

Shareholder activism business



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This paper looks at the issue of shareholder activism from an Irish and International perspective, in the context of understanding agency theory and corporate governance which acts as catalysts to this new phenomenon. This is done by looking at past and current published papers that revolve around the subject matter. Theoretical concepts within the business and finance literature are explained in relation to how agency theory and corporate governance are practised worldwide.

Three countries namely, the OECD countries (European Union as one whole entity), Ireland, and China, are assessed to identify how these concepts are practiced to gain a better insight into this new problem known as shareholder activism. Finally a critical review of matches and mismatches is used to compare and contrast similarities between the theoretical concepts and the empirical evidence within the literature review that is gathered for this paper to identify whether this problem is a worldwide problem or it is at the growth stage of becoming a worldwide phenomenon.

Chapter 1: The Concept of Shareholder Activism

Shareholder activism has begun to play a role in reshaping the corporate governance in companies all across the globe. In industrialised or advanced countries, institutional investors or financial intermediaries serve the function of active shareholders. In general, shareholder activism has become one of the most important and highly debated issues of the 21st century. The issue of shareholder activism (shareholder revolt against management objectives) can be said to have arisen due to the recent collapse of huge international organisations; in theoretical terms it is known as Corporate

Governance. Now, Corporate governance refers to structures and processes for directly and controlling companies.

Collectively, these constitute a set of rules that govern the relationships among management, company shareholders, and other stakeholders including consumers, creditors, employees, the general public, neighbouring people and suppliers. The rules of corporate governance aim to ensure that manager's act in the best interests of their shareholders rather than simply acting in their own interests or those of a majority shareholder. Good corporate governance can provide companies in emerging markets in particular, better access to outside capital by making them more attractive targets for portfolio investment.

The impact of recent corporate scandals, which has opened the debate as to the validity of corporate governance, has been felt all across the world and Ireland is no exception. Domestic scandals such as the fallout from the Inquiry into no-collection by certain banks of applicable tax on deposit accounts prompted a report on auditing standards which eventually resulted in the Companies (Auditing and Accounting) Act (2003), essentially is Ireland's Sarbanes- Oxley Act. Until relatively recently, meanwhile, there was scant compliance with corporate governance and companies legislation which led to government committee report on the matter in 1997 and ultimately to the enactment of company Law Enforcement Act, 2001.

This Act established the Office of Director of Corporate Enforcement, which now has responsibility for ensuring compliance with the Companies Acts (1963 -2003) in Ireland. This government body has significant powers of

investigation and prosecution, which are being exercised vigorously. In the European Union (OECD), although this had been a subject of thought for over a decade, it was originally developed in response to a call by the OECD council meeting at ministerial level in 1998, to develop, in conjunction with national governments, other relevant international organisations and the private sector, a set of corporate governance standards and guidelines. Since the principles were agreed in 1999, they have formed the basis for corporate governance initiatives in both OECD and non-OECD countries alike. Accordingly, they form the basis of the corporate governance component of the World/IMF Reports on the Observance of Standards and Codes (ROSC).

Aims and Objectives

The aim of this paper is to address the issue of aligning management objectives with the objectives of shareholders and help identify why this has not been successful. I. e. this genesis has led to shareholder activism at annual general meetings, which management have found it very unpleasant to bear with within organisations all across the globe. The objective of this research paper is to first look at the genesis (beginnings) of this problem pertaining agency theory and corporate governance with regard to their relevance in satisfying shareholder objectives.

Secondly, to explain the current trend in relation to shareholder activism within organisations and also how companies are preparing and dealing with this phenomenon at AGM's. I. e. The right information is given to shareholders as to the accurate financial earnings and gains of the organisation which they were appointed to manage. This will be looked at from an Irish and International perspective. Finally, a critical appraisal of the

validity of published material so far covering agency theory and corporate governance within organisations will be addressed.

Chapter 2: Existing Literature Review

The need to understand and deal with shareholder activism is one that has come of recent due to the collapse of major international organisations around the world within the past decade. According to Grace (2004), in Ireland, the role of the institutional shareholder and the extent of their responsibilities as such, insofar as these differ from those of individual shareholders, are governed by practice rather than legislation. In addition, she adds that in Irish incorporated companies the overall management function vests in a board of directors, although the directors may delegate functions to certain executives or committees of the board.

