

## CHAPTER 2

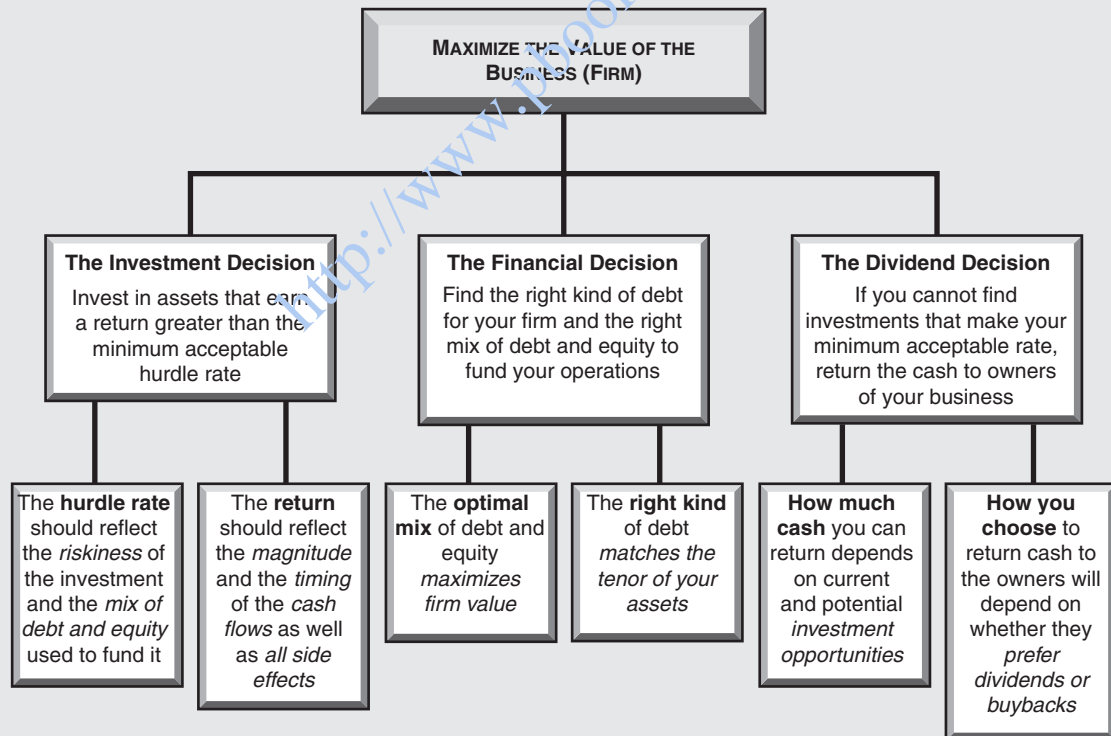
# THE OBJECTIVE IN DECISION MAKING

*If you do not know where you are going, it does not matter how you get there.*

ANONYMOUS

Corporate finance's greatest strength and greatest weakness 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





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assumptions needed for stock price maximization to be the right objective, what 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

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Let's 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, the managers of the firm, rather than the owners, 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 can't we have several? Let's 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 might well come to three separate conclusions.

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. For example, 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 under analysis 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 on 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? Because there is no gain, therefore, from having multiple objectives, and developing theory becomes much more difficult, we 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.

- It is *clear and unambiguous*. An ambiguous objective 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, because 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 three years, five years, or a longer period?

- It comes with a *timely measure* that can be used to evaluate the success or failure of decisions. Objectives that sound good but don't 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 on this objective, but stockholders will also have no way of holding them accountable for any decisions they do make.
- 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, because 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, not to society. This strikes us as short-sighted—the people who own and operate businesses are part of society!

## THE CLASSICAL OBJECTIVE

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*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 in addition to stockholders includes 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 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. Each of these stakeholders has different objectives, and there is the distinct possibility that there will be conflicts of interest among them. What is good for managers may not necessarily be good for stockholders, and what is good for stockholders may not be in the best interests of bondholders—and what is beneficial to a firm may create large costs for society.



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These conflicts of interest are exacerbated 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, again, this may conflict with what stockholders would prefer.

### **Potential Side Costs of Value Maximization**

As we noted at the beginning of this section, the objective in corporate finance can be stated broadly as maximizing the value of the entire business, more narrowly as maximizing the value of the equity stake in the business, and even more narrowly as maximizing the stock price for a publicly traded firm. The potential side costs increase as the objective is narrowed.

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; it 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 stockholder decisions, one way of maximizing stockholder wealth is to take actions that appropriate 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 to 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 just discussed, but there are three reasons for the focus on stock price maximization in traditional corporate finance:

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1. 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 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. Although managers consistently paint a rosy picture of every acquisition that they plan, the stock price of the acquiring firm drops at the time of the announcement of the deal in roughly half of all acquisitions, suggesting that markets are much more skeptical about managerial claims.
2. 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 an erroneous estimate of long-term value is better than a precise estimate of current earnings.
3. Finally, choosing stock price maximization as an objective allows us to make categorical statements about the best way to pick projects and finance them, and to test these statements with empirical observation.



#### 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 NONPROFIT 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 (which maximize firm value). Because 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, because its objective is often to deliver a service in the most



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efficient way possible, rather than 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 conflict between cost and quality will underlie all decisions made by the hospital. ■

### **MAXIMIZE STOCK PRICES: THE BEST-CASE SCENARIO**

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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 in which 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.

- ***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 via the board of directors) or because they own enough stock in the firm that maximizing stockholder wealth becomes their objective as well.
- ***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 by writing covenants proscribing the firm from taking any actions that hurt them.
- ***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.
- ***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.

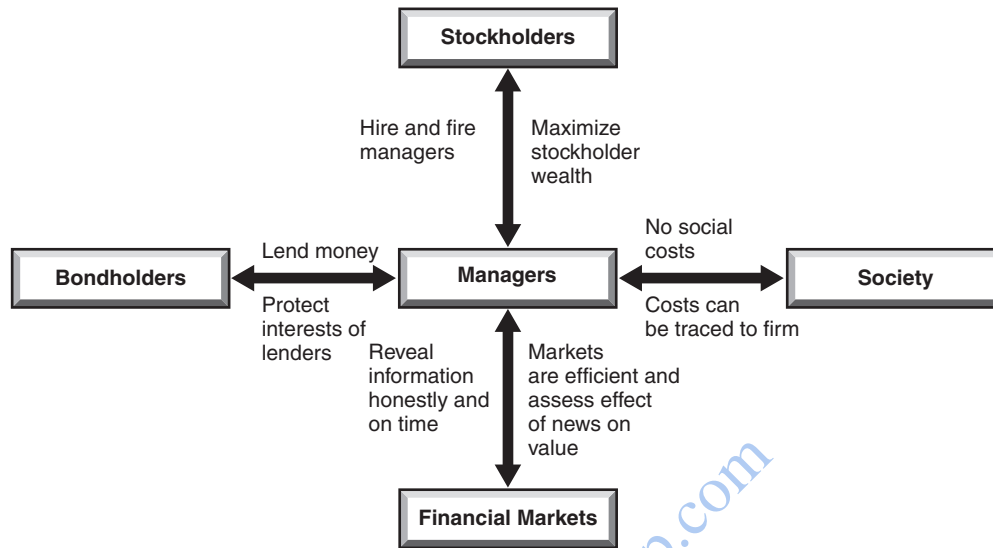
### **MAXIMIZE STOCK PRICES: REAL-WORLD CONFLICTS OF INTEREST**

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Even a casual perusal of the assumptions needed 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, the information delivered to markets is often erroneous and sometimes misleading, and there are social



Figure 2.1 Stock Price Maximization: The Costless Scenario



costs that cannot be captured in the financial statements of the company. In the section that follows, we consider some of the ways real-world problems might trigger a breakdown 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, wherein stockholders gather to evaluate management performance, and the board of directors, whose fiduciary duty it is to ensure that managers serve stockholders' interests. Although 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.<sup>1</sup> It is true that investors can

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

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exercise their power with proxies,<sup>2</sup> but incumbent management starts off with a clear advantage.<sup>3</sup> Many stockholders do not bother to fill out their proxies; 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,” which is to sell their stock and move on. An activist posture on the part of these stockholders would go a long way toward making managers more responsive to their interests, and there are trends toward more activism that will be documented later in this chapter.

