Moral Hazard in small caps

– German Corporate Governance from a New Institutional Economics perspective –

The German government commission recently proposed several amendments to the current German corporate governance code (as amended on May 26, 2010) to avoid board-level Moral Hazard. The proposed changes regarding the independence of Supervisory Board members give rise to question whether the provision is now suitable to foster good corporate governance, even when they are involved in certain relations with third parties. In particular, the underlying "comply-or-explain-principle" may not be an effective enforcement mechanism by itself to prevent such Supervisory Board members from taking undue risks for the company. Whenever their proprietary interests materially adversely affect the company, its employees and its (independent) shareholders, the enforcement mechanism of the code needs to be supplemented. Since small caps are forming the backbone of the economy, an effective enforcement mechanism is also socially important. There are several implications for practical Investor Relations.

The problem of governing opportunistic board members

Even more than a decade after the ˈNeuer Marktˈ of the Frankfurt Stock Exchange turned out to be a ˈmarket for lemons,’ quality uncertainty including Moral Hazard by board members is still a virulent issue for small caps. This segment comprises some 500 companies with a market cap up to € 100 million and is representing the vast majority of all listed companies in Germany. Consequently, some of the amendments to the German corporate governance code (as amended on May 26, 2010) recently proposed by the German Government Commission are explicitly focusing on the fiduciary duty and independence of Supervisory Board members.

The following new wording of 5.4.2 was drafted in the plenary session of January 17th, 2012:

> "To permit the Supervisory Board's independent advice and supervision of the Management Board, the Supervisory Board shall include *a reasonable* number of independent members. A Supervisory Board member is considered independent if he/she has no business or personal relations with the company, its Management Board *or third parties* which *may* cause a *material* conflict of interests. As a rule, a Supervisory Board member is considered independent if he/she has no business or personal relations with the company, or its Management Board or third parties which cause may cause a material conflict of interests. *As a rule, a Supervisory Board member cannot be assumed to be independent if in particular he/she*
>
> • *… [not exhaustive catalogue] …*
>
> *This does not have any effect on the special conditions arising from the Act on Co-Determination of Employees in the Supervisory Board or the One Third Employee Representation Act.*"

According to the explanation for the proposed changes published by the Commission, the negative definition of independence (from business or personal relations with the company or the Management Board) had to be supplemented by relations of Supervisory Board members with certain third parties. In other words, problematic board member's relations may now also be based on their own stakes in another economic, political, social or scientific entity in order to be encompassed by the Code. While only those third party interests shall be deemed to have a detrimental effect on their independence as board members, which ˈcould give riseˈ to a material conflict of interests, the Code does not ask for such a conflict to have actually emerged. Consequently, a qualified explanation in the declarations of conformity will be required in any case.

Furthermore, it will be a great challenge to measure the newly added materiality criterion of such interests with due reliability, validity and objectivity. While risk management, in combination with portfolio theory, principally offers the appropriate tools, personal evaluation of the board members – at the same time being responsible for enterprise risk management – may still be prevailing in small caps. In an attempt to overcome this problem of missing evidence criteria, the Commission has drafted "… a not exhaustive catalogue of typical situations, in which Supervisory Board members normally cannot be seen as independent". If the Commission succeeds in systematically developing these rule examples towards more practical relevance to be included in the declarations of conformity, the provision may become crucial in further facilitating good corporate governance in practical business, albeit its general lack of sufficient legal enforcement.

Board-level Moral Hazard in small caps

The Supervisory Board assumes a general monitoring responsibility in accordance with Section 111 of the German Stock Corporation Act. Furthermore, Section 93 Paragraph 1 Sentence 1 and Section 116 Sentence 1 of the German Stock Corporation Act together define the fiduciary duties of a conscientious and ordinary Supervisory Board member. Non-compliance to these general norms by Supervisory Board members may result in prosecution, especially in the events of fraudulent breaches of trust, false representations or concealments of the circumstances, breaches of confidentiality, insider trading using inside information, allowance for credit fraud, and commercial bribery. However, evidence is not always precisely and unambiguously defined by hard facts. Whenever board members are pursuing goals due to their involvement in competing third party interests, there will be a tendency to leave any formal statements as ambiguously as possible.