There is no statutory limit on the number of directors (hence wasting company funds on management) that can comprise a board, although limits may be imposed in the Articles of Association. Current legislation (Companies Act 2003) in Ireland requires a minimum of two directors, both of whom must be natural persons and one of whom must be an Irish resident. Grace (2004) also argues that the Articles of Association set out the requirements for the convening and holding of board meetings, while the corporate governance requirements for listed companies ensure that regular meetings are held. Written notice is usually required, including an agenda and all relevant documents to be considered at the meeting. All minutes of board meetings must be kept in the register of minutes but these are not generally available to shareholders, a major reason for shareholder activism.

Daily et al.(2003) suggest that the overwhelmingly dominant theoretical perspective applied in corporate governance studies is agency theory. This serves as an explanation of how the public corporation could exist, given the assumption that managers are self-interested, and a context in which those managers do not bear the full wealth effects of their decisions. The theory responds to the observation 70 years ago of some of the key problems inherent in the separation of ownership and control.

Daily et al. (2003) also add that in nearly all-modern governance research, governance mechanisms are conceptualised as deterrents to managerial self-interest. Corporate governance mechanisms provide shareholders some assurance that managers will strive to achieve outcomes that are in the shareholders' interests. Shareholders have available both internal and external governance mechanisms to help bring the interests of managers in line with their own. They also argue that internal mechanisms include an effectively structured board, compensation contracts that encourage a shareholder orientation, and concentrated ownership holdings that lead to active monitoring of executives.

The market for corporate control serves as an external mechanism that is typically activated when internal mechanisms for controlling managerial opportunism have failed. Abelson (2001) argue with regard to the collapse of Enron, that what made the Enron case different is how sudden and final the company's fall was for its shareholders, i. e. it was the shareholders that lost out and not management, adding that how can someone (people on the board of directors in Enron) who cannot own stock in a company serve on its board. In Europe, the OECD principles of corporate governance (2004) state <https://assignbuster.com/shareholder-activism-business/>

that corporate governance is one key element in improving economic efficiency and growth as well as enhancing investor confidence.

Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring. In addition the OECD (2004), also argue that while a multiplicity of factors affect the governance and decision making processes of firms, and are important to their long-term success, the principles focus on governance problems that result from the separation of ownership and control (agency theory). However, this is not simply an issue of relationship between shareholders and management, although that is indeed the central element. In some jurisdictions, governance issues also arise from the power of certain controlling shareholders over minority shareholders.

In other countries, employees have important legal rights irrespective of their ownership rights. The OECD (2004) also suggests that corporate governance is affected by the relationships among participants in the governance system. Controlling shareholders, which maybe individuals, family holdings, bloc alliances, or other corporations acting through a holding company or cross shareholdings, can significantly influence corporate behaviour.

As owners of equity, institutional investors are increasingly demanding a voice in corporate governance in some markets. Individual shareholders usually do not seek to exercise governance rights but may be highly concerned about obtaining fair treatment from controlling shareholders and management. Creditors according to the OECD (2004) play an important role in a number of governance systems and can serve as external monitors over corporate performance. Employees and other stakeholders play an important role in contributing to the long-term success and performance of the corporation, while governments establish the overall institutional and legal framework for corporate governance.

The role of each of these participants, OECD (2004), and their interactions vary widely among OECD countries and among non-OECD countries well. Adding that these relationships are subject, in part, to law and regulation and, in part, to voluntary adaptation and, most importantly, to market forces. Bebchuk (2003) also argue that in theory, if directors fail to serve shareholders, or if they appear to lack the qualities necessary for doing so, shareholders have the power to replace them. This relates to a document presented to the securities exchange commission in New York, considering the improved rights of shareholders.

Bebchuk (2003) also states that this shareholder power, in turn, provides incumbent directors with incentives to serve shareholders well, making directors accountable. He suggests that although shareholder power to replace directors is supposed to be an important element of corporate governance system, it's largely a myth. Attempts to replace directors he states are extremely rare, even in firms that systematically underperform

over a long period of time. By and large, directors nominated by the company run unopposed and their election is thus guaranteed. This varies from country to country. Hamid (2005) argues with regard to the International Financial Corporation, which is part of the World Bank in relation to corporate governance models in China.

It states that corporate governance is a new concept in China and most managers and boards remain unaware of basic governance procedures, often confusing governance with general management. As a result, bridging the gap between rhetoric and reality is required. It adds that the private sector in China has clearly become the engine of growth, seemingly offering enormous investment opportunities. But the structures in place at private companies are often immature, reflecting the newness of the private sector. Most small and mid-sized enterprises in Chinaware run informally.

