CHAPTER 2

THE OBJECTIVE IN DECISION MAKING

“If you do not know where you are going, it does not matter how you get there”

Anonymous

Corporate finance’s greatest strength and its greatest weaknesses is its focus on value maximization. By maintaining that focus, corporate finance preserves internal consistency and coherence, and develops powerful models and theory about the “right” way to make investment, financing and dividend decisions. It can be argued, however, that all of these conclusions are conditional on the acceptance of value maximization as the only objective in decision-making.

In this chapter, we consider why we focus so strongly on value maximization and why, in practice, the focus shifts to stock price maximization. We also look at the assumptions needed for stock price maximization to be the right objective, the things that can go wrong with firms that focus on it and at least partial fixes to some of these problems. We will argue strongly that, even though stock price maximization is a flawed objective, it offers far more promise than alternative objectives because it is self-correcting.

Choosing the Right Objective

Let us start with a description of what an objective is, and the purpose it serves in developing theory. An objective specifies what a decision maker is trying to accomplish and by so doing, provides measures that can be used to choose between alternatives. In most firms, it is the managers of the firm, rather than the owners, who make the decisions about where to invest or how to raise funds for an investment. Thus, if stock price maximization is the objective, a manager choosing between two alternatives will choose the one that increases stock price more. In most cases, the objective is stated in terms of maximizing some function or variable, such as profits or growth, or minimizing some function or variable, such as risk or costs.

So why do we need an objective, and if we do need one, why cannot we have several? Let us start with the first question. If an objective is not chosen, there is no
systematic way to make the decisions that every business will be confronted with at some point in time. For instance, without an objective, how can Disney's managers decide whether the investment in a new theme park is a good one? There would be a menu of approaches for picking projects, ranging from reasonable ones like maximizing return on investment to obscure ones like maximizing the size of the firm, and no statements could be made about their relative value. Consequently, three managers looking at the same project may come to three separate conclusions about it.

If we choose multiple objectives, we are faced with a different problem. A theory developed around multiple objectives of equal weight will create quandaries when it comes to making decisions. To illustrate, assume that a firm chooses as its objectives maximizing market share and maximizing current earnings. If a project increases market share and current earnings, the firm will face no problems, but what if the project being analyzed increases market share while reducing current earnings? The firm should not invest in the project if the current earnings objective is considered, but it should invest in it based upon the market share objective. If objectives are prioritized, we are faced with the same stark choices as in the choice of a single objective. Should the top priority be the maximization of current earnings or should it be maximizing market share? Since there is no gain, therefore, from having multiple objectives, and developing theory becomes much more difficult, we would argue that there should be only one objective.

There are a number of different objectives that a firm can choose between, when it comes to decision making. How will we know whether the objective that we have chosen is the 'right' objective? A good objective should have the following characteristics --

(a) It is clear and unambiguous. An objective that is ambiguous will lead to decision rules that vary from case to case and from decision-maker to decision-maker. Consider, for instance, a firm that specifies its objective to be increasing growth in the long term. This is an ambiguous objective since it does not answer at least two questions. The first is growth in what variable - Is it in revenue, operating earnings, net income or earnings per share? The second is in the definition of the long term: Is it 3 years, 5 years or a longer period?
(b) It comes with a *clear and timely measure* that can be used to evaluate the success or failure of decisions. Objectives that sound good but that do not come with a measurement mechanism are likely to fail. For instance, consider a retail firm that defines its objective as “maximizing customer satisfaction”. How exactly is customer satisfaction defined and how is it to be measured? If no good mechanism exists for measuring how satisfied customers are with their purchases, not only will managers be unable to make decisions based upon this objective, but stockholders will also have no way of holding them accountable for any decisions that they do make.

(c) It *does not create costs for other entities or groups* that erase firm-specific benefits and leave society worse off overall. As an example, assume that a tobacco company defines its objective to be revenue growth. Managers of this firm would then be inclined to increase advertising to teenagers, since it will increase sales. Doing so may create significant costs for society that overwhelm any benefits arising from the objective. Some may disagree with the inclusion of social costs and benefits and argue that a business only has a responsibility to its stockholders and not to society. This strikes us as short sighted because the people who own and operate businesses are part of society.

**The Classical Objective**

*There is general agreement, at least among corporate finance theorists that the objective when making decisions in a business is to maximize value.* There is some disagreement on whether the objective is to maximize the value of the stockholder’s stake in the business or the value of the entire business (firm), which includes besides stockholders, the other financial claim holders (debt holders, preferred stockholders etc.). Furthermore, even among those who argue for stockholder wealth maximization, there is a question about whether this translates into maximizing the stock price. As we will see in this chapter, these objectives vary in terms of the assumptions that are needed to justify them. The least restrictive of the three objectives, in terms of assumptions needed, is to maximize the firm value and the most restrictive is to maximize the stock price.

**Multiple Stakeholders and Conflicts of Interest**

In the modern corporation, stockholders hire managers to run the firm for them; these managers then borrow from banks and bondholders to finance the firm’s operations.
Investors in financial markets respond to information about the firm revealed to them by the managers and firms have to operate in the context of a larger society. By focusing on maximizing stock price, corporate finance exposes itself to several risks. First, the managers who are hired to operate the firm for stockholders may have their own interests that deviate from those of stockholders. Second, stockholders can sometimes be made wealthier by decisions that transfer wealth from those who have lent money to the firm. Third, the information that investors respond to in financial markets may be misleading, incorrect or even fraudulent, and the market response may be out of proportion to the information. Finally, firms that focus on maximizing wealth may create significant costs for society that do not get reflected in the firm’s bottom line.

These conflicts of interests are exacerbated further when we bring in two additional stakeholders in the firm. First, the employees of the firm may have little or no interest in stockholder wealth maximization and may have a much larger stake in improving wages, benefits and job security. In some cases, these interests may be in direct conflict with stockholder wealth maximization. Second, the customers of the business will probably prefer that products and services be priced lower to maximize their utility, but this again may conflict with what stockholders would prefer.

**Potential Side Costs of Value Maximization**

If the objective when making decisions is to maximize firm value, there is a possibility that what is good for the firm may not be good for society. In other words, decisions that are good for the firm, insofar as they increase value, may create social costs. If these costs are large, we can see society paying a high price for value maximization and the objective will have to be modified to allow for these costs. To be fair, however, this is a problem that is likely to persist in any system of private enterprise and is not peculiar to value maximization. The objective of value maximization may also face obstacles when there is separation of ownership and management, as there is in most large public corporations. When managers act as agents for the owners (stockholders), there is the potential for a conflict of interest between stockholder and managerial interests, which in turn can lead to decisions that make managers better off at the expense of stockholders.
When the objective is stated in terms of stockholder wealth, the conflicting interests of stockholders and bondholders have to be reconciled. Since stockholders are the decision-makers, and bondholders are often not completely protected from the side effects of these decisions, one way of maximizing stockholder wealth is to take actions that expropriate wealth from the bondholders, even though such actions may reduce the wealth of the firm.

Finally, when the objective is narrowed further to one of maximizing stock price, inefficiencies in the financial markets may lead to misallocation of resources and bad decisions. For instance, if stock prices do not reflect the long term consequences of decisions, but respond, as some critics say, to short term earnings effects, a decision that increases stockholder wealth (which reflects long term earnings potential) may reduce the stock price. Conversely, a decision that reduces stockholder wealth, but increases earnings in the near term, may increase the stock price.

**Why Corporate Finance Focuses on Stock Price Maximization**

Much of corporate financial theory is centered on stock price maximization as the sole objective when making decisions. This may seem surprising given the potential side costs listed above, but there are three reasons for the focus on stock price maximization in traditional corporate finance.

- Stock prices are the most observable of all measures that can be used to judge the performance of a publicly traded firm. Unlike earnings or sales, which are updated once every quarter or even once every year, stock prices are updated constantly to reflect new information coming out about the firm. Thus, managers receive instantaneous feedback from investors on every action that they take. A good illustration is the response of markets to a firm announcing that it plans to acquire another firm. While managers consistently paint a rosy picture of every acquisition that they plan, the stock price of the acquiring firm drops in roughly half of all acquisitions, suggesting that markets are much more skeptical about managerial claims.

- If investors are rational and markets are efficient, stock prices will reflect the long-term effects of decisions made by the firm. Unlike accounting measures like
earnings or sales measures such as market share, which look at the effects on current operations of decisions made by a firm, the value of a stock is a function of the long-term health and prospects of the firm. In a rational market, the stock price is an attempt on the part of investors to measure this value. Even if they err in their estimates, it can be argued that a noisy estimate of long-term value is better than a precise estimate of current earnings.

- Finally, choosing stock price maximization as an objective allows us to make categorical statements about what the best way to pick projects and finance them is.

2.1. **☞**: Which of the following assumptions do you need to make for stock price maximization to be the only objective in decision making?

- a. Managers act in the best interests of stockholders
- b. Lenders to the firm are fully protected from expropriation.
- c. Financial markets are efficient.
- d. There are no social costs.
- e. All of the above
- f. None of the above

**In Practice: What is the objective in decision making in a private firm or a non-profit organization?**

The objective of maximizing stock prices is a relevant objective only for firms that are publicly traded. How, then, can corporate finance principles be adapted for private firms? For firms that are not publicly traded, the objective in decision-making is the maximization of firm value. The investment, financing and dividend principles we will develop in the chapters to come apply for both publicly traded firms, which focus on stock prices, and private businesses, that maximize firm value. Since firm value is not observable and has to be estimated, what private businesses will lack is the feedback, sometimes unwelcome, that publicly traded firms get from financial markets, when they make major decisions.
It is, however, much more difficult to adapt corporate finance principles to a not-for-profit organization, since it’s objective is often to deliver a service in the most efficient way possible, rather than to make profits. For instance, the objective of a hospital may be stated as delivering quality health care at the least cost. The problem, though, is that someone has to define the acceptable level of care and the friction between cost and quality will underlie all decisions made by the hospital.

Maximize Stock Prices: The Best Case Scenario

If corporate financial theory is based on the objective of maximizing stock prices, it is worth asking when it is reasonable to ask managers to focus on this objective to the exclusion of all others. There is a scenario where managers can concentrate on maximizing stock prices to the exclusion of all other considerations and not worry about side costs. For this scenario to unfold, the following assumptions have to hold:

1. *The managers of the firm put aside their own interests and focus on maximizing stockholder wealth.* This might occur either because they are terrified of the power stockholders have to replace them (through the annual meeting or the board of directors) or because they own enough stock in the firm that maximizing stockholder wealth becomes their objective as well.

