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Does Corporate Governance Matter?

A brief synopsis of **Does Corporate Governance Matter in Competitive Industries?** (working paper, 2007) by Xavier Giroud and Holger M. Mueller

Please note that gray areas reflect artwork that has been intentionally removed. The substantive content of the article appears as originally published.

GOVERNANCE

Does Corporate Governance Matter?

Competition may be the more effective mechanism.

There is a time and a place when corporate governance has little influence over performance, say two researchers at New York University's Leonard N. Stern School of Business, because competitive forces cut away at management fat.

Holger M. Mueller and Xavier Giroud, associate professor of finance and doctoral student, respectively, studied the performance of companies before and after 30 anti-takeover laws were passed in different states between 1985 and 1991, to determine how the provisions affected performance. In theory, laws that make hostile takeovers more difficult weaken corporate governance and undermine the ability of directors (and investors) to hold management to task. With more opportunity for managers to slack off, financial performance could suffer.

Sure enough, that's what Mueller and Giroud found — but not for every industry. "A negative change in corporate governance [caused by the passage of an anti-takeover law], has a negative effect in noncompetitive industries," explains Mueller. "But a change in corporate governance has no effect in competitive industries."

In the 2007 working paper, *Does Corporate Governance Matter in Competitive Industries?* Mueller and Giroud explain how they tracked 10,960 companies from 1976 to 1995, and used the Herfindahl index — the sum of the squares of competitors' market shares in a single industry — as a measure of competitiveness. With this index, if one company has a monopoly position, the value approaches one; the more evenly a larger group of competitors divides market share, the closer the value approaches zero. What they found is that the passage of an anti-takeover law reduced return on assets by an average of 0.6% in that state's companies relative to the nation as a whole, but most of that effect was driven by companies with higher Herfindahl indi-

ces — the noncompetitive industries.

The analysis suggests more about how managers in noncompetitive industries are acting, by looking at companies' cost structures. The authors find evidence that leaders in those industries are softer on spending. "CEOs want to have a quiet life. They don't want to argue and quarrel with other parties," says Mueller. "So they fight less hard with unions and with input suppliers. ... Cutting costs is a tough thing." When competition fails to enforce discipline on managers, weaker corporate governance indeed allows managers to taste the quiet life.



To be sure, the authors studied the corporate governance regime, not the governance of specific companies. So while they establish a causal relationship between a governance regime and corporate performance, they don't offer much on how to make boards more effective. In actuality, there is a great deal of heterogeneity of governance approaches and abilities among companies operating within a governance regime, a point the authors concede.

In addition, the study's measure of governance covers anti-takeover provisions; "bad governance" means shielding a company from hostile takeovers. Any director will tell you that the practice of governance involves many activities — including compliance with financial regulations, setting CEO pay and advising on strategy — to which anti-takeover provisions are only peripherally related.

So anti-takeover provisions may not be a perfect window into the boardroom.

Still, Mueller says, "It's one example of a change in corporate governance. We wanted to see if the effect is different for competitive and noncompetitive industries. It may be that another [kind of] change in corporate governance has a different effect. But this is one piece of evidence that firms in competitive industries are not affected by corporate governance."

The granddaddy of corporate governance laws, of course, was the Sarbanes-Oxley Act of 2002. Since the regulation applied across the entire country, it's hard to find a control to compare against, using the authors' methodology. However, Mueller says, "I would conjecture, if there were any way to measure it against a control group, that changes that improve governance should improve performance mainly for firms in noncompetitive industries."

What does that tell directors? "You have to watch management much more closely if it's sitting in a very comfortable position where it doesn't face much competition," says Mueller. "On the one hand, you can make a lot more profit if you don't face competition. On the other hand, those profits could be squandered by management."

For policy-makers, Mueller suggests a different conclusion. "If competition is really an effective governance mechanism, perhaps we should think about laws to make markets more competitive. It kills two birds with one stone: We don't have antitrust problems and we will have better corporate governance.

"In a sense it all boils down to Adam Smith, I suppose," Mueller adds. "We think about all these complex corporate governance mechanisms, but competitive pressure is perhaps the best mechanism."

For more information, download the paper from http://ssrn.com/abstract_id=1006118, or contact Holger Mueller at hmueller@stern.nyu.edu.

— Larry Yu

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