Corporate governance: How useful is shareholder intervention? Insights from literature
Investors are expected to play an active role in ensuring good corporate governance. Sometimes they interfere, even without actually holding shares, like giant ABP in the recent Stork Case.

What exactly does drive institutional shareholders to engage in shareholder activities?

A review of literature on this issue poses a number of interesting questions. Is shareholder activism always directed at creating a positive effect on the value of the stock? Or do shareholders also intervene in an attempt to comply with societal, normative and ethical expectations?

Abe de Jong, Gerard Mertens, Hans van Oosterhout en Hélène Vletter: Most corporate governance codes these days call upon institutional investors to exercise their voting rights, to play an active, constructive role in good governance. Recently one of the world’s largest institutional shareholders (ABP) entered into Stork’s shareholders debate on the company’s future without even holding any shares (Financiële Dagblad, 17/1/2007). This raises the central question in this paper: what does drive institutional shareholders to engage in shareholder activism?

Focusing on what is known from literature about shareholder actions we investigate potential motives and means for this institutional shareholder activism. Which factors presumably condition the functioning of shareholder actions, as an instrument of corporate governance? After reviewing available empirical research we conclude by speculating on why investors continue to engage in shareholder activities, which do not seem to have any effect on share value or on other criteria for corporate financial performance.

Meaning and purpose of shareholder activism
Definitions of ‘shareholder activism’ – which is the term commonly used in literature to denote the kind of activities this report is about – are either quite broad or more specific. Black (1998) provides an example of the former, defining shareholder activism as ‘proactive efforts to change firm behavior or governance rules’. Gillan & Starks (1998) exemplify the latter when they define a shareholder activist as ‘an investor who tries to change the status quo through “voice”, without a change in control of the firm’. These two definitions demonstrate that to define shareholder activism is already to say something about the presumed ends towards which shareholder activism is to be understood as a means (Bainbridge, 2003). This end, allegedly, is to change the governance, management or performance of a portfolio firm, with the ultimate purpose of maximizing shareholder wealth through alleviating agency problems (Fama, 1980) that arise on account of the separation of ownership and control in public firms (Berle & Means, 1932; Jensen & Meckling, 1976). The most important corporate governance mechanisms are commonly held to include: incentives plans for managers, legal protection, board monitoring and the market for corporate control (Schleifer & Vishny, 1998).

A corporate governance instrument
Given that shareholder activism is to be understood as a means in the pursuit of the end of shareholder wealth maximization, it makes sense to take a clo-

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1 This article is based on De Jong et al. 2007.
ser look at the factors that presumably condition the functioning of this means of corporate governance. In general, shareholders in publicly listed companies retain control rights because not all that is relevant to shareholder wealth can exhaustively be provided for by substantive terms in the nexus of contracts that constitutes the public firm (Easterbrook & Fischel, 1991). Moreover, as a group, shareholders, who are residual claimants, constitute the only corporate constituency that has the proper incentives to maximize the long run value of the firm as a whole (Jensen, 2002).

At the same time, however, the bulk of everyday decision making in public firms must be delegated to directors and managers on account of efficiency considerations, as shareholders of public firms typically have neither the means nor the incentives to make informed decisions on everyday corporate issues. But even if they could, it would still be inefficient for shareholders to be actively involved in running the company on account of both transaction costs and collective action problems that prevent shareholders from having an active role in the day to day operations of the firm. Normally, therefore, the control rights of shareholders in public firms consist only of their right to vote in general meetings, and even then only on a rather limited set of issues (Easterbrook & Fischel, 1991: 63-72). These issues by and large include board appointments and decisions on significant corporate actions, such as mergers and charter amendments (Kraakman, 2004). That the formal corporate governance role of shareholders is typically limited to voting on a limited set of issues does not mean, however, that shareholder activism is limited to voting at general meetings. Voting on these issues is best seen as the ultimate step in what very much resembles a ‘political process’ of ex ante engagement and that includes the variety of activities we denote with the term shareholder activism in this research (Pound, 1992, 1993).