2. *The lenders to the firm are fully protected from expropriation by stockholders.* This can occur for one of two reasons. The first is a reputation effect, i.e., that stockholders will not take any actions that hurt lenders now if they feel that doing so might hurt them when they try to borrow money in the future. The second is that lenders might be able to protect themselves fully when they lend by writing in covenants proscribing the firm from taking any actions that hurt them.

3. *The managers of the firm do not attempt to mislead or lie* to financial markets about the firm’s future prospects, and there is sufficient information for markets to make judgments about the effects of actions on long-term cash flows and value. Markets are assumed to be *reasoned and rational* in their assessments of these actions and the consequent effects on value.

4. *There are no social costs or social benefits.* All costs created by the firm in its pursuit of maximizing stockholder wealth can be traced and charged to the firm.
With these assumptions, there are no side costs to stock price maximization. Consequently, managers can concentrate on maximizing stock prices. In the process, stockholder wealth and firm value will be maximized and society will be made better off. The assumptions needed for the classical objective are summarized in pictorial form in figure 2.1.

*Figure 2.1: Stock Price Maximization: The Costless Scenario*

**Maximize Stock Prices: Real World Conflicts of Interest**

Even a casual perusal of the assumptions that we need for stock price maximization to be the only objective when making decisions suggests that there are potential shortcomings in each one. Managers might not always make decisions that are in the best interests of stockholders, stockholders do sometimes take actions that hurt lenders, information delivered to markets is often erroneous and sometimes misleading and there are social costs that cannot be captured in the financial statements of the company. In the section that follows, we will consider some of the ways in which real world problems might trigger a break down in the stock price maximization objective.
Stockholders and Managers

In classical corporate financial theory, stockholders are assumed to have the power to discipline and replace managers who do not maximize their wealth. The two mechanisms that exist for this power to be exercised are the annual meeting, where stockholders gather to evaluate management performance, and the board of directors, whose fiduciary duty it is to ensure that managers serve stockholders’ interests. While the legal backing for this assumption may be reasonable, the practical power of these institutions to enforce stockholder control is debatable. In this section, we will begin by looking at the limits on stockholder power and then examine the consequences for managerial decisions.

The Annual Meeting

Every publicly traded firm has an annual meeting of its stockholders, during which stockholders can both voice their views on management and vote on changes to the corporate charter. Most stockholders, however, do not go to the annual meetings, partly because they do not feel that they can make a difference and partly because it would not make financial sense for them to do so.1 It is true that investors can exercise their power with proxies2, but incumbent management starts of with a clear advantage3. Many stockholders do not bother to fill out their proxies, and even among those who do, voting for incumbent management is often the default option. For institutional stockholders, with significant holdings in a large number of securities, the easiest option, when dissatisfied with incumbent management, is to vote with their feet, i.e., sell their stock and move on. An activist posture on the part of these stockholders would go a long way towards making managers more responsive to their interests, and there are trends towards more activism, which will be documented later in this chapter.

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1 An investor who owns 100 shares of stock in Coca Cola will very quickly wipe out any potential returns he makes on his investment if he flies to Atlanta every year for the annual meeting.

2 A proxy enables stockholders to vote in absentia for boards of directors and for resolutions that will be coming to a vote at the meeting. It does not allow them to ask open-ended questions of management.

3 This advantage is magnified if the corporate charter allows incumbent management to vote proxies that were never sent back to the firm. This is the equivalent of having an election where the incumbent gets the votes of anybody who does not show up at the ballot box.
The Board of Directors

The board of directors is the body that oversees the management of a publicly traded firm. As elected representatives of the stockholders, the directors are obligated to ensure that managers are looking out for stockholder interests. They can change the top management of the firm and have a substantial influence on how it is run. On major decisions, such as acquisitions of other firms, managers have to get the approval of the board before acting.

The capacity of the board of directors to discipline management and keep them responsive to stockholders is diluted by a number of factors.

(1) Most individuals who serve as directors do not spend much time on their fiduciary duties, partly because of other commitments and partly because many of them serve on the boards of several corporations. Korn Ferry\(^4\), an executive recruiter, publishes a periodical survey of directorial compensation and time spent by directors on their work illustrates this very clearly. In their 1992 survey, they reported that the average director spent 92 hours a year on board meetings and preparation in 1992, down from 108 in 1988, and was paid $32,352, up from $19,544 in 1988\(^5\). While their 1998 survey did not measure the hours directors spent on their duties, it does mention that their average compensation has climbed to $37,924. As a result of scandals associated with lack of board oversight at companies like Enron and Worldcom, directors have come under more pressure to take their jobs seriously. The Korn-Ferry survey in 2002 noted an increase in hours worked by the average director to 183 hours a year and a corresponding surge in compensation.

(2) Even those directors who spend time trying to understand the internal workings of a firm are stymied by their lack of expertise on many issues,

\(^4\)Korn-Ferry surveys the boards of large corporations and provides insight into their composition.

\(^5\) This understates the true benefits received by the average director in a firm, since it does not count benefits and perquisites - insurance and pension benefits being the largest component. Hewitt Associates, an executive search firm, reports that 67% of 100 firms that they surveyed offer retirement plans for their directors.
especially relating to accounting rules and tender offers, and rely instead on outside experts.

(3) In some firms, a significant percentage of the directors work for the firm, can be categorized as insiders and are unlikely to challenge the CEO. Even when directors are outsiders, they are not independent, insofar as the company's Chief Executive Officer (CEO) often has a major say in who serves on the board. Korn Ferry's annual survey of boards also found, in 1988, that 74% of the 426 companies it surveyed relied on recommendations by the CEO to come up with new directors, while only 16% used a search firm. In its 1998 survey, Korn Ferry did find a shift towards more independence on this issue, with almost three-quarters of firms reporting the existence of a nominating committee that is, at least, nominally independent of the CEO. The 2002 survey confirmed a continuation of this shift.

(4) The CEOs of other companies are the favored choice for directors, leading to a potential conflict of interest, where CEOs sit on each other’s boards.

(5) Most directors hold only small or token stakes in the equity of their corporations, making it difficult for them to empathize with the plight of shareholders, when stock prices go down. In a study in the late 1990s, Institutional Shareholder Services, a consultant, found that 27 directors at 275 of the largest corporations in the United States owned no shares at all, and about 5% of all directors owned fewer than five shares.

The net effect of these factors is that the board of directors often fails at its assigned role, which is to protect the interests of stockholders. The CEO sets the agenda, chairs the meeting and controls the information, and the search for consensus generally overwhelms any attempts at confrontation. While there is an impetus towards reform, it has to be noted that these revolts were sparked not by board members, but by large institutional investors.

The failure of the board of directors to protect stockholders can be illustrated with numerous examples from the United States, but this should not

Greenmail: Greenmail refers to the purchase of a potential hostile acquirer’s stake in a business at a premium over the price paid for that stake by the target company.
blind us to a more troubling fact. Stockholders exercise more power over management in the United States than in any other financial market. If the annual meeting and the board of directors are, for the most part, ineffective in the United States at exercising control over management, they are even more powerless in Europe and Asia as institutions that protect stockholders.

**The Consequences of Stockholder Powerlessness**

If the two institutions of corporate governance -- annual meetings and the board of directors -- fail to keep management responsive to stockholders, as argued in the previous section, we cannot expect managers to maximize stockholder wealth, especially when their interests conflict with those of stockholders. Consider the following examples.

1. **Fighting Hostile Acquisitions**

   When a firm is the target of a hostile takeover, managers are sometimes faced with an uncomfortable choice. Allowing the hostile acquisition to go through will allow stockholders to reap substantial financial gains but may result in the managers losing their jobs. Not surprisingly, managers often act to protect their interests, at the expense of stockholders:

   - The managers of some firms that were targeted by acquirers (raiders) for hostile takeovers in the 1980s were able to avoid being acquired by buying out the raider's existing stake, generally at a price much greater than the price paid by the raider and by using stockholder cash. This process, called *greenmail*, usually causes stock prices to drop but it does protect the jobs of incumbent managers. The irony of using money that belongs to stockholders to protect them against receiving a higher price on the stock they own seems to be lost on the perpetrators of greenmail.

   - Another widely used anti-takeover device is a *golden parachute*, a provision in an employment contract that allow for the payment of a lump-sum or cash flows over a period, if the manager covered by the contract loses his or her job in a takeover. While there are economists who have justified the payment of golden parachutes...
as a way of reducing the conflict between stockholders and managers, it is still unseemly that managers should need large side-payments to do that which they are hired to do--maximize stockholder wealth.

• Firms sometimes create poison pills, which are triggered by hostile takeovers. The objective is to make it difficult and costly to acquire control. A flip over rights offer a simple example. In a flip over right, existing stockholders get the right to buy shares in the firm at a price well above the current stock price as long as the existing management runs the firm; this right is not worth very much. If a hostile acquirer takes over the firm, though, stockholders are given the right to buy additional shares at a price much lower than the current stock price. The acquirer, having weighed in this additional cost, may very well decide against the acquisition.

Greenmail, golden parachutes and poison pills generally do not require stockholder approval and are usually adopted by compliant boards of directors. In all three cases, it can be argued, managerial interests are being served at the expenses of stockholder interests.

2. Anti-takeover Amendments:

Anti-takeover amendments have the same objective as greenmail and poison pills, i.e., dissuading hostile takeovers, but differ on one very important count. They require the assent of stockholders to be instituted. There are several types of anti-takeover amendments, all designed with the objective of reducing the likelihood of a hostile takeover. Consider, for instance, a super-majority amendment; to take over a firm that adopts this amendment, an acquirer has to acquire more than the 51% that would normally be required to gain control. Anti-takeover amendments do increase the bargaining power of managers when negotiating with acquirers and could work to the benefit of stockholders, but only if managers act in the best interests of stockholders.

Poison Pill: A poison pill is a security or a provision that is triggered by the hostile acquisition of the firm, resulting in a large cost to the acquirer.

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6 As an example, when AT&T tried to acquire NCR in 1991, NCR had a super-majority anti-takeover amendment. NCR's managers used this requirement to force AT&T to pay a much higher price for NCR.
2.2. ☞: Anti-takeover Amendments and Management Trust

If as a stockholder in a company, you were asked to vote on an amendment to the corporate charter which would restrict hostile takeovers of your company and give your management more power, in which of the following types of companies would you be most likely to vote yes to the amendment?

a. Companies where the managers promise to use this power to extract a higher price for you from hostile bidders
b. Companies which have done badly (in earnings and stock price performance) in the last few years
c. Companies which have done well (in earnings and stock price performance) in the last few years
d. I would never vote for such an amendment

Paying too much on acquisitions

There are many ways in which managers can make their stockholders worse off - by investing in bad projects, by borrowing too much or too little and by adopting defensive mechanisms against potentially value-increasing takeovers. The quickest and perhaps the most decisive way to impoverish stockholders is to overpay on a takeover, since the amounts paid on takeovers tend to dwarf those involved in the other decisions listed above. Of course, the managers of the firms doing the acquiring will argue that they never7 overpay on takeovers, and that the high premiums paid in acquisitions can be justified using any number of reasons -- there is synergy, there are strategic considerations, the target firm is undervalued and badly managed, and so on. The stockholders in acquiring firms do not seem to share the enthusiasm for mergers and shares than their initial offer.