### 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.

- Many 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,<sup>4</sup> 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.<sup>5</sup> As a result of scandals associated with lack of board oversight and the passage of Sarbanes–Oxley, directors have come under more pressure to take their jobs seriously. The Korn/Ferry survey for 2007 noted an increase in hours worked by the average director to 192 hours a year and a corresponding surge in compensation to \$62,500 a year, an increase of 45% over the 2002 numbers.
- 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, especially relating to accounting rules and tender offers, and rely instead on outside experts.
- In some firms, a significant percentage of the directors work for the firm, can be categorized as insiders, and are unlikely to challenge the chief executive officer (CEO). Even when directors are outsiders, they are often not independent, insofar as

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

<sup>3</sup>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 in which the incumbent gets the votes of anybody who does not show up at the ballot box.

<sup>4</sup>Korn/Ferry surveys the boards of large corporations and provides insight into their composition.

<sup>5</sup>This understates the true benefits received by the average director in a firm, because 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 surveyed offer retirement plans for their directors.

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the company's 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, whereas only 16% used a search firm. In its 1998 survey, Korn/Ferry found a shift toward more independence on this issue, with almost three-quarters of firms reporting the existence of a nominating committee at least nominally independent of the CEO. The latest Korn/Ferry survey confirmed a continuation of this shift, with only 20% of directors being insiders and a surge in boards with nominating committees that are independent of the CEO.

- The CEOs of other companies are the favored choice for directors, leading to a potential conflict of interest when CEOs sit on each other's boards. In the Korn/Ferry survey, the former CEO of the company sits on the board at 30% of U.S. companies and 44% of French companies.
- Many directors hold only small or token stakes in the equity of their corporations. The remuneration they receive as directors vastly exceeds any returns that they make on their stockholdings, making it unlikely that they will feel any empathy for stockholders if stock prices drop.
- In many companies in the United States, the CEO chairs the board of directors, whereas in much of Europe, the chairman is an independent board member.

The net effect of these factors is that the board of directors often fails at its assigned role—protecting the interests of stockholders. The CEO sets the agenda, chairs the meeting, and controls the flow of information, and the search for consensus generally overwhelms any attempts at confrontation. Although there is an impetus toward 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 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.

### Ownership Structure

The power that stockholders have to influence management decisions either directly (at the annual meeting) or indirectly (through the board of directors) can be affected by how voting rights are apportioned across stockholders and by who owns the shares in the company.

- **Voting rights** In the United States, the most common structure for voting rights in a publicly traded company is to have a single class of shares, with each share getting a vote. Increasingly, though, we are seeing companies like Google, News Corp, and Viacom, with two classes of shares, and with disproportionate voting rights assigned to one class. In much of Latin America, shares with different voting rights are more the rule than the exception, with almost every company having common

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shares (with voting rights) and preferred shares (without voting rights). While there may be good reasons for having share classes with different voting rights<sup>6</sup>, they clearly tilt the scales in favor of incumbent managers (relative to stockholders), since insiders and incumbents tend to hold the high voting right shares.

- **Founder/owners** In young companies, it is not uncommon to find a significant portion of the stock held by the founders or original promoters of the firm. Thus, Larry Ellison, the founder of Oracle, continues to hold almost a quarter of the firm's stock and is also the company's CEO. As small stockholders, we can draw solace from the fact that the top manager in the firm is also its largest stockholder, but there is still the danger that what is good for an inside stockholder with all or most of his wealth invested in the company may not be in the best interests of outside stockholders, especially if the latter are diversified across multiple investments.
- **Passive versus active investors** As institutional investors increase their holdings of equity, classifying investors into individual and institutional becomes a less useful exercise at many firms. There are, however, big differences between institutional investors in terms of how much of a role they are willing to play in monitoring and disciplining errant managers. Most institutional investors, including the bulk of mutual and pension funds, are passive investors, insofar as their response to poor management is to vote with their feet by selling their stock. There are few institutional investors, such as hedge funds and private equity funds, that have a much more activist bent to their investing and seek to change the way companies are run. The presence of these investors should therefore increase the power of all stockholders relative to managers at companies.
- **Stockholders with competing interests** Not all stockholders are single-minded about maximizing stockholders wealth. For some stockholders, the pursuit of stockholder wealth may have to be balanced against their other interests in the firm, with the former being sacrificed for the latter. Consider two not uncommon examples. The first is employees of the firm investing in equity either directly or through their pension fund. They have to balance their interests as stockholders against their interests as employees. An employee layoff may help them as stockholders but work against their interests as employees. The second is that the government can be the largest equity investor, which is often the aftermath of the privatization of a government company. While governments want to see the values of their equity stakes grow, like all other equity investors, they also have to balance this interest against their other interests (as tax collectors and protectors of domestic interests). They are unlikely to welcome plans to reduce taxes paid or to move production to foreign locations.
- **Corporate cross-holdings** The largest stockholder in a company may be another company. In some cases, this investment may reflect strategic or operating considerations. In others, though, these cross-holdings are a device used by investors or managers to wield power often disproportionate to their ownership stake. Many Asian corporate groups are structured as pyramids, with an individual

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<sup>6</sup>One argument is that stockholders in capital markets tend to be short-term, and that the investors who own the voting shares are long-term. Consequently, entrusting the latter with the power will lead to better decisions.

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or family at the top of the pyramid controlling dozens of companies towards the bottom, using corporations to hold stock. In a slightly more benign version, groups of companies are held together by companies holding stock in each other and using these cross-holdings as a shield against stockholder challenges.

In summary, corporate governance is likely to be strongest in companies that have only one class of shares, limited cross-holdings, and a large activist investor holding, and weakest in companies that have shares with different voting rights, extensive cross-holdings, or a predominantly passive investor base.



### **IN PRACTICE:** CORPORATE GOVERNANCE AT COMPANIES

The modern publicly traded corporation is a case study in conflicts of interest, with major decisions being made by managers whose interests may diverge from those of stockholders. Put simply, corporate governance as a subarea in finance looks at the question of how best to monitor and motivate managers to behave in the best interests of the owners of the company (stockholders). In this context, a company where managers are entrenched and cannot be removed even if they make bad decisions (decisions that hurt stockholders) is one with poor corporate governance.

In the light of accounting scandals, and faced with opaque financial statements, it is clear investors today care more about corporate governance at companies and companies know that they do. In response to this concern, firms have expended resources and a large portion of their annual reports to conveying to investors their views on corporate governance (and the actions that they are taking to improve it). Many companies have made explicit the corporate governance principles that govern how they choose and remunerate directors. In the case of Disney, these principles, which were first initiated a few years ago, have been progressively strengthened over time, and the October 2008 version requires a substantial majority of the directors to be independent and own at least \$100,000 worth of stock.

The demand from investors for unbiased and objective corporate governance scores has created a business for third parties that try to assess corporate governance at individual firms. In late 2002, Standard and Poor's introduced a corporate governance score that ranged from 1 (lowest) to 10 (highest) for individual companies, based upon weighting a number of factors, including board composition, ownership structure, and financial structure. The Corporate Library, an independent research group started by stockholder activists Neil Minow and Robert Monks, tracks and rates the effectiveness of boards. Institutional Shareholder Service (ISS), a proxy advisory firm, rates more than 8,000 companies on a number of proprietary dimensions and markets its corporate governance quotient (CGQ) to institutional investors. Other entities now offer corporate governance scores for European companies and Canadian companies. ■

### **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.

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### *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 own 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 acquirer's existing stake, generally at a price much greater than the price paid by the acquirer 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. Although 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 what they are hired to do and are richly compensated for doing—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 flipover right offers a simple example. In a flipover 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.

### *Antitakeover Amendments*

Antitakeover amendments have the same objective as greenmail and poison pills—dissuading hostile takeovers—but differ on one very important count. They require the assent of stockholders to be instituted. There are several types of antitakeover amendments, all designed with the objective of reducing the likelihood of a hostile takeover. Consider, for instance, a *supermajority 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. Antitakeover 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.



## 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 that 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 that have done badly (in earnings and stock price performance) in the past few years
- c. Companies that have done well (in earnings and stock price performance) in the past few years
- d. Never

### *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, because the amounts paid on takeovers tend to dwarf those involved in the other decisions. Of course, the managers of the firms doing the acquiring will argue that they never overpay on takeovers,<sup>7</sup> and that the high premiums paid in acquisitions can be justified using any number of reasons—synergy, 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 acquisitions that their managers have, because the stock prices of bidding firms decline on the takeover announcements—a significant proportion of the time.<sup>8</sup>

These illustrations are not meant to make the case that managers are venal and selfish, which would be an unfair charge, but they 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.



### *The Imperial CEO and Compliant Directors: A Behavioral Perspective*

Many corporate fiascos would be avoided or at least made less damaging if independent directors asked tough questions and reined in top managers. Given this reality, an interesting question is why we do not see this defiance more often in practice. Some of the failures of boards to restrain CEOs can be attributed to institutional factors and board selection processes, but some can be attributed to human frailties.