Yet even the exercise of the limited control rights that shareholders have is commonly problematic for shareholders. The reasons for this primarily involve the high transaction costs that burden collective decision making between dispersed shareholders, and collective action problems (Olson, 1965) that stifle incentives for individual shareholders to engage in shareholder activities (Downs, 1957). Because the presumed benefits of shareholder activism constitute a public good, individual shareholders are rational to remain inactive and free ride on the shareholder activities of others. And because all rational shareholders are assumed to think this way, this ultimately results in an undersupply of shareholder activity. The factors that condition the functioning of shareholder activism as a means in corporate governance are therefore for the most part the factors that burden or alleviate transaction costs and collective action problems in this context.

Conventional wisdom has it that the factors that burden shareholder activism include: the degree to which shareholdings in the target company are dispersed over different owners, the informational and legal barriers that stand in the way of exercising shareholder voice (see generally: Bebchuk, 2005), and the level of inside ownership in the target firm, which presumably is an indicator of the expected resistance against external shareholders seeking to influence either the management, governance or performance of the firm (Carleton, Nelson & Weisbach, 1998; Karpoff, Malatesta & Walking, 1996; Smith, 1996). Inversely, the factors that are believed to facilitate the functioning of shareholder activism as a means of corporate governance include: ownership concentration and the degree of institutional ownership – which both decrease transaction costs and collective action problems for obvious reasons, on the one hand, and the absolute size of the equity holding in the target firm, on the other. The latter is true because a straightforward cost-benefit analysis shows that it makes good sense for shareholders to actively intervene in portfolio companies more or less independent of what other shareholders will do. Say that one owns 1000 shares valued at € 5 a piece, while the total costs of intervention are € 50 and the share price increase after intervention turns out to be € 5.10. Then investing in shareholder activities seems to be a solid investment with a return on investment of 100%. Of course this assumes activism to be successful, and it is questionable whether this is typically true as a matter of fact (see below).

Because the factors that are believed to burden shareholder activism are abundantly present in many jurisdictions, and because alternative means of corporate governance – e.g. board monitoring or the market for corporate control – are commonly held to be both cheaper and more effective, share-
holder activism is often claimed to make little sense, except under conditions that are either very specific (e.g., Romano, 2001) or that apply only ‘in extremis’ (Easterbrook & Fischel, 1991: 66). According to this view, shareholder activism is best seen as an ultimum remedium that should be put to use only after a thorough cost-benefit analysis and under highly specific conditions that will be relatively rare as a matter of fact (Romano, 2001). And if shareholder activism is efficient only under such relatively rare conditions, the actual prevalence of shareholder activism may say very little about its true value as a means of corporate governance. This is for reasons similar to the reasons why the number of civil rights lawsuits in a given jurisdiction may say very little about the importance of civil rights in that jurisdiction. Ultimately, it is the availability of the option of shareholder voice, rather than its actual exercise, that matters most.

Performance consequences of shareholder activism
Because shareholder activism is predominantly understood as a means to secure the end of shareholder wealth maximization, the bulk of empirical research on shareholder activism has in some way or form addressed the activism-performance relationship (for reviews, see: Black, 1998; Gillan & Starks, 1998; Karpoff, 2001; Romano, 2001). The available empirical research is mostly about shareholder activism in the United States and provides a mixed bag of results. Karpoff (2001) attributes the conflicting findings on the activism-performance relationship largely to the different methodologies and measures used in empirical studies of shareholder activism. He concludes that in spite of the apparent disagreement on the performance consequences of shareholder activism, a relatively clear picture can be seen to emerge once the different measures for success of shareholder activities are accounted for. On the one hand, the studies that find no or negligible effects typically focus on firm value increases or other measures for corporate financial performance. The studies that find positive effects, on the other hand, tend to take management or governance changes as an indicator for the success of shareholder activism.

