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3 SHAREHOLDERS AND STAKEHOLDERS

Learning objectives

- to explain the cornerstones of evolution of corporate governance
- to describe the role of law and regulation in corporate governance
- to conclude on the importance of corporate social responsibility in corporate governance
- to explain why corporate governance matters nowdays

Key concepts and terms

- the corporation
- stock exchange
- Securities and Exchange Commission
- mergers and takeovers
- pension funds
- corporate governance
- corporate law and regulation
- code of best practices
- corporate ethics
- corporate social responsibility

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3.1 SHAREHOLDERS

1. Introduction

Although shareholders own corporations, they often do not run them. Shareholders elect directors, who appoint managers who, in turn, run corporations.

Although managers and directors have a fiduciary obligation to act in the best interests of shareholders, this structure implies that minority shareholders face two separate principal-agent problems, i.e. vis-à-vis the management, which is naturally concerned with its own welfare, and also vis-à-vis the directors, who may be beholden to particular groups. The many mechanisms of corporate governance described in this text are designed to align the behaviour of all parties with the best interests of shareholders broadly construed.

The idea that the welfare of shareholders should be the goal of the corporation stems from shareholders.status as .residual claimants. Other stakeholders in the corporation, such as creditors and employees have relatively specific claims to the cash flows of the corporation. In contrast, shareholders are uncertain as to when or how much they will realize from their investment in the corporation, getting their return on investment from the residual only after all other stake-

holders have been paid. Theoretically, setting shareholders as residual claimants imparts the strongest incentive to maximize the company's value. Because corporations are an important societal institution for allocating capital, this also benefits society at large.

Shareholders are distinguished as minority, or small, shareholders and large shareholders, comprising controlling blockholders and institutional investors

This chapter considers the interests and powers of shareholders. It is useful to distinguish among: 1) minority, or small, shareholders and; 2) large shareholders, comprising controlling blockholders and institutional investors.

Small shareholders are investors whose holdings are small in absolute terms and relative to the corporation's total outstanding shares, and are often a small part the investor's total portfolio. With only a small portion of the corporation's outstanding shares, these investors have little power to try to control the board of the corporation. With only a small share of their personal portfolios invested in the corporation, these investors have little motivation to control the corporation. These shareholders are typically passive investors interested only in favorable investment returns; they might not even bother to vote for directors. Their active role in governance is usually to sell shares if not satis.ed, or to refuse to invest in the first place.

In contrast, large shareholders may have a sufficient stake in the corporation to justify the time and expense necessary to monitor management actively. These large shareholders might be controlling blockholders or institutional investors, such as mutual funds, pension plans, employee stock ownership plans, banks (outside the U.S.), or other institutions. Their stake in the corporation might be only a minority of the corporation.s outstanding shares but large enough to motivate active engagement with management.

Nevertheless, some large shareholders, especially institutional investors, can be just as passive as small shareholders. Their chief interest is to achieve favorable investment results, and they might have little appetite for corporate management. Political or legal constraints may discourage their involvement, and also prevent their ownership share from becoming too large. Moreover, they face a "free rider" problem in that other shareholders would also benefit from their efforts to monitor management, but do not share in the costs.

Controlling blockholders are those with enough shares under their control to dominate or strongly in.uence the board of directors and therefore to choose management. These shareholders might help to resolve a serious agency problem for other small and large investors by monitoring management. They have the legal and financial power to act and the motivation to do so. Unfortunately for other shareholders, controllers also represent another agency problem. They might use their votes and influence to take disproportionate benefits, using their positions to engage in self-dealing or tunnelling (terms discussed below).
Patterns of shareholding and the presence of particular governance arrangements can be mutually reinforcing. For example, relatively illiquid markets for corpo-

rate stock might result in large blockholdings of stock which, in turn, might encourage legal protections of small shareholders to remain relatively underdeveloped which, in turn, might cause markets for stock to be relatively illiquid, and so on. Alternatively, stringent laws against self-dealing by majority shareholders might discourage large blockholdings which might, in turn, cause small shareholding to be common which, in turn, might increase political support for strict anti-self-dealing laws, and so on. The former type of cycle discourages investment by outsiders, just as the latter attracts it.

