

ECON 4245 Corporate Governance

Lecturer: Tore Nilssen, office ES 1216, tore.nilssen@econ.uio.no

Seminars: Alessia Russo, office ES 1139

13 lectures; 8 seminars

Lecture slides available before each lecture at:

<http://www.uio.no/studier/emner/sv/oekonomi/ECON4245/h14/>

Seminar topics – tentative plan

1. Introduction. Fixed-investment model.
2. More fixed-investment model. Variable-investment model.
3. Liquidity management.
4. Asymmetric information. Financing multiple projects.
5. More liquidity management.
6. Monitoring.
7. More monitoring.
8. Miscellaneous.

Contact student?

ECON4245 – Corporate Governance – Fall 2014

Department of Economics, University of Oslo

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Lecturer: professor Tore Nilssen, office ES 1216, tore.nilssen@econ.uio.no

Seminars: assistant professor Alessia Russo, office ES 1139

Textbook: Tirole, *The Theory of Corporate Finance*. Princeton University Press, 2006.

Lectures: Wednesdays 12:15-14:00, ES Aud 3.

Seminars: Wednesdays 14:15-16:00, HH 201.

Lecture dates: Lectures start on 20 Aug. There are no lectures on Wednesdays 27 Aug and 29 Oct. There is an extra lecture Thursday 4 Sep 16:15-18:00 in ES Aud 3.

[This plan is subject to change. Any changes will be announced on the website of the course.]

Seminar dates: 10 Sep; 17 Sep; 1 Oct; 8 Oct; 15 Oct; 22 Oct; 12 Nov; and 19 Nov.

Note: Seminar 1 Oct is in GS 3513.

Exam: Mon 24 Nov at 14:30-17:30

Lecture plan

Theme 1. Introduction to corporate governance. Tirole, chs 1-2. [Lecture 1]

Theme 2. Outside financing capacity. Tirole, ch 3, incl supplement. [Lecture 2]

Theme 3. Determinants of borrowing capacity. Tirole, ch. 4, incl supplement. [Lectures 3-4]

Theme 4. Multi-stage financing: liquidity management. Free cash flow. Tirole, ch 5. [Lectures 5-6]

Theme 5. Asymmetric information. Tirole, ch 6. [Lecture 7]

Theme 6. Product markets. Earnings manipulations. Career concerns. Risk taking. Tirole, ch 7. [Lecture 8]

Theme 7. Monitoring. Investor activism. Tirole, chs 8-9. [Lectures 9-10]

Theme 8. Control rights. Corporate governance. Takeovers. Tirole, chs 10-11. [Lectures 11-12]

Theme 9. Summary of course. [Lecture 13].

Course topic: **the firm**

- The firm has relationships with
 - Investors
 - Creditors
 - Suppliers
 - Employees (managers)
 - [customers, government, ...]

- Applying *economics* to understand these relationships
 - The economics of information
 - Contract theory
 - Three essential informational problems
 - Hidden action
 - Hidden information
 - Non-verifiable information

- At the centre stage: the firm/investor relationship
 - How are firms managed?
 - How are firms financed?
 - How do informational problems affect these questions?

Textbook: Jean Tirole, *The Theory of Corporate Finance*

- A unified treatment of the topic
- Building on a simple model
 - Hidden action (moral hazard)
- Required reading: chapters 1 through 11, including supplementary sections (unless noted otherwise).

Overview

- Basics: one-stage financing – fixed and variable investment models. Applications.
- Multistage financing: liquidity management
- Financing under asymmetric information.
- Exit and voice in corporate governance.
- Control rights.

(in the book, but not in the course:
macroeconomic implications of corporate governance;
political economy of corporate governance)

Corporate governance

- How *suppliers of finance* to a firm make sure they get returns on their investments.
 - Investors
 - Creditors
- How *corporate insiders* can credibly commit to returning funds to outside investors, thus attracting external finance
 - Insiders: management; current owners
- A narrow definition
 - Stakeholders vs shareholders
 - Employees, customers, suppliers, communities

The separation of ownership and control

- Berle and Means, *The Modern Corporation and Private Property* (1932).
 - Shareholder dispersion – managerial discretion
- Corporate insiders may not act in the interest of the providers of funds.
- How to deal with this problem?
 - Incentives
 - Monitoring

The moral-hazard problem

- *Moral hazard* is an awkward term but the one commonly used
 - No implication of immoral behavior
 - Behavioral risk; hidden action
- Owner/manager conflict
 - Manager does not always act in the interest of owners
- Insufficient effort
 - Insufficient internal control of subordinates
- Allocation of effort across tasks
 - Workforce reallocation, supplier switching
- Overinvestment
 - Pet projects, empire building, acquisitions
- Entrenchment
 - Managers making themselves indispensable
 - Manipulating performance measures
 - Being excessively conservative in good times, excessively risk-taking in bad times
 - Resisting takeovers
 - Lobbying against shareholder activism
- Self-dealing
 - Perks: private jets, big offices, etc.
 - Picking successor
 - Illegal activities: theft, insider trading, etc.

