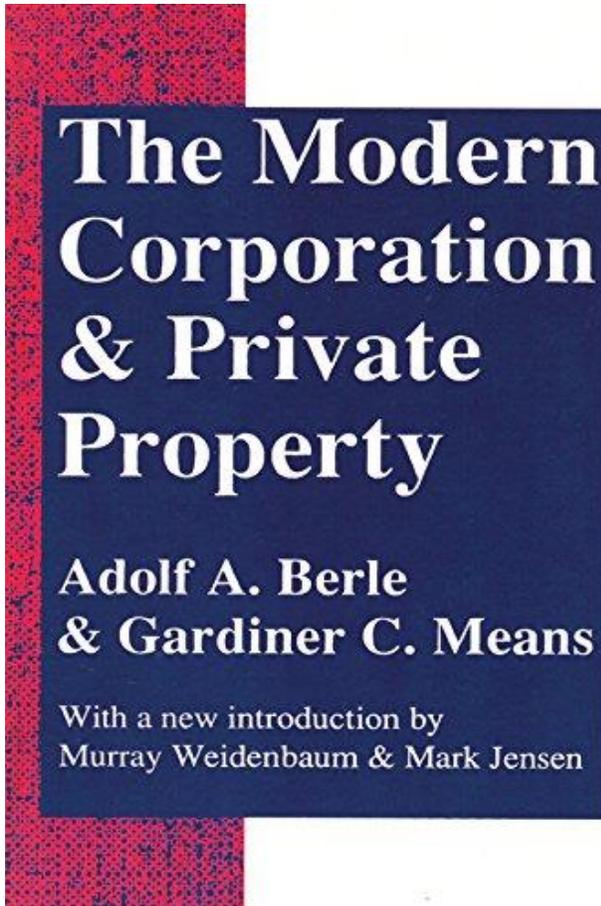


Board

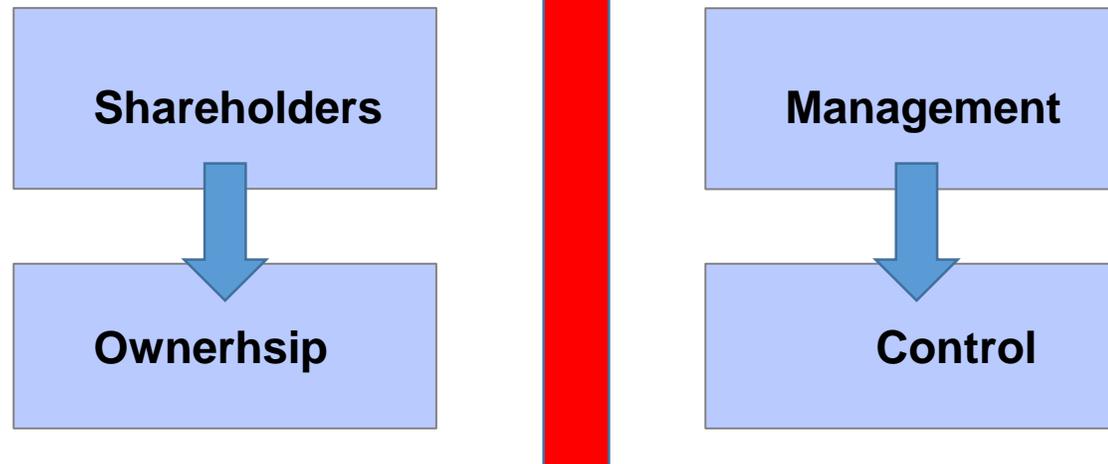


Shareholders / Members

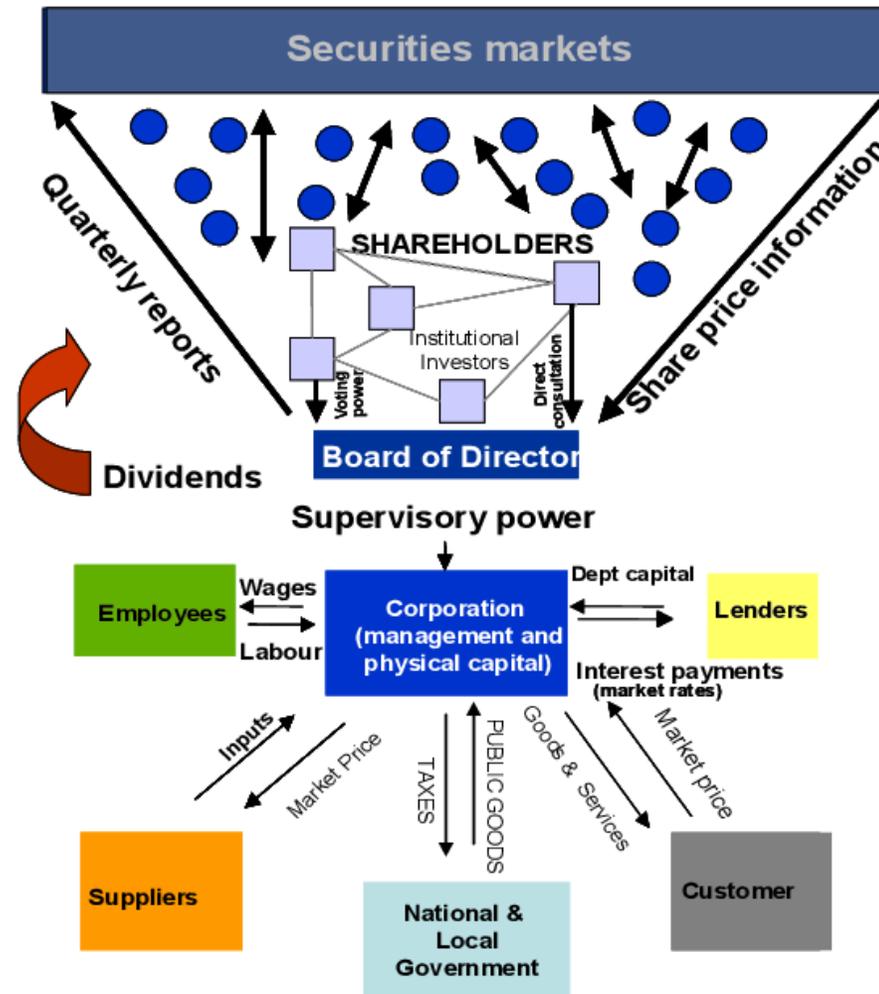
Separation Between Ownership & Control



- In Publicly held corporations control had to be separate from ownership (often highly dispersed)
- No individual, firm, or compact group owned more than a miniscule fraction of a corporation's stock



Berle & Means Model of Ownership and Control



Adapted from: M. Blair, Ownership and Control (1995)

Role of Shareholders: Hirschmann



How to bring a company's performance back to full potential:



- “The relation between corporate management and stockholders is a case in point. When the management of a corporation deteriorates, the first reaction of the best-informed stockholders is to look around for the stock of better-managed companies. In thus orienting themselves toward exit, rather than voice, investors are said to follow the Wall Street rule that “if you don’t like the management you should sell your stock.” According to a well-known manual this rule “results in perpetuating bad management and bad policies.” Naturally it is not so much the Wall Street rule that is at fault as the ready availability of alternative investment opportunities in the stock market which makes any resort to voice rather than to exit unthinkable for any but the most committed stockholder”.

Exit

- Wall Street Rule – If you don't like management, sell your stock
 - Corollary: If you don't sell, vote with management"
 - "Either or Decision"
- New Forms of Exit:
 - Consumer Boycotts
 - Labor Boycotts
- Economists favor 'exit':
 - Market forces presumed to work efficiently
 - Invisible Hand
- Legal intervention 'inefficient' and will fail to achieve shareholder's (the principal) goals



Voice

- Attempt to influence organization
- Remedy problems
- Attend annual meeting and question the Board or Managers
- Vote (or not) for Board members
- Different Votes:
 - Shareholder Voting
 - Engaging through an intermediary (mutual funds)
 - Nonatomistic Investors
 - Voice by Other Stakeholders

Loyalty

- Determines whether shareholder takes a 'voice' or 'exit'
- Loyalty stronger to 'political' or 'social' organizations, than to 'economic' organizations
- How organization structured its strategy to deal with participants' concerns can influence feelings of loyalty, and whether they choose 'exit' or 'voice'.