Typical Moral Hazard problems arise in public companies due to the separation of ownership and control. In small caps sometimes the founder, being the largest single shareholder, is acting as the chairman of the Supervisory Board. When he is also able to influence the composition of the complete board, there is no sufficient institutional differentiation left between ownership and control. Consequently, independent shareholders cannot rely on the usual enforcement mechanism that prevents Supervisory Board members from opportunistic behavior to the detriment of the company. Lavish payment and frequent replacement of Management Board members may both be signs of holding the executive management hostage to their detrimental goals rather than of outstanding management performance or capability. This, in turn, attracts a certain type of Management Board member with opportunistic utility functions.

In such an environment of opportunistic behavior, cooperation, trade and negotiation between the two boards are constantly redefining the institutional arrangement of management und supervision of the company. Due to this top level management deficiency, there is no systematic allocation of an efficient property rights structure within the company (i.e., via balanced scorecard or cockpit systems based on KPIs). Management actions cannot be observed and controlled properly and there is no enforcement mechanism in place to maximize the ˈbenefitˈ of the company as a rule or the (independent) investors’ interests in shareholder value.

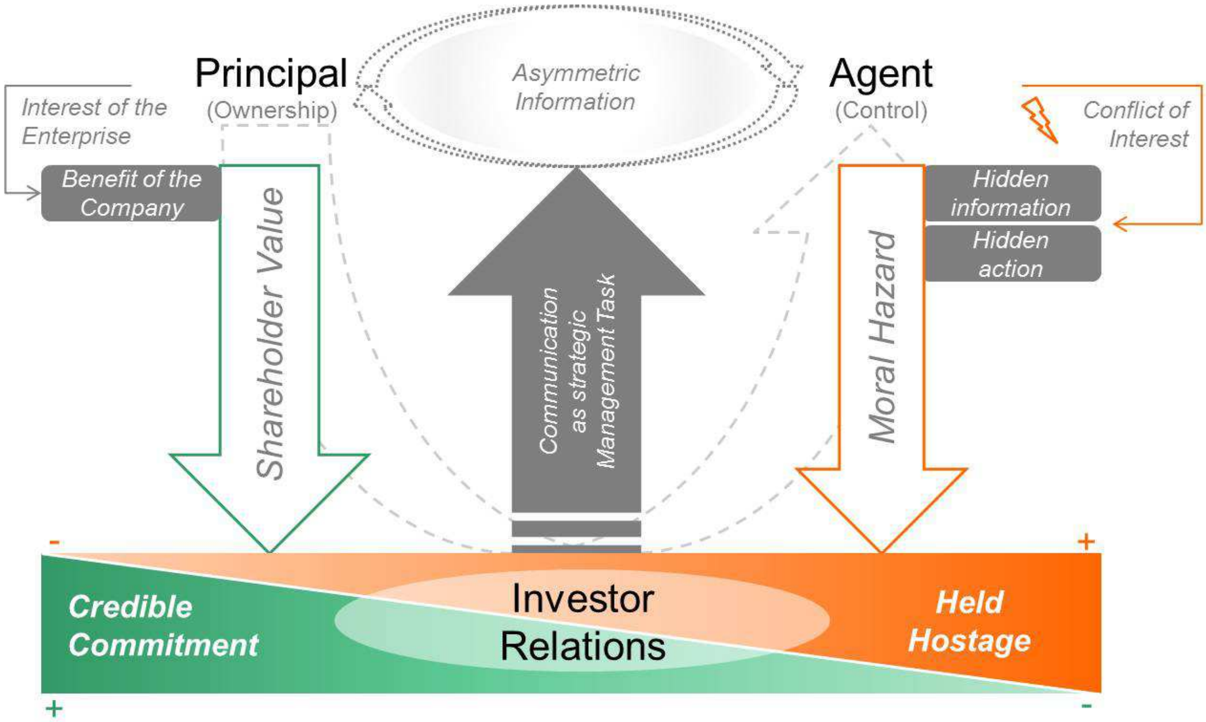
In general, agency theory offers four possible solutions to this problem: monitoring, bonding, change in ownership and organizational redesign, and explicit incentive contracts. While change in ownership and organizational redesign cannot be applied by (independent) investors due to their lack of voting power, monitoring and bonding expenditures appear to be prohibitive.

Explicit incentive contracts, however, might be linked to dignity, credibility, fairness and moral, which are offered by the concept of implicit contracts as soft factors of effective enforcement mechanisms. It is important to note in this context, that Supervisory Board members regularly interact with a variety of stakeholders of the company on various levels. In general, they have a higher than average self-image, often comprising superior social value concepts of a power elite as promoted by some social clubs. Shirking or hold-up by an opportunistic Supervisory Board member, if made public, would thus immediately result in a painful loss of personal reputation, aside from specific liability risks.

