Item #6
RESEARCH SEMINAR IN LAW, ECONOMICS, AND ORGANIZATION
Professors Bebchuk, Hart, and Kaplow

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CORPORATE GOVERNANCE IN CONTEXT

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Corporate Governance in Context

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Warren Buffett:

“In judging whether corporate America is serious about reforming itself, CEO pay remains the acid test. To date, the results aren’t encouraging”

Annual Letter to Shareholders 2004, Berkshire Hathaway
The Power Hypothesis

• CG system fundamentally flawed

• CEOs too powerful, boards too weak (Bebchuk-Fried, 2004)

• Correct power imbalance by giving shareholders intervention rights (Bebchuk, 2005)
Power Hypothesis – two challenges

• **Timing test:**
  – why did system perform so well for so long?
  – why did executive pay get out of hand in 1990s?

• **Governance test:**
  – do boards of closely held firms (family firms, buy-out firms) act very differently?
Corporate governance system – the two main tasks

- Decide who decides (selection problem)
- Make sure those in charge act responsibly (incentive problem)
Outline

- **Historical context** – rise of shareholder value
- **Executive compensation** – levels, structure and process
- **Governance context** – role of boards
- **Reforms** – selective job redesign
Rise of Shareholder Value
All Acquisition Volume
As % of beginning year total stock market value
1968-2001
Two big restructuring waves

80s bust-up wave:
- Hostile deals (takeovers)
- Going private (over 100 Billion/yr)
- All cash, high leverage (institutional money)
- Targets: firms with excess cash

90s build-up wave:
- Friendly deals
- Publicly traded
- Share swaps, stock options
- Targets: consolidating industries
Why did this happen?

- Greed (Blair)
- Return to healthy capitalism (Jensen)

....but WHY NOW?

- Need to understand past as well as present
An alternative interpretation

- Deregulation, technological change created need for reallocation of capital
- Shareholders (market) got involved in reassigning decision rights (capital)
- Scandals a side-effect of system creating strong incentives for corporate restructuring
- On net a positive outcome – stock markets, profits soared, acquisitions paid off (?)
Why did market influence increase?

• Organizational advantage in moving capital long distances (banks, VCs, LBOs, etc)

• Investors effective change agents
  – few vested interests (Hansman, Meyer-Milgrom-Roberts)

• Innovation
  – exploiting and exploring hard (Roberts)
  – “paying in dreams” (Amador-Landier)
Why do firms retain capital?

- Commitment to protect human capital (Shleifer-Summers, Hart-Moore)
- Commitment to limit short-termism (v Thadden)
- Utilizes knowledge effectively (Stein, Gromb-Scharfstein)
Executive Compensation
Executive compensation: the complaints

• **Levels** out of control (six fold increase in median pay 1980-2000; F-500 median 7.2 Mln in 2002)

• **Windfall gains** (60% from general market; no relative performance evaluation)

• **Distorted incentives** (earnings management; eg. Bergstresser-Philippon)
A family firm without agency problems

- We benchmark– salary, bonuses, options
- We pay above average
- We do not use RPE
- We ask before appointing new directors

Why?

- We want to avoid bargaining
- We do not want to be over-bearing
- We want an empowered CEO
Why did levels escalate in 1990?

- Increased value of executive talent (Hubbard-Himmelberg, Murphy-Zabojnik)
- Huge bargaining wedge
- Equilibrium determined by peer comparison
- Rise of shareholder value fuelled use of options
- Public attention did not help
- Boards may not have understood true cost (Hall-Murphy)
Why options?

- More bang for the buck
- Good at inducing value increasing transactions

...but

- Incentives sensitive to share price
- Reissuing makes dynamic cost opaque
- Curse of capitalization/overvaluation and earnings manipulation
- Pressure to grant options broadly, very costly
Incentive sensitivity

Incentive strength

Stock price

Three options

One share

Three options

Stock price

Incentive strength

One share

Stock price

Incentive sensitivity

Incentive strength

Stock price

Three options

One share

Stock price
Some other issues

• What do you want to achieve?