The Role of Corporate Law and Shareholders

- Corporate law should be assessed in terms of whether it supports ‘exit’ or ‘voice’.
- What are the objectives?
- Should corporate law provide a balance between ‘exit’ and ‘voice’?
 - How should ‘exit’ and ‘voice’ operate?
 - Should the size of the corporation matter? Large, publicly- held v. Small private company (ie., GmbH)
 - Price Signals
 - Disinvestment Campaigns – ‘Occupy Wall Street’

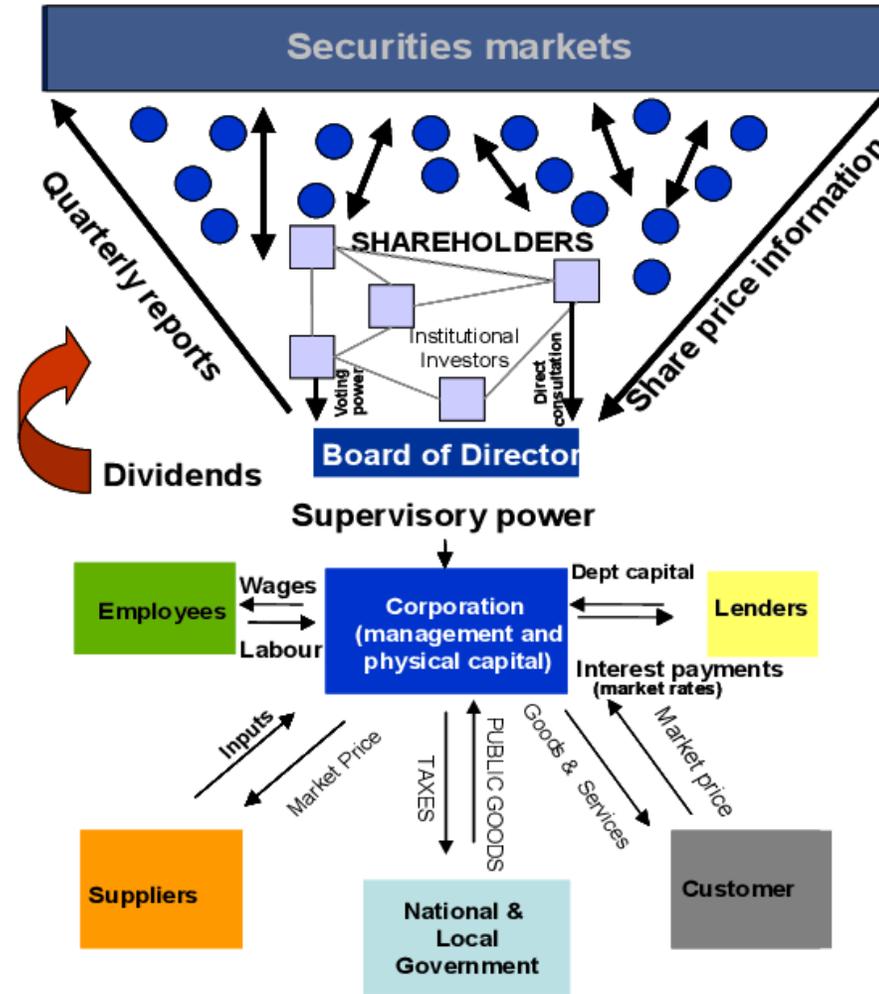
The landscape of shareholders

- Pension Funds
 - Private Pension Funds
 - Public Pension Funds
 - Independent Non-Profit Pension Funds
- Banks
- Investment companies
- Insurance Companies
- Foundations
- Unions
- Hedge Funds
- Private Equity Funds

Shareholders

- The principal-agent problem
 - Shareholder – company manager
 - Creditors - Shareholder/managers
 - Shareholder – institutional investor/mutual or pension fund
- Regulator (stakeholders/society) – company

