CHAPTER 13

Corporate Governance

Citigroup CEO Vikram Pandit has had a wild ride regarding compensation. In 2007, Pandit sold his hedge fund to Citigroup and made a reported $167 million profit (the fund was shut down later due to poor performance). Citi appointed Pandit CEO in late 2007 and paid him about $1.2 million in cash and over $39 million in stocks and options during 2007 and 2008. But as the global economic crisis worsened, Pandit offered to take only $1 a year in salary and did so during 2009 and 2010.

The year 2011 was much better financially for Pandit as he received a base salary of about $1.75 million and a retention bonus of over $23 million. Citi's board recommended that Pandit's salary be increased to $15 million at the 2012 board meeting. In addition, the board recommended a bonus plan in which Citi's top five executives could earn $18 million in 2012 if the combined 2011–2012 pretax income at Citi exceeded $12 billion.

Shareholders reacted angrily to these proposals and voted against the proposed compensation plans. What prompted such a reaction? It could have been that Citi earned $19.9 billion in pretax income in 2011, so the executives would still receive the proposed bonus even if Citi *lost* over $7 billion in pretax income in 2012!

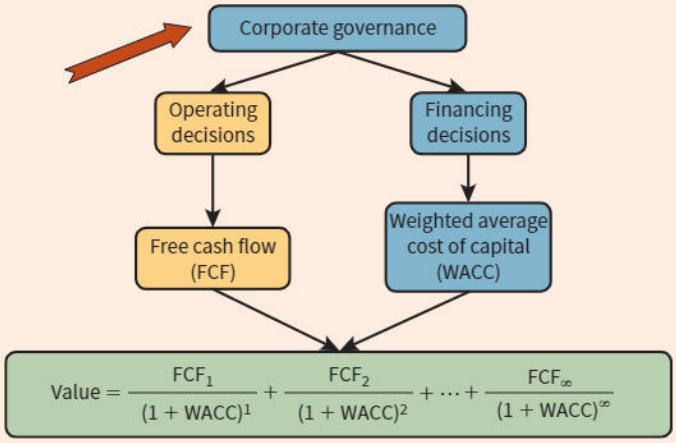
Shareholder votes are nonbinding, and Citi's board ignored the vote. Shortly after, a large shareholder sued Citi's board for a breach of duty. Perhaps not surprisingly, Pandit resigned in 2012.

Similar scenes are being played out at many other companies in the United States and overseas. Keep this example of corporate governance in mind as you read this chapter.

Source: Francesco Guerrera, "Citigroup's Pay Fiasco: Wake-Up Call for Board," *The Wall Street Journal,* April 24, 2012, p. C1.

Corporate Governance and Corporate Valuation

A company's managers make decisions that affect operations, financing, corporate culture, and many other organizational characteristics. These decisions affect the operating and financing choices the company makes, which in turn affect free cash flow and risk.



There is no conflict at a one-person company—the owner makes all the decisions, does all the work, reaps all the rewards, and suffers all the losses. This situation changes as the owner begins hiring employees because the employees don't fully share in the owner's rewards and losses. The situation becomes more complicated if the owner sells some shares of the company to an outsider, and even more complicated if the owner hires someone else to run the company. In this situation, there are many potential conflicts between owners, managers, employees, and creditors. These **agency conflicts** occur whenever owners authorize someone else to act on their behalf as their agents. The degree to which agency problems are minimized often depends on a company's **corporate governance**, which is the set of laws, rules, and procedures that influence the company's operations and the decisions its managers make. This chapter addresses these topics, beginning with agency conflicts.

13-1 Agency Conflicts

An **agency relationship** arises whenever someone, called a **principal**, hires someone else, called an **agent**, to perform some service, and the principal delegates decision-making authority to the agent. In companies, the primary agency relationships are between (1) stockholders and creditors, (2) inside owner/managers (managers who own a controlling interest in the company) and outside owners (who have no control), and (3) outside stockholders and hired managers.[1] These conflicts lead to **agency costs**, which are the reductions in a company's value due to agency conflicts. The following sections describe the agency conflicts, the costs, and methods to minimize the costs.

[1]One of the first and most important papers in finance and economics to address agency conflicts was written by Michael Jensen and William Meckling, titled "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," *Journal of Financial Economics*, Vol. 3, 1976, pp. 305–360.

13-1a Conflicts between Stockholders and Creditors

Creditors have a claim on the firm's earnings stream, and they have a claim on its assets in the event of bankruptcy. However, stockholders have control (through the managers) of decisions that affect the firm's riskiness. Therefore, creditors allocate decision-making authority to someone else, creating a potential agency conflict.

Creditors lend funds at rates based on the firm's perceived risk at the time the credit is extended, which in turn is based on (1) the risk of the firm's existing assets, (2) expectations concerning the risk of future asset additions, (3) the existing capital structure, and (4) expectations concerning future capital structure changes. These are the primary determinants of the risk of the firm's cash flows and hence the safety of its debt.

Suppose the firm borrows money, then sells its relatively safe assets and invests the proceeds in assets for a large new project that is far riskier. The new project might be extremely profitable, but it also might lead to bankruptcy. If the risky project is successful, most of the benefits go to the stockholders, because creditors' returns are fixed at the original low-risk rate. However, if the project is unsuccessful, the bondholders take a loss. From the stockholders' point of view, this amounts to a game of "heads, I win; tails, you lose," which obviously is not good for the creditors. Thus, the increased risk due to the asset change will cause the required rate of return on the debt to increase, which in turn will cause the value of the outstanding debt to fall. This is called *asset switching* or *bait-and-switch*.

A similar situation can occur if a company borrows and then issues additional debt, using the proceeds to repurchase some of its outstanding stock, thus increasing its financial leverage. If things go well, the stockholders will gain from the increased leverage. However, the value of the debt will probably decrease because now there will be a larger amount of debt backed by the same amount of assets. In both the asset switch and the increased leverage situations, stockholders have the potential for gaining, but such gains are made at the expense of creditors.

There are two ways that lenders address the potential of asset switching or subsequent increases in leverage. First, creditors may charge a higher rate to protect themselves in case the company engages in activities that increase risk. However, if the company doesn't increase risk, then its weighted average cost of capital (WACC) will be higher than is justified by the company's risk. This higher WACC will reduce the company's intrinsic value (recall that intrinsic value is the present value of free cash flows discounted at the WACC). In addition, the company will reject projects that it otherwise would have accepted at the lower cost of capital. Therefore, this potential agency conflict has a cost, an agency cost.

The second way that lenders address the potential agency problems is by writing detailed debt covenants specifying what actions the borrower can and cannot take. Most debt covenants prohibit the borrower from (1) increasing debt ratios above specified levels, (2) repurchasing stock or paying dividends unless profits and retained earnings are above specified amounts, and (3) reducing liquidity ratios below specified levels. These covenants can cause agency costs if they restrict a company from value-adding activities. For example, a company may not be able to accept an unexpected but particularly good investment opportunity if it requires temporarily adding debt above the level specified in the bond covenant. In addition, the costs incurred to write the covenant and monitor the company to verify compliance also are agency costs.