2. Minority Shareholders and Shareholder Rights

Shareholder rights are determined by the laws under which a corporation is created and vary from country to country and among sub-national jurisdictions

Shareholder rights are determined by the laws under which a corporation is created. These vary from country to country and among sub-national jurisdictions, such as the U.S. states. In some systems, such as under Delaware law in United States (which governs most large U.S. corporations, because they have chosen the State of Delaware as the site of their incorporation or legal corporate home), shareholders have legal primacy. Their status is also pre-eminent under British law. In other countries, or even other U.S. states, corporations may be legally enabled or legally bound to consider additional constituencies. An example of the former is the multiple constituency law of Ohio, a large U.S. state, under which corporations are permitted to trade o¤ some shareholder interest for the bene.t of other stakeholders. An example of the latter is the "Rhenan capitalism" system of co-determination, under which German labor unions have had very strong standing in corporate governance. Note that these variations imply that the .rst sentence of this chapter: "Shareholders own corporations…", provides just a rough sense for the legal status of shareholders, which varies across countries.

More developed countries' corporate governance systems typically provide shareholders the rights to: 1) vote for directors; 2) vote on, or even initiate, proposed changes to the corporation.s articles or by-laws; 3) vote on, or even initiate, proposed fundamental changes, such as mergers or dissolutions; 4) vote on proposed dividends; 5) participate in shareholder meetings; 6) pre-emptively purchase newly issued shares; 7) initiate and vote on "precatory" proposals that are not binding on management.

Even with extensive shareholder rights, corporate governance is not direct shareholder democracy. Directors, as fiduciary representatives of the shareholders, have the direct governing role. In particular, shareholders do not vote onmanagement, or choose the size andmethod of compensation for management. Further, shareholders who are unhappy with proposals approved by the board of directors face enormous difficulties having counter-proposals considered by their fellow shareholders.

Boards of directors are self-perpetuating in that nominees for the board are usually chosen by existing board members. In theory, a shareholder dissatis.ed with

the existing board.s policies or nominees can solicit proxy votes from other shareholders and to attempt election of more satisfactory board members. However, even large minority shareholders can face significant difficulty in removing an unsatisfactory board. Accordingly, successful proxy fights are a rare method of changing corporate control. Shareholder suits against directors are difficult to successfully prosecute. Takeovers, in which an outsider tenders for or otherwise purchases a majority of shares, are also expensive and relatively rare (though highly publicized). Thus, small shareholders depend heavily on the integrity and effective functioning of the board.

Given the difficulty of removing an unsatisfactory board, discontented minority shareholders generally solve their problem by selling their shares. This is to be expected from passive investors with no interest in active management. Yet the driving ethos of corporate governance is to protect exactly these disengaged investors. Is this sensible? Why, when individual harm is so relatively small and so easily ended, should corporate governance be an important economic, social, and political agenda? Two justifications stand out: 1) the collective harm from weak governance; 2) the integrity and e¢ ciency of the capital markets and the overall economy.

When corporate governance is weak, management can engage in expropriation, entrenchment, and empire-building, all to the detriment of shareholders, and large shareholders can exploit small shareholders. Good corporate governance should prevent or mitigate management's or large shareholders' bad behaviors and improve the returns enjoyed by shareholders. Weaknesses or failures of corporate governance will likely cause shareholder returns to be sub-optimal. While the harm done by management to one well-diversified investor at a given firm might be minimal, this harm does not exist in isolation. Other shareholders at the same firm will be similarly harmed and the collective harm can be very significant. Further, if there are weaknesses in corporate governance that allow misdeeds at one .rm, it is likely that the same weaknesses are being exploited at many other firms as well.