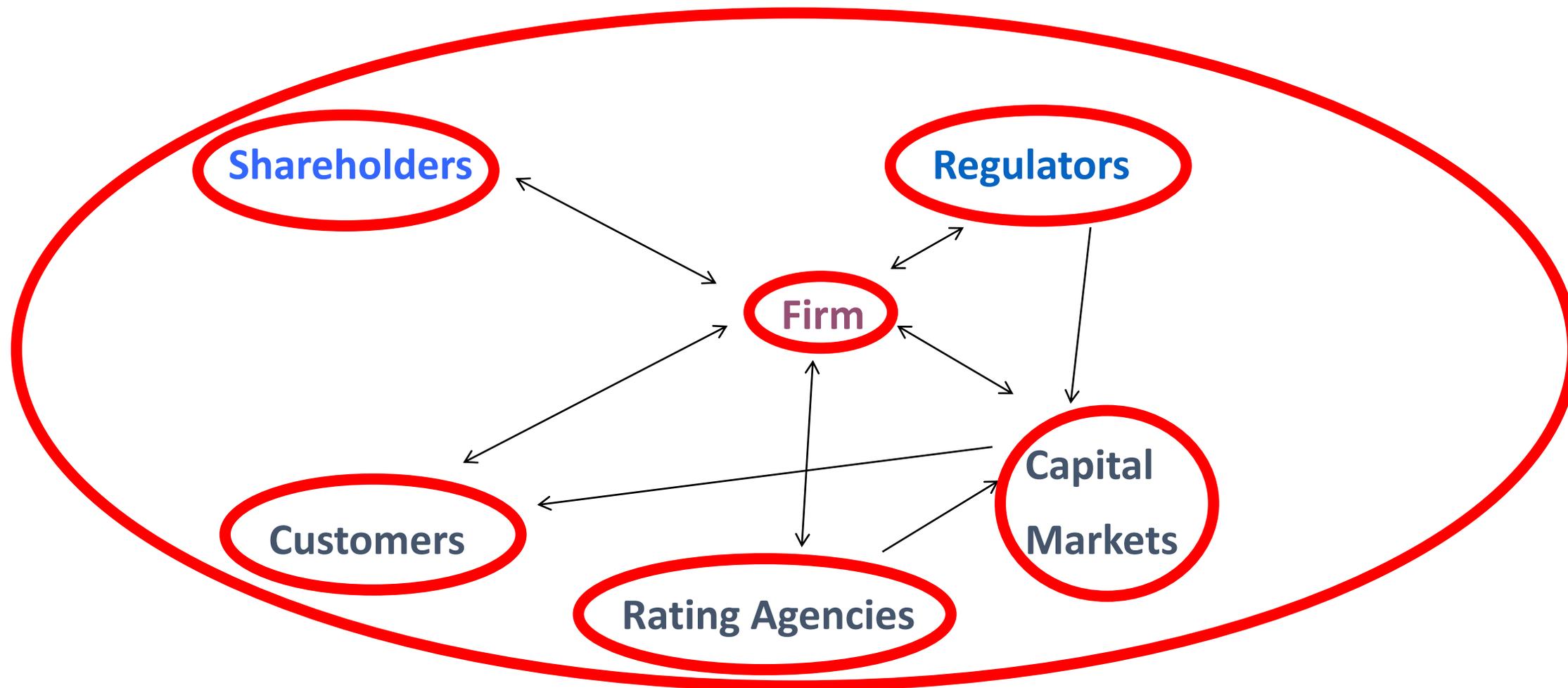
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Modern Securities Markets

