The legal environment of corporate governance

by

Christian Harm

September 2000
1 The legal environment

Demb and Neubauer (1992) asked their interviewees to characterize the relative merits of various sources of corporate governance in different economies. Surprisingly, the roles of boards and owners was viewed as comparatively unimportant in the USA, when compared to regulation and ‘society’. While interview responses can be viewed as less reliable than empirical analysis of more ‘objective’ data, these observations would provide an explanation of the generally lackluster support generated by the (largely US-focused) empirical literature on corporate governance. We now turn to an analysis of the legal environment.

1.1 Accounting and disclosure requirements

In a perfect market, all the Law needs to do is to define property rights and enforce contracts\(^1\). In that spirit, Watts and Zimmerman (1986) argue that disclosure standards should emerge as solutions to individual contracting problems between firms and financiers. The complexity of legally mandated accounting standards for public disclosure suggests that the contracting costs of individualized reporting standards are prohibitive. Also, investors want to compare performance across firms, making standardization desirable.

Whether the reporting standard should be defined by a professional association or the legislator is a different level of debate. Whittington (1993) discusses the trade-offs between public and private regulatory bodies. While the latter suffers a potential enforcement problem in the presence of free-riders, the former may be less flexible in its evolution. Whittington argues that self-regulation is – at best – a transitory phenomenon. In practice, there is a division of labor between expertise (private standard bodies), and enforcement (the Law).

Another question is the suitability of accounting standards pertaining to corporate governance issues. Benston (1982) argues that accounting measures are too coarse to compete with governance mechanisms aimed at the accountability of individual managers. While accounting information can support a conclusion that “a firm is doing good or bad”, it is not suitable to support (and verify) a statement such as “a manager is doing good or bad”.

Hence, disclosure of corporate information based on accounting standards is necessary for distant investors to make a financial decision, but it is not sufficient to trigger managerial replacement or other individually targeted action. Moreover, recent evidence suggests that accounting data are anyhow just a very crude information source. Rangan (1998) and Teoh, Welch and Wong (1998) examine seasoned equity offerings in the USA to conclude that firms use available discretion to over-report earnings prior to such offerings, and that a significant portion of post-issue underperformance can be attributed to investors not rationally absorbing all available information.

Furthermore, Alford and Jones (1998) compare US companies with foreign firms listed in the USA, which are exempt from certain SEC registration and reporting requirements. They conclude that their evidence does not allow the inference that the less stringent requirements on the foreign firms leads to greater information asymmetries. Of course, a plausible explanation could be that listing requirements on US exchanges are stringent enough to signal firm quality to investors, and that SEC regulation adds only little value on top of that. In countries with less stringent exchanges, the Law may take a greater role. Accounting information and disclosure

\(^1\) Coase (1962).
standards can be thought of as a rather crude measure to aid investors, but they do have a role in helping markets to function ‘better’.

1.2 Regulation of shareholder voting: rights and conduct

Pound (1991) looks in detail at the role of the SEC in shaping a governance framework for market participants to act in. While the efforts of the SEC to regulate shareholder communication and voting must also be seen as an effort to limit (fraudulently motivated) market failure, the results seem to confirm the proverb: “The road to hell is paved with good intentions.”

Pound documents how the SEC’s efforts have increasingly stifled shareholder activism, possibly leading to further management entrenchment. In 1992, the SEC has changed its rules, but up to that point, a shareholder, who communicated his ideas to more than 10 other shareholders was acting in violation of SEC regulations. According to Pound, this has increased the cost of proxy fights substantially. Thus, proxy fights tend to focus on contests for full control, rather than on more marginal issues such as the divestiture of parts of a business. The regulation induced costs of proxy contests has reduced the effectiveness of shareholder activism.

A similar force was at work in Germany, albeit from a rather different corner. The 1976 Co-determination Law granting labor participants a seat on the board has consistently reduced the number of decisions which the management board has to present to the supervisory board for approval. The result was diminished communications between shareholders and management, which equally led to diminished shareholder activism.

Yet, in the spirit of the analysis of chapter 1, we might argue that this may not have reduced the value of the firm much, if any. Increased management entrenchment is only a negative, when managers can rightly feel that they are accountable to nobody. Neither in the USA, nor in Germany this is the case. In that sense – while not intended that way – legislation that reduces the effectiveness of shareholder activism grants some degree of independence on managers that is vital to execute efficient leadership in large organizations.

1.3 Regulation of takeovers

While disclosure laws and proxy regulation are passed so that markets can function better, takeover laws – especially those passed in the late 1980s in the USA – can serve to limit the functioning of markets. The literature on US anti-takeover laws has been discussed above, and has yielded mixed results. Similarly, we argued that takeover defense mechanisms installed by management rarely have negative consequences for shareholder wealth. Schwert (2000) argues that they merely improve the negotiating positions of target management. Then, a hardly noticeable effect of anti-takeover laws shouldn’t come as a surprise.

Yet, if anti-takeover defenses and laws are of limited importance, the US is – by itself – not a suitable laboratory to examine the effect of the relevant legislation. In a study comparing the UK, France and Germany, Franks and Mayer (1990) concluded that the different level of takeover activity in the three countries was to a significant extent due to regulation rather than market forces. Takeover legislation is then part of a whole package of financial market legislation, and the legislative portfolio has been shaped over time to yield an internally consistent regime, but one that may take very different forms.

