

CHAPTER 2

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 businessHow 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. Antitakeover 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 nonvoting and represents the bulk of traded shares. What are the consequences for corporate governance?
8. In recent years, 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 nonvoting shares. About 70 percent 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 nonvoting 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 that are convertible into stock at the option of the bondholders) provide one form of protection against expropriation by stockholders. On what is this argument based?

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?

