Troisièmes Journées de la Fondation
3rd Fondation Banque de France Journées
13-14 novembre 2003

Leçon magistrale
Invited lecture

« Aspects politiques de la gouvernance d'entreprise »
"Political Issues in Corporate Governance"

Martin Hellwig (University of Mannheim)

Mr. Governor, thank you very much for this very kind introduction and for the invitation to give this presentation here at the conference of the "Fondation pour la Recherche" of the Banque de France. Let me begin by congratulating you on the work that the Fondation has done. Having been present at the beginning of its work, I am very much impressed how it has developed and has established the Fondation as one of the places to go if one is interested in having research in finance funded and discussed in a competent way.

To get to my topic, the topic is of course very much on the agenda because the European Takeover Directive is under discussion. The European Takeover Directive has been under discussions since the late 80s and for a long time had been prevented in particular by resistance from the German government, which at some point gave a green light, and then shortly afterwards gave a deep red light, again to the point of preventing its passing at a later stage, or contributed to the preventing of its passing at the very late stage in the European Parliament. The German vagaries of attitudes to takeover issues are actually a good example of what is involved and why these issues are so difficult to handle.

Just a few reminders. In the spring of '97, the German corporation Krupp announced a tender offer for the German corporation Thyssen, offering to pay some 15 billion Marks for a company that previously had been valued by the market at some 12 billion Marks. Management responded by saying: (a) that this is outrageous to have somebody come up with money and use this money to acquire the power of another company, and, (b) that in any case the company was worth 18 billion rather than 15 billion. Public outrage ensued, not over the fact that the German financial system was insufficiently competitive to permit somebody to force the bidder to raise the price up to the 18 billion that the company was said to be worth, but because it was considered outrageous for somebody to be coming up with money and acquiring power. Under the influence of the political system, the takeover was called off. Subsequently, a merger occurred. The main consequence of the entire episode seems to have been that following the increase of the stock price to something near 15 billion, it dropped back down again, and just for shareholders, in the subsequent exchange, it actually fared even worse.

The next episode was a takeover fight: Vodafone taking over Mannesmann around the turn of the year, from '99 to 2000. It seems to be generally agreed that: shareholders profited, but the headquarters of the Mannesmann Company disappeared, were moved, and the true headquarters moved to London, where Vodafone had its seat. Following that experience, the German government appointed a panel to prepare a law. The first idea was not to require everybody to make cash offers rather than share offers as a way of financing, of going through with takeovers. Now the corporate managers on this expert panel at some point appreciated that this would be a problem for themselves if they wanted to take somebody else over. The initial reaction in the Mannesmann-Vodafone affair had been: What problem if somebody is trying to take us over? The second reaction: What problem if I wanted to take somebody else over and I can't? So this idea was abandoned, and subsequent different stages with various interventions from the top layer of corporate management in Germany with the German Chancellor. One moved to a law which permits defensive measures of management in a takeover battle with hardly any restriction, except for the one that the supervisory board has to agree to whatever the executive board is proposing. So it is not a question of shareholders' assembly doing anything. Moreover, all this has to be done in the interest of the company. This is one of the catch words in discussions on corporate governance: in the interest of the company.

What is the interest of the company, and who should determine what it is? An example on this: in a takeover fight in Switzerland in '89, the management of the Geneva insurance company “La Suisse” determined that -- well, there were two offers on the table, one to the tune of 12,000 Swiss Francs per share and the other to the tune of 14,000 Swiss Francs per share, and the Swiss management had the privilege under the system with registered shares to agree to a change in ownership or not. So this Swiss management at that time said that they considered the bid for 12,000 Francs per share, which came from a white knight, to be better for the company, and therefore also better for the shareholders. Then the bid for 14,000 Francs per share which came from a hostile raider, and therefore, they were not going to agree to the registration of any shares tendered to the hostile raider.