Shareholder induced corporate governance reforms and firm performance
This issue is currently contested in the literature. Although research by Comens, Ishii & Metric (2003) finds a positive relationship, this finding is (partly) challenged by research from Larcker, Richardson & Tuna (2005) and Core, Guay & Rusticus (2006).

According to Romano (2001), the fact that no such a relationship presently exists is mostly explained by the fact that the kind of corporate governance changes that are typically sought after by investors, are not found to have a positive relationship with firm value and financial performance to begin with. More specifically, Romano argues that board structure reforms, executive compensation and confidential voting ‘have not found to be value enhancing corporate governance devices’, while the performance consequences of rescinding anti-takeover devices are at best ambiguous (Romano, 2001: 191). This raises the question why shareholder activities have aimed at these apparently inconsequential corporate governance changes in the first place? We will address that question below.

Different kinds of shareholder activities
Shareholder activism must be understood as consisting of a wide variety of activities and does not just comprise the right to vote at general meetings, even if this is about the only formal control right shareholders have in public firms. Shareholder activism has been known to include activities as diverse as: information gathering on portfolio companies, visiting general meetings, asking questions at general meetings, submitting proposals to general meetings, voting at general meetings, engaging in either public or private communications with other shareholders or managers of portfolio companies, and many other activities that are presumed to be fruitful in the pursuit of changes in the governance, management or performance of portfolio firms.

If we account for the different forms that shareholder activism may take in assessing its performance consequences, it seems that contrary to publicly submitting proposals at general meetings, private engagement of portfolio companies or announcing negotiated settlements with portfolio companies often does have a positive effect on firm
value or financial performance (e.g. Chrutchly, Hudson & Jensen, 1998; Smith, 1996; Strickland, Wiles & Zenner, 1996).

**Which firms are targeted by activist shareholders?**

Given that shareholder activism is to be understood as an instrument of corporate governance in the pursuit of shareholder wealth maximization, it can reasonably be expected that firms targeted for activism by shareholders have relatively lower stock values or financial performance than firms that are not targeted, as there will be ample room to improve the performance of such firms. Moreover, the conventional wisdom regarding the functioning of shareholder activities as a corporate governance instrument holds that shareholders will target only those firms were they expect their activities to have a reasonable chance of success. As explained above, the conditions that presumably increase the chance of success include the level of institutional ownership and the size of the absolute shareholding, while the degree of insider ownership is expected to have a negative impact on the chance of success.

From the empirical research on target firm selection we can defer some general trends that targeted firms are: relatively large (this being an indicator for the absolute size of the shareholding), relatively poor performers (as measured by either prior stock returns or a variety of accounting measures), have a relatively high institutional ownership, while simultaneously displaying a relatively low degree of insider ownership (Romano, 2001).

**How rational is shareholder activism?**

The question has been raised why institutional shareholders aim their activities on corporate governance changes that are not found to be value enhancing?

One answer is that shareholder activism may be motivated primarily by reasons other than the instrumental one of enhancing firm value or financial performance. These alternative reasons may involve either the agency problems that burden investors themselves – with asset managers presumably having different objectives than the beneficiaries of their asset management activities (Brown, Harlow & Starks, 1996) – or social and political pressures to which particularly institutional investors seem increasingly subjected (e.g. Davis & Thompson, 1994; Graves & Waddock, 1994; Johnson & Greening, 1999; Romano, 1993; Smith, 1996; Wahal, 1996). It should be clear, however, that to the extent that shareholder activism is prompted by social or political pressure on behalf of non-shareholding corporate constituencies – such as labor (Schwab & Thomas, 1998) – or by issues that concern society at large – such as the environment – it will conflict fundamentally with the instrumental understanding of shareholder activism that we subscribe to here and that is also dominant in the literature. Arguably, understanding shareholder activism as the result of social or political pressures rather than as a means in corporate governance would require a re-conceptualization of the phenomenon.

