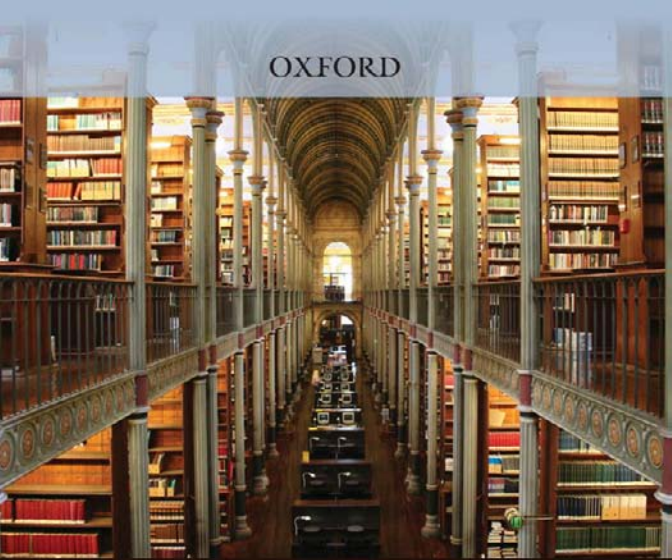
OXFORD



Michel Goyer

# Contingent Capital

Short-term Investors and the Evolution of Corporate Governance in France and Germany

# Contingent Capital

*This page intentionally left blank*

# Contingent Capital

## Short-term Investors and the Evolution of Corporate Governance in France and Germany

Michel Goyer

OXFORD
UNIVERSITY PRESS

OXFORD
UNIVERSITY PRESS

Great Clarendon Street, Oxford OX2 6DP

Oxford University Press is a department of the University of Oxford.
It furthers the University's objective of excellence in research, scholarship,
and education by publishing worldwide in

Oxford New York

Auckland Cape Town Dar es Salaam Hong Kong Karachi
Kuala Lumpur Madrid Melbourne Mexico City Nairobi
New Delhi Shanghai Taipei Toronto

With offices in

Argentina Austria Brazil Chile Czech Republic France Greece
Guatemala Hungary Italy Japan Poland Portugal Singapore
South Korea Switzerland Thailand Turkey Ukraine Vietnam



Published in the United States
by Oxford University Press Inc., New York



First published 2011



British Library Cataloguing in Publication Data

Data available

Library of Congress Cataloging in Publication Data

Data available

Typeset by SPI Publisher Services, Pondicherry, India
Printed in Great Britain
on acid-free paper by
MPG Books Group, Bodmin and King's Lynn

ISBN 978–0–19–957808–5

1 3 5 7 9 10 8 6 4 2

# Table of Contents

*This page intentionally left blank*

# Preface

Will the globalization of finance, investment, and trade lead to convergence across national systems of corporate governance? The growing fragmentation of ownership of continental European companies in the form of the arrival of UK/US-based shareholder value-oriented institutional investors has led to the resurgence of interest in issues of the institutional foundations of comparative corporate governance (Roe, 2003; Gourevitch and Shinn, 2005). Two institutionally distinct systems of corporate governance existed in separate spheres before the mid-1990s, indicating how the integration of national stock markets lagged behind other forms of financial globalization, which by this stage were more advanced (Cohen, 1996; see also Prowse, 1995). The policy of international diversification of Anglo-American institutional investors has led to increased interactions between these different national systems of corporate governance, but without the emergence of an accommodating hybrid model due to the presence of many differences in institutional starting points (Soskice, 2009: 134; see also Bebchuk and Roe, 1999). The increased importance of Anglo-American institutional investors as major shareholders has raised important questions for the process by which firms are controlled and operated.