Complexity of Agency Problem





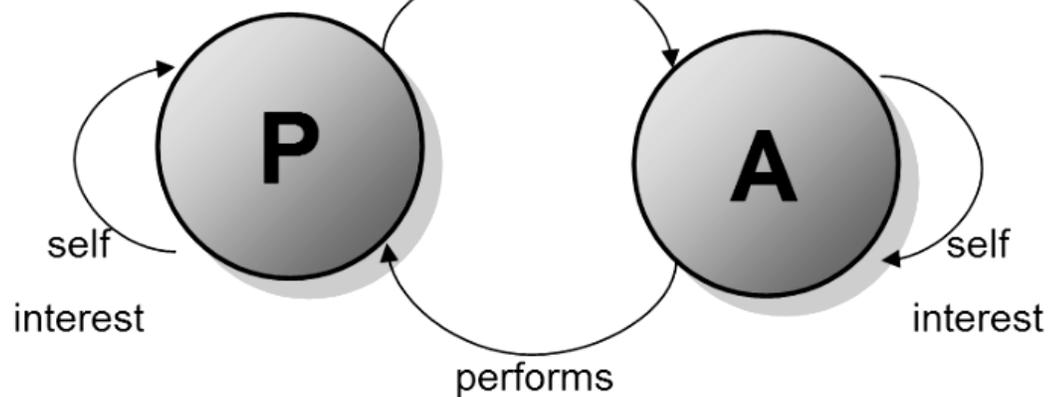
Principal-Agent Model



Moral Hazard

Asymmetric
information

hires



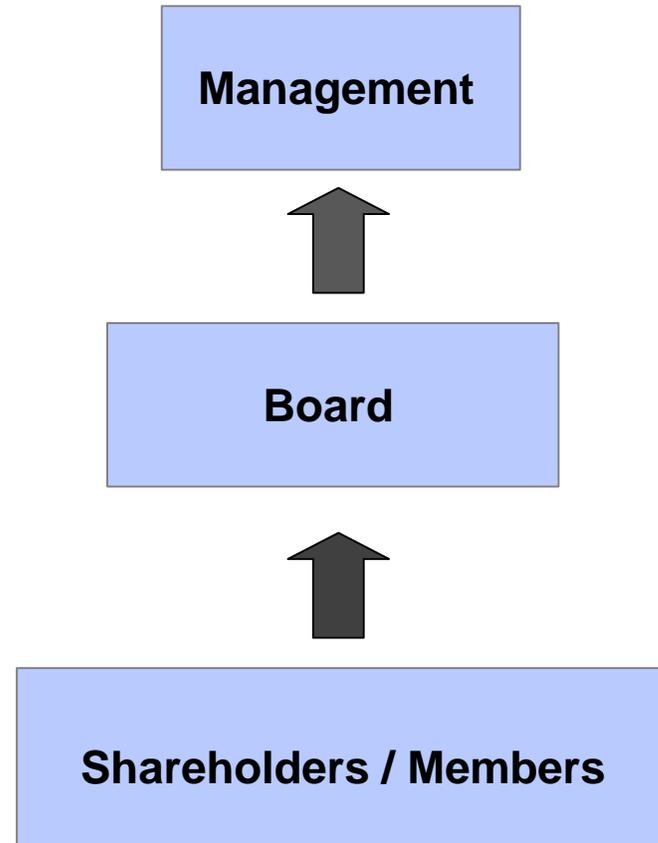
Shareholders

Directors

Adverse Selection

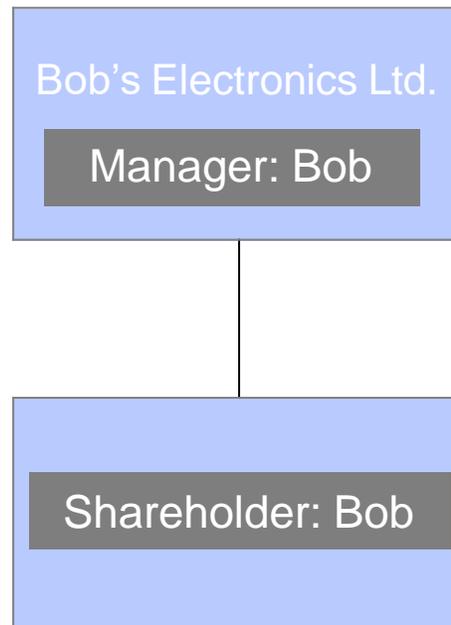
- Investor (principal) / Manager/employee (agent)
- Agent's incentive to expropriate or steal the principal's assets
- corporate law – governance structure to provide an appropriate degree of accountability among participants