13-1b Conflicts between Inside Owner/Managers and Outside Owners

If a company's owner also runs the company, the owner/manager will presumably operate it so as to maximize his or her own welfare. This welfare obviously includes the increased

wealth due to increasing the value of the company, but it also includes perquisites (or "perks") such as more leisure time, luxurious offices, executive assistants, expense accounts, limousines, corporate jets, and generous retirement plans. However, if the owner/manager incorporates the business and then sells some of the stock to outsiders, a potential conflict of interest immediately arises. Notice that the value of the perquisites still accrues to the owner/manager, but the cost of the perquisites is now partially born by the outsiders. This might even induce the owner/manager to increase consumption of the perquisites because they are relatively less expensive now that the outsider is sharing their costs.

This agency problem causes outsiders to pay less for a share of the company and require a higher rate of return. This is exactly why dual class stock (see Chapter 7) that doesn't have voting rights has a lower price per share than voting stock.

13-1c Conflicts between Managers and Shareholders

Shareholders want companies to hire managers who are able and willing to take legal and ethical actions to maximize intrinsic stock prices.[2] This obviously requires managers with technical competence, but it also requires managers who are willing to put forth the extra effort necessary to identify and implement value-adding activities. However, managers are people, and people have both personal and corporate goals. Logically, therefore, managers can be expected to act in their own self-interests, and if their self-interests are not aligned with those of stockholders, then corporate value will not be maximized. There are six ways in which a manager's behavior might harm a firm's intrinsic value.

1. Managers might not expend the time and effort required to maximize firm value. Rather than focusing on corporate tasks, they might shirk their duties and spend too much time on external activities, such as serving on boards of other companies, or on nonproductive activities, such as golf, gourmet meals, and travel.
2. Managers might use corporate resources on activities that benefit themselves rather than shareholders. For example, they might spend company money on such perquisites as lavish offices, memberships at country clubs, museum-quality art for corporate apartments, large personal staffs, and corporate jets. Because these perks are not actually cash payments to the managers, they are called **nonpecuniary benefits**.
3. Managers might avoid making difficult but value-enhancing decisions that harm friends in the company. For example, a manager might not close a plant or terminate a project if the manager has personal relationships with those who are adversely affected by such decisions, even if termination is the economically sound action.
4. Managers might take on too much risk, or they might not take on enough risk. For example, a company might have the opportunity to undertake a risky project with a positive NPV. If the project turns out badly, then the manager's reputation will be harmed, and the manager might even be fired. Thus, a manager might choose to avoid risky projects even if they are desirable from a shareholder's point of view. On the other hand, a manager might take on projects with too much risk. Consider a project that is not living up to expectations. A manager might be tempted to invest even more

[2]Notice that we said both legal and ethical actions. The accounting frauds perpetrated by Enron, WorldCom, and others that were uncovered in 2002 raised stock prices in the short run but only because investors were misled about the companies' financial positions. Then, when Enron finally revealed the correct financial information, the stocks tanked. Investors who bought shares based on the fraudulent financial statements lost tens of billions of dollars. Releasing false financial statements is illegal. Aggressive earnings management and the use of misleading accounting tricks to pump up reported earnings is unethical, and executives can go to jail as a result of their shenanigans. When we speak of taking actions to maximize stock prices, we mean making operational or financial changes designed to maximize intrinsic stock value, not fooling investors with false or misleading financial reports.

money in the project rather than admit that the project is a failure. Or a manager might be willing to take on a second project with a negative NPV if it has even a slight chance of a very positive outcome because hitting a home run with this second project might cover up the first project's poor performance. In other words, the manager might throw good money after bad.

5. If a company is generating positive free cash flow, a manager might "stockpile" it in the form of marketable securities instead of returning FCF to investors. This potentially harms investors because it prevents them from allocating these funds to other investments with good expected returns. Even worse, positive FCF often tempts a manager into paying too much for the acquisition of another company. In fact, most mergers and acquisitions end up as break-even deals, at best, for the acquiring company because the premiums paid for the targets are often very large.

   Why would a manager be reluctant to return cash to investors? First, extra cash on hand reduces the company's risk, which appeals to many managers. Second, a large distribution of cash to investors is an admission that the company doesn't have enough good investment opportunities. Slow growth is normal for a maturing company, but this isn't very exciting for a manager to admit. Third, there is a lot of glamour associated with making a large acquisition, and this can provide a large boost to a manager's ego. Fourth, compensation usually is higher for executives at larger companies; cash distributions to investors make a company smaller, not larger.
6. Managers might not release all the information that investors desire. Sometimes, they might withhold information to prevent competitors from gaining an advantage. Other times, they might try to avoid releasing bad news. For example, they might "massage" the data or "manage the earnings" so that the news doesn't look so bad. If investors are unsure about the quality of information managers provide, they tend to discount the company's expected free cash flows at a higher cost of capital, which reduces the company's intrinsic value.

If senior managers believe there is little chance they will be removed, the company has a problem with **entrenchment**. Such a company faces a high risk of being poorly run, because entrenched managers are able to act in their own interests rather than in the interests of shareholders.

resource

For excellent discussions of corporate governance, see the Web pages of CalPERS (the California Public Employees' Retirement System), **www.calpers.org**, *and TIAA-CREF (Teachers Insurance and Annuity Association College Retirement Equity Fund),* **www.tiaa-cref.org**.

SELF-TEST

What are agency conflicts? What groups can have agency conflicts?

Name six types of managerial behaviors that can reduce a firm's intrinsic value.

13-2 Corporate Governance

Agency conflicts can decrease the value of stock owned by outside shareholders. Corporate governance can mitigate this loss in value. Corporate governance can be defined as the set of laws, rules, and procedures that influence a company's operations and the decisions its managers make. At the risk of oversimplification, most corporate governance provisions come in two forms, sticks and carrots. The primary stick is the *threat of removal*, either as a decision by the board of directors or as the result of a hostile **takeover** in which the company is acquired by outsiders. If a firm's managers are maximizing the value of the resources entrusted to them, they need not fear the loss of their jobs. On the other hand, if managers are not maximizing value, they should be removed by their own boards of directors, by dissident stockholders, or by other companies seeking to profit by installing a better management team. The main carrot is *compensation*. Managers have

greater incentives to maximize intrinsic stock value if their compensation is linked to the firm's performance rather than being strictly in the form of salary.

Almost all corporate governance provisions affect either the threat of removal or compensation. Some provisions are internal to a firm and are under its control.[3] These internal provisions and features can be divided into five areas: (1) monitoring and discipline by the board of directors, (2) charter provisions and bylaws that affect the likelihood of hostile takeovers, (3) compensation plans, (4) capital structure choices, and (5) accounting control systems. In addition to the corporate governance provisions that are under a firm's control, there are also environmental factors outside of a firm's control, such as the regulatory environment, block ownership patterns, competition in the product markets, the media, and litigation. Our discussion begins with the internal provisions.

13-2a Monitoring and Discipline by the Board of Directors

Shareholders are a corporation's owners, and they elect the board of directors to act as agents on their behalf. In the United States, it is the board's duty to monitor senior managers and discipline them if they do not act in the interests of shareholders, either by removal or by a reduction in compensation.[4] This is not necessarily the case outside the United States. For example, many companies in Europe are required to have board members who represent interests other than those of shareholders, such as employee representatives. Also, many European and Asian companies have bank representatives on the board. But even in the United States, many boards fail to act in the shareholders' best interests. How can this be?