Moreover, the presence of shareholder value-driven funds in the capital structure of continental European companies also raises moral and practical concerns. The 2008 financial crisis has revealed the man behind the curtain – that is, the profound shortcomings associated with the sole focus on shareholder value as the guiding star for listed companies in the United States. The role of institutional investors in the transition process toward the prominence of shareholder value in the strategy of companies has been well documented.[1] Perhaps more importantly is the fact that shareholder value is embedded in the overall financialization of the American economy (Davis, 2010). Deregulated

[1] For instance, compare Jacoby (1997) with Jacoby(2005) and Davis (2009).

markets profoundly affect the way Americans live today. For instance, the subprime housing crisis has been made worse by the behavior of homeowners who viewed their dwelling as an investment whose value was assumed to be constantly rising. The subprime housing crisis illustrates how the "portfolio investment" behavior of American homeowners reinforced existing financial problems. The pursuit of material self-interest, operationalized in the obsession with wealth acquisition, is seen as the most important factor for the shrinking sense of collective purpose in American society (Judt, 2010). What happens when these same shareholder value-oriented institutional investors proceed to blockholding acquisitions in large French and German companies – two systems of corporate governance not previously exposed to the shareholder value mantra?

This book is about the investment allocations of short-term investors – namely hedge funds and actively managed mutual funds – in France and Germany and their consequences for the evolution of these two systems of corporate governance. The research question of this book constitutes a middle-range project that aims to account for the causes of diversity within classes of a changing phenomenon. The empirical evidence on the investment allocation of short-term, impatient investors highlights the greater attractiveness of French blue-chip companies over their German counterparts by a ratio of 2 to 1. But what are some of the key factors that influence the investment allocation of short-term-oriented shareholder value institutional investors, and what is the impact of these on the two systems of corporate governance?

The investigation of the uneven short-term capital allocation in France and Germany is structured around the insights of two institutionally based theoretical perspectives: law and economics (Shleifer and Vishny, 1997; LaPorta et al., 2000) and the varieties of capitalism (Hall and Soskice, 2001; Hall and Thelen, 2009; Soskice, 2009). The selection of these two perspectives is motivated not only by their importance in studies of comparative corporate governance (see Gourevitch and Shinn, 2005: 27–94) but also reflects different aspects of the governance of corporations and of the investment decision-making process of institutional investors. The law and economics perspective emphasizes the importance of institutional arrangements that protect the rights of minority shareholders. The presence of constraints and incentives that flow from the presence of specific sets of institutions is seen as crucial for the pursuit of shareholder value-enhancing strategies by corporate executives. Minority shareholders need assurance that they will get a return on their investment before parting with their financial assets. Their willingness to acquire equity stakes in companies is contingent upon the extent to which they are protected from shareholder value-destroying actions by managers or large controlling owners (Coffee, 2005). The varieties of capitalism perspective highlight the importance of the institutional frameworks by which firms coordinate their activities and build their innovative capabilities. Advanced capitalist economies are distinguished by their specific configuration of institutional arrangements that translate into divergent distributions of authority at the firm-level (Whitley, 2003). The varieties of capitalism perspective emphasizes the ability of corporate executives to implement strategies of shareholder value, not merely whether the preferences of managers fit with those of shareholders insofar as they have internalized the importance of financial market considerations.

The analysis of the importance of these two perspectives for the investment allocation of short-term investors departs from traditional research design in an original manner. On the one hand, the presentation of the insights of these two perspectives should not be interpreted as a paradigm war of the two approaches made to be tested against each other. The research design of scholars in social sciences often entails holding constant one set of variables while the presence of variation on another one is assumed to reveal its importance. One problem with this strategy is that both sets of variables can be changing – that is, nothing is constant (Gourevitch, 1999). Moreover, social scientists increasingly recognize that important political and social outcomes have more than a single cause (Hall, 2003, 2010*a*). Processes of complex causation highlight the importance of intersections of causal factors (Ragin, 1987). One the other hand, the focus on institutional variables as part of processes of complex causation is ontologically correct but potentially neglects an important issue, namely the relative weight of different causal factors (Goldthorpe, 1997). The relative strengths of different combinations of institutional variables, or of a single variable within a process of complex causation, remain unexplored. This shortcoming is potentially crucial since advanced capitalist economies have been responding in different ways to exogenous and endogenous challenges (Hall, 1999, 2007; Hall and Thelen, 2009).