We talked above about substitution effects between different governance mechanisms. What is true for different governance mechanisms invented by market participants seems to be equally
true for the legislative portfolio, albeit in a more inflexible framework over time. Takeover legislation may serve as an example for this pattern.

1.4 Corporate charters

The SEC and equivalent organizations in other countries regulate institutions that wish to sell financial claims in public markets. Yet, in most economies this is only a small fraction of companies, even when measured by the share of totally produced revenues they account for. All other firms have their degree of negotiating freedom limited at least in part by laws offering corporate charters.

A firm can decide between charters depending on whether it wants more than one shareholder, if these shareholders want to commit to the venture with their full wealth, if they want to limit their liability, if they want to receive their gains in the form of profits or improved purchasing conditions (co-operatives), or if they want to have traded securities that are easy to liquidate. Shareholders can decide which option appeals to them the most, but each option is regulated by the legislature: if you decide on a give option, you are bound by the rules. This is, of course, the argument by Hansmann (1988) that ownership is in part endogenous: firms structure in a way that they see fit.

We have mentioned above studies that examined the shift of corporate headquarters in the US to the State of Delaware, and found little effect. Yet, the set of choices to be examined is larger than taking one legal form and arbitraging between different varieties across States, but within the same national legislature. In the logic of Hansmann, the Law provides a self-selection mechanism, and firms optimize around the ‘grand choices’. Efforts to relocate to Delaware or reorganizing as a Master Limited Partnership in the US, or organizing as a GmbH & Co. KG in Germany will then be rather marginal ventures.

1.5 Regulation of the board of directors

One element of regulating corporate charters of public corporations is to prescribe form and conduct of the board of directors. In France, companies have the choice within the Law to select a monist or dual board. In Germany, the supervisory board is expressly prohibited to meddle in management’s operating decisions, and focus on supervisory activities exclusively. Yet, the Law fails to clearly distinguish between supervisory responsibility and operational decisions.

In the USA, board obligations and responsibilities are established by the business judgement rule stipulates that “directors make their decisions on an informed basis, in ‘good faith’ .... and that directors be disinterested and independent”. To make this concept operational, legal precedent has created the concepts of ‘duty of care’, and ‘duty of loyalty’.

Boardroom regulations in all countries share the problem that the Law tries to describe concrete phenomena that consistently resist a precise definition. Demb and Neubauer (1992) subtitle their book on corporate boards with ‘confronting the paradoxes’. The survey by Johnson, Daily and Ellstrand (1996) is unable to give a precise definition of what boards are supposed to do, exactly. Meanwhile, the Law defines categories such as supervisory vs. operational activities, or duty of care, without any guidance as to how to meaningfully interpret such concepts: “We don’t know

---

2 For a generalized version of this point of view, see Baums (1999).
3 Ciccotello and Muscarella (1997).
what directors are supposed to do; we only know that they have to do it ‘with care\(^5\).’ The
ambiguities left in the legal definition of board responsibilities give rise to frivolous law suits,
and disorientation on the side of directors: “Being on the board used to be a pleasure, then it
became an honor, now it is slowly turning into a burden\(^6\)”

1.6 Minority shareholder protection

The dispersion of ownership opens the door to a new agency problem between small
shareholders and large blockholders, who have more direct access to management. Holderness
and Sheehan (1991) describe organizational mechanisms to limit minority stockholder abuse in
the presence of a large owner at Turner Broadcasting by concentrating voting rights in the hands
of few ‘outside’ investors, and improving their voice in the board. Since organizational
mechanisms are arguably not always a feasible solution, the Law steps in to provide an
alternative protection mechanism for small shareholders.

Yet, the impact of such legislation is not uncontroversial. Becht (1999) examines the trade-off
between market liquidity, which provides a cheap exit option, and control, when illiquid markets
force large investors to engage in active monitoring. He argues that minority shareholder
protection Laws have competing effects on monitoring incentives and market liquidity. While
the primary effect is to encourage investment by small shareholders, thereby making markets
more liquid and reducing monitoring incentives for large shareholders, the secondary effect is to
encourage pyramidal holdings in the presence of one-share-one-vote restrictions.

The former prediction is supported by La Porta, Lopez-de-Silanes, Shleifer and Vishny (1998),
who find that the quality of investor protection legislation and ownership concentration across 49
countries are negatively related. Investor protection Laws tend to add to market liquidity. The
same authors (2000) find that the quality of minority shareholder protection Laws correlates
positively with the level of dividends firms pay across countries, thus shedding light on a direct
mechanism as to how shareholder protection legislation creates market liquidity.

1.7 The impact of the legal system as a whole

In a more broad-based study regarding the effect of the legal system on financial intermediation,
Demirgüç-Kunt and Maksimovic (1998) show that more efficient legal systems provide an
environment, where a greater proportion of firm growth is financed externally. This suggests that
the Law is successful in mitigating agency problems between providers and users of financial
resources. Similarly, Levine, Loayza and Beck (2000) demonstrate that countries with more
developed legal and accounting systems have more developed financial sectors, and that – more
importantly – a more developed financial sector can be causally linked to improved economic
growth.

These studies suggests that the Law is an important cornerstone to reduce agency problems
between firms and investors, and that they cannot be fully substituted by organizational or
market means. Thus, while we may believe that various market mechanisms of corporate
governance may substitute for each other, there is an incomplete substitution between market and
legal mechanisms, and a supportive legal environment is conducive to financial sector and
ultimately firm performance.

\(^6\) Demb and Neubauer (1992).
Bibliography


