Divorce between Ownership and Control

Ownership and control

The owners of a private sector company normally elect a **board of directors** to control the business’s resources for them. However, when the owner sells shares, or takes out a loan or bond to raise finance, they may sacrifice some of their control. Other shareholders can exercise their **voting rights**, and providers of loans often have some control (security) over the assets of the business. This may lead to a degree of conflict between them as these **different stakeholders** may have different objectives. The flow chart below attempts to show the possible divorce between ownership and control.

The Principal Agent Problem

How do the owners of a large business know that the managers they have employed and who are making the key day-to-day decisions operate with the aim of maximising shareholder value in both the short term and the long run?

This lack of information is known as the **principal-agent problem**. In other words, one person, the principal, employs an agent (e.g. a sales or finance manager) to perform tasks on his behalf but he or she cannot ensure that the agent always performs them in precisely the way the principal would like. The decisions and the performance of the agent are both impossible and expensive to monitor and the **incentives of the agent may differ from those of the principal**. The principal agent problem is illustrated in the flow chart above.

Examples of the principal-agent problem that have hit the headlines recently in the UK include the mis-management of financial assets on behalf of investors (e.g. the case surrounding **Equitable Life**) and the
management of companies on behalf of shareholders (e.g. during the turbulent years experienced by Marks and Spencer and Shell). The classic case in the United States is of course the Enron fraud and debacle. Follow this BBC news link for more background on the Enron case.

**Incentives Matter! - Employee Share Ownership Schemes**

There are various strategies available for coping with the principle-agent problem. One is the rapid expansion of employee share-ownership schemes and share-options programmes. The government has encouraged the wider use of share-ownership schemes through a series of tax incentives. But the use and occasional misuse of share options schemes has been controversial for several years. A recent example involved the US computer giant Apple.

**The growth of "shareholder activism"**

Many commentators question the assumption that shareholders play little direct role in influencing corporate strategy in modern corporations. There are plenty of examples in recent times when both institutional and individual shareholders have exercised their voting rights to express views on the direction that a company is taking or its performance. Typically they are critical of a perceived failure of a business to maximise shareholder value measured in terms of share price, the flow of dividend incomes etc.

An activist shareholder uses an equity stake in a business to put pressure on its management. The expansion of hedge funds has cemented the idea of shareholder activism. Many hedge funds take minority equity stakes and try to get the existing management to divest poorly performing or unprofitable parts of a business and focus instead on core activities.

Environmental groups such as Friends of the Earth have also latched onto the potential for shareholder activism to impact on businesses especially in the areas of the environmental impact of their business activities.

That said it remains the case that the general pattern of ownership and control within British industry is relatively dispersed. Typically the largest shareholder in any large business listed on the stock market is likely to own a minority of the shares. Majority ownership by a single shareholder is unusual. The usual presumption from this is that only the largest shareholders have any incentive to participate in corporate decision making and few individual shareholders have real voting power.

**Examples of recent shareholder activism**

**Sainsbury’s:** In 2004, a third of J Sainsbury’s shareholders voted against the supermarket’s pay policy, objecting to its decision to give a £2.3m bonus to ousted chairman Sir Peter Davis. Sainsbury’s subsequently decided to cancel the controversial pay award. Sir Peter Davis quit Sainsbury’s after a group of major institutional shareholders demanded management changes. He was replaced by Justin King.

**Disney:** In 2004, Michael Eisner, the chairman and chief executive of Disney, resigned after 43% of Disney shareholders voted against his re-election.

**EuroTunnel:** In 2004, the management board of EuroTunnel was ousted at the company's AGM.

**Vodafone:** In May of 2006, Vodafone announced the biggest loss in British corporate history (£14.9 billion). In July 2006, the CEO of Vodafone Arun Sarin came under huge pressure from a group of shareholders unhappy about the performance of the struggling telecoms company. In
the event, shareholders voted 86% in favour of Mr Sarin, with 9.5% voting against, and 4.5% abstaining.

**Daimler-Chrysler**: In April 2007, about 9,000 shareholders attended the German-US carmaker’s annual meeting and voiced strong criticisms of the businesses’ performance. Many shareholders stood up during the meeting to condemn the transatlantic merger which took place between Daimler-Benz and Chrysler in 1998.

**More reading on shareholder activism:**

### Shareholder activism at Woolworths

In many modern corporations there is a **divorce between ownership and control**. Many shareholders who have an equity investment in a business exert no day to day control or influence over the decisions of management. The rapid expansion of private equity is changing this view. Private equity funds such as Primera and KKR typically exercise a very active control and management of the companies in which they invest, and often bring in new management teams that focus on making the company more valuable and realise greater **shareholder value**.

Icelandic management company **Baugur**, the largest shareholder in Woolworths has told the senior management team to get its act together! **Baugur** is critical of the decision by Woolworths to spend millions of pounds over the last five years refurbishing some of Woolworths’ 800 stores at a time when they are suffering sliding sales and making losses. Woolworths has come under great pressure in the retail market in the UK. The major supermarkets are undercutting them when it comes to selling stationery, toys and music. Woolworths, traditionally the haunt of people looking for cut price CDs and DVDs is also being hit by the rapid expansion of online retailing as the broadband revolution continues apace. In March 2007 Woolworths **announced terrible financial results**. Full-year pre-tax profits sank to £16m from £61.5m a year earlier as like-for-like sales fell by 6.6%.

Baugur has controlling interests in the department store chain House of Fraser and many well known fashion retail chains including French Connection. Baugur also acquired the British toy shop chain Hamleys in 2003, followed by Mappin & Webb, the British jewellry chain, in 2005.

*Adapted from news sources and the Tutor2u blog, April 2007*

### Corporate Social Responsibility and Business Ethics

**Business ethics** is concerned with the **social responsibility of management** towards the firm’s stakeholders, the environment and society in general. There is a growing belief that ethical and ‘green’ business are linked to improved business performance because of increased public concern for human rights and the environment. Many businesses are now trumpeting their progress in making their activities **carbon neutral** by offsetting the impact of their production activities on their environment through offset activities. Businesses such as **Carbon Clear** provide a means by which organisations can find ways to offset their carbon emissions.

Business ethics extends to treating stakeholders ‘fairly’; hence the growing emphasis on health and safety issues, good working practices and the like in business decision-making.

For more reading on this try this link to the Institute for Business Ethics. The Times 100 Case Studies includes one on **Cadbury’s and corporate social responsibility**. [Click here for BBC news articles](https://www.bbc.com) on carbon neutrality.