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7 One explanation given for the phenomenon of overpaying on takeovers is given by Roll, who posits that it is managerial hubris (pride) that drives the process.
acquisitions that their managers have, since the stock prices of bidding firms decline on the takeover announcements a significant proportion\(^8\) of the time.

These illustrations are not meant to make the case that managers are venal and selfish, which would be an unfair charge, but are manifestations of a much more fundamental problem; when there is conflict of interest between stockholders and managers, stockholder wealth maximization is likely to take second place to management objectives.

This data set has the break down of CEO compensation for many U.S. firms for the most recent year.

**Illustration 2.1: Assessing Disney’s Board of Directors**

Over the last decade Disney has emerged as a case study of weak corporate governance, where a powerful CEO, Michael Eisner, has been given free rein by a captive board of directors. We will look at Disney’s board of directors in 1997, when Fortune magazine ranked it as having the worst board of the Fortune 500 companies and again in 2002, when it made the list of the five most improved boards.

At the end of 1996, Disney had 15 members on its board and the board members are listed in table 2.1, categorized by whether they work or worked for Disney (insiders) or not (outsiders).

**Table 2.1: Disney’s Board of Directors – 1996**

<table>
<thead>
<tr>
<th>Insiders</th>
<th>Outsiders</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sanford M. Litvack, 60: Chief of corporate operations.</td>
<td></td>
</tr>
<tr>
<td>Richard A. Nunis, 64: Chairman of Walt</td>
<td></td>
</tr>
</tbody>
</table>

\(^8\) Jarrell, Brickley and Netter (1988) in an extensive study of returns to bidder firms note that excess returns on these firms' stocks around the announcement of takeovers have declined from an average of 4.95% in the sixties to 2% in the seventies to -1% in the eighties. You, Caves, Smith and Henry (1986) examine 133 mergers between 1976 and 1984 and find that the stock prices of bidding firms declined in 53% of the cases.
Disney Attractions.
*E. Cardon Walker, 80: Disney chairman and chief executive, 1980-83
*Gary L. Wilson, 56: Disney Chief Financial Officer, 1985-89
*Thomas S. Murphy, 71: Former chairman and chief executive of Capital Cities/ABC Inc.
*Ex-officials of Disney


Stanley P. Gold, 54: President and chief executive of Shamrock Holdings Inc., which manages about $1 billion in investments for the Disney family.

The Rev. Leo J. O'Donovan, 62: President of Georgetown University, where one of Mr. Eisner's children attended college. Mr. Eisner sat on Georgetown board and has contributed more than $1 million to the school.

Irwin E. Russell, 70: Beverly Hills, Calif., attorney whose clients include Mr. Eisner.
*Sidney Poitier, 69: Actor.

Robert A.M. Stern, 57: New York architect who has designed numerous Disney projects. He received $168,278 for those services in fiscal 1996.

Note that eight of the sixteen members on the board are or were Disney employees and that Michael Eisner, in addition to being CEO, chaired the board. Of the eight outsiders, at least five had potential conflicts of interests because of their ties with either Disney or Michael Eisner. The potential conflicts are listed in italics in table 2.1. Given the composition of this board, it should come as no surprise that it failed to assert its power against incumbent management.

In 1997, Calpers, the California public employee pension fund, suggested a series of checks to see if a board was likely to be effective in acting as a counter-weight to a powerful CEO including:

- Are a majority of the directors outside directors?

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9 One case where it cost Disney dearly was when Mr. Eisner prevailed on the board to hire Michael Ovitz, a noted Hollywood agent, with a generous compensation. A few years later, Ovitz left the company after falling out with Eisner, creating a multi-million liability for Disney. A 2003 lawsuit against Disney’s board members in 1996 contended that they failed in their fiduciary duty by not checking the terms of the compensation agreement before assenting to the hiring.
• Is the chairman of the board independent of the company (and not the CEO of the company)?
• Are the compensation and audit committees composed entirely of outsiders?

When Calpers put the companies in the S&P 500 through these tests in 1997, Disney was the only company that failed all of the tests, with insiders on every one of the key committees.

Disney came under pressure from stockholders to modify its corporate governance practices between 1997 and 2002 and did make some changes to its board. Table 2.2 lists the board members in 2002.

<table>
<thead>
<tr>
<th>Board Members</th>
<th>Occupation</th>
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<tbody>
<tr>
<td>Reveta Bowers</td>
<td>Head of school for the Center for Early Education,</td>
</tr>
<tr>
<td>John Bryson</td>
<td>CEO and Chairman of Con Edison</td>
</tr>
<tr>
<td>Roy Disney</td>
<td>Head of Disney Animation</td>
</tr>
<tr>
<td>Michael Eisner</td>
<td>CEO of Disney</td>
</tr>
<tr>
<td>Judith Estrin</td>
<td>CEO of Packet Design (an internet company)</td>
</tr>
<tr>
<td>Stanley Gold</td>
<td>CEO of Shamrock Holdings</td>
</tr>
<tr>
<td>Robert Iger</td>
<td>Chief Operating Officer, Disney</td>
</tr>
<tr>
<td>Monica Lozano</td>
<td>Chief Operation Officer, La Opinion (Spanish newspaper)</td>
</tr>
<tr>
<td>George Mitchell</td>
<td>Chairman of law firm (Verner, Liipfert, et al.)</td>
</tr>
<tr>
<td>Thomas S. Murphy</td>
<td>Ex-CEO, Capital Cities ABC</td>
</tr>
<tr>
<td>Leo O’Donovan</td>
<td>Professor of Theology, Georgetown University</td>
</tr>
<tr>
<td>Sidney Poitier</td>
<td>Actor, Writer and Director</td>
</tr>
<tr>
<td>Robert A.M. Stern</td>
<td>Senior Partner of Robert A.M. Stern Architects of New York</td>
</tr>
<tr>
<td>Andrea L. Van de Kamp</td>
<td>Chairman of Sotheby's West Coast</td>
</tr>
<tr>
<td>Raymond L. Watson</td>
<td>Chairman of Irvine Company (a real estate corporation)</td>
</tr>
<tr>
<td>Gary L. Wilson</td>
<td>Chairman of the board, Northwest Airlines.</td>
</tr>
</tbody>
</table>

Note that many of the board members with conflicts of interests from 1996 continue to serve on the board. On a positive note, the number of insiders on the board has dropped from eight to six but the board size remains sixteen members. In summary, while the board itself may be marginally more independent in 2002 than it was in 1997, it is still far from ideal in its composition.

Illustration 2.2: Corporate Governance at Aracruz: Voting and Non-voting Shares

Aracruz Cellulose, like most Brazilian companies, had multiple classes of shares at the end of 2002. The common shares had all of the voting rights and were held by
incumbent management, lenders to the company and the Brazilian government. Outside investors held the non-voting shares, which were called preferred shares\textsuperscript{10}, and had no say in the election of the board of directors. At the end of 2002, Aracruz was managed by a board of seven directors, composed primarily of representatives of those who own the common (voting) shares, and an executive board, composed of three managers of the company.

Without analyzing the composition of the board of Aracruz, it is quite clear that there is the potential for a conflict of interest between voting shareholders who are fully represented on the board and preferred stockholders who are not. While Brazilian law provides some protection for the latter, preferred stockholders have no power to change the existing management of the company and little influence over major decisions that can affect their value.

\textit{Illustration 2.3: Corporate Governance at Deutsche Bank: Cross Holdings}

Deutsche Bank follows the German tradition and legal requirement of having two boards. The board of managing directors, which is composed primarily of incumbent managers, develops the company’s strategy, reviews it with the Supervisory Board and ensures its implementation. The Supervisory Board appoints and recalls the members of the Board of Managing Directors and, in cooperation with the Board of Managing Directors, arranges for long-term successor planning. It also advises the board of Managing Directors on the management of business and supervises it in its achievement of long-term goals.

A look at the supervisory board of directors at Deutsche provides some insight into the differences between the US and German corporate governance systems. The supervisory board at Deutsche Bank consists of twenty members, but eight are representatives of the employees. While the remaining twelve are elected by shareholders, employees clearly have a much bigger say in how companies are run in Germany and can sometimes exercise veto power over company decisions. Deutsche Bank’s corporate governance structure is also muddied by cross holdings. Deutsche is the

\textsuperscript{10} This can create some confusion for investors in the United States, where preferred stock is stock with a fixed dividend and resembles bonds more than conventional common stock.
largest stockholder in Daimler Chrysler, the German automobile company, and Allianz, the German insurance company, is the largest stockholder in Deutsche.

**In Practice: Is there a payoff to better corporate governance?**

While academics and activist investors are understandably enthused by moves towards giving stockholders more power over managers, a practical question that is often not answered is what the payoff to better corporate governance is. Are companies where stockholders have more power over managers managed better and run more efficiently? If so, are they more valuable? While no individual study can answer these significant questions, there are a number of different strands of research that offer some insight:

- In the most comprehensive study of the effect of corporate governance on value, a governance index was created for each of 1500 firms based upon 24 distinct corporate governance provisions.\(^{11}\) Buying stocks that had the strongest investor protections while simultaneously selling shares with the weakest protections generated an annual excess return of 8.5%. Every one point increase in the index towards fewer investor protections decreased market value by 8.9% in 1999 and firms that scored high in investor protections also had higher profits, higher sales growth and made fewer acquisitions. These findings are echoed in studies on firms in Korea\(^{12}\) and Germany\(^{13}\).

- Actions that restrict hostile takeovers generally reduce stockholder power by taking away one of the most potent weapons available against indifferent management. In 1990, Pennsylvania considered passing a state law that would have protected incumbent managers against hostile takeovers by allowing them to override stockholder interests if other stakeholders were adversely impacted. In

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\(^{11}\) Gompers, P.A., J.L. Ishii and A. Metrick, 2003, *Corporate Governance and Equity Prices*, Quarterly Journal of Economics, v118, 107-155. The data for the governance index was obtained from the Investor Responsibility Research Center which tracks the corporate charter provisions for hundreds of firms.


the months between the time the law was first proposed and the time it was passed, the stock prices of Pennsylvania companies declined by 6.90%.