Consider the election process. The board of directors has a nominating committee that selects one candidate per open board seat. Although outside candidates can run a "write-in" campaign, usually, only those candidates named by the board's nominating committee are on the ballot.[5] At many companies, the CEO is also the chair of the board and has so much influence on the nominating committee that the slate of nominees is, in effect, chosen by the CEO. Thus, the nominating process often results in a board that is handpicked by the CEO. Because prestige and high compensation accompany directorships, many directors are grateful to the CEO and wish to be nominated again at the ends of their terms. Given this process, it should be no surprise that many directors act in the best interests of the CEO rather than shareholders.

At most companies, a candidate is elected simply by having a majority of votes cast. The proxy ballot usually lists all candidates, with a box for each candidate to check if the shareholder votes "For" the candidate and a box to check if the shareholder "Withholds" a vote on the candidate—you can't actually vote "No"; you can only withhold your vote. In theory, a candidate could be elected with a single "For" vote if all other votes were withheld. In practice, though, most shareholders either vote "For" or assign to management their right to vote (*proxy* is defined as the authority to act for another, which is why it is

[3]We have adapted this framework from the one provided by Stuart L. Gillan, "Recent Developments in Corporate Governance: An Overview," *Journal of Corporate Finance,* June 2006, pp. 381–402. Gillan provides an excellent discussion of the issues associated with corporate governance, and we highly recommend this article to the reader who is interested in an expanded discussion of the issues in this section.

[4]There are a few exceptions to this rule. For example, some states have laws allowing the board to consider the interests of other stakeholders, such as employees and members of the community.

[5]As of late 2016, 40% of S&P 500 firms allow shareholders to nominate candidates for board positions and have these candidates listed on the proxy. This is called *proxy access.* See Harvard Law School on Corporate Governance and Financial Regulation, **https://corpgov.law.harvard.edu/2016/07/13/proxy-access-momentum-in-2016/**.

called a "proxy statement"). In practice, then, the nominated candidates virtually always receive a majority of votes and are thus elected.

Occasionally there is a "Just vote no" campaign in which a large investor (usually an institution such as a pension fund) urges stockholders to withhold their votes for one or more directors. Although such campaigns do not directly affect the director's election, they do provide a visible way for investors to express their dissatisfaction. Empirical evidence shows that "Just vote no" campaigns at poorly performing firms lead to better performance and a greater probability that the CEO will be dismissed.[6]

Voting procedures also affect the ability of outsiders to gain positions on the board. If the charter specifies cumulative voting, then each shareholder is given a number of votes equal to his or her shares multiplied by the number of board seats up for election. For example, the holder of 100 shares of stock will receive 1,000 votes if 10 seats are to be filled. Then, the shareholder can distribute those votes however he or she sees fit. One hundred votes could be cast for each of 10 candidates, or all 1,000 votes could be cast for one candidate. If noncumulative voting is used, the hypothetical stockholder cannot concentrate votes in this way: No more than 100 votes can be cast for any candidate, and the stockholder may do this for as many seats as there are to be filled.

With noncumulative voting, if management controls 51% of the shares, then they can fill every seat on the board, leaving dissident stockholders without any representation on the board. With cumulative voting, however, if 10 seats are to be filled, then dissidents could elect a representative, provided they have 10% plus 1 additional share of the stock.

Note also that bylaws specify whether the entire board is to be elected annually or if directors are to have **staggered terms** with, say, one-third of the seats to be filled each year and directors to serve 3-year terms. With staggered terms, fewer seats come up each year, making it harder for dissidents to gain representation on the board. Staggered boards are also called **classified boards**.

Many boards have **inside directors**—that is, people who hold managerial positions within the company, such as the CFO, and who also are board members. Because insiders report to the CEO, it may be difficult for them to oppose the CEO at a board meeting. To help mitigate this problem, several exchanges, such as the NYSE and NASDAQ, now require that listed companies have a majority of **outside directors** who are supposed to have no other affiliation or financial interest with the company.

However, some "outside" board members often have strong connections with the CEO through professional relationships, personal friendships, and consulting or other fee-generating activities. In fact, outsiders sometimes have very little expert business knowledge but have "celebrity" status from nonbusiness activities. Some companies also have **interlocking boards of directors**, where Company A's CEO sits on Company B's board and B's CEO sits on A's board. In these situations, even the outside directors are not truly independent and impartial.

Large boards (those with more than about 10 members) often are less effective than smaller boards. As anyone who has been on a committee can attest, individual participation tends to fall as committee size increases. Thus, there is a greater likelihood that members of a large board will be less active than those on smaller boards.

The compensation of board members has an impact on the board's effectiveness. When board members have exceptionally high compensation, the CEO also tends to have exceptionally high compensation. This suggests that such boards tend to be too lenient with

[6]See Diane Del Guercio, Laura Seery, and Tracie Woidtke, "Do Boards Pay Attention When Institutional Investor Activists 'Just Vote No'?" *Journal of Financial Economics,* October 2008, pp. 84–103.

the CEO.[7] The form of board compensation also affects board performance. Rather than compensating board members with only salary, many companies now include restricted stock grants or stock options in an effort to better align board members with stockholders.

Studies show that corporate governance usually improves under the following circumstances: (1) The CEO is not also the chairman of the board. (2) The board has a majority of true outsiders who bring some type of business expertise to the board and are not too busy with other activities. (3) The board is not too large. (4) Board members are compensated appropriately (not too high and not all cash, but including exposure to equity risk through options or stock). The good news for the shareholder is that the boards at many companies have made significant improvements in these directions during the past decade. Fewer CEOs are also board chairs, and, as power has shifted from CEOs to boards as a whole, there has been a tendency to replace insiders with strong, independent outsiders. Today, the typical board has about one-third insiders and two-thirds outsiders, and most outsiders are truly independent. Moreover, board members are compensated primarily with stock or options rather than a straight salary. These changes clearly have decreased the patience of boards with poorly performing CEOs. Within the past several years, the CEOs of Sprint Nextel, Hewlett-Packard, Home Depot, Citigroup, Pfizer, Groupon, Siemens, J.C. Penney, Men's Warehouse, and Barnes & Noble, to name just a few, have been removed by their boards. This would not have occurred 30 years ago.

13-2b Charter Provisions and Bylaws That Affect the Likelihood of Hostile Takeovers

Hostile takeovers usually occur when managers have not been willing or able to maximize the profit potential of the resources under their control. In such a situation, another company can acquire the poorly performing firm, replace its managers, increase free cash flow, and improve MVA. The following paragraphs describe some provisions that can be included in a corporate charter to make it harder for poorly performing managers to remain in control.[8]

A shareholder-friendly charter should ban **targeted share repurchases**, also known as **greenmail**. For example, suppose a company's stock is selling for $20 per share. Now a hostile bidder, or raider, who plans to replace management if the takeover is successful, buys 5% of the company's stock at the $20 price.[9] The raider then makes an offer to purchase the remainder of the stock for $30 per share. The company might offer to buy back the raider's stock at a price of, say, $35 per share. This is called a targeted share repurchase because the stock will be purchased only from the raider and not from any other shareholders. A raider who paid only $20 per share for the stock would be making a quick profit of $15 per share, which could easily total several hundred million dollars. As a part of the deal, the raider would sign a document promising not to attempt to take over the

[7]See I. E. Brick, O. Palmon, and J. Wald, "CEO Compensation, Director Compensation, and Firm Performance: Evidence of Cronyism?" *Journal of Corporate Finance,* June 2006, pp. 403–423.

