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Balancing Shareholder Rights vs. Managerial Authority by Loyalty Shares

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Abstract: The imbalance between shareholder rights and managerial authority can be regarded as the main reason for short-termism in corporate governance. So as to mitigate short-termism, a loyalty-share structure has been suggested to be an effective solution. By exploring the causes of short-termism, this essay focuses on how loyalty shares have effects on short-termism in business. Additionally, it evaluates potential risks of loyalty shares, including unfairness, unlimited dual-class share structure, loss of profits, and less liquidity. Finally, this essay demonstrates the assignment of loyalty shares can help to resolve the problem of short-termism derived from the imbalance between shareholder rights and managerial authority.

Keywords: corporate governance, short-termism, shareholder rights, managerial authority, loyalty shares.

1. Introduction

It seems that corporate short-termism has been a pressing global issue, and the sustainability of the firm is not the concern of the firm no longer. A report by Graham et al. estimates that most managers of firms can accept abandoning long-term value as the cost of pursuing short-term value.[1] According to Dallas, short-termism means shareholders or managers of the firm will focus on short-term results, including quarterly earnings and short-term portfolio returns, and ignore long-term value creation.[2] As the consequences of short-termism, Bolton and Samara worry about the lack of long-term investment opportunities, more active strategic planning, and fantastic innovation.[3]

Because of the trend of short-termism, there is a need for reform in corporate governance. Mio et al. support that loyalty shares can be regarded as an effective way to ensure corporate sustainability.[4] Against the traditional one-share-one-vote system, loyalty shares refer to shares of which holders holding for a required period of time can obtain certain rewards, including additional

[1] John Graham, Campbell Harvey and Shiva Rajgopal, "The Economic Implications of Corporate Financial Reporting" (National Bureau of Economic Research 2004) <http://dx.doi.org/10.3386/w10550> accessed September 12, 2021.

[2] Lynne L Dallas, "Short-Termism, the Financial Crisis, and Corporate Governance" (2012) 37 The Journal of Corporation Law 265, 268.

[3] Patrick Bolton and Frédéric Samama, "Loyalty-Shares: Rewarding Long-Term Investors" (2013) 25 Journal of Applied Corporate Finance 86, 86.

[4] Chiara Mio, Elise Soerger Zaro and Marco Fasan, "Are Loyalty Shares an Effective Antidote against Short-termism? Empirical Evidence from Italy" (2020) 29 Business Strategy and the Environment 1785, 1786.

dividends or voting power.[5] For example, if a shareholder has held his or her shares for 10 years, then the firm will give him or her more awards. Some firms will allow the loyalty shareholders to gain more dividends per year, and other firms are even willing to allow those shareholders to have more voting power when they attend the shareholder meetings. In this way, shareholders will be encouraged to hold their shares for a longer period of time, and they may pay more attention to the long-term development of the firm, which can be regarded as a useful tool to solve the short-termism in corporate governance.

The core problem is how to make a balance between the different values of the firm. It can be said that short-termism is derived from the firm's purpose of efficiency. This means if short-termism needs to be limited, then the efficiency of the firm will also be affected. For example, the one-share-one-vote system, which can be seemed like the basic ground of the structure of the firm, might be destroyed by those schemes for limiting short-termism. In other words, whether the efficiency of the firm will be affected and how to avoid unnecessary negative effects could be a significant concern. To take this risk into consideration, practical experience will be needed. This means this essay will pay attention to confirming, according to existing research, whether there has been enough evidence to prove that loyalty shares have unaffordable negative effects on the firm's efficiency. Therefore, first, this essay will begin by showing two potential sources of corporate short-termism. Next, how loyalty shares affect these sources will be discussed. Finally, the evaluation of potential risks of the loyalty-share structure will be provided. Based on this discussion, this essay will demonstrate that loyalty shares can be an effective tool to balance shareholder rights and managerial authority and mitigate corporate short-termism.

