

ACF 302: Week 19

Takeover defenses and Corporate Governance

Berk and DeMarzo Chapter 29

Lecture

Chapter Outline

29.1 Corporate Governance and Agency Costs

29.2 Monitoring by the Board of Directors and Others

29.3 Compensation Policies

29.4 Managing Agency Conflict

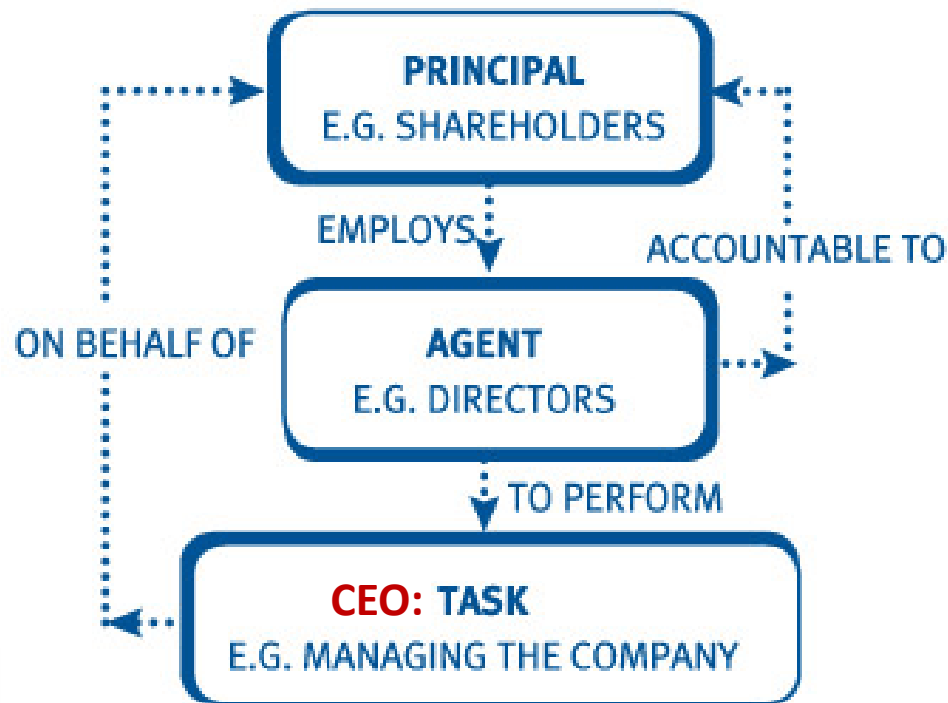
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Separation of ownership and control

- Separation of ownership and control creates an Agency Problem



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The Agency Problem

- Although investors, directors and managers might hold some ownership stake in the company, each of them may have different objectives:
 - Investors: Maximize value of the share
 - Board of Directors: Maximize personal profits being in an influential position, networking, etc.
 - Managers: maximize personal gains, reputation, empire building. But also, less diversified than shareholders (since all their human capital is invested in the company, possibly making them more risk averse).
- These divergent objectives create a **conflict of interest** and give place to an **Agency Cost** (the costs that arise when there are conflicts of interest between a firm's stakeholders. These costs are borne by shareholders to avoid the agency problem).

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29.1 Corporate Governance and Agency Costs

- **Corporate Governance**

- The system of controls, regulations, and incentives designed to minimize agency costs between managers and investors and prevent corporate fraud
 - The role of the corporate governance system is to mitigate the conflict of interest that results from the separation of ownership and control without unduly burdening managers with the risk of the firm.

Internal Corporate Governance

- Board oversight
- Compensation
- Ownership
- Shareholder activism

Note the two alternative mechanisms

- **Corporate Control** (also known as Market for corporate control): refers to what we have discussed last week during the lecture of M&A. It has to do with the market of acquisitions (friendly or hostile) that can threat to put inefficient management out of the firm. This is an EXTERNAL source of disciplining management.
 - The threat of a takeover (and subsequent job loss for management) creates incentives for the CEO to avoid running the company poorly.
 - This is one of the reasons that since 2002 there has been a lot of pressure for firms to reduce the number of takeover defences.
- **Corporate Governance:** as opposed to Corporate control, it is INTERNAL to the firm. The systems of controls is designed by the board.