- There seems to be little evidence of a link between the composition of the board of directors and firm value. In other words, there is little to indicate that companies with boards that have fewer insiders trade at higher prices than companies with insider dominated boards.

- While this is anecdotal evidence, the wave of corporate scandals – Enron, Worldcom and Tyco - in the United States 2000 and 2001 indicated a significant cost to having a compliant board. A common theme that emerged at problem companies was an ineffective board that failed to ask tough questions of an imperial CEO,

Stockholders and Bondholders

In a world where what is good for stockholders in a firm is also good for its bondholders (lenders), the latter might not have to worry about protecting themselves from expropriation. In the real world, however, there is a risk that bondholders, who do not protect themselves, may be taken advantage of in a variety of ways - by stockholders borrowing more money, paying more dividends or undercutting the security of the assets on which the loans were based.

The Source of the Conflict

The source of the conflict of interest between stockholders and bondholders lies in the differences in the nature of the cash flow claims of the two groups. Bondholders generally have first claim on cash flows, but receive fixed interest payments, assuming that the firm makes enough income to meet its debt obligations. Equity investors have a claim on the cashflows that are left over, but have the option in publicly traded firms of declaring bankruptcy if the firm has insufficient cash flows to meet its financial


obligations. Bondholders do not get to participate on the upside if the projects succeed, but bear a significant portion of the cost, if they fail. As a consequence, bondholders tend to view the risk in investments much more negatively than stockholders. There are many issues on which stockholders and bondholders are likely to disagree.

**Some Examples of the Conflict**

Existing bondholders can be made worse off by increases in borrowing, especially if these increases are large and affect the default risk of the firm, and these bondholders are unprotected. The stockholders' wealth increases concurrently. This effect is dramatically illustrated in the case of acquisitions funded primarily with debt, where the debt ratio increases and the bond rating drops significantly. The prices of existing bonds fall to reflect the higher default risk.16

Dividend policy is another issue on which a conflict of interest may arise between stockholders and bondholders. The effect of higher dividends on stock prices can be debated in theory, with differences of opinion on whether it should increase or decrease prices, but the empirical evidence is clear. Increases in dividends, on average, lead to higher stock prices, while decreases in dividends lead to lower stock prices. Bond prices, on the other hand, react negatively to dividend increases and positively to dividend cuts. The reason is simple. Dividend payments reduce the cash available to a firm, thus making debt more risky.

**The Consequences of Stockholder-Bondholder Conflicts**

As these two illustrations make clear, stockholders and bondholders have different objectives and some decisions can transfer wealth from one group (usually bondholders) to the other (usually stockholders). Focusing on maximizing stockholder wealth may result in stockholders taking perverse actions that harm

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16 In the leveraged buyout of Nabisco, existing bonds dropped in price 19% on the day of the acquisition, even as stock prices zoomed up.
the overall firm, but increase their wealth at the expense of bondholders.

It is possible that we are making too much of the expropriation possibility, for a couple of reasons. Bondholders are aware of the potential of stockholders to take actions that are inimical to their interests, and generally protect themselves, either by writing in covenants or restrictions on what stockholders can do, or by taking an equity interest in the firm. Furthermore, the need to return to the bond markets to raise further funds in the future will keep many firms honest, since the gains from any one-time wealth transfer are likely to be outweighed by the reputation loss associated with such actions. These issues will be considered in more detail later in the book.

**The Firm and Financial Markets**

There is an advantage to maintaining an objective that focuses on stockholder or firm wealth, rather than stock prices or the market value of the firm, since it does not require any assumptions about the efficiency or otherwise of financial markets. The downside, however, is that stockholder or firm wealth is not easily measurable, making it difficult to establish clear standards for success and failure. It is true that there are valuation models, some of which we will examine in this book, that attempt to measure equity and firm value, but they are based on a large number of essentially subjective inputs on which people may disagree. Since an essential characteristic of a good objective is that it comes with a clear and unambiguous measurement mechanism, the advantages of shifting to an objective that focuses on market prices is obvious. The measure of success or failure is there for all to see. Successful manager raises their firms’ stock price and unsuccessful managers reduce theirs.

The trouble with market prices is that the investors who assess them can make serious mistakes. To the extent that financial markets are efficient and use the information that is available to make measured and unbiased estimates of future cash flows and risk, market prices will reflect true value. In such markets, both the measurers and the measured will accept the market price as the appropriate mechanism for judging success and failure.

There are two potential barriers to this. The first is that information is the lubricant that enables markets to be efficient. To the extent that this information is
hidden, delayed or misleading, market prices will deviate from true value, even in an otherwise efficient market. The second problem is that there are many, both in academia and in practice who argue that markets are not efficient, even when information is freely available. In both cases, decisions that maximize stock prices may not be consistent with long-term value maximization.

### 2.3. ☞: The Credibility of Firms in Conveying Information

Do you think that the information revealed by companies about themselves is usually

<table>
<thead>
<tr>
<th></th>
<th>a. timely and honest?</th>
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<td></td>
<td>b. biased?</td>
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<td></td>
<td>c. fraudulent?</td>
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**The Information Problem**

Market prices are based upon information, both public and private. In the world of classical theory, information about companies is revealed promptly and truthfully to financial markets. In the real world, there are a few impediments to this process. The first is that information is sometimes suppressed or delayed by firms, especially when it contains bad news. While there is significant anecdotal evidence of this occurrence, the most direct evidence that firms do this comes from studies of earnings and dividend announcements made by firms. A study of earnings announcements, noted that those announcements that had the worst news tended to be delayed the longest, relative to the expected announcement date.\(^\text{17}\) In a similar vein, a study of earnings and dividend announcements by day of the week for firms on the New York Stock Exchange between 1982 and 1986 found that the announcements made on Friday, especially after the close of trading, contained more bad news than announcements made on any other day of the week.

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week.\textsuperscript{18} This suggests that managers try to release bad news when markets are least active or closed, because they fear that markets will over react.

The second problem is a more serious one. Some firms, in their zeal to keep investors happy and raise market prices, release intentionally misleading information about the firm's current conditions and future prospects to financial markets. These misrepresentations can cause stock prices to deviate significantly from value. Consider the example of Bre-X, a Canadian gold mining company that claimed to have found one of the largest mines in the world in Indonesia in the early 1990s. The stock was heavily touted by equity research analysts in the United States and Canada, but the entire claim was fraudulent. When the fraud came to light in 1997, the stock price tumbled, and analysts professed to be shocked that they had been misled by the firm. The more recent cases of Enron, WorldCom and Parmalat suggest that this problem is not restricted to smaller, less followed companies and can persist even with strict accounting standards and auditing oversight.

The implications of such fraudulent behavior for corporate finance can be profound, since managers are often evaluated on the basis of stock price performance. Thus Bre-X managers with options or bonus plans tied to the stock price probably did very well before the fraud came to light. Repeated violations of investor trust by companies can also lead to a loss of faith in equity markets and a decline in stock prices for all firms.

\begin{table}
\begin{center}
\begin{tabular}{|l|}
\hline
2.4. \textbf{Reputation and Market Access} \\
\textbf{Which of the following types of firms is more likely to mislead markets?} \\
a. Companies that access markets infrequently to raise funds for operations - they raise funds internally. \\
b. Companies that access markets frequently to raise funds for operations \\
\hline
\end{tabular}
\end{center}
\end{table}

2. The Market Problem

The fear that managers have of markets over reacting or not assimilating information well into prices may be justified. Even if information flowed freely and with no distortion to financial markets, there is no guarantee that what emerges as the market price will be an unbiased estimate of true value. In fact, there are many who would argue that the fault lies deeper and that investors are much too irrational and unreliable to come up with a good estimate of the true value. Some of the criticisms that have been mounted against financial markets are legitimate, some are overblown and some are flat out wrong, but we will consider all of them.

1. **Financial markets do not always reasonably and rationally assess the effects of new information on prices.** Critics using this line of argument note that markets can be volatile, reacting to no news at all in some cases; in any case, the volatility in market prices is usually much greater than the volatility in any of the underlying fundamentals. The argument that financial markets are much too volatile, given the underlying fundamentals, has some empirical support.19 As for the irrationality of markets, the frequency with which you see bubbles in markets from the tulip bulb mania of the 1600s in Holland to the dot-com debacle of the late 1990s seems to be proof enough that emotions sometime get ahead of reason in markets.

2. **Financial markets sometimes over react to information.** Analysts with this point of view point to firms that reports earnings that are much higher or much lower than expected and argue that stock prices jump too much on good news and drop too much on bad news. The evidence on this proposition is mixed, though, since there are other cases where markets seem to under react to news about firms. Overall, the only conclusion that all these studies agree on is that markets make mistakes in assessing the effect of news on value.

3. **There are cases where insiders move markets to their benefit and often at the expense of outside investors.** This is especially true with illiquid stocks and is exacerbated in markets where trading is infrequent. Even with widely held and

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traded stocks, insiders sometimes use their superior access to information to get ahead of other investors.\textsuperscript{20}

Notwithstanding these limitations, we cannot take away from the central contribution of financial markets. They assimilate and aggregate a remarkable amount of information on current conditions and future prospects into one measure -- the price. No competing measure comes close to providing as timely or as comprehensive a measure of a firm's standing. The value of having market prices is best illustrated when working with a private firm as opposed to a public firm. While managers of the latter may resent the second-guessing of analysts and investors, there is a great deal of value to knowing how investors perceive the actions that the firm takes.

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\textbf{2.5. ☞: Are markets short term?} \\
Focusing on market prices will lead companies towards short term decisions at the expense of long term value. \\
a. I agree with the statement \\
b. I do not agree with this statement \\
Allowing managers to make decisions without having to worry about the effect on market prices will lead to better long term decisions. \\
a. I agree with this statement \\
b. I do not agree with this statement \\
\hline
\end{tabular}
\end{center}

\textit{Illustration 2.4: Interaction with financial markets – A Case Study with Disney}

The complex interaction between firms and financial markets is best illustrated by what happens around earnings announcements. Consider, for instance, Disney’s earnings report for the last quarter of 2002 that was released to financial markets on February 1, 2003. The report contained the news that net income at the company dropped 42\% from the prior year’s level. The stock price increased by about 2\% on the announcement of this bad news, because the reported earnings per share of 17 cents per share was higher than the 16 cents per share expected by analysts.

