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**READING** + INTERACTIVE ILLUSTRATIONS

# Corporate Governance

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This reading contains links to online interactive illustrations, denoted by the icon above. To access these exercises, you will need a broadband Internet connection. Verify that your browser meets the minimum technical requirements by visiting <http://hbsp.harvard.edu/tech-specs>.

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# 1 INTRODUCTION: THE GROWING IMPORTANCE OF CORPORATE GOVERNANCE

The term *corporate governance* comprises a set of topics of long-standing and growing importance to businesses, the economy, and society. The world's economies are dominated by corporations—from Amazon to Walmart, from Alibaba to Toyota. How such companies are governed affects not only who controls their wealth and power but also the millions of people they employ and the even greater number of people who interact with them as consumers, investors, and citizens. The individuals in charge of these companies are chosen through varied and sometimes opaque procedures, and their actions can be equally opaque. Apart from the standard ways that businesses develop strategies to compete for customers, companies face an ever-growing list of legal, market, and operational constraints on their activities.

Governance is challenging for any large organization, but it is particularly problematic when an organization's owners are dispersed. Such owners have provided the company with capital but are not involved in its operations. One of the first known corporate governance disputes occurred at the Dutch East India Company. The company was funded through bonds and shares of stock sold to the public. In 1609, a shareholder complained about how his capital was being used. He argued that the company's board of governors sought to "retain another's money for longer or use in ways other than the latter wishes."<sup>1</sup> A few years later, the shareholders revolted, complaining that the company's accounting books had been "smeared with bacon" so that they might be "eaten by dogs."<sup>2</sup> They demanded an audit of the company's books, the same kind of accounting audit that today is an important part of how companies are governed.

Fast-forward to 2013, when Apple, Inc., the maker of iPhones and Macbooks, was sued by a shareholder, the noted hedge fund manager David Einhorn, who demanded that the company use its growing cash reserves—at that time around \$137 billion—more effectively by returning it to shareholders. Despite its popular products, Apple was suffering in 2013 from a weak stock price and concerns about its continuing ability to produce innovative products. In what several commentators referred to as a shareholder rebellion, Einhorn received support from other investors who had been concerned about Apple's tendency to be conservative with cash payouts despite building up its cash reserves and earning only about 1% on them. Such investor complaints about how corporate executives are managing shareholder wealth are common.

Today, corporate governance includes a wide array of mechanisms and expectations, some reflected in contract, some in public law, some in evolving norms and shared expectations, and others in important institutions such as stock exchange listing standards and the audit process. Some systematic features of governance are not simply the product of individualized negotiations between financiers and managers but are the consequence of deliberations among trade groups, nongovernmental organizations, professional associations, and public or quasi-public bodies with their own interests and goals. As a result, corporate governance consists of both practices (boards, laws, takeovers) and ideas about how corporations, large and small, should be governed. As a topic, corporate governance has grown steadily in scope and complexity. It is a contested, multidisciplinary field, defined differently by different people.

This reading presents an overview of corporate governance, focusing on for-profit businesses that are privately owned by dispersed investors—that is, not owned by a government and not owned by a single owner. The Essential Reading section covers the varied mechanisms that address two essential types of conflicts of interest that occur in corporations, both of which arise from the common feature of dispersed ownership:

- Conflicts between managers and owners.
- Conflicts between controlling and noncontrolling owners.

These conflicts correspond to two common patterns of ownership of businesses:

- Those owned by dispersed, noncontrolling investors, as is commonly the case for large US and UK companies.

Those controlled by a single owner, who nevertheless has sold ownership interests to a significant number of noncontrolling investors, as is traditionally common for large, privately owned companies in continental Europe, Asia, and Latin America.

La Porta et al. (1999) present the ownership structures of two companies at the end of 1995 to illustrate some different structures around the world (see **Exhibit 1**).<sup>3</sup> The first is Microsoft in the United States. The cofounders, Bill Gates and Paul Allen, owned 23.7% and 9% of Microsoft's shares, respectively. Steve Ballmer, then a senior executive at Microsoft, owned 5%. All shares carried one vote, so Bill Gates represented the largest ownership stake. The second is Barrick Gold in Canada. Its founder, and then chair and CEO, Peter Munk, was also chair and CEO of a publicly traded company Horsham, which owned 16.3% of the votes and equity capital of Barrick. Munk controlled Horsham by owning 7.3% of its capital but 79.7% of its votes. As we describe later, this is an example of a deviation from the one share, one vote principle. Through his control of Horsham, Munk controlled 16.3% of Barrick, providing an example of a simple pyramidal ownership. Later in the reading, we will present more complicated examples of holding structures and the range of ownership structures across countries.

```
graph TD; Microsoft[Microsoft Corp.] --> BillGates[Bill Gates  
23.7%  
(Chair and CEO)]; Microsoft --> PaulAllen[Paul Allen  
9%  
(Co-founder)]; Microsoft --> StevenBallmer[Steven Ballmer  
5%  
(Executive VP)]; BillGates --> BarrickGold[Barrick Gold  
(Chair and CEO: P. Munk)]; PaulAllen --> BarrickGold; StevenBallmer --> BarrickGold; BarrickGold --> Horsham[Horsham Corporation  
16.3% C&V  
(Chair and CEO: P. Munk)]; Horsham --> PeterMunk[Peter Munk  
7.30% C  
79.7% V]; Horsham --> Southeastern[Southeastern Asset Management  
18.2% C  
4.0% V];
```

The diagram illustrates the ownership structure of Microsoft Corp. and its subsidiaries. At the top is Microsoft Corp., which is owned by Bill Gates (23.7%, Chair and CEO), Paul Allen (9%, Co-founder), and Steven Ballmer (5%, Executive VP). Bill Gates, Paul Allen, and Steven Ballmer all own shares in Barrick Gold, which is chaired and CEOed by P. Munk. Barrick Gold owns shares in Horsham Corporation (16.3% C&V, Chair and CEO: P. Munk). Horsham Corporation is owned by Peter Munk (7.30% C, 79.7% V) and Southeastern Asset Management (18.2% C, 4.0% V).

## 2 ESSENTIAL READING

At its broadest, corporate governance encompasses the many components of the systems by which companies are directed and controlled. These components vary by country, over time, and by company type, size, and ownership.<sup>4</sup> Different researchers and commentators have different points of view on what topics and issues are central to the discipline. Economists have tended to take a finance view of the topic, that is,

focusing on how investors obtain returns for financing companies, or on the constraints that shape bargaining over corporate profits. Some observers have tracked one well-known economically oriented perspective on governance, grounded in the theory of agency costs, while others see corporate governance as emerging organically from the oversight and management of large organizations, and still others have seen corporate governance as playing an important political role by enhancing the perceived legitimacy of large private companies. Accounting scholars focus on mechanisms that provide information that allow investors to choose among investment opportunities and to monitor managerial performance.

## 2.2 Our Focus: For-Profit Companies Owned Privately by Dispersed Owners

This reading focuses on the governance of for-profit companies and does not address issues raised by other types of corporations, such as nonprofits. In this reading, we also focus on companies that are not owned by governments. Our focus is also primarily on what are commonly called public companies in the United States, that is, companies that are not owned by governments but that are listed on stock exchanges and/or owned by “public” (i.e., numerous) investors, and are subject to registration with the Securities and Exchange Commission (SEC) or its equivalent in other countries.

We organize the Essential Reading around two core conflicts of interest that both involve “owners” (i.e., shareholders). The conflicts are described in **Exhibit 2**. As a result, our analysis initially tracks the finance perspective on corporate governance. The two conflicts are fundamental features of the governance of the modal type of for-profit, non-government-owned corporations in the largest economies and necessarily inform any understanding of corporate governance.

### EXHIBIT 2 Conflicts of Interest Between Company Stakeholders

	Conflicts of interest between . . .	
<b>Owner-Manager Conflicts</b>	A company's equity owners	The company's senior management
<b>Intra-Shareholder Conflicts</b>	Equity owners who hold controlling shares in a company	Equity owners who hold noncontrolling shares in the company

Still, we review an array of mechanisms and institutions, including some that might not exist or might have taken a different form if the only interests relevant to corporate governance were those of equity investors. In the Supplemental Reading section, we

briefly review important, ongoing debates around the appropriate goals of corporate governance, including debates over shareholders versus stakeholders. Issues of legality, administration, legitimacy, accountability, and comparability have important influences on the evolution of corporate governance in practice, including ways that do not closely link to the core conflicts of interest we discuss in the Essential Reading section and that are sometimes neglected by finance-oriented commentators, to the detriment of a realistic understanding of how large, for-profit companies are governed.

## 2.3 What Problems Does Corporate Governance Try to Solve?

### 2.3.1 Two Types of Conflicts: Owner-Manager Conflicts

The most influential perspective on corporate governance, at least in the United States, addresses how equity investors can retain control over the companies in which they invest or otherwise induce managers to make decisions in the interests of equity investors.<sup>5</sup> By retaining control, owners can assure themselves of an adequate—or ideally, the maximum—return on their investment.

When a company can raise adequate finance from bank loans or from a sole founding shareholder, corporate governance is simple. The single shareholder retains both legal authority and practical ability to determine strategy, staffing, and financial policy for the company. Even if a professional manager is hired, the sole shareholder retains such power and authority that nothing beyond basic corporate law (augmented by contracts) is required to create effective and efficient corporate governance.

However, as companies grow, their ability to finance themselves in this simple way diminishes, and they increasingly resort to multiple providers of equity capital. Also, an initial founder-shareholder will eventually die or otherwise pass on ownership to others, who typically grow in number over time. Basic principles of efficient diversification also motivate single founder-shareholders to exchange equity in one company for other assets. Finally, for several reasons (such as to improve the liquidity of its shares and to have a liquid and reliable “acquisition currency” for merger-and-acquisition transactions), it can be useful for a company to list its stock on a stock exchange, which entails increasing the number of owners.

For these reasons, the number of shareholders at the largest companies that are *not* listed on a stock exchange, such as Cargill or Mars, has risen into the dozens or hundreds. The world’s largest companies that *are* listed on stock exchanges can have many thousands of shareholders and millions of shares outstanding. Shareholders of most large companies face difficulties coordinating or even using their control rights



to ensure effective and efficient use of their capital. Much control over the corporation passes to a group of directors and officers, often referred to as managers.

