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A SURVEY OF CORPORATE GOVERNANCE

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Abstract: *Main task in this article is to research corporate governance system, with special attention to the importance of legal protection of investors and of ownership concentration in corporate governance systems around the world. Large investors appear to be necessary to force managers to distribute profits. These investors require at least some basic legal rights, such as the voting rights or the power to pull collateral, to exercise their power over the management. Legal protection and large investors are complementary in an effective corporate governance system. Shleifer and Vishy (1997) want to know how investors get the managers to give them back their money, and which corporate governance systems is the best. In sum, this survey deals with the separation of financing and management of firms, and tries to discuss how this separation is dealt with in theory and in practice.*

Introduction

Shleifer and Vishy (1997) begin this survey by showing that the agency problem is serious: the opportunities for managers to abscond with financiers' funds, or to squander them on pet projects, are plentiful and well-documented. Considering the possibility of financing based on reputations of managers, or on excessively optimistic expectations of investors about the likelihood of getting their money back. Universal method of control that helps investors also to get their money back is concentrated ownership—through large share holdings, takeovers, and bank finance. Shleifer and Vishy (1997) discuss legal protection of investors and concentration of ownership as complementary approaches to governance.

There is a great deal of disagreement on how good or bad the existing governance mechanisms are. The agency problem is an essential element of the so-called contractual view of the firm, developed by Coase (1937), Jensen and Meckling (1976), and Fama and Jensen (1983a,b). Jensen's (1986) version of agency theory, is in which the worst agency problems occur in firms with poor investment opportunities and excess cash.

Several recent articles have presented different parts of agency model. Townsend (1978) and Gale and Hellwig (1985) consider models in which the borrower can abscond with the profits of the firm. A vast managerialist literature explains how managers use their effective control rights to pursue projects that benefit them rather than investors. Grossman and Hart (1988) aptly describe these benefits as the private benefits of control. Easterbrook (1984) articulates the agency theory of dividend payments, in which dividends are for equity what interest is for debt: pay out by the managers supported by the control rights of the financiers, except in the case of equity these control rights are the voting rights. Zingales (1994) and Barca (1995) suggest that managers in Italy have significant opportunities to divert profits to themselves and not share them with nonvoting shareholders.

Agency problem

The essence of the agency problem is the separation of management and finance, or—in more standard terminology— of ownership and control. There are several distinct forms that concentration can take, including large shareholders, takeovers, and large creditors.

Incentive contracts

Incentive contracts can take a variety of forms, including share ownership, stock options, or a threat of dismissal if income is low (Jensen and Meckling 1976; Fama 1980). Incentive contracts may be expensive if the personal benefits of control are high and there is a lower bound on the manager's compensation in the bad states of the world. The more serious problem with high powered incentive contracts is that they create enormous opportunities for self-dealing for the managers. Yermack (1997) finds that managers receive stock option grants shortly before good news announcements and delay or when contracts are incomplete and managers possess more expertise than shareholders. More recently, Jensen and Murphy (1990) looking at salary and bonuses, examine that executive pay rises (and falls) by about $3 per every $1000 change in the wealth of a firm's shareholders.

Shareholders

Large shareholders address the agency problem in that they both have a general interest in profit maximization, and enough control over the assets of the firm to have their interests respected. For this reason, large minority share holdings may be effective only in countries with relatively sophisticated legal systems, whereas countries where courts are really weak are more likely to have outright majority c. In the United States, large share holdings, and especially majority ownership, are relatively uncommon, legal restrictions on high ownership and exercise of control by banks, mutual funds, insurance companies, and other institutions (Roe (1994)). The effectiveness of large shareholders, then, is intimately tied to their ability to defend their rights.

Takeovers

The evidence suggests that managers resist takeovers to protect their private benefits of control rather than to serve shareholders. When managers take anti-takeover actions, shareholders lose. Takeovers can thus be viewed as rapid-fire mechanisms for ownership concentration. Effectiveness of takeovers as a corporate governance mechanism are sufficiently expensive, acquisitions increase agency costs, bring them private benefits of control, takeovers require a liquid capital market and are politically extremely vulnerable mechanism. Kaplan and Stein (1993), for example, present evidence suggesting that the high yield bonds that were used to finance takeovers in the United States in the late 1980s were systematically overvalued by investors. Walkling and Long (1984) find that managerial resistance

The Costs of Large Investors

The focus on large investors sheds new light on the relative powers of debt and equity. Creditors, such as banks, are usually large investors, their power comes in part of variety control rights in the firm at the time of or even before default, and in part because they typically lend short term, so borrowers have to come back at regular, short intervals for more funds. Specifically, debt and equity ought be compared in terms of the combination of legal protections and ease of ownership concentration. In many countries, banks end up holding equity as well as debt of the firms they invest in, or alternatively vote the equity of other investors (OECD (1995)). In Germany and Japan, the powers of the banks vis a vis companies are very significant because banks vote significant blocks of shares, sit on boards of directors, play a dominant role in lending, and operate in a legal environment favorable to creditors. As a result, banks and other large creditors are in many ways similar to the large shareholders. The effectiveness of large creditors, like the effectiveness of large shareholders, depends on the legal rights they have.

