Corporate Governance:

The Lessons of Democracy

Can Democracy Increase Profitability?

by

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Abstract:

In this paper, I evaluate the presence of democratic mechanisms in corporate governance and their effectiveness in facilitating economic efficiency. In approaching this task, I first will outline the institutional parallels between corporate governance and political democracy, and then explain how corporate democratic institutions can create a potential for accountability. I discuss existing provisions for accountability and suggest measures for improvement through an analysis of the democratic structural parallels within the corporation. I then argue that accountability can improve corporate governance. Using the democratic mechanisms of periodic elections and separation of powers, I conclude that while the principal-agency conflict cause corporate inefficiency, the solution to eliminating these agency lies in strengthening the institution of the board of directors. In order to increase corporate accountability, we must improve on the current inefficiencies of the election system and establish a more concrete separation of powers between the executive branch and the legislative branch in a corporation. Ultimately, I argue that democracy dictates a need for balance between management and shareholders, and this balance depends on a strong board of directors.

Introduction:

Proponents of democracy argue that its principles establish and promote stability within society. For example, the United States, which has maintained democracy for over three hundred years, had its stability threatened only once – during the Civil War from 1861-1865. Similar patterns emerge in democratic nations around the world. In Italy, a country where the word government is practically synonymous with corruption and prime ministers constantly rise and fall, the people know there will always be another democratic election.

Emmanuel Kant first discussed the affects that democratic institutions have on society in his essay, *Project for a Perpetual Peace* (1795). In that work, Kant observes that nations whose governments are liberal republics tend to be more stable and less likely to go to war with one another. The guiding principle for the theory he offered theory is now known as the democratic peace theory, developed by John M. Owen. It claims institutional constraints control both internal policies and external relations in a democracy. Furthermore, a complex system of checks and balances imposes these constraints and impedes democratic societies from making decisions that would jeopardize their citizen's well being[1].

Corporations and political democracies have parallel structures. Both incorporate elections, a representative government, and judicial review. Corporate management fulfills the role of the executive branch, monitoring day-to-day operations. The Board of Directors, like the legislative branch, ensures the executive branch is steering the corporation in the right direction. Ultimately, both must perform their obligations within the legal constraints imposed by the judicial branch. The existence of this parallel relationship implies that Kant's principles may apply to corporations and raises an important question: Can a company improve its performance by imposing more democratic corporate governance? This inquiry also raises a sub-question, which must be answered first: If we observe a connection between democratic corporate governance and performance, what drives it?

Democracy in the Corporation

Institutional Parallels

As background for these inquires, let us first review the institutional parallels between national government and corporations. At its core, modern corporate governance in the United States, which has large, well-developed capital markets, is based on the separation of ownership and management. The corporate governance structure consists of

[1] Russett, Bruce, Christopher Layne, David E. Spiro and Michael W. Doyle. *The Democratic Peace* International Security, Vol. 19, No. 4 (Spring, 1995), pp. 164-184 Publisher: The MIT Press Available at: http://www.jstor.org/stable/2539124

three layers: 1) common stock holders, having one vote for each share owned; 2) a board of directors, whom the shareholders elect; and 3) upper management, who the board designates. The parallels to a representative democracy are clear. In a presidential system such as the government of the United States, voters elect state legislatures, who appoint Presidential electors. Those Presidential electors then represent their electorate by choosing a president, typically in accordance with the popular vote from their district. In a parliamentary government, voters elect the parliament, which then elects the leader of the country. Regardless of the system, a common pattern emerges: voters elect the legislative branch or board of directors and then the legislators, government representatives, or board members elect the executive branch or management team.

The concept of a founding document is another commonality. All corporations are founded on their Articles of Incorporation. These documents are similar to the various charters, such as the United States Constitution, used to form democratic governments. As do the articles of incorporation, the Constitution sets forth the basic rights and principles on which the United States government is founded. It is a fundamental duty of government officials to act within this framework. Legal precedent establishes that the articles of incorporation are similarly strong parameters for corporate boards and management teams.

Both the legislative branch of government and the board of directors in a corporation share the duties of setting policy and overseeing the executive branch or management. Neither body can effect change without convening the group and voting upon proposals, but under those conditions can pass binding resolutions that empower or check the executive branch or management team. Just as the legislative branch can impeach a president for committing a crime, so can the board of directors remove management team members who are not fulfilling their roles. The parliamentary system has another interesting parallel in that an entire government can be removed from office based on a referendum or spontaneous election, similar to a proxy battle in the capital markets. Regardless of their status as elected government officials or elected corporate officials, both groups can ultimately be overruled by through the court system by the judicial branch should a serious violation of the law occur.

It is clear that there are multiple similarities between the governance structure in a democracy and a corporation, but both institutions are designed to serve different purposes. We must first ask whether these principles are actually present in the corporate world. If they are, what are the effects mechanisms of democracy have on the behavior of commercial societies or corporations? Can democratic principles help corporate institutions achieve their social mission? The answers to these questions depend on the subsidiary question: What are the social purposes of the business corporation? Furthermore, what is the difference between the social purpose of a corporation and the social purpose of the government in a political democracy? Do these differences prevent us from applying the principles that drive political democracy to our understanding of corporate governance?

The Affects of Corporate Democracy

The social purpose of a political government is to promote the well-being of the individual, which it accomplished by satisfying individuals' needs and wants. Among the benefits most often provided by governments are essential social services, education, and safety. The government also aims to enable individuals' accomplishments, such as wealth creation, by facilitating cooperation between individuals and markets. Quite differently, the primary purpose of the business corporation is to create wealth. A corporation's governance system facilitates efficient interaction among individuals in the production of goods or services, while managing risk and capital allocation. From this disparity arises a key question: Although its social purpose differs from that of a government, can a corporation apply democratic mechanisms to improve its corporate governance and can such polices contribute to long-term profitability?

