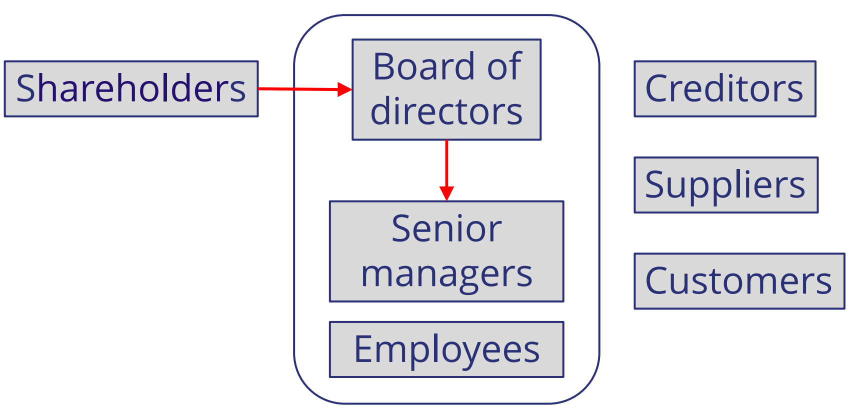
Corporate Issuers

Corporate Governance: Conflicts, Mechanisms, Risks, and Benefits

Exam Focus

- Principal-agent relationships
  - Identify the key features of the principal-agent relationship, including agency costs
- Controlling and minority shareholders
  - Differentiate between controlling and minority shareholders, including different types of class structures
- Corporate governance
  - Identify the risks and benefits of corporate governance

Principal-Agent Relationships



Principal-Agent Relationships

An **agent** is hired to act in the best interest of a **principal**.

Shareholders (principals) use agents to run a company (i.e., elect directors who appoint senior managers).

Conflicts may arise between agents' interests and principals' interests (resulting in **agency costs**).

Principal-Agent Relationships

Types of agency costs:

- Insufficient management effort of time, attention, monitoring
- Misaligned incentives, leading to too much or too little risk incentives
- Self-dealing, where management prefers to maximize personal benefits
- Empire building, leading to growth for growth's sake
- Entrenchment, leading to manager actions that help retain their jobs

Principal-Agent Relationships: Example

Agency costs of a corporate issuer

Consider a public company that hires an external independent auditor for the financial statements and internal controls.

- Audit fees associated with mitigating the risk that financial reports are materially misstated or deviate from GAAP are paid by the company, an agency cost ultimately paid by shareholders.

Controlling and Minority Shareholders

Corporate ownership can be dispersed (widely held) or concentrated.

- Dispersed ownership involves a large number of **minority shareholders**.
- Concentrated ownership can reflect individual ownership or a group (**controlling shareholders**).
- Ownership concentration can also arise from different share classes.
  - For example, a **dual-class share** structure typically involves Class A shares that have one vote each, and Class B shares that have multiple votes each. Class B shares are often held by the company's founders.

Controlling and Minority Shareholders: Example

A controlling shareholder of Stillcreek Corporation owns 55% of Stillcreek's shares, and the remaining shares are spread among a large group of shareholders. In this situation, conflicts of interest are most likely to arise between:

A. shareholders and bondholders.

B. the controlling shareholder and managers.

C. the controlling shareholder and minority shareholders.

Controlling and Minority Shareholders: Example

Dual-class structure

There are several well-known examples of dual-class shares. The different classes of shares may be separately traded, or some not traded at all:

- **Facebook:** Mark Zuckerberg holds 75% of Facebook's Class B shares, which carry 10 votes each.
- **Berkshire Hathaway:** Warren Buffet's company has Class A shares with high voting rights, and Class B shares with low voting rights. At the time of its 2010 split, Class B shares had 1/10,000th of the voting rights of Class A shares.

Corporate Governance: Example

A construction firm has the opportunity to invest in a high-risk, high-reward capital infrastructure project. Which of the following could be a reason why the company decides not to pursue the project?

A. The compensation of managers is closely tied to the size of the company's business.

B. Management receives excessive all-cash compensation.

C. Management has recently received a generous options reward in the company's shares.

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Corporate Governance: Example

Which of the following best describes dual-class share structures?

A. Dual-class share structures can be easily changed over time.

B. Company founders can maintain significant power over the organization.

C. Conflicts of interest between management and stakeholder groups are less likely than with single-class share structures.

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Corporate Governance Mechanisms

Corporate governance: internal controls and procedures for managing a company; structure to minimize and manage conflicts between company insiders and shareholders

It includes the following:

- Corporate reporting and transparency
- Shareholder mechanisms
- Creditor mechanisms
- Board/management mechanisms
- Employee mechanisms
- Customer and supplier mechanisms
- Government mechanisms

Corporate Governance Mechanisms

Corporate reporting and transparency

- Foundation of governance
- Reporting is mandated through legal and regulatory means
  - Extensive financial and non-financial information disclosed by public companies
  - Much less disclosure by private companies

Corporate Governance Mechanisms

Shareholder mechanisms

1. Annual general meeting (AGM
2. Extraordinary general meetings (EGMs)
3. Proxy voting
4. Shareholder activism
    1. Examples: Carl Icahn, Bill Ackman, Nelson Peltz

