Defining Corporate Governance

- Historical origins: the term “corporate governance” derives from an analogy between the government of cities, nations or states and the governance of corporations.
- “Corporate Governance”: **system of rules, practices and processes by which a company is directed and controlled**.
- Corporate Governance essentially involves **balancing the interests of the different stakeholders** within a company – these includes its shareholders, managers, customers, suppliers, financiers, the government and the community.
- **Governance structure**, therefore, identifies the **distribution of rights and responsibilities among the different participants** in a corporation and includes the rules and the procedures for making decisions in corporate affairs.

Agency Problems

- Corporate law performs two general functions:
  1. Establishing the structure of the corporate form;
  2. Setting the **conflicts of interest among corporate participants**, including:
     - those between **corporate "insiders"** (such as controlling shareholders and top managers), and
     - those between **corporate "outsiders"** (such as minority shareholders and creditors).

- Generally, an **agency problem** arises whenever the welfare of one party (termed the "**principal**"), depends upon the actions taken by another party (termed the "**agent**").

- The problems lies in motivating the agent to act in the principal's interest rather than in his own interest.

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Agency Problems (2)

- Agency problems arise in a broad range of contexts: almost **any contractual relationship is potentially subject to an agency problem**.
- The **core problem**: because **the agent commonly has better information than the principal**, the principal cannot easily assure himself that the agent's performance is precisely what was promised.
- As a consequence, **the agent has an incentive to act opportunistically**. This means that **the value of the agent's performance to the principal will be reduced**, either directly or because, to assure the quality of the agent's performance, the principal must engage in **costly monitoring of the agent**.

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Three generic Agency Problems

- Three generic agency problems arise in business firms:
  1. The **conflict between the firm's owners** (the principals) **and its hired managers** (the agents) – the problem lies in assuring that the managers are responsive to the owners' interest rather than pursuing their own personal interests;
  2. The **conflict between the owners who possess the majority** (c.d. controlling owners) **and the minority or noncontrolling owners**;
  3. The **conflict between the firm itself and the other parties** with whom the firm contracts (such as creditors, employees and customers).

- In each of the foregoing problems, the challenge of assuring agents' responsiveness is greater where there are **multiple principals** who will face **coordination costs**. Coordination costs, in turn, will interact with agency problems in two ways:
  1. Difficulties of coordinating between principals will lead them to delegate more of their decision-making to agents;
  2. The more difficult is for principals to coordinate their own interests, the more difficult is to ensure that the performance of agents will correspond to those interests.

Agency Problems: the Role of Law

- **Law can play an important role in reducing agency costs** (example: rules and procedures that enhance disclosure by agents).

- In addressing agency problems, the law turns to a **basic set of strategies**.

- We use the term “**legal strategy**” to mean a generic method of deploying substantive law to mitigate the vulnerability of principals to the opportunism of their agents.

- Legal strategies for controlling agency costs can be divided into two subsets: “**regulatory strategies**” and “**governance strategies**”.

Regulatory strategies vs Governance strategies

- **Regulatory strategies** are **prescriptive**: they dictate **substantive terms that govern the content of the principal-agent relationship**, trying to constrain the agent's behaviour directly;

- **Governance strategies** seek to **facilitate the principals' control over their agents' behaviour**. Coordination costs will make it more difficult for principals either to monitor the agent, or to punish nonperforming agents.

- **Regulatory strategies** have **different preconditions for success**:
  - Most of all, they **depend on the ability of an external authority** to determine whether or not the agent complied with particular prescriptions.

- In contrast, **governance strategies** require only that **the principals themselves are able to observe** the actions taken by the the agent.

Regulatory Strategies: Rules and Standards

- Both rules and standards attempt to regulate the substance of the agency relationships **directly**.

- RULES: **require or prohibit specific behaviours *ex ante***. They are commonly used in the corporate context to **protect corporation's creditors and public investors**.
  - Examples: dividend restrictions, minimum capitalization requirements, action to be taken following gross loss of capital, rules governing tender offers and proxy voting.