I argue in this book that the simultaneous analysis of complexity and hierarchy between causal variables is not only feasible but actually essential in order to capture the respective contributions of the law and economics and varieties of capitalism perspective for the value taken by the dependent variable, namely the marked preference for French companies by short-term investors. Moreover, the integration of causal complexity with hierarchy between causal variables extends beyond the (apparently) narrow dependent variable of this study. The institutional variables of work organization identified by the varieties of capitalism perspective constitute a hierarchically superior causal variable that offer greater insights into the complex causal process of underlying the investment allocations of short-term investors. The notion of the institutional arrangements of work organization as a hierarchically superior causal variable is operationalized in two ways. First, the institutional basis for the coordination of activities at the firm-level in the two countries differs substantially and impacts on the value taken by the dependent variable. Firm-level institutions in France are characterized by the concentration of power in top executives that, in turn, makes it easier to implement strategies of shareholder value that fit with the preferences of short-term investors. In contrast, the institutional arrangements of large German companies provide employees with voice and quasi-veto power over important corporate decisions, thereby resulting in lengthier negotiations that do not fit well with the short-term horizon of impatient investors.

Second, the contribution of the varieties of capitalism perspective also lies in the mediation of the relationship between the other causal variable (law and economics, with its focus on the legal protection of minority investors) and the dependent variable. For the law and economics perspective, the investment allocation of short-term investors is primarily driven by the quality of institutional arrangements that protect the rights of minority shareholders. The prediction is that the presence of ownership diffusion constitutes the most important and determining factor for the introduction of strategies of shareholder value in France and Germany – institutional legal arrangements in the two countries being better at preventing managerial opportunism than at curbing the value-destroying actions of the large shareholder. However, the relationship between the presence of ownership dispersion and investment allocation of short-term investors differs across the two cases: it is positive in France, since the quasi-totality of companies with ownership diffusion have been targeted by short-term investors; it is weak in Germany, given that many corporations with ownership diffusion have still not been targeted by these same impatient investors. The disappearance of large shareholders in France constitutes the removal of an important stumbling block for the implementation of short-term-oriented strategies of shareholder value but remains largely insufficient in Germany given the strength of organized labor at the firm-level.

In the course of this research project, I have been fortunate to rely on a group of top-rated scholars who have also become friends over the years. Chief among them are Suzanne Berger, Peter Hall, and Bob Hancké. Not only have they provided insightful comments and perceptive questions on the book, each one of them has contributed in profound ways to my thinking and intellectual development as a scholar. The influence of Suzanne Berger has been crucial at an early stage of my academic career and has been long-standing since then. She helped me define, redefine, refine, draft, redraft my dissertation topic in graduate school. She has transmitted an intellectual gift that still amazes me, namely the ability to ask the right questions. In an age of democratization of access to knowledge, intellectual contributions often result from the presentation of problems and intellectual puzzles in an innovative manner. On the specific issue of the French and German political economy, I always remember her point of not trying to compete with country specialists who will always be the first to comment on a specific event. She has taught me the value of original thinking. Peter Hall has encouraged me toward the study of "what is the big picture." In an age where academic contribution is often measured on the ability to make a contribution on a small point within a well-established debate, the broad and integrated nature of his works set the standards for scholars with uncompromising passion for original work. My raw intellectual thinking has been guided toward creative ends in great part from Peter's works. Moreover, his patience, intellectual rigor, and his extremely insightful and detailed comments provide the perfect picture of professionalism in the current context of academics being overloaded. Bob Hancké has also been there from the beginning. Bob's no-nonsense approach has been immensely helpful in the contextualization of my work. No man is an island, purposively or inadvertently. Bob Hancké has forced me to think about the relevance of one's work and the importance of engaging with others in order to highlight the relevance of one's own research. It is always easier to hide behind members of one's own tribe than to engage with the wider community, even with those who disagree. Moreover, Bob's friendship throughout the years has been instrumental in maintaining my sanity and enabling me to put into context what I am doing.

The corporate governance community is a dynamic and thriving one. Over much of the past decade, I have been fortunate to interact with a group of scholars whose thinking has been highly influential. Chief among them are Peter Gourevitch, Ruth Aguilera, Pepper Culpepper, David Soskice, Glenn Morgan, and Richard Deeg. They have been gracious with their time during the course of my research and have commented over numerous papers that I have presented at conferences and workshops over the years. The book is far more interesting as a result of their suggestions and unselfish criticisms. These are the members of my tribe!