The Company's Pyramid Model of Corporate Governance



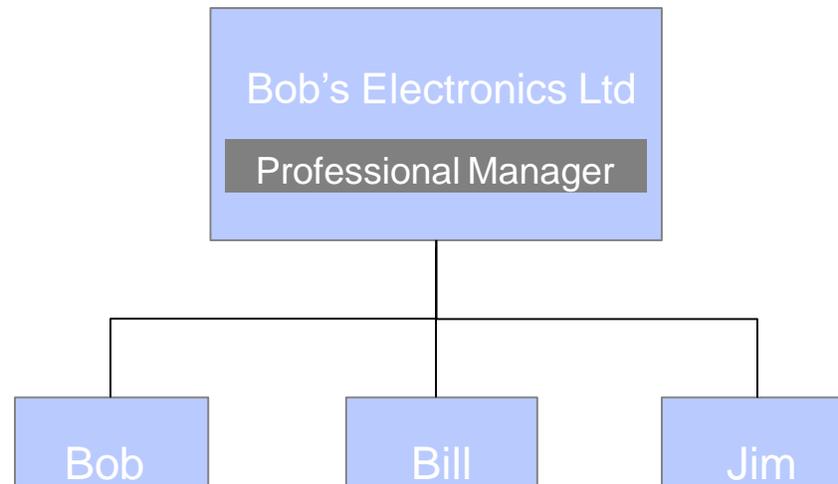
Closely Held Managed by Members

Manager and shareholder incentives completely aligned



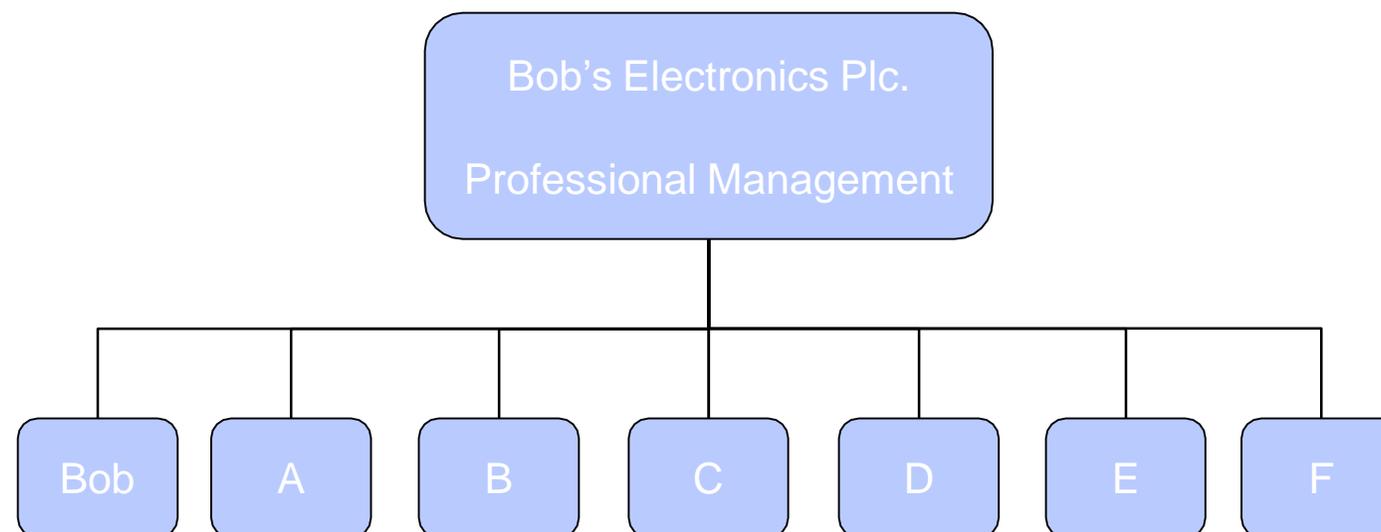
Closely Held Professional Management

- Managerial and member incentives not fully aligned
- Agency costs
- Controlling agency costs: monitoring and member control
 - Power to appoint and remove the board
 - The board's power to appoint and remove management
 - Power to reserve certain matters to the shareholders



Publicly Held Professional Management

- Company managed and controlled by management
- Collective Action Problem: Shareholders have poor incentives to monitor and control



Legal and regulatory disclosure for investors will lead to...

- Information leads to more efficient pricing of shares – reflecting market value based on available information
- Enhancing quality of publicly-traded companies – through disclosure of information and shareholder pressure for performance

Legal and regulatory disclosure

- For company issuers, investor protection requirements are conditions for entering securities markets:
 - mandatory disclosure
 - accounting reports/methodologies (fair value of assets)
 - standardization and comparability of data/information
- Is the mandatory information to be disclosed to investors really helpful for investors in making investment decisions – financial crisis 2007/08 showed that information of complex securities were available in prospectuses but investors still made bad decisions?

Property Model

- When shareholders invest, they become part owners of the company, or at least of the company's business
- Shareholders have the right to the company's residual income
- This legitimates the shareholders' right to have company run exclusively in their own interest
- Any deviation undermines respect for private property ownership, which requires property be used in the interest of its owners
- Employees = outsiders
- Statutory intervention in the employment bargain = illegitimate intrusion into the private realm of shareholders?

Nexus of Contracts Model

- Company = vehicle for contracting
- Bargaining to reduce transaction costs
- Shareholders provide capital on which they are remunerated
- Ownership right in shares, not company
- Company = ‘fiction’
 - legal fiction that serves as a nexus for a set of contracting relations among individual factors of production.
- Ownership of firm = irrelevant concept
- Bargaining and employee consent – no authority relationship between managers and employees
- ‘Misleading’ to state that ‘company owes moral or social responsibilities to employees,’ or other third parties.

