Exploratory Note 30

Corporate Governance – A Primer

**INTRODUCTION**

Corporate governance broadly consists of the system of rules and processes by which a company is directed and controlled. Though the ends of corporate governance can be somewhat varied, the central concern is the establishment of a foundation for ensuring that managers do not shirk, abscond with, or misallocate the funds supplied by investors—thereby ensuring, as best as possible, a return for the investors. This penultimate exploratory note of the semester provides a primer on the subject.

**THE BOARD OF DIRECTORS**

Corporate governance starts with the Board of Directors. A partial list of duties is below:

* Monitoring company performance
* Setting corporate strategy
* Overseeing/approving the capital and key operating budgets
* Setting/approving compensation for top executives
* Overseeing risk management
* Evaluating top executive performance
* Planning top executive succession

Though all of these functions are important, this evening, our concern revolves around the role that the Board of Directors plays in aligning the interests of managers and shareholders.

**THE AGENCY DILEMMA REVISITED**

Human nature arguably being as it is, managerial misbehavior is to be expected in the absence of appropriate mechanisms of control. As discussed earlier in the semester, the agency dilemma provides us with a theoretical rationale as to why this is the case. To review, what is the difference between a principal and an agent, in an economic setting?

Are principals and agents always privy to the exact same information? Why does this matter?

Are principals and agents always going to have the same goals? Consider both moral hazard and conflicts of interest, among other things.

**POTENTIAL EXAMPLES OF MANAGERIAL ABUSE AND/OR MISUSE**

Of course, the misalignment of managerial and investor interests can manifest itself in a number of ways, but let us consider a few: executive compensation and perquisites, transfer pricing, empire building, and entrenchment.

***Executive Compensation and Perquisites***

Do managers likely prefer more compensation and perquisites as opposed to less?

Are high managerial compensation and perquisite levels in the best interests of investors?

Of course, not all forms of compensation are the same—a matter to be addressed in more depth a little later on this evening.

***Transfer Pricing***

What is transfer pricing?

Consider a managerial buyout (MBO). What is an MBO? Does management potentially have an informational advantage when it comes to the true value of a firm’s assets?

After the fact, if investors feel cheated out of a deal that they agreed to and executed, do they have opportunity for recourse in the legal system?

For smaller firms, pricing squabbles frequently erupt over questionable lease, rental, and other financing arrangements. What might these look like?

***Empire Building***

What is empire building in a business sense?

Alleged instances of empire building often involve acquisitive growth. Are the returns associated with acquisitive growth typically impressive or underwhelming?

***Managerial Entrenchment***

What is managerial entrenchment? What mechanisms exist to assist managers in entrenching themselves? Is managerial entrenchment likely good or bad for investors? What does the historical record suggest?

Entrenched managers may have a tendency to diversify holdings at the firm-level. Why?

Are firm-level diversification efforts likely to generate solid returns? Why or why not?

**CORPORATE GOVERNANCE MECHANISMS FOR ALIGNING INTERESTS**

Three mechanisms offer potential solutions for alignment: contracts, incentives, and control.

***Contracts***

Naturally, the simplest way to align interests is to use legal contracts where the use of funds is precisely scripted as is the distribution of cash flows between managers and investors. But, can *ex ante* contracts adequately cover all possible states of nature?

Would it make sense to use contracts which give the investors final say whenever information changes? Consider both large and small companies as the answers may be different.

This leads us to the legal issue of managerial discretion. Though courts will protect investors from blatant managerial abuse, they are reluctant to otherwise intervene in company-level affairs. Accordingly, managers are generally afforded significant discretion in their decision-making and actions. Is this reasonable?

That said, do managers still have a duty to the stockholders? Is it legally exclusive?

***Incentives***

Both theory and practice suggest that positive incentives can be an effective way to align the interests of management with those of investors. Stock options are frequently used for this purpose. How do they work in a compensation setting?

Ultimately, who grants options to management? Interestingly enough, when a poorly motivated board does the negotiating, these arrangements can come up short. For instance the evidence seems to suggest the options grants come before good news and are delayed until after bad news. Why? Does this defeat the purpose of the incentive?

Stock-based incentives are also used in smaller firms for similar purposes. Are such incentives likely to be as effective? Why or why not?

***Control***

For companies both large and small, controlling blocks of stock hold higher values than do minority blocks after a transaction. Why does control matter?

Though large shareholders can potentially abuse small shareholders, if we treat their interests monolithically for a moment, does the existence of a large shareholder likely advance the interests of small shareholders? Consider the issue of the monitoring of the firm.

If all else fails, a credible threat of elimination by takeover can help to align managerial interests with those of investors. How do takeovers work in the public arena? Is this the case when it comes to private firms?

**HIGHLY LEVERAGED STRUCTURES**

Arguably, a highly leveraged capital structure offers a superior corporate form that eliminates many agency issues. Why?

Are their significant downsides to this type of corporate form? Do they potentially outweigh the benefits?

**MANAGERIAL REPUTATION**

Might reputation constrain the actions of managers? Why?

Under what circumstances might reputation be insufficiently strong to constrain managerial opportunism?

**STARTUPS**

How important is corporate governance in a startup setting? Do the same concerns, remedies, etc. apply?

Can advisory boards assist in establishing and maintaining good governance processes in a startup?

As a quick digression, in what other areas can and do advisory boards assist startups?

**CONCLUSIONS**

Given that factors external to the firm make business quite risky to begin with, does the additional issue of paid managers shirking, absconding, and/or misallocating funds make investment completely unattractive? What prompts investors to hand over money?