This basic conflict of interest between managers and owners, then, is a primary reason for the existence of the interesting and complex reality of corporate governance. From this perspective, the goal of corporate governance is to mitigate this conflict of interest. Economists commonly refer to shareholders as principals and to managers as their agents, and they call the associated conflicts part of principal-agent theory or the principal-agent problem.<sup>6</sup> As in other agency relationships, such as employer/employee and home-seller/real-estate-broker settings, **agency costs** inevitably arise. In a classic taxonomy sketched by Michael Jensen for corporations, agency costs are defined as (1) the reduced value that shareholders earn as a result of the agents taking actions (or failing to take actions) that will maximize shareholder returns, as well as (2) costs incurred by shareholders as they attempt to monitor managers and (3) costs incurred by managers as they attempt to demonstrate that they are acting in shareholders' interests.<sup>7</sup> Even if these managers own equity or stock options in the companies, they can have interests or beliefs that diverge significantly from the shareholders overall.

Agency costs can never be eliminated because there are important benefits to agency, such as professional management, that arise from specialization. Given dispersed and differently positioned owners, imperfect and asymmetric information is inevitable.

Governance practices trade off the benefits of professional management and dispersed ownership against the costs that the conflicts of interest would impose on owners if left unchecked. The difficulty of precisely optimizing this trade-off—over time and across companies—is a large part of why corporate governance is so contested and complex.

### 2.3.2 Two Types of Conflicts: Intra-Shareholder Conflicts

Ownership dispersion can also give rise to a second type of conflict: a conflict among shareholders. Many large companies—especially outside the United States but also in the United States—have a large block of controlling shareholders and numerous noncontrolling shareholders. While a controlling shareholder can help mitigate the manager-owner conflict described in the previous section, the controlling shareholder can and generally does have interests that diverge from other shareholders. For example, control shareholders may seek to pass practical control to their personal heirs and family, whereas other shareholders may want management to pass such control to professionals. Control shareholders may seek to engage in transactions with other businesses they control, to the detriment of noncontrolling shareholders. At the extreme, control shareholders can simply seek to extract directly to themselves all value not necessary for the continuation of the business and not share that value with other owners, even if equal sharing is the formal legal arrangement.

A second major objective of corporate governance is to resolve or mitigate conflicts of interest among owners: intra-shareholder conflicts of interest. On the one hand, in practice, some of the mechanisms to mitigate this second type of conflict also mitigate owner-manager conflicts, and vice versa. For example, both types of conflicts can be mitigated by companies providing disclosure to investors or by hiring independent auditors to verify information about the value and operations of the company.

On the other hand, mechanisms that can protect owners from management's conflicts, such as elections of directors, may fail to protect minority shareholders because voting rights are held by controlling shareholders. The two objectives can even conflict with each other. Giving owners as a group—including controlling shareholders—more control rights can undermine the ability of managers to protect the interests of minority shareholders from controlling shareholders. For example, at some companies, shareholders can remove directors at any time without cause. That right that can reduce manager-shareholder conflicts by giving shareholders' continuous power to determine the identity of directors. But the same right can worsen intra-shareholder conflicts by concentrating more power in the hands of controlling shareholders. Such power makes it impossible for independent directors to resist controlling shareholders, even where doing so would protect other shareholders.

### 2.3.3 Mechanisms to Mitigate Agency Conflicts

As reflected in the above outline, corporate governance's most basic elements address either the owner-manager conflict or the intra-shareholder conflict. After presenting some basic data on ownership patterns and basic laws governing corporations, the remainder of this Essential Reading will review the major types of mechanisms that address these conflicts.

#### **Owner-Manager Agency Conflicts**

The core mechanisms for mitigating owner-manager conflicts of interest are law, boards, compensation contracts, various intermediaries (including credibility enhancers), and institutional owners. These mechanisms are reinforced by market pressures, including those arising in the capital markets, the product and labor markets, and (for some companies) the market for corporate control. An important component of the capital markets for many companies includes loans, bonds, and other debt contracts, and an important component of the labor markets consists of executive compensation arrangements. Each mechanism is an important topic, with many nuances and complexities. This reading focuses on the way each mechanism makes a distinct contribution to the mitigation of owner-manager conflicts as a component of corporate governance, and it notes only briefly other functions that these mechanisms perform.

Precisely how a given mechanism functions for a given company can vary because of choices made by the company's representatives. For example, voting rights for investors can vary in many countries, with the details dependent on the precise terms of the contracts governing the capital investment and/or the precise terms of the company's governing legal documents. We keep our attention on standard choices among these variations and note only major exceptions of interest.

### **Intra-Shareholder Agency Conflicts**

To mitigate intra-shareholder conflicts of interest, core mechanisms include direct legal restraints, taxation, disclosure laws, specially designed minority rights and process protections, business groups, debt-based governance (often by banks), and public law enforcement. More so than with mechanisms addressing owner-manager conflicts, these mechanisms vary significantly by the country in which a corporation is organized, headquartered, or has its stock listed, and they have varied over time. As a result, our presentation is general, attempts to capture stable regularities across countries, and notes only in passing some of the more unusual country-specific mechanisms. As with owner-manager mechanisms, many intra-shareholder mechanisms can be and are tailored at the individual company level, and we focus on standard choices and note only a few unusual choices in passing.

Several mechanisms address both types of conflicts, such as disclosure laws and credibility enhancements, capital market pressures, and public law enforcement. We present these overlapping mechanisms under the heading of the type of conflict for which they are most important.

### **2.3.4 Importance and Prevalence of Two Types of Conflicts Vary**

Before we turn to the individual mechanisms of corporate governance, it is worth noting two regularities that affect the relative importance of owner-manager versus controller-noncontroller conflicts and their related mechanisms. First, corporate governance and ownership structures vary by country, loosely grouped into what are often called common law and civil law countries. Second, passive ownership (by owners that are themselves institutions, such as indexed mutual funds, which invest in a relatively passive way on behalf of dispersed individuals or other institutions) have grown significantly in importance over the past thirty years. Both regularities have influenced and continue to influence the development of corporate governance mechanisms across countries and over time.

### **Common Law Versus Civil Law Countries**

Specifically, in the United States, the United Kingdom, and other British-heritage countries, more so than in other countries, more of the largest companies have

ownership structures that are fully dispersed, in the sense that there is no single shareholder that owns enough stock to control the company in the ordinary course. By contrast, in Europe, Asia, and Latin America, more companies have one or a small number of controlling shareholders, even if they have sold substantial amounts of stock to the public, meaning dispersed private investors.

As a result, owner-manager conflicts are more common in the United States and other British-heritage countries, and intra-shareholder conflicts are more common elsewhere. Indeed, some academic research suggests that the two historical legal systems, that is, common law versus civil law, that correlate fairly closely with these two groups of countries may have had some causal role in generating the patterns of ownership and corporate governance that the two groups of countries exhibit. For example, compared to civil countries, common law (Anglo-American) countries have historically had more initial public offerings, more companies with dispersed ownership, and deeper capital markets. Other research contests these claims about the causal mechanisms involved. But the general fact of the regularity is not disputed.

In truth, even the descriptive fact of this regularity is only general. There are many public companies in the United States with controlling shareholders—Ford, Google, Facebook, and Walmart are prominent examples—and there are prominent public companies in Germany, France, Japan, and elsewhere that have no single controlling shareholder, such as Deutsche Bank, Vivendi, and Toyota. Nevertheless, the regularity is real, and the control mechanisms that address the different conflicts are more prominent in those different sets of countries.

### 2.3.5 Recent Trends in Ownership

A more recent but growing regularity in corporate governance involves the type and role of owners themselves. Once owners were predominantly individuals, but now ownership is increasingly institutionalized. Banks were important institutional owners in Japan and Germany from the early twentieth century, although not in the United States and the United Kingdom. Pension funds, mutual funds, and insurance companies rose in prominence over the middle part of the twentieth century in the United States and the United Kingdom, and in other countries since then. **Exhibit 3** shows the rise of institutional ownership in the United States since 1980.<sup>8</sup>

**EXHIBIT 3** Institutional Ownership of Corporate Equity in the United States, 1980–2013

	(1)	(2)	(3)	(4)
	Total Conventional Institutions (FRBFOF)	Pension Funds	Insurance Companies	Regulated Funds (ICI)
1980	28%	20%	6%	3%
1990	41%	27%	5%	7%
2000	49%	23%	7%	22%
2010	48%	16%	7%	24%
2013	46%	22%	6%	24%

As a first effect, the growth of institutional owners can mitigate some causes of the owner-manager conflict because institutional owners can—and indeed, in many instances, likely do—reduce the number of individuals who assemble a controlling block of shares and direct the actions of corporate managers. However, for reasons briefly discussed below, this prospect is not realized in anything like the theoretical potential for it to address the owner-manager conflict, in part because institutional investors are themselves managed by managers and are further restricted by many laws and regulations designed to address conflicts between those managers and the beneficiaries or owners of the institutions.

More recently, starting in roughly 1970 but greatly accelerating since 1990, purely passive institutions such as indexed mutual funds and exchange-traded funds have become an increasingly important type of institutional owner of publicly listed companies. Indeed, many institutions nominally willing to make active choices in their selection and oversight of companies are in practice quite passive. We will discuss below the effects that the rise in institutional and passive ownership has had on corporate governance for some mechanisms of corporate governance, but the ongoing growth in passive investors makes it likely that more change in governance is to come.

## 2.4 Mechanisms for Mitigating Owner-Manager Agency Conflicts

The most basic elements of corporate governance in for-profit, privately owned corporations arise from law, which structures the relationship between the group of people who have formal authority over the corporation (the board of directors) and the owners of the corporation's equity (shareholders). Over time, as noted above, institutional equity owners are increasingly key players in corporate governance.

Intermediaries also play a core role in mitigating owner-manager conflicts. Such intermediaries include auditors, lawyers, bankers, compensation consultants, stock exchanges, and, more recently, proxy advisers and index sponsors. In this section, we briefly review each of these core elements of corporate governance.

### 2.4.1 Corporate Law

The law of nearly every country permits individuals to establish private corporations and sets out basic rules for the governance of corporations. The law treats corporations as “legal persons” with their own assets and liabilities, distinct from the owners of their stock and distinct from the individuals that participate in their governance and operation. Authority over a corporation is given to a board, which is elected by shareholders. The authority of officers, employees, and other agents is subject to the control of that board. Boards are the core of legal authority over companies: While shareholders elect directors, shareholders generally cannot legally directly control a company; they can do so only through the board.