How to minimize Agency Costs

Property Model

- Commission Payments
- Profit Sharing
- Efficiency Wages
- Performance Measurement
- Fear of Firing
- Enhanced Shareholder rights

Nexus of Contract Model

- View that affording control rights to shareholders is efficient
- Shareholders = group best able to bear risk
- Shareholders have the right to the company's residual income
- Shareholders stand last in line, but enjoy an unlimited right to the surplus
- The group that faces the greatest risk has the most powerful incentive to monitor management

Corporate Law Theories (Common Law)

- Aggregate theory, UK Companies Act 2006 s. 33(1) ‘the provisions of a company's constitution bind the company and its members to the same extent as if there were covenants on the part of the company and of each member to observe those provisions...’ but limits on member enforcing the articles – rule of Foss v Harbottle (1843)
- Contractual relationships determinative of obligations/duties of Board
- Majority decision of contractors represents company will. Contractually negotiated rules of company governance by shareholders serves as will of the corporation.
- Corporation entitled to autonomy from state – classical laissez- faire approach – emerges as common western state practice in 19th century

Role of the Board of Directors

- Elected by shareholders to oversee the company
- Executive members – CEO, CFO, other senior management
- Independent members (non-executive). Represent the interest of the company and its shareholders. Elected by shareholders by resolution at corporate meeting
- Fiduciary duties
 - Fiduciary principles are uncommon in contractual relations: because parties bargain at arms length and enforce their deals to the letter no matter how severe the consequences for the other side
- Investor rights – cannot foresee all future events. Investors contract locates uncertainties in the holders of residual claims. They receive few explicit promises except: right to vote and protection of interests

Board duties – Fiduciary Duties

‘to say that a man is a fiduciary only begins analysis: it gives direction to further inquiry. To whom is he a fiduciary? What obligation does he owe as a fiduciary?’ *Justice Felix*

Frankfurter, SEC v Cheney Corp., 318 U.S. 80, 85-86

Board Duties

Fiduciary Duties in Swiss Law

Art. 717 Swiss Code of Obligations (The Company Limited by Shares)

IV. Duty of care and loyalty

- ¹ The members of the board of directors and third parties engaged in managing the company's business must perform their duties with all due diligence and safeguard the interests of the company in good faith.
- ² They must afford the shareholders equal treatment in like circumstances.

See BGE 139 III 24 (Jurisprudence similar to the Business Judgment Rule)

- Shareholder claim for damage caused to the company due to unnecessary legal proceedings resulting in court and legal costs of about one million CHF
- The misuse of court proceedings can be seen as a breach of Art. 717 I OR (E. 3.3.)
- In the particular case were the court proceedings between the stock company and the minority shareholder not in the interest of the company, but in the mere interest of the majority share holder (E. 3.4,5)
- Breach of the duty of equal treatment (E. 3.4)
- General restraint of the Swiss Courts in the review of decisions of the board of directors

Liability in Swiss Law

Art. 754 Swiss Code of Obligations

III. Liability for administration, business management and liquidation

- 1 The members of the board of directors and all persons engaged in the business management or liquidation of the company are liable both to the company and to the individual shareholders and creditors for any losses or damage arising from any intentional or negligent breach of their duties.
- 2 A person who, as authorised, delegates the performance of a task to another governing officer is liable for any losses caused by such officer unless he can prove that he acted with all due diligence when selecting, instructing and supervising him.

See BGE 139 III 24

- Differentiation between «direct damage» caused directly to the shareholders and «indirect damage» caused directly to the Stock Company but indirectly to the share holders

BGE 139 III 24

- Summary:** Board denied shareholders to register their shares.
The shareholders sued the board in order to be registered.
- Direct damage:** Damage the appellant had by the litigation.
- Indirect damage:** Damage the board caused through their decision,
which reduced the value of the appellants' shares.
- Ruling:** The denial for registering the shares was not in the
interest of the company and was in breach of the
principle of equal treatment of the shareholders.
Therefore, the board caused unnecessary costs for
the company.

To whom is he/she a fiduciary in corporate law?

