European Corporate Governance and the New Economy
An ESF Exploratory Workshop

Scientific Report

1 EXECUTIVE SUMMARY

New technologies bring new topics on the research agenda. The world is changing and so are the insights relating to corporate governance in the new economy. A joint CEPR/ESF/ECGI exploratory workshop, that was held in Brussels on 13/14 April 2002, delivered several interesting topics for discussion ranging from an empirical analysis of the changing role of the stock market to more theoretical considerations of the role played by information in relation to optimal arrangement between management and monitor, information acquisition and capital structure, optimal contractual terms for innovations and venture capital.

The contributions could be broadly classified into two areas: information and finance, and innovation and venture capital. In the information and finance section it was for example highlighted that the different practices of corporate governance in Continental Europe and in the Anglo-Saxon model might be due to a trade-off between objectivity and proximity. It was also asked what the implications are of the growing migration of capital raising for the local stock market and how capital structure will affect the amount of information that is available about a firm and implications thereof. In the section of innovation and venture capital it was suggested that turning new ideas into a profitable business requires expertise in several fields of expertise related to this means, like technical feasibility and legal aspects of a new product. Also it was concluded that choice of organisation and financial structure of the R&D activity plays a strategic role by committing a research unit and its down steam firm to an accelerated R&D activity. At the end of the section venture capital contracts were discussed by attempting to establish regularities in soft data.

Overall, this conference managed to identify the important key issues and to redirect the attention of corporate governance researchers towards the new economy. Very little is generally known about corporate governance in the new economy. Governance experts are usually pre-occupied with the old economy, while new economy experts are usually pre-occupied with technological or anti-trust issues. Furthermore, due to the fragment of the European research community, we know less about new economy in Europe than in the United States. Furthermore, the scientific agenda is today in the top of the policy agenda, in Europe and elsewhere, where it is intimately related to the competitiveness of economy, incentives to innovate and to establish firms, and that of development of financial markets. This workshop has brought together European experts in governance and in the new economy for the first time, drawn from a variety of disciplines. This critical mass of scholars formulated a new, medium-term agenda for pan-European research in the new, exciting, and important field.

2 SCIENTIFIC REPORT

New technologies bring new topics on the research agenda. The world is changing and so are the insights relating to corporate governance in the new economy. A joint CEPR/ESF/ECGI exploratory workshop, that was held in Brussels on 13/14 April 2002, delivered several interesting topics for discussion ranging from an empirical analysis of the changing role of the stock market to more theoretical considerations of the role played by information in relation to optimal arrangement between management and monitor, information acquisition and capital structure, optimal contractual terms for innovations and venture capital.

The contributions could be broadly classified into two areas: information and finance, and innovation and venture capital.

Information and Finance

The workshop opened with a session on corporate governance and financial systems focusing on questions like what makes control effective, and in particular why do we observe different practices for corporate governance in Continental Europe and the Anglo-Saxon model. The former has an emphasis on the board of directors, whereas the latter puts more weight on the market for corporate control. The first paper, entitled '**Objectivity, Proximity and Adaptability in Corporate Governance' by Arnoud Boot (Universiteit van Amsterdam and CEPR) and Jonathan Macey (Cornell Univeristy**), highlighted why this may be the case by identifying that there will be a trade-off between objectivity and proximity. Thus the ideal solution with an informed and objective monitor may not be feasible, since once a monitor gets better informed there is a loss in terms of objectivity. They modelled this by assuming that the advantage of being informed is that corrective action can be taken at an earlier stage. Their key result is that 'the optimal arrangement between management and monitor (board or shareholders) should either capitalize on the better information that comes with proximity or seek to optimally exploit the objectivity that comes with distance.'

In the discussion that followed several participants commented on why this trade-off would arise. The psychological literature has suggested three reasons: (i) a theory of escalating commitments, (ii) cognitive bias, and (iii) self-perpetuating beliefs. Several suggestions were made of economic reasons for the existence of such a trade-off, such as the monitor caring about renewal of his contract (which was made by Josef Zechner, Universität Wien). Javier Suarez (CEMFI) suggested a story of collusion between informed and uninformed parties in a model where there is also someone who monitors the monitor.

The next issue on the agenda was the growing migration of capital raising, listing and trading activity to international exchange and it was asked what the implications are for the local stock exchange. In the second paper, entitled '**The Future of Stock Markets: Evolution and Prospects', Stijn Claessens (Univeriteit van Amsterdam and CEPR), Daniela Klingbiel (The World Bank) and Sergio Schmukler (The World Bank)** found that economies with higher income per capita, sounder macro economic policies, more efficient legal systems with better shareholder protection, and more open financial markets have larger and more liquid markets. As such fundamentals improve, however, the degree of migration to international exchanges also increases. The question is whether this would be a problem or not. Colin Mayer (University of Oxford) saw a problem insofar as there is a need for a local market for venture capital.

