Morning Keynote: Corporate governance and investor protection in companies with a controlling shareholder

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I’m going to discuss controlling shareholders and the protection of investors. Our programme is setting up a research project on this subject and Harvard is motivated by our belief that there has been insufficient attention by the corporate governance community around the world to this important subject, of core business controlling shareholders. A fair amount of attention, but still insufficient relative to its importance. So I’ll briefly talk about some of the research that we’ve already done and some of the research that is now in progress, or planned for the future.

Core business controlling shareholders are extremely important and especially for the ICGN audience, that brings together investors and others interested in governance from around the world. So a substantial fraction of the public traded companies in the US, and a large majority of public traded companies around the world are companies that have a controlling shareholder, I call them CS companies. Understanding the governance problems of such companies and what rules and arrangements are best for them, is therefore of great importance to ICGN members and unfortunately, most of the attention in the US or the Anglo American literature has been on widely held firms. And even so, many people think that one can extrapolate from this literature to companies with controlling shareholders, I’m going to suggest to you in a minute that this extrapolation often is impossible, and often might be misleading, so this literature is of limited relevance for people who are focused on companies with controlling shareholders.

To say in the next seven slides is based on a paper that Assaf Hamdani and I already published, titled The Elusive Quest for Global Governance Standards, and the key point that we were trying to make, is that the difference between CS companies and widely held companies, has not been adequately taken into account in the design and use of governance metrics, in the design and use of methodologies for approaching governance. And that’s because the governance arrangements that are beneficial for CS companies, might well, often are, either irrelevant or even counterproductive for the other type of companies and vice versa.

In particular, this means that the global metrics that have been extensively used by scholars, by advisors, by practitioners, for example, if you look at academics, or the Anti-Director and the Anti-Self-Dealing Index of La Porta et al, or the quick score of ISS, those metrics don’t really provide you with an effective tool for assessing governance around the world. And indeed, it’s not just that they didn’t do it right and one can find some metrics to do it right, it’s really that any governance metric that you try to apply to both CS and widely held firms, is going to miss the mark, either for one type of companies, or for the other, or for both. And
therefore, we shouldn’t really look for global governance standards, but really develop separate methodologies, which we’re trying to do in that paper, for assessing governance in CS firms and widely held firms.

Let me try to persuade you of the validity of this theis by going very quickly, if anyone is interested, you can look at the articles I’ve just mentioned, but looking at the number of issues, so take for example, contestability of control. So control is contestable in widely held France, but it’s locked by definition, in CS companies. If you look at most of the governance metrics, they pay a lot of attention to whether or not there are various anti-takeover provisions in place, whether or not you have appeal, or staggered boards and so forth, and those things might well be important for companies that are widely held, they are completely irrelevant for companies and for CS companies.

Take the nature of the agency problem. The fundamental agency problem in CS companies is protecting the minority shareholder vis-a-vis the controlling shareholder. In widely held companies you are concerned about managers. What does that imply? It implies that rules and provisions that increase the majority of the shareholders, which is something that many reformers in the US have been trying to get, I think that protect public investors. But in a CS company, if you give more power to the majority of the shareholders, you give even more power to the controlling shareholder vis-a-vis the board, and that might well be counterproductive.

Take a look at the existence of collective action programmes. So, if you have a widely held firm with shareholders distributed and perhaps even sometimes dispersed, then you have collective action problems that might impede the ability of a shareholder majority to exercise its powers. That’s the case in a widely held firm, but not in a CS company. This means that various rules, provisions, reforms that facilitate the ability of the majority of the shareholders to have, let’s say, a proxy access reform, might be beneficial for a widely held firm, but it’s generally irrelevant in a CS company.

There are other areas of corporate law that I could go over, but I think that what I’ve said might illustrate for you that it’s probably the case, that if you look at any area of corporate governance, and most legal rules in governance arrangement, you'll see that they play out differently and different rules might be optimal and counterproductive in CS companies and widely held firms. So, from that you can derive a very different methodology, a very different metric for assessing if you’re coming to a CS company, you should look at it very differently than you look at the widely held firm, and you should have a very different perspective.

Now, the next point that I would like to make, that for assessing the large number of public traded companies that we see around the world, including in markets with most companies of that nature, it’s important, not only to recognise that CS companies are different than widely held firms, but also that CS companies can be usefully broken into subsets. They differ markedly and again, call for a different methods of assessment and different perspectives from investors and their advisors. And I’ll talk about two distinctions. Two ways of separating different types of CS companies. So one is, that CS companies, where you have a separation between cash flow rights and voting rights, that’s the subject of the next panel. Those are companies where control is logged in the hands of a controller that
has just a minority of equity capital but a majority of voting rights. We label those controllers, controlling minority shareholders, because they have control, but they are really owners of a minority of the equity capital. Those companies are very different from companies where you have a controlling shareholder that has majority ownership and they pose especially large governance risks.

