

## FOCUSING ON CORPORATE SHORT-TERMISM

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Much concern has been expressed over the problem of ‘short-termism’ as evidenced in the numerous discussion papers made public by industry and investor associations and regulatory bodies in the US and the UK. While concerns over short-termism and its effects are not new, the short-termism being experienced now is the result of structural changes brought about by agency theory based managerial compensation and its four legged strategy of short term managerial employment contracts, stock based compensation, high stock price, and the pursuit of high-risk high-return investment strategies to achieve the latter. This article investigates the changes to corporate governance structure that have produced short-termism, short-termism’s present form and continuing hold, how it has impacted on corporate governance, and what, if anything, should be done about it.

### I. INTRODUCTION

Much concern has been expressed about the perceived short term focus of capital markets, investment managers and corporate managers. Perhaps the first to raise concerns over this was Martin Lipton.<sup>1</sup> More recent studies on this include the study by the Business Roundtable in the US,<sup>2</sup> and the Discussion Paper released in the UK by the Department of Business, Innovation and Skills.<sup>3</sup> Though concerns over short-termism and its effects are not new, the reasons for these concerns appear to have changed over a period of time. For example, while earlier research<sup>4</sup> concerned itself with short-termism as the product of market imperfections arising from information asymmetry and the like, recent research views short-termism as a deliberate strategy

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<sup>1</sup> “Takeover Bids in the Target’s Boardroom” (1979) 35 Bus. Law. 101 [Lipton Boardroom].

<sup>2</sup> Dean Krehmeyer, Matthew Orsagh & Kurt N. Schacht, “Breaking the Short-Term Cycle” Business Roundtable Institute for Corporate Ethics (24 July 2006), online: Business Roundtable Institute for Corporate Ethics <[http://www.corporate-ethics.org/pdf/Short-termism\\_Report.pdf](http://www.corporate-ethics.org/pdf/Short-termism_Report.pdf)> [Business Roundtable].

<sup>3</sup> Department for Business, Innovation and Skills, Discussion Paper, URN 10/1225, “A Long Term Focus for Corporate Britain” (October 2010), online: BIS <<http://www.bis.gov.uk/assets/biscore/business-law/docs/l/10-1225-long-term-focus-corporate-britain>> [BIS Paper].

<sup>4</sup> See Jeremy C. Stein, “Efficient Capital Market, Inefficient Firm: A Model of Myopic Corporate Behaviour” (1989) 104 Quarterly Journal of Economics 655; Andrei Shleifer & Robert W. Vishny, “Equilibrium Short Horizons of Investors and Firms” (1990) 80 American Economic Review 148; Von Thadden, “Long Term Contracts, Short Term Investment and Monitoring” (1995) 62 Review of Economic Studies 557, where managerial short-termism in these models are described as being due to information and other forms of imperfection.

required of managers by shareholders.<sup>5</sup> Yet, the downside of short-termism has been considerable. These include excessive risk taking, risk shifting that favours shareholders generally and managers in particular, an increase in the cost of capital to entities with short-term focus, and the neglect of investments that yield returns in the long-term. Consequently, commentators and regulators have come to view short-termism with considerable concern and as being potentially harmful in the long run to the welfare of markets, the economy, and society generally. They also fear that short-termism would have an adverse impact on the decision of capital providers to lend, discourage corporate managers from undertaking investments that yield returns in the long term—such as research and development<sup>6</sup> (“R&D”)—and add to the volatility of capital markets in general through rapid shifts in investment. The BIS Paper focuses amongst other things on this latter issue, given the place occupied by the city of London in the world’s capital markets. In other words, existing literature on the subject focuses on the damage to the economy caused by the short-term focus of investors with substantial capital (such as hedge funds and institutional shareholders such as pension funds and insurance companies), as well as on whether short-termism is the product of investors with substantial capital forcing managers to so act, or whether the investors choose to invest in entities whose managers engage in short-term conduct.

This article by contrast, examines what causes short-term behaviour. Its central thesis is that short-termism has become the means employed to achieve the objectives of agency theory efficiency strategy by means of its three-pronged strategy, namely, the balancing of: (1) short-term employment contracts coupled with generous managerial compensation with the directive to engage in high-risk high-return ventures; (2) high-risk high-return ventures at the expense of debt-holders for the benefit of equity holders; and (3) high returns to be reflected in high stock price. Short-termism has become the means employed to achieve the goal of high stock price, as required by agency theory strategy. Conversely, it is this search for high stock price that has been the driver of short-termism. This article concludes that short-termism has now become institutionalised in the US, UK, and Australian business systems, aided by a push factor from capital suppliers and pull from corporate managers, as the end result has proven to be to the advantage of both investors and investee managers. The discussion in this article is structured as follows: Part II examines the causes of short-termism; Part III discusses the agency theory strategy based employment contract and the interrelationship between short term employment contracts, generous compensation (mostly stock based) and high-risk, high-return investment

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<sup>5</sup> See Patrick Bolton, José Scheinkman & Wei Xiong, “Executive Compensation and Short-Termist Behaviour in Speculative Markets” (2006) 73 *Review of Economic Studies* 577 [Bolton], which viewed managerial short-termism as being consistent with the speculative motive of incumbent shareholders.

<sup>6</sup> Marjorie Kelly & Allen White, “Corporate Design: The Missing Organizational and Public Policy Issue of our Time” (2008) 42 *New Eng. L. Rev.* 764. According to the authors, BP (the company investigated by them) had not resolved its central design challenge of structuring its internal decision making to give priority to long-term environmental sustainability instead of short-term cost cutting. See also Bill George, “Another View: Can Biotech Survive Icahn?”, online: Bill George <<http://www.billgeorge.org/page/nyt-dealbook-another-view-can-biotech-survive-icahn>>, where Professor George comments on the tension between investors pushing for the maximisation of short-term shareholder value and an industry largely dependent on substantial investments and time lag, surmising the survivability of the US biotechnology industry in this environment.

strategy; Part IV examines the interaction between high stock price, the cost of debt capital, and the reaction of the securities markets to this market interplay; and Part V concludes.

## II. THE CAUSES OF SHORT-TERMISM

While ‘short-termism’ has been defined by many,<sup>7</sup> the definition offered by the Business Roundtable perhaps best captures its essence. It is described as “the excessive focus of ... investors and analysts on short-term quarterly earnings and lack of attention to the strategy, fundamentals and conventional approaches to long term value creation.”<sup>8</sup> The underlying concern expressed therein is that “the obsession with short-term results by investors, asset management firms, and corporate managers collectively leads to the unintended consequences of destroying long-term value, decreasing market efficiency, reducing investment returns, and impeding efforts to strengthen corporate governance.”<sup>9</sup>

There is almost universal agreement amongst management theorists that markets are ‘short-termist’. For example, Drucker,<sup>10</sup> Hayes and Abernathy,<sup>11</sup> Porter,<sup>12</sup> Zaheer, Albert & Zaheer,<sup>13</sup> all argue that business in the US and the UK is dominated by management that is short sighted with respect to making investments, particularly in advanced technologies such as R&D<sup>14</sup> and in relation to capital expenditures<sup>15</sup> which are only expected to pay off in the long term. As against this, Williamson<sup>16</sup> sees efficient markets optimising the trade-off between short-term performance and long-term investment, and argues that market and competitive forces prevent or mitigate under-investment in the long term. However, as Palley<sup>17</sup> observes, while this may be a valid observation in relation to the long-term, managers are always conscious of the fact that they may not be around to reap the benefits of long-term projects or the restructuring of the firm to deliver high stock price by a raider.

<sup>7</sup> The BIS Paper, for example, defines short-termism as “the focus of investors and managers on short-term returns at the expense of those over the longer-term”: see BIS Paper, *supra* note 3 at para. 4.17.

<sup>8</sup> Business Roundtable, *supra* note 2 at 3.

<sup>9</sup> *Ibid.* at 1.

<sup>10</sup> Peter F. Drucker, *Post-Capitalist Society* (New York: Harper Collins, 1993).

<sup>11</sup> R. H. Hayes & W. J. Abernathy, “Managing Our Way to Economic Decline” (1980) 60(3) *Harvard Business Review* 71.

