Directors' Duties and Behavioral Economics

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I
Scope of the Topic

• Intensity of „codification“ (statute or case law based) of duties of full time corporate executives or controlling shareholders who are responsible for the day-to-day management of „public corporations“
  - inside directors in the one-tier board system
  - members of the executive board in the two-tier board system

Scope of the Topic

• Note that the unitary system of corporation law (US jurisdictions, UK) does not have a technical full separation of rules concerning the function of directors as in the „European“ setting:
  - AG with non-dispositive independent powers of the Vorstand
  - GmbH with dispositive „contractual“ dependence on the ongoing voting of the close group of shareholders
• Many caveats concerning US and UK literature on corporate governance

II
Directors' Duties – A Scandal Driven Subject

• Frey and Osterloh (WP 2003) identify two main causes:
  (1) exorbitant salaries (CEOs earn, on average, 75 times as much as industry worker, Murphy 1999
  (2) fraudulent behavior illustrated by Kenneth Lay (Enron), Scott Sullivan (WorldCom) and recently Calisto Tanzi, Fausto Tonna and friends (Parmalat, NZZ Dec 31 2003, FAZ Jan 2 2004)

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III
Policy Reactions

Increasing supervision by commissions
- classic: SEC with constantly increasing powers
- ad-hoc reporting duties to e.g. BAFin in Germany in accordance with the KonTraG 1998 TransPubG 2004 e.g. § 15 WpHG
- Parmalat: Tremonti demands a new supervisory authority formed after the model of UK Financial Services Authority to replace Consob and traditional functions of Banca d’Italia

Policy Reactions

2. Increasing involvement of „outside“ monitors – Sarbanes-Oxley: accountants and consulting attorneys face personal liabilities
3. Increasing „inside“ monitoring by requiring reporting about future policy decisions (sect 90 I Nr. 1 AktG) installation of a „preventive“ monitoring system (sect 90 II AktG) – both introduced in 1998
4. Formulation of detailed catalogues of duties either in the statute, or in a corporate governance codex
Policy Reactions

5. Increasing personal director liabilities
   a) demanding or introducing lower thresholds for creditors suits (sect 93 AktG still requires gross fault)
   b) demanding lower thresholds for the required quorum in the general meeting for damage suits (sect 147 II, III AktG require either 10% or 5% of the vote) – (further reduction to 1% under way)
   c) demanding the introduction of a genuine shareholder suit actio pro societate

IV Agency Theory as the Classical Economic Model

Standard assumptions:
1. Shareholder-owners are principals who monitor director-agents
2. Both are rational maximizers
3. Hence „agency problem“, to be resolved by “adjusted” rewards and penalties
4. Market performance of the stock serves as quasi-objective reference for managerial performance

Epistemology

- Does the legal argument matter that directors/managers are no agents of the shareholders, but rather of the company? (Clark 1976)
- It is clear that directors are agents. It is less clear whether and to what extent shareholders are, even in a positive economic sense, principals.
  - They may be principals in an ascribed, normative function, simply because we want to channel a specific set of residual stakes to one group of stakeholders

V Epistemology

- Alchian/Demsetz 1972 were concerned with „team“ production, less with the entrepreneurial specialization relevant for corporate governance. Monitoring the carrying of the grand piano is not precisely the choice of corporate opportunities
- Jensen/Meckling 1976, Fama 1980 established a correlation between market performance and managerial performance and detailed decision-making procedures, but took for granted that the Berle- Means concept of division between ownership and control could be fully translated into agency terms

VI A Research Agenda Based on Behavioral Economics

- Behavioral Economics should not be confined to a mere repair shop for neo-classical economics, but should be an avenue for integrating economics in the more general subject of human decision making
- For purposes of analysis we may distinguish the following problem areas:
  1. the design of incentive compatible contracts/rules (still a stronghold of neo-classical economics)
  2. the problem of the relative substitution of (personal) monitors and (abstract) norms: professional education may have a vital bridge building function, but the subject is largely untreated
  3. problems of rule recognition (psychology, sociology, law)
  4. problems of rule compliance (psychology, sociology, law)
A Critique of Conventional Agency Theory

The blind spot of agency theory

- traditional concentration on monitoring, screening may be more important (Schanze 1987, 1990) - particularly for agents who perform highly specialized „choice“ tasks and hence need „discretion“ (we delegate for lack of time, location, or competence - if competence is concerned, it is delegation of choice)

“It is nonsense to talk about a fully specified contract with a corporate manager“ (Schanze 1990, 687).