Many commentators have attempted to answer the question of whether the level of democracy within a corporation affects its performance. Among the common questions raised are those that seek to understand whether corporate governance provisions that decrease or increase shareholder rights are detectibly associated with performance affects. Some researchers explore whether companies with anti-greenmail policies, blank check preferred stock, and bylaw and charter amendment limitations underperform companies that have fewer of these provisions and have more 'democratic provisions' such as cumulative voting and secret ballots. Studies have shown that such corporate governance measures seem to play a role in the profitability of a corporation.

In *Corporate Governance and Equity Prices*, Professors Gompers, Ishii, and Metrick created a corporate governance index and tested to see if there was a correlation between their index and the equity price performance sample of firms. Their Corporate Governance Index, or G Score, served as a proxy for the varying balance of power between management and shareholders throughout the 1500 corporations in their sample. In creating the index, they identified various corporate governance provisions as "pro-shareholder power" or "anti-shareholder power." They assigned points to each corporation based on its policies. Anti-shareholder provisions earned one point each, while pro-shareholder power provisions reduced the score by one point. Their study concluded that only two provisions increase shareholder rights: cumulative voting and secret ballots. In the end, each firm received a cumulative governance score, with a higher score indicating fewer shareholder rights.

To test whether there was a relationship between the degree of democracy in governance and shareholder returns, which they used as a proxy for efficiency, the researchers back tested their theory on historical price data. Focusing on two extremes, a “Management Portfolio” and a “Shareholder Portfolio”, they found that an investment strategy which involved purchasing share of firms with low G scores and selling shares of firms with high G scores would lead to positive abnormal returns of about 8.5% over a period of ten years. They also found that firms with higher G scores (less democracy) had lower profit margins and sales and higher capital expenditures and expensive acquisitions.

Ultimately, however, Gompers, Ishii, and Metrick were reluctant to conclude that there was a correlation between firm performance and corporate governance provisions due to the overwhelming presence of lurking variables within the study. For example, they did not address whether all corporate governance provisions affect performance, nevermind whether they do so equally. They also did not study how each policy affects shareholder wealth in the long run. In the end, there was no evidence to conclude that a greater number of pro-shareholder provisions had an affect on how a firm’s stock performs in the market place.

In fact, several of the 24 provisions in the Gompers, Ishii, and Metrick study have ambiguous affects on shareholder rights and, as a result, firm value. Poison pills are a device deployed by management to require any hostile acquirer to negotiate with the board itself should it seek to gain corporate control through a tender offer. A poison pill accomplishes that task by offering existing shareholders the right to purchase stock at a deep discount in the event of a hostile takeover, unless the board of directors agrees to the takeover. The affect of poison pills on shareholder rights and firm value has been debated for a long time. At first, they seem like a powerful governance device, but their effects can shift power toward or away from shareholders, depending on the situation. A poison pill can decrease shareholder voting rights because it removes the possibility of shareholders independently selling control of the company in a tender offer. It can also improve the outlook for shareholder returns by increasing management's bargaining power with the potential acquirer.

Anti-greenmail provisions are also ambiguous. Greenmail allows a target company to pay a premium to a large shareholder to stop them from acquiring the company. By ruling out this possibility, anti-greenmail provisions are thought to increase the likelihood of all shareholders benefiting from a hostile acquisition at a high price. At the same time, greenmail provides a safety net to potential acquirers, giving them more confidence of some payoff in approaching a company, regardless of whether the acquisition ultimately happens. In that respect, greenmail can serve as an incentive for acquirers to approach a company and potentially offer shareholders a premium for their stock. Without this safety net, acquirers may be less likely to get involved in an acquisition transaction in the first place. Because corporate governance provisions have such inconclusive effects, it is difficult to prove any correlation with firm performance. Given these potential results, it is not surprising that some researchers have hypothesized that corporate governance provisions do not have an effect on stock returns.

In their study *What Matters in Corporate Governance*, Professors Bebchuk, Cohen and Ferrell tested the hypothesis that not all corporate governance provisions had an affect on firm performance. Unlike Gompers, Ishii, and Metrick, this team established an entrenchment index of only six out of the 24 IRRC provisions. They chose a small selection based on the belief that some rules reduce efficiency rather than promote it, and some rules have no effect. The entrenchment index focuses on reduced shareholder power and anti-takeover provisions established by management. These provisions usually include staggered boards, limits to shareholder amendments of the bylaws, supermajority requirements for mergers, and supermajority requirements for charter amendments. The anti-takeover provisions include poison pills and golden parachutes, which are anti-takeover amendments within charters that increase management's power in the event of hostile takeovers. Ultimately, the study concludes that the "kitchen sink" hypothesis of corporate governance provisions will not lead to greater corporate performance.

In her study on the determinants of corporate governance mechanisms, Stuart Gillan (2003) confirms this idea when she points out that it is an active corporate governance mechanism, not necessarily a strong corporate governance doctrine, which promotes efficiency. For example, investors and corporate oversight bodies theorize that boards with a majority of independent directors might provide more unbiased judgments because their evaluations are not clouded by their ties to corporate management[2]. At the same time, however, independent directors, by definition, are not directly and intimately involved with the firm's day-to-day business, and they often have little incentive to ensure the future well-being of the firm. As a result, insider directors are just as valuable because they possess close ties to and an in depth knowledge of the workings of a firm, which undoubtedly assists them in making smart decisions for the firm.

Although many corporate governance indices measure the number of democratic provisions instituted at a corporation, these indices are not necessarily an indicator of whether a company will perform better. Perhaps the fault with these studies is that they do not explore the principles surrounding corporate governance institution enough to explain fully the dynamics driving performance.

Fundamental Principles

Conflict of Interests

Although they do not entirely explain the effects of corporate governance on performance, corporate governance studies confirm the presence of an agency-principal conflict between the management of a corporation and its shareholders through the dynamics surrounding hostile takeovers. Due to their own lack of in-depth knowledge, shareholders turn over control of corporate decisions to an experienced management team. However, since it is rare that a manager's incentives will coincide entirely with the interests of shareholders, management may choose act according to their own incentives,

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[2] Gillan, Stuart L., Jay C Hartzell. and Laura T. Starks. "Explaining Corporate Governance: Boards, Bylaws, and Charter Provisions" (August 21, 2003). Weinberg Center for Corporate Governance Working Paper No. 2003-03. http://ssrn.com/abstract=442740

disregarding shareholders. In the case of a takeover attempt, it might be in the best interest of shareholders to accept a deal, but if management does not have the right incentives in terms of future career progression or generous exit packages, they may turn the deal down.