\textsuperscript{20} This is true even in the presence of strong insider trading laws, as is the case in the United States. Studies that look at insider trades registered with the SEC seem to indicate that insider buying and selling does precede stock prices going up and down respectively. The advantage is small, though.
There are several interesting points that are worth making here. The first relates to the role that analysts play in setting expectations. In early 2003, for example, there were 17 analysts working at brokerage houses and investment banks who provided estimates of earnings per share for Disney. The lowest of the estimates was 13 cents per share, the highest was 20 cents per share and the average (also titled consensus) estimate was for 16 cents per share. The second relates to the power of expectations. Any news that a company reports has to be measured relative to market expectations before it can be categorized as good or bad news. Thus, a report of a drop in earnings (as was the case with Disney for the last quarter of 2002) can be good news because it did not drop as much as expected. Conversely, Disney reported an increase of 12% in earnings for the last quarter of 2003 (in February 2004) and saw its stock price decline slightly on the news because the increase was smaller than expected.

<table>
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<th>In Practice: Are markets short term?</th>
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<tr>
<td>There are many who believe that stock price maximization leads to a short-term focus for managers - see for instance Michael Porter’s book on competitive strategy. The reasoning goes as follows: Stock prices are determined by traders, short term investors and analysts, all of whom hold the stock for short periods and spend their time trying to forecast next quarter's earnings. Managers who concentrate on creating long-term value, rather than short-term results, will be penalized by markets. Most of the empirical evidence that exists suggests that markets are much more long term than they are given credit for:</td>
</tr>
<tr>
<td>1. There are hundreds of firms, especially small and start-up firms, which do not have any current earnings and cash flows, do not expect to have any in the near future, but which are still able to raise substantial amounts of money on the basis of expectations of success in the future. If markets were in fact as short term as the critics suggest, these firms should be unable to raise funds in the first place.</td>
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21 These analysts are called sell-side analysts because their research is then offered to portfolio managers and other clients. The analysts who work for mutual funds are called buy side analysts and toil in relative obscurity since their recommendations are for internal consumption at the mutual funds and are not publicized.
2. If the evidence suggests anything, it is that markets do not value current earnings and cash flows enough and value future earnings and cash flows too much. Studies indicate that stocks with low price-earnings ratios, i.e., high current earnings, have generally been under priced relative to stocks with high price-earnings ratios.

3. The market response to research and development and investment expenditure is not uniformly negative, as the 'short term' critics would lead you to believe. Instead, the response is tempered, with stock prices, on average, rising on the announcement of R&D and capital expenditures.

Do some investors and analysts focus on short term earnings and not on long term value? Of course. In our view, financial managers cater far too much to these investors and skew their decisions to meet their approval, fleeting though it might be.

**The Firm and Society**

Most management decisions have social consequences, and the question of how best to deal with these consequences is not easily answered. An objective of maximizing firm or stockholder wealth implicitly assumes that the social side-costs are either trivial enough that they can be ignored or that they can be priced and charged to the firm. In many cases, neither of these assumptions is justifiable.

There are some cases where the social costs are considerable but cannot be traced to the firm. In these cases, the decision-makers, though aware of the costs, may choose to ignore the costs and maximize firm wealth. The ethical and moral dilemmas of forcing a managers to choose between their survival (which may require stockholder wealth maximization) and the broader interests of society can be debated but there is no simple solution that can be offered in this book.

In the cases where substantial social costs exist, and firms are aware of these costs, ethicists might argue that wealth maximization has to be sublimated to the broader interests of society, but what about those cases where firms create substantial social costs without being aware of these costs? John Manville Corporation, for instance, in the fifties and sixties produced asbestos with the intention of making a profit, and was unaware of the potential of the product to cause cancer. Thirty years later, the lawsuits from those afflicted with asbestos-related cancers have driven the company to bankruptcy.
To be fair, conflicts between the interests of the firm and the interests of society are not restricted to the objective of maximizing stockholder wealth. They may be endemic to a system of private enterprise, and there will never be a solution to satisfy the purists who would like to see a complete congruence between the social and firm interests.

2.6. 😏: Can laws make companies good citizens?

It has often been argued that social costs occur because governments do not have adequate laws on the books to punish companies that create social costs. The follow-up is that passing such laws will eliminate social costs.

a. I agree with the statement
b. I do not agree with this statement

Illustration 2.5: Assessing Social Costs

The ubiquity of social costs is made clear when we look at the three companies we are analyzing – Disney, Aracruz and Deutsche Bank. These companies, in spite of their many differences, have social costs to consider:

- Disney was built and continues to market itself as the ultimate family oriented company. When its only businesses were theme parks and animated movies, it faced relatively few conflicts. With its expansion into the movie business and television broadcasting, Disney has exposed itself to new problems. To provide an illustration, the Southern Baptist Convention voted in 1997 to boycott Disney theme parks and movies in response to the airing of “Ellen” a show on the ABC network, starring Ellen de Generes as a gay bookstore owner. It is because of this fear of a backlash that Disney maintains separate movie studios – Touchstone/Miramax for grown-up movies and Disney Studios for animated movies.

- Aracruz is at the center of the controversy about the deforestation of the rain forests in South America. In the later 1990s, Aracruz was accused by
environmental groups of replacing old growth forests in Brazil with eucalyptus plantations and displacing native and indigenous peoples from these areas.  

• Deutsche Bank has been challenged for its role as banker for the Nazis during the holocaust. Its acquisition of Bankers Trust in 2000 was almost derailed by accusations that it had helped fund the construction of the concentration camp at Auschwitz during the Second World War. Both Deutsche Bank and Dresdner Bank were sued by survivors of the holocaust for profiting from gold and other assets stolen from concentration camp victims during World War II.  

For all three companies, these accusations are serious not only because they damage their reputations but can also create serious economic costs. All three aggressively defended themselves against the charges and spend a substantial number of pages in their annual reports detailing what they do to be good corporate citizens.

### In Practice: Stakeholder Wealth Maximization and Balanced Scorecards

Some theorists have suggested that the best way to consider the interests of all of the different stakeholders in a modern corporation is to replace stockholder wealth maximization with a broader objective of stakeholder wealth maximization, where stakeholders include employees and society. While it sounds wonderful as a concept, we believe that it is not a worthwhile alternative for the following reasons:

• When you have multiple stakeholders, with very different objectives, you will inevitably have to choose between them. For instance, laying off employees at a firm that is overstuffed will make stockholders and bondholders better off while creating costs and society. Stakeholder wealth maximization provides little direction on the proper way to balance these competing interests.

• Adding to the problem is the fact that not all of the costs and benefits to some stakeholders can be quantified. This is especially true of social costs and benefits, leaving the assessment to analysts who have their own biases.

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22 In the 1990s, the Tupinikim and Guarani Indians launched an international campaign against Aracruz in the state of Espirito Santo to recover and expand their traditional territories.

23 A 1946 investigation by the US military recommended Deutsche Bank be liquidated and its top officials be tried as war criminals.
Most importantly, stakeholder wealth maximization makes managers accountable to no one by making them accountable to every one. Managers can essentially go before each stakeholder and justify their failures by arguing that other stakeholder interests were being considered.

It may still useful for firms to go beyond the proverbial bottom line, which is what a balanced scorecard attempts to do. As devised by Robert Kaplan, a Harvard strategy professor, balanced scorecards try to go beyond financial measures and look at customer satisfaction and internal business processes.24

The Real World - A Pictorial Representation

We have spent the last few pages chronicling the problems, in the real world, with each of the linkages -- managers and stockholders, stockholders and bondholders, firms and financial markets and firms and society. Figure 2.2 summarizes the problems with each linkage in a pictorial representation.

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Figure 2.2: Stock Price Maximization in the Real World

STOCKHOLDERS

- Put managerial interests over stockholder interests
- Have little control over firm

BONDHOLDERS

- Lend Money
- Hurt by stockholder actions

Managers

- Lend Money
- Large Social Costs
- Cannot trace social costs to firm
- Delayed or Misleading Information
- Markets that are volatile, short term and make mistakes

SOCIETY

FINANCIAL MARKETS
Alternatives to Stock Price Maximization

There are obvious problems associated with each of the linkages underlying wealth maximization. Stockholders often have little power over managers, and managers consequently put their interests above those of stockholders. Lenders who do not protect their interests often end up paying a price, when decisions made by firms transfer wealth to stockholders. Information delivered to financial markets is often erroneous, misleading or delayed, and there are significant differences between price and market value. Finally, firms that maximize wealth may do so while creating large costs for society.

Given these problems, there are alternative courses of action that we can follow. One is to find a different system for keeping errant management in check. The second is to find an alternative objective for the firm. In this section, we will consider these alternatives.

A Different System for Disciplining Management (Corporate Governance)

In the system we have described thus far, stockholders bear the burden of replacing incompetent management; we can call this a market-based corporate governance system, where investors in financial markets govern how corporations are run. There are some who believe that this is too much of a responsibility to put on investors who, as they see it, often operate with poor information and have short time horizons. Michael Porter, a leading thinker on corporate strategy, has argued that firms in the United States are hamstrung by the fact that investors are short term and demand quick returns. He contrasts them with Japanese firms, which he argues can afford to adopt strategies that make sense in the long term, even though they might not maximize profits in the short term. He suggests that investors should form long-term relationships25 with firms and work with them to devise long-term strategies. His view of the world is not unique and is shared by many corporate executives, even in the United States.

25 There is some movement towards "relationship investing" in the United States, where funds such as Allied Partners (run by Dillon Read), Corporate Partners (run by Lazard Freres) and Lens (run by activist Robert Monks) have attempted to create long term relationships with the managers of firms.
These executives argue that there are alternatives to the market-based corporate governance systems, where stockholders act to discipline and replace errant managers and stock prices measure their success. In the German and Japanese systems\textsuperscript{26} of corporate governance, firms own stakes in other firms and often make decisions in the best interests of the industrial group they belong to, rather than their own. In these systems, the argument goes, firms will keep an eye on each other, rather than ceding power to the stockholders. In addition to being undemocratic - the stockholders are after all the owners of the firm -- these systems suggests a profound suspicion of how stockholders might use the power if they get it and is heavily skewed towards maintaining the power of incumbent managers.

While this approach may protect the system against the waste that is a by-product of stockholder activism and inefficient markets, it has its own disadvantages. Industrial groups are inherently more conservative than investors in allocating resources and thus are much less likely to finance high risk and venture capital investments by upstarts who do not belong to the group. The other problem is that entire groups can be dragged down by individual firms that have made bad decisions\textsuperscript{27}. In fact, the troubles that Japanese firms have had dealing with poor investments in the 1990s suggests to us that these alternative corporate governance systems, while efficient at dealing with individual firms that are poorly run, have a more difficult time adapting to and dealing with problems that are wide-spread. These problems, consequently, tend to fester and grow over time. For instance, while financial markets pushed corporate banks in the United States to confront their poor real estate loans in the late 1980s, Japanese banks spent much of the 1990s denying the existence of such loans on their books\textsuperscript{28}.