They are family owned, they don't have checks and balances, and their financial reporting is not transparent. It goes on to argue that the state-owned enterprises on their way to becoming private enterprises suffer from a different set of governance problems. When these companies take on private ownership, they carry the legacy of the state-dominated decision making regime. They often have complex and opaque corporate ownership structures, overlapping new and traditional bodies of corporate control, and reporting practices that are focused on satisfying the information requirements of the authorities rather than the needs of investors.

Stutchbury (2001) states that in Australia, when AMP handed down its 1999 results showing a \$1.2 billion abnormal loss from the GIO takeover, the AMP

chairman was nowhere to be seen. He did not deem it necessary to front up to the cameras or to face media questioning to explain himself to shareholders. He left it to the relatively new CEO, who was required to deal with the many serious questions about the company's board, its relationship with top management, and the departure of its former CEO. These were questions, which the new CEO could not properly answer. They had to be answered by the Chairman, if they were to be answered at all. This shows across misconduct of rules and guidelines with regard to corporate governance.

Although CSR has only become one of the most heated topics of the new millennium, its roots undoubtedly go back to some of the key philosophical debates over ethics, values, equity and equality, Smith(2003). However, the systematic treatment of business ethics has been neglected in most advanced economies, which directly relates to CSR. Hartley (1993), for example, suggests that the interests of a firm are actually best served by scrupulous attention to the public interest and by seeking a trusting relationship with the various stakeholders with which a firm is involved.

In the process, society is also best served because the firm is forced to consider a whole range of competing objectives and to move away from activities, which are derived from short-term performance indicators. Hartley (1993) also adds that any philosophy or course of action that doesn't take the public interest into consideration is intolerable in today's society. Today's firms face more critical scrutiny from stakeholders and operate in a setting, which is becoming more regulatory and litigious.

The Pensions and Investment Research Consultants (PIRC) (2000) in the UK, argue that the law should require all proxy votes are brought to bear on the business of a company's annual general meeting, which should encourage institutions to vote their proxies. Adding that they do not consider that abolishing the show of hands would act as a disincentive for small shareholders to attend and vote as they are aware of their lack of voting power under current UK law arrangements. The show of hands is largely symbolic. The PIRC (2000), also state that if the annual general meeting (AGM) is not made the focus of the decision making process, but merely one moment in the process, companies would be tempted to lobby shareholders after the AGM, thus undermining the value of the AGM. They emphasise that such a proposal gives companies an ability to evade accountability to their shareholders.

The OECD (2004) states that shareholders have access in a number of countries to the company's proxy materials, which are sent to shareholders, although sometimes subject to conditions to prevent abuse. The OECD (2004) also states that co-operation among investors could also be used to manipulate markets prior to proxy voting, and to obtain control over a company without being subject to any takeover regulations. For this reason, in some countries, the ability of institutional investors to co-operate on their voting strategy is either limited or prohibited.

Shareholder agreements may also be closely monitored. On the other hand although corporate governance around the world varies with regard to successes and failure, Reuters(2004) stated that News Corp, one of the world's largest media empires, had a proxy vote, in which more than 90

present voted in favour of the Chairman's plan to reincorporate the organisation in the United States, where it generates more than 75 percent of its earnings. This can be seen as very good reaction from the shareholders of the company, in which corporate governance in this case has been a success.

It is worthwhile noting that the adherence and practice of corporate governance to avoid shareholder activism does vary from country to country and so the rules, guidelines, regulations, and procedures governing this concept are subject to different interpretations in companies around the world.

Chapter 3: Theoretical Perspectives On Agency Problem, Corporate Social Responsibility and Corporate Governance

It is often assumed that the role conflict between those who own firms (i. e., who want the firm to maximise the value of their stake in the business) and those who manage them (who want to maximise their own reward) will be detrimental to the pursuit of profit maximisation as an overriding objective. The significance of this separation of ownership and control and the potential problems it can cause is known as the agency problem. While, corporate governance deals with how an organisation establishes who it is there to serve, how this should be decided, and by whom. This relates to how managers deal with issues of ethics and corporate responsibility. The following is a detailed elaboration of the agency problem and corporate governance with regard to the concepts acting as a catalyst that leads to shareholder activism.

The Agency Problem

Potential conflict arises where ownership is separated from management.