Moreover, the improvement in performance that results from increased shareholder rights implies that a conflict of interests between management and shareholders creates agency costs for shareholders that are eliminated with greater shareholder rights. The estimates surrounding potential synergies from mergers, benefits from strategy changes, and the present value of a company's future business are highly subjective and, in many ways, unknowable. Even in businesses with a high degree of visibility and economically insensitive cash flows, execution risk always exists; this risk and the impacts of other random, unknowable events leave ample room for management to disagree with others' projections if it is in their best interest to deny a deal. Investors, because of limited information, can attempt to analyze the costs and benefits of corporate transactions, but in many cases, it is difficult to prove management wrong and many shareholders follow the recommendations of the board of directors and management when it comes to these pivotal decisions.

Given that some investors trust in the recommendations of management and the board, agency costs arise because some transactions, such as takeovers, are detrimental to shareholders but come with sufficient incentives that management will recommend completing the transaction anyway. Firms that have increased shareholder rights, avoid some of these potential agency costs because management is more determined to choose projects that create value for shareholders. Still, these provisions do not entirely prevent management from masking or massaging the truth to its own benefit, and the information asymmetry issue present in this situation is one that plagues most principle-agent relationships, but finds itself particularly prevalent and impactful in the corporate and political realms. This is because both politicians and executives are entrusted to make decisions that can have an enormous impact on the individual but that the individual neither has the time, information, means nor, in many cases, skill to asses himself.

Conflict Drivers

Agent-principal relationships are formed out of the desire for one party to achieve a goal without expending the resources necessary to do so. In a corporation, by empowering management to be the main decision maker within the corporation, investors are able to create wealth without having to make the decisions themselves. Unfortunately, the benefits of centralized management decision-making come with agency costs. Perhaps a greater understanding of what drives these costs can help us understand how to improve the corporate governance system.

Thirst for Power

It is the almost inevitable tendency of leaders, once in power, to strive to stay in power. In 49 BC, Julius Caesar ignited a civil war when the Senate ordered him to renounce his position as Proconsul of Rome. To maintain control of the vast territories that he conquered throughout Europe, Napoleon Bonaparte installed close friends and family members into positions of power and maintained elaborate strategic alliances with important figureheads. In the 1950s, Stalin instituted purges that resulted in the deaths of hundreds of thousands of people, in attempt to protect his position from treacherous members of society.

With the exception of General Washington retiring from Presidency of the US at a time when he could have easily been president for life, American history is marred by desperate decisions made by leaders in attempt to retain their positions of power. James Madison, in order to please Congress, implemented unfavorable trade restrictions that eventually resulted in a US declaration of the War of 1812. In possibly the most corrupt deal known to a United States presidential race, John Quincy Adams appointed Henry Clay as Secretary of state in exchange for the votes necessary to win an Electoral College majority[3].

Today, we continue to see leaders around the world struggle for power. In the parliamentary democracies of Europe, parties often advocate policies on issues that cater to the interests of the support groups who put them into power, rather than those that are for the best interest of the nation as a whole. In the US presidential campaigns, the democratic primaries are almost entirely dependent on the votes of unelected super-delegates, who will "bargain ferociously" to extract favorable terms for themselves and their constituents[4]. Consequently, if the nominee wins the election, they arrive saddled with a laundry list of commitments that usually divert their attention away from the platform initiatives on which they were elected[5].

In less established democratic governments, the struggle for power often takes on particularly violent forms. In early 2008, Pakistan's President Pervez Musharaff suspended the government and reinstated military rule in order to maintain a stronghold on his position. In African countries, political elections sometimes result in the death of

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[3] Yoo, John. "The Democrats' Super Disaster. " Wall Street Journal [New York, N.Y.] 24 Mar. 2008, Eastern edition: A.15. ABI/INFORM Global. ProQuest. Bobst Library, New York, NY 7 May. 2008 http://www.proquest.com/

[4] Ibid.
[5] Ibid.

candidates, party members, and even innocent family members. In 2007, for example, Zimbabwe police savagely beat 56-year-old trade unionist Morgan Tsvangirai, incumbent candidate Robert Mugabe's main opposition in the upcoming presidential elections. Mugabe, President of Zimbabwe for nine years often relies on party loyalists to coerce support in such a violent fashion[6].

Corporate Thirst for Power: Defenses and Consequences

Similarly, corporate executives' struggle to retain power is a significant driver of the principal-agency conflict. A manager's position is sensitive to the risk specific to their firm; if the firm goes under, so does the manager. Therefore, a manager's job, even today, relies on his ability to maintain the image that the firm is growing. This improves the perception of their "human capital" and confidence from the market (Amihud and Lev 1981). Furthermore, whereas shareholders have portfolios that diversify their risk without incurring serious costs in the capital markets, management's "human capital" investment is not diversifiable. As a result, management's primary priorities – to create wealth for shareholders by increasing the value of the corporation – are often replaced by incentives to create safety nets for their volatile careers.

Significant agency costs arise out of managerial desire to increase its degree of entrenchment within the corporation. Because management compensation has for too long been insufficiently (and imperfectly) tied to firm performance, management has been able to divert corporate resources to diversifying their human capital rather than increasing long-term shareholder welfare. Although stock options and ownership

[6] "Coming to a Crunch." The Economist Mar. 2008. 19 Mar. 2008 http://www.economist.com/daily/news/displaystory.cfm?story_id=10880693

compensations have reduced this cost to some extent in recent years, the problem remains. As a result, many managers often avoid risky investments, foregoing high potential increases in firm value out of a desire to maintain a positive reputation[7]. Since abilities are judged by the success or failure of the project choices, a manager who wants to keep his job will be less likely to invest in risky projects because he will want to avoid the reputation damage of a failed investment. He will also be less likely to choose long term projects with high initial costs and long term benefits if they do not yield positive results immediately. Evidence indicates that this behavior is not limited to unsuccessful or unskilled managers[8]. Even the most experienced managers may prefer the option of investing in projects that will never fail.