The issue of what is the interest of the company, how does the interest of the company relate to the interest of shareholders, is one of the key issues in discussions on corporate governance. This is an issue where the American attitude would be quite different from attitudes in continental Europe. From the American perspective, the shareholder - and I suppose this is more generally true for the common law countries - the shareholder is an owner of the company and the management is the agent of the owner. Therefore, the management should be acting in the interest of the owners. This actually has, outside of issues such as takeover regulations and the like, implications for legal approaches to fiduciary duty of corporate managers; fiduciary duty involves the obligation to the owners which can actually be made the subject of a lawsuit, and, as I will explain in a few minutes, this is probably one of the strongest defences of shareholder interests in the American system, as we have it at the moment.

Some ten years ago, I was asked to act as academic advisor to some study that was being done at the McKinsey Global Institute, and at that time they were proposing the view that continental European and Asian systems of corporate governance are corrupt, because there is no control of shareholders of owners of companies, over what these companies are doing. Consequently, these companies are going to engage in a lot of inefficient activities. Well, I can see McKinsey likes to attack inefficiency, which presumably their advice is then going to alleviate.

The very same argument was heard in 1998 when, at least, on the American East Coast, between Cambridge, New York, and Washington, the so-called Washington Consensus was that the Korean crisis was due to bad corporate governance. Of course this wasn't just academic talk, just as McKinsey had not intended these things as academic talk, but this was the basis for policy intervention, because the International Monetary Fund did try to impose improvements in corporate governance as a precondition for providing assistance to Korea. The only trouble they had was that the Koreans got so quickly out of the crisis and, subsequently, in some respects, fared better than some of the countries in which shareholder protection works so wonderfully. These ideas - having corporate governance run in the interest of shareholders is a precondition for efficiency - have over the last ten years also permeated academic thinking. Prime exponents would be La Porta, Lopez-de-Silanes, Shleifer and Vishny, writing on law and finance, with the basic message that legal systems that provide for shareholder protection are good for finance and good for efficiency. Recent work of Rajan and Zingales provides similar messages, I will not go into any details.

Thinking about the political context in which these discussions are taking place, also the political context for the European Takeover Directive, we should appreciate the international element to the market for corporate control. When Hoesche and Rhône Poulenc merged to become Aventis, they located in Strasbourg, which meant that the merged company moved out of the domain of German co-determination. When Mannesmann was taken over by Vodafone, this company too moved out of the domain of German co-determination, it also moved out of the domain of continental corporate law and into the domain of the common law, also into the domain of the English language. If you appreciate that some 60% of outstanding shares of Mannesmann were at that point held by international funds active in London, you will probably appreciate the importance of these considerations. To some extent, the discussion about what system of corporate governance and the discussion of what organization for the market for corporate control has this element of competition for corporate headquarters.

Let me talk a little bit about the analytical content of the American view. The American view is in some sense inherited from an older debate, about market oriented versus bank oriented systems of corporate governance. Continental systems being identified with banks and the Anglosaxon systems being identified with markets. So in terms of substance, there are three basic propositions to be considered. First, market dominated systems based on shareholder protection are more efficient. Secondly, the allocation of power between different parties and different institutions in market dominated systems is different from that in bank dominated systems. And thirdly - and this is something that you see most outspokenly in the work of Rajan and Zingales - bank dominated systems are on the way out and market nominated systems are on the way in. I suspect the evidence there is based on experience until the year 2000. It is not clear how subsequent developments have been, or what fit into this empirical assessment.

If you look at the conceptual basis of these propositions, it seems to involve basically the following elements. First, corporate governance is about the protection of financiers' rights, in particular shareholder rights. In the survey by Shleifer and Vishny on the subject, you find quite explicitly the proposition: Corporate governance is about making sure that financiers get some return. There is an exchange going on: Finance versus control. Secondly, if financiers do not have sufficient control, finance would be rationed. Rationing of finance leads to inefficiencies. Thirdly - and this is the La Porta et al. view, it may also be the view of

London based investment funds - that common law provides better support for control by financiers. To the extent that this last statement is actually true, it would imply that if we have an internationalization of the market, an international opening of the market for corporate control, continental European locations would have a problem and be at a competitive disadvantage.