• Partial transparency – leads to stealth compensation (Singh)

• Why so little relative performance evaluation? (LBOs, family firms)

• Implicit incentives – pros and cons of short-termism
Improving compensation

• Structure:
  – Restricted stock (robust, transparent)
  – Longer horizons, fixed cash-out dates
  – Smaller, more frequent awards (partial indexation)
  – Avoid performance plans

• Level:
  – More not less benchmarking

External credibility limits designs (ISS)
The Role of Boards
Why do we have boards?

• Bebchuk (2005): treats executives and board as one body – “management”
• Where’s the role for boards?

• Three economic reasons:
  – Economizes on information acquisition
  – Protects confidentiality of information
  – Acts as intermediary (buffer) between shareholders and management
Bebchuk and Fried (p 203):

“..the [directors] would still be subject to social and psychological factors inducing them to remain on good terms with the CEO. As long as directors are supposed to act collegially and feel like part of a team of which the CEO is for many purposes the leader, they will feel more comfortable accommodating his or her wishes than opposing them.”
What do boards (try to) do?

• **Evaluate (main task):** Is the right team in charge? Does strategy make sense? Is capital efficiently used?
• **Monitor (side task):** Oversee conduct

• Auditors check fraud
• Management designs strategy

• What is the objective of boards?
Board challenges:

Challenge # 1:

Maintaining credibility with management
Impacts access to crucial, tacit information

Challenge # 2:

Maintaining credibility with shareholders
Impacts ability to use expert information
Two Communication Problems

CEO

Board

Communication

Intervention

Shareholders

Communication

Intervention
Management-Board Game (Crawford-Sobel, Adams-Ferreira)

• Management wants a (reasonably) informed board:
  – needs board understanding in times of crises
  – values advice

  ....but

• Worried about excessive intervention. Over-bearing board kills information flow (family firms, Coca-Cola)
On entrenchment (Hermalin-Weisbach)

- Management that does well gains power
- Leads to consolidation of power
- This is an efficient commitment mechanism

Additional prediction:

- Dismissal has positive stock price effect if it accords with public perception and negative if it goes against public perception
Board-Shareholder Game

• Reputation concerns can lead to limited use of information (Holmstrom, Ely-Valimaki)
• Shareholder pressure leads to short-termism (Stein), biased behavior (Aghion-Stein)

…therefore

• Entrenched board can be valuable (Fisman-Khurana and Rhodes-Kropf)
• Biased supervisor can be valuable (Dessein)
One way to think about reforms – how do they affect information games?

- **Mandatory rules** can facilitate board access to information (e.g., non-executive sessions)
- **Shareholder intervention rights** can suppress board’s use of expert information
- **Selective job re-design** -- e.g., external evaluation of compensation plans (ISS versus GACP)
Concluding observations

• Organizational experiments (Enron) may fail at times; that’s okay

• Public outrage part of overall corporate governance system

• Is advocacy a good social system for reforming corporate governance?
Going private volume
As fraction of total stock market value
U.S. Private Equity (fundraising)

Billions of 2002 $s

Source: Venture Economics and Asset Alternatives.
The analysis controls for the changing composition of firm size over time. Thus, these estimates show the pay to performance link for a similarly sized company over time, in this case a company with a market value of $1 billion.
Adams-Ferreira (adapted):

• Two periods: \( x_1 = a + \varepsilon_1 \) and \( x_2 = a + s + \varepsilon_2 \)
  a -- management ability; estimate \( e_0 = E(a) \)

• Stage 1: Public observes \( x_1 \) and board updates to \( e_1 = E(a| x_1) \)

• Stage 2: Mgt learns \( s \); Communicates \( r: \{s \geq r\} \) verifiably to board

• Stage 3: Board updates to \( e_2 = E(x_2| x_1, r, m) \), where \( m \) is additional private signal about \( a + \varepsilon_2 \). Board replaces management if \( e_0 \geq e_2 \)

• Stage 4: Management gets private benefit from continuing and from perks. Board maximizes profits and can limit perks more effectively, the higher is \( r \).
Hermalin-Weisbach:

- Two periods: $x_t = a + \epsilon_t; a =$ management value
- Stage 1: board observes $x_1$ and updates a-estimate
- Stage 2: Negotiation over wage and filling of board vacancies
- Stage 3: Board observes additional information about management ability with probability $p$ (depends on monitoring intensity)
- Stage 4: Board updates a-estimate (if it got info) and decides on replacing management
- Stage 5: $x_2$ realized