CORPORATE GOVERNANCE FOR KNOWLEDGE PRODUCTION

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Research Question

Firm specific knowledge today is the main source of competitive 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

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**


<table>
<thead>
<tr>
<th></th>
<th>Fraud firms</th>
<th>Innocent firms</th>
</tr>
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<tbody>
<tr>
<td>Relationship</td>
<td></td>
<td></td>
</tr>
<tr>
<td>fix/variable</td>
<td>33 %</td>
<td>43 %</td>
</tr>
<tr>
<td>pay</td>
<td></td>
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<tr>
<td>Value of options and stocks</td>
<td>38.7 Mio</td>
<td>24.5 Mio</td>
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<tr>
<td>dollars-on-dollars incentive (Median)</td>
<td>22</td>
<td>10</td>
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dollars-on-dollars incentive = change in an executive's stock and option portfolio for a 1000 dollar change in firm value

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 be 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