CORPORATE GOVERNANCE FOR KNOWLEDGE PRODUCTION

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Research Question

Firm specific knowledge today is the main source of competititve advantage of a firm

➡ Consequences for Corporate Governance ?

Three Theories of the Firm

1. Firm as a nexus of contracts
2. Firm as a nexus of firm specific investments
3. Firm as a nexus of firm specific knowledge investments

➡ different concepts of Corporate Governance

1. Firm as a Nexus of Contracts (Alchian & Demsetz 1972)

= dominating concept of Corporate Governance

Basic idea:

- All stakeholders with the exception of shareholders can contract their claims ex ante
- Only the shareholders carry a residual risk
- Only the shareholders should have residual ownership and control
- ➡ Board is the representative of shareholders only
- ➡ Interests of shareholders, board and management have to be aligned by equity based pay for performance

1. Firm as a Nexus of Contracts(2)

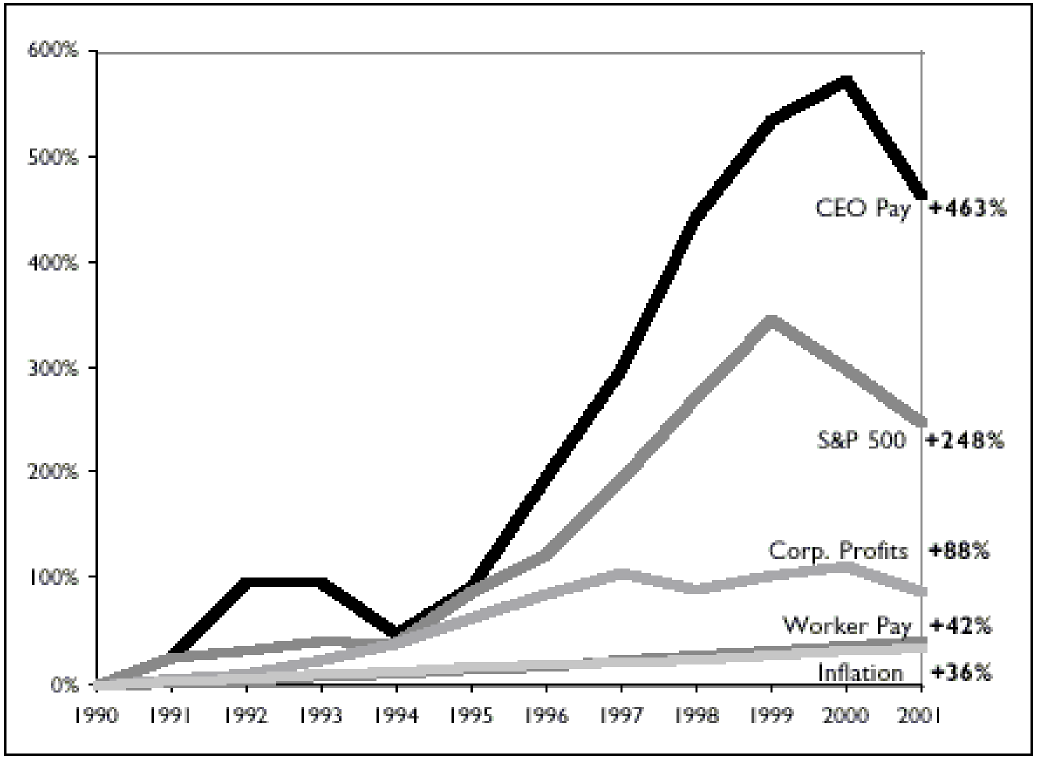
Results:

- Huge discrepancies between the development of CEO pay and stock prices
- Corporate scandals

➡ Control of Managers by the Board is insufficient

CEO pay, Stock Prices, Corporate Profits, Worker Pay and Inflation, 1990 - 2001

CEO Pay, Stock Prices, Corporate Profits, Worker Pay, and Inflation, 1990-2001



Sources: CEO Pay: *Business Week* annual executive pay surveys. **S&P 500 Index:** Standard & Poor's Corporation. Figures are year-end close. **Corporate Profits:** Bureau of Economic Analysis, National Income and Product Accounts. **Average Worker Pay:** Bureau of Labor Statistics, Average Weekly Hours of Production Workers (Series EEU00500005) and Average Hourly Earnings of Production Workers (Series EEU00500006). **Inflation:** Bureau of Labor Statistics, Consumer Price Index, All Urban Consumers.

