The Objective in Corporate Finance

Aswath Damodaran

"If you don't know where you are going, it does not matter how you get there."

Stern School of Business
First Principles

Objectives: Maximize the Value of the Firm

- Choose a financing mix that minimizes the hurdle rate and matches the assets being financed.
- Returns on projects should be measured based on cash flows generated.
- If there are not enough investments that earn the hurdle rate, return the cash to the owners of the firm (if public, these would be stockholders).
- The form of returns - dividends and stock buybacks - will depend upon the stockholders' characteristics.
- The hurdle rate should be higher for riskier projects and reflect the financing mix used - owners' funds (equity) or borrowed money (debt). Returns on projects should be higher for riskier projects and reflect the acceptable hurdle rate. Invest in projects that yield a return greater than the minimum.
The Classical Viewpoint

Aswath Damodaran

In this book, we assume that the objective of the firm is to maximize the value to its stockholders.

Brealey & Myers: Success is usually judged by value to its stockholders.

Copeland & Weston: The most important theme is that the objective of the firm is to maximize its value to its stockholders.

Brigham and Gapenski: Throughout this book we operate on the assumption that the management’s primary goal is stockholder wealth maximization, which translates into maximizing the price of the common stock.

Van Horne: In this book, we assume that the objective of the firm is to maximize the wealth of its stockholders.
In traditional corporate finance, the objective in decision making is to maximize the value of the firm. A narrower objective is to maximize stockholder wealth. When the stock is traded and markets are viewed to be efficient, the objective is to maximize the stock price. All other goals of the firm are intermediate ones, leading to firm value maximization, or operate as constraints on firm value maximization.
Maximizing stock price does not imply that a company has to be a social outlaw.

Maximizing stock price maximization does not mean that customers are not critical.

In most businesses, keeping customers happy is the route to success.

Maximizing stock price does not mean that customers are not critical.

Employees are often stockholders in many firms that have treated employees well.

- Firms that maximize stock price generally are firms that have treated employees well.
- Employees' needs/objects. In particular:

Maximizing stock price is not incompatible with meeting employee needs/objects.
Why traditional corporate financial theory focuses on maximizing stockholder wealth.

The objective of stock price performance provides some very elegant theory.

- how much to pay in dividends
- how to finance them
- how to pick projects

If investors are rational (are they?), stock prices reflect the wisdom of decisions, short-term and long-term, instantaneously.

If investors are irrational (are they?), stock prices may not be as easily observable, and measures of performance, which may not be as easily observable, and stock price is easily observable and constantly updated (unlike other...
The Classical Objective Function

**STOCKHOLDERS**

- Maximize stockholder wealth
- Hire & fire managers - Board
- Annual Meeting

**BONDHOLDERS**

- Lend Money
- Project
- Protect bondholder interests

**MANAGERS**

- Reveal information honestly and on time
- Efficient and value assessment
- Market are efficient and value can be traced to firm
- No Social Costs

**FINANCIAL MARKETS**

- Markets are efficient and assess effect on value
- Reveal information

**SOCIETY**

- Lend Money
- Annual Meeting
- Board
- Managers
- Stockholder wealth
- Maximize

**STOCKHOLDERS**

- Lend Money
- Project
- Protect bondholder interests
- Maximize
- Stockholder wealth
- Hire & fire managers - Board
- Annual Meeting
- No Social Costs
What can go wrong?

**STOCKHOLDERS**
- Managers put their interests above stockholders
- Have little control over managers

**MANAGERS**
- Delay bad news or provide misleading information
- Get ripped off by bondholders
- Put managers above stockholders

**BONDHOLDERS**
- Lend money

**FINANCIAL MARKETS**
- Information can overreach
- Markets make mistakes and can overreact
- Significant social costs
trace to them
- Some costs cannot be traced to firms

**SOCIETY**
- Significant social costs

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Aswath Damodaran
I. Stockholder Interests vs. Management Interests

Theory: The stockholders have significant control over management.

Practice: Neither mechanism is as effective in disciplining and the board of directors.

The mechanisms for disciplining management are the annual meeting.
The Annual Meeting as a disciplinary venue

Factors

The power of stockholders to act at annual meetings is diluted by three

Managers that they do not like, is to vote with their feet.

For large stockholders, the path of least resistance, when confronted by
incumbent management.

Incumbent management.

The exercising of proxies. Proxies that are not voted becomes votes for
the exercising exceeds the value of their holdings.

For large stockholders, the path of least resistance, when confronted by
incumbent management.

Incumbent management.

Most small stockholders do not go to meetings because the cost of going

To the meeting exceeds the value of their holdings.