Likewise, I also received feedbacks to parts of the argument from David Bach, Alex Boersch, Richard Bronk, Brian Burgoon, Steve Casper, John Cioffi, Steve Coulter, Frieda Fuchs, Orfeo Fioretos, David Furch, Miguel Glatzer, Margarita Gomez-Reino, Frederick Guy, Barbara Haskel, Ilir Haxhi, Martin Hoepner, Simon Johnson, Daniel Kinderman, Jette Knudsen, Soo Hee Lee, Jonah Levy, André Mach, Hudson Meadwell, Guglielmo Meardi, Kenneth Oye, Vivien Schmidt, Marco Simoni, Arndt Sorge, Mark Thatcher, Gunnar Trumbull, Rocio Valdivielso del Real, Inger Weibust, and Richard Whitley. Interviews with Donald Cassidy (Fidelity, Boston) and Selina Siak (St. Albans Commodities, London), and fund managers at State Street (Boston), GLG Partners (London), and Hermes (London) were also insightful.

Financial and institutional support has been important at various stages of the preparation and writing of the book. In particular, I would like to thank David Soskice, then at the WZB in Berlin (summer 1999), Wolfgang Streeck at the Max Plank Institute in Cologne (February 2001 – September 2002), Christian Levesque at the CRIMT in Montréal (summers 2006 and 2008), and Arndt Sorge at the WZB in Berlin (autumn 2009). Each one of them made me feel welcome and provided a congenial place to do research and interact with colleagues. I would also like to thank David Musson and Emma Lambert of Oxford University Press. Their patience and encouragement were pivotal.

Special thanks are due to Rocio Valdivielso del Real. Finally, this book is dedicated to my parents – Murielle Ouellet and Pierre Goyer. Buying world atlases for me at an early age proved to be the critical juncture in the development of my path.

Michel Goyer<br>Coventry, December 2010

# List of Figures

# List of Tables

# 1

# Introduction

The topic of corporate governance – the system by which firms are controlled and operated, the rules and practices that govern the relationship between managers and shareholders, and the overall process by which investment capital is allocated – has become an important issue for policymakers and scholars in recent years in the wake of financial scandals both in Europe and in the United States (Coffee, 1999, 2002, 2005; Shinn and Gourevitch, 2002). The 2008 financial crisis, and the two preceding decades prior to its occurrence, has highlighted the shortcomings associated with unbridled pursuit of shareholder value as the guiding star for listed companies in the United States. In the context of the heightened influence of institutional investors, some of them largely unregulated, such as hedge funds, the strategy of corporations has essentially been oriented toward financial objectives (market valuation) with little consideration for the interests of stakeholders – most notably employees. The creation of shareholder value in the form of share price appreciation is seen as a reflection of the quality of corporate executives, the latter group being increasingly compensated through variable pay such as stock options (Davis, 2009). In addition to the neglect of the interests of employees, the focus on shareholder value has incentivized corporate executives to develop a short-term focus that has sometimes resulted in earnings manipulation designed to create an earnings spike (Coffee, 2005: 202). What happens when these same institutional investors diversify their financial assets in settings traditionally not open to the concept of shareholder value?

I investigate in this book the evolution of corporate governance in the wake of increased capital mobility in the form of portfolio investment in France and Germany – two settings previously insulated from strategic investments by Anglo-American shareholder value-oriented institutional investors (Achleitner et al., 2010; Dafsaliens, various years).