<sup>7</sup>One explanation given for the phenomenon of overpaying on takeovers is that it is managerial hubris (pride) that drives the process.

<sup>8</sup>See G. A. Jarrell, J. A. Brickley, and J. M. Netter, “The Market for Corporate Control: The Empirical Evidence since 1980,” *Journal of Economic Perspectives* 2:49–68. In an extensive study of returns to bidder firms, these authors note that excess returns on these firms’ stocks around the announcement of takeovers have declined from an average of 4.95% in the 1960s to 2% in the 1970s to –1% in the 1980s. Studies of mergers also generally conclude that the stock prices of bidding firms decline in more than half of all acquisitions.

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Studies of social psychology have noted that loyalty is hardwired into human behavior. While this loyalty is an important tool in building up organizations, it can also lead people to suppress internal ethical standards if they conflict with loyalty to an authority figure. In a famous experiment illustrating this phenomenon, Stanley Milgram, a psychology professor at Yale, asked students to electrocute complete strangers who gave incorrect answers to questions, with larger shocks for more subsequent erroneous answers. Milgram expected his students to stop when they observed the strangers (who were actually only acting) in pain, but he was horrified to find that students continued to shock subjects if ordered to do so by an authority figure. In the context of corporate governance, directors remain steadfastly loyal to the CEO, even in the face of poor performance or bad decisions—and this loyalty seems to outweigh their legal responsibilities to stockholders, who are not present in the room.

How can we break this genetic predisposition to loyalty? The same psychological studies that chronicle loyalty to authority figures also provide guidance on factors that weaken that loyalty. The first is the introduction of *dissenting peers*; if some people are observed voicing opposition to authority, it increases the propensity of others to do the same. The second is the existence of *discordant authority figures*, and disagreement among these figures; in the Milgram experiments, having two people dressed identically in lab coats disagreeing about directions reduced obedience significantly. If we take these findings to heart, we should not only aspire to increase the number of independent directors on boards, but also allow these directors to be nominated by the shareholders who disagree most with incumbent managers. In addition, the presence of a non-executive as chairman of the board, and lead independent directors, may allow for a counterweight to the CEO in board meetings.

Even with these reforms, we have to accept the reality that boards of directors will never be as independent, nor as probing, as we would like them to be, for two other reasons. The first is that people tend to go along with a *group consensus*, even if that consensus is wrong. To the extent that CEOs frame the issues at board meetings, this consensus is likely to work in their favor. The second comes from work done on *information cascades*, where people imitate someone they view to be an informed player, rather than pay to become informed themselves. If executive or inside directors are viewed as more informed about the issues facing the board, it is entirely likely that the outside directors, even if independent, will go along with their views. One solution, offered by Randall Morck, and modeled after the Catholic church, is to create a Devil's advocate—a powerful counterauthority to the CEO whose primary role is to oppose and critique proposed strategies and actions.<sup>9</sup>

### ILLUSTRATION 2.1 Assessing Disney's Corporate Governance

To understand how corporate governance has evolved at Disney, we have to look at its history. For much of its early existence, Disney was a creation of its founder, Walt Disney. His vision and imagination were the genesis for the animated movies and theme parks that made the company's reputation. After Walt's demise in 1966, Disney went through a period of decline during which its movies failed at the box office

<sup>9</sup>R. Morck, "Behavioral Finance in Corporate Governance: Independent Directors, Non-Executive Chairs and the Importance of the Devil's Advocate," NBER working paper series, 2004.

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and attendance at theme parks crested. In 1984, Michael Eisner, then an executive at Paramount, was hired as CEO for Disney. Over the next decade, Eisner succeeded in regenerating Disney, with his protégé, Jeffrey Katzenberg, at the head of the animated movie division, producing blockbuster hits that included *The Little Mermaid*, *Beauty and the Beast*, and *The Lion King*.<sup>10</sup>

As Disney's earnings and stock price increased, Eisner's power also amplified, and by the mid-1990s, he had brought together a board of directors that genuflected to that power. In 1996, *Fortune* magazine ranked Disney as having the worst board of the Fortune 500 companies, and the sixteen members on its board and the members are listed in Table 2.1, categorized by whether they worked for Disney (insiders) or not (outsiders).

Note that eight of the sixteen members on the board were current or ex-Disney employees and that 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 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

Table 2.1 DISNEY'S BOARD OF DIRECTORS 1996

Insiders	Outsiders
1. Michael D. Eisner: CEO	1. Reveta F. Bowers: Head of school for the Center for Early Education, <i>where Mr. Eisner's children attended class</i>
2. Roy E. Disney: Head of animation department	2. Ignacio E. Lozano Jr.: Chairman of Lozano Enterprises, publisher of <i>La Opinion</i> newspaper in Los Angeles
3. Sanford M. Litvack: Chief of corporate operations	3. George J. Mitchell: Washington, D.C., attorney, former U.S. senator. <i>Disney paid Mr. Mitchell \$50,000 for his consulting on international business matters in 1996. His Washington law firm was paid an additional \$122,764.</i>
4. Richard A. Nunis: Chairman of Walt Disney Attractions	4. Stanley P. Gold: President and chief executive of Shamrock Holdings, Inc., which <i>manages about \$1 billion in investments for the Disney family.</i>
5. * Raymond L. Watson: Disney chairman in 1983 and 1984	5. The Rev. Leo J. O'Donovan: President of Georgetown University, where one of Mr. Eisner's children attended college. <i>Mr. Eisner sat on the Georgetown board and has contributed more than \$1 million to the school.</i>
6. * E. Cardon Walker: Disney chairman and chief executive, 1980–83	6. Irwin E. Russell: Beverly Hills, Calif., attorney, <i>whose clients include Mr. Eisner</i>
7. * Gary L. Wilson: Disney chief financial officer, 1985–89	7. * Sidney Poitier: Actor
8. * Thomas S. Murphy: Former chairman and chief executive of Capital Cities/ABC Inc.	8. Robert A. M. Stern: New York architect <i>who has designed numerous Disney projects.</i> He received \$168,278 for those services in fiscal year 1996.

\*Former official of Disney

<sup>10</sup>For an exceptionally entertaining and enlightening read, we would suggest the book *Disney Wars*, authored by Michael Lewis. The book tracks Michael Eisner's tenure at Disney and how his strengths ultimately became his weakest links.

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Table 2.2 DISNEY'S BOARD OF DIRECTORS 2008

Board Members	Occupation
John E. Pepper, Jr. (chairman)	Retired Chairman and CEO, Procter & Gamble Co.
Susan E. Arnold	President, Global Business Units, Procter & Gamble Co.
John E. Bryson	Retired Chairman and CEO, Edison International
John S. Chen	Chairman, CEO, and President, Sybase, Inc.
Judith L. Estrin	CEO, JLab, LLC.
Robert A. Iger	CEO, Disney
Steven P. Jobs	CEO, Apple
Fred Langhammer	Chairman, Global Affairs, The Estée Lauder Companies
Aylwin B. Lewis	President and CEO, Potbelly Sandwich Works
Monica Lozano	Publisher and CEO, <i>La Opinion</i>
Robert W. Matschullat	Retired Vice Chairman and CFO, The Seagram Co.
Orin C. Smith	Retired President and CEO, Starbucks Corporation

power against incumbent management.<sup>11</sup> In 1997, CALPERS, the California Public Employees Retirement System, suggested a series of checks to see if a board was likely to be effective in acting as a counterweight to a powerful CEO, including

- Are a majority of the directors outside directors?
- 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 Standard & Poor's (S&P) 500 through these tests in 1997, Disney was the only company that failed all three 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 made some changes to its corporate governance practices. By 2002, the number of insiders on the board had dropped to four, but it remained unwieldy (with sixteen board members) and had only limited effectiveness. In 2003, two board members, Roy Disney and Stanley Gold, resigned from the board, complaining that it was too willing to rubberstamp Michael Eisner's decisions. At the 2004 annual meeting, an unprecedented 43% of shareholders withheld their proxies when asked to reelect Eisner to the board. In response, Eisner stepped down as chairman of the board in 2004, and, finally, as CEO in March 2005. His replacement, Bob Iger, has shown more signs of being responsive to stockholders. At the end of 2008, Disney's board of directors had twelve members, only one of whom (Bob Iger) was an insider.

<sup>11</sup>One case that cost Disney dearly was when 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 multimillion-dollar liability for Disney. A 2003 lawsuit against Disney's board members contended that they failed in their fiduciary duty by not checking the terms of the compensation agreement before assenting to the hiring.