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Internal Corporate Governance

- Board oversight
- Compensation
- Ownership
- Shareholder activism

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29.2 Monitoring by the Board of Directors and Others

- In the United States, the board of directors has a clear fiduciary duty to protect the interests of the shareholders.
 - Other countries give some weight to the interests of other stakeholders in the firm, such as the employees (for example Germany).

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Example of a board: AA 2017

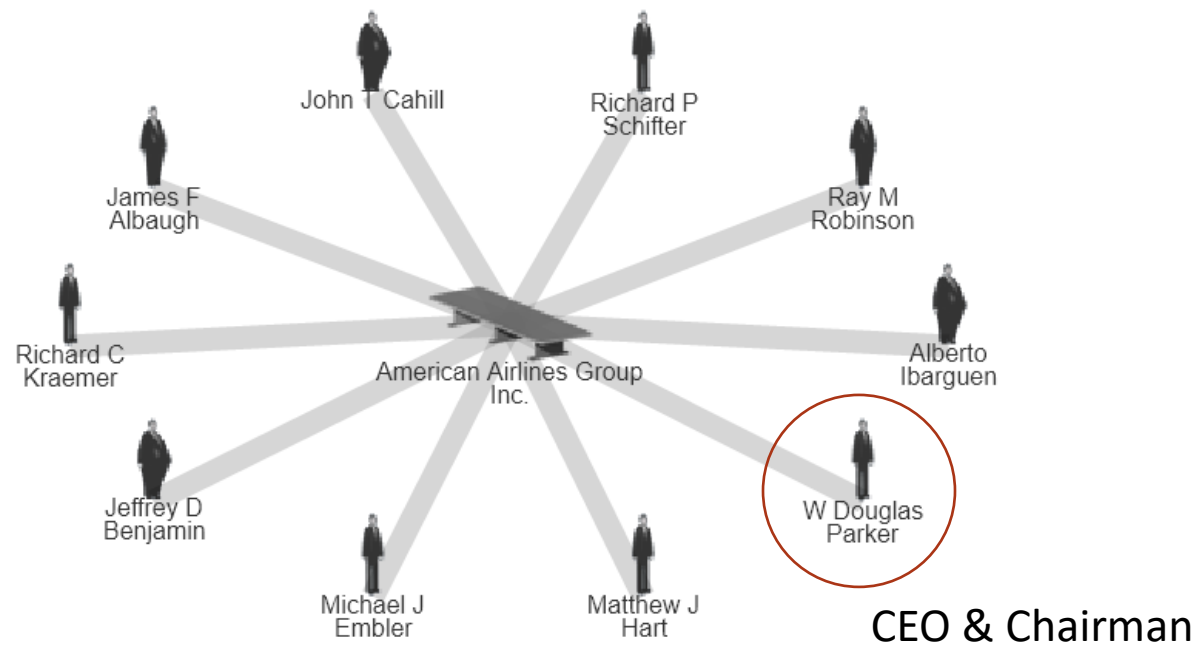


Chart made using information from theyrule.net

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Types of Directors

- **Inside Directors**

- Members of a board of directors who are employees, former employees, or family members of employees

- **Gray Directors**

- Members of a board of directors who are not as directly connected to the firm as insiders are, but who have existing or potential business relationships with the firm. For example, bankers, lawyers, and consultants who are already retained by the firm, or who would be interested in being retained may sit on a board. Thus their judgment could be compromised by their desire to keep the CEO happy.

- **Outside (Independent) Directors**

- Any member of a board of directors other than an inside or gray director

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Board Independence

- On a board composed of insider, gray, and independent directors, the role of the **independent** director is really that of a watchdog.
 - However, because independent directors' personal wealth is likely to be less sensitive to performance than that of insider and gray directors, they may have less incentive to closely monitor the firm.
- **Captured Boards**
 - Describes a board of directors whose monitoring duties have been compromised by connections or perceived loyalties to management

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Situations that compromise the independence of a director:

- A. Interlocking directors
- B. Directors that provide other services or serve other interests to the board.
 - Consultancy
 - Auditing
- C. Directors appointed by the CEO.
 - This practice is becoming more and more common and there is strong empirical research that shows that directors appointed by the incumbent CEO are less independent.