Corporate Governance: Example

Which of the following best describes shareholder activists?
Shareholder activists:

A. help stabilize a company's strategic direction.

B. have little effect on the company's long-term investors.

C. are unlikely to alter the composition of a company's shareholder base.

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Corporate Governance Mechanisms

Creditor mechanisms

- **Bond indentures and covenants**: legal contract between company and creditors
- **Creditor committees**: often established after bankruptcy filing; bondholders may also form an *ad hoc committee*

Corporate Governance Mechanisms

Board/management mechanisms

- Boards often delegate functions to various **committees**:
  - Audit
  - Nominating/governance
  - Compensation/remuneration
  - Other committees (risk, investment)

Corporate Governance: Example

A company's compensation committee seeking to discourage excessive risk-taking by managers is *most likely* to design an incentive compensation plan that:

A. allows directors and managers to have greater discretion over their remuneration.

B. includes a variable component comprising stock options contingent on near-term stock performance.

C. grants shares, rather than options, that vest over several years and are subject to minimum holding requirements.

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Corporate Governance Mechanisms

Employee mechanisms

- Labor laws, employment contracts, right to form unions
- Employee stock ownership plans (ESOPs): to align interests

Corporate Governance Mechanisms

Customer and supplier mechanisms

- Contracts with suppliers
- Social media, to communicate with and influence stakeholders

Corporate Governance Mechanisms

Government mechanisms

- Laws and regulations, including protecting/enforcing property and contract rights
- Corporate governance codes
  - Interestingly, the U.S. does not have national corporate governance codes, although it has national securities laws (e.g., Sarbanes-Oxley Act)

Risks and Benefits of Corporate Governance

Strong corporate governance will benefit companies, while weak governance may decrease company value. Risks and benefits include the following:

1. Operational risks and benefits
2. Legal, regulatory, and reputational risks
3. Financial

Corporate Governance: Example

Which of the following is not a benefit of an effective corporate governance structure?

A. Operating performance can be improved.

B. A corporation's cost of debt can be reduced.

C. Corporate decisions and activities require less control

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Corporate Governance: Examples

Examples of (1) strong and (2) weak corporate governance

- **Strong: Royal Bank of Canada (RBC)—**continuous improvement of policies and principles; transparent reporting and clear separation or roles and responsibilities; RBC also actively engages with its stakeholders
- **Weak: FTX—**cryptocurrency exchange FTX began operations in 2019 and filed for Chapter 11 bankruptcy in November 2022
  - Corporate governance failures included the following:
    - Financially unsophisticated managers; no board of directors
    - Significant self-dealing, misappropriation of funds
    - Lack of centralized controls of many functions
    - Compromised systems integrity

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Solutions

Controlling and Minority Shareholders: Example

A controlling shareholder of Stillcreek Corporation owns 55% of Stillcreek's shares, and the remaining shares are spread among a large group of shareholders. In this situation, conflicts of interest are most likely to arise between:

A. shareholders and bondholders.

B. the controlling shareholder and managers.

C. the controlling shareholder and minority shareholders.

Conflicts of interest are most likely to arise between the controlling shareholder and minority shareholders. The controlling shareholder could make decisions not in the best interest of minority shareholders.

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Corporate Governance: Example

A construction firm has the opportunity to invest in a high-risk, high-reward capital infrastructure project. Which of the following could be a reason why the company decides not to pursue the project?

A. The compensation of managers is closely tied to the size of the company's business.

B. Management receives excessive all-cash compensation.

C. Management has recently received a generous options reward in the company's shares.

When compensation is entirely in cash, the risk tolerance of managers may be too low, as they are inclined to protect their cash compensation. Additionally, there may be little upside for them if the project performs well.

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Corporate Governance: Example

Which of the following best describes dual-class share structures?

A. Dual-class share structures can be easily changed over time.

B. Company founders can maintain significant power over the organization.

C. Conflicts of interest between management and stakeholder groups are less likely than with single-class share structures.

Under dual-class share systems, company founders may control board elections, strategic decisions, and other significant matters.

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Corporate Governance: Example

Which of the following best describes shareholder activists? Shareholder activists:

A. help stabilize a company's strategic direction.

B. have little effect on the company's long-term investors.

C. are unlikely to alter the composition of a company's shareholder base.

Shareholder activists often narrow a company's strategic direction to focus on the few things that the company has historically done well, often shedding assets and closing divisions in the process.

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Corporate Governance: Example

A company's compensation committee seeking to discourage excessive risk-taking by managers is *most likely* to design an incentive compensation plan that:

A. allows directors and managers to have greater discretion over their remuneration.

B. includes a variable component comprising stock options contingent on near-term stock performance.

C. grants shares, rather than options, that vest over several years and are subject to minimum holding requirements.

Granting shares, rather than options, that vest over several years and must be held discourages "short-termism" or excessive risk-taking by managers.

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Corporate Governance: Example

Which of the following is not a benefit of an effective corporate governance structure?

A. Operating performance can be improved.

B. A corporation's cost of debt can be reduced.

C. Corporate decisions and activities require less control

A benefit of an effective corporate governance structure is to enable adequate scrutiny and control over operations.

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