Source: S. Klinger & Ch. Jartmann: Executive Excess 2002. CEOs Cook the Books, Skewer the Rest of Us, S. 14

Pay for failure instead of pay for performance

Comparison of 43 „fraud firms“ with 2500 S&P „innocent firms“ 1992 - 2001:

	Fraud firms	Innocent firms
Relationship fix/variable pay	33 %	43 %
Value of options and stocks	38.7 Mio	24.5 Mio
dollars-on-dollars incentive (Median)	22	10

dollars-on-dollars incentive = change in an executive‘s stock and option portflio for a 1000 dollar change in firm value

Source: S.A. Johnson; H.E. Rayan jr. & Y.S. Tian (2003): Executive Compensation and Corporate Fraud. Working Paper E.J. Ourso College of Business Administration, Louisiana State University

1. Firm as a Nexus of Contracts (3)

Measures of „Nexus of contract“-view:

1. Board should become more independent of CEO
   - ➡ more outside directors
     (Jensen, Murphy & Wruck 2004)
2. Board should become more dependent on their shareholders
   - ➡e.g. annual election of board members
     (Bebchuk & Fried 2004)

1. Firm as a Nexus of Contracts (4)

Problems:

Firm specific assets as the main resource of hard to imitate competitive advantage are completely disregarded!

2. Firm as a nexus of firm specific investments (1)

Firm specific investments for non-shareholders

- can be contracted ex ante only with high transaction costs
- decrease outside opportunities ➡ they mitigate bargaining positions during the contractual relationship

but are necessary for creating

- sustainable competitive advantages
- synergies or quasi-rents

➡ **No incentives for stakeholders for firm-specific investments without ex post protection of their interests!**
(Blair & Stout 1999)

2. Firm as a nexus of firm specific investments (2)

- Corporate Governance can be defined as a set of constraints shaping ex post bargaining over the joint output of firm specific investments (Zingales 1998)
- Board should act as a „mediating hierarch“. It should consist of outside directors elected by shareholders only (Blair & Stout 1999, 2001)

2. Firm as a nexus of firm specific investments (3)

Problem:

Fundamental differences between firm specific knowledge investments and financial investments are disregarded

3. Firm as a nexus of firm specific knowledge investments (1)

- **Future knowledge cannot be contracted ex ante.**

  Arrow (1973): The value of knowledge invested is not known to the buyer until the knowledge is revealed. Once revealed, the potential buyer has no need to pay for it.

- **Generation of knowledge cannot evaluated by outsiders**

  but only by peers who understand the knowledge process

3. Firm as a nexus of firm specific knowledge investments (2)

Three proposals

1. More reliance on insiders ➡ knowledge investors on the board
2. Insider to be elected by employees making firm specific knowledge investments
3. Neutral chair of the board

➡ Provision of incentives to invest in firm specific knowledge

➡ Help to overcome Corporate Governance crisis

➡ Introduce Knowledge Based Theory of the Firm into Corporate Governance

3. Firm as a nexus of firm specific knowledge investments (3)

1. Insiders on the Board

- are better informed than outsiders
  - ➡ More explicit and tacit knowledge
  - ➡ More independence from CEOs
  - ➡ More efficient control of CEOs
- are able to evaluate procedures, not only outcomes
  - ➡ Mutual monitoring by insiders

3. Firm as a nexus of firm specific knowledge investments (4)

2. Representation of Knowledge Investors on the Board

„Knowledge Directors“are able to protect the bargaining position of investors in firm specific knowledge

- ➡ Incentives for investment in hard to imitate resources are raised
- ➡ Incentives to contribute to synergies are raised

3. Firm as a nexus of firm specific knowledge investments (5)

Proposals for Representation and Election of Knowledge Investors:

Proportional to relation of investments in financial capital and firm specific knowledge capital

3. Firm as a nexus of firm specific knowledge investments (6)

3 Neutral Chair of the Board

- Elected unanimously
- Has no voting rights (compared to judge in relation to jury)
- True outsider
- Specialist on procedures

3. Firm as a nexus of firm specific knowledge investments (7)

Potential Counterarguments

- Professionals have better outside opportunities and will not invest in firm specific Knowledge
- Investors can become shareholders?
- Similar to (inefficient?) German co-determination?

3. Firm as a nexus of firm specific knowledge investments (8)

Advantages

- Countervails dominance of executives
- Provides incentives for firm specific knowledge investments
- Strengthens intrinsic motivation and firm loyalty by distributive and procedural justice
- Ensures diversity in boards while lowering transaction costs of decision making