I focus on the investment allocation of two categories of impatient short-term oriented investors, namely hedge funds and actively mutual funds from the United Kingdom and the United States. The empirical evidence on the investment allocation of short-term, impatient investors highlights the greater attractiveness of French blue-chip companies over their German counterparts in a ratio of 2 to 1. What are the causes of this disparity in investment allocation of short-term-oriented investors and what are the consequences for the French and German model of capitalist economies? These apparently narrow empirical questions entail crucial political issues and also constitute important inquiries for research methods. The argument presented in this book builds on an impressive literature that emphasizes the importance of institutions in defining the scope and nature of new problems (Locke and Thelen, 1995), its impact on the process of preference formation of actors (Berger, 1981; Hall, 2010*a*), and its structuring influence on the process of interactions between actors (Hall, 1986: 19). More specifically, I argue that the firm-level institutional arrangements of workplace organization in France and Germany provides important insights to account for the divergence in the investment allocation of short-term investors. Hedge funds and actively managed mutual funds possess a short-term horizon and high incentives to maximize the value of their portfolio. The content and speed by which portfolio companies implement strategies of shareholder value matter to them. The issue is not about shareholder value per se, but rather concerns the presence of impatient investors aiming at portfolio companies implementing short-term oriented strategies designed to boost their market capitalization and/or secure the release of dividend payments (Clark and Wojcik, 2007; Brav et al., 2008; Klein and Zur, 2009; see also the discussion in Chapter 5). The Varieties of Capitalism (VoC) perspective offers important insights on this question. The institutional basis for the coordination of activities at the firm-level in the two countries differs substantially (Soskice, 1999; Hall and Soskice, 2001).[1] The attractiveness of French companies lies in the concentration of power in the CEO that, in turn, allows for a rapid reorganization of the workplace under the guidance of a small number of corporate officials. The decision-making process of large French firms is management-led with the exclusion of the workforce

[1] See Culpepper (1999, 2003), Hancké (2002), Woywode (2002), Whitley (2003), Sorge (2005), and Goyer (2006*a*) for an institutional perspective on the organization of work in France and Germany and the impact of this on the process by which firms coordinate their activities. To provide for a comparative-longitudinal perspective, see also Gallie (1983), Maurice et al. (1986), Thelen (1991), Soskice (1994), and Boyer (1995).

from important aspects of the decision-making process. The investment strategies of hedge funds and actively managed mutual funds, in contrast, do not fit well with the firm-level institutions found in Germany. Firm-level institutions impose several constraints on the ability of management to develop and implement strategies in a unilateral fashion. The process of adjustment to external pressures in Germany is the result of negotiation between management and employee representatives as several legal obstacles stand in the way of a rapid and unilateral reorganization of the shop floor.

Nonetheless, and despite the statement that institutions matter, the role of institutional analyses remains in some ways undetermined in social sciences for several factors. How do institutional arrangements affect corporate governance outcomes? Institutional analyses of comparative corporate governance raise many issues also found in other areas of the social sciences. The focus of many corporate governance inquiries might be specific to particular subfields – determinants of ownership structures, legal protection of minority shareholders, impact of the market for corporate control, and many others – but questions and insights about the role of institutions are present across disciplinary boundaries. Three key debates stand prominently in social science discussions with significant implications for the argument presented in this book. The first one concerns the extent to which scholars assign analytical primacy to institutions. This debate often pits institutionally based versus interest-oriented theoretical perspectives. The first group highlights the ways in which differences in national institutional arrangements result in different trajectories regarding patterns of policy-making, economic performance, and clusters of innovative specialization (Soskice, 1999; Whitley, 1999; Hall and Soskice, 2001). Institutions matter because they independently shape the distribution of power among social actors (Berger, 1981; Hall, 1986; see also Moe, 2005). The second group, in contrast, emphasizes how institutions reflect something perceived to be deeper in society – the usual suspect being the underlying distribution of power among groups (Pontusson, 1995; Howell, 2003). These critiques of institutional perspectives point to two alternative scenarios that lessen the importance of institutions: coalitional and policy realignments can take place within stable institutions, and institutions themselves become the objects of struggle if they are so influential over outcomes (see e.g. Gourevitch, 1977, 1986, 1999).

A second debate concerns the nature of interaction of institutions with other features. Scholars working from an institutional perspective rarely advance the notion that only institutions matter for outcomes. For some, institutions are mid-level variables (as distinct from macrostructures) that act as a midrange theory (Thelen and Steinmo, 1992; see also Merton, 1968). For instance, Katzenstein (1977) analyzes how variations in institutional frameworks provided for divergent political responses to the changes in the world economy in the 1970s – but does not seek to account for the origins of these important macro changes. Institutions are highly important at a given analytical level and, moreover, refract the impact that results from the occurrence of external developments. For others, institutions are part of a phenomenon of complex causation whereby an outcome results from potentially different combinations of conditions (Ragin, 1987; Mahoney, 2004).

