De Universiteit van Amsterdam UvA

Amsterdam Center for Law and Economics

ecgi
european corporate governance institute

The Law and The Balance Between Discretion and Accountability in Corporate Governance

Alessio M. Pacces
Professor of Law and Finance
University of Amsterdam

Corporate Governance: Search for the Advanced Practices
February 28th, 2019

Outline

- Motivation
- The Issue
- The Theoretical Framework
- The Corporate Governance Implications
- The Solution: Dual Class Recaps
- Other Proposals

Motivation

- Hedge fund activism → polarized debate on short-termism in corporate governance
- Both camps seem to have a point
- However, look at shareholder activists

"Activist investors are like UPS drivers. They turn in only one direction. […] **The vast majority are making similar demands of their targets**, delivered with what now feels like a dull percussion: Raise the dividend, buy back shares, cut these costs, spin off that division, sell the company. […] **Many times they are right**… **[But why] can't activists find targets where the misallocation is going the other way?** In other words, identify companies that are **playing it too safe**, perhaps pushing too much into dividends or buybacks. Or missing a great opportunity in a new market."

"A Radical Idea for Activist Investors", *Wall Street J.* (27 Jan 2015)

The Issue

1. Exposure to HF activism depends on accountability
   - HF influence → institutional investors onboard
   - Management accountability → need to justify to investors
   - Unjustifiable action → HF engagement (overt or covert)
2. Discretion-accountability balance
   - Management accountability → less mistakes, shirking, and stealing
   - Management discretion → more entrepreneurship, perhaps long-term
3. Law matters
   - Distribution of corporate powers set by law
   - Depends on the jurisdiction // articles of incorporation
   - Can be altered midstream, but that's hard

The Framework

1. Justification cost as Agency cost
   - Justification protects agent's downside (adverse outcomes)
   - Ex-ante: incentive to choose actions easier to justify
   - Agency cost insofar actions depart from principal's best interest
2. Justification cost vs traditional Agency cost
   - Justification → accountability → lower monitoring/bonding cost
   - But, justification cost may lead to residual loss > monitoring/bonding cost
3. Striking the right balance
   - In some contexts, justifiable actions most sensible thing to do
   - In other contexts, cost of "playing too safe" > benefit of accountability

The Problem: Uncertainty

1. Process accountability and Outcome accountability
   - Good outcome, soon enough → outcome accountability
   - No good outcome, maybe later → process accountability
   - But what if there is no standard procedure to deal with the situation, or the standard procedure is not the best way to decide?
2. Uncertainty makes justification harder
   - Justifications based on probability distributions (bad outcome → bad luck)
   - Knightian uncertainty: no reliable probability distribution
   - Justification → avoid uncertainty → seek quick outcome / justifiable failure
3. Where uncertainty is higher, justification cost is higher
   - Some industries must be entrepreneurial and deal with uncertainty
   - Playing it safe instead → Justification cost

Justification Cost in Corporate Governance

1. This isn't the usual short-termism story
   - Uncertainty → nobody knows the 'right term'
   - Managers may be long-termist as much activists may be short-termist
   - Debate can't be resolved empirically
2. However, justification generates short-term bias
   - **OK**: Incremental innovation (short cycle) → timely feedback (Hirschman)
   - **Not OK**: Discontinuous innovation (long cycle) → play too safe
3. Adaptation is key
   - Kind of innovation fitting the company varies w/industry and over time
   - Example: telecoms yesterday and today
   - Example: automotive yesterday and today
   - What implications for corporate governance?

Corporate Governance Implications

1. Hedge fund activism may increase justification cost
   - Activists want streamlined, justifiable strategies → standard playbook
   - Often best thing to do, but not always (entrepreneurship overkill)
2. Institutional investors are no panacea
   - Activists propose, institutions dispose → index funds pivotal
   - Index funds vote, but have no incentive to screen idiosyncratic strategies
   - They too have to justify (to investors) → justifiable, standard strategies
3. Neither are controlling shareholders
   - Majority of companies worldwide have controlling/dominant shareholders
   - But, dominant shareholders can still be outvoted → room for activism
     - E.g. in FR, DE, IT, SE = some 20% of listed companies
   - Minority shareholder protections → room for activism

Our Solution: Dual-Class Shares

1. Standard contracting for leeway / less justification at IPO
    - 10% of U.S. main indices are dual-class companies
2. Hard to introduce midstream
    - Recaps with voting stock prohibited in the US, must be non-discriminatory in Europe
    - Loyalty shares seem to provide a way out
3. Fix that: Dual Class Recaps
    - Super-voting stock for managers / controlling shareholders
    - Institutional investors should have veto rights
        - Effectively setting the price → the wedge
        - MoM vote + SC advice (as Del.Ch. MFW 2013)
    - Default rule:
        - Sunset unless parties opt out (spares distributional concerns)

Why Other Proposals Fare No Better

1. Curbing hedge fund activism
   - Tightening the ownership disclosure window (e.g. SHL rights Directive)
   - Deprives of feedback mechanism also companies that need it
2. Loyalty shares
   - Apparently supporting long-termism, effectively enhancing control
   - Can be introduced midstream, investors have no veto
   - Can be abused by dominant shareholders (French Gov, FCA automobiles)
3. Dual-class shares with mandatory sunset
   - Bebchuk & Kastiel (2017), getting some traction among institutional investors
   - Not clear why sunsets should be mandatory
   - Their worry is only in one direction (leeway becoming excessive), why not also excessive accountability → justification cost?

Hungry for more?

- Claire A. Hill and Alessio M. Pacces (2018)
  "The Neglected Role of Justification under Uncertainty in Corporate Governance and Finance"
  Annals of Corporate Governance: Vol. 3: No. 4, pp 276-407 http://dx.doi.org/10.1561/109.00000016

Thank you very much for your attention

Questions, Suggestions, Remarks?

a.m.pacces@uva.nl