A significant agency cost for shareholders emerges when management uses corporate resources to diversify the company risk in order to reduce the volatility inherent to their careers**.** For example, many managers engage their firms in risky mergers and acquisitions believing they will still benefit shareholders by increasing synergy and profitability. However, a merger that diversifies risk, though it looks lucrative in the valuation stage, may not provide significant benefits for the company[9]. In a merger or acquisition, the acquirer usually overpays for the target firm and it is usually the acquired

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[7] Amihud, Yakov and Baruch Lev *Risk Reduction as a Managerial Motive for Conglomerate Mergers* The Bell Journal of Economics, Vol. 12, No. 2 (Autumn, 1981), pp. 605-617 The RAND Corporation http://www.jstor.org/stable/3003575

[8]Hirshleifer, David and Anjan V. Thakor *Managerial Conservatism, Project Choice, and Debt* The Review of Financial Studies, Vol. 5, No. 3 (1992), pp. 437-470 Oxford University Press. Sponsor: The Society for Financial Studies. http://www.jstor.org/stable/2962134

[9] Jarrell,Gregg A., James A. Brickley, and Jeffry M. Netter The Market for Corporate Control: The Empirical Evidence Since 1980 *The Journal of Economic Perspectives,* Vol. 2, No. 1 (Winter, 1988), pp. 49-68 American Economic Association http://www.jstor.org/stable/1942739

company that receives the bulk of the premium in the transaction. More importantly, different management styles, fears by major stakeholders of being displaced from the company due to the consolidation of resources, and organizational restructurings in the merged companies may create unforeseen costs that reduce or even eliminate the synergies aimed for by the merger transaction[10].

Aligning Incentives

Shareholder Rights

To a degree, corporate law has taken into account the need for corporate governance mechanisms that align managerial interests with shareholder interests. Therefore, certain provisions have been built into corporate governance structure that attempt to correct for the conflict of interests between management and shareholders. These provisions take the form of 1) voting rights, 2) the ability to sue management for breach of fiduciary duties, and 3) liquidity. However, have these governance provisions have not been entirely successful in eliminating agency costs.

Voting Rights

Shareholders' voting rights are the most direct way for owners to exercise control over the direction of the company. For example, corporate law mandates that all large merger and acquisition transactions be approved by a majority of shareholders. It also requires shareholder approval of directors, changes in the articles of incorporation, bylaws, liquidation, and asset sales. On the one hand, this allows management to devote

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[10] Lubatkin, Michael *Mergers and the Performance of the Acquiring Firm* The Academy of Management Review, Vol. 8, No. 2 (Apr., 1983), pp. 218-225 Academy of Management http://www.jstor.org/stable/257748

its efforts entirely to wealth creation by reducing the potential for distracting inquiries from shareholders. On the other hand, by restricting shareholder access to the corporation, it limits shareholder ability to prevent management from abusing its autonomous powers.

Furthermore, shareholder voting in a capital market centered system of corporate governance suffers from systematic, collective action problems. In most cases, a shareholder's holding in a publicly traded company is only a minuscule portion of that shareholder's diversified portfolio and represents an equally insignificant portion of the corporation. As a result, getting items "on the ballot" is difficult, with management in control of the ballot under most circumstances. Moreover, even if management allowed shareholders to introduce their own policies, the mass dispersion of shares also makes it nearly impossible for enough shareholders to join forces to pass them[11]. Ultimately, the most shareholders can do is send in their vote on initiatives put forth by management. Even this input is somewhat constrained because their vote alone is too small to make an impact on company decision making anyway.

Judicial System

Another, more indirect method for shareholders to impose their will on management is to sue for breach of fiduciary duty. Management is obligated to act in the best interests of the shareholders owning the company and when shareholders believe that these duties have been breached, they have the right to ask the courts to intervene on their

[11] Ribstein, Larry E., *Accountability and Responsibility in Corporate Governance*. Notre Dame Law Review, Forthcoming Available at SSRN: http://ssrn.com/abstract=746844 or DOI: 10.2139/ssrn.746844

behalf[12]. Though judicial courts are reluctant to interfere in corporate management, they have ruled in favor of shareholders in several cases where there has been evidence of corrupt managerial behavior[13].

Still, the act of suing is a somewhat inefficient in promoting accountability because it substitutes the corporation's agency costs with the plaintiff's attorney agency costs[14]. The plaintiff's lack of knowledge about specific litigation procedures and requirements prevents them from being able to direct the lawyer's labor. This, coupled with the inefficient payment methods for an attorney's representation creates room for the existence a conflict of interests due to diverging incentives between the two parties[15]. If an attorney is paid for his efforts, rather than the result of the case, he might have an incentive to extend the number of hours spent on the case or decide against settling even though these decisions are not in the best interest of the client. Paying the attorney a contingency fee, while shifting the burden of costs of labor to the attorney, does not resolve the problem either. This is because an attorney may not take on a case if he deems the potential rewards of the case to exceed the cost of his labor hours. Similarly, the attorney may be more likely to settle to diminish the costs of effort spent on the case even though this may not be in the best interest of the client. Although there exist payment strategies that could potentially align the interests of the attorney and the plaintiff by

[12] Ibid.

[13] Ribstein, Larry E., *Accountability and Responsibility in Corporate Governance*. Notre Dame Law Review, Forthcoming Available at SSRN: http://ssrn.com/abstract=746844 or DOI: 10.2139/ssrn.746844

[14] Ibid.

[15] Polinsky, A. Mitchell and Daniel L Rubinfeld., *Aligning the Interests of Lawyers and Clients* (April 2002). Stanford Law and Economics Olin Working Paper No. 223. Available at SSRN: http://ssrn.com/abstract=281628 or DOI: 10.2139/ssrn.281628

splitting the labor costs been attorney and client, they are neither widely known nor accepted norms for payment[16].