[8]Some states have laws that go further than others to protect management. This is one reason that many companies are incorporated in manager-friendly Delaware. Some companies have even shifted their state of incorporation to Delaware because their managers felt that a hostile takeover attempt was likely. Note that a "shareholder-friendly charter" could and would waive the company's right to strong anti-takeover protection, even if the state allowed it.

[9]Someone can, under the law, acquire up to 5% of a firm's stock without announcing the acquisition. Once the 5% limit has been hit, the acquirer has 10 days to "announce" the acquisition by filing Schedule 13D with the SEC. Schedule 13D reports not only the acquirer's number of shares but also his or her intentions, such as a passive investment or a takeover. These reports are monitored closely, so as soon as one is filed, management is alerted to the possibility of an imminent takeover.

company for a specified number of years; hence, the buyback also is called greenmail. Greenmail hurts shareholders in two ways. First, they are left with $20 stock when they could have received $30 per share. Second, the company purchased stock from the bidder at $35 per share, which represents a direct loss by the remaining shareholders of $15 for each repurchased share.

Managers who buy back stock in targeted repurchases typically argue that their firms are worth more than the raiders offered and that, in time, the "true value" will be revealed in the form of a much higher stock price. This situation might be true if a company were in the process of restructuring itself, or if new products with high potential were in the pipeline. But absent compelling evidence, one should question whether the true purpose of the buyback was to protect stockholders or management.

Another characteristic of a stockholder-friendly charter is that it does not contain a **shareholder rights provision**, better described as a **poison pill**. These provisions give the shareholders of target firms the right to buy a specified number of shares in the company at a very low price if an outside group or firm acquires a specified percentage of the firm's stock. Therefore, if a potential acquirer tries to take over a company, its other shareholders will be entitled to purchase additional shares of stock at a bargain price, thus seriously diluting the holdings of the raider. For this reason, these clauses are called poison pills because if they are in the charter, the acquirer will end up swallowing a poison pill if the acquisition is successful. Obviously, the existence of a poison pill makes a takeover more difficult, and this helps to entrench management.

A third management entrenchment tool is a **restricted voting rights** provision, which automatically cancels the voting rights of any shareholder who owns more than a specified amount of the company's stock. The board can grant voting rights to such a shareholder, but this is unlikely if that shareholder plans to take over the company.

13-2c Using Compensation to Align Managerial and Shareholder Interests

The typical CEO's compensation is comprised of (1) a fixed salary, (2) cash bonuses awarded by the board of directors (often to a new CEO at the time of the hire or to the current CEO for successfully completing a specific task), (3) stock awards, (5) stock option awards, (6) non-equity incentive awards based on the firm's operating performance, and (7) miscellaneous compensation such as deferred compensation and contributions to pension/retirement accounts. Senior executives and board directors usually have some of these items in their own compensation plans.

Non-equity incentive awards often are based upon short-term operating factors, such as this year's growth in earnings per share or improvements in certain traditional ratios, such as the return on equity and the return on assets. Incentive awards will align managers' and shareholders' interests to the extent that the performance metrics actually reflect changes in the stock's intrinsic value. Unfortunately, humans are creative (especially accountants) and managers often find ways of maximizing these awards without significantly increasing intrinsic value.

As a result, companies today are shifting to the performance metrics described in Chapter 2, such as the return on invested capital (ROIC), economic value added (EVA), and market value added (MVA).[10] For example, increases in EVA are closely linked to

[10]For a discussion of EVA, see Al Ehrbar, *EVA: The Real Key to Creating Wealth* (New York: John Wiley & Sons, 1998); and Pamela P. Peterson and David R. Peterson, *Company Performance and Measures of Value Added* (The Research Foundation of the Institute of Chartered Financial Analysts, 1996).

increases in intrinsic value. Also, it is much more difficult to manipulate EVA in ways that don't also increase intrinsic value; the same cannot be said about earnings per share.

EQUITY-BASED COMPENSATION

Equity-based compensation can be in the form of (1) restricted stock awards, (2) restricted stock units (RSUs), or (3) stock options. These forms of compensation increase if the stock price increases, which seems to align the interests of managers and shareholders. We will have more to say later in this section, but first let's take a look at the forms of equity-based compensation.

Restricted stock awards (or grants) allow the recipient to vote and collect dividends, but they may not be sold until after some specified period (the **vesting period**), which is usually 1 to 5 years. Some grants have **cliff vesting**, with all stocks in the grant vesting at the same date, such as 3 years after the grant. Other grants have **annual vesting**, which means that a certain percentage vests each year. For example, one-third of the stocks in the grant might vest each year.

Restricted stock units (RSUs) are similar to restricted stocks in that they entitle the recipient to shares of stock after vesting. However, the recipient does not collect dividends or vote. Usually the RSUs are paid with shares of stock after vesting, but sometimes they are paid with the cash equivalent. In addition, there are tax issues associated with the RSUs versus restricted stock awards.

Chapter 8 explains option valuation in detail, but here we discuss how a typical **stock option compensation plan** works. Suppose IBM decides to grant an option to an employee, allowing her to purchase a specified number of IBM shares at a fixed price, called the **strike price** (or **exercise price**), regardless of the actual price of the stock. The strike price is usually set equal to the current stock price at the time the option is granted. Thus, if IBM's current price were $100, then the option would have an exercise price of $100. Like restricted stock and RSUs, options usually cannot be exercised until after vesting.

The options have an **expiration date**, usually 10 years after issue. For our IBM example, assume that the options have cliff vesting in 3 years and an expiration date in 10 years. Thus, the employee can exercise the option 3 years after issue or wait as long as 10 years. Of course, the employee would not exercise unless IBM's stock is above the $100 exercise price, and if the price never rose above $100, the option would expire unexercised. However, if the stock price were above $100 on the expiration date, the option would surely be exercised.

Suppose the stock price had grown to $134 after 5 years, at which point the employee decided to exercise the option. She would buy stock from IBM for $100, so IBM would get only $100 for stock worth $134. The employee would (probably) sell the stock the same day she exercised the option and hence would receive in cash the $34 difference between the $134 stock price and the $100 exercise price. There are two important points to note in this example. First, most employees sell stock soon after exercising the option. Thus, the incentive effects of an option grant typically end when the option is exercised. Second, option pricing theory shows that it is not optimal to exercise a conventional call option on stock that does not pay dividends before the option expires: An investor is always better off selling the option in the marketplace rather than exercising it. But because employee stock options are not tradable, grantees often exercise the options well before they expire. For example, people often time the exercise of options to coincide with the purchase of a new home or some other large expenditure. But early exercise occurs not just for liquidity reasons, such as needing cash to purchase a house, but also because of behavioral reasons. For example, exercises occur more frequently after stock run-ups, which suggests that grantees view the stock as overpriced.

DOES EQUITY-BASED COMPENSATION ALIGN THE INTERESTS OF MANAGERS AND SHAREHOLDERS?

In theory, equity-based compensation should align a manager's interests with those of shareholders, influencing the manager to behave in ways that maximize the company's value. But in practice, this does not always occur for two reasons. We illustrate these reasons using stock options, but the same logic also applies to restricted stock and RSU grants.