Most small stockholders do not go to meetings because the cost of going

Factors
The Average Director: Underworked and Overpaid

Board of Directors as a disciplinary mechanism
Many directors are themselves CEOs of other firms. Directors often hold only token stakes in their companies. Only 16% used an outside search firm. The 1992 survey by Korn/Ferry revealed that 74% of companies relied on recommendations from the CEO to come up with new directors. The CEO hand-picks most directors.
Directors lack the expertise to ask the necessary tough questions.

The search for consensus overwhelms any attempts at confrontation.

The CEO sets the agenda, chairs the meeting and controls the information.
The Best Boards in 1997...
And the Worst Boards in 1997..

<table>
<thead>
<tr>
<th>Rank</th>
<th>Company</th>
<th>Overall Score</th>
<th>Survey Score</th>
<th>Analysis Score</th>
<th>Details</th>
<th>Shareholder Accountability</th>
<th>Board Accountability</th>
<th>Corporate Performance</th>
<th>Governance Guideline Analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Disney</td>
<td>10.3</td>
<td>1.8</td>
<td>8.5</td>
<td>Investors decry board for conflicts; many directors own little if any stock</td>
<td>3.3</td>
<td>4.3</td>
<td>2.0</td>
<td>5.8</td>
</tr>
<tr>
<td>2</td>
<td>AT&amp;T</td>
<td>10.9</td>
<td>-16.6</td>
<td>27.5</td>
<td>Investors scorn board for failing to control succession, not ousting CEO</td>
<td>3.0</td>
<td>4.2</td>
<td>3.5</td>
<td>2.8</td>
</tr>
<tr>
<td>3</td>
<td>H.J. Heinz</td>
<td>15.4</td>
<td>-1.1</td>
<td>16.5</td>
<td>Longtime CEO dominates insider-filled board; resists investor calls for change</td>
<td>2.8</td>
<td>3.7</td>
<td>2.0</td>
<td>4.7</td>
</tr>
<tr>
<td>4</td>
<td>Archer Daniels Midland</td>
<td>16.8</td>
<td>-12.2</td>
<td>29.0</td>
<td>Board changes fail to satisfy investors, who say directors still lack independence</td>
<td>2.3</td>
<td>2.1</td>
<td>1.3</td>
<td>3.5</td>
</tr>
<tr>
<td>5</td>
<td>Dow Jones</td>
<td>21.1</td>
<td>1.6</td>
<td>19.5</td>
<td>Investors disenchanted with performance; weakest attendance record of any board</td>
<td>2.6</td>
<td>4.6</td>
<td>2.8</td>
<td>2.6</td>
</tr>
<tr>
<td>6</td>
<td>Dillard's</td>
<td>22.0</td>
<td>5.0</td>
<td>17.0</td>
<td>Board loaded with insiders, lacks an outsider with retail expertise or CEO</td>
<td>2.0</td>
<td>3.0</td>
<td>2.0</td>
<td>3.5</td>
</tr>
<tr>
<td>7</td>
<td>Rollins International</td>
<td>22.7</td>
<td>1.7</td>
<td>21.0</td>
<td>Board dominated by family members and insiders; lacks nominating panel</td>
<td>1.0</td>
<td>1.0</td>
<td>0.0</td>
<td>2.0</td>
</tr>
<tr>
<td>8</td>
<td>Occidental Petroleum</td>
<td>24.0</td>
<td>-1.5</td>
<td>25.5</td>
<td>Investors outraged over $95 million payout to CEO by cozy, aging board</td>
<td>1.3</td>
<td>2.0</td>
<td>1.1</td>
<td>2.0</td>
</tr>
<tr>
<td>9</td>
<td>Ogden</td>
<td>27.2</td>
<td>4.2</td>
<td>23.0</td>
<td>Board has three consultants and a lawyer who do business with company</td>
<td>2.0</td>
<td>1.5</td>
<td>2.0</td>
<td>2.5</td>
</tr>
<tr>
<td>10</td>
<td>Maxxam</td>
<td>28.3</td>
<td>4.3</td>
<td>24.5</td>
<td>Tiny board with little business experience dominated by CEO</td>
<td>1.5</td>
<td>2.0</td>
<td>1.0</td>
<td>3.5</td>
</tr>
</tbody>
</table>
1997

Who’s on Board? The Disney Experience -
A Contrast: Disney vs. Campbell Soup in 1997