<sup>12</sup> Michael E. Porter, “Capital Choices: Changing the Way America Invests in Industry” (1992) 2 *Journal of Applied Corporate Finance* 5.

<sup>13</sup> Stuart Albert, Akbar Zaheer & Srilata Zaheer, “The Importance of Time Scales” in Carey L. Cooper & Denise M. Rousseau, eds., *Trends in Organisational Behaviour, Vol 7* (Chichester, England: John Wiley & Sons Canada, Ltd, 2000) 1 [Zaheer].

<sup>14</sup> Parthiban David, Michael A. Hitt & Javier Gimeno Insead, “The Influence of Activism by Institutional Investors on R&D” (2001) 44(1) *Academy of Management Journal* 144.

<sup>15</sup> M. P. Narayanan, “Managerial Incentives for Short-Term Results” (1985) 40(5) *Journal of Finance* 1469; Ernst-Ludwig von Thadden, “Long Term Contracts, Short-Term Investment and Monitoring” (1995) 62(4) *Review of Economic Studies* 557.

<sup>16</sup> Oliver E. Williamson, “Perspectives on the Modern Corporation” (1984) 24 *Quarterly Review of Economics and Business* 64.

<sup>17</sup> Thomas Palley, “Managerial Turnover and the Theory of Short-Termism” (1997) 32 *Journal of Economic Behaviour and Organization* 547.

While commentators appear to be divided on the causes of short-termism, for example, whether it has been due to (1) investor pressure;<sup>18</sup> (2) managerial preference; or (3) the management systems in place,<sup>19</sup> it may equally be said that causes (2) and (3) above are no more than managerial responses to investor pressure.<sup>20</sup> For example, research on the behaviour of mutual funds by Li Jin<sup>21</sup> shows that mutual fund managers face large incentives to perform in the short run, as both the asset under management and the firing decision depend on short-term performance. More interestingly, evidence shows that fund managers facing higher short-term performance pressure are more focused on short horizon investments due to their investors' short horizons—and not the other way around. In other words, there is a double-agency problem: as between unit holders and mutual fund managers, and between investor fund managers and investee entities. This combination of the double-agency problem and analyst evaluation based on quarterly earnings has had a cataclysmic effect on corporate decision making. As described by one commentator:<sup>22</sup>

Financial analysts fixate on quarterly earnings at the expense of fundamental research. Corporate executives, in turn, point to the behaviour of the investment community to rationalise their own obsession with earnings. Short-termism is the disease; earnings and tracking error are the carriers.

The fact is that pressure by investors on managers to perform and deliver high stock price forces managers to meet targets, budgets, market position, profitability, and high stock price. In this sense, both individual and organisational factors are important determinants of short-termism.<sup>23</sup> Specifically, finance markets have forced managers to be short-termist.<sup>24</sup>

From a managerial perspective, the prevalence of information asymmetry and “information impactedness”<sup>25</sup> (*i.e.* when investors do not have complete information about long-term prospects, managers use short-term performance to indicate to

<sup>18</sup> Brian J. Bushee, “The Influence of Institutional Investors on Myopic R&D Investment Behaviour” (1998) 73 *Accounting Review* 305.

<sup>19</sup> See Kevin J. Lavery, “Managerial Myopia or Systemic Short-Termism?” (2004) 42(8) *Management Decision* 949 [Lavery 2004].

<sup>20</sup> See Razeen Sappideen, “Corporate Governance and the Surrogates of Managerial Performance” (2011) 34(1) *U.N.S.W.L.J* [Surrogates of Managerial Performance].

<sup>21</sup> Li Jin, “How Does Investor Short-termism Affect Mutual Fund Manager Short-termism” (27 February 2005) Harvard Business School, online: <<http://ssrn.com/abstract=675262>> (last accessed February 2011).

<sup>22</sup> Alfred Rappaport, “The Economics of Short-Term Performance Obsession” (2005) 61 *Financial Analysts Journal* 65.

<sup>23</sup> See e.g. Kenneth A. Merchant & Wim A. Van der Stede, *Management Control Systems: Performance Measurement, Evaluation and Incentives* (New York: Financial Times/Prentice-Hall, 2003); S. Bhojraj & Robert Libby, “Capital Market Pressure, Disclosure Frequency-Induced Earnings, Cashflow, Conflict, and Managerial Myopia” (2005) 80 *Accounting Review*.

<sup>24</sup> John Grinyer, Alex Russell & David Collison, “Evidence of Managerial Short-Termism in the UK” (1998) 9 *British Journal of Management* 13. They observe that, overall, the evidence of the paper is consistent with the view that many finance directors of large UK companies are short-termist in their perceptions, and that such short-termism is positively associated with their beliefs about the level of emphasis placed by the capital market on figures of reported earnings.

<sup>25</sup> Meaning situations where it is difficult to ascertain the costs to information, a condition present when true underlying circumstances relevant to the transaction or related set of transactions, are known to one or more parties, but cannot be costlessly discerned by or displayed for others. See Oliver Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications* (New York: Free Press, 1975).

investors that the entity's assets are being managed to their maximum value) compounds the problem.<sup>26</sup> For this reason, even known unknowns become casualties. For example, Graham, Harvey & Rajgopal,<sup>27</sup> in their survey of more than 400 corporate managers, found "that almost four out of every five respondents indicated that they would decrease discretionary spending on such areas as research and development, advertising, maintenance and hiring in order to meet short-term earnings targets. More than half of the respondents said they would delay new projects, even if it meant sacrificing value creation." Their object for doing so was to smooth earnings or to hit a quarterly target to avoid being punished by the securities market.<sup>28</sup> They hypothesise that given the reality of severe market (over)reactions to earnings misses, corporate managers might be making the optimal in the existing equilibrium. Evidence of market overreaction was first identified by behavioural theorists such as De Bondt & Thaler.<sup>29</sup> This has been further reinforced by findings which show that humans are innately biased towards the immediate and the certain, even when a distant and less certain alternative is likely to be more valuable.<sup>30</sup> In like vein, organisation theorists such as Zaheer have observed that "crises tend to focus attention on the most immediate, and hence force one to react at micro-level time scales. In the process, actions that have a longer life span may be ignored or missed, or underweighted in one's responses."<sup>31</sup>

Compensation strategy, especially stock options, has also greatly facilitated short-termism. For example, early studies<sup>32</sup> considered short-termism as a general tendency, with the granting of options seen as a means of overcoming it. However, more recent studies have identified the downside of stock options as a solution to short-termism. For example, Souder & Bromiley,<sup>33</sup> in a study of investments by large US corporations for the period 1993-2006, showed that managers shifted investment resources to more visible categories such as R&D when they held exercisable options, and to less visible categories such as capital expenditure when their options were still "unexercisable". Implicit in the earlier studies is that managers

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<sup>26</sup> See Kevin J. Lavery, "Economic Short-Termism: The Debate, the Unresolved Issues, and the Implications for Management Practice and Research" (1996) 21(3) *Academy of Management Review* 825 at 834 [Lavery 1996].

<sup>27</sup> John R. Graham, Campbell R. Harvey & Shiva Rajgopal, "The Economic Implications of Corporate Financial Reporting" (2005) 40 *Journal of Accounting and Economics* 3.

<sup>28</sup> See Harris Collingwood, "The Earnings Game: Everyone Plays, Nobody Wins" (2001) *Harvard Business Review* 65. There's a tyrant terrorising nearly every public company in the US—it's called the quarterly earnings report. It dominates and distorts the decisions of executives, analysts, investors and auditors. Yet it says almost nothing about a business's health. How did a single number come to loom so large?

<sup>29</sup> Werner F. M. De Bondt & Richard Thaler, "Does the Stock Market Overreact" (1985) 40 *Journal of Finance* 793.

<sup>30</sup> Richard Thaler & Hersch M. Shefrin, "An Economic Theory of Self-Control" (1981) 89(2) *Journal of Political Economy* 392; S. M. McClure *et al.*, "The Psychology of Preference Elicitation" (May 2004), online: Harvard University <[http://www.eecs.harvard.edu/~parkes/radcliffe/laibson\\_talk.pdf](http://www.eecs.harvard.edu/~parkes/radcliffe/laibson_talk.pdf)>.