Ownership Transfer

Empirical evidence indicates that the most effective provision to align incentives between shareholders and management is the ability of shareholders to 'vote with their feet'[17]. The 'vote with their feet' provision allows shareholders that are unsatisfied with the way management is running the company to sell their shares. This mechanism becomes an effective check on managerial behavior when shareholders threaten to tender their shares to a potential acquirer. Management knows that restructuring acquisitions tend to reorganize the company in such a way that the executive branch is removed from power[18]. Therefore, to prevent shareholders from selling their shares in the event of a hostile takeover attempt, management becomes more inclined to ensure shareholder satisfaction through wealth creation in the corporation. This pattern of performance is validated by the aforementioned corporate governance studies.

However, hostile takeovers are sensitive to market factors and may not always be a legitimate governance constraint on excessive agency costs. For example, rigid lending conditions, like those that emerged during the subprime crisis of 2007-2008, have made it difficult for many potential acquirers to raise enough capital to finance merger and

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[16] Polinsky, A. Mitchell and Daniel L Rubinfeld., *Aligning the Interests of Lawyers and Clients* (April 2002). Stanford Law and Economics Olin Working Paper No. 223. Available at SSRN: http://ssrn.com/abstract=281628

[17] Ribstein, Larry E., *Accountability and Responsibility in Corporate Governance*. Notre Dame Law Review, Forthcoming Available at SSRN: http://ssrn.com/abstract=746844

[18] Vedder, Price, Kaufman, and Kammholz. *Recent Trends in M&A Activity*. Spring 2002. Corporate M&A Advisor, Finance and Transactions Group.

acquisition transactions. Therefore, in a scenario where hostile takeovers are unlikely, it becomes challenging for shareholders to enforce corporate accountability. Furthermore, come corporations have anti-takeover provisions embedded into the company bylaws, making it more difficult for the acquirer to succeed in their attempts to takeover the corporation. In fact, this often deters potential acquirers from initiating bids in the first place.

The Quest for Corporate Accountability

Ultimately, situational factors often limit the effectiveness of democratic provisions in corporate governance systems. As a result, neither voting rights nor the judicial system or liquidity can completely eliminate agency costs. Creating a restrictive environment for management is not a viable alternative either because managerial autonomy in fast-paced strategic decision-making is essential for a firm's survival in a hypercompetitive market place. Perhaps then, the solution to the agency-principal problem in the corporate governance lay not in democratic provisions, but rather in the democratic institution of the governance system.

According to Owen's Democratic Peace theory, the long-term stability of political democracy is attributable to the structural control mechanisms of the governance institution. For example, in a representative democracy, the ability of a president to implement policies and embark on strategic initiatives depends on congressional support. In turn, congress must make sure that its decisions represent its constituents' interests or it will be replaced in the following election. By subjecting the agents' policy making to constant oversight, with implementation of decisions contingent upon the approval of overseers, institutional control mechanisms reduce the potential for an agent to prioritize individual incentives over voters' interests.

That government stability depends on the appropriate representation of the interests of its constituency reveals that the foundation of a stable democratic government is the notion of accountability. Accountability, the obligation to inform and justify its behavior by one party to another, makes it difficult for a policy maker to implement decisions that would lead to unfavorable consequences for the parties upon whose approval the decision is contingent[19]. In Germany, whose parliament consists of two houses with four to seven parties each, decisions are reached only through extensive negotiations and cooperation between parties. However, because each party is accountable to one another as well as to their constituents, policies tend to satisfy a greater proportion of society[20].

The Democratic Solution

We observe, therefore, that while agency costs are common to both institutions, political democracies have developed measures of accountability to minimize these costs. Government accountability in a political democracy reconciles the conflict of interests between leadership and voters by forcing representatives to divulge and justify their initiatives. As a result, unfavorable initiatives cannot pass because they are unable to

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[19] Accountability: "A is accountable to B when A is obliged to inform B about A's (past or future) actions and decisions, to justify them, and to suffer punishment in the case of eventual misconduct." **(** Schedler, Andreas (1999). "Conceptualizing Accountability", in Andreas Schedler, Larry Diamond, Marc F. Plattner: *The Self-Restraining State: Power and Accountability in New Democracies*. London: Lynne Rienner Publishers, pp. 13-28.)

[20] Hofferbert, Richard I., and Hans-Dieter Klingemann. *The Policy Impact of Party Programmes and Government Declarations in the Federal Republic of Germany*. (1990) European Journal of Political Research 18 (3), 277–304

overcome opposition by the other participants in the decision making process. This begs the question; what structural provisions force policy makers to be accountable to one another and to voters? Perhaps a deeper analysis of those institutional measures will provide insight on how a corporation can reduce its agency-principal conflict as well.

In their study, *Separation of Powers and Political Accountability*, Professors Torsten Persson, Gerard Roland, and Guido Tabellini claim that because an agent's incentives never coincide entirely with those of the principal, the principal faces the danger of experiencing rent seeking costs when the agent prioritizes his own incentives before those that he was designated to represent. To combat this issue, the government structure of a political democracy imposes structural checks on an agent's power that force him to re-align incentives. They argue that the most effective structural checks on the abuse of power are elections and a separation of powers.

Elections

Elections are the formal decision-making process by which voters in a government system choose leaders they believe are most qualified to represent their interests. The team cites four reasons for why elections make government representation more effective; 1) they are an aggregate representation of voters' preferences, 2) they bring together dispersed information regarding political issues and concerns, 3) they represent the opinion of voters as to who is most qualified for the job, and 4) they are a control mechanism that keeps representatives accountable to voters. The first three reasons merely provide justification for why elections are an efficient institutional control; the fourth reason, however, alludes to why elections reduce agency costs.