The reason for this is twofold. If you look at companies where you have a controlling minority shareholder, then if you can trust them with widely held firms, the insiders are not subject to removal, to the discipline of the market for corporate control and therefore relative to those firms, agency problems are likely to be more severe. And if you compare them to companies where you have a controlling shareholder that has a majority of shares, when you have a controlling minority shareholder, that shareholder is not managing mostly his or her own money, which is the case for the majority shareholder, and therefore their financial incentives to do things in the alignment of interest, is much less good than a company that has a majority shareholder.

Indeed, in early paper, we show that when you have separation between cash flow rights and voting rights, then when the fraction of the equity capital that the controller earns goes down, and we know that there are many companies with separation, where the controller might own as little as 10% or 5% of equity capital. So, when the fraction goes down, the severity of agency problems not just increases, but it increases more than proportionately. It really grows almost exponentially. So, we have to worry about those situations and in current work we further identify within the set of companies with controlling shareholder, situations in which dual class structures are especially pernicious, when the separation of cash flow rights and voting rights is especially extreme, or when the time sees the passage – sees the IPO, is especially long.

Let me conclude by talking about yet another distinction that I think is important for people in this room when they approach a company with a controlling shareholder. The critical dimension that I would like to touch on now, is whether the controller owns substantial business assets outside the controlled public company. So many people in the literature are saying, what’s important for us is when you have controller and what is the fraction of the equity capital the controller has, let’s say 25%.

In a respect with Assaf Hamdani on the limits of limiting controlling shareholder, what we show that it makes a huge difference whether there’s 25% owner, the controlled public companies really comprise the main business asset, and they don’t have other assets, or whether this is just one asset and they have other companies, or privately owned businesses, where you could imagine various complications. And our claim that agency problems are likely to be much more substantial when you have business assets outside, than when you have a standalone CS company. So when you think about, say company with differential voting rights, you might think differently about, say, Google, or Facebook, where that’s really the main business asset the controller has.

Then another corporate, it might be in a similar line of business, but where the controller, let’s say Ali Baba were the controller, might have substantial business assets outside the publically traded company. And what we conclude, that when you have a lot of business
assets outside, the potential for a transfer of value or the potential that the interest of public investors will be sacrificed, is much greater and moreover, it’s very difficult, even if one could adopt potentially any reforms one would want. It’s really difficult to limit the transfer of value and the deviation for value maximisation, without rules that are so intrusive and costly that they are really impractical and therefore, our conclusion is that we should really pay close attention to this distinction and should pay close attention to what business assets are controlled by their controller outside of the public firm.

So I say, that if you have already separation, it’s very important what you have outside and this also suggests that when you have not just a small equity stake, which can result either for a dual class structure, or for pure middle structure, so imagine a pyramid with 5% equity stake and a standalone dual class structure with 5%, the pyramidal group poses much more significant governance risks, because of the fact that there are so many business assets outside any given publically traded firm.

Let me conclude with, by emphasising that we need to develop the importance of, not just paying attention to CS companies and to the governance problems. Separate governance metrics for CS companies, than for widely held firms and for CS companies. We should also make adjustments, for those two key distinctions that I suggested to you, and this is an enterprise to which our programme and the research, as I’m describing, will seek to contribute in the coming years. Thank you very much [applause].

Audience:

First of all, I appreciate we have lots of companies on our portfolio and customer index where either because of the voting structure, or ownership structure, who are stuck in there and were unable to move reform right there and protect our interests, and I know that the next panel will take this up as well. Maybe you, though, can explain a contradiction that I’ve never fully understood? So, in the US, in the Listing Standard requirements, the independence requirements are more lenient for controlled companies, which I think, under Listing Standards are just a 20% inside state, not a majority, than for others, and that seems to be completely upside down. Are you aware of that and can you explain how that got in there and why, am I missing something?

Lucian Bebchuk:

I am aware of that. The exchange has accepted the idea that if you are a controlling shareholder and take the example, or if you’re a majority owner, you should be entitled, “to choose the majority of the board.” Now, as a practical matter, most of those companies actually do have a lot of Independent Directors, even though the controller is not required by the Listing Standards, and that is because under State Law, you get a lot of judicial difference if you have Independent Directors that approve compensation, save during transactions and the like.
In one of the research projects that we are doing, we actually take a view that goes further than it seems you would like to see. I mean, your concern is, we want to have Independent Directors when you have the controlling shareholder and your intuition is, if we have enough of them, I will feel sufficiently comfortable that we have investor protection. And our view is that if you have a controlling shareholder, and the controlling shareholder chooses Directors that are formally independent, so they have no material connection, but the controlling shareholder has complete control over their election and the replacement. Then if you think about the lesson that many people in this room have drawn from the last 20 years about the election of Independent Directors in widely held firms, the lesson there was, look, even though the Directors are independent, we cannot fully count on them if we don’t have an election process in which public investors, who are supposed to be protected, have at least some say or inference. So this suggests that if you have a company with a controlling shareholder, and you have Independent Director, but the controlling shareholder has absolute power over election and removal, you are going to end up with Directors that perhaps cannot be fully expected to protect the interests of public investors.