<sup>31</sup> See Zaheer, *supra* note 13.

<sup>32</sup> See e.g. Brian Hall & Jeffrey Liebman, "Are CEOs Really Paid like Bureaucrats?" (1998) CXIII(3) *The Quarterly Journal of Economics* 653; Michael C. Jensen & Kevin J. Murphy, "CEO Incentives—It's Not How Much You Pay, But How" (1990) 70 *Harvard Business Review* 138.

<sup>33</sup> David Souder & Philip Bromiley, "Short-termism, Stock options, and Visibility in Firm Investment Behaviour" (November 2009), online: Darden School of Business: University of Virginia <<http://www.darden.virginia.edu/web/Home/>>.

can determine and stockholders can accurately value the right level of long-term investments and their future returns.<sup>34</sup>

Shareholder market value theory (which emerged in the late 1980s), takes this understanding on managerial responses to financial market pressures a step further by highlighting the role played by managers in shaping share price through target based budgeting and corporate earnings management.<sup>35</sup> Under target based budgeting systems, managers are compensated for meeting agreed upon targets, without reference to what they should have done relative to the actions of their competitors, with the result that managers set targets that they can well satisfy.<sup>36</sup> Earnings management takes the form of managing accounting earnings (*i.e.* accruals management through the selective interpretation of accounting regulations), as well as real earnings (*i.e.* management operating decisions made to achieve desired accounting numbers).<sup>37</sup> For example, studies show that firms are significantly more likely to report earnings that exactly matched analysts' predictions rather than report earnings that overshoot, and are less likely to report earnings which undershoot.<sup>38</sup> Such a systematic pattern can only emerge when managers have been able to manage the earnings in a myriad of ways. One consequence of earnings management is the overvalued stock price of the company,<sup>39</sup> which enables targets to be taken over more cheaply, though they

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<sup>34</sup> See Laverty 1996, *supra* note 26 at 827.

<sup>35</sup> Neil Fligstein & Taek-Jin Shin, "Shareholder Value and Changes in American Industries" *Institute for Research on Labour and Development Working Paper Series* (2 January 2005), online: Institute for Research on Labour and Employment, University of California, Berkeley <<http://escholarship.org/uc/item/82j7915n;jsessionid=0F392BA35EC70116CCF16CF73DD3E40D#page-1>>.

<sup>36</sup> However, commentators point out that despite strong theoretical and emerging empirical evidence that firms can benefit from incorporating some form of relative performance evaluation in incentive contracts, it is almost never a feature of executive compensation arrangements. See Iman Anabtawi, "Explaining Pay without Performance: The Tournament Alternative" (2005) 54 *Emory LJ* 1557 at 1570 [Anabtawi]; Kevin J. Murphy, "Executive Compensation" in Orley Ashenfelter & David Card, eds., *3 Handbook of Labor Economics* (Amsterdam: Elsevier, 1999) 2485 at 2537 [Murphy]; that "although stock options could theoretically be indexed to industry or market movements, indexed options are virtually nonexistent in practice". See Lisa K. Meulbroek, "Restoring the Link between Pay and Performance: Evaluating the Costs of Relative-Performance-Based (indexed) Options" *Harvard Business School Working Paper No. 02-021* (2001), online: Harvard Business School <<http://www.hbs.edu/research/facpubs/workingpapers/papers2/0102/02-021.pdf>> at 38, that only one US firm had an indexed option plan as at the author's 2001 publication date. Likewise, Haig R. Nalbatian & Wei Zheng, "Relative Performance Evaluation and the Selection of Peers" in Peter T Chingos, ed., *Responsible Executive Compensation for a New Era of Accountability* (Hoboken, N.J: John Wiley & Sons, 2004) at 172 states that few companies incorporate relative performance criteria in their stock option plans, and instead executives are typically rewarded based on absolute share price fluctuations. The widespread failure to provide executives with efficient incentives has led Murphy to observe that "the paucity of relative performance evaluation in options and other components of executive compensation remains a puzzle worth understanding".

<sup>37</sup> Marcia Millon Cornett, Alan J. Marcus & Hassan Tehranian, "Corporate Governance and Pay-for-Performance: The Impact of Earnings Management" (2008) 87 *Journal of Financial Economics* 357 [Cornett (2008)].

<sup>38</sup> See e.g. Francois Degeorge, Jayendu Patel & Richard Zeckhauser, "Earnings Management to Exceed Thresholds" (1999) 72(1) *Journal of Business* 1.

<sup>39</sup> As explained by Jensen & Murphy, "Just as managers' compensation suffers if they miss their internal targets, CEOs and CFOs know that the capital markets will punish the entire firm if they miss analyst's forecasts by so much as a penny. Generally, the only way for managers to meet those expectations year in and year out is to cook their numbers to mask the inherent uncertainty in their businesses. And that cannot be done without sacrificing value ...and once on the treadmill, there is no going back..." (Jensen

have proven to be value destroying in the long run.<sup>40</sup> An even more egregious consequence has been the increases in managerial compensation in the form of options and restricted options,<sup>41</sup> especially where top management compensation is closely tied to the value of stock based compensation,<sup>42</sup> and where Chief Executive Officers (“CEOs”) hold large options positions.<sup>43</sup> These studies also show that governance mechanisms—which stress CEO pay for performance—actually encourage CEOs to manage earnings and option compensation, and to reduce monitoring, which causes a dramatic decline in the quality of reported earnings.<sup>44</sup> Moreover, abnormally high accruals which temporarily inflate earnings have been found to be linked to increases in insider sales of shares, with stock returns after the ‘event period’ tending to be poor.<sup>45</sup> Together, these findings show that short-termism is the product of stock market demand, and managers are using it to further their personal interests in the face of agency theory strategy. These points are examined in greater detail below.

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& Murphy, *infra* note 53 at 10, 11). They cite the case of Enron which at its peak had a market value of \$70 billion, though it was worth only about \$30 billion. Enron’s managers could have helped the market reduce its expectations by resetting its value. Instead, they destroyed it by trying to fool the markets through accounting manipulations, hiding debt through off balance sheet partnerships, and other hyped new ventures such as their broadband futures effort.

<sup>40</sup> Matthew Rhodes-Kropf & S. Viswanathan, “Market Valuation and Merger Waves” *Journal of Finance* 59:6 (December 2004) at 2685-2718: showing that firm specific and market wide mis-valuations cause merger waves. See also Christopher Tobler, “An Empirical Analysis of Valuation-Based Acquisition Theory” (PhD Dissertation, University of Arkansas, 2007), AAT3276909, online: ProQuest <<http://proquest.umi.com/pqdlink?did=1404347581&Fmt=7&clientId=18803&RQT=309&VName=PQD>>, who finds in keeping with Jensen (Michael C. Jensen, “Agency Costs of Overvalued Equity” ECGI—*Finance Working Paper No. 39/2004*; *Harvard Business School NOM Working Paper No. 04-26* (March 2005), online: Social Science Research Network <<http://ssrn.com/abstract=480421>>) that overvalued firms are both more likely to make acquisitions and more likely to use stock in doing so. The study also found that shareholders of bidders realised long term wealth appreciation even where the acquiring firm was overvalued, as long as it was more overvalued than the target. Many other studies point to the value destroying acquisitions made during the height of the internet bubble: See Christopher K. Polk & Paola Sapienza, “The Real Effects of Investor Sentiment” (November 2002), AFA 2003 Washington, DC Meetings, online: Social Science Research Network <<http://ssrn.com/abstract=354386>> and Gilchrist, Himmelberg & Huberman, “Do Stock Price Bubbles Influence Corporate Investment” *NBER Working Papers 10537* (2005), who demonstrate that when stocks are overvalued, firms over-invest by taking advantage of a cheap source of capital, as cited in the studies referred to in this footnote.

<sup>41</sup> Daniel B. Bergstresser, Mihir A. Desai & Joshua A. Rauh, “Earnings Manipulation, Pension Assumptions, and Managerial Investment Decisions” (2006) 121 *Quarterly Journal of Economics* 157.