Now let me question these various propositions. The first proposition that I want to question is whether the American system of corporate governance is really all that much more shareholder friendly than the European systems of corporate governance. I deliberately exaggerate a little bit in order to get the point across, and subsequently, I will revise the exaggeration. Observation: while rhetoric about the shareholder value expanded in the 1990's, immunization from shareholder interference expanded in tune. The years from '89 to '95 were years where corporate managers introduced "poison pill" amendments into their corporate charges in order to make hostile takeovers difficult, if impossible, where corporate managers re-incorporated their institutions in the state of Delaware, which is precisely very management friendly, and finally, where Delaware Courts adjusted their jurisdiction more and more in the direction of corporate managers' wishes. This suggests that to the extent that there has been a trade of finance versus control, the trade has not been all that effective, and that control by outside shareholders may be just as difficult in the context of the United States as it is in the European context; only the mechanisms are different.

I would like to propose a different interpretation of the American financial system of corporate governance. It is true it is a system where banks do not have much influence on corporations. The notion of the main bank relation that we used to have in German and in Japan hasn't played much of a role since the 30s. However, this does not mean that there has been much control by markets. To some extent, one can actually see the market as a liberating device for management, relying on a dispersed population of outside shareholders, which makes it much more autonomous then having to rely on a single or a set of five or six bankers. Shareholder protection legislation and regulation in the U.S. - and this has been documented by various authors - has actually served to make sure that concentration of control, power in the hands of shareholders would be difficult. So, for instance, inside the trading regulation, it has the effect of preventing investment funds that want to make sure that their assets are liquid, from actually taking much of a say in corporations.

We may also wonder, if we look at the 90s, whether shareholder value rhetoric has not just been a disguise for personal enrichment. Hostile takeovers did not take place. Friendly takeovers did take place and were paid very well. Treatment of accounting for options given to managers, legal stipulations in this respect would provide support for the view that the regulatory framework in the United States is one that actually is very much in favour of corporate management, which reminds me of a statement by a German banker of over a hundred years ago - of course in a completely different system of governance - "Shareholders are stupid and impertinent; they are stupid because they give somebody else their money without any control, and they are pertinent because they want a reward for their stupidity in the form of a dividend."

In both cases, we have systems where insider power plays an enormous role, power of corporate management on the inside. In one case, it is insider power focused on the corporation. In the other case, it is insider power as part of a network, either involving banks or, what used to be the case in Germany, of involving a network of cross holdings of different corporations. Either system has the property, but it prevents outsider interference.

Interestingly, this observation that a system prevents outsider interference was first made in the American context by authors such as Roe and Bapchak.

So the first proposition is: can we be really so sure that the American system of corporate governance is all that different from the European systems? Or couldn't it be the case that both are systems where the people who manage companies, and by the very fact that they are managing, have advantages and information and initiative, make sure that they keep the position of power, albeit through different mechanisms? Reliance on the anonymous market as an institution that doesn't provide much interference there may be just as effective as reliance on the system of cross ownership, where you agree with your friends that outsiders are bad.

The second notion to be discussed is: is it really clear that a system with outsider control is more efficient? Superficially, the argument would be a system without outsider control doesn't get any outside finance raised; finance is rationed. This is a thesis which goes back to an old paper by Myers and Majluf, which finds itself reflected in the literature on cash flow sensitivity of investment activities, but it is at odds with the opposing view where corporate management wastes free cash flow, as proposed by Jensen. So the true problem, I would submit, is not so much a problem of rationing, at least when we are talking about mature economies where revenues that are available in corporations are relatively plentiful in relation to aggregate investment. The true problem is more a problem of match-up. What is the relation between the places where free cash flow arises and the places where we have investment needs?

The notion that a system without sufficient control by outsiders, in particular, by outside shareholders, runs into various objections. First, two empirical observations. One is due to Chandler's account of the second industrial revolution. In brief, his argument was that in the second industrial revolution, the United Kingdom fell behind because a system of personal capitalism, as he called it, involved large capitalists making lots of withdrawals, large capitalists being fearful of making the large commitments of resources that were needed in order to finance the investments that were needed to take advantage of scale and scope. He contrasts that with manager-run capitalism in the United States and in Germany, which enabled both U.S. corporations and German corporations in the late 19th century to take advantage of scale and scope in new industries.