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At least in terms of appearances, this board looks more independent than the Disney boards of earlier years, with no obvious conflicts of interest. There are two other interesting shifts. The first is that there are only four board members from 2003 (the last Eisner board), who continue on this one, an indication that this is now Iger's board of directors. The other is the presence of Steve Jobs on the list. While his expertise in technology is undoubtedly welcome to the rest of the board members, he also happens to be Disney's largest stockholder, owning in excess of 7% of the company.<sup>12</sup> Disney stockholders may finally have someone who will advocate for their interests in board deliberations. External monitors who track corporate governance have noticed the improvement at Disney. At the start of 2009, ISS ranked Disney first among media companies on its corporate governance score (CGQ) and among the top ten firms in the S&P 500, a remarkable turnaround for a firm that was a poster child for bad corporate governance only a few years ago.

### ILLUSTRATION 2.2 Corporate Governance at Aracruz: Voting and Nonvoting Shares

Aracruz Cellulose, like most Brazilian companies, had two classes of shares at the end of 2008. 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 nonvoting shares, which were called preferred shares,<sup>13</sup> and had no say in the election of the board of directors. At the end of 2008, 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. Although Brazilian law provides some protection for the latter, preferred stockholders have no power to change the existing management of the company and have little influence over major decisions that can affect their value.<sup>14</sup> As a more general proposition, the very existence of voting and nonvoting shares can be viewed as an indication of poor corporate governance, even at companies like Google that are viewed as well-managed companies.

### ILLUSTRATION 2.3 Corporate Governance at Deutsche Bank: Two Boards?

Deutsche Bank follows the German tradition and legal requirement of having two boards. The board of managing directors, 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 that board, 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.

<sup>12</sup>This holding can be traced back to the large ownership stake that Steve Jobs had in Pixar. When Pixar was acquired by Disney, Jobs received shares in Disney in exchange for this holding.

<sup>13</sup>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.

<sup>14</sup>This was brought home when Ambev, a large Brazilian beverage company, was acquired by Interbrand, a Belgian corporation. The deal enriched the common stockholders, but the preferred stockholders received little in terms of a premium and were largely bystanders.



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

### ILLUSTRATION 2.4 Corporate Governance at Tata Chemicals: Family Group Companies

As we noted in Chapter 1, Tata Chemicals is part of the Tata Group of companies, one of India's largest family group companies. In 2009, the company had eight directors, four of whom could be categorized as insiders and four as independent.<sup>15</sup> The chairman of the board, Ratan Tata, also operates as the chairman of the boards of twelve other Tata companies. In fact, many of the directors on the board of Tata Chemicals serve on the boards of other Tata companies as well. The intermingling of group and company interests is made even greater by the fact that other Tata group companies own 29.15% of the outstanding shares in Tata Chemicals and Tata Chemicals has significant investments in other Tata companies.

As stockholders in Tata Chemicals, there are two key implications for corporate governance:

1. **Limited power** The large cross-holdings by group companies make it unlikely that individual investors (who are not members of the Tata family) will be able to exercise much power at any of these companies.
2. **Conflict of interest** The conflict between what is good for the investors in the company (Tata Chemicals) and what is good for the group (Tata Group) will play out on almost every major corporate finance decision. For instance, when it comes to how much Tata Chemicals should pay in dividends, the key determinant may not be how much the company generates in excess cash but how much funding is needed by other companies in the group. Generalizing, decisions that are made with the best interests of the Tata Group may be hurtful or costly to investors in Tata Chemicals.

Note that this is not a critique directed specifically at the Tata Group. In fact, many investors who follow Indian companies view the Tata Group as one of the more enlightened family businesses in India. It is more of a general problem with investing in a company that belongs to a larger group, since group interests may render waste to the interests of investors in individual companies.



### **IN PRACTICE:** IS THERE A PAYOFF TO BETTER CORPORATE GOVERNANCE?

We do not want to oversell the importance of strong corporate governance. It is not a magic bullet that will somehow make bad managers into good managers. In fact, we can visualize a well-managed company with poor corporate governance just as easily

<sup>15</sup>Two of the directors are categorized as promoters, a term that indicates that they are either founders or descendants of the founders of these firms.



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as we can a poorly managed company with good corporate governance. The biggest payoff to good corporate governance is that it is far easier to replace bad managers at a firm, thus making long-term mismanagement less likely.

Academics and activist investors are understandably enthused by moves toward giving stockholders more power over managers, but a practical question that is often not answered is what the payoff to better corporate governance is. Are companies whose stockholders have more power over managers managed better and run more efficiently? If so, are they more valuable? Although 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 1,500 firms based on twenty-four distinct corporate governance provisions.<sup>16</sup> 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 1-point increase in the index toward 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 and Germany.<sup>17</sup> The recent studies are more nuanced in their findings. While most continue to find a link between corporate governance scores and market pricing (such as price to book ratios), they find little relationship between operating performance measures (profit margins, returns on equity) and these scores.
- 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 passed 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 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%.<sup>18</sup>
- 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 more independent directors trade at higher prices than companies with insider-dominated boards.<sup>19</sup>
- Although this is anecdotal evidence, the wave of corporate scandals indicates a significant cost to having a compliant board. A common theme that emerges at

<sup>16</sup>P. A. Gompers, J. L. Ishii, and A. Metrick, "Corporate Governance and Equity Prices," *Quarterly Journal of Economics* 118:107–155. The data for the governance index was obtained from the Investor Responsibility Research Center, which tracks the corporate charter provisions for hundreds of firms.

<sup>17</sup>For Korea: B. S. Black, H. Jang, and W. Kim, "Does Corporate Governance Affect Firm Value? Evidence from Korea," Stanford Law School working paper, 2003. For Germany: W. Drobetz, "Corporate Governance: Legal Fiction or Economic Reality," working paper, University of Basel, 2003.

<sup>18</sup>J. M. Karpoff and P. H. Malatesta, "The Wealth Effects of Second-Generation State Takeover Legislation," *Journal of Financial Economics* 25:291–322.

<sup>19</sup>Sanjai Bhagat and Bernard Black, "The Uncertain Relationship between Board Composition and Firm Performance," *Business Lawyer* 54:921–963.

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problem companies is an ineffective board that failed to ask tough questions of an imperial CEO. The banking crisis of 2008, for instance, revealed that the boards of directors at investment banks were not only unaware of the risks of the investments made at these banks, but had few tools for overseeing or managing those risks.

In closing, stronger corporate governance is not a panacea for all our troubles. However, it does offer the hope of change, especially when incumbent managers fail to do their jobs. ■

### 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 the firm makes enough income to meet its debt obligations. Equity investors have a claim on the cash flows 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.<sup>20</sup>

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, whereas 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, making debt more risky.

<sup>20</sup>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 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 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, because 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 this 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, because 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. Because 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 managers raise their firms' stock prices; unsuccessful managers reduce them.

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

Which do you think that the information revealed by companies about themselves is, usually?

- a. Timely and honest
- b. Biased
- c. Fraudulent



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### The Information Problem

Market prices are based on 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. Although there is significant anecdotal evidence of this occurrence, the most direct evidence that firms do this comes from studies of earnings and dividend announcements. 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.<sup>21</sup> 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.<sup>22</sup> This suggests that managers try to release bad news when markets are least active or closed, because they fear that markets will overreact.

The second problem is more serious. In their zeal to keep investors happy and raise market prices, some firms release intentionally misleading information about 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 gold reserves 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 implications of such fraudulent behavior for corporate finance can be profound because 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. Again, the potential for information distortions is greater in emerging markets, where information disclosure laws and corporate governance are weaker. In 2008, the CEO and top management of Satyam Computers, a well-regarded Indian software company, stepped down after admitting to accounting fraud.<sup>23</sup>

### 2.4 REPUTATION AND MARKET ACCESS



Which of the following types of firms is more likely to mislead markets?

- Companies that access markets infrequently to raise funds for operations—they raise funds internally.
- Companies that access markets frequently to raise funds for operations.

Explain.

<sup>21</sup>S. H. Penman, "The Distribution of Earnings News over Time and Seasonalities in Aggregate Stock Returns," *Journal of Financial Economics* 18, no. 2:199–228.

<sup>22</sup>A. Damodaran, "The Weekend Effect in Information Releases: A Study of Earnings and Dividend Announcements," *Review of Financial Studies* 2, no. 4:607–623.

<sup>23</sup>To illustrate the pervasiveness of the misstatements in the financial statements, the cash balance that was reported on the balance sheet did not exist.

### The Market Problem

The fear that managers have of markets overreacting 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, many 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 simply wrong, but we will consider them all nonetheless.