So, in this paper that we are planning to issue this fall, is called Making Independent Directors Work and we will refer to controlled companies, is we advocate, in one way or another, arrangement that actually now exist, to some extent, in the UK, in Italy, in Israel, those are arrangements in which public investors, in a company with a controlling shareholder, have some input into the election of some Independent Directors. And there are a number of ways you can do it. You can give them a veto right over the approval of some Independent Directors. You can give them stronger rights. Indeed, for some companies with dual class structures that went public on AMEX, a long time ago, they were required to give minority public investors some input into the election of Independent Directors. So that’s the direction, I think, where we need to go to fully protect public investors.

Audience:

Thank you, Lucian. So most of the companies, many of the companies that have a controlling shareholder are tech companies, and many of them claim that it’s the fact that they’re controlling that has allowed them to be so disruptive and this obviously influences their performance in the long run. Would we risk, by changing the rules of how controlling companies operate, will we be risking performance, or is this just like an excuse they have, to say that they want more power, the disruption and to ignore generation?

Lucian Bebchuk:

Obviously, things can differ from a situation to a situation. I tend to be undecided. I always think that we all understand the cost of separation, of dual class structures with extreme separation. The fact that you have entrenchment, the fact that you have distorted incentives. On the other side, people give arguments from, we have this genius who founded the company and it’s important to give them power for now, and so obviously there is a trade-off.
I tend to be on the side that says that overall, the balance of consideration weighs in favour of not allowing those structures. But I would say that even if you accept the validity of those benefits and that you think that these are not justified, there is some piece, and a very critical piece of the existing arrangements we see in the US, that should be fully unacceptable to people who have those views.

There are two elements. One is, that when you look at those tech companies, say Google, or Facebook, and let’s suppose for a moment that the founder is this exceptional unique individual, and it’s extremely important to leave them control for now. That’s not the reason to give them perpetual control. Why? Because if Mark Zuckerberg is an amazing visionary now, you know, we all know the bitter song, how will you be when you’re 64 [laughter]? So, even if you fully accept that Mark Zuckerberg is a unique individual, we don’t have the same confidence at the age of 64. Mark Zuckerberg, or perhaps his heirs, would also be, kind of, especially unique, so the argument for having dual class structures, without bit in sunset provisions, which is what we have, say, with private equity, you give people absolute power over your money, but it’s for limited period of time, it’s for ten years, let’s say. So the argument for perpetual dual class structure is, I think, untenable, and that most people who are willing to accept this argument, should be willing to accept dual class structures with some bit in sunset.

The other thing is, that we really have to distinguish between structures in which somebody say has 15% of the cash flow rights, and structures in which somebody has half a percent of the cash flow rights. And if you look at dual class structures in the US, many people lump them together, but there is a huge variation in this sense and the extreme separation situations, and there are very prominent examples of those, are especially pernicious, and even if you accept those other arguments, the case for them, I view it as untenable.

**Audience:**

My question is, have you looked at whether the identity of the controlling shareholder makes a difference? And I’m thinking the difference between state owned controlled companies, for example, which is less of an issue in this market, but is an issue in other markets, between that and individuals, and actually, not just individuals, but perhaps family owned businesses, where you do have the continuity and the point about the perpetuity issue is perhaps different? And just thinking about a number of pieces of research that came out recently, showing that family owned companies, in, under some conditions, outperform, especially in the aftermath of the credit crisis, where they were able to take long-term ideas, resist the temptation to overleverage and then be able to capitalise on the best price market, and actually do quite well.

**Lucian Bebchuk:**

I understand there is a question of endogeneity and the like there. I think that in terms of my identifying two kind of situations, being especially pernicious. One’s where you have
something that goes on for a very long period of time, in perpetuity in most situations. And the other, when you have substantial separation, so the family doesn’t own 25%, the family might own 1%. My view is, that as investors, you should be really very concerned about situations where you either have seen the goal for a long time, or you have a small percentage. And the reason is that unfortunately, we all have to recognise that no matter how successful a person is, their children are not bound to be as talented as they are.

So, when you have a founder, and Colonel Sanders referred to the problem of the idiot son, or the idiot daughter, but you don’t need to go that far. The likelihood that you would necessarily have the second generation to be of the same unique talent. And secondly, when the separation is very large and the family owns a very small fraction, then the perverse incentives are very, very powerful. Because you have a situation which somebody’s having a local control, but having a small ownership stake, like many in a widely held firm, accept that they don’t have any discipline for the market, unlike the managers of the widely held firm. So they have neither the discipline of the market for corporate control, nor the force of powerful financial incentives, and that’s a situation that not always, not in each and every case, but by and large, we have to be very worried about.

Thank you very much for your patience [applause].