The second empirical observation : Margaret Blair has shown in some historical research that the joint shock corporation was founded as a mechanism to establish trust worthiness, and that the problem in partnerships previously had been the partners who would be taking resources out of the corporation would, by the very fact that that they had this right, undermine the credit worthiness of the institution as a business partner for people delivering inputs as well as potential creditors. So the notion that the owners' control and ability to take funds out of the corporation has been dysfunctional in certain constellations.

So, let us address the issue from a theoretical point of view. Jensen's view that management is going to waste free cash flow is to some extent based on the notion that they are likely to waste this because, after all, if returns are not what they are supposed to be, there is an external effect on shareholders. If you actually take the view that management has discretion over the use of company earnings, that extra knowledge does not play much of a role, because in a sense management is a residual claimant. If management makes a bad investment, the consequences of that bad investment do not necessarily fall on outside shareholders. First of all, they fall on management, which has less play money for subsequent investments, Empire Building and whatever way it can be thinking of.

I am proposing here a slightly alternative perspective to what is the role of the financial system. The traditional view of the financial system, which is very much underlying this notion of a deal of finance versus control, is viewed on the financial system as being a set of institutions that make households willing to provide funds to corporations, and they are willing to do so because they get a return. Reverse the pattern of the question and just ask: How do we get funds from companies that have excess cash flows to places where investment is taking place? Internal finances, one channel; distributing funds to the household sector and having them reinvested through the market is another channel. How do we know which one of these two channels is better, or we don't? We don't have much of a good theory for this. We could of course point to the fact that the American oil industry wasted free cash flow from known wells with excessive drilling which was not very profitable. We could point to the fact that a company like Daimler in the 1980s wasted funds by using profits from automobiles in order to subsidize losses in electrical appliances in, well, the Airbus, among other things. But then we have the instance of a company like Mannesmann, using profits from engineering activities in order to invest very profitably in mobile telecommunications. The examples that we have don't tell us anything about the system, and if we think about the system, we find that we have agency problems in external capital markets and agency problems in internal capital markets, and we don't really know which ones are worth. In internal capital markets, a major issue seems to be incumbency buyers. Those groups and sectors that are represented in the company will get a share of their cake even if their investment opportunities are not very good. It may also have the effect that the presence of a cash cow reduces effort all around.

In external capital markets, one issue that we have to worry about is the issue to what extent the nexus between companies, investment banks, brokerage firms isn't introducing a certain amount of waste through fees and hype. Mergers and acquisitions are wonderful for the investment banking community and for the financial press, but it isn't so clear that they are always efficiency enhancing. We also have this issue of the power of disruption through external capital markets, which plays a role in quite a number of instances. Well established patterns of interaction tend to be disturbed.

Let me now get back to the issue of what is the difference between U.S. and Europe. I think there is one, but it is not so much -- but it tends to be exaggerated in the, say, the Washington Consensus. It has a lot to do with the role of fiduciary duty, the fact that shareholders, if nothing else works, have a legal claim for managers to be fulfilling fiduciary duties. This supports, if nothing else does, the workability of markets, and in that sense, supports at least to a greater degree than we have it in Europe, the notion that we have an ability of corporate entities to take recourse to financing in markets, and something like the mechanism which we observe of corporations, buying back stock and reissuing them, which they use as a reputational device, reputational commitment device, would support that.

Remember I said previously availability of the market is a mechanism that supports management autonomy. So they actually have a stake in this as a public good, and this stake is to some extent supported by the role of the legal stipulation of fiduciary duty. This is not just a matter of relevance for organized stock markets. It is built over -- and this is where we are very close to Ulrich Hege's talk, to the viability of unorganized share markets, like venture capital markets, which rely on the availability of organized stock markets for their exit options. I mean my spontaneous reaction to this morning's talk would have been that, in

Europe, exit options are much more difficult; to have an exit in the market is much more difficult to have than elsewhere, than in the U.S.