<sup>42</sup> Daniel B. Bergstresser & Thomas Phillipon, “CEO Incentives and Earnings Management” *Journal of Financial Economics* [forthcoming]; *HBS Finance Working Paper No. 640585*, online: Social Science Research Network <<http://ssrn.com/abstract=640585>> and Qiang Cheng & Terry D. Warfield, “Equity Incentives and Earnings Management” (2005) 80(2) *2005 Accounting Review* 441. These studies also found that once earnings are adjusted for discretionary accruals the link between compensation and performance disappears.

<sup>43</sup> Burns & Kedia (2003), cited in Cornett (2008), *supra* note 37.

<sup>44</sup> Cornett (2008), *supra* note 37.

<sup>45</sup> Beneish & Vargus, “Insider Trading, Earnings Quality, and Accrual Mispricing” (2002) 4 *Accounting Review* 755.

### III. SHORT-TERM EMPLOYMENT CONTRACTS AND STOCK BASED INCENTIVE REMUNERATION

The agency problem was articulated by a number of researchers in the 1970s.<sup>46</sup> In economics, examples include Alchian & Demsetz (1972)<sup>47</sup> and Ross (1973).<sup>48</sup> Mitnick (1973) provides an example in politics,<sup>49</sup> and Michael C. Jensen & William H. Meckling in 1976 provide an example in finance theory. Of these, the version articulated by Jensen and the late Meckling has been the most comprehensive and proven to be the most persuasive. Jensen articulated his version of agency theory and its corollary, stock based compensation (*i.e.* shares and options on shares), in three famous articles:<sup>50</sup> the first he co-authored with Meckling;<sup>51</sup> the second with Eugene F. Fama;<sup>52</sup> and the third with Murphy.<sup>53</sup> In these articles, Jensen linked the theory of the firm with the governance of the firm itself, and wrote of overcoming these problems through a scheme of targeted and structured executive compensation with the influential observation that what mattered was not how much you pay, but how you pay.<sup>54</sup> Under these schemes, executives receive a basic fixed salary, an annual bonus (tied to accounting performance), long term incentive plans (restricted stock options tied to multi-year accounting based performance plans and retirement programs), and stock compensation (based on the appreciation of the firm's stock). It is this last element of the package, stock and stock options, which links pay to performance. The consequences flowing from this have of course been profound. Under agency theory contracts, managers are employed on short-term performance based contracts

<sup>46</sup> The law has of course long recognised the possibility of conflicts of interest in the exercise of duties of company promoters, directors, and other officers acting on behalf of the corporation. These relationships are seen as fiduciary in nature, with requirements of full disclosure, duties to take care or to exercise due diligence, and a prohibition of self-dealing transactions. While the law requires the Board to act in the interests of the corporation (which is the shareholder meeting), the strategy of agency theory in economics and finance has been to view the Board and managers as agents acting on behalf of shareholders, as owners and principals. Nevertheless, in both scenarios it falls on the Board to determine, administer, and monitor the compensation package awarded—*i.e.* to measure the performance of managers, and to pay them for such performance.

<sup>47</sup> Armen Alchian & Harold Demsetz, "Production, Information Costs, and Economic Organization" (1972) 62(5) *American Economic Review* 774.

<sup>48</sup> Stephen A. Ross, "The Economic Theory of Agency: The Principal's Problem" (1973) 62 *American Economic Review* 134.

<sup>49</sup> There is in fact some controversy as to who articulated it first: see Barry Mitnick, "The Hazards of Agency" (Paper delivered at the annual meeting of The American Political Science Association, October 1996), online: Social Science Research Network <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1417412](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1417412)>.

<sup>50</sup> Agency relationships arise where one party (the principal) is reliant on another (the agent) to mind the interests of the former. Agency problems arise in that relationship when the actions of the agent are incapable of being monitored effectively, either because it is too costly to monitor, or too difficult because of the special skills exercised by the agent. In other words, agency problems arise in situations where agents are required to exercise their discretionary judgment over matters in their charge.

<sup>51</sup> Michael C. Jensen & William H. Meckling, "Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure" (1976) 3 *Journal of Financial Economics* 305 [Jensen & Meckling].

<sup>52</sup> Eugene F. Fama & Michael C. Jensen, "Separation of Ownership and Control" (1983) 26 *J.L. & Econ* 301 [Jensen & Fama].

<sup>53</sup> Kevin J. Murphy & Michael C. Jensen, "Performance Pay and Top Management Incentives" (1990) 98(2) *Journal of Political Economy* 225 [Jensen & Murphy].

<sup>54</sup> *Ibid.*

and subjected to the rigours of the marketplace, such as hostile takeovers and the stock market. Furthermore, in keeping with its open-ended strategy, it recognises the need for incomplete contracting and grants managers wide powers and discretion in the running and managing of the enterprise and with it the duty of safeguarding the entity's crown jewels—namely, share price and revenue. In return, managers are to be well compensated with cash and more importantly, substantial grants of stock based compensation to make them feel and behave like shareholders.

Agency theory assumes that agents behave in an economically rational manner, capital markets are efficient, share prices reflect all available information, and managers will respond rationally to incentives offered under compensation contracts and other governance measures.<sup>55</sup> Implicit in these assumptions is that contractual arrangements can ensure managerial performance in the long-term interests of the corporation, that compensation packages will be determined by independent Boards, that managers will remain neutral when their firms are being appraised by the stock market (despite stock based compensation constituting a substantial part of the package), and that managers will not game the system.<sup>56</sup> Its core strategy is to discourage shirking and encourage risk taking through the use of debt capital to the advantage of the entity. The Board as principal is entrusted to negotiate a contract that specifies in detail the duties of a manager in various situations,<sup>57</sup> the incentives to be provided in return for their engaging in sustainable, long-run value creation for the entity, and provides for the firing of CEOs who fail to perform.<sup>58</sup> In all, the strategy seeks to ensure that managers serve the interests of shareholders, and hold their positions at the will of the Board. With this view in mind, managers (in addition to being judged by key performance indicators and the like) have short-term employment contracts and are exposed to the full rigours of the marketplace, such as the takeovers market where their services could be terminated by a hostile raider, even if their performance has been satisfactory. Other uncertainties facing managers in dynamic and competitive markets include the satisfaction of more than one performance measurement in the face of competing considerations (sales, profits, or share price<sup>59</sup>), alongside the random movement of share price. Ironically, it is this vulnerability of managers under agency theory employment contracts coupled with stock based compensation—the value of which itself is dependent on the market price of the shares/options—which in a perverse sense, serves to unite the interests of managers and shareholders in a manner not anticipated by agency theory. In this contextual setting, the perceived harm of short-termism must be seen as collateral flowing from the search for high

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<sup>55</sup> See Jensen & Meckling, *supra* note 51 at 308.

<sup>56</sup> The issue of efficiency of capital markets and its disciplinary force has been canvassed elsewhere and is not discussed here. See The Paradox, *infra* note 86.

<sup>57</sup> See Morey W. McDaniel, "Bondholders & Stockholders" (1988) 13(2) J. Corp. L. 206 at 231.

<sup>58</sup> See Tim Campbell, Yuk-Shee Chan & Anthony M. Marina, "Incentive Contracts for managers who Discover and manage investment Projects" (1989) 12 Journal of Economic Behaviour and Organisation 353; and Anup Agrawal & Gershon N. Mandelker, "Managerial Incentives and Corporate Investment and Financing Decisions" (1987) 42 Journal of Finance 823.