When corporate governance does not work

- Lack of transparency
 - Shareholders do not observe compensation details, such as perks and stock options
- Level of compensation
 - Tripling of average CEO compensation in the US 1980-1994, a further doubling until 2001.
 - Average CEO/worker income ratio in the US went from 42 in 1982 to 531 in 2000.
 - CEO/worker compensation ratio among top US firms was at 296 in 2013, according to the Economic Policy Institute.
 - Proponents argue this is a byproduct of more performance-based pay.
 - Norway: average CEO/worker compensation ratio at 10 in 2005
 - Smaller companies than the US ones
 - Report by Randøy and Skalpe (2007)
- Fuzzy links between performance and compensation
 - Bebchuk and Fried, *Pay without Performance* (2004).
 - Compensation in an oil company based on stock price, when management has little control over the oil price.
 - Golden parachutes when leaving.
- Accounting manipulations
 - The Enron scandal.
 - Manipulating stock price, and therefore compensation.
 - Hiding bad outcomes and therefore protecting against takeovers.

Managerial incentives

- Monetary incentives
 - Compensation
 - Salary: fixed
 - Bonus: based on accounting data
 - Stock-based incentives: based on stock-market data
 - Bonuses vs. stock-holdings
 - Bonuses provide incentives for short-term behavior
 - Shares provide incentives for long-term behavior
 - The two are complements, not substitutes
 - The compensation base
 - Relative performance
 - Shares vs. stock options
 - Stock options provide stronger incentives
 - ... but do not perform well after a downturn (excessive risk, lack of credibility).
 - Too low managerial incentives in practice?
 - In the US in the 1980s, the average CEO kept 3‰ of shareholder wealth; later estimate: 2.5%.
 - But incentives are costly to owners, because of manager risk aversion.

- Implicit incentives
 - Keeping the job
 - Firing or takeover following poor performance
 - Bankruptcy
 - Career concerns
 - Explicit vs implicit incentives
 - Substitutes: Strong implicit incentives lower the need for explicit incentives
 - ... but this is difficult to trace empirically.

Managerial incentives, cont.

- Monitoring
 - Boards of directors
 - Auditors
 - Large shareholders
 - Large creditors
 - Stock brokers
 - Rating agencies
- Active monitoring
 - Interfering with management in order to increase the value of one's claims in the firm.
 - Linked to control rights
 - Forward looking
 - Examples
 - large shareholder sitting on the board
 - resolutions at general assembly
 - takeover raid
 - creditor negotiations during financial distress
- Speculative monitoring
 - Not linked to control rights
 - Partly backward looking, aiming at *measuring* value, rather than at enhancing it.
 - Example: stock-market analysts, rating agencies
 - Provides incentives by making firm's stock value more informative about past performance.
- Product-market competition
 - Relative performance is easier
 - Exogenous shocks are filtered out
- The board of directors
 - Independence; attention; incentives; conflicts
 - Many differences across countries.

Investor activism

- Active monitoring requires control
- Formal control vs real control
 - Majority owner has formal control
 - Minority owners may have real control, convincing other owners of the need to oppose management
- Ownership structure important for the scope of investor activism
 - Institutional investors: pension funds, life insurers, mutual funds
 - Cross-shareholdings
 - Firms owning shares in each other
 - Ownership concentration: huge variations across countries
 - For example: US vs Italy
 - Ownership stability: again international variation
- Limits to active monitoring
 - Monitoring the monitor: incentive problems inside institutional investors
 - Externalities from monitoring
 - One shareholder's monitoring benefits all shareholders – underprovision of monitoring?
 - Costs of monitoring
 - Illiquidity
 - Focus by management on short-term news
 - Incentives for manipulating accounts

The market for corporate control

- Takeovers
 - Keep managers on their toes
 - Make managers act myopically
- Takeover bids: tender offer
- Takeover defenses
 - Corporate charter defenses
 - Making it technically difficult to acquire control
 - Staggered board
 - Supermajority rules
 - Differential voting rights
 - Diluting the raider's equity
 - Scorched-earth policies: selling out those parts of the firm that the raider wants
 - Poison pills
 - Current shareholders having special rights to purchase additional shares at a low price in case of a takeover attempt
 - White knight
 - An alternative acquirer who is friendly to the current management
 - Greenmail
 - Repurchases of stock from the raider, at a premium
 - Management colluding with the raider, at the expense of other owners.
- Leveraged buyout (LBO)
 - Going private, borrowing to finance the share purchase
 - Management buyout (MBO): an LBO by management

The role of debt in corporate governance

- Debt provides management discipline
 - Management must make sure there is cash flow available in the future for paying back debt
 - Management has less cash available for perks
 - If the firm does not pay back debt, creditors can force the firm into bankruptcy
- Debtholders are more conservative than equityholders
 - Debtholders suffer from bad projects, but get no extra benefit from good projects.
- But there are limits to debt
 - Debt means the firm is less liquid, which is costly.
 - Internally generated funds are the cheapest source of capital available for firms.
 - Bankruptcy is costly.

International comparison

- Two broad legal traditions
 - Common law
 - Independent judges
 - Limited codification
 - US, UK
 - Civil law
 - Politically appointed judges
 - Codification
 - France, Germany, Scandinavia

- Differences across legal systems
 - Shareholders have more protection in common law countries.
 - Correspondingly, common-law countries have a higher ratio of external capital to GDP.
 - Common-law countries have a more dispersed ownership of firms.

Note: Supplementary section to Tirole's ch. 1 is *not* required reading.