- **Financial markets do not always reasonably and rationally assess the effects of new information on prices.** Critics using this 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.<sup>24</sup> 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.
- **Financial markets sometimes overreact 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, because there are other cases in which markets seem to underreact 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.
- **There are cases in which insiders move markets to their benefit, 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 traded stocks, insiders sometimes use their superior access to information to get ahead of other investors.<sup>25</sup>

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 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. Although 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.

<sup>24</sup>R. J. Shiller, *Irrational Exuberance* (Princeton, NJ: Princeton University Press, 2000).

<sup>25</sup>This is true even in the presence of strong insider trading laws, as in the United States. Studies that look at insider trades registered with the Securities and Exchange Commission (SEC) seem to indicate that insider buying and selling does precede stock prices going up and down, respectively. The advantage is small, though.



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### *Irrational Exuberance: A Behavioral Perspective on Markets*

The belief in efficient markets, long an article of faith in academic finance, has come under assault from within the academy. The notion that markets make systematic mistakes and fail to reflect true value often is now not only backed up by evidence but also linked to well-documented quirks in human nature. In a survey article on the topic, Barberis and Thaler list the following characteristics that skew investor behavior:<sup>26</sup>

- **Overconfidence** Investors are overconfident in their own judgments, as evidenced by their inability to estimate confidence intervals for quantities (such as the level of the Dow) and probabilities of event occurring.
- **Optimism and wishful thinking** Individuals have unrealistically optimistic views of their own capabilities. For instance, 90% of people, when characterizing their own skills, describe themselves as above average.
- **Representativeness** Individuals show systematic biases in how they classify data and evaluate. One manifestation of this bias is that they ignore sample sizes when judging likelihood, treating a 60% success rate in a sample of 10 and the same success rate in a sample of 1,000 equivalently, even though the latter should convey more information.
- **Conservatism and belief perseverance** Individuals seem to attach too much weight to their prior beliefs about data and to not react sufficiently to new information. Once they form an opinion, they are reluctant to search for evidence that may contradict that opinion, and when faced with such evidence, they view it with excessive skepticism. In some cases, in what is called the confirmation bias, they actually look at contradictory evidence as supportive of their beliefs.
- **Anchoring** When forming estimates, individuals start with an initial, often arbitrary, value and adjust this value insufficiently.
- **Availability biases** When assessing the likelihood of an event, individuals looking for relevant information often overweight more recent events and events that affect them personally more than they should in making their judgments.

Given that these characteristics are widespread and perhaps universal, we should not be surprised that markets reflect them. The overconfidence and overoptimism feed into price bubbles in individual stocks as well as the entire market, and those who question the rationality of the bubbles are often ignored (belief perseverance). Anchoring and availability biases can skew how we value individual companies, again leading to significant differences between market prices and true values. In general, behavioral finance provides explanations for why stock prices may deviate from true value for extended periods.



### 2.5 ARE MARKETS SHORT-TERM?

Focusing on market prices will lead companies toward short-term decisions at the expense of long-term value.

- I agree.
- I do not agree.

<sup>26</sup>N. Barberis and R. Thaler, "A Survey of Behavioral Finance," NBER working paper, 2002.



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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.
- b. I do not agree.

### ILLUSTRATION 2.5 Interaction with Financial Markets: A Case Study with Disney

The complex interaction between firms and financial markets is best illustrated by what happens when firms make information announcements. Consider, for instance, Disney's earnings report for January–March 2009, which was released to financial markets on May 5, 2009. The report contained the news that net income at the company dropped 26% from the prior year's level, resulting in earnings per share of \$0.43 a share. The stock price increased by about 2% on the announcement of this bad news, because the reported earnings per share was higher than the \$0.40 per share expected by analysts.

There are several interesting points that are worth making here. The first relates to the role that analysts play in setting expectations. In May 2009, for example, there were twenty-five analysts working at brokerage houses and investment banks who provided estimates of earnings per share for Disney.<sup>27</sup> The lowest of the estimates was 33 cents per share, the highest was 48 cents per share, and the average (also called consensus) estimate was 40 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 in this example) can be good news because earnings did not drop as much as expected.

### **IN PRACTICE: ARE MARKETS SHORT-TERM?**

There are many who believe that stock price maximization leads to a short-term focus for managers. 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 the 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.

- There are hundreds of firms, especially small and startup firms that do not have any current earnings and cash flows and do not expect to have any in the near future but that 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 critics suggest, these firms should be unable to raise funds in the first place.
- 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

<sup>27</sup>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 because their recommendations are for internal consumption at the mutual funds and are not publicized.

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indicate that stocks with low price–earnings ratios and high current earnings have generally been underpriced relative to stocks with high price–earnings ratios.

- The market response to research and development (R&D) and investment expenditure is not uniformly negative, despite what the “short-term” critics would lead you to believe. Instead, the response is tempered, with stock prices rising on average 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 in which 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 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, produced asbestos in the 1950s and 1960s with the intention of making a profit and was unaware of the potential of the product to cause cancer and other illnesses. Thirty years later, the lawsuits from those afflicted with asbestos-related disease 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.

- I agree.
- I do not agree.

#### ILLUSTRATION 2.6 Assessing Social Costs

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

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- 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 TV 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 DeGeneres as a gay bookstore owner. It is because of this fear of a backlash that Disney maintains separate movie studios—Miramax for edgier, more adult movies and Disney/Pixar Studios for animated and family-friendly 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.<sup>28</sup>
- While Tata Chemicals has not been the focus of serious social backlash, the Tata Group has had its share of societal conflicts. Tata Motors, for instance, was forced to relocate a new plant that it was planning to build on former agricultural land in West Bengal in the face of protests from farmers and community activists.
- 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 World War II. 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.<sup>29</sup> Finally, in the aftermath of the banking crisis of 2008, Deutsche Bank has been challenged both by regulators and activists for its role in creating the crisis.

For all these companies, these accusations are serious not only because they damage their reputations, but because they can also create serious economic costs. All of the firms aggressively defended themselves against the charges and spent 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 wherein stakeholders include employees and society. Although 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 among them. For instance, laying off employees at a firm that is overstaffed will make stockholders and bondholders better off while

<sup>28</sup>In the 1990s, the Tupinikim and Guarani Indians launched an international campaign against Aracruz in the state of Espírito Santo to recover and expand their traditional territories

<sup>29</sup>A 1946 investigation by the U.S. military recommended that Deutsche Bank be liquidated and its top officials tried as war criminals.

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creating costs to society as a whole. Stakeholder wealth maximization provides little direction on the proper way to balance these competing interests.

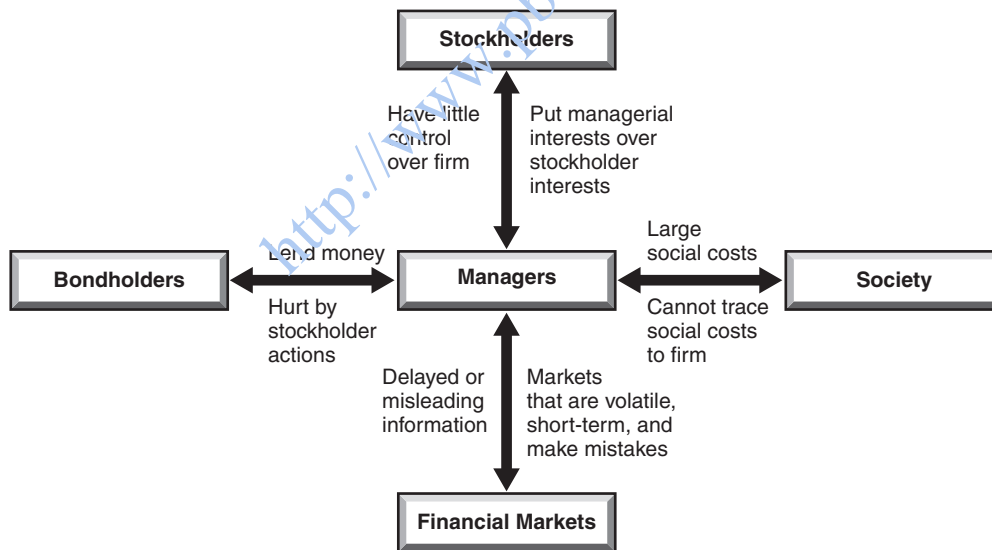
- Adding to the problem is the fact that not all of the costs and benefits to some stakeholders can be quantified. This is especially true of social costs and benefits, leaving the assessment to analysts who have their own biases.
- Most important, stakeholder wealth maximization makes managers accountable to no one by making them accountable to everyone. Managers can essentially go before each stakeholder and justify their failures by arguing that other stakeholder interests were being considered.