<sup>59</sup> The takeovers market on the one hand, and stock based compensation on the other have ensured the dominance of stock price over other targets such as market share and even profits. As to the history underlying the battle for supremacy between accounting profits and share price, see Lawrence A. Cunningham, "Finance Theory and Accounting Fraud: Fantastic Futures versus Conservative Histories" (2006) 53 Buff. L. Rev. 789.

share price. For as Bolton explains, in a speculative market where stock prices may deviate from fundamentals, an emphasis on short-term stock performance may be the outcome of an optimal contracting strategy rather than rent extraction by managers.<sup>60</sup>

An implication of the Bolton analysis is that a failure to maximise long-run firm value is not necessarily a symptom of weak corporate governance, but a reflection of the more short-term, speculative orientation of shareholders. If so, this may explain why it is optimal for shareholders to offer compensation contracts under which CEOs can make early gains from a speculative stock price upswing even though the firm's market value may collapse at a later date, as well as the observed increase in stock-based compensation during speculative phases. In all, the Bolton theory gives an alternative perspective on managerial behaviour as compared to the views of Bertrand & Mullainathan,<sup>61</sup> and Bebchuk, Fried & Walker,<sup>62</sup> who attribute managerial power and its abuse to the lack of adequate board supervision, and to the views of Murphy,<sup>63</sup> and Jensen, Murphy & Wruck,<sup>64</sup> who see it in terms of compensation committees having underestimated the cost of issuing stocks and options to managers, despite corporate governance having been strengthened over this period. The Bolton model by contrast, links short-term behaviour to differences of opinion between shareholders as measured by share turnover, and finds that high turnover is likely to be observed in firms in new industries, where it is usually more difficult to evaluate fundamentals and consequently, provides greater opportunity to disagree.

#### IV. THE IMPACT OF AGENCY THEORY ON STOCK PRICE

The agency theory compensation strategy—particularly providing stock options—impacts on the cost of capital-debt and equity in many ways. Of note here is the interaction between the incentive payment strategy used to ensure high stock price and the response of debt capital markets to these strategies, the reaction of the securities markets to this market interplay, and the relationship between share price and the takeovers market. More precisely, while agency theory strategy requires managers to be paid stock based compensation to discourage shirking and encourage risk taking, capital markets read these same strategies for their own purposes and in the opposite way: by reference to the riskiness of the undertaking, the risk profile of the borrower, and the composition of the compensation package of managers. Overshadowing this is the scrutiny of the takeovers market. The underlying tensions these competing considerations generate and their relationship to stock price and short-termism are considered below.

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<sup>60</sup> See Bolton, *supra* note 5.

<sup>61</sup> Marianne Bertrand & Sendhil Mullainathan, "Are CEOs Rewarded for Luck? The Ones Without Principals Are" (2001) 116(3) *Quarterly Journal of Economics* 901.

<sup>62</sup> Lucian A. Bebchuk, Jesse M. Fried & David I. Walker, "Managerial Power and Rent Extraction in the Design of Executive Compensation" (2002) 69 *U. Chicago L. Rev.* 751.

<sup>63</sup> See Murphy, *supra* note 36 at 2537.

<sup>64</sup> See Michael C. Jensen, Kevin J. Murphy & Eric G. Wruck, "Remuneration: Where We've Been, How We Got to Here, What are the Problems, and How to Fix them" *Harvard NOM Working Paper No. 4-28* (12 July 2004), online: Social Science Research Network <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=561305](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=561305)>.

### A. Compensation Strategy and the Cost of Capital

A key assumption of agency theory compensation strategy is that variable equity-based compensation induces effort, whereas fixed compensation makes managers become conservative and expend less effort. In this connection, the use of ordinary stock as compensation has not been as useful in inducing managers to overcome their natural aversion to risk and engage in risk taking, as ordinary stock has both an upside and a downside.<sup>65</sup> On the other hand, stock options<sup>66</sup> have proven to be useful in this regard as they have only an upside and no downside.<sup>67</sup> Moreover, managerial inclination to undertake risky projects such as acquisitions and divestitures has been found to increase with the levels of CEO stock option holdings, but not with their stock ownership.<sup>68</sup> While this absence of downside may embolden managers, it also makes the task of governance more difficult. A step removed from normal options is the performance-vested stock option (“PVSO”),<sup>69</sup> based on the achievement of absolute or relative targets.<sup>70</sup> As these require the satisfaction of targets of accomplishment, they have proven to be an effective motivator for managers to engage in risky projects and encourage risk seeking behaviour in keeping with the performance requirements of the PVSO.<sup>71</sup> While high risk taking is supposedly reflective of high effort and closer monitoring by creditors—which may benefit governance as pointed out by Hellwig—it also enables managers to hide low effort behind high ventures.<sup>72</sup> Consequently,

<sup>65</sup> Given that excessive risk taking benefits shareholders at the expense of creditors, it is in the interests of shareholders to encourage managers to engage in high risk taking and to reward them appropriately. Unlike shareholders, however, managers are not diversified in their risk portfolio. Managers prompted by a desire for loss avoidance and risk aversion have generally been found not to engage in excessive risk taking. See Razeen Sappideen, “Fiduciary Obligations to Corporate Creditors” (1991) *J. Bus. L.* 365.

<sup>66</sup> It must be noted that employee stock options, unlike ordinary market traded options, are generally not transferable, and forfeited when the employee leaves the company.

<sup>67</sup> Because increases in value benefit the holder, while declines in value do not adversely affect the holder, there being no obligation on the option holder to acquire the underlying share.

<sup>68</sup> See W. Sanders, “Behavioral Responses of CEOs to Stock Ownership and Stock Option Pay” (2001) 44(3) *The Academy of Management Journal* 477-492. The later study by W. Sanders & D. Hambrick, “Swinging For the Fences: The Effects of CEO Stock Options on Company Risk-Taking and Performance” (2007) 50(5) *The Academy of Management Journal* 1055-1078, shows that CEO stock option pay generates greater investment spending, more extreme levels of corporate performance and more often with big losses rather than big gains.

<sup>69</sup> PVSOs or LTIPs (long term incentive plans) became popular in the UK following the recommendations of the Greenbury Committee in 1995; see T. Buck *et al.*, “Long Term Incentive Plan, Executive Pay and UK Company Performance” (2003) 40(7) *Journal of Management Studies* 1709-1727 at 1710 [Buck *et al.*].

<sup>70</sup> Commonly observed option vesting targets used in the UK are absolute accounting performance and relative market performance, while those in the US are absolute stock returns and absolute accounting performance. See Y. Kuang & H. Dekker, “Does Stock Compensation Encourage Managerial Risk Taking?” *Management Control & Accounting* 2008(1): 46-51 [Kuang & Dekker]. See Buck *et al.*, *supra* note 69 at 1711, that the complexity of LTIPs in the UK gives executives additional opportunity to tilt the design of LTIPs in their favour.

<sup>71</sup> See Kuang & Dekker, *supra* note 70 at 51.

<sup>72</sup> Since Jensen, Martin F. Hellwig, “A Reconsideration of the Jensen-Meckling Model of Outside Finance” (2009) 18 *Journal of Financial Intermediation* 495, has demonstrated that low risk and low effort are not associated with debt and equity respectively, but as being present in relation to both. Moreover, managers can also shirk by employing low effort to high risk investments in respect of both debt and equity. Rewarding managers then proves to be much more complicated than under the plan contemplated in agency theory.

the effectiveness of PVSOs in achieving agency theory objectives has proven to be uncertain. Faced with the use of restricted options,<sup>73</sup> indexed options<sup>74</sup> have been suggested as strategies to overcome the problem. Again, its usefulness has been disputed. For example, Bebchuk & Fried consider their usefulness to be overstated.<sup>75</sup> Jensen is more candid in his assessment of their efficacy: his view is that despite the wide acknowledgement that the problem of opportunistic conversion of options is controllable through the use of the devices referred to, there has been a failure of will to implement such controls. In other words, even if one assumes that they will have some effect in controlling abuse, the battle for restricting the realisation of options (as well as indexing them) will be hard to win.

Unsurprisingly, agency theory's strategy of benefiting stockholders at the expense of creditors through risk shifting (where shareholders receive all or most of the upside, but share in the downside with creditors), has resulted in creditors seeking recompense through higher rates of interest.<sup>76</sup> To explain, capital markets have responded to such risk shifting by adjusting the cost of capital to each of the various CEO pay components. For example, the form which executive compensation takes (whether in the form of cash bonuses, stocks, stock options, or PVSOs) has been found to have a direct bearing on the cost of capital, particularly on debt financing. First, stock based compensation has been identified as being a strong proxy for predicting aggressive accounting behaviour,<sup>77</sup> and to lead to the manipulation of accruals in order to inflate reported earnings. Consequently, debt holders have come to view earnings management by corporations negatively. Similarly, bond holders view the reporting of high levels of abnormal accruals as lowering the quality of reported earnings in their use of them as a proxy to assess the default risk of firms.<sup>78</sup> These negatives have resulted in debtholders requiring a higher risk premium from the firm, increasing the cost of capital to the corporation.<sup>79</sup> Second, UK data for 2003-2006 shows that while both cash bonus and CEO-defined benefit pension plans have been found to reduce the cost of debt capital (the former because it motivates managers to seek stable cash flows to achieve earnings targets and so lowering the risk

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<sup>73</sup> See Lucian A. Bebchuk & Jesse Fried, *Pay without Performance: The Unfulfilled Promise of Executive Compensation* (Cambridge, Mass: Harvard University Press, 2004) and Lucian Bebchuk & Jesse Fried, "Pay Without Performance: Overview of the Issues" (2005) 30 J. Corp. L. 647 [Bebchuk & Fried].