\textsuperscript{26} There are subtle differences between the Japanese and the German systems. The Japanese industrial groups called keiretsus are based primarily on cross-holdings of companies and evolved from family owned businesses. The German industrial groups revolve around leading commercial banks, like Deutsche Bank or Dresdner, with the bank holding substantial stakes in a number of industrial concerns.

\textsuperscript{27} Many Korean industrial groups (called chaebols), that were patterned after the Japanese keiretsu, were pushed to the verge of bankruptcy in 1990s because one or two errant firms in the group made bad real estate loans.

\textsuperscript{28} Kaplan, S.N., 1997, \textit{Corporate Governance and Corporate Performance, A Comparison of German, Japan and the United States}, Journal of Applied Corporate Finance, v9(4), 86-93. He compares the U.S.,
Is there a way in which we can measure the effectiveness of alternative corporate governance systems? One suggestion is that corporate governance systems be measured on three dimensions - the capacity to restrict management's ability to obtain private benefits from control, easy access of firms that want capital to financial markets and the ease with which inefficient management is replaced. It can be argued that corporate governance system in the United States does a better job than alternative systems on all three counts.\textsuperscript{29}

**Choosing an alternative objective**

Given its limitations, the easy answer would be to cast aside stock price maximization as an objective. The tough part is replacing it with another objective. It is not that there are no alternatives, but that the alternatives come with their own sets of problems and it is not at all obvious that there is a benefit to switching. This is especially true when the alternative objective is evaluated on the three criteria we used to evaluate the wealth maximization objective - Is the objective clear and unambiguous? Does it come with a timely measure that can be used to evaluate success and failure? Does it create side costs that exceed the overall benefits? Let us consider three commonly offered alternatives to stock price maximization.

1. **Maximize Market Share**

   In the 1980s, Japanese firms inundated global markets with their products and focused their attention on increasing market share. Their apparent success at converting this market share to profits led other firms, including some in the United States, to also target market share as an objective. In concrete terms, this meant that investments that increased market share more were viewed more favorably than investments that increased them less. Proponents of this objective note that market share is observable and

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measurable like market price, and does not require any of the assumptions about efficient financial markets that are needed to justify the stock price maximization objective.

Underlying the market share maximization objective is the belief (often unstated) that higher market share will mean more pricing power and higher profits in the long term. If this is, in fact, true, maximizing market share is entirely consistent with our objective of maximizing firm value. If however, higher market share does not yield higher pricing power, and the increase in market share is accompanied by lower or even negative earnings, firms that concentrate on increasing market share can be worse off as a consequence. In fact, many of the same Japanese firms that were used by corporate strategists as their examples for why the focus on market share was a good one discovered the harsh downside of this focus in the 1990s.

**II. Profit Maximization Objectives**

There are objectives that focus on profitability rather than value. The rationale for them is that profits can be measured more easily than value, and that higher profits translate into higher value in the long term. There are at least two problems with these objectives. First, the emphasis on current profitability may result in short term decisions that maximize profits now at the expense of long-term profits and value. Second, the notion that profits can be measured more precisely than value may be incorrect, given the leeway that accountants have to shift profits across periods.

In its more sophisticated forms, profit maximization is restated in terms of accounting returns (such as return on equity or capital) rather than dollar profits or even as excess returns (over a cost of capital). While these variants may remove some of the problems associated with focusing on dollar profits next period, the problems with accounting measurements carry over into them as well.

**III. Size/Revenue Objectives**

There are a whole set of objectives that have little to do with stockholder wealth but focus instead on the size of the firm. In the 1970s, for instance, firms like Gulf and Western and ITT, with strong CEOs at their helm, were built up through acquisitions into giant conglomerates. There seemed to be no strategic imperative to these acquisitions, other than the desire on the part of the CEOs to increase the sizes of their corporate
empires. Empire building may no longer be in vogue, but there have been cases where corporations have made decisions that increase their size and perceived power at the expense of stockholder wealth and profitability.

**Maximize Stock Prices: Salvaging a Flawed Objective**

The alternatives to stock price maximization – a corporate governance system build around self-governance or a different objective – have their own limitations. In this section, we consider the case for salvaging stock price maximization as an objective, but consider ways in which we can reduce some of the problems highlighted in the earlier section. In particular, we consider ways in which we can reduce the conflicts of interest between stockholders, bondholders and managers, and the potential for market failures. We also present an argument for stock price maximization based upon the market’s capacity to correct systematic mistakes quickly and effectively.

**Conflict Resolution: Reducing Agency Problems**

If the conflicts between stockholders, managers and bondholders lie at the heart of the problems with stock price maximization, reducing these conflicts should make it a more palatable objective. In this section, we examine the linkages between stockholders and managers, stockholders and bondholders, firms and financial markets and firms and society and look at how best we can reduce the side costs to maximizing stock prices.

**Stockholders and Managers**

There are clearly conflicts of interests between stockholders and managers, and the traditional mechanisms for stockholder control -- annual meetings and boards of directors -- often fail at their role of discipline management. This does not mean, however, that the chasm between the two groups is too wide to be bridged, either by closing the gap between their interests or by increasing stockholder power over managers.

*Making managers think more like stockholders*

As long as managers have interests that are distinct and different from the interests of the stockholders they serve, there is potential for conflict. One way to reduce this conflict is to provide managers with an equity stake in the firms they manage, either
by providing them with stock or warrants on the stock. If this is done, the benefits that accrue to management from higher stock prices may provide an inducement to maximize stock prices.

There is a downside to doing this, which is that while it reduces the conflict of interest between stockholders and managers, it may exacerbate the other conflicts of interest highlighted in the prior section. It may increase the potential for expropriation of wealth from bondholders and the probability that misleading information may be conveyed to financial markets.

There is a final distinction that we need to make between stock based compensation and warrant based compensation. As we will see in the coming chapters, options can sometimes become more valuable as you increase the risk in a business. Consequently, managers who have substantial option holdings and little in common stock may be tempted to take on far more risk than would be desired by other shareholders in the firm.

### 2.7: Stockholder Interests, Managerial Interests and Management Buyouts

In a management buyout, the managers of the firm buy out the existing stockholders and make the company a private firm. Is this a way of reducing the conflict of interests between stockholders and managers?

a. Yes
b. No

Explain.

### More Effective Boards of Directors

In the last few years, there have been encouraging trends both in the composition and the behavior of boards, making them more effective advocates for stockholders. Korn Ferry’s survey of boards of directors at 900 large US corporations in 1998 revealed the following:

**Warrants:** A warrant is a security issued by a company that provides the holder with the right to buy a share of stock in the company at a fixed price during the life of the warrant.
• Boards have become smaller over time. The median size of a board of directors has decreased from 16 to 20 in the 1970s to between 9 and 11 in 1998. The smaller boards are less unwieldy and more effective than the larger boards.

• There are fewer insiders on the board. In contrast to the 6 or more insiders that many boards had in the 1970s, only two directors in most boards in 1998 were insiders.

• Directors are increasingly compensated with stock and options in the company, instead of cash. In 1973, only 4% of directors received compensation in the form of stock or options, whereas 78% did so in 1998. This stock compensation makes it more likely that directors will think like stockholders.

• More directors are identified and selected by a nominating committee rather than being chosen by the CEO of the firm. In 1998, 75% of boards had nominating committees; the comparable statistic in 1973 was 2%.

Is there a payoff to a more active board? MacAvoy and Millstein (1998) present evidence that companies with more activist boards, where activism was measured based both up assessments by CALPERS and indicators of board behavior, earned much higher returns on their capital than firms that had less active boards.

**Increasing stockholder power**

There are many ways in which stockholder power over management can be increased. The first is to provide stockholders with better and more updated information, so that they can make better judgments on how well the management is doing. The second is to have a large stockholder become part of incumbent management, and have a direct role in decisions that the firm makes. The third is to have more 'activist' institutional stockholders, who play a larger role in issues such as the composition of the board of directors, the question of whether to pass anti-takeover amendments and overall management policy. In recent years, some institutional investors have used their considerable power to pressure managers into becoming more responsive to their needs. Among the most aggressive of these investors has been the California Public Employees Retirement System (CALPERS), one of the largest institutional investors in the country. Unfortunately, the largest institutional investors – mutual funds and pension fund companies – have remained largely apathetic. The fourth change, pushed by these activist
stockholders, is to make boards of directors more responsive to stockholders, by reducing the number of insiders on these boards and making them more independent of CEOs.

It is also critical that institutional constraints on stockholders exercising their power be reduced. All common shares should have the same voting rights and state restrictions on takeovers have to be eliminated and shareholder voting should be simplified. The legal system should come down hard on managers (and boards of directors) who fail to do their fiduciary duty. Ultimately, though, stockholders have to awake to the reality that the responsibility for monitoring management falls to them. Like voters in a democracy, shareholders get the managers they deserve.

2.8. ☞: Inside Stockholders versus Outside Stockholders

There are companies like Microsoft where a large stockholder (Bill Gates) may be the on the inside as the manager of the concern. Is it possible that what is in Bill Gates’ best interests as an “inside” stockholder may not be in the interests of a stockholder on the outside?

a. Yes. Their interests may deviate.
b. No. Their interests will not deviate

If yes, provide an example of an action that may benefit the inside stockholder but not the outside stockholder.

The Threat of a Takeover

The perceived excesses of many takeovers in the eighties drew attention to the damage created to employees and society some of them. In movies and books, the raiders who were involved in these takeovers were portrayed as 'barbarians', while the firms being taken over were viewed as hapless victims. While this may have been true in some cases, the reality was that in most cases, companies that were taken over deserved to be taken over. One analysis found that target firms in hostile takeovers in 1985 and 1986 were generally much less profitable than their competitors, had provided sub-par returns to their stockholders and that managers in these firms had significantly lower holdings of
the equity. In short, badly managed firms were much more likely to become targets of hostile takeover bids.30

An implication of this finding is that takeovers operate as a disciplinary mechanism, keeping managers in check, by introducing a cost to bad management. Often, the very threat of a takeover is sufficient to make firms restructure their assets and become more responsive to stockholder concerns. It is not surprising, therefore, that legal attempts to regulate and restrict takeovers have had negative consequences for stock prices.

2.9. ☞: Hostile Acquisitions: Who do they hurt?