Implications for Investor Relations

According to the German Investor Relations Association (ˈDIRKˈ), Investor Relations are defined as a management task with the strategic goal of reaching a realistic perception of the company in the public, especially in the financial market. Efficient Investor Relations activities should also contribute to optimizing capital costs of the company. Investor Relations activities are mainly focused on aligning capital market expectations with actual and probable developments of the company. This goal is achieved through an ongoing dialogue about the long-term prospects of the company (i.e., corporate strategy and goals, forward-looking statements, market developments) and timely, reliable information about current business.

All information provided to investors, analysts, journalists, and other stakeholders has to be consistent to reach the strategic goal of conveying a homogeneous and realistic perception in the public. The reduction of uncertainty via credible commitments helps lowering investment thresholds of potential investors. Thus, Investor Relations managers are constantly seeking to reduce information asymmetries between current and potential investors and board-level management under the premise that board members are acting according to the mandate received by the shareholders.



Investor Relations Trade-off based on board-level Moral Hazard

© Dr. Kai Holtmann

In case of board-level Moral Hazard, however, Investor Relations managers are caught between a rock and a hard place. They have the choice between adapting to this opportunistic behavior and pursuing their original task. If they decide to adapt in order to secure their own job position within the company, they irrevocably turn into captives of the opportunistic board member and can therefore also be held hostage for future actions which are detrimental to the company. Additionally, they are personally left in the legal limbo of misrepresenting the company and its actual and probable developments. If they decide to follow their original strategic goal of providing a realistic view of the status and prospects of the company, however, credible commitments to the investors and other stakeholders in the interest and to the benefit of the company are inevitable. In these cases, opportunistic behavior of board members becomes apparent to investors, who may then utilize their own enforcement mechanism. It is obvious, that opportunistic board members would do anything to prevent this from happening.

Economic Analysis Approach to Governing Moral Hazard

In recent decades, the neoclassical paradigm of utility maximization has been the common theory framework, also accounting for the rise of the classical shareholder value management approach in Investor Relations. However, certain empirical phenomena such as Moral Hazard can only be explained by theoretical hypotheses of New Institutional Economics (NIE), thus exceeding the limitations of the neoclassical paradigm for the first time. In this effort, the innate methodological individualism is competing with the frictionless neoclassical world. At the same time, NIE offer a rich economic theory framework to systematically evaluate the effectiveness of governance mechanisms.

Although New Institutional Economics, in principle, is based on the neoclassical paradigm and its utility maximization under certain restrictions, the market economy with complete information of the ˈhomo oeconomicusˈ is only regarded as a special institutional arrangement. Moreover, transaction costs and bounded rationality are explicitly recognized within the NIE paradigm as part of reality. In this sense, institutional arrangements arise from pre-conceived limitations of people to order their societal structures. They are composed of formal constraints (rules, laws, and constitutions), informal constraints (norms of behavior, conventions and self-imposed codes of conduct) and their enforcement characteristics. All institutional arrangements together define the incentive structure of societies. As a nexus of implicit contracts they simultaneously form the governance mechanism of modern economies. In the equilibrium state, all property rights are distributed efficiently, realizing maximum utility for the economy. Therefore, an efficient enforcement mechanism needs to be established.

The concept of implicit contracts has evolved from the (positive) theory of incomplete contracts. It does not stress the actual legal liability of contracts according to the civil law or whether the contracts are subject to external enforcement at all. Nor is it seeking to find mathematical solutions as in normative principal-agency theory. The enforcement mechanism rather focusses on the ongoing interaction between the parties. This gives the parties an incentive to resolve matters themselves rather than go to court. In combination with the positive agency theory and its methodological individualism, soft factors such as dignity, credibility, fairness and moral become available for the design of enforcement mechanisms to prevent agents from actions based on their Moral Hazard.

Moral Hazard evolves as an agency problem, when one party to a ˈcontractˈ has not entered into the transaction or institutional arrangement in good faith, so that undue risks are taken based on an ex post behavior which is detrimental to the other party. This problem especially arises in situations of information asymmetry between the parties regarding the outcome of the institutional arrangement. The Agent may provide misleading information (hidden information) or may take undue actions (hidden action) based on his informational advantage. In any case, the additional costs of such an ex post opportunism are passed on to the principal, who is left to hold the responsibility for these actions.