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Interlocking directors

- Interlocking directors is a business practice wherein a member of one company's board of directors also serves on another company's board or within another company's management. Under the antitrust legislation, interlocking directorates are not illegal as long as the corporations involved do not compete with each other.
- Interlocking directors were outlawed in specific instances wherein they gave a few board members outsized control over an industry. In some cases, this opened the door for them to synchronize pricing changes, labor negotiations, and more.
- One near-violation of this rule occurred in 2009 when Google announced that its board member Arthur D. Levinson was stepping down since he also served on the board of Apple. Earlier in the year, Apple announced that Google's CEO, Eric E. Schmidt was stepping down from the Apple board. Since the two companies are competitors, they would have violated antitrust laws if they had not taken steps to separate their boards.

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Board Size and Performance

- Researchers have found that smaller boards produce surprisingly robust results that are associated with greater firm value and performance.
 - The likely explanation for this phenomenon comes from the psychology and sociology research, which finds that smaller groups make better decisions than larger groups.
 - Information flows easier among small groups.
 - It is faster to reach consensus.

Board Size and Performance

- However, some firms will always have larger boards (regardless of their performance). This includes cases as large firms with multiple divisions, bank holding firms with several banks under control of the holding, etc.
- Firm size will be correlated with board size.

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Board composition requirements

- In the past few years there's been increased pressure from regulator and investors regarding the composition of the Board of Directors.
 - Majority of independent directors: NYSE and NASDAQ requirements. SOX introduced majority of independent directors in the Auditing Committee after the Enron scandal.
 - Gender diversity: different countries are introducing mandatory gender quotas (Norway was one of the first, followed by several European countries and California state).
 - Ethnic diversity: not a requirement yet, but in the radar of shareholder advise groups (i.e. ISS).
 - Mandatory retirement age and term limits: UK Corporate Governance Code introduced a term limit of 9 years for directors. Several boards have introduced mandatory retirement ages for their directors (average 72 years old).
 - Separation of the CEO role and the role of Chairman of the Board

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Other Monitors

- **Includes security analysts, lenders, the SEC, and employees**
 - Securities analysts produce independent valuations of the firms they cover so that they can make buy and sell recommendations to clients.
 - Lenders carefully monitor firms to which they are exposed as creditors.
 - Employees of the firm are most likely to detect outright fraud because of their inside knowledge.
 - The SEC protects the investing public against fraud and stock price manipulation.

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Other monitors

- Just like with independent directors that can be captured, other monitors can also be captured by the board:
- Revolving doors,
- Bias of analysts, etc.

Internal Corporate Governance

- Board oversight
- **Compensation**
- Ownership
- Shareholder activism

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Managerial Compensation

- CEO compensation is set by the compensation committee (a group of independent directors that serve on the board and also on this especial committee).
- Some firms also hire a compensation consulting company to provide advice to the Compensation committee.
- Compensation is set based on peers comparison and firm performance metrics.

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CEO Compensation structure

- In general, CEO pay can be broken down in different components:
 - Salary (cash)
 - Bonus
 - Stock awards
 - Option awards
 - Non – equity incentives
 - Pension
 - Other Compensation
- Total Compensation is equal to the sum of all these components.

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CEO Total compensation (annual) in SP1500 for 2017

- The average CEO pay in the SP1500 was \$7.873 million.
- 50% of the CEOs had total compensation below \$5.6 million
- The top 1% of highest paid CEOs earned more than \$38 million per year.