Corporate law allows for variations in many aspects of governance, including voting rights and rules for director elections. Typically, boards are elected on a one share, one vote basis by the common shareholders of a company. In most countries, other participants, for example, lenders, employees, customers, and so on, are generally not entitled to vote in director elections at standard for-profit companies. A minority of companies (although the number is increasing in recent years) gives different classes of stock different voting rights, which can effectively concentrate control in the hands of a single or a small set of shareholders. Director elections are commonly held annually, and the law varies about whether and how shareholders can remove directors between elections. Some countries permit companies to provide for multiple classes of directors, with overlapping multi-year terms, known as **staggered boards** or **classified boards**. Staggered boards make it harder to remove or replace a majority of the board and so are sometimes said to entrench existing directors.

Several other elements of basic corporate law are important to corporate governance. US law, for example, permits shareholders to demand information, specifies default rules for the transferability of shares, and commonly gives shareholders the ability to sue in court for specified reasons. The ease and usefulness of shareholder litigation varies significantly by country. The United States is generally an outlier, with a much higher incidence of shareholder litigation due to rules permitting actions to be brought by shareholder representatives, generous rights to obtain information during lawsuits, and rules generally requiring litigants to pay for their own costs and legal fees.

A final way in which US corporate law influences corporate governance (and, by virtue of the economic importance of US corporations and governance practices generally, influences global practices) is through the enforcement of fiduciary duties. This law imposes duties on directors, officers, and agents to act with care and loyalty.



Those general requirements are given specificity by courts in shareholder-initiated lawsuits challenging board or officer conduct. These duties are purposefully vague and open-ended, allowing courts—particularly Delaware’s unusually business-focused Court of Chancery—to play an ongoing quasi-regulatory role supervising and evaluating corporate governance. The instances in which personal liability is imposed on individuals are few. However, the threat of liability and, perhaps even more, the sheer fact of court scrutiny and its detailed, fact-specific, and public opinions, gives US courts a significant role in shaping governance standards.

### 2.4.2 Securities Law and Stock Exchange Standards

Companies with dispersed ownership must comply with securities law, and companies with stock exchange listings must comply with both securities law and listing standards established by the stock exchanges. These rules require disclosures, including audited financial statements, both at the time a stock is initially offered for sale and at regular intervals thereafter. Securities laws also mandate an increasing number of governance-specific disclosures and, in some cases, prescribes rules for specific governance choices. In the United States, the Sarbanes-Oxley Act mandates fully independent audit committees (more on that below) and requires that those committees control the company’s relationship with its auditor. The law also regulates auditors and mandates auditor review of disclosures about a company’s control systems.

Securities regulations also restrict *insider trading*. (Company insiders are individuals who are employed by the company.) Regulations mandate disclosures for insiders regarding compensation and trades in company securities, and impose a duty not to trade while in possession of material nonpublic information, with limited exceptions, and this duty may extend to those given tips by insiders. These laws are enforced in most countries by specialized regulatory agencies with enforcement staff and independent rule-making authority. In the United States, securities class actions premised on trading fraud are routinely brought and result in intermittent close scrutiny of disclosures and conduct by courts and shareholders. At times they produce information that results in governance changes or public law enforcement.

Stock exchange listing standards are even more prescriptive, with additional requirements for board composition and practices. After the Enron-era scandals, the New York Stock Exchange (NYSE) mandated that the majority of a company’s board members be independent (not an officer or employee of the company) and that the compensation and nomination committees of the board be fully independent. It also mandated *executive sessions* (portions of meetings with only independent directors and no officers present), direct reporting lines from inside and outside auditors to the audit committee, inclusion of financial experts on audit committees, ethics codes, and disclosure of any waivers of those codes. Companies can choose not to list their stock on an exchange, but to do so has many advantages, especially from the increased

liquidity of their equity. Because most companies with dispersed public equity do list on an exchange and thus adopt the exchange-mandated practices, stock exchange listing requirements exert a strong normative force in corporate governance.

### 2.4.3 Boards

As noted above, corporate law generally locates final authority over corporations in a **board of directors**. While single-member boards are generally permitted for companies with limited numbers of shareholders, the law in various ways encourages or even requires companies to have multi-member boards. No one director is empowered to act; boards act collectively, typically by majority vote. In practice, board members generally strive for and usually obtain consensus. In the past, boards tended to be larger—over 20 directors was not unusual. Now boards typically have about 10 to 12 directors, a size believed to be best for balancing the benefits of diverse perspectives and skills, on the one hand, with the need for efficient deliberation and action, on the other.

Because boards are the ultimate legal authorities over corporations, their identity, selection, and methods of operation are central to corporate governance. Conventionally, board directors have nominated their successors through a process controlled by the board itself. Even today, board elections are rarely contested. Increasingly, however, board procedures for nominating new directors, as well as the composition and characteristics of directors themselves (such as demographic or experiential background), are the focus for public pressures to change the governance of large corporations.

By law, stock exchange requirement, or choice, the majority of directors at public companies are now typically independent, that is, not an officer or employee of the company. Indeed, the standard norm for boards is for only one or two directors not to be independent.

In addition, director selection is increasingly shaped by **activist shareholders** (discussed below). These activists threaten or actually begin election competitions by soliciting votes directly from other shareholders—a process called a **proxy fight** or **proxy contest** in the United States—and reach settlements in which incumbent boards agree to nominate and support one to three directors chosen by a minority or activist shareholder.

In the United States and United Kingdom, boards are termed unitary because a single group of individuals has full authority over a corporation. In Germany and Scandinavian countries, corporations have two boards: a **supervisory board** composed of independent directors and a **management board** that is the equivalent of the C-suite of officers at US companies. In Germany and other European countries, **co-**



**determination** requires or permits boards to include representatives from national labor unions.

## Committees

Boards divide tasks by function and organize themselves in committees. By law, listing standards and norms, boards usually have at least three important, fully independent committees:

**Audit committees** oversee the independent audit process (discussed more below) and sometimes have other roles, such as overseeing legal compliance programs and risk management. In the United States, audit committees must include a minimum number of financial experts who meet specific legal criteria for experience in preparing or overseeing the preparation of financial statements.

**Compensation committees** oversee executive compensation, especially for the top officers, and increasingly have direct relationships with compensation consultants.

**Nominating committees** and **governance committees** oversee the ongoing need to refresh boards with new directors and set policies on a variety of other governance issues, such as board leadership (for example, whether the chair should be separate from the chief executive officer), self-evaluation, retirement, tenure, insider trading, executive sessions, and takeover defenses.

In general, board committees are subject to overall board oversight and can be overruled, but in practice they often function with a high degree of autonomy within their subject areas. Increasingly, such issues have been the focus of institutional owners and others interested in corporate governance, and these three key committees also increasingly play a role in mediating between a board's own inclinations about what constitutes good corporate governance, compensation or audit practices, subject to law, and what shareholders and the public more generally viewed as good practices. Lead directors and/or corporate governance committee chairs, in particular, have increasingly played a role in meeting with representatives of large institutional shareholders in so-called engagements, during which governance issues generally and as applied to a given corporation are discussed.

## Officers

Because independent directors generally have day jobs at other companies or institutions, they typically need to delegate day-to-day management to **corporate officers**. Traditionally, in the United States and the United Kingdom, corporate officers followed a military model, with a single chain of command down from the CEO; in

continental Europe, a company's officers function in a more collaborative way, through the management committee, although in practice that distinction is likely not sharp. As noted above, it is increasingly typical that only the CEO, or perhaps one other officer, sits on the board of a listed company.

Today, a typical C-suite includes the chief executive officer (CEO), chief operating officer (COO), chief financial officer (CFO), chief audit officer (CAO), and chief legal officer (CLO). Increasingly common are chief information officers, chief risk officers, chief compliance officers, and chief innovation officers. Some of these individuals may, by law or choice, have direct reporting lines to the board as a whole rather than reporting solely to the CEO. In the United States, CFOs must personally attest to corporate disclosures, and CLOs or their designates often play a hands-on role to help organize and staff board meetings, a role that is enhanced in jurisdictions (such as the United States) where attorneys have the ability to preserve the confidentiality of privileged advice and communications. Current officers are also commonly a key pool for potential CEO successors and can influence the CEO and other officers directly and by communicating with boards.

#### 2.4.4 Compensation Contracts

An important and often controversial item among the set of complementary corporate governance arrangements are compensation arrangements for executives. Agency theorists consider a compensation contract to be efficient when it minimizes agency costs between shareholders and managers. In the efficiency view, the observed compensation schemes reflect the demands of a competitive market for senior executive talent. The controversy arises from the concern that boards of directors are sometimes not at arm's length from the executives whose pay they have to set. Such boards, the critique goes, are captured by powerful CEOs and provide excessive levels of pay to executives. The critique is most prevalent in the United States, where the level of pay is considerably higher than what is observed in other countries.

Executive pay is typically comprised of a base salary, short-term incentive compensation, and a long-term incentive plan. Short-term incentives are often in the form of a bonus tied to accounting performance. Long-term incentives typically take the form of stock-based pay such as stock options. The different components are designed to both reward past performance as well as provide incentives to motivate some desired future performance. The short- and long-term incentive plans create a pay-for-performance structure. Such incentive schemes, especially when they are tied to stock price performance, reduce agency costs because a manager's income is tied to wealth generation for shareholders. They can also provide opportunities for significant—and sometimes, for that reason, controversial—payouts to executives.

### 2.4.5 Institutional Owners

As noted above, institutions have increasingly displaced individuals as owners of corporate stock, particularly in large companies. Institutions achieve economies of scale for individual owners, particularly in assembling diversified investment portfolios. The corporate governance role played by institutions varies: Some (such as brokers) are simple pass-throughs of rights and powers associated with the stock they hold; others (such as pension funds and hedge funds) legally retain all such rights and powers.