Elections promote accountability because they operate on the principal that the most qualified agents will be rewarded for efficient representation with power. This system of choosing representatives promotes accountability because it redistributes the driver of agency costs – the agent's struggle for entrenchment – to being agent's reward for adequately representing the principal's interests. To illustrate, the goal of a member of the House of Representatives, once in power, is to stay in power. Without elections, the congressional representative might institute various entrenchment provisions that reduce the risk of losing power by being removed from the position. However, when elections are instituted, the representatives' ability to entrench himself depends on his ability to promote and satisfy the interests of the constituents that vote for him. Essentially, by turning the driver into the reward, elections eliminate the agency-principal conflict.

Separation of Powers Doctrine

Professors Persson, Roland, and Tabellini's second claim was that the separation of powers between branches of government also promotes accountability in a political democracy. The separation of powers doctrine requires that each policy maker have differing interests, but that decision making be contingent upon a common consensus[21]. A common consensus is necessary to alleviate the common pool problem, which states that policy makers with diverging incentives claims on government resources would immediately deplete them.

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[21] Persson, Torsten, Gerard Roland and Guido Tabellini *Separation of Powers and Political Accountability* The Quarterly Journal of Economics, Vol. 112, No. 4 (Nov., 1997), pp. 1163-1202 Publisher: The MIT Press http://www.jstor.org/stable/2951269

Through an economic analysis of the payoffs in a government with only one policy maker in the system, they demonstrated that voters will tolerate a principal's abuse of power up to a certain threshold[22]. The team explains that an agent's rent seeking ability arises out of the information asymmetry in a system with one to oversee the policy maker. Because voters have no means of verifying the validity of the information presented, they have no choice but to place their trust in the agent. As a result, with only one policy maker in the system, nothing can prevent the agent from keeping information from the principal. If the president of a country tells the nation that the budget for defense spending should be a certain amount and there is no one to dispute his claim, this amount will be allocated to defense spending, regardless of actual needs of the defense department. In such a scenario, the voters are powerless to prevent the costs incurred when agent diverts the excess allocated public resources for private use.

In fact, as a second policy maker with differing interests enters the system, the spectrum shifts back in the favor of the voters. A government system that requires a consensus for policy implementation forces policy makers to compete with one another to pass their initiatives. Competing policy makers that are elected by the voters have an incentive to reveal more information to voters about competitors, in order to their gain support for their own initiatives. Therefore, in pushing for their competing interests, the policy makers will limit each other's ability to acquire rents from informational asymmetry and eliminate each other's opportunities for rent seeking.

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[22] Persson, Torsten, Gerard Roland and Guido Tabellini *Separation of Powers and Political Accountability* The Quarterly Journal of Economics, Vol. 112, No. 4 (Nov., 1997), pp. 1163-1202 Publisher: The MIT Press http://www.jstor.org/stable/2951269

Corporate Application: The Democratic Method

The theory put forth by Professors Persson, Roland, and Tabellini implies that the presence of a second policy maker with diverging interests from the first policy maker creates a separation of powers that forces the government to be accountable to the interests of the voters. Furthermore, elections ensure the government's accountability by rewarding the second policy maker for representing the voters' interests. In a political democracy, the first policy maker can be paralleled to the executive branch and the second policy maker, to the legislative branch. Extending this parallel to the corporation, the role of the first policy maker is fulfilled by management, which has an incentive to abuse power in order to increase its entrenchment level, and the second policy maker is the board of directors, which is elected to power in order to promote the interests of the voters in the system. Therefore, accountability in a corporation depends on the board of directors.

While periodic elections exist, they have not been effective in promoting accountability within corporations. As we have already established when we explained the inefficiencies of the voting system as a shareholder right, the election system's weaknesses stem from the shareholder collective action problem. Because the average institutional investor owns only an insignificant stake in a large number of companies, it is not sensible for a "voter" to spend much time or money becoming informed or coordinating with shareholders around elections. Therefore, most shareholders do not closely follow the progress of a company and the costs of attending the annual meetings of each of the often hundreds of companies in their portfolios far outweigh the benefits. Even those shareholders who choose to be more active in the proceedings of their company suffer because they are unable to create enough alliances with other shareholders to make their vote matter. Consequently, directors tend to be automatically re-elected, even if they are not representing the interests of shareholders sufficiently.

Provisions for fairer elections for members of the board of directors will increase the level of accountability within the corporation. Fair elections, however, depend on voter participation or at the very least, voter knowledge; the voters must know whom they are electing and whether or not the candidates will be effective representatives. In their study *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors,* Professors April Klein and Emmanuel Zur test for the affects of activist investors on corporate performance and demonstrate that investor knowledge has positive affects on the profitability of a firm. They conclude that not only does the market react positively when activist shareholders file Schedule 13Ds with a corporation, but the company continues to experience abnormal returns after the activist investors' intervention. The fact that that the stock price of a company goes up indicates that confidence of the market increases upon the announcement that knowledgeable investors are taking greater control in influencing the direction of the company[23].

The separation of powers between the legislature and the executive branch in a political democracy demonstrates that government accountability hinges on the effectiveness of the legislative branch to represent the interests of voters. Because leading the nation is a task that requires unique knowledge and experience, the executive branch is given enough autonomy to ensure that they are able to do what is best for the nation. It is then up to the legislature to prevent the executive branch from abusing the power that

[23] Klein, April and Emanuel Zur. *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors* (September 2006). AAA 2007 Financial Accounting & Reporting Section (FARS) http://ssrn.com/abstract=913362

comes with this autonomy by rejecting initiatives that do not promote the well-being of its constituents. This implies that the control mechanism described by the Democratic Peace theory, that has promoted the stability of democratic countries like the US for centuries by preventing leaders from implementing unfavorable decisions is actually the legislative branch.

Similarly, corporate accountability hinges on the ability of the legislative branch to promote the interests of shareholders. Management must be given a degree of autonomy to create benefits from centralized decision-making. However, as in a political democracy, autonomy creates the potential for agency costs. Therefore, it is imperative that the board of directors oversee management policy making in order to ensure that managerial incentives are aligned with those of shareholders. This raises the question – if the ability of the board of directors to act as a check on the power of management is increased, perhaps the level of accountability in a corporate governance system will increase as well.