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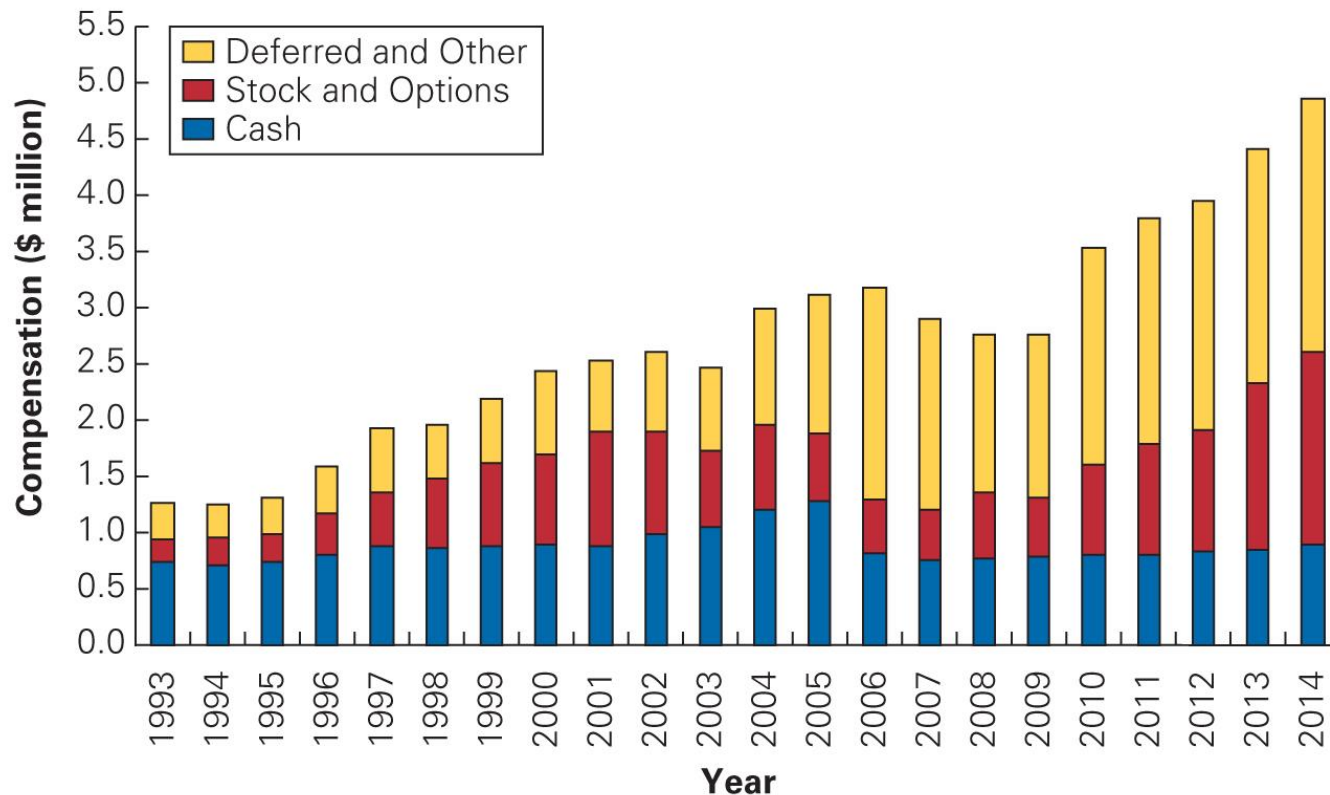
Highest and lowest paid CEOs in 2017