A third source of debate is methodological and takes two forms. First, the dichotomy between institutional-based and interest-oriented theoretical perspectives often entails specific research design choices that mirror the other perspective's approach. Institutionally oriented researchers hold preferences constant with the aim of showing how changing institutions produce different outcomes. Interest-driven scholars, on the other hand, hold institutions constant to show how changing interests lead to different results. A problem with this often necessary but incomplete ploy is that both institutions and interests can be changing – that is, nothing is constant (Gourevitch, 1999; see also Frieden, 1999). Moreover, this methodological ploy neglects the importance of causal complexity whereby outcomes result from the intersection of variables. Second, the presence of change (or stability) of institutional frameworks is riddled with problems of assessment. For instance, the occurrence of institutional change is not always interpreted as leading to behavioral change. Comparative political economy scholars increasingly distinguish between institutional change that does not affect the process by which firms coordinate their activities versus institutional transformation that implies a transformation of coordination (Culpepper, 2005; Goyer, 2006*a*; Hall, 2007; Hall and Thelen, 2009; see also Sorge, 2005: 142–83). Distinguishing between radical and incremental institutional change becomes crucial (Campbell, 2004; Hall, 2010*a*; see also Deeg, 2001, 2005*b*). On the other hand, the presence of institutional stability can be associated with substantial modifications in the behavior of actors. The occurrence of functional conversion – whereby institutions are redirected to new purposes in the presence of formal institutional stability – complicates analytical inquiries (Gilson, 2001; Thelen, 2003, 2004). The practice associated with an institution can change without a corresponding transformation in its formal structure.

The above overview of the debates surrounding institutional analyses in contemporary capitalism points to the difficulties in assessing how institutions matter for corporate governance outcomes. Should one attempt to account for institutional variation across national systems of corporate governance? Or, in contrast, should the analytical focus revolve around differences in corporate governance outcomes among advanced capitalist economies? Important political questions lie beneath these methodological questions. For some authors, the process of piecemeal-incremental institutional change reflects the strategic behavior of actors seeking to erode the existing functions of institutions rather than to abolish their formal existence (Hyman, 2001; Streeck, 2008; see also Crouch, 2004). Why, this behavior suggests, aim for a full confrontation if the achievement of one's goal could result from incremental changes? However, institutional change is often full-scale as illustrated by the removal of control on capital flows – an important stimulus for the research question of this book (Abdelal, 2007; see also Berger, 2003, 2010). The ability of actors to aim for full-scale institutional change is often contingent upon the visibility and politicization of issues (Culpepper, 2010). Actors are more likely to seek institutional change if important issues are under the political and social radar.[2] Thus, the nature and role of institutions do not lend themselves to a single viewpoint. Inquiries highlighting the importance of institutions should also avoid inferring a mechanical relationship between institutional stability/change and outcomes. These issues are important in the assessment of the meaning and extent of convergence across national VoC (Gourevitch, 2003*b*: 328). To overcome these conceptual and methodological issues, this introductory chapter is organized in the following manner. First, I present the theoretical foundations of politically inspired institutional analyses on comparative corporate governance. I proceed to review their contributions to the analysis of diversity in both institutional arrangements and outcomes across national systems of corporate governance. These approaches are also characterized by substantial internal diversity as regard the role of institutions – thereby increasing the analytical variety of inquiries.

Second, I present the main argument of the book which is organized in three interrelated blocks: institutional diversity and the settlements of conflict, hierarchical character of institutional variables that are part of a process of complex causation, and the importance of context. The first building block highlights the importance of historical developments characterized by location-specific settlements of conflict negotiated

[2] Full-scale institutional change is also the result of the specifics of the settlements of conflicts negotiated in different advanced capitalist economies and constitutes an important theme for the study of comparative corporate governance (see Roe, 2000, 2003).