

Corporate duty waivers limit organic company growth and innovation, with R&D investment falling by nearly one fifth

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Research co-authored by Bayes Business School (formerly Cass) shows that larger public companies suffer from loss of innovation and lower

share price value when managers are permitted to make decisions in their own self-interest rather than that of the organization.

The study, by Anh Tran, Professor of Finance and Academic Director in the Mergers and Acquisitions Research Center (MARC) at Bayes, Professor Eliezer Fich, Drexel University and Professor Jarrad Harford, University of Washington, examined the effects of waiving fiduciary duties—effectively the agreement that management makes decisions to benefit an organization rather than itself—in the United States following gradual relaxations in state law.

Agency conflicts arise when managers and shareholder interests diverge, most commonly in the event of managers accepting contracts for extra remuneration or to further their own careers, or through a "corporate opportunity waiver." As the study suggests, these conflicts become more problematic in larger corporations where there is greater distance between shareholders and decision makers.

Key findings of the research include:

- Investment in research and development (R&D) falls by 19%, firm patent value falls by 18% and patent volume declines by 9% in the year after fiduciary waivers are adopted and remain lower thereafter.
- The contribution of remaining R&D spend and incremental patent value are also lowered by waiving fiduciary laws. A 1% rise in R&D intensity yields a 0.4% increase in market value with a waiver, down from 0.52% without.
- Firms who undergo waiver laws experience a higher rate of inventor and skilled employee departures. Those who possess the most talent are more likely to leave for startups, while those who remain are less productive in terms of their innovation, obtaining 1.4% fewer patents and 5.5% fewer citations than before the

waiver was put in place.

- Firm value increases by \$0.85 for holding an additional dollar of cash reserves but this effect is seven to 12% lower than prior to adopting a waiver.
- Once adopting the waiver, firms are more likely to make acquisition bids but their deals are of lower quality. The deal announcement returns are on average 77 basis points lower and these acquirers are less likely to withdraw from acquisitions with negative returns than without legal waivers in place.
- Higher managerial ownership and a higher proportion of independent directors on the board reduce negative effects of adopting waivers. Small companies benefit, in fact, because relaxing fiduciary duty enables them to attract capital from venture capital and private equity investors while retaining experienced individuals. Removing them would make this harder to accomplish due to the overlapping or fiduciary duties with other firms.

Firm-level data to calculate R&D activity and quality of innovation used a merged dataset between CRSP and Compustat for a sample of 76,558 firm-year observations for 9,692 unique U.S. firms from 1996 to 2017.

Inventor-level analysis was also carried out to determine "inventor mobility" and "stayer productivity" in line with new powers of flexibility given to management in the event of a corporate waiver. Data for this was provided by USPTO's PatentViews database and previous research from Kogan et al (2017), which yielded almost 800,000 unique inventors employed in the United States between 1996 and 2018—with a resulting sample of over six million inventor-employer-year observations.

Professor Tran said the study proved the value of reducing agency conflicts and giving managers and innovators enough license to further their own interests without wishing to look elsewhere.

"Directors and managers of public corporations in the U.K. and across the world have fiduciary duties towards their firm's shareholders," Professor Tran said.

"One of these is the duty of loyalty in which managers must put their shareholders' interests ahead of their own. If such a duty is vacated, these shareholder interests become compromised, dropping the value of the firm in terms of share price and level of innovation."

In spite of the issues caused to larger organizations by corporate waiver legislation, Professor Tran said more could be done to mitigate the issue of agency conflicts.

"Providing incentives such as better pay and performance-related remuneration is just one mechanism by which larger organizations can keep their top talent to ensure organic innovation and growth," he continued.

"External mechanisms such as monitoring by institutional investors, equity analysts, and regulators have also been shown in the literature to be successful in reducing agency problems.

"Small businesses and start-ups, in contrast to large public companies, benefit from waivers of fiduciary duties because they can enjoy greater flexibility in raising capital from [venture capital](#) and private equity, while they are modeled more closely towards manager-ownership which in itself eliminates conflict between the two parties.

"Our research informs broader literature on how corporate governance and loyalty duties are critical in generating shareholder value."

"Disloyal Managers and Shareholders' Wealth" by Professor Anh Tran, Professor Eliezer Fich and Professor Jarrad Harford is published in *The*

Review of Financial Studies.

More information: Eliezer M Fich et al, Disloyal Managers and Shareholders' Wealth, *The Review of Financial Studies* (2022). [DOI: 10.1093/rfs/hhac070](https://doi.org/10.1093/rfs/hhac070)

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