Social Governance of Moral Hazard

The theory of incomplete contracts is originally based on Hobbes views on the mutual transfer of (property) rights for the use of social gains in society. Accordingly, a contract is a voluntary and reasonable granting of rights, to protect each player from the arbitrariness of the other and thereby constitute a basis for the community. From this point of view, a social duty arises for each player to perform the contracts. Hobbes idea of this social contract was originally derived from a natural law, but only for an overarching purpose to serve a "Leviathan" state; however, this neither reflects the central tenet of bounded rationality nor does it represent contemporary social market economies. Kant’s insight into metaphysical moral principles, on the other side, certainly sheds some light on opportunistic behavior by players under asymmetric information. Finally, the underlying (neo-classical) homo oeconomicus design of utility maximization is driving the distribution of property rights within each society. Thus, the theory of incomplete contracts facilitates the design of an enforcement mechanism for governing Moral Hazard based on ethically virtuous values in modern societies. The equilibrium state with maximum social wealth can be regarded as the efficient distribution of property rights within the society.

In general, the German corporate governance code is meant to "*clarify the obligation of the Management Board and the Supervisory Board to ensure the continued existence of the enterprise and its sustainable creation of value in conformity with the principles of the social market economy (interest of the enterprise)*." In emphasizing this obligation of the two boards to the (independent) shareholders, the Code attempts to set the standard for the universally applicable interest of enterprises based on a broad social acceptance.

Specific legal obligations such as the Business Judgment Rule pursuant to Section 93 Paragraph 1 Sentence 2 of the German Stock Corporation Act, are further adding up to the obligation. This ˈlex specialisˈ provision is regularly focusing on the (forward-looking) benefit of the company, which is also pointed out by Supreme Court jurisprudence. If the risk associated with decisions, however, is completely misjudged by board members in an irresponsible manner, they can be held internally liable to the company and its (independent) shareholders.

This includes those settings of Moral Hazard, which are based on the board members involvement of deviant third party interests, i.e. within M&A transactions, Joint Ventures, public funding and budgeting of a third party R&D partner, etc. While the Code is recommending that the Supervisory Board shall inform the General Meeting of any conflicts of interest which have occurred together with their treatment, it recommends the termination of the mandate of a Supervisory Board member, whenever these conflicts of interest are material and are not merely temporary in respect of the person arise (5.5.3).

Obligations imposed on Supervisory Board members must always follow generally accepted economic rules, which at the same time have to be in line with our common understanding of social market economy. While the Code explicitly names continued existence of the enterprise and sustainable creation of value as microeconomic goals, the social relevance of the interest of each enterprise must be recognized and the social responsibility of the board members therefore needs to be perceived in a broader macroeconomic scope. In other words, certain relations of a Supervisory Board member with third parties may not only adversely affect the given company, but they may also impede the efficient allocation of property rights within the society.

As a result, any economic shortfall on the enterprise level is also impacting the economy as a whole, not only its fiscal capacity but also its banking and/or the labor sector. On the European level, where small and medium sized companies are widely recognized as the backbone of the economy, the social dimension of the individual obligation becomes even more apparent. Consequently, any practical problem of individual Moral Hazard always imposes residual costs on the society in terms of a dead-weight loss.

Conclusion

A conflict of interest based on a Supervisory Board’s involvement in third party interests leads to an efficiency loss of the company. The aggregate effects are also impeding the economy as a whole in such a way, that property rights are not efficiently distributed. The German Corporate Governance Code has been amended in an attempt to set the standard for the universally applicable interest of enterprises based on a broad social acceptance. The theory of incomplete contracts offers a systematic design of an enforcement mechanism for governing Moral Hazard based on ethically virtuous values in modern societies. Soft factors such as dignity, credibility, fairness and moral can serve as central criteria for the loss of personal reputation via social disapproval to prevent opportunistic board members from undue actions such as shirking or hold-up. While Investor Relations are instrumental in this enforcement mechanism, managers are facing a trade-off with far-reaching consequences. This pitfall requires a diligent and systematic decision making process by Investor Relations managers. The loss of own credibility due to opportunistic behavior is by definition their biggest problem, which may even burden their future professional activities. Therefore, they should be encouraged to pursue their original task of providing a realistic perception of the company. This way, they cannot be held hostage by opportunistic board members and residual costs can be saved for the society.