To increase accountability in a corporation, the election system for the board of directors must establish a concrete separation of powers between the two major policy making entities in a governance system. The requirement for consensus between management and the board of directors is established by directors' ability to remove management it deems unfit to direct the corporation. However, control of the company is split only theoretically between management and the board of directors. While fiduciary duties mandate that the board members must represent shareholders, historically these boards have acted more as rubber stamps on managerial decision-making. With the exception of choosing management and forcing it out, the average director has had minimal independent input in the proceedings of company on the board of which he serves, especially if the director is not an executive director.

In a political democracy, members of congress and parliament must consciously behave in accordance with the interests of the people because the legislative branch is elected to create policies that will promote the well-being its constituents. In a corporation, on the other hand, directors are elected, usually upon the nomination of management. Due to collective action problems, they are then re-elected at every annual meeting and remain in power until they choose to leave, the corporation is dissolved, or an outside event, such as a proxy fight, induces shareholders to consider new management[24]. In extremely rare cases, directors are asked to leave by other directors. At companies that have included staggered board provisions in their bylaws, it is even more difficult to remove a director.

In an analysis of the deficiencies of the Board of Directors, Chancellor William Allen of the Delaware Court of Chancery analyzes the limited role of directors in a firm's corporate governance system:

> "The conventional perception is that boards should select senior management, create incentive compensation schemes and then step back and watch the organization prosper. In addition, board members should be available to act as advisors to the CEO when called upon and they should be prepared to act during a crisis: an emergency succession problem, threatened insolvency or an MBO proposal, for example.

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[24] Mizruchi, Mark S. *Who Controls Whom? An Examination of the Relation between Management and Boards of Directors in Large American Corporations* The Academy of Management Review, Vol. 8, No. 3 (Jul., 1983), pp. 426-435 Academy of Management Stable URL: http://www.jstor.org/stable/257831

This view of the responsibilities of membership on the board of directors in a corporation is, in my opinion, badly deficient. It ignores a most basic responsibility: the duty to monitor performance of senior management in an informed way.[25]"

Essentially, Chancellor Allen points out that the lack of accountability in a corporation is due to the inefficiency of the institution of the board of the directors. While the role of directors implies that they should provide valuable oversight on management policy and prevent managerial excesses, their actual role is limited to consulting the firm in the event of a crisis. As a result, the board of directors has not been as successful as the legislative branch in a political democracy at promoting accountability in a corporation.

The inability of the board of directors to ensure that corporate management's interests are aligned with shareholders interests is due to the fact that they still rely on management approval. While it is the shareholders that elect the board of directors, each board member is usually nominated for a spot by the CEO or management of the firm[26]. Therefore, even if the directors are categorized as independent, their jobs depend to a degree on the favor of their nominator. Moreover, a small loophole in the corporate voting system has given management control over the director election process as well. Although shareholders vote for the board of directors, management controls the proxies. Therefore, when shareholders do not vote, their votes are assigned to incumbent management, who use these votes to elect board members of their choice.

Director Independence is Not the Answer

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[25] Lipton, Martin, and Jay W. Lorsch. A Modest Proposal for Improved Corproate Governance. 48 Bus. Law. 62 (1992-1993)

[26] Mizruchi, Mark S. *Who Controls Whom? An Examination of the Relation between Management and Boards of Directors in Large American Corporations* The Academy of Management Review, Vol. 8, No. 3 (Jul., 1983), pp. 426-435 Academy of Management Stable URL: http://www.jstor.org/stable/257831

It has been suggested accountability in a corporation can be increased by making sure that the board of directors in a corporation are independent from management. However, a position on a board is rarely the central focus of a director's career; therefore, board member independence is usually accompanied by a lack of in-depth knowledge about the firm. Ironically, outside, or 'independent', directors often have the least expertise in the company. Some independent directors join boards to gain steady sources of revenue to supplement revenues from other careers. Often, directors serve on the boards of multiple companies, which require that they split their attention between their main careers and the proceedings of each of the companies on whose boards they sit. Thus, while many directors have significant business experience and wisdom, they often have limited knowledge of individual companies and are not capable of providing effective oversight.

As Gillan (2003) points out, independent directors may not guarantee greater accountability than insiders because insider directors have valuable knowledge and experience that often enables them to provide better oversight of executive policies. Moreover, the most concrete method to ensure a director's independence is to establish that the director has no ties to the company or management. However, this method ignores the potential for ulterior motives such as the desire to be appointed to more boards. Additionally, some relationships are unobservable; therefore, there is no guarantee that an independent director will be more likely to represent the interest of shareholders better than an insider director will. Because the potential for collusion with management exists with both types of representatives, efficiency of the corporate governance institution depends on the ability of the board to represent the interests of the shareholders rather than their members' level of independence.

Recent Trends

Recent trends seem to support the idea that corporate governance can be improved by ensuring accountability through the board of directors. By reforming the election process and modifying the structure of the Board of Directors, a greater separation of powers has been established by default because directors must promote the interests of voters in order to be reappointed in the future.

The number of corporations with staggered boards has declined. Staggered boards, one of the most effective anti-takeover mechanisms, occur when a board is composed of several classes of directors serving different terms than each other. As a result, each director goes for re-election during different years and it becomes more difficult to remove an entire board. Since electing a new board is done in order to replace management, making it hard to do this creates a safety net for existing management. The fact that this safety net has been eliminated in large part forces management to rely less on entrenchment and more on performance measures to stay in power.

Another example of how the corporate world has attempted to improve corporate accountability through the board of directors has been the establishment of director evaluation services. For example, Institutional Shareholder Services, Inc. (ISS) was created to evaluate the performance of directors and provide this information to institutional shareholders in the process of electing boards of directors. Its aim was to reduce the costs to diversified shareholders that had neither the time nor the resources to do thorough research on the board candidates in their vast portfolio of companies. This has reduced the informational asymmetries that have, in the past, prevented shareholders from ensuring the most effective representation in a corporation. Additionally, some corporations such as Intel have further modified the voting systems. In order to be elected, a director must now obtain a majority of votes. This contrasts from the previous plurality voting system standard, which simply required a candidate to get more votes than any other candidate in order to be elected to the board of a company.