Another important issue that was addressed was how capital structure, debt to equity, will affect the amount of information that is available about a firm and implications thereof. In a paper entitled '**The Good Cop and the Bad Cop: Complementarities between Debt and Equity in Disciplining Management', Alexander Guembel (University of Oxford) and Lucy White (University of Oxford and CEPR)** propose a model where capital structure affects managerial incentives through its effect on incentives to acquire information. Their contribution offers the insight that the shareholders incentive to acquire information will be increased in the presence of a debt-holder that provides a credible commitment to shut down in the absence of good news. Thus debt and equity are shown to be complementary instruments in firm finance.

In the discussion that followed Zsuzsanna Fluck (Michigan State University) raised the point that debt holders may also have incentives to acquire information since they would become equity holders in the case of bankruptcy. Ulrich Hege (HEC) followed up on this point by concluding that the interests of the debt holders and shareholders are related to different maturities, and that the paper suggested that one should give control rights to short term debt holders.

Another aspect of the production of more information is that disclosing information may have external as well as an internal effect. Thus when a firm is faced with different audiences, such as the workers and the capital market, it would like to give different signals to different audiences. In a paper entitled '**Capital Structure and Transparency' by Andres Almazan (University of Texas), Javier Suarez (CEMFI and CEPR), and Sheridan Titman (University of Texas)** the point was made that firms that are more leveraged are forced to raise capital more often, a process that generates information about the firm. Low leverage is therefore a commitment not to disclose too much information, which will allow a firm to reduce the wage bill. This was shown in a model where there is both firm and worker heterogeneity, i.e. there is uncertainty both about whether a firm is a winner or not, and whether a worker is a quick or a slow learner. On the assumption that the firm cannot screen its employees, they analyse the wage that a firm will have to set to retain both types of workers when information is disclosed as well as when it is not. Several possible extensions of the model were brought up in the discussion that followed. Guido Friebel (SITE, Stockholm School of Economics) suggested that firms should be able to screen workers if workers could signal their types to the rest of the world. Paolo Fulghieri (INSEAD) further suggested that quick learners would be able to learn the type of the firm without disclosure. Another suggestion was to apply the story to a situation with consumers instead of workers as the second audience.

Colin Mayer concluded the session by bringing the conclusions from the last two papers together. Both papers showed that capital structure is important for information production and that debt holders are more eager to liquidate if there is a greater discrepancy in liquidation value. An example of that would be high-tech companies that have a low liquidation value because of human capital.

Innovation and Venture Capital

Coming up with novel ideas is just the first step in a long and costly process to the final marketing of a new product. The financing of R&D is therefore a crucial issue. One aspect of this is how to define the boundaries of the firm when it comes to R&D effort. If the expertise needed to evaluate and develop a new idea is not part of the firm there might be a problem of providing incentives to an expert not to steal a good idea. This idea was put forward in a paper entitled '**Entrepreneurs and New Ideas,' by Bruno Biais (Universite de Toulouse and CEPR) Enrico Perotti (Universiteit van Amsterdam and CEPR)**. They propose a model where a novel idea is seen as a new combination of existing means. Whether new ideas can be turned into a profitable business or not thus requires expertise in several fields related to this means. Examples of such fields could be technological feasibility and legal aspects of a new product. The problem is that an expert may have an incentive to steal a good idea when he is asked to evaluate it. However, since the implementability of the project is going to depend on positive responses from all experts the signals will be complementary rather than additive. This in turn implies that the entrepreneur will be able to design a partnership, unless the idea is too good.

An issue that was not dealt with in the paper is the possibility of exploiting experts, which was noted by Zsuzsanna Fluck. Guido Friebel suggested that an alternative arrangement would be partial disclosure to an expert in order to prevent him from stealing the idea.

Whether or not research is done in-house, affects not only whether ideas are being stolen, but it also might affect a firm's strategic position in competition with other firms. The strategic role of research alliances was highlighted in a paper entitled '**The Ownership and Financing of Innovation in R&D Races', Paolo Fulghieri (INSEAD and CEPR) and Merih Sevilir (INSEAD)**. They show that the choice of organization and financial structure of the R&D activity plays a strategic role by committing a research unit and its downstream firm to an accelerated R&D activity. They identify factors that will matter for whether the structure will be characterised by integration or not. One such factor is whether the R&D cycle involves early- or late-stage research, with more integration if the research is late-stage. Another factor is the intensity of competition in the R&D race, where more intense competition would lead to more integration. The final factor is the productivity of the research unit, where a more productive unit would lead to a less integrated structure.