Where is this important? Well, it is important, these types of mechanisms, in situations where structural change requires you to do entirely new things, and I don't think it is by accident that the prominence of venture capital and the ascendancy of the American type financial system has been connected with the new economy, IT and biotechnology, new technologies which were to some extent outside the domain of vision of established institutions. Example: the German chemical industry is wonderful at doing lots of things in their own areas, but they were very late in recognizing the importance of the shift of a pharmaceutical paradigm from new chemical entities to biological processes. That is a version of incumbency buyers where the presence of the people who take decisions and have certain visions prevents them from seeing new things arising. So that would be a type of situation where this openness at the margin provides an advantage to the American type system. However, if you look at the simple question of due differences and performance over the past 150 years permit any influence about one system being drastically or significantly more efficient than the other, I doubt that you can.

I suspect that the political importance of differences in governance may actually be much greater than the economic importance. Political importance: you should ask yourselves what are the reasons why people don't like open takeover markets, and open markets for corporate control. Now I am not referring to corporate managers who of course don't like to be displaced, but I am referring to all the various stakeholders that corporate managers mobilize as allies, labour unions, local newspapers, politicians. The example of the Krupp-Thyssen takeover attempt will be a good example. Why is it that they are so easy to mobilize? There are basically two reasons. One of them, they have something to gain in sharing in the resources that corporate managers have their hands on. Don't we all love corporate sponsors, at least if they think of us rather than somebody else. Secondly, there are lots of externalities from having a corporation with a relatively stable existence in the neighbourhood and lots of externalities from having corporate plans disrupted on a regular basis. Reorganization of the American industry in the 1980s in the takeover wave of the 1980s was not entirely painless for the various stakeholders involved.

What are the counter-arguments against the desires for stability? Well, the first one, if you look at distributive measures that make it difficult for outsiders, for outside financiers, to get a return on their investment, that impedes the openness of the entire system, and this is where I am thinking of the 3 billion that Thyssen shareholders lost through intervention of the political system. The second objection, again incumbency buyers is: we look at the shop keepers, the workers, the newspaper publishers and distributors in the neighbourhood of existing firms, but we don't see the fact that if resources are forcibly distributed, for instance, through the payment of a takeover premium, and are reinvested elsewhere, there will be workers, shop keepers, newspapers and so on, politicians, in other places.

There is a famous article by Shleifer and Summers on corporate takeovers as ventures of trust talks only about the stakeholders in the neighbourhood of existing companies; it doesn't say anything about the opportunity costs in terms of externalities for stakeholders of companies that are not been funded because the system is closed.

A more important objection, as far as I confirm in my opinion, is an issue that these structures give rise to a certain lack of accountability. Having stable structures is nice because it allows a give-and-take between different institutions in a stable social system. To some extent, the public sector, cities, labour unions, the media and the corporations play out a repeated game and use the advantages of informal arrangements in the repeated game which consent anything that you can contract upon. At the same time, there is a lack of accountability. You tell to whoever you are responsible to: "I would really love to follow your interest, but I have to take account of such, such and such", which is precisely the corporate manager telling his shareholders: "I would love to take account of your interest, but I am responsible for the overall economy, including the workers, including the customers, and therefore I cannot do this". It is all very nice, but the manager who is saying this is not meaning: "I am accountable to the workers", or "I am accountable to the customers". What he really means is: "Don't meddle", which suggests that the ascendancy of shareholder value rhetoric in the 90s at the same time as shareholder control rights were being reduced. It may also have had much more to do with trying to readjust the terms of trade in these informal relations, rather than anything that was meant seriously.

A final problem that I see for political and social systems concerns a problem of openness there. If I go back to the Thyssen-Krupp example, where there was a notion that money is not a legitimate source of power; position and hierarchy is a legitimate source of power, which means that power is acquired through playing according to the rules of the game. This is one reason why established structures don't like open markets for corporate control, which goes back to a very old point that Marx, who was one of the admirers of capitalism, once made; he treated capitalism as being very revolutionary, because, whereas under feudalism, rank and power depended on position and hierarchy, and that capitalism provided money as an alternative source of power, which is of course why from feudal structures to more socialist structures, capitalism has never been liked. However, I personally think that actually for political systems and social systems, having close hierarchical structures is a very bad thing, and, therefore, some greater degree of openness than we have at the moment in Europe would be desirable.