<sup>74</sup> See Anabtawi, *supra* note 36 at 1567.

<sup>75</sup> For example, Bebchuk & Fried, *supra* note 73, observe that their use may at best impose some limits on abuse, but do not address the underlying problem.

<sup>76</sup> Suggestions have included managerial compensation consisting of a combination of stock based compensation and a basket of debt securities representative of reflective of the risk exposure of each class of debt security (e.g. senior debt, subordinated debt, preference shares) so as to contain the problem of risk shifting. See John McCormack & Judy Weiker, "Rethinking 'Strength of Incentives' for Executives of Financial Institutions" (2010) 22(3) Journal of Applied Corporate Finance 65.

<sup>77</sup> Daniel Cohen, Aiysha Dey, & Thomas Z. Lys, "Trends in Earnings Management and Informativeness of Earnings Announcements in the Pre- and Post-Sarbanes Oxley Periods" (1 February 2005), online: Social Science Research Network <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=658782](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=658782)>.

<sup>78</sup> Daniel Bergstresser & Thomas Phillippon, "CEO Incentives and Earnings Management" (2006) 80 Journal of Financial Economics 511.

<sup>79</sup> Andrew Prevost, Christopher Skousen & Ramesh Rao, "Earnings Management and the Cost of Debt" (2008), online: Social Science Research Network <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1083808](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1083808)>.

of default;<sup>80</sup> and the latter because it results in the CEO pension holder becoming a creditor),<sup>81</sup> stock options and PVSOs have been found to increase the cost of debt capital. Third, creditors have been found to penalise corporations in which CEOs have high levels of stock options, because they link CEO wealth with that of shareholders and assume that managers will engage in excessive risk taking at the cost of debt holders. Fourth, capital markets have also been found to react differently to ordinary options and PVSOs, with PVSOs attracting higher borrowing costs given their association with high risk strategies. Finally, the evidence is mixed on whether CEO restricted stock helps reduce the cost of debt, or whether it results in higher prices for bonds.

Overall, the findings show that debt capital markets do respond to the various CEO pay components when pricing publicly traded bonds. This highlights not only the tension between incentive compensation and debt capital markets, but also of the agency problem between debt and equity capital generally. The upside of this tension is the role of debt as a market disciplinarian. Additionally, debt also serves to significantly enhance the value of equity. For in addition to sharing in the risk of the venture with share capital, debt capital receives fixed returns which rank higher in priority. Moreover, these interest payments are tax deductible to the borrower, thus roughly halving the cost of capital associated with debt. Despite these attractions of debt, the need to ensure that regular interest payments are met, which of course has the result of imposing additional pressure on managers to engage in short-termism in preference to long term investment strategies.<sup>82</sup> Unsurprisingly, managers as recipients of stock based compensation favour it for several reasons, including its focus on stock price, its direct bearing on their total remuneration package, and the freedom of action it gives them to influence stock price.

### B. *The Market for Corporate Control*

The corporate control market influences stock price through the control it exerts over managerial performance. The causes and consequences of corporate takeovers themselves continue to be debated.<sup>83</sup> For example, management theorists claim that a company may be taken over not because it is inherently inefficient but because the bidder company wants to eliminate or limit competition, or increase its market share as distinct from any efficiency concerns. Consequently, many of the hostile takeovers are seen as purely speculative transactions seeking to realise a quick profit by breaking up undervalued firms, in spite of the loss of long-run efficiency that results from splitting up the firm. Finance theorists steeped in market efficiency arguments claim that good corporate governance adds value to the firm, increases

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<sup>80</sup> A. Duru, S. Manshaw & D. Reeb, "Earnings based bonus plans and the agency cost of debt" (2005) 24 *Journal of Accounting and Public Policy* 431.

<sup>81</sup> Joseph Gerakos, "CEO Pensions: Disclosure, Managerial Power, and Optimal Contracting" (2007), online: Social Science Research Network <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=982180](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=982180)>.

<sup>82</sup> See Rezaul Kabir, Hao Li & Yulia Veld-Merkoulova, "Executive Compensation and the Cost of Debt" *University of Twente Publications* (January 2010), online: University of Twente <<http://doc.utwente.nl/74066/>>.

<sup>83</sup> See Julie Caswell & Ronald W. Cotterill, "Two New Theoretical Approaches to Measuring Industry and Firm Performance" (1988) 4:6 *Agribusiness* at 511-520.

its share price, makes existing shareholders reluctant to sell their shares and more importantly, makes it very expensive for a potential raider to take over the company.<sup>84</sup> According to this view, share price, takeovers, and corporate governance are linked to the need for the offeror to entice shareholders to sell at a price higher than the prevailing market price. Consequently, since market values are the best available measure of a firm's long-term value, any value-increasing takeover measured by short-term stock price movements should go forward. Studies show that top management turnover is more prevalent in companies that have been taken over than in companies not targeted for takeovers, and that even failed takeovers may prompt a re-evaluation of the performance of the company by investors because of newly revealed information, with resulting managerial turnover even when a takeover fails.<sup>85</sup> Despite the inconclusive nature of these claims, the fact remains that takeovers threaten the target directors' employment; and this in itself, is sufficient inducement for managers to ensure that share prices remain high, such that the company remains an unattractive target. Takeovers (or the threat of them) keep managers and Boards on their toes, and this has a positive impact on governance. Moreover, given that the realisable value of stock based compensation is dependent on the market value of the shares, the maintenance of high share price remains uppermost in the minds of managers, to be achieved by whatever means possible, as was explained in the earlier discussion on the role and consequences of agency theory executive compensation.

### C. Equity Markets' Responses

While equities markets respond to price sensitive information, which would include compensation strategy, it is fair to say that unlike the debt market, the focus of the equities markets is more on stock price than the particularities of the cost of capital. In this sense, equities markets would approve of stock based compensation and with it the promise of managerial effort to keep share prices high. As noted, this demand for high stock price only adds to the pressure for short-termism. Two issues bear on equity markets: whether equity prices reflect their underlying value in any objective equilibrium sense, and its impact on short-termism.

The efficient markets hypothesis ("EMH"),<sup>86</sup> behavioural theory,<sup>87</sup> and entrepreneurship theory,<sup>88</sup> all provide explanations of how market players capture price sensitive information, what such information represents, and how share prices are formed. According to EMH, in efficient securities markets, all of the market inputs

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<sup>84</sup> See Henry G. Manne, "Mergers and the Market for Corporate Control" (1965) 73 *The Journal of Political Economy* 110.

<sup>85</sup> O'Sullivan & Wong, "The Governance Role of Takeovers" in Keasey & Wright, eds., *Corporate Governance: Accountability, Enterprise and International Comparisons* (London: John Wiley & Sons, 2005) at 172. Takeovers do not feature as prominently in the Japanese and German insider financing based corporate governance systems; the concentration of ownership in the hands of a few families and banks is thought to be the reason for the limited number of hostile takeover attempts.

<sup>86</sup> This sees share price as representing the price determined by the objectively determined profit maximising actions of investors. See Razeen Sappideen, "The Paradox of Securities Market Efficiency: Where to Next?" [2009] Sing. J.L.S. 80 [The Paradox].

<sup>87</sup> This sees share price as being the product of investment decisions by individual investors based on their own frames of risk preferences.