2. Causes of Short-termism

In order to find effective methods of addressing short-termism, it is crucial to search out the causes or sources of short-termism. Mio et al. summarise that there are two main drivers of short-termism, including shareholders (principals) and managers (agents). [6]

First, shareholders preferring to ensure that they can earn as much money as soon can drive the firm to pursue short-term interests. Although, generally speaking, shareholders are not the actual controllers of the firm, the capital market can still push pressure on managers to force them to make decisions to pursue short-termism interests. [7]

On the other hand, according to Mio et al.'s article, when managers focus on their self-interest, instead of long-term corporate value, they will also have a short-term horizon and make myopic decisions. [8] This means if they cannot obtain enough immediate payoffs, they may not pay attention to those innovations anymore. [9]

To summarise, there are two main types of short-termism, including shareholder-driven short-termism and manager-driven short-termism. And this is also the reason why it is difficult to balance shareholder rights and managerial authority. Because if shareholders are granted too many rights, then those holding short-term demands may force managers to pursue immediate benefits. On the contrary, if managers have more freedom without enough monitoring, they may tend to obtain immediate payoffs instead of long-term firm value. Therefore, it is crucial to find a way to avoid both short-term-oriented shareholders and short-term-oriented managers.

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[5] Jeroen Delvoie and Carl Clottens, "Accountability and Short-Termism: Some Notes on Loyalty Shares" (2015) 9 Law and Financial Markets Review 19, 19.

[6] Mio et al. (n 4) 1786.

[7] D Daniel Keum, "Innovation, Short-termism, and the Cost of Strong Corporate Governance" (2020) 42 Strategic Management Journal 3, 11.

[8] Mio et al. (n 4) 1785.

[9] Keum (n 7) 4.

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3. Potential Solution – Loyalty Shares

To what extent can loyalty shares have effects on two main sources of short-termism? More specifically, how can this system distinguish different types of shareholders and managers with different preferences?

First, because of the capital market pressure, the shareholders' preference seems to have more effects on managers. [10] This means if more shareholders are paying more attention to long-term corporate value in a firm, then more managers focusing on the long-term development of the firm will be supported. As a result, the firm can limit short-termism by attracting more shareholders to the long-term horizon.

However, as pointed out by Pozen, a company cannot assume that all of its shareholders would prefer long-term value. [11] Afterall, some investors regard holding shares as a method of earning as much money as possible. Although the firm tends to give more power or rights to shareholders who prefer to achieve the company's success in the long term, how to find those investors is a problem. Therefore, a way in which the firm can appeal to more long-term-oriented investors is needed.

So as to divide all public shareholders into different groups, a rewarding system can be helpful. Loyalty shares mean those shareholders who hold shares for a long period can be awarded more benefits. [12] Therefore, in order to maximise their own interests, shareholders of the firm choosing to issue loyalty shares will tend to hold shares for a longer time. As a result, they will not force managers to target short-term value. Afterall, only if the firm runs long enough, can they hold shares for a longer time.

On the other hand, loyalty shares give shareholders more promotion to monitor managers' actions. It seems to be obvious that, with enough monitoring from shareholders, managers tend to be consistent with investors' preferences. However, monitoring means a high cost to shareholders. Only if shareholders have enough returns, will they prefer to engage in costly actions. [13] And loyalty shares provide them more rewards for their monitoring or interventions. Mio et al. also agree with this perspective. [14]

Additionally, with more long-term investors attracted by the firm, managers can be given more confidence to target long-term firm value. [15] As a result, according to Dallas and Barry, loyalty shares may contribute to the change of corporate culture, which means the long-term value will be the main target of the firm. [16]

To summarise, as argued by Bolton & Samama,[17] loyalty shares can allow the firm to discriminate between short-term-oriented investors and long-term-oriented investors. Additionally, this system can help the firm to attract more shareholders and managers who focus on the firm's success in the long term.

[10] Keum (n 7) 8.

[11] Robert C Pozen, "How to Curb Short-Termism in Corporate America" (2015) 50 Business Economics 20, 22.

[12] Mio et al. (n 4), 1787.

[13] Patrick Bolton and Frédéric Samama, "Loyalty-Shares: Rewarding Long-Term Investors" (2013) 25 Journal of Applied Corporate Finance 86, 89-90.

[14] Mio et al. (n 4) 1789.

[15] Bolton and Samama (n 13) 92.

[16] Lynne L Dallas and Jordan M Barry, "Long-Term Shareholders and Time-Phased Voting" (2015) 40 Journal of Corporate Law 541, 571.

[17] Bolton and Samama (n 13) 90.