- STANDARDS: leave the precise determination of compliance to adjudicators after the fact (**ex post**). They are commonly used with reference to **intra-corporate topics**.
  - Examples: law requiring the directors to act in "good faith" or requiring that transactions must be "entirely fair".

Regulatory Strategies: terms of entry and exit

- Terms of entry and exit involve regulating the **conditions under which principals affiliate with agents** rather than regulating the actions of agents after the principal/agent relationship is established.

- The **entry strategies** are particularly **important in screening out opportunistic agents**. They may, for example, require agents to disclose information about the likely quality of their performance before contracting with principals.
  - Example: public investors generally require some form of systematic disclosure by the corporation before purchasing its stocks.

- There are mainly two kind of exit strategies:
  - The **right to withdraw** the value of one's investment;
  - The **right of transfer** (the right to sell shares in the market). For example the transfer of control rights, or even the threat of it, can be highly effective device for disciplining management.

Governance Strategies: Selection and Removal

- **Appointment rights** (the **power to select or remove directors or managers**) are key strategies for controlling the enterprise.

- The power to appoint directors is a **core strategy** not only for addressing **agency problems of shareholders in relation to managers**, but also, in some jurisdictions, for addressing agency problems of **minority shareholders in relation to majority shareholders**, and of **employees in relation to the shareholder class** as a whole.

Governance Strategies: Initiation and Ratification

- They expand the **power of principals to intervene in the firm's management**.
- They are termed "**decision rights**", which **grant principals the power to initiate or ratify management decisions**.
- However, under existing corporation statutes, only the largest and most important corporate decisions (such as mergers and charter amendments) require the ratification of shareholders.

Governance Strategies: Trusteeship and Reward (1)

- They alter the incentives of agents rather than expanding the power of principals.

- The first incentive strategy is the **reward strategy**, which rewards agents for successfully performing the interests of their principals. There are two principal reward mechanism in corporate law:
  1. The most common form is a **sharing rule** that motivates loyalty by tying the agent’s monetary return directly to those of the principal;
  2. Less common is the **pay-for-performance regime**, in which an agent, although not sharing in his principal’s return, in nonetheless paid for successfully advancing the interest of the firm.

Governance Strategies: Trusteeship and Reward (2)

- The second incentive strategy, the **trusteeship strategy**, seeks to **remove conflict of interest *ex ante*** to ensure that an agent will not obtain personal gain from disserving its principal.
- This strategy assumes that, in the absence of strongly focused monetary incentives to behave opportunistically, agents will respond to the "low-powered" **incentives of conscience, pride and reputation**.
  - Example: the independent director

Compliance and Enforcement

- Legal strategies are relevant only to the extent that they **induce compliance**.
- Therefore, **each strategy depends on the existence of other legal institutions** (such as courts, regulators and procedural rules) **to secure enforcement** of the legal norms.
- Enforcement is more relevant with reference to regulatory strategies, such as rules and standards.
  - Rules and standards are not credible until they are in fact enforced. This necessitates well-functioning enforcement institutions, such as courts and regulators.
  - In contrast, governance strategies rely largely upon intervention by principals to generate agent compliance. Their success in securing agents' compliance depends primarily upon the ability of principals to coordinate and act at low cost.

Modes of enforcement

- It is possible to distinguish three modalities of enforcement, according to the character of the actors responsible for taking the initiative:
  - Public officials;
  - Private parties acting in their own interests;
  - Strategically placed private parties (gatekeepers) conscripted to act in the public interest.

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Modes of enforcement: Public Enforcement

- By "public enforcement" we refer to **all legal and regulatory actions brought by organs of the state**.

- This mode includes:
  - Criminal and civil suits brought by public officials and agencies;
  - Ex ante right of approval exercised by public actors;
  - Reputational sanctions that may accompany the disclosure that a firm is under investigation.

- Public enforcement action can be initiated by a wide variety of state organs: local prosecutors' office, national regulatory authorities, national stock exchange authorities (which are a kind of self-regulatory authorities).