<sup>88</sup> This views it as the product of the actions of individuals striving to improve their position.

and outputs that are of a price sensitive nature, such as those discussed above, will be reflected in the share price. EMH rests on three assumptions: economically rational behaviour by market participants (utility maximisation behaviour),<sup>89</sup> homogeneous expectations of participants in the marketplace, and price movements based on the instantaneous transfer of information by arbitrageurs. Implied in this is the claim that stock markets readily capture price sensitive information. It also assumes that individuals behave in an economically rational manner, and that therefore markets—particularly securities markets—are *per se* perfectly competitive. Based on these assumptions, the paradigm asserts that securities prices reflect their fundamental value and are rightly priced, such that securities markets are efficient both in the individual and the aggregate market sense. However, these claims have been refuted. For example, entrepreneurship theory shows that dynamic markets—such as stock markets—are volatile, in a state of flux, and constantly adjusting and readjusting themselves in the face of actions taken by its various participants to make a gain. For this very reason, they are subjective and error prone. It sees the existence of opportunities for exploitation when markets are not perfectly coordinated (which is almost always the case), with the spotting of opportunities for gain, initiating actions, and reaping their consequences as being the function of the entrepreneur.<sup>90</sup> This is particularly so of investment transactions as parties enter into them with opposite expectations.<sup>91</sup> And since actions are based on the individual's store of knowledge, the inability to predict one's future knowledge means that one's future decisions will have to be based on guesstimates. Moreover, individuals even when presented with common information may not necessarily come to the same conclusion, because of their different expectations of outcomes based on their different appreciation of such knowledge. Consequently, the arbitrageur and investment banker are subject to uncertainty as anticipated conditions do not often materialise and losses may result. This is because although entrepreneurial profit opportunities may exist, they are uncertain in the face of time and ignorance.

Additionally, behavioural theorists show that individuals do not and often cannot, behave in an economically rational manner for any number of reasons, especially in relation to securities markets.<sup>92</sup> They identify significant deviations in individual investor behaviour from the profit maximisation models assumed by EMH and

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<sup>89</sup> That is the discounted sum of expected future cash flows, where in forming expectations, investors correctly process all available information, and where the discount rate is consistent with a normatively acceptable preference specification. See Nicholas Barberis & Richard Thaler, "A Survey of Behavioral Finance" in George Constantinides, Milton Harris & Rene M. Stulz, eds., *Handbook of the Economics of Finance* (Boston: Elsevier, 2003) at 1053 [Barberis & Thaler].

<sup>90</sup> E.C. Pasour, "The Efficient-Markets Hypothesis and Entrepreneurship" (1987) 3 *The Review of Austrian Economics* 95.

<sup>91</sup> See Kirzner, *Competition and Entrepreneurship* (Chicago: University of Chicago Press, 1973) at 97, 98.

<sup>92</sup> See The Paradox, *supra* note 86. While the wealth of behavioural theory scholarship is enormous, its outer boundaries roughly consist of the following: (1) perception bias (e.g. on selection, confirmation, matters hindsight, and mind suppression of contrary data); (2) prediction bias (arising from undue optimism, overconfidence, self serving, and regret); (3) probabilities bias (inability to estimate probabilities caused by bounded rationality, anchoring and adjustment, sunk cost effect—*i.e.* throwing good money after bad, and time delay trap); and (4) Prospect theory's view of how individuals go about making decisions (framing, mental accounting, risk aversion and loss rescuing, *i.e.* preference for avoiding losses than making gains).

entrepreneurship. These studies show that individuals, far from maximising their utility through use of complex statistical analysis, act in a very subjective way,<sup>93</sup> use simple rules of thumb to make decisions, and are swayed by herd behaviour. Overall, behavioural theory makes three fundamental points: rather than engaging in utility/profit maximisation, investors rely on heuristics to make sense of complexity; these heuristics are conditioned by their individual frames of reference and have a preference for avoiding losses rather than making gains; and consequently, stock prices are subjective preferences of individual participants based on their particular frames of risk preference.

These explanations demonstrate that while market movements generate profits (or losses) for participants, such movements may have little or no relevance to any notion of fundamental or objective value, but instead is a moving target devoid of any equilibrium when market uncertainty is the dominant factor. This can only add to the pressure on managers to be short-termist not only for fear of hostile raiders, but also to safeguard their nest egg of stock based compensation, the value of which depends on their realisation value. In all, the point made by these explanations is that equity securities markets have greater difficulties in assessing the cost of capital and the valuation of equity securities than do credit markets. Consequently, this enables managers to focus on high stock price through short-termist strategies for the benefit of shareholders.

## V. CONCLUSION

The crisis of short-termism facing corporations observing the Anglo-American form of corporate strategy must be understood in light of the demands of agency theory based managerial compensation strategy and its four components, namely: short term employment contracts, stock based compensation, high stock price, and the pursuit of high-risk high-return investment strategies in order to achieve the latter. These end benefits have now been institutionalised by changes in what shareholders expect managers to deliver. This is captured in the Bolton model, with its framing of stock price as embodying two components: a long-run fundamental, and a short-term speculative component, with CEOs consequently facing a multi-task problem. The stock market itself is seen as speculative, investors as having heterogeneous expectations, and “overconfident investors”<sup>94</sup> engaging in speculation against one another.<sup>95</sup> CEOs split their time between increasing the long-term value of the

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<sup>93</sup> D. Kahneman & A. Tversky, “On the Psychology of Prediction” (1973) *Psychological Review* 237-251 use the notion of ‘subjective probability heuristics’ to explain what individuals rely on when assessing the likelihood of alternative events.

<sup>94</sup> Overconfidence is a frequently observed behavioural bias in psychological studies: see Kent Hirshleifer & David Teoh, “Investor Psychology in Capital Markets: Evidence and Policy Implications” (2002) 49(1) *Journal of Monetary Economics* 139, and Barberis & Thaler, *supra* note 89, for reviews of the related psychological studies and the applications of overconfidence in economics and finance.

<sup>95</sup> Bolton, *supra* note 5, cites the explanation given by Lewis, “In Defense of the Boom” *New York Times Magazine* (27 October 2002) as illustrative of the thought process of many investors making their investment decisions. In explaining the reason behind his purchase of the Internet company stock Exodus Communications at the end of 1999, Bolton at 57, n. 7 quotes Lewis as stating: “I figured that even if Exodus Communications didn’t wind up being a big success, enough people would believe in the thing to drive the stock price even higher and allow me to get out with a quick profit.”

firm and encouraging speculation in stock in the short-term by pursuing projects over which investors are likely to have diverging beliefs. In other words, CEOs are encouraged to pursue short-term speculative projects even at the expense of long-term fundamental value.<sup>96</sup> In all, short-termism has become synonymous with agency theory and its strategy of achieving high stock price.

High share price may result in the following benefits: for the corporation, access to cheaper capital from the marketplace, a readymade defence against hostile bidders, and the corollary power of acquiring targets more cheaply; for shareholders, a higher exit price; and for managers (as well as Board members) higher remuneration, higher realisation price for the stock based component of their remuneration packages, as well as longer tenures of office when corporate raiders are kept at bay. Against this backdrop, it is in the interest of the triumvirate of Board, managers, and shareholders to ensure that share price remains high.

Part III highlighted the considerable downside associated with high share price. These include managerial efforts to manipulate share price<sup>97</sup> as both an offensive and defensive strategy. While use as a defensive strategy is primarily to thwart the corporate raider and better secure their tenure of office, use as an offensive strategy is to both secure better remuneration packages and to realise their stock based component at the best price. Such practices do have the potential to harm the reputation of and confidence in securities markets, of the stock market as an institution, and with it the long term financial stability of corporations. Overall, the evidence is that short-termism encourages excessive risk taking and risk shifting from managers to shareholders, from shareholders to debt holders, and from subordinated debt holders to senior debt holders. As the 2008 financial crisis has shown, excessive risk taking and risk shifting may cause the systemic failure of institutions and impact adversely on the welfare of the firm, markets, and society in general.