- Board members (both executive and non-executive members)
 - Duty to the company?
 - Duty to shareholders?
 - Or duty to both?
-
- Fiduciary duties help the shareholders to control divergent interests of managers and shareholders

Fiduciary Principle

- Optimal fiduciary rules approximate the bargain that investors and managers would have reached if they could have bargained and could enforce their agreements at no cost
- Easterbrook & Fischel:
 - The ‘rules preserve the gains resulting from the separation of management from risk bearing, while limiting the ability of managers to give priority to their own interests at the expense of the firm’
- Distinction between
 - management practices that harm investors’ interests
 - practices that at the same time benefit managers and investors
- Fiduciary principles: rules for completing ‘incomplete contracts’. Overcome high costs of contracting
- Fiduciary duties goal:
 - overriding the high cost of expressly specifying things for all contingencies in a contract.
 - Detailed contracting to address all future contingencies after firm established is almost impossible (ie., raising capital & strategy)

Duty of care, duty of loyalty and duty of disclosure

- Duty of loyalty- to maximize the investors' wealth rather than one's own wealth (Swiss & UK).
- Duty of care – to act as a prudent person does in the management of his own affairs of equal gravity.
- Distinction due to conflict of interest problem – decisions based on conflict of interest receive less judicial deference than general business decisions
- Duty to Disclose Conflicts and Material Interests

Fiduciary Duties: US Case Law

Duty	Test for Whether Duty is Met	Remedy
Loyalty	Fair Process (approval by noninterested directors) or else burden on directors to show ENTIRE FAIRNESS	Injunction or Damages
Care	BUSINESS JUDGEMENT RULE	None, except in very extreme cases.
Disclosure	Disclose all material information when seeking shareholder approval, or when a conflict of interest exists.	Corrective disclosure or damages
Extra Care When Selling Company	No Clear Test; careful scrutiny of decision process.	Injunction or Damages

Business Judgment Rule (US law)

- Absolving managers of liability if their judgment is negligent.
- They are protected from making ‘stupid’ decisions
- Investors’ wealth would be lower if managers’ decisions were routinely subjected to strict judicial review. Judicial deference
- Justification: Fear of personal liability will cause corporate managers to be more cautious; the role of judges second-guessing managers
- It is better to insulate all honest (but dumb) decisions from review than to expose managers and directors to review by judges and juries who do not face market pressures.
- S.Ct case *Smith v. Van Gorkom* decided that business judgment rule only applies to decisions that are ‘informed’.

Smith v. Van Gorkom

- Trans Union Corp. (a producer of railcars) merged with a subsidiary of the Marom Group, In., controlled by the Pritzker family.
- Trans Union for years had had investment tax credits, which it couldn't use up; the merger with Marmon permitted it finally to cash in on these.
- Every TU shareholder was paid \$ 55 per share – a premium of approximately \$20 over the market price.
- The board approving the merger consisted of several men with impeccable credentials. The five outside directors were:
 - a former dean of the University of Chicago Business School and chancellor of the University of Rochester, and the chief executives of IC Industries Holding Company, American Steel, U.S. Gypsum, and Swift and Company.
- Nevertheless, some shareholders, who thought the share price too low, brought suit.

Smith v. Van Gorkom

- Trans Union's chairman, Jerome Van Gorkom:
 - Had single-handedly put the deal together, had presented it to the board almost as a fait accompli
 - Had obtained the board's go-ahead in just two hours
 - Had never solicited the advice of an investment banker
 - Had signed the merger documents during a social affair for the benefit of the Chicago Lyric Opera after little more than a cursory reading.

Some critiques of Van Gorkom

“In small part, the court's decision may rest on a simple misunderstanding of how the world works: how business decisions are made, how bargains are struck. But the court's decision rests on more than misunderstanding; it rests on widespread fallacy. Unless identified and undermined, it may in turn under- mine the entire business judgment”

“To begin with, the court failed to appreciate that courts are not very good at evaluating a director's business acumen and disciplining his or her lapses. That job is accomplished much more efficiently by the market for directors. Courts can only review a single transaction at a time. That makes it very difficult for them to tell whether the litigated misfortune is due to bad luck or bad decision making. The market, on the other hand, evaluates directors on the basis of a long record of transact”

“Another thing the court failed to appreciate is the need to help directors be bold. The threat of crushing legal liability will make them too cautious. In business, at least, caution is not always the virtue it's often made out to be, but rather a costly vice.

In addition, the court failed to appreciate an important fact about human decision making: good decision making is almost impossible to formally describe.”