As more shareholders are able to track the effectiveness of the directors up for re-election, directors have become more responsive to shareholder pressure. This confirms the idea that accountability is increased when the driver of agency costs becomes the agent's reward for eliminating the agency-principal conflict. This effect is particularly notable in the wave of new CEO compensation contracts that have tied a greater portion of bonuses to firm performance[27]. For a long time, shareholders have been putting significant pressure on boards of directors to link executive compensation with firm performance in order to align management's goals with profit maximization. Recently, such attempts to align management interests with those of shareholders have resulted in reductions of CEO tenures, increases in CEO firings, and option grant compensation packages tied to increased firm value.

In 2007, Dorrit Bern, CEO of Charming Shoppes Inc., renewed an employment contract with significantly fewer perquisites than her prior three contracts. In addition to having more of her equity grants pegged to firm performance, Bern lost a significant cash

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[27] O'Reilly, Charles A. III, Brian G. Main and Graef S. Crystal CEO Compensation as Tournament and Social Comparison: A Tale of Two Theories Administrative Science Quarterly, Vol. 33, No. 2 (Jun., 1988), pp. 257-274 Publisher: Johnson Graduate School of Management, Cornell University http://www.jstor.org/stable/2393058

value of her annual rewards, which paid for her Philadelphia apartment and her weekend flights to Chicago. She also lost the $1 million signing bonus she received every year and the right to renew her contract without negotiation[28]. The terms of Ms. Bern's renewal reflect the significant pressure boards face from shareholders to hold management more accountable for their by decisions by making compensation dependent on firm value.

Other evidence pointing to the alignment of board interests with those of shareholders is the slew of CEO firings that resulted in response to the massive write-downs of 2007. In his article, *Who Controls Whom? An Examination of the Relation between Management and Boards of Directors in Large American Corporations*, Mizruchi argues that CEO firings by the board in response to poor firm performance represent a greater accountability of directors to shareholders. The period of increased CEO firings during 2007 seems to confirm that board accountability has increased. While it could be argued that these removals were due to unusually bad performance on the part of the CEO, companies have underperformed in the past and boards of directors have not responded by immediately removing them from power. Therefore, there is reason to believe that boards are becoming less patient with unsuccessful CEOs than they were in the past, most likely in response to increased shareholder pressure to oversee management decision-making and ensure efficiency.

These trends demonstrate that more efficient election standards have enabled shareholders to pick directors that are better able represent their interests. In turn, directors have realized that their position on a company's board depends on whether or

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[28] Lublin, Joann S. *CEO Compensation Survey (A Special Report); Boards Flex Their Pay Muscles: Directors are increasingly exercising more clout in setting CEO compensation; And in some cases, the boss is actually feeling a little pain.* Wall Street Journal [New York, N.Y.] 14 Apr. 2008, Eastern edition: R.1. ABI/INFORM Global. ProQuest. Bobst Library, New York, NY. 7 May. 2008 http://www.proquest.com

not shareholders believe their interests are being represented. The increased determination by directors to represent shareholders interests implies that as shareholders carefully choose directors that will effectively represent their interests, corporate policies may align with shareholder interest to a greater degree.

Conclusion:

Studies have demonstrated that weak corporate governance has a negative affect on firm performance. This is a result of the agency costs that are created due to diverging incentives between management and shareholders. A number of theories have proposed how to reduce agency costs in order to improve corporate governance. Some have suggested that the solution lies in independent directors. However, there is no way of confirming whether the director is independent due to the unobservable nature of human relationships. Others have suggested the activist shareholders force the alignment of managerial interests with shareholder interests. However, while a small number of activist investors can be helpful in improving corporate governance, too many of them may turn a corporation into a ‘town hall meeting’, diverting management’s interest from running the firm to appeasing shareholders.

When the founding fathers created our constitution and our system of government, they were fully aware of the dangers of mob mentality. This is why they instituted a voting system that relied on an Electoral College to elect leaders, rather than giving this power to the voters. Similarly, while greater shareholder ‘voice’ in the corporation is inherently more democratic, this ‘democracy’ may actually create more harm than benefits due to lack of shareholder knowledge. The management of a corporation best knows the firm, the industry, and how to operate in such a way as to maximize profits and increase the value of the firm. Therefore, a corporation's profitability depends, to a great extent, on shareholders' inability to affect management decision-making.

The dilemma is that, on the one hand, management must maintain enough autonomy to make fast-paced decisions that are in the best interest of firm profitability. On the other hand, management must be prevented from diverting corporate assets to satisfying their individual incentives. The solution to this dilemma lies in the democratic notion of accountability. Increasing accountability within a corporation means aligning the interests of the corporation with shareholders. In order for this to be done, the interests of shareholders must be represented by agents with enough knowledge and expertise to understand the company and the industry as well as the concerns of their constituents. In a political democracy, this is achieved through elections and a separation of powers between the two main branches of government. Recent trends show that applying these two institutional mechanisms to corporate governance increases the accountability in a corporation as well.

Therefore, returning to our original question – yes, we can in fact learn something from democracy in order to improve corporate governance, despite the different social purposes of the two institutions. Strict election standards and a distinct separation of powers make corporate governance more efficient. Therefore, implementing policies that improve these two mechanisms will enable corporation to achieve an optimal balance between management and shareholders. This, in turn, will allow shareholders to maximize the benefits from centralized managerial decision making, while minimizing potential agency costs.

James Madison writes in *The Federalist,* number LI, "If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls on government would be necessary. In framing a government which is to be administered by men over men, the great difficulty lies in this: you must first enable the government to control the governed; and in the next place oblige it to control itself." His point is that government is essential for stability. However, while a government system is created to monitor and oversee society or organization, it is just as important to oversee the government. As all humans are prone to flaws, all institutions, man made or not, are prone to inefficiencies. And in order to maximize our benefits from the institution, we have to minimize those inefficiencies. Only then will they be able to fulfill their social purpose, which in the case of a corporation, is to increase profitability.

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