Institutions are governed by varied laws and are subject to varying market and political pressures, which influence and constrain their ability to act as or on behalf of shareholders. Even an overview of these laws would be too lengthy for this reading, but some examples illustrate the variety. US pension funds and insurance companies cannot legally take full control of a company held in their portfolios; a few mutual funds are legally able to do so. Hedge funds, by contrast, can take full control of a company, within limits imposed by market discipline and contracts with their investors. Some institutions are more constrained in the resources they devote to governance than others. As a result, disclosure obligations that arise when any institution acquires more than a set percentage of stock (5% in the United States) can incur significant costs, which can be borne better by some institutions than others. Passive institutions, such as index funds, cannot liquidate stocks (or threaten to do so) as a tool for influencing governance and for cost reasons cannot actively monitor the thousands of companies in their portfolios in anything like a real-time, company-by-company basis. Instead, they establish policies that govern the bulk of their governance behavior and reserve focused interventions to a small number of companies at any given time. In Europe, tax laws often inhibit the ability of banks to sell portfolio stocks, effectively locking them into long-term positions.

Despite these limits and variations, institutions overall have become more influential in corporate governance over the past thirty years. Traditional investment institutions—pension funds, insurance companies, and mutual funds—have formed associations, such as the Council of Institutional Investors in the United States and the Pension and Lifetime Savings Association in the United Kingdom. Through these associations, they have taken an increasingly active role in reaching policy positions on various aspects of observable corporate governance and in pressuring governments and boards to adopt their positions. Another way traditional institutions have gained power is by outsourcing the research and initial position-taking on shareholder votes to **proxy advisers** (discussed in more detail below). While not binding on any given institution, the ability of Institutional Shareholder Services (ISS) and other proxy advisers to coordinate the votes of disparate institutions has significantly increased the ability of reaching a consensus position on a given governance issue to result in “voluntary” change by corporate boards. Further enhancing the power of institutions has been the development of withhold-vote campaigns (discussed in more detail below).

### 2.4.6 Intermediaries

For capital markets to function efficiently, savers of capital must be able to entrust their capital to entrepreneurs and managers of companies and receive a satisfactory return on the capital. This exchange of capital and returns is facilitated by intermediaries that provide a monitoring and informational role. These intermediaries include auditors, sell-side analysts, credit rating agencies, the business press, proxy advisory services, and shareholder plaintiffs and lawyers.

#### Auditors

Auditors in US publicly listed companies conduct two kinds of audits. They audit the financial statements of the company and attest that the financial statements comply with the tenets of the Generally Accepted Accounting Principles (GAAP). Since the Sarbanes-Oxley Act of 2002, they also review the company's internal controls relating to financial reporting. The company's annual financial report, filed with the SEC on Form 10-K, includes the auditor's report, a statement by the auditors where they confirm that the financials are fairly presented or qualify the report and warn investors if they are not. Qualified reports are a signal that the viability of the firm is in question. Auditor reports always include the word *independent*, meaning that auditors are expected to be independent of the company and its management, even though they are paid by the company for services rendered.

#### Sell-Side Analysts

Sell-side analysts work at brokerage firms and provide information and analysis on the companies they cover. They write reports that include recommendations to buy, hold, or sell the stock, forecasts of performance and stock price, and analysis of the company in the context of the market and industry. Research shows that the views of sell-side analysts are informative even if they are often biased in favor of the company. Analysts are often seen to be advocating buying or holding a stock and rarely recommending selling.

#### Business Press

A well-functioning business press can play a significant role in enhancing the effectiveness of capital markets. The press plays multiple roles. It plays a dissemination role by reporting on company performance and broadcasting information. Reporters add value by identifying newsworthy information and distributing it broadly. The press also plays an analytical role by interpreting available information and combining information either from different sources, such as sell-side reports, or providing new information, such as interviews or market intelligence. Most critically, it plays an investigative role by identifying managerial fraud, uncovering new information, or

reporting on information uncovered by other intermediaries—which is often negative information that managers might want to suppress.

### Proxy Advisory Services

Proxy advisers provide advice to institutional shareholders on how to vote their shares on a range of corporate matters such as director election, executive compensation, auditor ratification, and special situations such as proxy contests or mergers and acquisitions. The demand for proxy advisers can be traced back to 1998, when the US Department of Labor started requiring pension plans to vote the shares they managed as part of the employees' retirement assets. In 2003, the SEC started requiring registered investment management companies to disclose proxy voting policies and how they voted on specific resolutions. Two proxy advisers—Institutional Shareholder Services and Glass Lewis—significantly influence shareholder voting behavior and the recognition of corporate governance issues. By some estimates, they drive about 25 percent of voting support. Other developments, such as the mandatory “say on pay” votes and the rise of shareholder activism (covered later in this reading), have contributed to the growing influence of proxy advisers.

### Shareholder Plaintiffs and Lawyers

Shareholders are allowed to sue managers and companies that they own shares in for violations of securities laws. These actions can come in two forms. First, the **derivative suit** allows shareholders to seek redress for the company for harm inflicted on it by management or the board of directors (or even third parties if the board faces a conflict of interest in evaluating such a lawsuit). Under this method, the lawsuit is brought on behalf of the corporation, and damages are awarded to the corporation rather than directly to the shareholders.

Second, **direct suits**, including **class actions**, are lawsuits initiated by shareholders that allege that they were harmed because the company management provided misinformation or incomplete disclosure or in some other way violated the law to harm shareholders directly. When shareholders are dispersed and/or each owns a small fraction of all stock, no one shareholder may have a large enough interest in the outcome of a given lawsuit to pay the upfront costs of retaining lawyers and starting the suit. However, in the United States and increasingly in other countries (e.g., Australia), the legal system permits class actions, in which lawyers seek out one or a small number of shareholders and sue on behalf of all shareholders, in return for fees paid out of a settlement or winning verdict.

The system effectively has created an entrepreneurial class of plaintiff lawyers. The counsel in successful shareholder lawsuits receives a share of the damages awarded to the entire class of affected shareholders. The prospect of recovering fees from such

cases provides an incentive to plaintiff lawyers to identify potential violations of securities laws and hold managers accountable through litigation. However, the system also creates the risk of frivolous litigation and may create an incentive for lawyers to settle too cheaply once they have secured a proposal that will pay their fees. Shareholder litigation of this kind is an active area of ongoing public policy debate and reform proposals.

## 2.4.7 Market Pressures

### Competition in Factor Markets

Competition in product and labor markets can affect managerial behavior and lower agency costs. Customers exercise the power of the wallet by shunning poor products and labor markets. Other supply-side markets also impose discipline because poorly performing firms will have a harder time recruiting top talent or obtaining goods or services on credit. The resulting impact of cash flow and earnings exposes poor management. Competition in factor markets forces management to improve managerial execution and financial performance.

However, the competitive structure of factor markets determines how quickly managers must change value-destroying strategies. For instance, monopolies and companies with state protection are punished more slowly. Some scholars suggest that competitive product markets can serve as a substitute for other governance mechanisms. They point to the success of Japanese companies like Toyota and Honda, which operate in extremely competitive product markets but are not known for having effective boards or other governance structures and are protected from discipline by the weak market for corporate control in Japan.

Competition in capital markets can also lower agency costs. Investors have a choice of investment options and are less likely to tolerate persistent underperformance or being mistreated by majority shareholders. In some settings, capital providers can negotiate directly for enhanced governance rights or impose contract constraints on managers. Similar pressures, channeled through intermediaries such as underwriters, work to enhance governance in advance of initial public offerings or other major capital market transactions. As with other factor markets, capital market constraints vary by industry and by firm. As discussed next, many established companies generate sufficient free cash flow that they do not need to return to capital markets frequently or even at all.

## Free Cash Flow Agency Problems and the Role of Debt in Corporate Governance

Owner-manager agency conflicts are exacerbated when companies generate substantial profits. Managers of profitable companies must decide whether (and how) to reinvest internal funds or return the profits to shareholders as dividends or share buybacks. Jensen defines free cash flow as “cash flow in excess of that required to fund all projects that have positive net present values when discounted at the relevant cost of capital.”<sup>9</sup> Jensen and Stulz outline the free cash flow hypothesis, which predicts that shareholders will limit managerial discretion over free cash flow in order to mitigate agency conflicts.<sup>10</sup>

The challenge for shareholders is to create a mechanism that will provide enough capital for managers to pursue value-enhancing investments while restricting investments that are wasteful and block managerial consumption of perquisites that do not enhance shareholder value. One method of achieving this is with a credible threat that self-serving managers can be replaced. Cross-country research evidence shows that companies in countries with greater shareholder rights hold lower levels of cash.<sup>11</sup>

Jensen argues that debt limits the use of free cash flow since it forces managers to “bond their promise to pay out future cash flow.”<sup>12</sup> That is, when companies issue debt, the promise of regular payments to service the debt reduces the cash flow at the hands of managers for discretionary spending. While debt issuance can assuage the agency problem of free cash flow, it gives rise to its own agency problems due to the competing financial interests of creditors and shareholders. In addition, managers may simply avoid incurring debt or keep debt levels low precisely to avoid the constraints debt imposes.

### Buybacks and Leveraged Recapitalizations

Share repurchases are the primary method by which companies return cash to shareholders. Consistent with the free cash flow hypothesis, research has found that share repurchases are value-enhancing for shareholders. It has also become increasingly common (and controversial) for firms to finance the repurchases by taking on debt. The risk with leveraged buybacks is that they could lead to excessive debt levels, which lower firm value and increase the risk of financial distress, and (given transaction costs and other impediments to raising new finance) impede companies from pursuing good investments, such as in research and development. As we will discuss later, this critique is often levied at activist investors who encourage companies to take on more debt and return cash to shareholders. The following quote from *The Economist* magazine aptly summarizes the critique: “Some firms may be borrowing too much to pay for their buyback habit. . . . Shareholder capitalism is about growth and creation, not just dividing the spoils.”<sup>13</sup>

## Market for Corporate Control

An important mechanism to limit agency costs comes from competition for control of corporations. CEOs of poorly performing companies risk being replaced following an acquisition by another company (sometimes after a bankruptcy). Boards of directors that are unable or unwilling to discipline managers of poorly performing companies can be replaced by vigilant shareholders. We discuss some of these mechanisms below.

## Mergers and Acquisitions (M&As)

Takeovers and M&A transactions are common ways of transferring control of corporate assets. If dispersed shareholders believe that the incumbent managers are not acting in their best interest, a third party can even initiate an M&A process by launching a *hostile takeover*, an offer made directly to public shareholders. A successful bid by a hostile acquirer will likely result in the incumbent management team being replaced. The threat of a hostile takeover therefore acts as a disciplinary influence on managers.