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Therefore, good corporate governance is essential to the integrity and efficiency of the capital markets. Individual, relatively small investors are unlikely to invest their money in markets that they judge to be rigged for the benefit of insiders. Participation in the capital markets by numerous, small, dispersed, and disengaged investors is a key indication of success for the prevailing corporate governance system. Broad, deep, and efficient capital markets promote efficiency in the overall economy by allocating capital to its best uses and withdrawing it from sub-optimal uses. Good corporate governance promotes essential social and economic welfare. Further, the fact that corporate governance is substantially successful in certain countries is not reason to be complacent; even relatively small misalignments in corporate governance can have absolutely large negative effects.

Good corporate governance promotes essential social and economic welfare

Because corporate governance underlies minority investors' confidence to invest at all, the extent to which small shareholders are a sizeable share of companies' ownership structure varies across countries. Economies where legal systems and firms' internal governance setups are focused on shareholder protection exhibit a sizeable proportion of large companies with a majority of shares owned by small shareholders (such as the U.S. and Great Britain).

Others, even large Western economies do not, whether their laws and governance structures focus on the rights of non-shareholder constituencies (e.g., Germany) or where the rule of law is not so certain (e.g., the Philippines). For a review of the connections between shareholder rights and the robust development of .nancial and economic systems, see Beck and Levine (2004).

For economic reasoning and evidence on legal systems and shareholder rights, see La Porta, Lopez de Silanes, Shleifer and Vishny (1998). For reasoning and evidence on the limits of law in determining corporate governance, an analysis of the importance of politics, and a characterization of the corporate governance setup in seven representative developed countries, see Roe (2003).

3. Large Shareholders

Adam Smith pointed out in 1776 that employees and managers may work less hard and make different choices than owners would. This principal-agent problem is at the heart of corporate governance. For companies with dispersed small shareholders, the problem is exacerbated because possibly no shareholder's interest is large enough to justify a substantial monitoring and enforcement effort.

Large shareholders, whether they are owners on their own account or institutional investors who invest on behalf of others, can be a blessing or a curse when it comes to corporate governance. These investors provide a possible solution to the owner-manager principal-agent problem. Large shareholders, precisely because they own a large equity position in the firm, possess sufficient control rights to effectively monitor and discipline management. Just as important, protecting the value of their large positions provides the incentive to undertake these activities. This is the blessing of large shareholders. The possibly-accompanying curse comes in the form of self-dealing, tunneling, rigged transactions, private use of corporate resources, and other schemes that use the large shareholders greater degree of control to shift an undue proportion of corporate resources to benefit the large owner. The specifics of these schemes vary. Large shareholders might cause the corporation to enter into any number of transactions on terms that are beneficial to them but disadvantageous to the corporation. For example, the corporation might hire a large shareholder, or one of a large shareholder's other business interests, to serve as a consultant or as management for the corporation; or a large shareholder might cause the corporation to buy, sell, or lease assets at non-market prices that are disadvantageous to it but that benefit the large investor; or a large shareholder might transact in good

or services with the corporation at non-market prices that benefit that large shareholder.

An example illustrates how some of these transactions might occur through a typical pyramid ownership structure. Suppose “Controlling Shareholder” owns 51% of Corporation A, literally controlling it. Corporation A owns 51% of both Corporations B and C, thereby controlling both of them. Corporation B owns 51% of both Corporations D and E. Corporation C owns 51% of both Corporations F and G. By this arrangement, Controlling Shareholder controls every one of these companies. Yet, at the level of Corporations D, E, F, and G, Controlling Shareholder (with 100% control) is entitled to just 13.3% (0:51 -0:51 - 0:51) of the cash flow from these businesses. It is unlikely that Controlling Shareholder would be the best guardian of the interests of the shareholders owning the other 86:7% of Corporations D, E, F, and G. Indeed, since e¤ective control can usually be established with less than 51% of the stock of a corporation, the situation in many actual pyramid arrangements is even more imbalanced than shown here.