Given the information presented in this chapter, which of the following groups is likely to be the most likely to be protected by a law banning hostile takeovers?

a. Stockholders of target companies
b. Managers and employees of well-run target companies
c. Managers and employees of badly-run target companies
d. Society

Illustration 2.6: Restive Stockholders and Responsive Managers: The Disney Case

In 1997, Disney was widely perceived as having an imperial CEO in Michael Eisner and a captive board of directors. After a series of missteps including the hiring and firing of Michael Ovitz and bloated pay packages, Disney stockholders were restive but there were no signs of an impending revolt at that time. As Disney’s stock price slid between 1997 and 2000, though, this changed as more institutional investors made their displeasure with the state of corporate governance at the company. As talk of hostile takeovers and proxy fights filled the air, Disney was forced to respond. In its 2002 annual report, Disney listed the following corporate governance changes:

- Required at least two executive sessions of the board, without the CEO or other members of management present, each year.

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• Created the position of non-management presiding director, and appointed Senator George Mitchell to lead those executive sessions and assist in setting the work agenda of the board.
• Adopted a new and more rigorous definition of director independence.
• Required that a substantial majority of the board be comprised of directors meeting the new independence standards.
• Provided for a reduction in committee size and the rotation of committee and chairmanship assignments among independent directors.
• Added new provisions for management succession planning and evaluations of both management and board performance
• Provided for enhanced continuing education and training for board members.

What changed between 1997 and 2002? While we can point to an overall shift in the market towards stronger corporate governance, the biggest factor was poor stock price performance. The truth is that stockholders are often willing to overlook poor corporate governance and dictatorial CEOs if stock prices are going up but are less tolerant when stock prices decrease.

Towards the end of 2003, Roy Disney and Stanley Gold resigned from Disney’s board of directors, complaining both about the failures of Michael Eisner and his autocratic style.31 When the board of directors announced early in 2004 that Michael Eisner would receive a $6.25 million bonus for his performance in 2003, some institutional investors voiced their opposition. Soon after, Comcast announced a hostile acquisition bid for Disney. At Disney’s annual meeting in February 2004, Disney and Gold raised their concerns about Eisner’s management style and the still-captive board of directors and 43% of the stockholders voted against Eisner as director at the meeting. In a sense, the stars were lining up for the perfect corporate governance storm at Disney, with Eisner in the eye of the storm. Soon after the meeting, Disney announced that Eisner would step down as chairman of the board even though he would continue as CEO until his term expired in 2006.

31 You can read Roy Disney’s letter of resignation on the web site for the book.
In Practice: Proxy Fights

In the section on annual meetings, we pointed out that many investors who are unable to come to annual meetings also fail to return their proxies, thus implicitly giving incumbent managers their votes. In a proxy fight, activist investors who want to challenge incumbent managers approach individual stockholders in the company and solicit their proxies, which they then can use in votes against the management slate.

In one very public and expensive proxy fight in 2002, David Hewlett, who was sitting on the board of Hewlett Packard (HP) at the time, tried to stop HP from buying Compaq by soliciting proxies from HP stockholders. After eight months of acrimony, HP finally won the fight with the bare minimum 51% of the votes. How did Hewlett come so close to stopping the deal? One advantage he had was that the Hewlett and Packard families owned a combined 18% of the total number of shares outstanding. The other was that Hewlett’s position on the board and his access to internal information gave him a great deal of credibility when it came to fighting for the votes of institutional investors. The fact that he failed, even with these advantages, shows how difficult it is to win at a proxy fight. Even a failed proxy fight, though, often has the salutary effect of awakening incumbent managers to the need to at least consider what shareholders want.

Stockholders and Bondholders

The conflict of interests between stockholders and bondholders can lead to actions that transfer wealth to the former from the latter. There are ways in which bondholders can obtain at least partial protection against some of these actions.

The Effect of Covenants

The most direct way for bondholders to protect themselves is to write in covenants in their bond agreements specifically prohibiting or restricting actions that may be wealth expropriating. Many bond (and bank loan) agreements have covenants that do the following:

1) Restrict the firm's investment policy: Investing in riskier projects than anticipated can lead to a transfer of wealth from bondholders to stockholders. Some bond agreements put restrictions on where firms can invest and how much
risk they can take on in their new investments, specifically to provide bondholders with the power to veto actions that are not in their best interests.

(2) Restrict dividend policy: In general, increases in dividends increase stock prices while decreasing bond prices, because they reduce the cash available to the firm to meet debt payments. Many bond agreements restrict dividend policy, by tying dividend payments to earnings.

(3) Restrict additional leverage: Some bond agreements require firms to get the consent of existing lenders before borrowing more money. This is done to protect the interests of existing secured bondholders.

While covenants can be effective at protecting bondholders against some abuses, they do come with a price tag. In particular, firms may find themselves having to turn down profitable investments because of bondholder-imposed constraints and having to pay (indirectly) for the legal and monitoring costs associated with the constraints.

_Taking an Equity Stake_

Since the primary reason for the conflict of interests between stockholders and bondholders lies in the nature of their claims, another way that bondholders can reduce the conflict of interest is by owning an equity stake in the firm. This can take the form of buying stock in the firm at the same time as bonds, or it can be accomplished by making bonds convertible into stock at the option of the bondholders. In either case, bondholders who feel that equity investors are enriching themselves at the lenders’ expense, can become stockholders and share in the spoils.

_Bond Innovations_

In the aftermath of several bond market debacles in the late 1980s, bondholders became increasingly creative in protecting themselves with new types of bonds. While we will consider these innovations in more detail later in this book, consider the example of puttable bonds. Unlike a conventional bond, where you are constrained to hold the bond to maturity, the holders of a puttable bond can put the bond back to the issuing company and get the face value of the bond if the company violates the conditions of the bond. For instance, a sudden increase in borrowing or a drop in bond ratings can trigger this action.
Firms and Financial Markets

The information that firms convey to financial markets is often erroneous, and sometimes misleading. The market price that emerges from financial markets can be wrong, partly because of inefficiencies in markets and partly because of the errors in the information. There are no easy or quick fix solutions to these problems. In the long term, however, there are actions that will improve information quality and reduce deviations between price and value.

Improving the Quality of Information

While regulatory bodies like the Securities and Exchange Commission can require firms to reveal more information and penalize firms that provide misleading and fraudulent information, the quality of information cannot be improved with information disclosure laws alone. In particular, firms will always have a vested interest in when and what information they reveal to markets. To provide balance, therefore, an active market for information, where analysts, who are not hired and fired by the firms that they follow, collect and disseminate information, has to exist. While these analysts are just as likely to make mistakes as the firm, they presumably should have a greater incentive to unearth bad news about the firm and to disseminate that information to their clients. For this system to work, analysts have to be given free rein to search for good as well as bad news and to make positive or negative judgments about a firm.

Making Markets more efficient

Just as better information cannot be legislated into existence, markets cannot be made more efficient by edict. In fact, there is widespread disagreement on what is required to make markets more efficient. At the minimum, these are necessary (though not sufficient) conditions for more efficient markets --

a. Trading should be both inexpensive and easy. The higher transactions costs are, and the more difficult it is to execute a trade, the more likely it is that markets will be inefficient.

b. There should be free and wide access to information about firms.

c. Investors should be allowed to benefit when they pick the right stocks to invest in and to pay the price when they make mistakes.
Restrictions imposed on trading, while well intentioned, often lead to market inefficiencies. For instance, restricting short sales, where investors who don’t own a stock can borrow and sell it if they feel it is overpriced, may seem like good public policy, but it can create a scenario where negative information about stocks cannot be reflected adequately in prices.

**Firms and Society**

There will always be social costs associated with actions taken by firms, operating in their own best interests. The basic conundrum is as follows; social costs cannot be ignored in making decisions, but they are also too nebulous to be factored explicitly into analyses. One solution is for firms to maximize firm or stockholder value, subject to a 'good citizen' constraint, where attempts are made to minimize or alleviate social costs, even though the firm may not be under any legal obligation to do so. The problem with this approach, of course, is that the definition of a 'good citizen' is likely to vary from firm to firm and from manager to manager.

Ultimately, the most effective way to make companies more socially responsible is to make it in their best economic interests to behave well. This can occur in two ways. First, firms that are construed as socially irresponsible could lose customers and profits. This was the galvanizing factor behind a number of specialty retailers in the United States disavowing the use of sweatshops and underage labor in other countries in making their products. Second, investors might avoid buying stock in these companies. As an example, many college and state pension plans in the United States have started reducing or eliminating their holding of tobacco stocks to reflect their concerns about the health effects of tobacco. In fact, investors now have access to “ethical mutual funds” which invest only in companies that meet a social consciousness threshold.\(^{32}\) Figure 2.3 summarizes the ways in which we can reduce potential side costs from stock price maximization.

\(^{32}\) Studies of these funds indicate that they earn returns comparable to conventional mutual funds.
In Practice: Can you add value while doing good?

Does doing social good hurt or help firms? On the one side of this argument stand those who believe that firms that expend considerable resources to generate social good are misguided and are doing their stockholders a disservice. On the other side, there are those who believe that socially conscious firms are rewarded by consumers and investors. The evidence is mixed and will undoubtedly disappoint both sides:

- Studies indicate that the returns earned by stockholders in socially conscious firms are no different than the returns earned by stockholders in the rest of the market. Studies of ethical mutual funds find that they neither lag nor lead other mutual funds.
- There is clearly a substantial economic cost borne by companies that are viewed by society as beyond the pale when it comes to creating social costs. Tobacco firms, for instance, have seen stock prices slide as investors avoid their shares and profits hurt by legal costs.
When firms are profitable and doing well, stockholders are usually willing to give managers the flexibility to use company money to do social good. Few investors in Microsoft begrudged its decision in 1998 to give free computers to public libraries around the country. In firms that are doing badly, stockholders tend to be much more resistant to meeting society’s ills.

Summarizing this evidence, we can draw some conclusions. First, a firm’s foremost obligation is to stay financially healthy and to increase value; firms that are losing money cannot afford to be charitable. Second, firms that create large social costs pay a high price in the long term. Finally, managers should not keep stockholders in the dark about the company’s charitable giving; after all, it is the stockholder’s money that is being used for the purpose.

An Argument for Stockholder Wealth Maximization

Let us start off by conceding that all of the alternatives - choosing a different corporate governance system, picking an alternative objective and maximizing stockholder wealth with constraints – have their limitations and lead to problems. The questions then become how each alternative deals with mistakes and how quickly errors get corrected. This is where stock price maximization does better than the alternatives. It is the only one of the three that is self-correcting, in the sense that excesses by any stakeholder attract responses in three waves.

1. **Market reaction:** The first and most immediate reaction comes from financial markets. Consider again the turmoil created when we have well publicized failures like Enron. Not only did the market punish Enron (by knocking its stock and bond price down) but it punished other companies that it perceived as being exposed to the same problems as Enron – weak corporate governance and opaque financial statements - by discounting their values as well.