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4. Evaluation of Loyalty Shares

Although loyalty shares seem to have many effective advantages, there is still some concern about the potential risks of this structure. As shown below, there are four main challenges that loyalty shares may meet.

First, it is argued that the traditional one-share-one-vote system is a fairer design. Because the shares mean the contribution of shareholders, more contribution leads to more return benefits. However, shareholders' contribution includes not only the capital, but also costly monitoring. Now that some shareholders have provided more support for the long-term development of the firm, awarding them more profits can be viewed as a fair arrangement. On the contrary, if the firm insists traditional one-share-one-vote system, this means those long-term-oriented investors are burdened with the most of monitoring and intervention, however, the profits are shared by all the shareholders, which is unfair [18]. Therefore, Bolton & Samam note that loyalty shares create a new way to restore the balance between the benefits of long-term shareholders and short-term shareholders. [19]

Second, it is concerned whether loyalty shares lead to an unlimited dual-class share structure. Because one type of loyalty shares is to give long-term shareholders more voting rights or control rights. This seems similar to the design of the dual-class share structure. And the worsen point is that only if a shareholder holds shares for enough long period, his or her voting rights will not be limited by sunset clauses. Additionally, in the same firm, new shareholders will never have more voting rights than the old shareholders. On the other hand, it is also argued that it is not always true that long-term-oriented shareholders are better at decision-making than others. Therefore, giving them more voting rights may not be an appropriate option. This is indeed a problem; however, it is not too tough to solve it. In fact, if the firm limits the way of rewarding, for example, the firm only provides long-term investors more dividends, instead of voting rights, which means long-term holding can only obtain profits instead of power. By this way, the firm can attract long-term investors and avoid risks in decision-making at the same time.

Third, as Mio et al. are concerned, focusing too much on long-term value may lead to a significant loss in current profits.[20] According to the discussion in Keum's article, if managers are allowed to abandon current benefits, it will be difficult to check whether managers have worked hard enough for the firm value, which means managerial shirking may be a new problem.[21] Afterall, long-term value is a term that shareholders cannot define specifically. Therefore, it seems that, even for long-term development, current profits are still needed. However, according to Bajo et al., no evidence shows that the introduction of loyalty shares reduces the firm value. [22] Additionally, Mio et al.'s study based on Italian companies does not find obvious outcomes that whether firms with loyalty shares have lower/higher firm value.[23] Therefore, to confirm whether there will be negative influences on the firm value, more empirical evidence is needed.

Fourth, another counterargument is whether there will be less liquidity in markets with fewer short-term holders of shares, or perhaps other negative effects. In order to get enough rewards from the long-term shareholding, shareholders may refuse to contribute to the liquidity in the capital markets. This means the markets in the future may lack enough liquidity, which will have negative effects on the development of both firms and economics. Although whether there is any actual

[18] Bolton and Samama (n 13) 89-90.
[19] ibid 96.
[20] Mio et al. (n 4) 1787.
[21] Keum (n 7) 4.
[22] Emanuele Bajo and others, "Bolstering Family Control: Evidence from Loyalty Shares" (2020) 65 Journal of Corporate Finance 101755, 18.
[23] Mio et al. (n 4) 1787.

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negative effect on the firm seems not to be proved by enough evidence, this concern still needs to be observed for a long time.

5. Conclusion

In conclusion, this essay firstly showed how short-term-oriented shareholders and short-term-oriented managers lead to corporate short-termism. And this means the crucial way to limit short-termism is to grant appropriate shareholders more rewards.

Next, the essay analyzed that loyalty shares can contribute to mitigating short-termism. Because of the loyalty-share system, the benefits of long-term investors will be increased, and these rewards can encourage more investors to focus on the long-term development of the firm. Additionally, this system gives long-term investors more promotion to monitor managers, in order to prevent them from pursuing self-interest.

Then, this essay responded to the worry about the potential risks of loyalty shares. Most potential risks can be controlled by limiting the field of rewards to loyal shareholders. Granting them more financial benefits instead of voting rights can be a solution.

Therefore, this essay has demonstrated that it can be an appropriate method to mitigate corporate short-termism by loyalty shares. However, situations can be various in different countries, and practical experience is very important to improve the loyalty-share system. This means whether the model mentioned in this essay is appropriate for different companies in different regions needs to be examined by more research in the future.

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