Modes of enforcement: Private Enforcement

- Private enforcement refers both to **civil lawsuits brought by private parties**, such as shareholders suits and class actions, and to **informal or reputational sanctions imposed by private parties**, which might take the form of lower share prices, a decline in social standing.

- Private enforcement depends chiefly on the mechanism of deterrence, that is the **imposition of penalties ex post upon discovery of misconduct**. However, **private actors are of course very involved in ex ante governance interventions** to secure compliance by agents.

Modes of enforcement: Gatekeeper Control

- Gatekeeper control involves the **intervention of noncorporate actors**, such as **accountants and lawyers**, in policing the conduct of corporate actors.
- This conscription generally involves **exposing the gatekeepers to the threat of sanction for participation in corporate misbehaviour**, or for failure to prevent or disclose misbehaviour.
- These actors are defined as “gatekeepers” since their participation is generally necessary to accomplish the corporate transactions.
- Compliance is generally secured through the ex ante mechanism of constraint (e.g. auditors refuse to issue an unqualified report), rather than through the ex post mechanism of penalizing the wrongdoers.

Disclosure (1)

- Disclosure **plays a fundamental role in controlling corporate agency costs**.
- Prospectus disclosure forces agents to provide prospective principals with information that helps them to decide upon which terms they wish to enter the firm as owners. Periodic disclosure and ad hoc disclosure also permits principals to determine the extent to which they wish to remain owners, or rather exit the firm.
- In relation to **regulatory strategies** that require enforcement, **disclosure of related party transactions help to reveal the existence of transactions that may be subject to potential challenge**, and provides potential litigants with information to bring before a court.

Disclosure (2)

- In relation to **governance strategies**, disclosure can be used to in several different ways:
  - Mandating **disclosure of the terms of the governance arrangements** that are in place **allows principals to assess appropriate intervention tactics**;
  - Specifically in relation to decision rights, **mandatory disclosure of the details of a proposed transaction for which the principal's approval is sought** can improve the principal's decision;
  - **Disclosure of those serving in trustee roles** serves to bond their reputations publicity to the effective monitoring of agents.

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Legal Strategies in Corporate Context

- The law does not apply legal strategies in the abstract but only in specific regulatory context.

- It is possible to group these contexts into **six basic categories of corporate decisions and transactions**:
  1. **Regulation of ordinary business transactions and decisions**;
  2. **Corporate debt relationships**;
  3. **Related-party transactions**;
  4. **"Significant" transactions**, such as mergers and major sales of assets;
  5. **Control transactions**, such as sales of control blocks and hostile takeovers.
  6. **Investor protection** and regulation of issuers on the public market.

- Jurisdictions adopt a **mix of regulatory and governance strategies** almost in all of transactional context.

Differences across Jurisdictions (1)

- **The use of the various legal strategies** for controlling agency costs, **and of the associated modes of enforcement**, **differs** systematically **across jurisdiction**.

- There are **strong complementarities between the structure of share ownership and the type of legal strategies** relied upon most heavily to control agency costs, since **the efficacy of governance mechanism is closely linked to the extent to which principals are able to coordinate**.
  - Example: in jurisdictions where the ownership of shares is concentrated in the hands of few shareholders, owners face relatively low coordination costs and are able to rely on governance strategies to control managers. In contrast, where ownership of shares is more diffuse, governance mechanism are less effective, and there is more need for regulatory mechanism.

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Differences across Jurisdictions (2)

- The choice of legal strategies is complemented by the **nature and sophistication of the enforcement institutions**.

- **Rules** require a **sophisticated and quickly responding regulator**, **standards**, on the other hand, require **independent and sophisticated lawyers and courts**.

- Also the extent of **disclosure** varies depending on the ownership structure:
  - Where owners are highly coordinated, frequent disclosure may be less important for controlling managers and governance strategies can be used to stimulate disclosure of greater information;
  - However, disclosure is important too in systems with coordinated owners, in order to prevent the so-called “selective disclosure”.

References

- Kraakman R. et al., *The Anatomy of Corporate Law. A Comparative and Functional Approach*, Second Edition, Oxford University Press (2009), Chapter 2