In a self-dealing, abuse of, for example, Corporation D, Controlling Shareholder might cause Corporation D to transact business with Controlling Shareholder or with one of Controlling Shareholder’s other unrelated businesses on terms that are disadvantageous to Corporation D. Evidence of self-dealing is taken seriously in corporate law, and is often enough to overturn the legal presumption that “business judgment” should be given wide berth. In a “tunnelling” abuse, Controlling Shareholder might cause Corporation D to transact business with Corporation A on terms that are disadvantageous to D. This would serve Controlling Shareholder.s interests because it is entitled to 51% of the cash flow from A, versus just 13:3% from D. Tunneling abuses often involve internal or “transfer” prices for intra-group transactions, and so can be very difficult to observe directly. Zingales (1994) recounts the story of one very public situation involving IRI, an conglomerate firm owned by the Italian state (and therefore a “state-owned enterprise” or just “SEO”). In 1992, IRI sold its 83% stake in software firm Finsiel to telecommunication firm STET, in which IRI had a 53% stake. As the controller of both Finsiel and STET, IRI was in a position to set the terms of trade as it liked. Because of its larger stake in Finsiel, IRI would benefit directly if STET were to overpay, and STET’s minority shareholders would be the losers. This is exactly what appears to have occurred, as the deal was priced at a large premium to the market values of similar firms.

The roles played by large shareholders vary considerably across different circumstances. Non-institutional blockholders, including founding and controlling families, bring a strong dose of both the blessing and the curse. State owners are usually thought to bring an undue measure of curse. Institutional owners, including banks, pension funds, and investment funds, are not usually thought to bring much of a curse, but may not be very effective in securing benefits either.

There is no perfect structure, only the hope of an effective balancing of interests that will result in a highly-productive corporation.

For statistical evidence on ownership structure around the world, as well as some detailed examples involving large corporations in large economies, see La Porta, Lopez de Silanes, Shleifer and Vishny (1999). For case stories involving pyramid ownership structures for smaller companies in smaller economies, see IFC (2006).

3.1 Families

Ownership by a dominant family is a common starting place for a corporation. The founder may involve family members in management and financing for various reasons including convenience, skill, trust, and a need for capital. Historically, families have been especially important in industries where trust is paramount to profit, as with the Rothschilds and Morgans in banking. As time goes on and the company grows, ownership may remain in the family. Especially in economies without strong small-shareholder protections, outsiders, understanding that they would not be e¤ectively protected from family expropriation, shy away from providing financing or buying ownership rights on any terms that the family would find acceptable. This may be additionally detrimental to the firm's value over time, because there are only weak reasons, at best, for thinking that managerial skill would be centered in the line of the founder.s descendants. Thus, in some economies, family ownership of a large segment of the economy.s productive capacity may be more or less inevitable. But it is in general not most desirable for creating economic value.

With stronger shareholder protections, economies tend to develop more extensive and deeper financial markets. In such economies, firms that become large enough and have strong enough needs for outside financing may eventually become more widely held and family control may become diluted.

With stronger shareholder protections, economies tend to develop more extensive and deeper financial markets

Even in the latter situation, families sometimes retain a dominant role in setting the broad course of the company. Evidence suggests that this continuity and steady direction can be value enhancing, especially when the family does not continue to directly manage the operations. This may be why families continue to play a central role in some countries that are reputed to have strong corporate governance. In Sweden, for example, the Wallenberg family controls or heavily in.uences a large proportion of the country's industrial structure, including such companies as ABB, Ericsson and Electrolux, via the family's foundations and its Investor AB investment vehicle. Investor AB generally controls a larger proportion of votes relative to its cash-flow rights. Even in this Swedish case, however, the stock market portfolio has sometimes traded at a substantial discount to the value of assets, leading to speculations that a fully-private structure might be more appropriate. Family leadership has consistently maintained that taking the

long view, even nurturing companies for decades, is in the interest family and non-family shareholders alike.

