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Enjoying the quiet life: Corporate decision-making by entrenched managers

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ABSTRACT

In this study, we empirically test “quiet life hypothesis,” which predicts that managers who are subject to weak monitoring from the shareholders avoid making difficult decisions such as risky investment and business restructuring with Japanese firm data. We employ cross-shareholder and stable shareholder ownership as the proxy variables of the strength of a manager's defense against market disciplinary power. We examine the effect of the proxy variables on manager-enacted corporate behaviors and the results indicate that entrenched managers who are insulated from disciplinary power of stock market avoid making difficult decisions such as large investments and business restructures. However, when managers are closely monitored by institutional investors and independent directors, they tend to be active in making difficult decisions. Taken together, our results are consistent with managerial quiet life hypothesis.

1. Introduction

For decades, Japan has suffered from low corporate profitability, low economic growth, and poor stock market performance. Despite unprecedented and prolonged monetary policy meant to boost the economy, capital investments in the corporate sector have remained stagnant. Some have attributed the low profitability of Japanese firms to their failure to restructure and their aversion to risk (which, in turn, has suppressed innovation). The failure of firms to restructure and innovate may be related to the fact that managers' interests may not always coincide with shareholders' interests. That is, managers may make decisions to maximize their own utility rather than maximize shareholders' wealth. For instance, managers may overinvest to grow a firm's size and increase their own private benefits. Given this problem, corporate governance may be useful for mitigating the conflict of the interest between managers and shareholders. To this end, some studies have suggested that corporate governance can assuage problems related to free cash flow/overinvestment (Jensen, 1986; Gompers et al., 2003; Harford, 1999). Interestingly, underinvestment on the part of managers has gone largely unexplored. This is likely because costs associated with under investment are relatively difficult to identify.¹

Hicks (1935) argued that managers of monopolistic enterprises that are insulated from competition in the product market may not be motivated to adequately enact their managerial duties; shirking their responsibilities increases their own utility. Hicks (1935) dubbed this practice the “quiet life.” In other words, Hicks argued that when

discipline from the product market is not sufficiently punitive, managers avoid difficult decisions and exert less effort. Hart (1983) also contended that discipline from the product market reduces managerial slack. Scharfstein (1988) and Schmidt (1997) came to similar conclusions.

This line of research was limited in its exclusive focus on discipline from the product market, but the quiet life hypothesis also includes discipline from the capital market (see Giroud and Mueller, 2010). This work shows that managers avoid making difficult decisions not only in companies protected from discipline from the product market, but also in companies that are protected from hostile takeovers or, more broadly, pressure from unfriendly shareholders. Bertrand and Mullainathan (2003) performed a critical study to empirically examine this extended version of the quiet life hypothesis. In this study, they focused on the introduction of state anti-takeover laws, which reduces the threat of a hostile takeover. More specifically, the authors used factory-level data in the US to evaluate how the introduction of state laws affects the corporate decision-making. Their results show that for companies with head offices located in the state where the anti-takeover legislation was passed, rates of factory construction and closure decreased, employees' wages increased, and the firm's financial performance suffered. These results were not consistent with the free cash flow hypothesis, which predicts that managers seek to increase their own prestige by maximizing firm size rather than shareholder value.

The quiet life hypothesis essentially predicts that managers avoid making difficult decisions when they are protected from the

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E-mail address: inoue.k.aq@m.titech.ac.jp (K. Inoue).¹ In this paper, we define investment as an increase of real assets. It does not include a decrease in real assets.

disciplinary effects of the capital market. Because increasing investments (e.g., new facility development, acquisitions, R&D) requires substantial effort on the part of managers, managers may decrease these investments, even if they are expected to increase firm value. This forms the basis of the quiet life hypothesis—when insulated from disciplinary effects of the capital market, managers often underinvest. Because many managers of Japanese firms are protected from the disciplinary effects of the stock market through cross-shareholding, the quiet life problem is cause for some concern. Despite the importance of the quiet life problem, there has been no empirical study of underinvestment problem caused by Japanese firm managers who entrenched themselves.

It is also possible that the under-investment problem or failing to restructure their unprofitable businesses can be explained by the career concern hypothesis (see [Holmström, 1999](#)). The career concern hypothesis predicts that when managers face pressure from shareholders and have resultant concern for their own careers, they avoid risky investments that may fail due to exogenous shocks. Although it is rare for managers of Japanese firms to fail to get approval for their own director nomination proposals in shareholder meetings, the increasing influence of foreign institutional investors can raise these career-related concerns.² Since friendly cross-shareholders reduce the career-related concerns held by managers, a higher ratio of these shareholders is likely to increase managers' confidence in their job security, and will therefore lead to an increase in risky investments. So, by examining the effects of cross-shareholding on corporate behaviors, it is possible to simultaneously test these competing hypotheses.