This theoretical analysis was only concerned with the bargaining (strategic) position of the firms and did thus omit an analysis of contractual terms, as was pointed out by Ulrich Hege. Such contractual terms were however the final contributions to the workshop, consisting on empirical evidence in support of findings in the incomplete contracts literature as well as a theoretical discussion of existing contractual terms.

Two empirical papers by **Steven Kaplan (University of Chicago), Per Strömberg (University of Chicago and CEPR) and Frederic Martel (UBS Asset Management AG)** were the basis for an empirical discussion of venture capital contracts. The papers try to establish regularities in soft data.

In '**Venture Capital Contracts around the World'**, the authors conclude that although contracts differ across legal regimes, there seems to be few legal or tax rules that restrict the use of mechanisms that are very similar to the US ones. The results suggest that the limited accumulated experience in the European venture capital market, together with fixed costs of learning, are important for explaining the differences between European and US contracts.

In '**Characteristics, Contracts, and Actions: Evidence From Venture Capitalist Analyses'** the same authors find that greater asymmetric information risk is associated with more contingent compensation for the entrepreneur and greater VC control. Greater external risk is also associated with more VC control. Greater complexity is associated with less contingent compensation. The findings that founder pay-for-performance incentives increase in asymmetric information and decrease in complexity are consistent with theories of how to compensate managers when not all contingencies can be written into a contract.

The workshop concluded with a theoretical paper on contractual terms.

The use of put and call options, pre-emption rights, catch-up clauses, drag-along rights, demand rights, and tag-along rights in shareholder agreements, are argued to (i) preserve the incentives to make ex ante investments and (ii) minimize ex post transfers in a paper entitled '**An Analysis of Shareholder Agreements' by Gilles Chemla (University of British Columbia and CEPR), Michel Habib (London Business School), and Alexander Ljungqvist (New York University and CEPR).** One insight provided in the paper was that different rights might complement one another. Though the wide variety of contracts that are used in practice indicate the need to tailor in response to specific circumstances.

3 ASSESSMENT OF RESULTS

Very little is known about the corporate governance in the new economy. Governance experts are usually pre-occupied with the old economy, while new economy experts are usually pre-occupied with technological or anti-trust issues. Furthermore, due to the fragment of the European research community, we know less about new economy in Europe than in the United States. Yet the key issues which has traditionally motivated the study of corporate governance – how to reconcile the competing interests of owners and investors, managers and employees – is even more acute in new economy where so many assets are intangible such as human capital, ideas, and networks. The scientific agenda is today also in the top of the policy agenda, in Europe and elsewhere, where it is intimately related to the competitiveness of economy, incentives to innovate and to establish firms, and that of development of financial markets. This workshop has brought together European experts in governance and in the new economy for the first time, drawn from a variety of disciplines. This critical mass of scholars formulated a new, medium-term agenda for pan-European research in the new, exciting, and important field. The workshop contributed particularly in two broad areas of information and finance, and innovation and venture capital. In the information and finance section it was for example highlighted that the different practices of corporate governance in Continental Europe and in the Anglo-Saxon model might be due to a trade-off between objectivity and proximity. It was also asked what the implications are of the growing migration of capital raising for the local stock market and how capital structure will affect the amount of information that is available about a firm and implications thereof. In the section of innovation and venture capital it was suggested that turning new ideas into a profitable business requires expertise in several fields of expertise related to this means, like technical feasibility and legal aspects of a new product. Also it was concluded that choice of organisation and financial structure of the R&D activity plays a strategic role by committing a research unit and its down steam firm to an accelerated R&D activity. At the end of the section venture capital contracts were discussed by attempting to establish regularities in soft data. Overall, this conference managed to identify the important key issues and to redirect the attention of corporate governance researchers towards the new economy.

4 FINAL PROGRAMME

European Corporate Governance and the New Economy
An ESF Exploratory Workshop

Organized By CEPR and ECGI in Collaboration with ECARES

Brussels, 13/14 April 2002

Organization of the ESF Workshop on European Corporate Governance and the New Economy

Presenters present the papers and describe what they regard as being the most important research issues in the area. They have half an hour.

Authors discuss their own papers and describe what they regard as being the most important research issues in the area. They have quarter of an hour.

There is quarter of an hour for open discussion about both the papers and research issues in the area.

Chairmen should sum up the sessions and the rapporteur should provide a written summary of the papers, discussions and research areas.