Highest paid CEOs in S&P1500. In thousands. Year 2017										
CEO	Company	Sector	Salary	Bonus	Stocks	Options	Non equity	Pension	Other	Total Pay
E. Hunter Harrison, LL.D.	CSX CORP	Railroads	\$1,885.70	\$0.00	\$0.00	\$115,884.00	\$3,490.37	\$600.34	\$29,286.88	\$151,147.29
Mark Vincent Hurd	ORACLE CORP	Systems Software	\$950.00	\$0.00	\$0.00	\$103,700.00	\$3,612.55	\$0.00	\$32.47	\$108,295.02
Hock E. Tan	BROADCOM INC	Semiconductors	\$1,100.00	\$0.00	\$98,322.84	\$0.00	\$3,712.50	\$0.00	\$75.82	\$103,211.16
Frank J. Bisignano	FIRST DATA CORP	Data Processing & Outsourced Services	\$1,320.00	\$559.00	\$99,876.04	\$0.00	\$0.00	\$0.00	\$455.36	\$102,210.40
Alex A. Molinaroli	JOHNSON CONTROLS INTL PLC	Building Products	\$1,486.83	\$0.00	\$9,042.44	\$2,860.36	\$0.00	\$43.49	\$64,849.25	\$78,282.38
Lowest paid CEOs in S&P1500. In thousands. Year 2017										
CEO	Company	Sector	Salary	Bonus	Stocks	Options	Non equity	Pension	Other	Total Pay
Lawrence Edward Page	ALPHABET INC	Interactive Media & Services	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
Jack Dorsey	TWITTER INC	Interactive Media & Services	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
David L. Liniger	RE/MAX HOLDINGS INC	Real Estate Services	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
Gregory Edward Abel	BERKSHIRE HATHAWAY ENERGY CO	Multi-Utilities	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
Kosta N. Kartotolis	FOSSIL GROUP INC	Apparel, Accessories & Luxury Goods	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00

29.3 Compensation Policies

- **Stock and Options**
 - Managers' pay can be linked to the performance of a firm in many ways.
 - Many companies have adopted compensation policies that include grants of stock or stock options to executives (very widespread since 2005).
 - These grants give managers a direct incentive to increase the stock price, which ties managerial wealth to the wealth of shareholders.

Figure 29.1 CEO Compensation



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Source: Execucomp



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Pay and Performance Sensitivity (1 of 3)

- The use of stock and option grants in the 1990s has lead to a substantial increase in management compensation (total pay).
- The substantial increase in the use of stocks and stock options to increase CEO's pay-performance sensitivity has disadvantages:
 - Increasing the pay-for-performance sensitivity comes at the cost of burdening managers with risk.
 - Creates incentives for CEOs to manipulate their pay.
 - Studies have found evidence that the practice of timing the release of information to maximize the value of CEO stock options is widespread.

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Pay and Performance Sensitivity (2 of 3)

- For example, often options are granted “at the money,” meaning that the exercise price is equal to the current stock price.
 - In this case, managers have an incentive to manipulate the release of financial forecasts so that bad news comes out before options are granted (to drive the exercise price down) and good news comes out after options are granted.

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Pay and Performance Sensitivity (3 of 3)

- Recent research has found evidence suggesting that many executives have engaged in *backdating* their option grants, which is a more direct form of manipulating their stock option compensation.
- **Backdating**
 - The practice of choosing the grant date of a stock option retroactively, so that the date of the grant would coincide with a date when the stock price was lower than its price at the time the grant was actually awarded
 - By backdating the option in this way, the executive receives a stock option that is already in-the-money, with a strike price equal to the lower price on the supposed grant date.

Internal Corporate Governance

- Board oversight
- Compensation
- **Ownership**
- Shareholder activism

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29.4 Managing Agency Conflict

- Academic studies have supported the notion that greater managerial ownership is associated with fewer value-reducing actions by managers.
 - But while increasing managerial ownership may reduce perquisite consumption, **it also makes managers harder to fire.**

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Internal Corporate Governance

- Board oversight
- Compensation
- Ownership
- Shareholder activism

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Direct Action by Shareholders (1 of 3)

- **Shareholder Voice**

- Any shareholder can submit a resolution that is put to a vote at the annual meeting.
 - Recently, unhappy shareholders have started to refuse to vote to approve the slate of nominees for the board.

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Direct Action by Shareholders (2 of 3)

- **Shareholder Approval**
 - Shareholders must approve many major actions taken by the board.
 - For example, target shareholders must approve merger agreements.