It may still be useful for firms to go beyond the proverbial bottom line, and a balanced scorecard attempts to do just that. 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.<sup>30</sup> ■

### 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.

Figure 2.2 Stock Price Maximization in the Real World



<sup>30</sup>Robert S. Kaplan and David P. Norton, *The Balanced Scorecard: Translating Strategy into Action* (Cambridge, MA: Harvard Business School Press, 1996).

## ALTERNATIVES TO STOCK PRICE MAXIMIZATION

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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 own 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 run, even though they might not maximize profits in the short term. He suggests that investors should form long-term relationships with firms and work with them to devise long-term strategies.<sup>31</sup> His view of the world is not unique and is shared by many corporate executives, even in the United States. 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 of corporate governance,<sup>32</sup> firms own stakes in other firms and often make decisions in the best interests of the industrial group they belong to rather than in their own interests. 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 suggest a profound suspicion of how stockholders might use the power if they get it and is heavily skewed toward maintaining the power of incumbent managers.

Although this approach may protect the system against the waste that is a byproduct of stockholder activism and inefficient markets, it has its own disadvantages. Industrial

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<sup>31</sup>There is some movement toward 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.

<sup>32</sup>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 Bank, with the bank holding substantial stakes in a number of industrial concerns.

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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 the bad decisions of individual firms.<sup>33</sup> 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, though efficient at dealing with individual firms that are poorly run, have a more difficult time adapting to and dealing with problems that are widespread. 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.<sup>34</sup>

In the wake of the success of Chinese companies in the last decade and the meltdown of global financial markets, there is another alternative being offered by those who dislike the market-based mechanism. Why not let the government be a larger player and decide where investments make the most sense? In the aftermath of a market meltdown in 2008, with subsequent government bailouts of banks and troubled companies, the number of advocates for an activist government role has increased even in the United Kingdom and United States, historically countries that have been friendly to market-based solutions. We remain skeptical for two reasons. The first is that history does not provide much encouragement for government-driven investment. When governments have tried to pick winners among companies, they have generally been unsuccessful. Not only did the Soviet and other socialist systems fail badly for decades after World War II at planning economic growth, but enlightened systems like the Japanese Ministry of Finance have not been able to forecast where growth will come from next. The second is that governments have other agendas besides economic growth, and there can be conflicts between these different interests. Thus, even if it is in the best long-term economic interests of taxpayers in the United States to let GM go under, it is unlikely that any government that has to face voters in Michigan (GM's home state) will be willing to let it happen. Finally, if the argument is that financial markets are hotbeds of investor irrationality, note that government agencies are also staffed with human beings, and there is no reason to believe that these decision makers will be immune from making the same mistakes.

Is there a way 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 to financial markets for firms that want capital, and the ease with which inefficient management is replaced. It can be argued that a market-based

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<sup>33</sup>Many Korean industrial groups (called *chaebols*), which 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 or borrowed too much.

<sup>34</sup>S. N. Kaplan, "Corporate Governance and Corporate Performance: A Comparison of German, Japan and the United States," *Journal of Applied Corporate Finance* 9, no. 4, 86–93. He compares the U.S., German, and Japanese corporate governance systems. He finds that the U.S. system provides better incentives for firms performing well, and that it is easier for companies in the United States to return cash to the stockholders.

corporate governance system does a better job than alternative systems on at least the last two counts.<sup>35</sup>

### 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 used to evaluate the wealth maximization objective: (1) Is the objective clear and unambiguous? (2) Does it come with a timely measure that can be used to evaluate success and failure? (3) Does it create side costs that exceed the overall benefits? Let us consider three commonly offered alternatives to stock price maximization.

#### I. 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 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 run. If this is in fact true, maximizing market share is entirely consistent with the objective of maximizing firm value. However, if 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 run. 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.

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<sup>35</sup>J. R. Macey, "Measuring the Effectiveness of Different Corporate Governance Systems: Towards a More Scientific Approach," *Journal of Applied Corporate Finance* 10, no. 4:16–25.



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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). Although 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 & 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

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The alternatives to stock price maximization—a corporate governance system build around self-governance or choosing a different objective like maximizing market share—have their own limitations. In this section, we consider the case for salvaging value maximization as an objective but consider ways we can reduce some of the problems highlighted in the earlier section. In particular, we consider ways we can reduce the conflicts of interest between stockholders, bondholders, and managers and the potential for market failures. We also present an argument for market-based mechanisms based on 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



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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, for although 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 will be conveyed to financial markets.

There is a final distinction that we need to make between stock-based compensation and option-based compensation. As we will see in the coming chapters, options can sometimes become more valuable as businesses become more risky. 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. It is for this reason that companies are increasingly turning away from option-based packages to restricted stock in compensating managers.



### 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 past 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 large global corporations in 2007 revealed the following.

- **Boards have become smaller over time.** The median size of a board of directors has decreased from a range of between sixteen and twenty in the 1970s to ten in 2007. The smaller boards are less unwieldy and more effective than larger boards.
- **There are fewer insiders on the board.** In contrast to the six or more insiders that many boards had in the 1970s, only two directors in most boards in 2007 were insiders.
- **Directors are increasingly compensated with equity in the company.** In 1973, only 4% of directors received compensation in the form of equity, whereas 86% did so in 2007. There has also been a shift away from options to restricted stock; 72% of firms used restricted stock, and only 14% used options. While the use of restricted stock in compensation has increased in Europe as well, it is still uncommon in Asia.
- **More directors are identified and selected by a nominating committee rather than chosen by the CEO of the firm.** In 2007, 97% of boards had nominating committees; the comparable statistic in 1973 was 2%.

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- **More firms restrict the number of outside directorships held by their directors.** In 2001, only 23% of firms limited the number of other board memberships of their directors. In 2007, that number had risen to 62%. While many UK and European companies also restrict board memberships, such restrictions are less common in Asia.
- **More firms have appointed lead directors to counter the CEO as chair.** While it was unusual for boards to appoint lead directors twenty 0 years ago, almost 84% of U.S. boards now have a lead director to serve as a counterweight to the CEO.
- **More firms are evaluating CEOs on an annual basis.** In 1999, 56% of U.S. corporate boards evaluated CEOs on an annual basis. That number had risen to 92% in 2007. In Asia, almost 95% of boards claim to evaluate CEOs on an annual basis.

While these are all positive trends, there are two precautionary notes that we add. The first is that the survey focused on large companies; board practices at smaller companies have been much slower to change. The second is that it is not clear how much of this change is window dressing—giving the appearance of active oversight to prevent lawsuits.

Is there a payoff to a more active board? MacAvoy and Millstein present evidence that companies with more activist boards, where activism was measured based upon indicators of board behavior, earned much higher returns on their capital than firms that had less active boards.<sup>36</sup> As hedge funds and activist investors have raised their profile in the last few years, there is evidence that directors that they place on the boards of challenged companies make a difference, at least in stock price performance. A study by the Investor Responsibility Research Center (IRRC) of 120 companies with hybrid boards—i.e., boards with directors elected by activist investors—found that their stock prices at these companies outperformed their peer group by almost 17% a year, with the bulk of the return occurring around the months that activists challenged the company. Interestingly, the performance of companies with a single dissident director elected was much better than those where three or more dissident directors were elected.

### *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 informed 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

<sup>36</sup>See P. W. MacAvoy and I. M. Millstein, “The Active Board of Directors and Its Effect on the Performance of Large Publicly Traded Companies,” *Columbia Law Review* 98:1283–1322.



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the most aggressive of these investors has been the California State Pension fund (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. In the last few years, hedge funds have stepped into the breach and have challenged even large companies to defend existing practices.

It is also critical that institutional constraints on stockholders exercising their power be reduced. All common shares should have the same voting rights, 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 perform their fiduciary duty. Ultimately, though, stockholders have to awaken to the reality that the responsibility for monitoring management falls to them. Like voters in a democracy, shareholders get the managers they deserve.



### **IN PRACTICE:** THE LEGAL REMEDY

Can we legislate good corporate governance? Whether we can or not, legislators often try to fix what they see as significant corporate governance problems by passing laws. This is especially true in the aftermath of scandals, when stockholders, bondholders, and society bear the cost of managerial incompetence. As an example, after the accounting scandals in the United States in 2001 and 2002, the Sarbanes–Oxley Act was passed with the explicit intent of preventing future Enrons and Worldcoms. The act was far-reaching in its coverage, but large parts of it related to the composition of corporate boards and the responsibilities of boards. Without going into the provisions of the law, the objective was to create more transparency in the way boards were created and increase the independence of the directors from the CEO and the legal responsibilities of directors for managerial actions. Sarbanes–Oxley also substantially increased the information disclosure requirements for firms.