2. **Group Activism:** Following on the heels of the market reaction to any excess is outrage on the part of those who feel that they have been victimized by it. In response to management excesses in the 1980s, we saw an increase in the number of activist investors and hostile acquisitions, reminding managers that there are limits to their power. In the aftermath of well-publicized scandals in the late
1980s where loopholes in lending agreements were exploited by firms, banks and bondholders began playing more active roles in management.

3. Market Innovations: Markets often come up with innovative solutions to problems. In response to the corporate governance scandals in 2002 and 2003, Institutional Shareholder Services began scoring corporate boards on independence and effectiveness and selling these scores to investors. After the accounting scandals of the same period, the demand for forensic accounting, where accountants go over financial statements looking for clues of accounting malfeasance, increased dramatically. The bond market debacles of the 1980s gave birth to dozens of innovative bonds designed to protect bondholders. Even in the area of social costs, there are markets that have developed to quantify the cost.

Note that we have not mentioned another common reaction to scandal, which is legislation. While the motives for passing new laws to prevent future excesses may be pure, laws are blunt instruments that are often ineffective for three reasons. First, they are almost never timely. It takes far more time for legislation to be put together than for markets to react, and the outrage has often subsided before the laws becomes effective. Second, laws written to prevent past mistakes often prove ineffective at preventing future mistakes, as circumstances change. Third, laws often have unintended consequences, where in the process of correcting one distortion, they create new ones.

A postscript - The limits of corporate finance

Corporate finance has come in for more than its share of criticism in the last decade. There are many who argue that the failures of corporate America can be traced to its dependence on stock price maximization. Some of the criticism is justified and based upon the limitations of a single-minded pursuit of stockholder wealth. Some of it, however, is based upon a misunderstanding of what corporate finance is about.

Economics was once branded the gospel of Mammon, because of its emphasis on money. The descendants of those critics have labeled corporate finance as unethical, because of its emphasis on the 'bottom line' and market prices, even if this focus implies that workers lose their jobs and take cuts in pay. In restructuring and liquidations, it is
true that value maximization for stockholders may mean that other stakeholders, such as customers and employees, lose out. In most cases, however, decisions that increase market value also make customers and employees better off. Furthermore, if the firm is really in trouble, either because it is being undersold by competitors or because its products are technologically obsolete, the choice is not between liquidation and survival, but between a speedy resolution, which is what corporate financial theory would recommend, and a slow death, while the firm declines over time, and costs society considerably more in the process.

The conflict between wealth maximization for the firm and social welfare is the genesis for the attention paid to ethics in business schools. There will never be an objective and therefore decision rules that perfectly factor in societal concerns, simply because many of these concerns are difficult to quantify and are subjective. Thus, corporate financial theory, in some sense, assumes that decision makers will not make decisions that create large social costs. This assumption that decision makers are, for the most part, ethical and will not create unreasonable costs for society or for other stakeholders, is unstated but underlies corporate financial theory. When it is violated, it exposes corporate financial theory to ethical and moral criticism, though the criticism may be better directed at the violators.

2.10. ☞: What do you think the objective of the firm should be? 

Having heard the pros and cons of the different objectives, the following statement best describes where I stand in terms of the right objective for decision making in a business.

a. Maximize stock price or stockholder wealth, with no constraints
b. Maximize stock price or stockholder wealth, with constraints on being a good social citizen.
c. Maximize profits or profitability
d. Maximize market share
e. Maximize Revenues
f. Maximize social good
g. None of the above
Conclusion

While the objective in corporate finance is to maximize firm value, in practice we often adopt the narrower objective of maximizing a firm’s stock price. As a measurable and unambiguous measure of a firm’s success, stock price offers a clear target for managers in the course of their decision-making.

Stock price maximization as the only objective can be problematic when the different players in the firm – stockholders, managers, lenders and society – all have different interests and work at cross purposes. These differences, which result in agency costs can result in managers who put their interests over those of the stockholders who hired them, stockholders who try to take advantage of lenders, firms that try to mislead financial markets and decisions that create large costs for society. In the presence of these agency problems, there are many who argue for an alternative to stock price maximization. While this path is alluring, each of the alternatives, including using a different system of corporate governance or a different objective, comes with its own share of limitations.

Given the limitations of the alternatives, stock price maximization is the best of a set of imperfect choices for two reasons. First, we can reduce the agency problems between the different groups substantially by trying the align the interests of stockholders, managers and lenders (using both rewards and punishment), and by punishing firms that lie to financial markets or create large social costs. Second, stock price maximization as an objective is self correcting. In other words, excesses by any one of the groups (whether it be managers or stockholders) lead to reactions by the other groups that reduce the likelihood of the behavior being repeated in future periods.
Problems and Questions

1. There is a conflict of interest between stockholders and managers. In theory, stockholders are expected to exercise control over managers through the annual meeting or the board of directors. In practice, why might these disciplinary mechanisms not work?

2. Stockholders can transfer wealth from bondholders through a variety of actions. How would the following actions by stockholders transfer wealth from bondholders?
   
   (a) An increase in dividends
   
   (b) A leveraged buyout
   
   (c) Acquiring a risky business

   How would bondholders protect themselves against these actions?

3. Stock prices are much too volatile for financial markets to be efficient. Comment.

4. Maximizing stock prices does not make sense because investors focus on short term results, and not on the long term consequences. Comment.

5. There are some corporate strategists who have suggested that firms focus on maximizing market share rather than market prices. When might this strategy work, and when might it fail?

6. Anti-takeover amendments can be in the best interests of stockholders. Under what conditions is this likely to be true?

7. Companies outside the United States often have two classes of stock outstanding. One class of shares is voting and is held by the incumbent managers of the firm. The other class is non-voting and represents the bulk of traded shares. What are the consequences for corporate governance?

8. In recent year, top managers have been given large packages of options, giving them the right to buy stock in the firm at a fixed price. Will these compensation schemes make managers more responsive to stockholders? Why or why not? Are lenders to the firm affected by these compensation schemes?
9. Reader’s Digest has voting and non-voting shares. About 70% of the voting shares are held by charitable institutions, which are headed by the CEO of Reader’s Digest. Assume that you are a large holder of the non-voting shares. Would you be concerned about this set-up? What are some of the actions you might push the firm to take to protect your interests?

10. In Germany, large banks are often large lenders and large equity investors in the same firm. For instance, Deutsche Bank is the largest stockholder in Daimler Chrysler, as well as its largest lender. What are some of the potential conflicts that you see in these dual holdings?

11. It is often argued that managers, when asked to maximize stock price, have to choose between being socially responsible and carrying out their fiduciary duty. Do you agree? Can you provide an example where social responsibility and firm value maximization go hand in hand?

12. Assume that you are advising a Turkish firm on corporate financial questions, and that you do not believe that the Turkish stock market is efficient. Would you recommend stock price maximization as the objective? If not, what would you recommend?

13. It has been argued by some that convertible bonds (i.e., bonds which are convertible into stock at the option of the bondholders) provide one form of protection against expropriation by stockholders. What is this argument based on?

14. Societies attempt to keep private interests in line by legislating against behavior that might create social costs (such as polluting the water). If the legislation is comprehensive enough, does the problem of social costs cease to exist? Why or why not?

15. One of the arguments made for having legislation restricting hostile takeovers is that unscrupulous speculators may take over well run firms and destroy them for personal gain. Allowing for the possibility that this could happen, do you think that this is sensible? If so, why? If not, why not?
Live Case Study

I. Corporate Governance Analysis

Objective: To analyze the corporate governance structure of the firm and to assess where the power in the firm lies – with incumbent management or with stockholders in the firm?

Key Questions:
- Is this a company where there is a separation between management and ownership? If so, how responsive is management to stockholders?
- Is there a potential conflict between stockholders and lenders to the firm? If so, how is it managed?
- How does this firm interact with financial markets? How do markets get information about the firm?
- How does this firm view its social obligations and manage its image in society?

Framework for Analysis:
1. The Chief Executive Officer
   - Who is the CEO of the company? How long has he or she been CEO?
   - If it is a “family run” company, is the CEO part of the family? If not, what career path did the CEO take to get to the top? (Did he or she come from within the organization or from outside?)
   - How much did the CEO make last year? What form did the compensation take? (Salary, bonus and option components)
   - How much stock and options in the company does the CEO own?

2. The Board of Directors
   - Who is on the board of directors of the company? How long have they served as directors?
   - How many of the directors are “inside” directors?
   - How many of the directors have other connections to the firm (as suppliers, clients, customers..)?
   - How many of the directors are CEOs of other companies?
   - Do any of the directors have large stockholdings or represent those who do?
3. **Bondholder Concerns**
   - Does the firm have any publicly traded debt?
   - Are there are bond covenants (that you can uncover) that have been imposed on the firm as part of the borrowing?
   - Do any of the bonds issued by the firm come with special protections against stockholder expropriation?

4. **Financial Market Concerns**
   - How many analysts follow the firm?
   - How much trading volume is there on this stock?

5. **Societal Constraints**
   - What does the firm say about its social responsibilities?
   - Does the firm have a particularly good or bad reputation as a corporate citizen?
   - If it does, how has it earned this reputation?
   - If the firm has been a recent target of social criticism, how has it responded?

**Information Sources:**

For firms that are incorporated in the United States, information on the CEO and the board of directors is primarily in the filings made by the firm with the Securities and Exchange Commission. In particular, the 14-DEF will list out the directors in the firm, their relationship with the firm and details on compensation for both directors and top managers. You can also get information on trading done by insiders from the SEC filings. For firms that are not listed in the United States, this information is much more difficult to obtain. However, the absence of readily accessible information on directors and top management is more revealing about the power that resides with incumbent managers.

Information on a firm’s relationships with bondholders usually resides in the firm’s bond agreements and loan covenants. While this information may not always be available to the public, the presence of constraints shows up indirectly in the firm’s bond ratings and when the firm issues new bonds.

The relationship between firms and financial markets is an uneasy one. The list of analysts following a firm can be obtained from publications such as the Nelson Directory.
of Securities Research. For larger and more heavily followed firms the archives of financial publications (the Financial Times, Wall Street Journal, Forbes, Barron’s) can be useful sources of information.

Finally, the reputation of a firm as a corporate citizen is the toughest area to obtain clear information on, since it is only the outliers (the worst and the best corporate citizens) that make the news. The proliferation of socially responsible mutual funds, however, does give us a window on those firms that pass the tests (arbitrary, though they sometimes are) imposed by these funds for a firm to be viewed as “socially responsible”.

Online sources of information:

http://www.stern.nyu.edu/~adamodar/cfin2E/project/data.htm