Direct Action by Shareholders (3 of 3)

- **Proxy Contests**

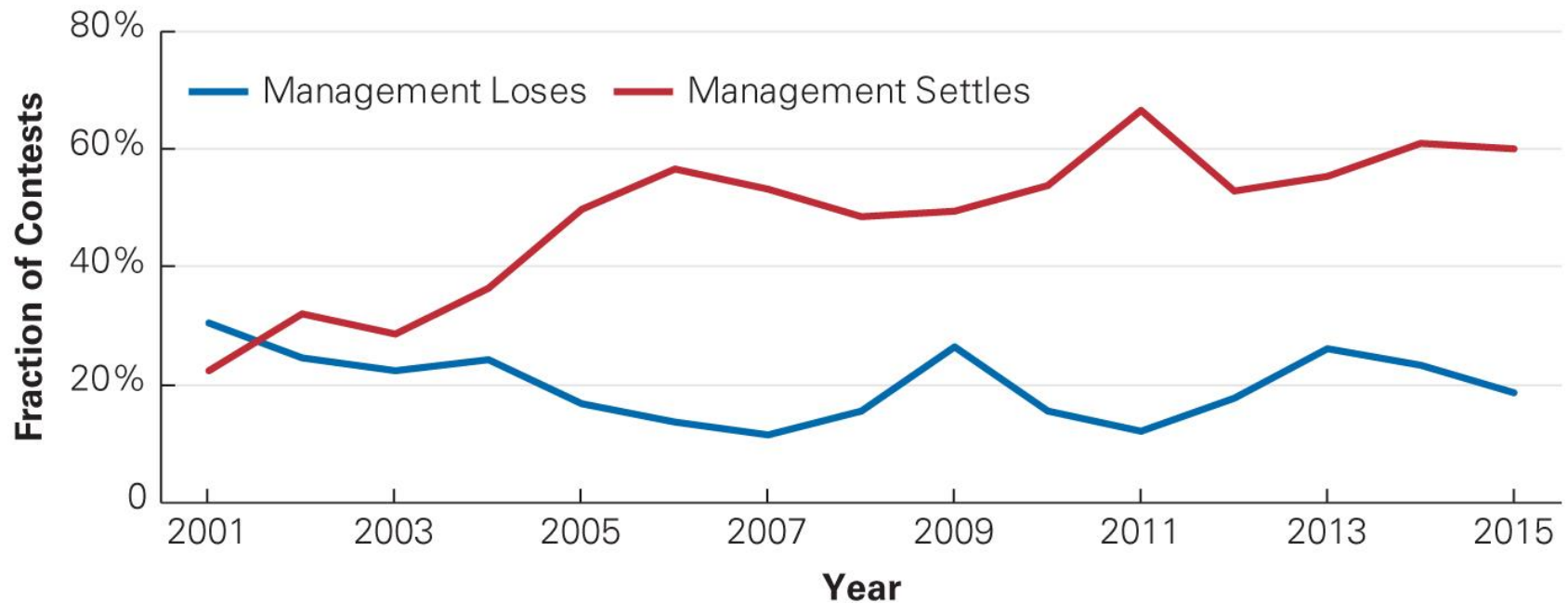
- Disgruntled shareholders can hold a proxy contest and introduce a rival slate of directors for election to the board.
 - This gives shareholders an actual choice between the nominees put forth by management and the current board and a completely different slate of nominees put forth by dissident shareholders.
- Another trigger of a Proxy fight is a hostile takeover (as studied earlier today).

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Figure 29.2 Proxy Contest Outcomes



Source: Fact Set Shark Watch

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The role of takeovers in corporate governance

- When internal governance systems such as ownership, compensation, board oversight, and shareholder activism fail, the one remaining **way to remove poorly performing managers is by mounting a hostile takeover.**
- Thus the effectiveness of the corporate governance structure of a firm depends on **how well protected its managers** are from removal in a hostile takeover.
- An active takeover market is part of the system through which **the threat of dismissal** is maintained.
- In fact, some research has suggested that an active takeover market complements a board's own vigilance in dismissing incompetent managers. That research found **that boards are actually more likely to fire managers for poor performance** during active takeover markets than they are during lulls in takeover activity.

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Revision and practice questions

- This topic WILL be included in the final exam!
- The workshop question sheet will provide for several MCQs and essay type questions to help revision on this topic.