The other legal remedy that stockholders have is to sue the managers when they feel that they have been misled about future prospects. In recent years, class action lawsuits against companies whose stock prices have plummeted have multiplied, and the plaintiffs have won large awards in some of these suits. While the right to sue when wronged may seem fundamental, legal remedies are likely to be both imperfect and very expensive ways of bringing about better corporate governance. In fact, the cost of complying with Sarbanes–Oxley has been substantial, and the only group that consistently is enriched by lawsuits is trial lawyers. ■



### 2.8 INSIDE STOCKHOLDERS VERSUS OUTSIDE STOCKHOLDERS

There are companies like Microsoft where a large stockholder (Bill Gates) may be on the inside as the top manager of the concern. Is it possible that what is in Bill Gates's 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 so, provide an example of an action that may benefit the inside stockholder but not the outside stockholder.



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### *The Threat of a Takeover*

The perceived excesses of many takeovers in the 1980s 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. Although this may have been accurate in some cases, the reality was that most companies that were taken over deserved it. One analysis found that target firms in hostile takeovers in 1985 and 1986 were generally much less profitable than their competitors, had provided subpar returns to their stockholders, and had managers with significantly lower holdings of the equity. In short, badly managed firms were much more likely to become targets of hostile takeover bids.<sup>37</sup>

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: WHOM 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?

- Stockholders of target companies
- Managers and employees of well-run target companies
- Managers and employees of badly-run target companies
- Society

### ILLUSTRATION 2.7 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 Oitz 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
- Created the position of 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

<sup>37</sup>A. Bhide, "The Causes and Consequences of Hostile Takeovers," *Journal of Applied Corporate Finance* 2:36-59.

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- Required that a substantial majority of the board be made up 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? Although we can point to an overall shift in the market toward stronger corporate governance, the biggest factor was Disney's 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.

Toward the end of 2003, Roy Disney and Stanley Gold resigned from Disney's board of directors, complaining both about the failures of Eisner as a manager and about his autocratic style.<sup>38</sup> When the board of directors announced early in 2004 that 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 concerns about Eisner's management style and the still-captive board of directors; 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 but would continue as CEO until his term expired in 2005.

### **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 David 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. ■

<sup>38</sup>You can read Roy Disney's letter of resignation on the Web site for the book.

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### 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 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 make them worse off. Many bond (and bank loan) agreements have covenants that do the following:

- **Restrict the firm's investment policy.** Investing in riskier businesses 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.
- **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.
- **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.

Although 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, through higher interest rates) for the legal and monitoring costs associated with the constraints.

#### *Taking an Equity Stake*

Because 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 equity in the firm at the same time as they lend money to it or 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. Although we will consider these innovations in more detail later in this book, consider the example of puttable bonds. Unlike a conventional bond, which constrains bondholders 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



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violates the conditions of the bond. For instance, a sudden increase in borrowing by the company or a drop in its bond rating can trigger this action.



### IN PRACTICE: HEDGE FUNDS AND CORPORATE GOVERNANCE

In the last few years, hedge funds have become key players in the corporate governance battle. They have accumulated large shares in many companies, including some large market cap firms, and have then used those shares to nominate directors and challenge management. While this may seem like an unmitigated good, at least from the perspective of corporate governance, there are four reasons for concern:

1. **Management shakedowns** There have been cases where hedge funds have banded together, threatened management with dire consequences, and used that threat to extract side payments and special deals for themselves. In the process, other stockholders are made even worse off.
2. **Short-term objectives** Some hedge funds have short-term objectives that may diverge from the long-term interests of the firm. Giving hedge funds more of a say in how companies are run can lead to decisions that feed into these short-term interests while damaging long-term firm value.
3. **Competing interests** Since hedge funds can go long or short and invest in different markets (bonds and derivatives), it is conceivable for a hedge fund that owns equity in firm to also have other positions in the firm that may benefit when the value of equity drops. For instance, a hedge fund that owns stock in a company and has bet on the firm's demise in the derivatives market may use its voting power to drive the company into bankruptcy.
4. **Herd mentality** While we assume that hedge fund managers are somehow smarter and more sophisticated than the rest of the market, they are not immune from the behavioral characteristics that bedevil other investors. In fact, the herd mentality seems to drive many hedge fund managers, who flock to the same companies at the same time—and their prescriptions for corporate renewal seem to follow the same script.

In spite of these concerns, we believe that the presence of hedge funds and activist investors in the mix of stockholders empowers other stockholders, for the most part, not because the changes they suggest are always wise or because management is always wrong, but because they force managers to explain their actions (on capital structure, asset deployment, and dividends) to stockholders. ■

### 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 run, however, there are actions that will improve information quality and reduce deviations between price and value.



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### *Improving the Quality of Information*

Although regulatory bodies like the SEC can require firms to reveal more information and penalize those 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 what information they reveal to markets—and when. To provide balance, therefore, an active external market for information has to exist where analysts who are not hired or fired by the firms that they follow collect and disseminate information. These analysts are just as likely to make mistakes as the firm, but they presumably have a greater incentive to unearth bad news about the firm and 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 minimum, these are necessary (though not sufficient) conditions for more efficient markets:

- 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.
- There should be free and wide access to information about firms.
- 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, although 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 in which negative information about stocks cannot be reflected adequately in prices.

### *Short Term versus Long Term*

Even in liquid markets with significant information about companies, investors not only make mistakes, but make these mistakes systematically for extended periods, for the behavioral reasons that we noted earlier. In other words, there is no way to ensure that stock prices will not deviate from value for extended periods. As a consequence, even believers in stock price maximization need to pause and consider the possibility that doing what is right for a company's long-term value may result, at least in the short term, in lower stock prices. Conversely, actions that hurt the long-term interests of the firm may be accompanied by higher stock prices.

The lesson for corporate governance is a simple one. Managers should not be judged and compensated based upon stock price performance over short periods. If compensation is tied to stock prices, a portion of the compensation has to be held back to ensure that management actions are in the best long-term interests of the company. More companies now have claw-back provisions in compensation contracts, allowing them to reclaim compensation from earlier years in case stock prices come down after

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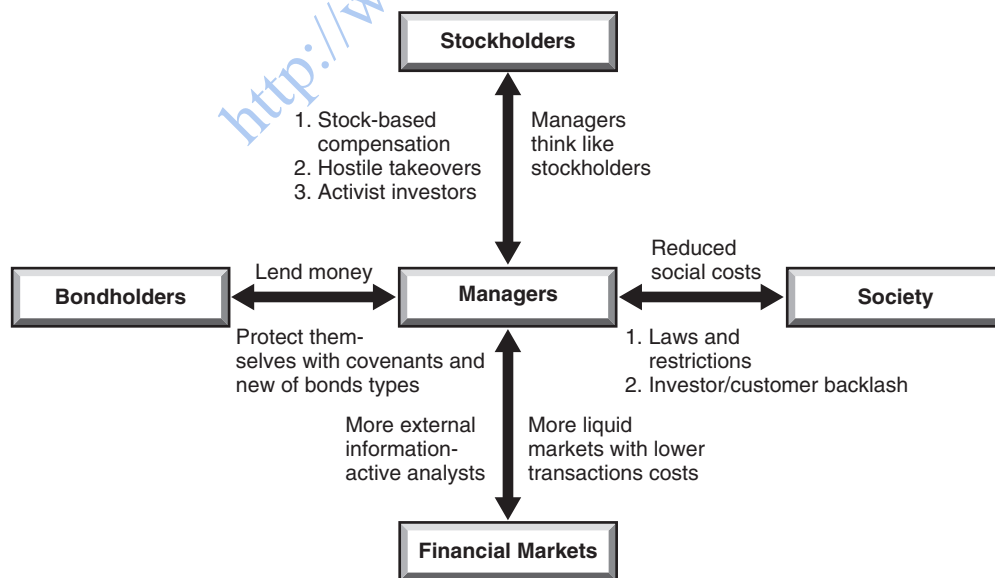
the initial blip, or require managers to wait to cash out their compensation. With restricted stock, for instance, managers often have to wait three or five years before the stock can be liquidated. Implicitly, we are assuming that stock prices ultimately will reflect the true value.

**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 U.S. college and state pension plans 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. Figure 2.3 summarizes the ways in which we can reduce potential side costs from stock price maximization.

**Figure 2.3** Stock Price Maximization with Market Feedback



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**IN PRACTICE: CAN YOU ADD VALUE WHILE DOING GOOD?**

Does doing social good hurt or help firms? On 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 are those who believe that socially conscious firms are rewarded by consumers (with higher sales) and by investors (with higher values). 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 are 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 Microsoft investors begrudged its 1998 decision to give free computers to public libraries around the country. In firms that are doing badly, stockholders tend to be much more resistant to spending company money in mending society's ills.