If the company's board of directors is unwilling to replace poorly performing managers, and if hostile bids are disciplinary in nature and can serve as corrective measures for poor management, the market for corporate control can substitute for poor internal governance. For example, the takeover bid by Broadcom for Qualcomm in early 2018 followed a year during which Qualcomm's performance lagged the Nasdaq stock index by more than 20%.

The functioning of the market for corporate control is affected by regulation and by other corporate governance mechanisms. For example, US companies can adopt so-called poison pills to block hostile tender offers and force bidders to wage proxy fights for control (discussed in more detail below). UK companies cannot adopt poison pills. US companies with staggered boards are harder to take over than other companies because it takes longer to elect a majority of directors. Companies that have most of their shares held by a smaller number of institutions are easier to take over than companies in which individuals own relatively more stock.

## Leveraged Buyouts (LBOs)

Corporate control is often achieved when the public ownership of a company is taken over (purchased) by a controlling shareholder (e.g., a private equity firm) and the company is made private. In some cases, existing management teams take a significant ownership stake, creating a management buyout (MBO). The ownership is often financed by the company buying back stock using high levels of leverage (recall the role of debt as a solution to the free cash flow problem). LBOs modify the governance of the company; the high debt levels increase the level of monitoring by debt holders, and concentrated ownership greatly reduces manager-owner conflicts. Targets of LBOs are



traditionally seen as companies with stable free cash flows that have poor investment opportunities, or where incentive misalignment and poor board monitoring have led to poor performance. LBOs are accompanied by high-powered incentive schemes whereby managers are handsomely rewarded for company performance.

## **Bankruptcy**

In the event of bankruptcy, conflict between shareholders and managers is superseded by duties to and rights of creditors. In the United States, bankruptcies are governed by two “chapters” of law: Chapter 7 and Chapter 11. In a Chapter 7 liquidation, secured creditors, usually a bank, are paid first from the liquidated assets of the company. After that, unsecured creditors are compensated and then shareholders. In a Chapter 11 reorganization, creditors usually become the owners of the company’s shares, and the company may cancel existing equity.<sup>14</sup> Often, companies are acquired by third parties as part of a Chapter 11 reorganization, and prebankruptcy managers are generally replaced.

## **Shareholder Activism**

Shareholder activism refers to efforts of minority shareholders to prod companies to improve performance. The growth in shareholder activism in the United States can be traced back to two phenomena. As discussed previously, the extent of institutional shareholding, especially by index funds, has increased in the United States. The growth of index investing and the need for diversification prevents many fund managers from practicing the Wall Street walk (i.e., where they sell shares of underperforming companies). Moreover, the sheer cost and financing challenges of launching a large hostile takeover, coupled with legal constraints on the ability of many institutions (such as pension funds) to take full control of underperforming companies, have led such shareholders to seek alternate ways to influence firm performance. Shareholder activism is now widely practiced and takes different forms, which we discuss below.

## **Engagements**

As noted above in our discussion of boards, large shareholders now frequently engage with boards to influence corporate governance. In the United States, pension funds and other institutional investors have actively engaged with the management of companies to improve shareholder value. Such engagements range from brief phone calls to lengthy meetings, and from general dialogue about overall governance to specific discussions of corporate debt, payout policies, or operational strategy. Through these meetings and calls, large institutions exert influence, obtain information, and form opinions about whether directors and officers are competent and loyal. BlackRock reported 1,480 engagements with portfolio companies in the year ended June 30, 2017, including 836 isolated conversations, 499 “moderate” engagements generally involving

multiple meetings, and 145 “extensive” engagements, which are “high profile” and include “numerous meetings over a longer time frame.”<sup>15</sup>

## **Public Shaming and Vote No Campaigns**

Shareholders also engage in public shaming of directors and officers, who are often protective of their reputations for career and other reasons. A particularly effective form of shaming is a vote no campaign, a trend that emerged in the 1990s. In such campaigns, activists lobby other shareholders to withhold votes in director elections as an expression of investor displeasure with the company’s performance or strategy, executive pay, or some governance practice such as inadequate director qualification. These campaigns were first proposed by Joseph Grundfest in 1990 as a low-cost way of expressing shareholder dissatisfaction. Vote no campaigns rely on public shaming and reputational costs to targeted directors as a way to motivate such directors to take action.<sup>16</sup>

Such votes can be viewed as merely symbolic in conveying shareholder dissatisfaction because, even with a majority of shareholders withholding their votes, directors can still get elected if the company is governed by default plurality voting rules, in which the directors receiving the largest number of votes win. But over time, many companies have adopted majority vote bylaws or charter provisions, which result in directors failing to get reelected unless they obtain positive votes from a majority of shareholders. Even then, a board can often use its power to legally reappoint the unelected director, but such actions tend to stimulate even more public scrutiny and negative shareholder opinion. Because directors strongly dislike the negative personal attention that such campaigns bring to bear, research studies find that directors seek to avoid them. When they do occur, vote no campaigns are followed by improvements in operating performance and disciplinary CEO turnover.

## **14a-8 Resolutions**

Shareholders can submit proposals for presentation at a meeting of the company’s shareholders and can even include such proposals in the company’s own proxy statement under SEC rule 14a-8, along with up to 500 words of advocacy, with the cost borne by the company and not the submitting shareholder. Under current rules, the shareholder has to have held either \$2,000 or 1% of a company’s shares for at least one year before he or she can submit a proposal to be voted on by other shareholders. Between 2003 and 2015, a total of around 12,600 proposals were filed by shareholders—one or two on average at most large companies. The proposals that shareholders bring can range from the frivolous (such as calls to cancel *The Rachel Maddow Show*) to the serious (such as a proposal that AT&T “publicly commit to operate its wireless broadband network consistent with Internet network neutrality principles”).<sup>17</sup> Many

of the most successful proposals focus on other aspects of corporate governance, such as staggered boards and executive compensation.

The SEC rule permits omission of some proposals at the request of management on a variety of grounds. One ground is that they relate to day-to-day operations of the business. Another is that they are unlawful, including on the basis that they interfere with the board's authority over business decisions. As a result, most proposals are framed to be nonbinding, which avoids conflicting with law. (Some purely governance-related proposals can be framed as binding bylaws.) The nonbinding nature of most proposals means that companies do not have to implement a proposal even if it wins majority shareholder support. However, if a proposal does receive majority support and is ignored by boards, shareholders now routinely resort to shaming boards. This tactic is so commonly expected that most proposals that receive majority shareholder support are now implemented in some fashion. Of the 12,600 proposals filed between 2003 and 2015, boards sought to exclude 4,800 (or 38%), and the SEC allowed exclusion of around 3,500 (28%).

### **Hedge Fund Activism**

On February 14, 2017, Trian Partners, a New York-based hedge fund, announced that it had accumulated a \$3.5 billion stake in consumer products giant Procter & Gamble (P&G), amounting to a 1.5% ownership stake in the company. Pound defined the likes of Trian as an entrepreneurial activist (i.e., an investor who buys a large stake in a publicly held corporation to force change and realize a profit on the investment).<sup>18</sup> Trian proceeded to engage P&G on numerous issues, demanding that the company simplify its organizational structure, accelerate revenue growth, and accelerate its cost savings. To ensure that the company would follow its proposals, Trian demanded a seat on the P&G board be held by its founder and CEO Nelson Peltz.

In recent years, activist campaigns by hedge fund investors such as Trian have become a powerful influence in forcing operational, financial, and governance changes in companies. From 2004 to 2015, there were around 2,250 such campaigns waged against US companies, of which 200 ended up in a proxy contest.

Hedge fund activism differs from other forms of institutional activism. Hedge fund managers have stronger financial incentives to improve the value of their investment than the average mutual fund money manager and are not bound by mutual fund economics, which increasingly emphasizes low costs, and investment restrictions, which can impede efforts to influence a portfolio company. Hedge funds receive significant performance fees (typically 20% of returns over some benchmark) as well as a high fixed fee (often 2%) on the assets under management. Investors in hedge funds typically comprise institutions and high net worth individuals; the sophisticated nature of the investor base allows hedge funds greater regulatory freedom to intervene and take actions in companies that is normally not allowed for mutual funds. Hedge funds

tend to make large, concentrated investments, providing them with ownership leverage over the management of target companies and credibility with other investors. They also tend to have shorter holding periods than many other investors, with more than 95% of all “activist” investments exiting their investments within two years, and more than half exit within 266 days.<sup>19</sup>

What kind of companies do hedge funds target? As one would expect, hedge funds target companies that appear to have valuations lower than their fundamentals would suggest they should. Target firms typically appear to suffer from the kind of free cash flow problem identified by Jensen.<sup>20</sup> That is, targets have good operating cash flows but low sales growth, leverage, and dividend payouts. Targets are also generally smaller, although some activists like Trian typically target larger companies. Activists also target firms with greater stock liquidity and greater institutional ownership. Target companies are seen to have weaker shareholder rights than comparable firms, lending some credence to the notion that activists target firms where poor performance was likely driven by weak governance.

## **Proxy Fights**

Trian executives met with P&G management over the months following the initial February announcement, but P&G’s board of directors balked at giving Peltz a seat on the P&G board. Unhappy with the company’s response, Peltz and Trian announced on July 17, 2017, that they would solicit proxies ahead of P&G’s general meeting to elect Peltz to the board. On September 6, Trian published an exhaustive whitepaper detailing its proposals for making improvements at P&G. The hedge fund asserted that P&G had underperformed relative to the market and its peer companies for around a decade. Trian critiqued P&G’s corporate governance and the track record of its board. P&G launched a proxy defense and argued that Peltz and Trian had “no new ideas” and that the company had already implemented many of the suggestions made by Trian, so Peltz’s presence on the board was thus unnecessary. P&G also pushed back on the perception that it was struggling. This example is fairly descriptive of typical proxy fights between activist investors seeking board seats and the incumbent board that resists it.

The above categories of action, while seemingly distinct, are often practiced together. Proxy fights often reflect a failed attempt at behind-the-scene negotiation. Vote no campaigns can lead boards to eliminate takeover defenses, making hostile takeovers easier, and can attract attention from activist hedge funds.

## 2.5 Mechanisms for Mitigating Intra-Shareholder Conflicts of Interest

Next, we turn our attention to intra-shareholder agency problems, in which there are conflicts of interest among different owners of a corporation. The conflicts arise from the difference between ownership (referred to as *cash flow rights*) and control of management (also referred to as *voting rights*); controlling shareholders can influence firm policies to benefit themselves rather than benefit all investors. In many companies around the world, a small group of controlling shareholders has limited direct ownership (cash flow rights) but controls the company's operations through various mechanisms. The agency problem therefore involves a conflict between minority and controlling owners. As noted above, in companies with a high level of ownership concentration, it is commonly assumed that the large owners can monitor managers closely. Agency problems caused by information asymmetry are thought to be mitigated because the controlling owner can obtain the information needed for monitoring.