The Debt Versus Equity Choice

The literature on debt can be usefully divided into that before Grossman- Hart (1986), and that after. Debt is a contract in which a borrower gets some funds from the lender, and promises to make a prespecified stream of future payments to the lender. In the Modigliani-Miller (1958) framework, debt is associated only with a particular pattern of cash flows, the defining feature of debt is the ability of creditors to exercise control. Debt is particularly easy to value where there is abundant collateral, so that investors need only concern themselves with the value of the collateral and not with the valuation of the entire firm, as equity investors would need to.

Equity is the most suitable financing tool when debt contracts are difficult to enforce, and when near-term cash flows are insufficient to service debt payments. Such firms often have highly concentrated equity ownership by the entrepreneur and a venture capitalist. Equity financing still leaves an important question open: how can firms raise equity finance in countries with virtually no protection of minority investors, even if these countries are rapidly growing?

Reputation-building in the capital market

As pointed out by Bulow and Rogoff (1989), pure reputational stories run into a backward recursion problem. Reputation is surely an important reason why firms are able to raise money. However, several recent articles have presented reputation building models of private financing. Diamond (1989, 1991) shows how firms establish reputations as good borrowers by repaying their short term loans, and Gomes (1996) shows how dividend payments create reputations that enable firms to raise equity.

Legal protection

Much of the subject of corporate governance deals with constraints that managers put on themselves, or that investors put on managers, to reduce the ex post misallocation and thus to induce investors to provide more funds ex ante. Managerial investment decisions may reflect their personal interests rather than those of the investors. In this free cash flow theory, Jensen (1986) argues that managers choose to reinvest the free cash rather than return it to investors. If legal protection does not give enough control rights to small investors to induce them to part with their money, then perhaps investors can get more effective control rights by being large. Interesting problem concerns the efficiency of the ex post resource allocation, after investors have put up their funds. Dewatripont and Tiróle (1994) model explains how the cash flow structure of debt as senior claimant with little upside potential makes debt holders tough on managers after a default. (Milosevic D, et. al. 2017; 2016; 2015, 2012).

How large investors reduce agency costs

Morck, Shleifer, and Vishny (1988h) present evidence on the relationship between cash flow ownership of the largest shareholders and profitability of firms, as measured by their Tohin's

Qs. Morck et al. find that profitability rises in the range of ownership between 0 and 5 percent, and falls afterwards.

Mc-Connell and Servaes (1990) empirical work presents that German and Japanese banks earn rents from their control over industrial firms, and therefore effectively benefit themselves at the expense of other investors. The Japanese example brings up a very different view of large investors. There are costs associated with high ownership and entrenchment, as well as with exceptionally dispersed ownership. One interpretation of this finding is that, consistent with the role of incentives in reducing agency costs, performance improves with higher manager and large shareholder ownership at first.

LBOs leveraged buy outs

LBOs are efficient organizations which typically buys enough equity at a substantial premium to control the firm. There is direct evidence from the sample that LBOs are targeted at highly diversified firms, which sell off many of their noncore divisions shortly (Bhagat, Shleifer, and Vishny (1990)). In these transactions, shareholders of a publicly owned company are bought out by a new group of investors, that usually includes old managers, a specialized buyout firm, banks and public debt holders (Jensen (1989a, 1989b)).

Control rights with significant cash flow rights. In the process of using his control rights to maximize his own welfare, the large investor can therefore redistribute wealth—in both efficient and inefficient ways—from others. For Germany, Franks and Mayer (1994) find that large shareholders are associated with higher turnover of directors, because large shareholders govern by exercising their voting rights. All these findings support the view that large shareholders play an active role in corporate governance (Shleifer and Vishny (1986b)).

Cooperatives and State Ownership

Where monopoly power, externalities, or distributional issues raise concerns, private profit-maximizing firms may fail to address these concerns. These firms are controlled by the public, de facto control rights belong to the bureaucrats, having extremely concentrated control rights, no significant cash flow, often cater to special interest groups that help them win elections. The reality of state firms do not appear to serve the public interest, are enormous inefficient, makes pressures on public budgets and have created a common response around the world namely privatization. In most cases, privatization replaces political control with private control by outside investors, and creates concentrated private cash flow.

Conclusion

Shleifer and Vishy (1997) analysis leads us to conclude that both the legal protection of investors and some form of concentrated ownership are essential elements of a good corporate governance system. The conclusion draw is simple: Corporate governance systems of the United States, Germany, and Japan have more in common than is typically thought, namely a combination of large investors and a legal system that protects investor rights. Despite a great deal of controversy, we do not believe that either the theory or the evidence tells us which of the three principal corporate governance systems is the best.

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