The history of the automobile industry provides a very interesting and dynamic perspective on family in.uence. Early in the 20th century, Henry Ford built a company, a dynasty, and, in large part, an industry. His vision transcended his own generation, and, almost 100 years later, his family is central to the identity of the corporation. Yet the second third of the 20th century saw General Motors ascendant in the industry. GM, in that era, was an agglomeration of formerly independent brands that developed into a world-wide enterprise under the strong influences of three unrelated individuals: a visionary entrepreneur (William Durant), a committed and deep-pocketed strategic owner with a commitment to fiscal responsibility and professional management (Pierre DuPont), a penetrating, far-sighted

CEO (Alfred Sloan). Whereas Henry Ford.s ethos brought continuity, it also leaned against a broadening of the core concept of what a car could do for and represent to its owners. Losing the lead in management, Ford also lost the lead in design. More recently, General Motors has itself been eclipsed by Toyota, another .rm with strong family in.uence (the Toyoda family).

There appear to be times in the life of a company, and perhaps even in the life of an economy, for the unified vision brought by family owners, but the time is not always at hand.

For some extended histories/case studies of families in industry, including several in the auto industry, see Landes (2006). For a theory of family ownership along the lines described in this section, see Burkart, Panunzi and Shleifer (2003). For evidence on family ownership and management, see Villalonga and Amit (2006). For a review of the reasoning and evidence, see Morck and Yeung (2004).

3.2 State Ownership

State ownership of major corporations is a common form of corporate governance. Especially in less-developed countries and in those without strong shareholder protections, the state may be the only means of bringing large amounts of capital to bear. In the absence of state ownership, large corporations might be impossible. State ownership, however, is inherently political.

Almost always, the state will infuse the corporation with goals other than value maximization. It is especially likely that the state will sacrifice value to consolidate the political power of some ruling group or to further the social welfare of labor.

The absence of both value-maximization goals and of the discipline that comes with a natural-person residual claimant is deadly to minority shareholder interests

Non-political aspects of the performance of state-owned enterprises are difficult to assess precisely, but are generally thought to be dismal. The absence of both value-maximization goals and of the discipline that comes with a natural-person residual claimant, combined with the potential for outside shareholders to be expropriated using the force of the state, is deadly to minority shareholder interests.

Since the 1990s, the world has experienced an unprecedented wave of privatization. This has been driven partly by the dismantling of communist economies, and additionally by globalization and the spread of the capitalist model (causes that have been, in turn, driven by both politics and economics). A variety of methods, including voucher systems, direct foreign investment, public .otation, and outright theft have been employed to transfer control from the state to private hands. Privatized companies have seldom moved to an atomistic ownership structure, but have most often come under the control of their former managers or foreign strategic investors. Foreign financial investors have not been as common.

It had been hoped by those holding the view that in the mid-1990s became known as the "Washington Consensus" that this "Big Bang"of privatization, along with borders open to capital flows, would naturally lead to demand for property rights, fostering good governance and good corporate governance. This has occurred in some cases witness a number of Soviet bloc countries that have been able to join the European Union, but not so uniformly or quickly as had been hoped. More recently, others have argued that, without prior well-developed institutions, such a view is wishful thinking, as uncertainly about future law and future capital encourage short-term opportunism. For a review of studies on privatization and its economic outcomes, see Megginson and Netter (2001), and, for a book-length treatment, see Megginson (2005).

3.3 Individual Blockholders

Individual blockholders are at the fulcrum of the teeter-totter of positive and negative e¤ects of large shareholders on minority shareholders. On the one hand, they have both the incentive and the ability to effectively oversee management. One the other hand, their meddling may stand in the way of professional management effectiveness, and their use of corporate resources for private benefit may more than offset the value of their monitoring of management.

Management itself might be a blockholder group, especially with the support of private equity firms and through leveraged buyout mechanisms. The historical evidence suggests that management buyouts are a strong force for reorganizing a company's operations and creating shareholder as well as managerial value. Much of the value is realized when the company goes public again.