### 2.5.1 How the Potential for Intra-Shareholder Conflict Is Manifest

In much of the world, but less so in the United States and United Kingdom, companies are controlled by a small group of shareholders, often by families (for example, the Tata group in India or the Agnelli family in Italy). In some countries, such as Japan and Germany, control rests with financial institutions (banks). Even in the United States, many large companies are controlled by family owners (e.g., Walmart) or by founders (e.g., Google, Facebook). In a 2016 analysis of 26,843 companies around the world in 2012, researchers found that 44% of companies were controlled by a single shareholder. The nature of the majority shareholder differs greatly: companies controlled by a single family made up a plurality of these controlled firms, with approximately 34.5% of controlled firms falling under family control. Other major groups included private firms without an identifiable controlling shareholder, governments, widely held public companies, and widely held private firms. As **Exhibit 4** suggests, the prevalence of controlling shareholders can differ greatly from one country to the next.<sup>21</sup>

**EXHIBIT 4** Ownership and Control, by Country, in 2012

Country	Firms	Market Cap (billion USD)	% Controlling Shareholder
Argentina	79	33.3	64.7
Australia	1,347	1,069.1	22.1

Bulgaria	77	4.3	53.1
Canada	2,019	1,418.2	25.5
France	788	1,448.0	46.4
Germany	722	1,152.8	45.3
Greece	229	33.1	44.2
Hong Kong	694	1,251.6	37.9
India	1,478	1,035.4	27.3
Indonesia	250	311.5	51.0
Kenya	19	8.1	44.6
Nigeria	38	30.3	43.2
Philippines	57	122.6	47.8
Russia	436	797.9	53.1
United Kingdom	1,347	2,444.4	19.5
United States	4,461	14,499.0	21.4

### **Control Shareholders with Majority Ownership**

Many studies on emerging market companies show that majority ownership is often held directly by a controlling family. For example, the majority ownership accounted for over 50% of Indian and Singaporean family-controlled businesses. These families also typically sit on boards and are involved in management. In cases of direct shareholding, there is no divergence between cash flow rights and control (voting) rights. Yet conflicts can exist, as when a majority shareholder appoints an unqualified manager who has other relationships (e.g., family) with the shareholder.

### **Control Shareholders with Less Than Majority Ownership**

On September 19, 2014, the Chinese e-commerce giant Alibaba listed its shares on the NYSE in what was until then the world's largest initial public offering (IPO). For Alibaba, the road to listing in New York went through a failed attempt to list on the Hong Kong Stock Exchange because the exchange had refused to exempt the company from the exchange's one share, one vote rule. Alibaba maintained a governance structure under which 28 current or former Alibaba managers, who comprised the so-called Alibaba partnership, collectively owned around 12% of the equity of the company but retained nominating control of the majority of the company's board of directors. The NYSE had no such restriction.

In fact, several NYSE listed companies had a dual share class structure whereby a superior class of shareholders (typically the founders) owned shares that conferred a greater proportion of the voting rights. This included technology giants Google and Facebook and media companies like the New York Times and News Corporation. However, the Alibaba structure attracted widespread concern, with a prominent governance expert commenting, “Investors rushing to participate in the Alibaba IPO must recognize the substantial governance risk that they would be taking. Alibaba’s structure does not provide adequate protection to public investors.”<sup>22</sup>

## **Multiple Classes of Shareholders**

The Alibaba partnership is an uncommon way of exercising control. More commonly, control is exercised through multiple classes of stock that effectively restrict or dilute the voting rights of minority shareholders. For example, Google’s founders control the parent company Alphabet using a three-class share structure. Class A shares are held by regular public investors. Class B shares, held by the founders, provide super-voting rights and carry 10 times as much voting rights as the Class A shares. Class C shares carry no voting rights and are held primarily by employees that receive stock and by investors of Class A shares who received Class C shares as dividends. Using this share structure, the co-founders control 56% of the company while earning only 15% of the cash flow rights.<sup>23</sup>

A dramatic and controversial example of controlling ownership is provided by Snap Inc., the company that owns the popular social media application Snapchat. The company’s IPO, completed in February 2017, was the first in which the stock offered to the public carried no voting rights at all. Snap offered three classes of common stock: Class A, Class B, and Class C. Class A carried no voting rights and was sold to the public. Class B carried one vote per share and was held by pre-IPO investors. Class C carried 10 votes per share and was held by the co-founders of the company, giving them control over all matters requiring stockholder approval.

An important characteristic of multiple-class shareholder arrangements is that they aim only to preserve the voting rights of a select few controlling shareholders while maintaining standard, proportional rights to cash flow, creating a wedge between shareholder groups based on unevenly distributed cash flow rights and voting rights.

## **Pyramidal Ownership**

Pyramidal ownership structures allow a minority shareholder to maintain voting control of a company through holding companies, often with byzantine arrangements. A group, usually a family, could use a series of holding companies in which the stake in each successive holding company is increased in order to control the final company through a smaller initial stake. The Hong Kong-based Li Ka-shing group is a good

example. The Li Ka-shing family operates through the Cheung Kong public company in which it had a 35% stake. Cheung Kong had a 44% stake in the operating company Hutchison Wampoa, which in turn owned Cavendish International, the holding company of Hong Kong Electric. Pyramidal ownership was most common in Asia companies and in some European companies.

### Cross Holdings

A common control mechanism involves cross holdings. A simple example is shown in **Exhibit 5**. Consider three publicly listed companies: A, B, and C. Each has equity worth \$100. To take over any one of the companies, one would need \$51 of the outstanding equity (notwithstanding any of the issues that commonly plague takeover attempts), assuming more than a 50% stake is needed.

**EXHIBIT 5** Equity Ownership of Three Companies, Each with Total Equity of \$100

Company A	Company B	Company C
100% public ownership	100% public ownership	100% public ownership

**Cross holdings** between companies, however, allow a party to maintain control over multiple companies without necessarily owning a majority of the shares in these companies. For example, Person X owns 51% of a company A that is publicly listed, meaning 49% of the capital comes from public shareholders. Company A then buys 51% of company B, which is publicly listed, thereby providing control of company B to Person X, who has invested only 26 percent of his or her funds in Company B ( $0.51 \times 0.51$ ). Now, imagine that Company B buys 31% of Company A from Person X. By doing so, it reduces Person X's investment in Company A, but still allows him or her to control both company A and company B.

The Jardine Group in Hong Kong, which owns major companies like Mandarin Oriental and Dairy Farm, offers a good example of how cross holdings work. Jardine Matheson, the group holding company, owns 81.7% of Jardine Strategic, a publicly listed company. In turn, Jardine Strategic owns 54.5% of equity in Jardine Matheson, which is also publicly listed. The Keswick family, which controls the Jardine Group, owns only about a 10% stake in Jardine Matheson and a negligible stake in Jardine Strategic.<sup>24</sup> Cross holding thus allows the Keswick family to control these companies with little ownership and protects it from hostile takeovers.

A different form of cross shareholdings exists in Japan, where companies in close supplier-customer relationships hold ownership stakes in each other. While such investments can promote long-term partnerships, governance experts worry that such structures also protect managers by creating large blocks of supportive shareholders.



## What Is the Value of Voting Rights?

As noted above, Google offers three classes of shares. The founders of Google own Class B shares that have ten times the voting power of Class A shares, which are held by ordinary investors. In 2012, Google issued to Class A shareholders dividends in the form of Class C shares, a third-tier of shares with no voting rights. This would have further diluted the ownership rights of Class A shareholders. Investors led by a Massachusetts pension fund sued the company and its executives for breach of fiduciary duty. Before the suit came to trial, Google settled with the plaintiffs by agreeing to let the market price determine the value of voting rights lost by the investors. The Class C shares traded at a significant discount to the share with voting rights, forcing Google to pay over \$560 million as compensation to investors toward lost voting rights.

More generally, the economic value of voting rights is hard to assess, given the contextual nature of that determination. The value of a vote fluctuates significantly over time, with the probability that the vote will matter and be important to a corporate decision requiring shareholder approval.

### 2.5.2 Mitigating Intra-Shareholder Agency Conflicts

Major concerns with conflicts between controlling and minority shareholders arise from the possibility that the controlling shareholders or corporate insiders can engage in **self-dealing** transactions to the detriment of the minority shareholders. Self-dealing can take different forms. In some cases, it refers to excessive executive compensation (as discussed above). Most often the negative impact of controlling shareholders is seen in the form of **related party transactions (RPTs)**, which are transactions or resource transfers between the company and the controlling shareholders that harm the minority shareholders. For example, a controlled company can buy raw materials from a supplier owned 100 percent by the controlling shareholders at higher than market prices, thereby transferring profits from the publicly owned company to one fully owned by the controlling shareholders. Other types of self-dealing arrangements are intercorporate financing, credit guarantees to related parties, and transfer of assets to related parties at below market prices.

Three approaches have typically been used to mitigate the impact of intra-shareholder agency problems: a ban on the separation of ownership and control rights, prohibition of related party transactions, and transparency and approval requirements.

## **Ban on the Separation of Ownership and Control Rights**

The first approach is the outright ban on the separation of ownership and control rights. In the Alibaba case referred to above, the Hong Kong stock exchange refused the listing of a dual-share class company (though many Hong Kong listed companies create controlled ownership through pyramidal ownership, and Hong Kong changed its rules in 2018 to permit listings by dual-share companies). Other countries continue to maintain bans. Company law regimes in Germany, Spain, and China ban variable voting right structures for all companies (listed and unlisted), whereas some countries (e.g., the United Kingdom, Australia, and Singapore) prohibit these structures in listed companies. Other countries, including Canada and Sweden, allow variable voting rights. The United States permits them but does not allow a listed traditional company to switch to a dual-class structure while remaining listed.

## **Prohibition of Related Party Transactions**

The second approach is to try to limit self-dealing by prohibiting related party transactions. For example, in 2002, the Sarbanes-Oxley Act in the United States prohibited loans by the company to corporate executives and directors because of abuses in two scandal-ridden companies, WorldCom and Tyco. Other types of RPTs remain permitted in the United States.