SATURDAY 13 APRIL

12:30 – 14:00 Lunch

Session 1 ***Corporate Governance and Financial Systems***

Chair: Colin Mayer (University of Oxford and CEPR)

14:00 – 15:00 **Objectivity, Proximity and Adaptability in Corporate Governance**

Arnoud Boot (Universiteit van Amsterdam and CEPR)

Jonathan Macey (Cornell University)

Presenter: Marco Becht (ECARES, Université Libre de Bruxelles and ECGI)
Discussant: Arnoud Boot (Universiteit van Amsterdam and CEPR)

15:00 – 16:00 **The Future of Stock Markets: Evolution and Prospects**

	Stijn Claessens (Universiteit van Amsterdam and CEPR) Daniela Klingebiel (The World Bank) Sergio Schmukler (The World Bank)
Presenter: Discussant:	Joseph Zechner (Universität Wien and CEPR) Sergio Schmukler (The World Bank)
16:00 – 16:30	Tea and Coffee
Session 2	**Capital Structure**
Chair:	Colin Mayer (University of Oxford and CEPR)
16:30 – 17:30	**The Good Cop and the Bad Cop: Complementarities between Debt and Equity in Disciplining Management** Alexander Guembel (University of Oxford) Lucy White (University of Oxford and CEPR)
Presenter: Discussants:	Sudipto Bhattacharya (London School of Economics and CEPR) Alexander Guembel (University of Oxford) Lucy White (University of Oxford and CEPR)
17:30 – 18:30	**Capital Structure and Transparency** Andres Almazan (University of Texas) Javier Suarez (CEMFI and CEPR) Sheridan Titman (University of Texas)
Presenter: Discussant:	Giovanna Nicodano (Università di Torino) Javier Suarez (CEMFI and CEPR)
18:30	Conclusion
19:30	Dinner

SUNDAY 14 APRIL

Session 3	**Innovation**
Chair:	Marco Becht (ECARES, Université Libre de Bruxelles and ECGI)
08:30 – 09:30	**The Ownership and Financing of Innovation in R&D Races** Paolo Fulghieri (INSEAD and CEPR) Merih Sevilir (INSEAD)
Presenter: Discussant:	Ulrich Hege (HEC School of Management and CEPR) Paolo Fulghieri (INSEAD and CEPR)

09:30 – 10:30 **Entrepreneurs and New Ideas**
Bruno Biais (Université de Toulouse and CEPR)
Enrico Perotti (Universiteit van Amsterdam and CEPR)

Presenter: Guido Freibel (SITE, Stockholm School of Economics and CEPR)
Discussant: Enrico Perotti (Universiteit van Amsterdam and CEPR)

10.30 – 11:00 Tea and Coffee

Session 4 **Shareholder Agreements and Venture Capital Contracts**

Chair: Marco Becht (ECARES, Université Libre de Bruxelles and ECGI)

11.00 – 12:00 **Characteristics, Contracts, and Actions: Evidence from Venture Capitalist Analyses**
Steven Kaplan (University of Chicago)
Per Stromberg (University of Chicago and CEPR)
Frederic Martel (UBS, Asset Management AG)

Presenter: Lucy White (University of Oxford and CEPR)

Discussant: Per Stromberg (University of Chicago and CEPR)

The discussion will also draw on: **Venture Capital Contracts Around the World**
Steven Kaplan (University of Chicago)
Per Stromberg (University of Chicago and CEPR)
Frederic Martel (UBS, Asset Management AG)

12:00 – 13:00 **An Analysis of Shareholder Agreements**
Gilles Chemla (University of British Columbia and CEPR)
Michel Habib (London Business School)
Alexander Ljungqvist (New York University and CEPR)

Presenter: Zsuzanna Fluck (Michigan State University)
Discussant: Gilles Chemla (University of British Columbia and CEPR)

13:00 Conclusion followed by lunch

Organizers: Marco Becht (ECARES, Université Libre de Bruxelles and ECGI)
Colin Mayer (University of Oxford and CEPR)

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Guido Ferrarini (University of Genoa)
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Professor Gilles Chemla	CANADA	34
Professor Zsuzsanna Fluck	USA	
Dr Guido Friebel	SWEDEN	37
Professor Paolo Fulghieri	FRANCE	45
Dr Alexander Gümbel	UK	31
Professor Ulrich Hege	FRANCE	40
Dr Christoph Kaserer	SWITZERLAND	39
Professor Christine Mallin	UK	
Mr Frederic Martel	SWITZERLAND	33
Professor Colin Mayer	UK	49
Professor Giovanna Nicodano	ITALY	42

Dr Mikael Olsson	SWEDEN	36
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Dr Susanna Sällström	UK	33
Mr Sergio Schmukler	USA	34
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