The ownership of most larger companies is widely spread, while the day-to-day control of the business rests in the hands of a new managers who usually have a relatively small proportion of the total shares issued. This can give rise to what is termed managerialism, self-serving behaviour by managers at the shareholders ' expense. Examples of managerialism include pursuing more perquisites(splendid offices and company cars, etc.) and adopting low-risk survival strategies and satisficing behaviour. This conflict has been explored by Jensen and Mackling (1976), who developed a theory of the firm under agency arrangements. Managers are, in effect, agents forth shareholders and are required to act in their best interests. However, they have operational control of the business and the shareholders receive little information on whether the managers are acting in their best interests.

A company can be viewed as simply a set of contracts, the most important of which is the contract between the firm and its shareholders. This contract describes the principal-agent relationship, where the shareholders are the principals and the management team the agents. An efficient agency contract allows full delegation of decision-making authority over use of invested capital to management without the risk of that authority being abused. However, left to themselves, managers cannot be expected to act in the shareholders' best interests, but require appropriate incentives and controls to do so. Agency costs are the difference between the return expected from an efficient agency contract and the actual return, given that

managers may act more in their own interests than the interests of shareholders.

Managing the agency problem

To attempt to deal with such agency problems, various incentives and controls have been recommended, all of which incur costs. Incentives frequently take the form of bonuses tied to profits (profit-related pay) and share options as part of a remuneration package scheme. Share options only have value when the actual share price exceeds the option price; managers are thereby encouraged to pursue policies that enhance long-term wealth-creation. In reality, the agency problem between investors and directors is more illusory than real for the following reasons:

- The principal in the business relationship is the company rather than the shareholder and the directors set the priorities and goals forth business, not the shareholders.
- Because directors, in most firms, invariably own shares in their business they will benefit in the same way as the ordinary shareholders from the activities of the firm.

Chief executives in a number of large companies have recently come under fire for their outrageously high pay resulting from such schemes. Executive compensation schemes, such as those outlined above, are imperfect, but useful, mechanisms for retaining able managers and encouraging them to pursue goals that promote shareholder value. Another way of attempting to minimise the agency problem is by setting up and monitoring managers' behaviour. Examples of these include:

- Audited accounts of the company
- Management audits and additional reporting requirements, and
- Restrictive covenants imposed by lenders, such as ceilings on the dividend payable or the maximum borrowings.

To what extent does the agency theory problem invalidate the goal of maximising the value of the firm? In an efficient, highly competitive stock market, the share price is a fair reflection of investors' perceptions of the company's expected future performance. So agency problems in a large publicly quoted company will, before long, be reflected in a lower than expected share price. This could lead to an internal response, the shareholders replacing the board of directors with others more committed to their goals, or an external response, the company being acquired by a better-performing company where shareholder interests are pursued more vigorously.

Corporate Social Responsibility

Corporate social responsibility (CSR) is now on the global policy agenda, with the last 20 years having seen great strides forward in it. Domestically and internationally governmental, business and other organisations are getting involved with CSR initiatives. This relates to the fact that independent legal entities such as pension fund managers, institutional investors, private investors, green peace, and Christian churches are leading the way in attending annual general meetings of organisations, to ask tough and environmental questions concerning the conduct and performance of management within organisations. This has proved difficult to comprehend

with in recent times for major organisations such as the Shell, Financial Times(1997), facing its shareholders on the grounds of its ethical approach on human rights grounds in the Niger Delta region of Nigeria.

At the European and UK domestic levels, the European Commission in 2002 adopted a new strategy on CSR, and in the same year the UK government published its second national CSR report. The UK government has now also appointed a minister for CSR. Internationally, organisations such as the United Nations, the International Labour Organisation (ILO), and the Organisation for Economic Co-operation and Development (OECD) have also taken the lead. Initiatives such as the UN Global Compact, theology Declaration on Fundamental Principles and Rights at Work and the Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy, and the OECD voluntary guidelines for multinational enterprises now dominate the corporate agenda, thus making CSR important for organisations of all kinds, large and small alike Hopkins (2003).

The emergence of business ethics and responsible action on the corporate agenda is, however, more a function of the growing awareness of the social, political, and environmental impact of the modern industrial enterprise.

Many of the shifts in political attitudes towards firms, for example, reflect serious abuse by specific companies and specific business leaders. The misappropriation of pension funds, repression of workers in the Third World, environmental incidents, and even the bribery and corruption associated with deals to gain large government contracts is all issues which have hit the headlines over the last few years. One of the major sticking points with regard to the rise in shareholder activism is the fact that corporate decisions

are linked to a set of business ethics, and that by considering the structures and procedures which define the ethics of an organisation we ought to be able to say something about the prospects and preconditions for corporate performance. These various stakeholders, whom the firm must consider, are its customers, suppliers, values on which stakeholders requirement are based can be, in themselves, contradictory.