A Critique of Conventional Agency Theory

- „pay“ may be more a reaction to the scarcity of specialists than an incentive to outperform others (problem of stars, artists)

- „monitoring“ of complex tasks is substituted by massive entry requirements (signaling, tournaments, quasi-kinship relations).

Lessons from Behavioral Economics

1. Covert communication, expectation effects

- agents do better if principals assume they are better (Rosenthal 1978, 2003) – student and rat-maze learning studies show: students, raise in performance Ø 35% rats, maze learning improved Ø 65%

- examples may be explained in terms of neo-classical effort, but more plausibly in terms of „reputation“ effects for both students and teachers – essential for explaining managerial performance

Lessons from Behavioral Economics

2. Rule recognition in complex decision making situations

- top managers work selectively responding to tasks without necessarily understanding the routines. They operate by „presence“ and „threat of intervention“ (Zajac and Westphal 1997) – Boards of directors are characterized „as large, elite, episodic decision making groups that face complex tasks pertaining to strategic issue processing“ (Forbes and Milliken 1999)

Lessons from Behavioral Economics

3. Motivation crowding effects

- Osterloh and Frey WP 2003 „Corporate Governance for Crooks?“ documents - failure of compensation schemes - failure of tight „codification“ of duties - original example: air traffic control and the effect of „working to the rule“ - agents will crowd-in or -out

Lessons from Behavioral Economics

4. Compliance with the law: procedural fairness and logic of reciprocity

- proof of existence of „corporate virtue“/ intrinsically motivated pro-social behavior (experiments since Deci 1975, Frey 1993: increase in payment may reduce effort – increase in monitoring may reduce effort; Barkema 1995: work hour study of managers)

- result: „low levels of legal contract enforcement crowd-in trustworthiness, more order results from less law“

- policy proposals:
  1) selection of directors with pro-social intrinsic motivation
  2) emphasis on fixed salaries
  3) participation, increased self-governance

- threats of punishment are likely an ineffective strategy to enforce legal rules
- compliance is associated with acceptance of social values
- moral climate
- fair procedures
- „feeling of legitimacy and obligation“
Lessons from Behavioral Economics

b) Dan Kahan (WP 2003)
“Logic of Reciprocity: Trust, Collective Action and Law” (based inter al. on Fehr and Gächter, AER 2000)
- promotion of cooperation: “incentives vs. trust”
examples: tax compliance, site selection, street crime

Lessons from Behavioral Economics

- essential strategies: self-commitment and self-policing
result: conventional theory of bribes and threats attracts costly regulation and rent-seeking

“We are reciprocators”

Policy Proposals for Directors‘ Duties

- stress on promotion and degradation
- dismissal as „drastic“ sanction
- non-renewal of term
- lowering the bonus levels (Frey)
- „freezing“ parts of the bonuses in trust holdings

Policy Proposals for Directors‘ Duties

- „bright line“ sanction system
i.e. pecuniary liability with respect for the business judgment rule
inside threshold: negligence but discretion
outside threshold: evident misconduct
reliance on self-policing
- note: civil sanctions have penal effects
- traditional penal sanctions should be used more effectively in cases of fraud

Policy Proposals for Directors‘ Duties

example: D&O-insurance:
does it relieve directors from risk-taking?
a new potential cash-cow: preparation of litigation metered by the hour

- effective incentive system stresses reputation mechanisms in the employment contract – election of directors with high scrutiny and publicity (Bebchuk 2003)