## **Increasing Transparency and Approval Requirements**

A third approach is to regulate RPTs by increasing transparency and by requiring special approvals before they occur. Many countries require independent directors to approve related party transactions. However, critics worry about the true independence of nominally independent directors in controlled companies where the directors need the approval of the controlling shareholders to join the board.

As a potential remedy to lax board oversight, some countries (e.g., Israel and India) provide a formal role for shareholders in approving substantial transactions. Israel requires extraordinary transactions (as defined in the regulations) to be approved not only by the audit committee of the board but also by the majority of shareholders that are not part of the controlling group. In India, market regulations require a “majority of minority” shareholders to vote in favor of a proposed merger before it can proceed. Both these approaches face the constraint of weak enforcement in many countries due to weaknesses in the legal system and in regulators.

In the United States, no formal approval by shareholders is triggered simply because a transaction is an RPT, but as discussed below, court enforcement of fiduciary duties gives boards an incentive to present RPTs to noncontrolling shareholders for their approval.

## **Taxation's Incidental but Important Effect in Discouraging Pyramids in the United States**

While pyramidal ownership is common in many countries, as discussed above, they are virtually absent in the United States. Such ownership was common in the United States until the 1930s, however. Morck identifies the introduction of intercorporate dividend taxes by Franklin Delano Roosevelt's administration in 1935 as a cause of the dismantling of pyramid ownership in the United States.<sup>25</sup> The tax of 10% in 1935 was subsequently raised to 15% in 1936. Prior to this, corporations were not taxed for the dividends they received. This meant that pyramid ownerships that passed on dividends from one company to another up the pyramid paid taxes at every stage, thus reducing the desirability of such ownership structures. The United States is unique in taxing intercorporate dividends.

## **Appraisals and Cash-out Rights to Obtain or Force Liquidation**

Often, a company may attempt a fundamental change, usually through a merger and/or acquisition. Such actions may be taken at the behest of the majority shareholders despite objections from minority shareholders, in which cases minority rights would need to be protected. Appraisal statutes allow objecting shareholders to sell their shares back to the corporation at "fair value." This protects minority shareholders from *freeze-out mergers* where majority shareholders approve a merger that does not provide minority shareholders with fair value for their shares.<sup>26</sup>

## **Enhancement of Independent Director Roles**

As discussed above, regulators often look to independent directors for protection of minority shareholder rights. The past two decades have seen a significant enhancement of corporate governance to increase the proportion of independent directors on boards of directors as well as an increase in independent director responsibilities to offer greater protection to minority shareholder rights.

The importance of independent directors is generally increasing worldwide. This trend includes recommendations in some cases and mandates in others on (1) the fraction of independent directors on the board, (2) the presence of independent directors on board committees, notably the audit committee, and (3) the greater role of independent directors in monitoring and approving self-dealing by managers or controlling shareholders. For example, the Japanese Corporate Governance Code, which took effect in June 2015, requires the appointment of at least two independent directors to the board of publicly listed companies. The European Commission recommended governance standards in 2005 that require directors to be independent of controlling shareholders. Member countries were then free to define independence and mandate their own requirements.

Similarly, independence on board committees is also on the rise. In 2014, the European Union issued a directive mandating a majority of independent directors to the audit committees of public companies. India, China, and Japan are examples of countries that, over the past decade, have adopted similar mandates on majority independence of audit committees. As noted above, the role of independent directors has also been increasing in the monitoring of RPTs. For example, since 2014, India has required that all RPTs require the prior approval of the audit committee (which is comprised of a majority of independent directors). Italy requires that significant RPTs be approved by an independent committee of the board.

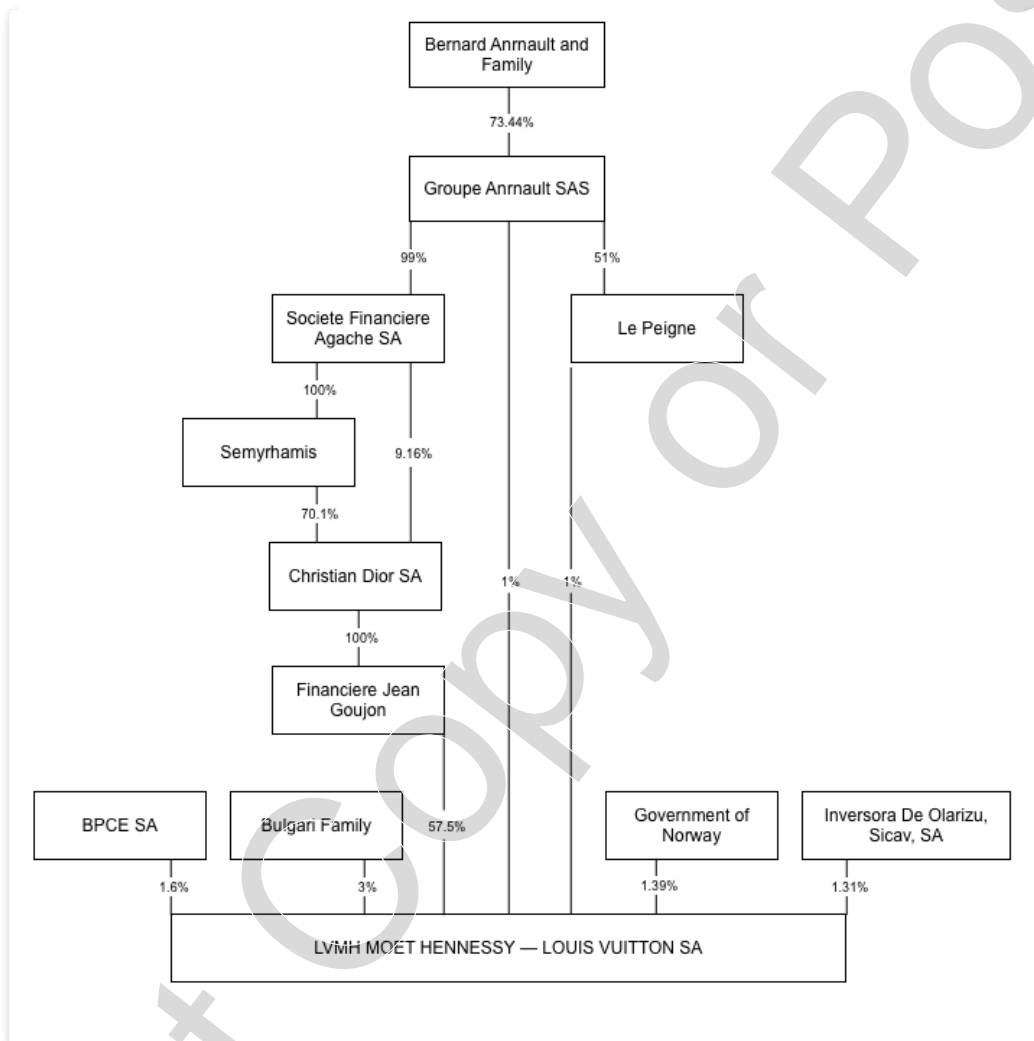
### **Debt Governance—Banks**

Besides shareholders, creditors (especially large banks) can have numerous interests in the long-term prospects of a company. Creditors had substantial rights to cash flow and thus significant ability to affect corporate strategy and behavior. In addition, debt is often easier to value than stock given that there is collateral. In Japan, companies with a principal banking relationship had greater management turnover due to poor performance. In Germany, bank involvement has been found to improve performance. The examples of Japan and Germany were specific to those countries because their corporate governance structures engendered longer-lasting partnerships between a company and its creditors. In the United States and United Kingdom, the role of banks is more muted: They play a significant governance role only in instances of company bankruptcy.<sup>27</sup>

### **2.5.3 Some Examples of Ownership Structures**

**Exhibit 6** provides the 2012 ownership pattern for LVMH, the French luxury goods company.<sup>28</sup> The authors of that study describe how the ultimate control of LVMH rests with financier Jean Goujon, an investment company that holds a 57.5% stake in LVMH through a series of intermediary investment companies. The ultimate ownership can be traced to the private company Groupe Arnault SAS, which is the investment vehicle of French businessman Bernard Arnault and his family.

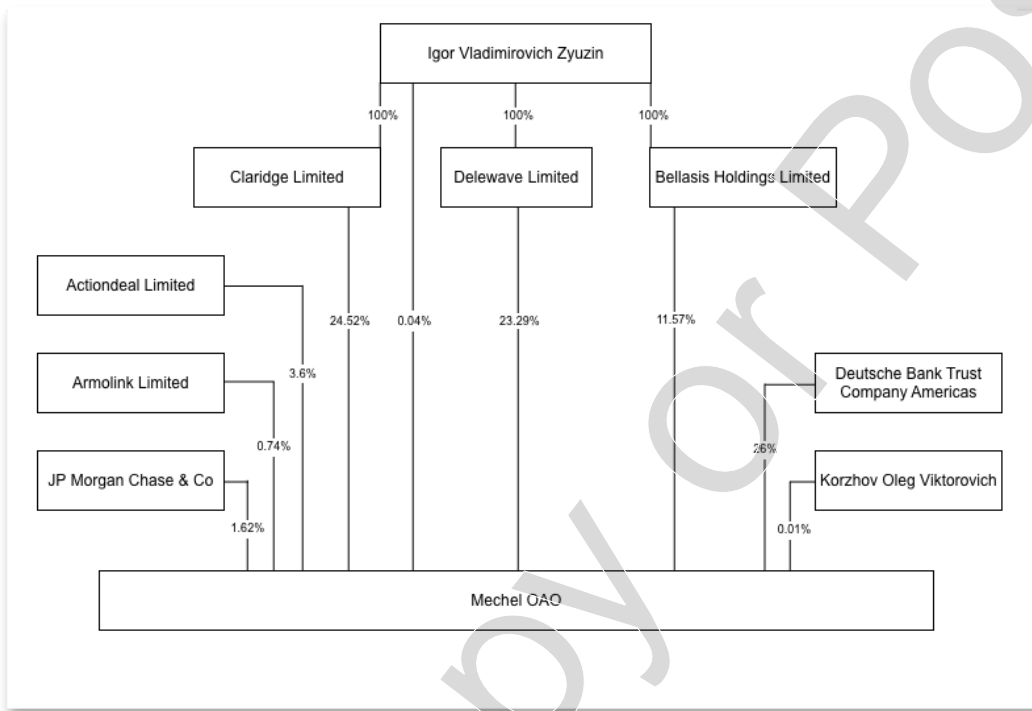
**EXHIBIT 6** Ownership Pattern of LVMH (France)



Source: Gur Aminadov and Elias Papaionnou, "Corporate Control around the World," NBER Working Paper 23010, [www.nber.papers/w23010](http://www.nber.papers/w23010), 2016.