The traditional way of resolving these issues is for the organisation to assume primacy over individuals, allowing it to pursue objectives dictated by senior management subject to financial constraints imposed by owners and lenders. The notion of public trust is also becoming more important. A clear measure of how far we have come towards a more responsive and responsible business climate is indicated by the fact that if a firm violates public trust, then it is likely to be surpassed by its competitors, who will be eager to please customers by addressing their wants more accurately. Moreover, while the overwhelming majority of business dealings are non-controversial, any abuses increasingly receive considerable publicity, harming the image of business. Once a company's image has been damaged, it often takes a long time to reverse that damage.

In order to remain economically active, organisations need to learn from their mistakes or from those of other organisations. They need to take care to avoid situations and actions that might harm their relationship with their various stakeholders. In the worst of all cases, where an organisation faces a catastrophe, suddenly and without warning, its whole market image and business strategy can be destroyed. Examples of such events are increasingly commonplace. For example, in the case of Union Carbide, when <https://assignbuster.com/shareholder-activism-business/>

one of its chemical plants in Bhopal, India leaked 40 tons of toxic chemicals, the event had (and continues to have) a profound effect on the reputation of that company. Although the company quickly rushed aid to the victims, it was bitterly condemned for complacency and the loose controls that permitted the accident to happen in the first place.

Environmental considerations are only one of many issues, which might be included under the umbrella of business ethics. They nevertheless constitute an issue, which has grown in importance. As a result of them any accidents and growing environmental damage caused by organisations, there have been increasing demands from consumers for firms to operate more ethically in this area. The consumer movement has fundamentally shaped and contributed to the significant increase in legislation and regulation at all levels of government. This has been aimed at preventing abuses in the marketplace and in the environment and, therefore, environmental management strategies are increasingly commonplace in leading organisations around the world. To date, however, environmental considerations have not been given enough attention within the framework of business ethics, because dominant ideologies are being shaped more by short-term financial considerations than by the need to do business in a sustainable way. Ethics also vary internationally, due to cultural differences that exist across borders.

The Corporate Governance

In recent years, there has been considerable concern in the UK and around the world about standards of corporate governance, the system by which companies are directed and controlled. While, in company law, directors are

obliged to act in the best interests of shareholders, there have been many instances of boardroom behaviour difficult to reconcile with this ideal. There have been numerous examples of spectacular collapses of companies, often the result of excessive debt financing in order to finance ill-advised takeovers, and sometimes laced with fraud. Many companies have been criticised for the generosity with which they reward their leading executives.

The procedures for remunerating executives have been less than transparent, and many compensation schemes involve payment by results in one direction alone. Many chief executives have been criticised for receiving pay increases several times greater than the increases awarded to less exalted staff. In the train of these corporate collapses and scandals, a number of committees have reported on the accountability of the board of directors to their stakeholders and risk management procedures. The principles of Good Governance and Code of Best Practice, which apply to all listed companies from 1999 onwards within the OECD countries, are mentioned below:

- Directors and the Board

An effective board is required to lead and control the company. It should have a balance of executive and non-executive directors; no individual or group must dominate the board; running the board and running the business are separate activities; no individual has unfettered powers; timely and quality information is given to the board; clear procedures for appointments; re-election at least every three years.

- Directors' remuneration

Executive remuneration is linked to corporate and individual performance; directors are not involved in deciding their own remuneration.

- Relations with shareholders

Encourage dialogue on objectives with institutional shareholders; seems to communicate with shareholders and encourage participation.

- Accountability

Reports influencing share price to give a balanced, understandable assessment of the company's position and prospects; a sound system of internal control to safeguard shareholders' interests and company assets.

Chapter 4: Critical Analysis of Theoretical Perspectives and the Empirical Evidence Gathered In The Literature Review

The critical analysis in this chapter covers all aspects relating the theoretical perspectives of agency theory, corporate social responsibility and corporate governance from published books and articles. An analysis is made as to whether there is any consistency from the published material as far gathered and the already established theories. Due to the lack of time attached to this paper the empirical evidence used is one that has been covered in the literature review.

One could say that the issue from shareholder activism from an international perspective is one that has come about of recent. Thesis rectified by the new guidelines, which only came into effect in 1999, within the OECD countries including Ireland, and in China, it is still seen as a very new concept.

The issue of agency theory with regard to the objectives of management and shareholders still varies from country to country. It can be