Summarizing this evidence, we can draw some conclusions. First, a firm's foremost obligation is to stay financially healthy and 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 run. Finally, managers should not keep stockholders in the dark about the cost of meeting social obligations; after all, it is the stockholders' money that is being used for the purpose. ■

**A Compromise Solution: Value Maximization with Price Feedback**

Let us start off by conceding that all of the alternatives—choosing a different corporate governance system, picking an alternative objective, and maximizing stock price with constraints—have limitations and lead to problems. The questions then become how each alternative deals with mistakes and how quickly errors get corrected. This is where a market-based system 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 by well-publicized failures like Enron. Not only did the market punish Enron (by knocking its stock and bond prices 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.



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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 offering 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.

Having made this argument for market-based mechanisms, we also need to be realistic. To the extent that market prices and value can deviate, tying corporate financial decisions to current stock prices can sometimes lead to bad decisions. As a blueprint for decision making, here is what we suggest:

- **Focus on long-term value** Managers should make decisions that maximize the long-term value of the firm. This, of course, will require that we be more explicit about the link between operating and financial decisions and value, and we will do so in the coming chapters.
- **Improve corporate governance** Having an independent and informed board of directors can help top managers by providing feedback on major decisions and by acting as a check on management ambitions. The quality of this feedback will improve if there are adversarial directors on the board. In fact, having an independent director take the role of devil's advocate may force managers to think through the consequences of their decisions.
- **Increase transparency** When managers make decisions that they believe to be in the best long-term interests of the firm, they should make every attempt to be transparent with financial markets about the motivation for and the consequences of these decisions. Too often, managers hold back critical information from markets or engage in obfuscation when dealing with markets.
- **Listen to the market** If the market reaction is not consistent with management expectations—i.e., the stock price goes down when markets receive news about a what managers believe to be a value-increasing decision—managers should consider the message in the market reaction. There are three possible explanations:
  1. The first is that the information provided about the decision is incomplete and or not convincing, in which case framing the decision better for betters may be all that is required (public relations response).



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2. The second is that investors are being swayed by irrational factors and are responding in accordance. In this case, managers should consider modifying the decision to make it palatable to investors, so long as these modifications do not alter the value enhancement dynamic.
  3. The third is that the market is right in its assessment that the decision will destroy and not increase value. In this case, managers should be willing to abandon decisions. While markets are not always right, they should never be ignored, and managers should consider modifying their decisions to reflect the market reaction.
- ***Tie rewards to long-term value*** Any management compensation and reward mechanisms in the firm should be tied to long-term value. Since market prices remain the only tangible manifestation of this value, this implies that any equity compensation (options or restricted stock) be tied to the long-term stock price performance of a firm, not the short-term.

Since this mechanism is central to how we will frame key corporate finance decisions, Figure 2.4 summarizes the process with the feedback loops.

A confession is in order here. In earlier editions of this book, we argued that the objective in corporate finance should be stock price maximization, notwithstanding the failures of financial markets. This is the first time that we have strayed from this classical objective, illustrating not only the effects of the market turmoil of 2008–2009 but also the collective evidence that has accumulated: that investors are not always rational in the way they price assets, at least in the short term.

We will stay with this framework as we make our way through each major corporate finance decision. With investment, financing, and dividend policies, we will begin by focusing on the link between policy and value and what we believe is the best approach for maximizing value. We will follow up by examining what information about these decisions has to be provided to financial markets, and why markets may provide dissonant feedback. Finally, we will consider how best to incorporate this market feedback into decisions (and the information we provide about these decisions) to increase the chances of aligning long-term value and stock prices.

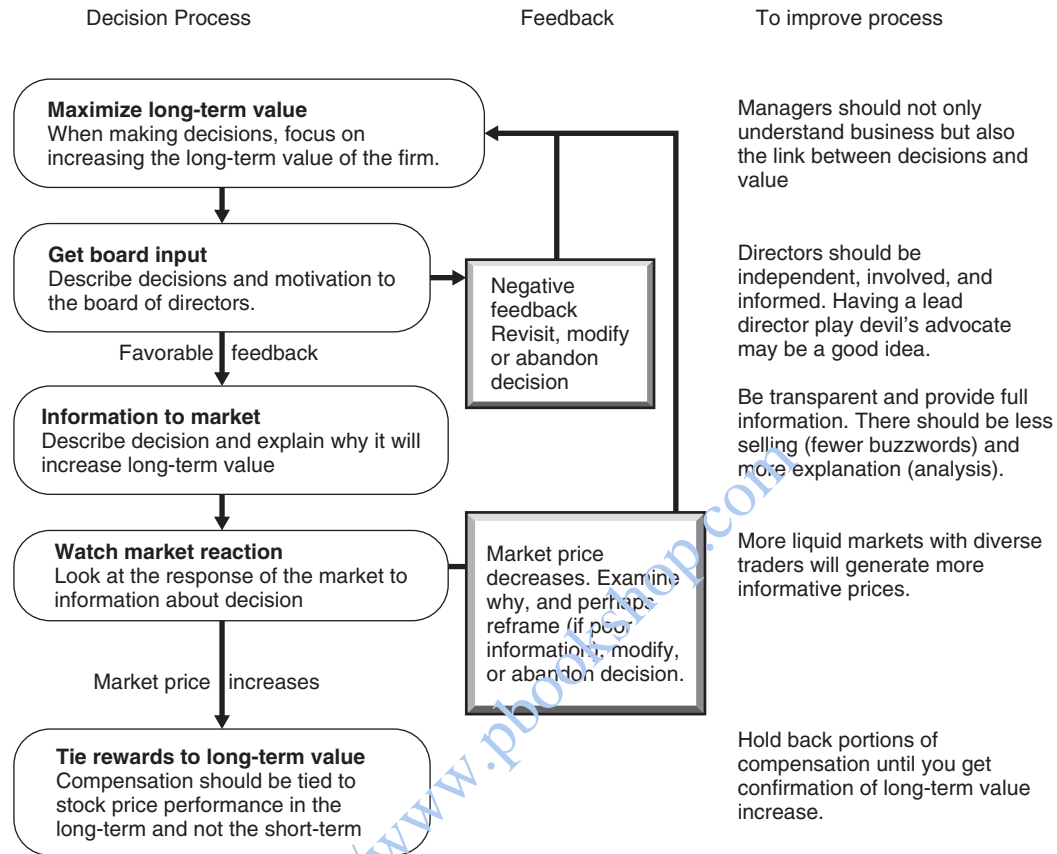
### **A POSTSCRIPT: THE LIMITS OF CORPORATE FINANCE**

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

Economics was once branded the gospel of Mammon because of its emphasis on wealth. The descendants of those critics have labeled corporate finance as unethical, because of its emphasis on the bottom line and market prices. 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,

Figure 2.4 Value Maximization with Feedback



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 set of 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, although the criticism may be better directed at the violators.

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### 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

Although 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. Implicitly, we are assuming that the stock price is a reasonable and unbiased estimate of the true value of the company, and that any action that increases stock prices also increases value.

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. Although this path is alluring, each of the alternatives, including using a different system of corporate governance or a different objective, comes with its own set of limitations. Stock price maximization also fails when markets do not operate efficiently and stock prices deviate from true value for extended periods—and there is mounting evidence that they do.

Given the limitations of the alternatives, we will split the difference. We believe that managers should make decisions that increase the long-term value of the firm and then try to provide as much information as they can about the consequences of these decisions to financial markets. If the market reaction is not positive, they should pay attention, since there is a message in the price reaction that may lead them to modify their decisions.

## LIVE CASE STUDY

### CORPORATE GOVERNANCE ANALYSIS

**Objective:** To analyze the corporate governance structure of the firm and assess where the power in the firm lies and the potential for conflicts of interest at 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, option components)?
- How much equity in the company does the CEO own, and in what form (stocks, or options)?

##### 2. *The Board of Directors*

- Who are 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, etc.)?
- 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 any 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?

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4. *Financial Market Considerations*

- How widely held and traded is the stock? What proportion of its shares are widely traded (floats)?
- 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 SEC. In particular, the 14-DEF will list 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. Although 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 tougher to gauge. 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 (e.g., the *Financial Times*, *The Wall Street Journal*, *Forbes*, *Barron's*) can be useful sources of information.

Finally, the reputation of a firm as a corporate citizen is the most difficult area to obtain clear information on, because 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.

## 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 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 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% 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 setup? 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?