Ironically, however, this is also true when the occurrence of shareholder activism is explained from social and political pressures that aim to promote shareholder activism itself. In many jurisdictions such pressures have lead to the enactment of laws or corporate governance codes that present activism by institutional investors either as a fiduciary obligation to beneficiaries, or as a socially desirable activity that produces a public good in a world in which alternative corporate governance mechanisms – such as the market for corporate control in continental Europe – function all but perfectly. It should be clear, however, that promoting shareholder activism across the board as a matter of public policy defies any rational approach to shareholder activities; as such an approach would dictate a highly selective use of this corporate governance instrument instead (Romano, 2001). Because corporate governance issues have been found to defy rational explanations more often, some authors have suggested an alternative ‘institutional’ explanation of corporate governance phenomena (e.g. Zajac & Westphal, 1998).

In general, institutional theory explains the prevalence of organizational forms from symbolic rather than from functional premises (Mizruchi & Fein, 1999; Scott, 2001; Tolbert & Zucker, 1996). It proceeds from the observation that there is often a significant ‘decoupling’ (Meyer & Rowan, 1977) between an adopted organizational form, on the one hand, and its functioning in reality, on the other hand. The thrust of so-called ‘institutional explanations’ of organizational forms and features is that these may be adopted not so much on account of their instrumental contribution to organizational
‘Corporate governance issues defy rational explanations’
performance, but rather to create organizational legitimacy with crucial constituencies in the organizational environment. Institutional explanations of corporate governance features and reforms have already been tested and found to be empirically powerful for the adoption of long term incentive plans, share buyback programs and the dissemination of a shareholder value orientation over German firms (Fiss & Zajac, 2004; Zajac & Westphal, 1995, 2004; Westphal & Zajac, 1998, 2001).

An institutional explanation of shareholder activism could involve either cognitive or normative legitimacy. Seen through the lens of cognitive legitimacy, undertaking shareholder activities is to be understood as an effort to conform to a dominant cognitive logic (Zajac & Westphal, 2004) that pervades financial markets and advanced economies (e.g. Davis & Thompson, 1994), and according to which it is assumed that shareholder activism has a positive effect on firm value, more or less independent of whether this is true as a matter of fact. Alternatively, shareholder activism can be understood in terms of normative legitimacy, when shareholders attempt to comply with societal expectations that pressure shareholders to actively monitor their portfolio companies because this is deemed desirable or even required. In this view, engaging in shareholder activities is simply what shareholders are supposed to do, more or less in the same way society expects doctors to cure patients, even if they have no curative options at their disposal anymore. In an empirical setting, we should try to measure these institutional pressures on shareholders to be able to distinguish the extent to which shareholder activism results from either rational (or functional) or institutional antecedents.

To be active or not?

Corporate governance codes around the world call upon shareholders to become more active (i.e. exercise their voting rights), assuming that active shareholders are the key to a well established system of corporate governance. However, we show that existing literature provides a ‘mixed bag’ of results. One strand of the literature claims that shareholder activism makes little sense (Romano, 2001), except for specific conditions, and should therefore only be used after a thorough cost-benefit analysis. Other research claims both positive and no effects of shareholder induced changes in corporate governance and firm value. Again the empirical evidence provided to date is inconclusive. Why then do institutional investors engage in shareholder activities?

One potential answer is that these shareholders are motivated primarily by reasons other than the instrumental one of enhancing firm value or financial performance. It is claimed that social and political pressures prompt these actions rather than rational or economic motives. Engaging in shareholder activities is simply what shareholders are supposed to do. The challenge ahead of us is to try and measure institutional pressures on shareholders and to distinguish the extent to which shareholder activism results from either rational (or functional) or institutional antecedents. It is too early yet to draw final conclusions on this matter.

References
~ Larcker, D.F., S.A. Richardson & A.I. Tuna (2005). How Important is Corporate Governance?

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