First, suppose a CEO is granted options on 1 million shares. If we use the same stock prices as in our previous example, then at expiration the grantee would receive $34 for each option, or a total of $34 million. But take a closer look at this example. If the risk-free rate is 5.5%, the market risk premium is 6%, and IBM's beta is 1.19, then the expected return, based on the CAPM, is 5.5% + 1.19(6%) = 12.64%. IBM's dividend yield is only 0.8%, so the expected annual price appreciation must be about 11.84% (12.64% − 0.8% = 11.84%). Now note that if IBM's stock price grew from $100 to $134 over 5 years, this would translate to an annual growth rate of only 6%, not the 11.84% shareholders expected. Thus, the executive would receive $34 million for helping run a company that performed below shareholders' expectations. As this example illustrates, standard stock options do not necessarily link executives' wealth with that of shareholders.

Second, and even worse, the events of the early 2000s showed that some executives were willing to illegally falsify financial statements in order to drive up stock prices just prior to exercising their stock options.[11] In some notable cases, the subsequent stock price drop and loss of investor confidence have forced firms into bankruptcy. Such behavior is certainly not in shareholders' best interests!

Just as "all ships rise in a rising tide," so too do most stocks rise in a bull market such as that of 2011–2018. In a strong market, even the stocks of companies whose performance ranks in the bottom 10% of their peer group can rise and thus trigger handsome executive bonuses. This situation is leading to compensation plans that are based on *relative* as opposed to *absolute* stock price performance. For example, some compensation plans have indexed options whose exercise prices depend on the performance of the market or a subset of competitors.

Finally, the empirical results from academic studies show that the correlation between executive compensation and corporate performance is mixed. Some studies suggest that the type of compensation plan used affects company performance, while others find little effect, if any. But we can say with certainty that managerial compensation plans will continue to receive lots of attention from researchers, the popular press, and boards of directors.

13-2d Capital Structure and Internal Control Systems

Capital structure decisions can affect managerial behavior. As the debt level increases, so does the probability of bankruptcy. This increased threat of bankruptcy affects managerial behavior in two ways. First, as discussed earlier in this chapter, managers may waste money on unnecessary expenditures and perquisites. This behavior is more likely when times are good and firms are flush with cash; it is less likely in the face of high

[11]Several academic studies show that option-based compensation leads to a greater likelihood of earnings restatements (which means having to refile financial statements with the SEC because there was a material error) and outright fraud. See A. Agrawal and S. Chadha, "Corporate Governance and Accounting Scandals," *Journal of Law and Economics*, 2006, pp. 371–406; N. Burns and S. Kedia, "The Impact of Performance-Based Compensation on Misreporting," *Journal of Financial Economics,* January 2006, pp. 35–67; and D. J. Denis, P. Hanouna, and A. Sarin, "Is There a Dark Side to Incentive Compensation?" *Journal of Corporate Finance,* June 2006, pp. 467–488.

The Dodd-Frank Act and "Say on Pay"

The Dodd-Frank Act requires corporations to hold a non-binding vote to approve or reject the company's executive compensation plan. As of October 2016, 1,972 companies in the Russell 3000 have held say on pay votes since 2011 when the vote was first required. Since then, 93% have passed with at least 70% shareholder support. There have been some notable exceptions, however, with shareholders rejecting compensation plans at companies such as Navistar International, RadioShack, Abercrombie & Fitch, and Big Lots.

In addition to say on pay, shareholders are also concerned with other issues, submitting proposals on topics dealing with political lobbying, social responsibility and takeover defenses.

Source: Selmer Brossy "2016 Say on Pay Results," published by Semler Brossy and available at **http://www.semlerbrossy.com/sayonpay**.

debt levels and possible bankruptcy. Thus, high levels of debt tend to reduce managerial waste. Second, however, high levels of debt may also reduce a manager's willingness to undertake positive-NPV but risky projects. Most managers have their personal reputation and wealth tied to a single company. If that company has a lot of debt, then a particularly risky project, even if it has a positive NPV, may be just too risky for the manager to tolerate because a bad outcome could lead to bankruptcy and loss of the manager's job. Stockholders, on the other hand, are diversified and would want the manager to invest in positive-NPV projects even if they are risky. When managers forgo risky but value-adding projects, the resulting **underinvestment problem** reduces firm value. So increasing debt might increase firm value by reducing wasteful expenditures, but it also might reduce value by inducing underinvestment by managers. Empirical tests have not been able to establish exactly which effect dominates.

Internal control systems have become an increasingly important issue since the passage of the Sarbanes-Oxley Act of 2002. Section 404 of the act requires companies to establish effective internal control systems. The Securities and Exchange Commission, which is charged with the implementation of Sarbanes-Oxley, defines an effective internal control system as one that provides "reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles." In other words, investors should be able to trust a company's reported financial statements.

13-2e Environmental Factors outside a Firm's Control

As noted earlier, corporate governance is also affected by environmental factors that are outside a firm's control, including the regulatory/legal environment, block ownership patterns, competition in the product markets, the media, and litigation.

REGULATIONS AND LAWS

The regulatory/legal environment includes the agencies that regulate financial markets, such as the SEC. Even though the fines and penalties levied on firms for financial misrepresentation by the SEC are relatively small, the damage to a firm's reputation can have significant costs, leading to extremely large reductions in the firm's value.[12] Thus, the regulatory system has an enormous impact on corporate governance and firm value.

[12]For example, see Jonathan M. Karpoff, D. Scott Lee, and Gerald S. Martin, "The Cost to Firms of Cooking the Books," *Journal of Financial and Quantitative Analysis,* September 2008, pp. 581–612.

The Sarbanes-Oxley Act of 2002 and Corporate Governance

In 2002, Congress passed the Sarbanes-Oxley Act, known in the industry as SOX, as a measure to improve transparency in financial accounting and to prevent fraud. SOX consists of 11 chapters, or *titles*, which establish wide-ranging new regulations for auditors, CEOs and CFOs, boards of directors, investment analysts, and investment banks. These regulations are designed to ensure the following: (1) Companies that perform audits are sufficiently independent of the companies that they audit. (2) A key executive in each company *personally* certifies that the financial statements are complete and accurate. (3) The board of directors' audit committee is relatively independent of management. (4) Financial analysts are relatively independent of the companies they analyze. (5) Companies publicly and promptly release all important information about their financial condition. The individual titles are briefly summarized as follows.

Title I establishes the Public Company Accounting Oversight Board, whose charge is to oversee auditors and to establish quality control and ethical standards for audits.

Title II requires that auditors be independent of the companies that they audit. Basically this means they can't provide consulting services to the companies they audit. The purpose is to remove financial incentives for auditors to help management "cook the books."

Title III requires that the board of directors' audit committee must be composed of "independent" members. Section 302 requires that the CEO and CFO must review the annual and quarterly financial statements and reports and personally certify that they are complete and accurate. Penalties for certifying reports that executives know are false range up to a $5 million fine, 20 years in prison, or both. Under Section 304, if the financial statements turn out to be false and must be *restated,* then certain bonuses and equity-based compensation that executives earn must be reimbursed to the company.

Title IV's Section 401(a) requires prompt disclosure of and more extensive reporting on off–balance sheet transactions. Section 404 requires that management evaluate its internal financial controls and report whether they are "effective." The external auditing firm must also indicate whether it agrees with management's evaluation of its internal controls. Section 409 requires that a company disclose to the public promptly and *in plain English* any material changes to its financial condition. Title IV also places restrictions on the loans that a company can make to its executives.

Title V addresses the relationship between financial analysts, the investment banks they work for, and the companies they cover. It requires that analysts and brokers who make stock recommendations disclose any conflicts of interest they might have concerning the stocks they recommend.