In this study, we examine the effects of cross-shareholding and stable shareholding on corporate behaviors among companies listed on the Tokyo Stock Exchange from 2004 to 2014. Results of our analyses show that managers of companies characterized by a high proportion of cross-shareholding and/or stable shareholding avoid making difficult decisions or risky choices (e.g., large investments, restructuring). We also find that monitoring by institutional investors and independent directors mitigates these effects. Our results are consistent with quiet life hypothesis, but not with the career concern or free cash flow hypothesis. In addition, among the three shareholder categories, zaibatsu group firms, industry group firms, and lender banks, which mainly constitute cross-shareholding, none of one specific group dominates the observed negative effects on corporate investments and restructuring behavior. At most we can tell is that industry group shareholders tend to impede M&A and restructuring behavior of the firms.

To address the issues outlined above, we have organized this paper into a series of interrelated sections. In the following section, we discuss the relatively recent phenomenon of cross-shareholding in Japan. Then, in [Section 3](#), we develop our hypotheses. In [Section 4](#), we describe the data and methods we employ to test the hypotheses. We present the results of these analyses in [Section 5](#). In [Section 6](#), we report the results of robustness checks on our main results. In [Section 7](#), we report relation between composition of cross-shareholders and corporate behavior, and we offer some concluding remarks in [Section 8](#).

2. Cross-shareholding and stable shareholding

When there is little threat of hostile takeover or shareholder intervention, firm managers are free to make decisions that increase their own utility because they are unlikely to be replaced. Related to this, [Bertrand and Mullainathan \(2003\)](#) explored the effects of a state anti-takeover law in the American manufacturing industry from 1976 to 1995. They found that for companies with head offices in states where

anti-takeover laws were passed, there were decreases in factory construction or closures, increases in worker wages, and worsened firm performance. [Bertrand and Mullainathan \(2003\)](#) results are consistent with the quiet life hypothesis; they indicate that the introduction of state anti-takeover laws resulted in a situation of moral hazard for the managers of companies located in those states.

Cross-shareholding is a mechanism that weakens the threat of takeovers and shareholder interventions. Because cross-shareholders are friendly to managers, they often refuse to sell their shares to the hostile acquirer when a takeover does occur. This reduces the likelihood of the takeover being successful.

There is real-world evidence of cross-shareholding arrangements strengthening the defense against hostile takeovers. When Mittal Steel acquired Arcelor (a European steel company) in early 2006 via unsolicited bid, Nippon Steel—the largest steel company in Japan—recognized the possibility that Mittal may next target it for acquisition. To defend against this possibility, Nippon Steel increased its cross-shareholding arrangements with many business counterparties including Sumitomo Metal Industries and Kobe Steel.

In Japan, the “poison pill” was introduced in 2005. However, to enact a poison pill in Japan, it is necessary for the general shareholder meeting to invoke its use. Therefore, if a company does not have a sufficient number of friendly shareholders (i.e., cross-shareholders and stable shareholders), the poison pill is unlikely to be enacted or effective ([Tanaka, 2012](#)).

Given the limitations of a poison pill, cross-shareholding is a more effective measure for thwarting hostile takeover attempts. This is why Nippon Steel enhanced its cross shareholding arrangements besides adopting poison pill to itself also in 2006. Therefore, in this study, we use the cross-shareholding ratio as a variable to measure the degree to which managers are subject to disciplinary effects of the stock market. The quiet life hypothesis dictates that when a company has a high cross-shareholding ratio, managers avoid making difficult business decisions.

For the purposes of this study, we define cross-shareholding as an interlocking ownership arrangement among related firms such as within zaibatsu (conglomerate-type corporate groups in Japan) and industry groups (horizontal or vertical corporate group consist of business transaction counterparts), and between lending banks and their borrowers. The concept of cross-shareholding in Japan initially developed in the late 1960s as a means to deter foreign takeovers ([Hoshi and Kashyap, 2001](#)).³ To this end, cross-shareholding has been largely successful; its practice has largely eliminated the possibility of hostile takeover of Japanese firms. Although attempts at hostile takeover are relatively rare in Japan, cross-shareholding also protects managers from shareholder activism and hostile block shareholders, particularly in shareholder meeting elections. Institutional owners and proxy advisory firms have recently gained in influence, but friendly shareholders still serve as a protective barrier for managers. Between 1997 and 2004, cross-shareholding declined as a result of banks selling their shares during a banking crisis ([Miyajima and Nitta, 2011](#)). Nevertheless, many firms still engage in cross-shareholding, and it still acts as a strong impediment to the exertion of shareholder power.

Stable shareholders, who retain blocks of a firm's shares for a long period of time through ongoing business relationships with the firm, play a similar role for managers as cross-shareholders. In most cases, stable shareholders act as friendly shareholders for incumbent managers, though they do not necessarily offer as much protection as cross-shareholders. Also distinct from cross-shareholding, stable shareholding is difficult to identify externally because it is not characterized by interlocking arrangements. So, although we analyze the effects of stable shareholding in conjunction with cross-shareholding, our primary focus is on the effects of the latter.

It is important to note that there is potentially a positive association

² In contrast, [Aghion et al. \(2013\)](#) found institutional investors reduce managers' concerns about their careers. However, collaboration between firm managers and institutional investors is rare in Japan. As such, we do not expect the same results as [Aghion et al. \(2013\)](#) in the Japanese context.

³ See p. 126 of [Hoshi and Kashyap \(2001\)](#) for details related to this.

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