Individual corporate activists can sometimes be a force in corporate governance, either by force of their investment or by use of the media. T. Boone Pickens and other corporate raiders, prominent in the U.S. in the 1980s were well-organized activists who enacted their strategies via the takeover markets. Sears was embarrassed into changing its corporate strategy in the early 1990s by a group of activists who worked via public relations and the press. A multi-year campaign for change by several active investors, including George Soros, eventually resulted in the sale of Waste Management to a much smaller firm in 1996. In 2007, the CEO of Home Depot was effectively pressed to resign in an effort spearheaded by an activist with only a one percent stake.

Blockholders, whether by virtue of large outright positions or by virtue of control derived from pyramids or disproportional voting rights, may also have the ability to turn corporate resources to private use. An illustrative case is that of Conrad Black, in which Hollinger Corporation investors may have been defrauded of nearly $100M (U.S.) through egregious illegal self-dealing and (much earlier) Dominion Corporation pension claimants may have lost more than half that amount via legal means. In less famous cases, the use of corporate perquisites and related-party transactions quietly and continuously transfers wealth to the blockholder. Overall, the evidence suggests that the monitoring benefit of blockholders has outweighed the cost only in economies with strong legal protections. For a review of the blockholders and their importance in corporate control, see Holderness (2003).

The monitoring benefit of blockholders has outweighed the cost only in economies with strong legal protections

3.4 Institutional Investors

“Institutional investor” is a catchphrase that refers to any of a large set of managed investment funds acting on behalf of ultimate economic equity claimants. These include banks, trust funds, pension funds, mutual funds, and similar “delegated investors”. These investors add both another layer of agency problems and another opportunity for oversight.

The additional layer of agency problems begs the question “who monitors the monitor?” In other words, why should one expect that a bank or pension fund will look out for minority shareholder interests any better than corporate management? One response is that those who run institutional investing organizations may have purer motives than management: they should be strictly interested in a favorable investment return, for this drives most of their pay and reputation. Also, given reasonable financial reporting, they have less opportunity and motive than either management or other blockholders to engage in expropriation. On the other hand, the nature of institutional investors might make them passive, indi¤erent monitors. Specifically, managers of investment institutions might prefer the quiet life of not making trouble for fellow managers at their portfolio companies. Further, institutional investors might be banned by regulatory prohibition or by their own internal investment rules from: 1) acquiring more than a certain percentage of any one company’s shares, or 2) investing

more than a certain percentage of their investment portfolio in any one company. These percentage limits are typically low single-digit levels (e.g. 3% or 5%).

Although institutional investors are usually not aggressive monitors, there are exceptions. For example, CalPERS, the State of California employees' pension fund, has a long history of shareholder activism. It regularly assesses the quality of governance at corporations and has published an annual "Focus List"on which it identi.es a handful of companies whose poor governance has contributed signi.cantly to shareholder value destruction. Other public pension funds in the U.S. have recently been active in promoting shareholder initiatives on board elections and executive compensation. For a cross-country review of institutional investors, their activities and effectiveness, with an extensive reference list on the topic, see Gillan and Starks (2003). For political/legal reasoning and evidence with a U.S. focus as to why many types of institutional investors have not been active, see Roe (1994).

4. Conclusion

Economic thinking implies that shareholder interests ought to be paramount in corporate governance. Most nations.corporate governance systems give substantial prominence to shareholders.rights, though in some systems the rights of other stakeholder groups seem almost equally prominent. In every system, a number of agency problems stand between minority investors and the realization of the fullest gains of their investments. Moreover, not all shareholders are subject to the effects of these agency problems in the same way. All things considered, the effective reality of shareholder rights varies greatly across companies and countries.

In this chapter, we have used shareholder rights as a lens through which to view the nature and in.uences of several important classes of shareholders, including small shareholders, families, the state, blockholders, and institutional investors. Subsequent chapters discuss various mechanisms for protecting and balancing the interests of these shareholder groups.

Questions

- What is the justification for treating shareholder welfare as the paramount goal of corporate governance?
- Why should protection of minority shareholders be an important social agenda?
- How can large shareholders harm small shareholders? How can they help them?
- What are the pros and cons of long-termfamily domination in corporate ownership? What conditions make it more likely?

- Why might institutional investors not be diligent monitors of management?

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