Titles VI and VII are technical in nature, dealing with the SEC's budget and powers and requiring that several studies be undertaken by the SEC.

Title VIII establishes penalties for destroying or falsifying audit records. It also provides "whistleblower protection" for employees who report fraud.

Title IX increases the penalties for a variety of white-collar crimes associated with securities fraud, such as mail and wire fraud. Section 902 also makes it a crime to alter, destroy, or hide documents that might be used in an investigation. It also makes it a crime to conspire to do so.

Title X requires that the CEO sign the company's federal income tax return.

Title XI provides penalties for obstructing an investigation and grants the SEC authority to remove officers or directors from a company if they have committed fraud.

The regulatory/legal environment also includes the laws and legal system under which a company operates. These vary greatly from country to country. Studies show that firms located in countries with strong legal protection for investors have stronger corporate governance and that this is reflected in better access to financial markets, a lower cost of equity, increases in market liquidity, and less nonsystematic volatility in stock returns.[13]

[13]For example, see R. La Porta, F. Lopez-de-Silanes, A. Shleifer, and R. Vishny, "Legal Determinants of External Finance," *Journal of Finance,* January 1997, pp. 1131–1150; Hazem Daouk, Charles M. C. Lee, and David Ng, "Capital Market Governance: How Do Security Laws Affect Market Performance?" *Journal of Corporate Finance,* June 2006, pp. 560–593; and Li Jin and Stewart C. Myers, "R^2 Around the World: New Theory and New Tests," *Journal of Financial Economics,* February 2006, pp. 257–292.

International Corporate Governance

Corporate governance includes the following factors: (1) the likelihood that a poorly performing firm can be taken over, (2) whether the board of directors is dominated by insiders or outsiders, (3) the extent to which most of the stock is held by a few large "blockholders" versus many small shareholders, and (4) the size and form of executive compensation. An interesting study compared corporate governance in Germany, Japan, and the United States.

First, note from the accompanying table that the threat of a takeover serves as a stick in the United States but not in Japan or Germany. This threat, which reduces management entrenchment, should benefit shareholders in the United States relative to the other two countries. Second, German and Japanese boards are larger than those in the United States. Japanese boards consist primarily of insiders, unlike German and American boards, which have similar inside/outside mixes. It should be noted, though, that the boards of most large German corporations include representatives of labor, whereas U.S. boards represent only shareholders. Thus, it would appear that U.S. boards, with a higher percentage of outsiders, would have interests most closely aligned with those of shareholders.

German and Japanese firms are also more likely to be controlled by large blocks of stock than those in the United States. Although institutional investors such as pension and mutual funds are increasingly important in the United States, block ownership is still less prevalent than in Germany and Japan. In both Germany and Japan, banks often own large blocks of stock, something that is not permitted by law in the United States, and corporations also own large blocks of stock in other corporations. In Japan, combinations of companies, called **keiretsus**, have cross-ownership of stock among the member companies, and these interlocking blocks distort the definition of an outside board member. For example, when the performance of a company in a keiretsu deteriorates, new directors are often appointed from the staffs of other members of the keiretsu. Such appointees might be classified officially as insiders, but they represent interests other than those of the troubled company's CEO.

In general, large blockholders are better able to monitor management than are small investors, so one might expect the blockholder factor to favor German and Japanese shareholders. However, these blockholders have other relationships with the company that might be detrimental to outside shareholders. For example, if one company buys from another, transfer pricing might be used to shift wealth to a favored company, or a company might be forced to buy from a sister company in spite of the availability of lower-cost resources from outside the group.

Executive compensation packages differ dramatically across the three countries, with U.S. executives receiving by

BLOCK OWNERSHIP PATTERNS

Prior to the 1960s, most U.S. stocks were owned by large numbers of individual investors, each of whom owned a diversified portfolio of stocks. Because each individual owned a small amount of any given company's stock, there was little that he or she could do to influence its operations. Also, with such a small investment, it was not cost effective for the investor to monitor companies closely. Indeed, dissatisfied stockholders would typically just "vote with their feet" by selling the stock. This situation began to change as institutional investors such as pension funds and mutual funds gained control of larger and larger shares of investment capital—and as they then acquired larger and larger percentages of all outstanding stock. Given their large block holdings, it now makes sense for institutional investors to monitor management, and they have the clout to influence the board. In some cases, they have actually elected their own representatives to the board. For example, when TIAA-CREF, a huge private pension fund, became frustrated with the performance and leadership of Furr's/Bishop, a cafeteria chain, the fund led a fight that ousted the entire board and then elected a new board consisting only of outsiders.

In general, activist investors with large blocks in companies have been good for all shareholders. They have searched for firms with poor profitability and then replaced management with new teams that are well versed in value-based management techniques,

far the highest compensation. However, compensation plans are remarkably similar in terms of how sensitive total compensation is to corporate performance.

Which country's system of corporate governance is best from the standpoint of a shareholder whose goal is stock price maximization? There is no definitive answer. U.S. stocks have had the best performance in recent years. Moreover, German and Japanese companies are slowly moving toward the U.S. system with respect to size of compensation, and compensation plans in all three countries are being linked ever more closely to performance. At the same time, however, U.S. companies are moving toward the others in the sense of having larger ownership blocks; because those blocks are primarily held by pension and mutual funds (rather than banks and related corporations), they better represent the interests of shareholders.

Source: Steven N. Kaplan, "Top Executive Incentives in Germany, Japan, and the USA: A Comparison," in *Executive Compensation and Shareholder Value,* Jennifer Carpenter and David Yermack, eds. (Boston: Kluwer Academic Publishers, 1999), pp. 3–12.

International Characteristics of Corporate Governance

	Germany	Japan	United States
Threat of a takeover	Moderate	Low	High
Board of directors			
Size of board	26	21	14
Percent insiders	27%	91%	33%
Percent outsiders	73%	9%	67%
Are large blocks of stock typically owned by			
A controlling family?	Yes	No	No
Another corporation?	Yes	Yes	No
A bank?	Yes	Yes	No
Executive compensation			
Amount of compensation	Moderate	Low	High
Sensitivity to performance	Low to moderate	Low to moderate	Low to moderate

thereby improving profitability. Not surprisingly, stock prices usually rise on the news that a well-known activist investor has taken a major position in an underperforming company.

Note that activist investors can improve performance even if they don't go so far as to take over a firm. More often, they either elect their own representatives to the board or simply point out the firm's problems to other board members. In such cases, boards become less tolerant of management behavior when they realize that the management team is not acting to increase shareholder value. Moreover, the firm's top managers recognize what will happen if they don't whip the company into shape, and they go about doing just that.

COMPETITION IN PRODUCT MARKETS

The degree of competition in a firm's product market has an impact on its corporate governance. For example, companies in industries with lots of competition don't have the luxury of tolerating poorly performing CEOs. As might be expected, CEO turnover is higher in competitive industries than in those with less competition.[14] When most firms in an industry are similar, you might expect it to be easier to find a qualified replacement

[14]See M. De Fond and C. Park, "The Effect of Competition on CEO Turnover," *Journal of Accounting and Economics,* Vol. 27, 1999, pp. 35–56; and T. Fee and C. Hadlock, "Management Turnover and Product Market Competition: Empirical Evidence from the U.S. Newspaper Industry," *Journal of Business,* April 2000, pp. 205–243.

from another firm for a poorly performing CEO. This is exactly what the evidence shows: As industry homogeneity increases, so does the incidence of CEO turnover.[15]

THE MEDIA AND LITIGATION

Corporate governance, especially compensation, is a hot topic in the media. The media can have a positive impact by discovering or reporting corporate problems, such as the Enron scandal. Another example is the extensive coverage that was given to option backdating, in which the exercise prices of executive stock options were set *after* the options officially were granted. Because the exercise prices were set at the lowest stock price during the quarter in which the options were granted, the options were in-the-money and more valuable when their "official" lives began. Several CEOs lost their jobs over this practice.