The consequence of all this has been the emergence of stock price as the surrogate of corporate performance. This has led to the functional role of the board—as an intermediary between managers and shareholders, as well as its role in directing the corporate agenda in its competitive setting—to come under siege. In this sense, Corporate Governance has itself undergone a paradigm shift: rather than Boards sitting at the apex with managers carrying out their directives and shareholders judging the response of the marketplace and determining share price, it has become share price driving the agenda of all these corporate players. In other words, instead of the Board deciding what is best in the long-run based on accounting notions of earnings and provision for the future, the focus now is on share price based on cash flow estimates with the drive towards higher share price. And as managers are best placed to influence the financial strategy of the corporation, they are also able to influence stock price to leverage and consolidate their position of power within the organisation. At the same time, this focus on share price seems to have succeeded in addressing the separation problem between shareholders, managers and the Board, responded to the hostile takeover threat, and aligned managerial and shareholder interests with stock based compensation, as high share price seems to benefit all parties.<sup>98</sup>

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<sup>96</sup> See Bolton, *supra* note 5.

<sup>97</sup> Strategies used for this purpose include earnings management and the like.

<sup>98</sup> Given that managers, unlike shareholders, have all their eggs in the basket of their employment contract, whereas shareholders generally hold diversified portfolios, it will be the case that managers will

The problem of short-termism is then reflective of a crisis of corporate governance. Some see the solution to corporate governance problems as lying in strengthening the power of corporate boards (or at least in not eroding the powers they have traditionally exercised), while others see the solution in further strengthening the power of the shareholder body. A leading protagonist of the former view is Martin Lipton, where the latter view is provided by Lucian Bebchuk. Lipton's views have been prescient in anticipating the future. In an article written as far back as 1979, he queried:<sup>99</sup>

Whether the long-term interests of the nation's corporate system and economy should be jeopardized in order to benefit speculators interested not in the vitality and continued existence of the business enterprise in which they have bought shares, but only in a quick profit on the sale of shares?

Lipton sees the problem of short-termism as flowing from the speculative actions of hedge funds and arbitrageurs<sup>100</sup> engaged in investing over much shorter time horizons, more particularly in the context of target Boards facing a hostile takeover bid.<sup>101</sup> He sees the evolution of corporate governance to its present stage to be evenly balanced and any erosion of Board power to be antithetical to the long-term interests of the corporation. Bebchuk<sup>102</sup> on the other hand, champions a dual strategy of increasing the dependence of Boards on shareholders while at the same time reducing their current dependence on managers (particularly the CEO). Stated differently, and translated into the context of the debate on short-termism, this view sees a need to further strengthen the power of shareholders over managers (or Boards). Bebchuk's recommendations flow from his analysis of the problems arising from executive compensation packages.

The problems presented by corporate short-termism, however, have mutated to become much more complex. For example, on the one hand, the problem of excessive compensation flowing mainly from stock based compensation—a direct offspring of agency theory based compensation—cannot be resolved by increased Board power, as Boards have been shown to be in the pockets of managers, particularly the CEO. On the other hand, increasing shareholder power is no solution to the short-termism problem in that the “vocal shareholders”,<sup>103</sup> namely hedge funds, arbitrageurs and other institutional shareholders, whose holdings would far outnumber those held by personal investors, cannot be said to be in need of additional legislative protection as they should be able to keep errant managers in check, given their combined size.<sup>104</sup>

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manipulate financials to suit their timing preferences. Yet, shareholders with diversified portfolios will benefit from an averaging out of the results.

<sup>99</sup> See Lipton Boardroom, *supra* note 1 at 104.

<sup>100</sup> To which may be added latter day investor behemoths such as pension funds as well as the derivatives trade.

<sup>101</sup> Mark Lipton & William Savitt, “The Many Myths of Lucian Bebchuk” (2007) 93 Va. L. Rev. 733 at 746 [Many Myths].

<sup>102</sup> See Bebchuk & Fried, *supra* note 73. They detail a series of changes to the manager-Board relationship which ensures the independence of the Board from managers while at the same time increasing the dependence of managers on shareholders. It must be noted that their advocacy is directed at handling problems flowing from executive compensation.

<sup>103</sup> See Many Myths, *supra* note 101 at 746.

<sup>104</sup> See *ibid.* at 756, 757: “...short-term, highly hedged investors such as hedge funds increasingly acquire corporate electoral power far beyond their economic interests. ‘Vote buying by hedge funds is probably common’, and such professional investors may often ‘borrow’ millions of shares for short periods and

What prevents them from grouping together, as observed by John Coffee over two decades ago, was their having to choose between the benefit of liquidity or control.<sup>105</sup> Coffee, like Lipton, though in a more oblique way, alerted the world to the problem of short-termism. A more graphic description of the role of these investors is that they are:<sup>106</sup>

“primarily financial engineers interested in the largest possible profit in the shortest period of time,” who usually maintain “laser-beam focus on quarter-to-quarter earnings” – and they accordingly favour a short-term spike in the share price over long-term wealth creation. Indeed, “[i]n most cases, the[se] investors have no interest at all in the long-term economic success of the enterprise.”

In the face of the changing corporate governance landscape, a specific solution to the corporate governance problem inherent in short-termism will be to take heed of the concerns alluded to by both Lipton and Bebchuk, and to combine the wisdom of the strategies they have advocated. A *modus-vivendi* will then be to rebalance the impact of the agency theory strategy employment contract equation of short term employment contracts on one hand and stock based compensation on the other, with longer term managerial employment contracts alongside longer vesting periods for stock options and a tightening of corporate governance requirements by ensuring greater Board independence from the CEO. The recent strategies adopted by the US, the UK and Australia to handle the problem of excessive executive compensation and to increase managerial accountability have been along somewhat similar lines. Two key aspects of these strategies are the provisions for ‘clawback’ of compensation paid to executives in certain circumstances where their performance has fallen short of previously negotiated expectations, and the ‘two strike rule’, where the entire Board may be forced to resign if at least 25% of the shareholders present and voting vote against the compensation packages awarded to executives at two successive annual general meetings.<sup>107</sup> While these measures have been much needed to combat the problem of excessive compensation, they have to be balanced against the precariousness of managerial tenure that currently prevails under agency theory strategy as well as the problem of short-termism that corporate governance is now confronted with. Such a balancing requires recognising the need for longer term tenures as identified by Lipton. While there can be no optimum prescribed period for such positions, the common standard seems to be three years. Longer terms can be provided for in individual contracts with a right of renewal for a further period of three years and beyond, subject to the overriding ‘clawback’ and ‘two strike’ rules.

An alternative approach is to balance stock based compensation with a basket of mixed debt claims (thereby forcing managers to share in the losses of debt holders

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at nominal amounts at or around voting record dates in order to influence corporate elections (without, of course, a corresponding interest in corporate performance). Such investors may be in a position to influence corporate policy so as to advance their private interests—which may be inimical to the interest of the corporation as a whole—and yet they owe no duty of any kind to any of their fellow shareholders.” Citations by Lipton omitted.

<sup>105</sup> John Coffee, “Liquidity versus Control: The Institutional Investor as Corporate Monitor” (1991) 91 Colum. L. Rev. 1278.

<sup>106</sup> Many Myths, *supra* note 101 at 746. Citations in the quotes have been omitted.

<sup>107</sup> See *supra* note 20.

caused by increased risk shifting to them), alongside the adoption of a Basel type capital adequacy<sup>108</sup> requirement (of say 2%)<sup>109</sup> imposed on equity capital as a cushion against the entity's insolvency.<sup>110</sup> This would also require longer term employment contracts (two periods of three years and beyond) coupled with long term vesting of compensation packages and the 'two strike' and 'clawback' rules. In both of the above approaches, while the Board members' services may be terminated during their period of renewable tenure, they will remain entitled to the salary component, if not their bonus payments, for the entire period.<sup>111</sup>

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<sup>108</sup> There have been two Basel Accords and a so-called Basel III which attempted to rectify the downside flowing from asset and mortgage backed securitisation following the global financial crisis of 2008. The Accords require the maintaining of capital reserves of around 8% by financial institutions, to safeguard against credit, market and operational risk. See the various Capital Adequacy Accords, online: Bank for International Settlements <<http://www.bis.org/>>.

<sup>109</sup> Approximately a quarter of that required of financial institutions.

<sup>110</sup> The strength of the capital adequacy approach is that it helps check excessive risk taking at its source.

<sup>111</sup> These would be agreed to through employment contract payments rather than ex gratia golden shakes.