**Exhibit 7** shows the ownership structure of Mechel OAO, a major Russian mining and metals company. Control appears to be dispersed among the largest shareholders for Mechel; however, these companies are 100% controlled by a Russian businessman, Igor Vladimirovich Zyuzin.<sup>29</sup>

**EXHIBIT 7** Ownership Structure of Mechel OAO (Russia)



Source: Gur Aminadov and Elias Papiaonnu, "Corporate Control around the World," NBER Working Paper 23010, [www.nber.papers/w23010](http://www.nber.papers/w23010), 2016.

## 3 SUPPLEMENTAL READING

### 3.1 Shareholder Versus Stakeholder Models

In July 2016, Prime Minister Theresa May of the United Kingdom made a speech on the British economy during which she proposed that corporate boards of directors include employee representatives. The issue of employee representation on company boards illustrates the ongoing debate on shareholder versus stakeholder models of corporate governance. The stakeholder model, as opposed to the shareholder model, considers corporate governance broadly “as the design of institutions that induce or force management to internalize the welfare of stakeholders.”<sup>30</sup> Next we provide some examples of stakeholder models of governance.

### 3.2 Co-Determination and Employee Directors

The German co-determination model provides for a two-tier board structure for all listed companies. Under this model, the management board consists of managers and deals primarily with strategic and operational issues. The supervisory board, like the board of directors of a US corporation, includes only nonexecutive directors and is elected by shareholders. Members of the management board are appointed by the supervisory board. For companies with more than 2,000 employees, German corporate law requires that one half of the supervisory board must comprise employees (one-third for companies with 500 to 2,000 employees). These representatives are chosen and elected by the employees, giving them full control of the process. The trade union can also seek representation by nominating candidates.<sup>31</sup>

Nordic states with the largest economies—Norway, Sweden, Denmark, and Finland—have long been defined by a model of collective decision making among labor, owners, and the government. This model extends to the boardroom, with a mandate for employee representation on corporate boards. In 2015, France expanded the obligation for companies with 1,000 or more employees in France or more than 5,000 worldwide to have employee representation on the board of directors.<sup>32</sup>

### 3.3 Corporate Governance in Japan

Japan’s corporate governance practices are viewed as protecting managers from shareholder pressure. Managers are seen as having an obligation to all stakeholders in

a company, including employees, customers, banks, and suppliers. Ownership of corporations was long characterized by the *keiretsu* system—a web of cross holdings across group companies, often suppliers and customers of one another, with the main bank in the middle as a significant owner of the group companies (some of the largest Japanese corporations, such as Mitsubishi and Sumitomo, were part of *keiretsu* structures). The main bank was a dominant governance force that approved significant investments and intervened to discipline managers. The cross-holding structure prevented hostile takeovers. When Shinzo Abe became prime minister of Japan in 2012, however, he introduced reforms meant to change Japanese corporate governance. The reforms eroded some of the key tenets of *keiretsu*, such as systematic cross holding.

### 3.4 Constituency Statutes

Constituency statutes arose in the United States in the 1980s. They allow directors to recognize the effects of business decisions on stakeholders who are not shareholders. They somewhat reverse standard corporate governance, in which the board has a fiduciary responsibility only to shareholders. Most of these laws allow directors to consider the consequences of their decisions on nonshareholder constituencies in discharging their duty of care. As of 2016, these statutes have been enacted in 34 states across the United States. The nonshareholder stakeholders that can be considered include employees, customers, suppliers, creditors, and local communities. Some constituency statutes also allow directors to consider both the long- and short-term effects of their decisions.

While constituency statutes arose initially in the context of anti-takeover laws (discussed earlier in this reading), they also pertain to other contexts besides takeovers. They therefore apply broadly to operational and investment decisions. They allow, but do not require, directors to account for nonshareholder interests. In practice, the application of these statutes varies widely across jurisdictions, and there appears to be limited consensus among legal scholars on their implications for the fiduciary responsibility of directors or on whether the statutes affect behavior in practice.

### 3.5 Golden Shares

Golden shares are a popular tool used predominantly by governments when they privatize certain companies. They came about in the 1980s when the United Kingdom began to privatize numerous key industries as a safeguard against foreign takeover. **Golden shares** give the controlling party—in this case, the government—the power to veto any decisions by the privatized corporation. Golden shares were popular in post-



Soviet Union Russia and have appeared in privatization transactions in other countries around Europe. However, golden shares have been challenged by the European Union, which has ruled in multiple cases that golden shares violate the free movement of capital. As such, the European Court of Justice has often moved to block the exercise of golden share privileges.<sup>33</sup> For instance, in 2003, the European courts ruled that the UK government's golden share in British Airports Authority was invalid.

### 3.6 Consistency with Shareholder Model If All Externalities Can Be Internalized

Business decisions are not just transactions between management and shareholders; they have numerous externalities that can affect employees, other business partners, creditors, and general citizens. As Jean Tirole succinctly put it: "Divergence of objectives create externalities." Tirole further describes a stakeholder society as one with a "broad mission of management,"<sup>34</sup> that is, a society in which management aims to maximize all stakeholder utility, thus internalizing the externalities inherent in various business decisions. This internalization process can improve corporate value consistent with the shareholder model.

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## 5 KEY TERMS

**activist shareholders** Shareholders who demand that a company's management make changes because they are dissatisfied with a company's performance and who often attempt to solicit votes directly from other shareholders to gain support for their proposals.

**agency costs** The reduction in a corporation's value that occurs when agents act in ways that fail to maximize shareholder returns. Also, costs incurred by shareholders in attempting to monitor managers. Also, costs that managers incur as they attempt to demonstrate that they are acting in shareholders' interests.

**audit committee** A committee that oversees the independent audit process and sometimes has other roles, such as overseeing legal compliance programs and risk management.

**board of directors** The group of people who have formal authority over a corporation.

**cash flow rights** The rights that shareholders own to the corporation's cash flows.

**class actions** Legal actions in which lawyers seek one or a small number of shareholders and sue on behalf of all shareholders, in return for fees paid out of a settlement or winning verdict.

**classified boards** Boards of directors with multiple classes of directors who have overlapping terms on the board so that not all board members are elected simultaneously. Also known as *staggered boards*.

**co-determination** A model of governance with a two-tier structure for boards of directors, and neither board has sole decision-making authority over the corporation.

**compensation committee** A committee that oversees compensation decisions for the corporation's top officers, often with the input of independent compensation consultants.

**corporate officers** The members of a company's senior management team who are responsible for managing the company's daily operations and planning its long-term future.

**cross holdings** A practice in which one corporation owns shares in a second corporation, which sometimes enables the first corporation to control the second corporation.

**derivative suits** Lawsuits in which shareholders seek redress for the company for harm inflicted on the company by management or the board of directors (or even third parties). Under this method, the lawsuit is brought on behalf of the corporation, and damages are awarded to the corporation rather than directly to the shareholders.

**direct suits** Lawsuits initiated by shareholders that allege that they were harmed because the company management provided misinformation, incomplete disclosure, or in some other way violated the law so that shareholders were harmed directly.

**executive sessions** Portions of meetings among a corporation's board of directors in which only independent directors and no officers are present.

**freeze-out mergers** Transactions in which a majority shareholder approves a merger that does not provide minority shareholders with fair value for their shares.

**golden shares** A tool used predominantly by governments when privatizing companies. The shares give the controlling party—here, the government—the power to veto any decisions by the privatized corporation.

**governance committee** A committee that sets policies on governance issues such as board leadership, self-evaluation, retirement, tenure, insider trading, executive sessions, and takeover defenses.

**hedge fund** A form of investment fund in which most investors are institutions and high-net-worth individuals; it has more regulatory freedom to intervene and take actions in companies than mutual funds do and usually has large concentrated investments in a small number of companies.

**hostile takeover** An offer that a prospective acquiring firm makes directly to public shareholders, often after a target firm has rejected the acquirer's initial bid. Usually, the hostile acquirer will replace the target's management team after it purchases the target.

**insider trading** Trading in the shares of a company on the basis of material, nonpublic information held by company insiders.

**keiretsu** A governance structure that is a web of cross holdings across companies that are often suppliers and customers of one another, with a main bank in the middle as a significant owner of the companies in this group.

**leveraged buyout (LBO)** An acquisition in which the acquiring firm assumes a high degree of leverage to purchase a firm that is viewed as underperforming. LBOs typically use high-powered incentives to reward managers for superior performance.

**management board** A board of directors that includes only managers from within the corporation and that is usually part of a two-board system of governance.

**nominating committee** A committee that oversees the ongoing need to refresh boards with new directors.

**proxy advisers** Providers of advice to institutional shareholders on how to vote their shares on a range of corporate matters such as director election, executive compensation, auditor ratification, and special situations such as proxy contests or mergers and acquisitions.

**proxy contest** A situation in which shareholder activists threaten to initiate or actually begin election competitions for seats on a corporation's board of directors by soliciting votes directly from other shareholders. Also known as *proxy fight*.

**proxy fight** See proxy contest.

**related party transactions (RPTs)** Transactions or resource transfers between the company and controlling shareholders that harm the minority shareholders.

**self-dealing** Transactions in which corporate insiders or controlling shareholders take self-interested actions that are to the detriment of noncontrolling shareholders.

**staggered boards** See classified boards.

**supervisory board** A board composed solely of independent directors.


**voting right** The right of a company's shareholders to vote for or against proposals made by a corporation's board of directors.

## 6 PRACTICE QUESTIONS




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**Corporate Governance**



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**Sections**  
Return here to check your progress [Expand All](#)

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<b>2.3.2</b>	Intra-Shareholder Agency Conflicts	▼
<b>2.3.4</b>	Importance and Prevalence of Two Types of Conflicts ...	▼
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<b>2.5.1</b>	How the Potential for Intra-Shareholder Conflict is Ma...	▼
<b>2.5.2</b>	Mitigating Intra-Shareholder Agency Conflicts	▼

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