However, the media can also hurt corporate governance by focusing too much attention on a CEO. Such "superstar" CEOs often command excessive compensation packages and spend too much time on activities outside the company, resulting in too much pay for too little performance.[16]

In addition to penalties and fines from regulatory bodies such as the SEC, civil litigation also occurs when companies are suspected of fraud. Research indicates that such suits lead to improvements in corporate governance.[17]

SELF-TEST

What are the two primary forms of corporate governance provisions that correspond to the stick and the carrot?

What factors improve the effectiveness of a board of directors?

What are three provisions in many corporate charters that deter takeovers?

Describe how a typical stock option plan works. What are some problems with a typical stock option plan?

13-3 Employee Stock Ownership Plans (ESOPs)

WWW

See **www.esopassociation.org** *for updates on ESOP statistics.*

Studies show that 90% of the employees who receive stock under option plans sell the stock as soon as they exercise their options, so the plans motivate employees only for a limited period.[18] Moreover, many companies limit their stock option plans to key managers and executives. To help provide long-term productivity gains and improve retirement incomes for all employees, Congress authorized the use of **Employee Stock Ownership Plans (ESOPs)**. As of 2018, there were over 7,000 ESOP plans representing 14 million employees. Typically, the ESOP's major asset is shares of the common stock of the company that created it, and of the 10,000 total ESOPs, about half of them actually own a majority of their company's stock.[19]

[15]See R. Parrino, "CEO Turnover and Outside Succession: A Cross-Sectional Analysis," *Journal of Financial Economics,* Vol. 46, 1997, pp. 165–197.

[16]See U. Malmendier and G. A. Tate, "Superstar CEOs," *Quarterly Journal of Economics,* November 2009, pp. 1593–1638.

[17]For example, see D. B. Farber, "Restoring Trust after Fraud: Does Corporate Governance Matter?" *Accounting Review,* April 2005, pp. 539–561; and Stephen P. Ferris, Tomas Jandik, Robert M. Lawless, and Anil Makhija, "Derivative Lawsuits as a Corporate Governance Mechanism: Empirical Evidence on Board Changes Surrounding Filings," *Journal of Financial and Quantitative Analysis,* March 2007, pp. 143–166.

[18]See Gary Laufman, "To Have and Have Not," *CFO,* March 1998, pp. 58–66.

[19]For current information on ESOPs and other equity-based compensation, see The National Center for Employee Ownership's Web page at **www.nceo.org.** See also **www.esop.org.**

To illustrate how an ESOP works, consider Gallagher & Abbott Inc. (G&A), a construction company located in Knoxville, Tennessee. G&A's simplified balance sheet follows:

G&A's Balance Sheet Prior to ESOP (Millions of Dollars)

Assets		Liabilities and Equity	
Cash	$ 10	Debt	$100
Other	190	Equity (1 million shares)	100
Total	$200	Total	$200

Now G&A creates an ESOP, which is a new legal entity. The company issues 500,000 shares of new stock at $100 per share, or $50 million in total, which it sells to the ESOP. The company's employees are the ESOP's stockholders, and each employee receives an ownership interest based on the size of his or her salary and years of service. The ESOP borrows the $50 million to buy the newly issued stock.[20] Financial institutions are willing to lend the ESOP the money because G&A signs a guarantee for the loan. Here is the company's new balance sheet:

G&A's Balance Sheet after the ESOP (Millions of Dollars)

Assets		Liabilities and Equity	
Cash	$ 60	Debt[a]	$100
Other	190	Equity (1.5 million shares)	150
Total	$250	Total	$250

[a]The company has guaranteed the ESOP's loan, and it has promised to make payments to the ESOP sufficient to retire the loan, but this does not show up on the balance sheet.

The company now has an additional $50 million of cash and $50 million more of book equity, but it has a de facto liability due to its guarantee of the ESOP's debt. It could use the cash to finance an expansion, but many companies use the cash to repurchase their own common stock, so we assume that G&A will do likewise. The company's new balance sheets, and that of the ESOP, are as follows:

G&A's Balance Sheet after the ESOP and Share Repurchase (Millions of Dollars)

Assets		Liabilities and Equity	
Cash	$ 10	Debt	$100
Other	190	Equity (1 million shares)	150
		Treasury stock	(50)
Total	$200	Total	$200

ESOP's Initial Balance Sheet (Millions of Dollars)

Assets		Liabilities and Equity	
G&A stock	$50	Debt	$50
		Equity	0
Total	$50	Total	$50

[20]Our description is simplified. Technically, the stock would be placed in a suspense account and then be allocated to employees as the debt is repaid.

Note that, although the company's balance sheet looks exactly as it did initially, there is actually a huge difference: The company has guaranteed the ESOP's debt, and hence it has an off–balance sheet liability of $50 million. Moreover, because the ESOP has no equity, the guarantee is very real indeed. Finally, observe that operating assets have not been increased at all, but the total debt outstanding supported by those assets has increased by $50 million.[21]

If this were the whole story, then there would be no reason to have an ESOP. However, G&A has promised to make payments to the ESOP in sufficient amounts to enable the ESOP to pay interest and principal charges on the debt, amortizing it over 15 years. Thus, after 15 years, the debt will be paid off, and the ESOP's equity holders (the employees) will have equity with a book value of $50 million and a market value that could be much higher if G&A's stock increases, as it should over time. Then, as employees retire, the ESOP will distribute a pro rata amount of the G&A stock to each employee, who can then use it as a part of his or her retirement plan.

An ESOP is clearly beneficial for employees, but why would a company want to establish one? There are five primary reasons.

1. Congress passed the enabling legislation in hopes of enhancing employees' productivity and thus making the economy more efficient. In theory, employees who have equity in the enterprise will work harder and smarter. Note too that if employees are more productive and creative, then this will benefit outside shareholders because productivity enhancements that benefit ESOP shareholders also benefit outside shareholders.
2. The ESOP represents additional compensation to employees: In our example, there is a $50 million (or more) transfer of wealth from existing shareholders to employees over the 15-year period. Presumably, if the ESOP were not created, then some other form of compensation would have been required, and that alternative compensation might not have the secondary benefit of enhancing productivity. Also note that the ESOP's payments to employees (as opposed to the payment by the company) come primarily at retirement, and Congress wanted to boost retirement incomes.
3. Depending on when an employee's rights to the ESOP are vested, the ESOP may help the firm retain employees.
4. There are strong tax incentives that encourage a company to form an ESOP. First, Congress decreed that when the ESOP owns 50% or more of the company's common stock, financial institutions that lend money to ESOPs can exclude from taxable income 50% of the interest they receive on the loan. This improves the financial institutions' after-tax returns, which allows them to lend to ESOPs at below-market rates. Therefore, a company that establishes an ESOP can borrow through the ESOP at a lower rate than would otherwise be available; in our example, the $50 million of debt would be at a reduced rate.

   There is also a second tax advantage. If the company were to borrow directly, it could deduct interest but not principal payments from its taxable income. However, companies typically make the required payments to their ESOPs in the form of cash dividends. Dividends are not normally deductible from taxable income, but *cash dividends paid on ESOP stock are deductible if the dividends are paid to plan participants or are used to repay the loan*. Thus, companies whose ESOPs own 50% of their stock can in effect borrow on ESOP loans at subsidized rates and then

[21]We assumed that the company used the $50 million paid to it by the ESOP to repurchase common stock and thus to increase its de facto debt. It could have used the $50 million to retire debt, in which case its true debt ratio would remain unchanged, or it could have used the money to support an expansion.

deduct both the interest and principal payments made on the loans. American Airlines and Publix Supermarkets are two of the many firms that have used ESOPs to obtain this benefit, along with motivating employees by giving them an equity interest in the enterprise.

5. A less desirable use of ESOPs is to help companies avoid being acquired by another company. The company's CEO or someone appointed by the CEO typically acts as trustee for its ESOP, and the trustee is supposed to vote the ESOP's shares according to the will of the plan participants. Moreover, the participants, who are the company's employees, usually oppose takeovers because they frequently involve labor cutbacks. Therefore, if an ESOP owns a significant percentage of the company's shares, then management has a powerful tool for warding off takeovers. This is not good for outside stockholders.

Are ESOPs good for a company's shareholders? In theory, ESOPs motivate employees by providing them with an ownership interest. That should increase productivity and thereby enhance stock values. Moreover, tax incentives mitigate the costs associated with some ESOPs. However, an ESOP can be used to help entrench management, and that could hurt stockholders. How do the pros and cons balance out? The empirical evidence is not entirely clear, but certain findings are worth noting. First, if an ESOP is established to help defend against a takeover, then the firm's stock price typically falls when plans for the ESOP are announced. The market does not like the prospect of entrenching management and having to give up the premium normally associated with a takeover. However, if the ESOP is established for tax purposes and/or to motivate employees, the stock price generally goes up at the time of the announcement. In these cases, the company typically has a subsequent improvement in sales per employee and other long-term performance measures, which stimulates the stock price. Indeed, a study showed that companies with ESOPs enjoyed a 26% average annual stock return compared to a return of only 19% for peer companies without ESOPs.[22] It thus appears that ESOPs, if used appropriately, can be a powerful tool for creating shareholder value.

SELF-TEST

What are ESOPs? What are some of their advantages and disadvantages?

SUMMARY

- An **agency relationship** arises whenever an individual or group, called a **principal**, hires someone called an **agent** to perform a service and the principal delegates decision-making power to the agent.
- Important agency relationships include those between stockholders and creditors, owner/managers and outside shareholders, and stockholders and managers.
- An **agency conflict** refers to a conflict between principals and agents. For example, managers, as agents, may pay themselves excessive salaries, obtain unreasonably large stock options, and the like, at the expense of the principals, the stockholders.
- **Agency costs** are the reductions in a company's value due to actions by agents, including the costs that principals incur (such as monitoring costs) trying to modify their agents' behaviors.
- **Corporate governance** involves the manner in which shareholders' objectives are implemented, and it is reflected in a company's policies and actions.

[22]See Daniel Eisenberg, "No ESOP Fable," *Time,* May 10, 1999, p. 95.

- The two primary mechanisms used in corporate governance are (1) the threat of removal of a poorly performing CEO and (2) the type of plan used to compensate executives and managers.
- Poorly performing managers can be removed either by a takeover or by the company's own board of directors. Provisions in the corporate charter affect the difficulty of a successful takeover, and the composition of the board of directors affects the likelihood of a manager being removed by the board.
- Managerial **entrenchment** is most likely to occur when a company has a weak board of directors coupled with strong anti-takeover provisions in its corporate charter. In this situation, the likelihood that badly performing senior managers will be fired is low.
- **Nonpecuniary benefits** are noncash perks such as lavish offices, memberships at country clubs, corporate jets, foreign junkets, and the like. Some of these expenditures may be cost effective, but others are wasteful and simply reduce profits. Such fat is almost always cut after a hostile takeover.
- **Targeted share repurchases**, also known as **greenmail**, occur when a company buys back stock from a potential acquirer at a price higher than the market price. In return, the potential acquirer agrees not to attempt to take over the company.
- **Shareholder rights provisions**, also known as **poison pills**, allow existing shareholders to purchase additional shares of stock at a price lower than the market value if a potential acquirer purchases a controlling stake in the company.
- A **restricted voting rights** provision automatically deprives a shareholder of voting rights if he or she owns more than a specified amount of stock.
- **Interlocking boards of directors** occur when the CEO of Company A sits on the board of Company B and B's CEO sits on A's board.
- A **stock option** provides for the purchase of a share of stock at a fixed price, called the **exercise price**, no matter what the actual price of the stock is. Stock options have an **expiration date**, after which they cannot be exercised.
- An **Employee Stock Ownership Plan (ESOP)** is a plan that facilitates employees' ownership of stock in the company for which they work.

QUESTIONS

(13-1) Define each of the following terms:

a. Agent; principal; agency relationship
b. Agency cost
c. Basic types of agency conflicts
d. Managerial entrenchment; nonpecuniary benefits
e. Greenmail; poison pills; restricted voting rights
f. Stock option; ESOP

(13-2) What is the possible agency conflict between inside owner/managers and outside shareholders?

(13-3) What are some possible agency conflicts between borrowers and lenders?

(13-4) What are some actions an entrenched management might take that would harm shareholders?

(13-5) How is it possible for an employee stock option to be valuable even if the firm's stock price fails to meet shareholders' expectations?

MINI CASE

Suppose you decide (as did Steve Jobs and Mark Zuckerberg) to start a company. Your product is a software platform that integrates a wide range of media devices, including laptop computers, desktop computers, digital video recorders, and cell phones. Your initial market is the student body at your university. Once you have established your company and set up procedures for operating it, you plan to expand to other colleges in the area and eventually to go nationwide. At some point, hopefully sooner rather than later, you plan to go public with an IPO and then to buy a yacht and take off for the South Pacific to indulge in your passion for underwater photography. With these issues in mind, you need to answer for yourself, and potential investors, the following questions.

a. What is an agency relationship? When you first begin operations, assuming you are the only employee and only your money is invested in the business, would any agency conflicts exist? Explain your answer.
b. If you expanded and hired additional people to help you, might that give rise to agency problems?
c. Suppose you need additional capital to expand, and you sell some stock to outside investors. If you maintain enough stock to control the company, what type of agency conflict might occur?
d. Suppose your company raises funds from outside lenders. What type of agency costs might occur? How might lenders mitigate the agency costs?
e. Suppose your company is very successful, and you cash out most of your stock and turn the company over to an elected board of directors. Neither you nor any other stockholders own a controlling interest (this is the situation at most public companies). List six potential managerial behaviors that can harm a firm's value.
f. What is corporate governance? List five corporate governance provisions that are internal to a firm and under its control.
g. What characteristics of the board of directors usually lead to effective corporate governance?
h. List three provisions in the corporate charter that affect takeovers.
i. Briefly describe the use of stock options in a compensation plan. What are some potential problems with stock options as a form of compensation?
j. What is block ownership? How does it affect corporate governance?
k. Briefly explain how regulatory agencies and legal systems affect corporate governance.