<table>
<thead>
<tr>
<th>BEST PRACTICES</th>
<th>CAMPBELL SOUP</th>
<th>DISNEY</th>
</tr>
</thead>
<tbody>
<tr>
<td>Majority of outside directors are insiders</td>
<td>7 of 17 members</td>
<td>3,000 shares</td>
</tr>
<tr>
<td>Bans from executives from board</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Mandatory retirement age</td>
<td>None</td>
<td>70, with none</td>
</tr>
<tr>
<td>Appointment of 'lead director'</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Outside directors meet w/o CEO annually</td>
<td>Never</td>
<td>Annually over 64</td>
</tr>
<tr>
<td>Governance committee</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Self-evaluation of effectiveness every two years</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Director pensions</td>
<td>None</td>
<td>Yes</td>
</tr>
<tr>
<td>Share-ownership requirement</td>
<td>3,000 shares</td>
<td>None</td>
</tr>
<tr>
<td>Chairman of panel</td>
<td>None</td>
<td>No: CEO is</td>
</tr>
<tr>
<td>No: CEO is insiders</td>
<td>Yes</td>
<td>Among 15 directors</td>
</tr>
<tr>
<td>Only one insider on board</td>
<td>CEO</td>
<td></td>
</tr>
<tr>
<td>Majority of outside directors</td>
<td>Campbell Soup</td>
<td>Disney</td>
</tr>
</tbody>
</table>
Application Test: Who’s on board?

Look at the board of directors for your firm. Analyze

- How many of the directors are inside directors (employees of the firm), and how many are ex-managers?
- Is there any information on how independent the directors in the firm are from the managers?
Gary I. Winnick: Chairman of the Board of Northwest Airline Corporation
Raymond I. Watson: Vice Chairman of the Board of The Irvine Company
Andre B. van de Kamp: Chairman of Sotheby’s West Coast
Robert A. M. Stern: Architect, teacher and writer
Sidney Poitier: Actor, director and writer
Leo J. O’Donovan, S.J.: Professor of Theology at Georgetown University
Thomas S. Murphy: Chairman of the Board and CEO of Capital Cities/ABC
George J. Mitchell: United States Senator from 1980 to 1995
Monica C. Lozano: President and Chief Operating Officer of the University of California
Robert A. Iger: President and Chief Operating Officer of the Company
Stanley R. Gold: CEO of Shamrock Holdings, Inc., an investment firm
Judith E. Estrin: President and Chief Executive Officer of Packet Design
Michael D. Eisner: Chairman, President and Chief Executive Officer of the Company
Roy E. Disney: Nephew of the late Walt Disney
Revera F. Powers: Head of School for the Center for Early Education
When the cat is idle, the mice will play...

So what next? When the cat is idle, the mice will play...
Overpaying on takeovers

The quickest and perhaps the most decisive way to impoverish stockholders is to overpay on a takeover. An even more damming indictment is that a large number of mergers are increased significantly after mergers. The profitability of merged firms relative to their peer groups, does not many mergers do not work, as evidenced by a number of measures. Many mergers do not work, as evidenced by a number of measures. Many mergers do not work, as evidenced by a number of measures. Many mergers do not work, as evidenced by a number of measures. Many mergers do not work, as evidenced by a number of measures. Many mergers do not work, as evidenced by a number of measures.
Aswath Damodaran

Eastman Kodak's Great Victory

A Case Study: Kodak - Sterling Drugs

Source: The Accel Group Inc.

Purchase in Kodak's market value = $2.2 billion
Premium bid = $3.1 billion
Market to announcement = $3.6 billion
Sterling's market
Kodak's bid = $2.1 billion

Kodak's market reaction indicates that investors expected no premium.
Sterling Drug under Eastman Kodak: Where is the synergy?
Aswath Damodaran

Kodak Says Drug Unit Is Not for Sale

(NYTimes, 8/93)

Q

An article in the NY Times in August of 1993 suggested that Kodak was eager to shed its drug unit.

• In response, Eastman Kodak officials say they have no plans to sell Kodak's Sterling Winthrop drug unit.

• Louis Mails, Chairman of Sterling Winthrop, dismissed the rumors as "massive speculation, which flies in the face of the stated intent of Kodak that it is committed to be in the health business."

• Samuel D. Isaly, an analyst, said the announcement was "very good for Kodak and very good for Sanofi and York Stock Exchange." Shares of Eastman Kodak rose 75 cents yesterday, closing at $47.50 on the New York Stock Exchange.

A few months later... Taking a stride out of the drug business, Eastman Kodak said that the Sanofi Group, a French pharmaceutical company, agreed to buy the prescription drug business of Sterling Winthrop for $1.68 billion.

• Shares of Eastman Kodak rose 75 cents yesterday, closing at $47.50 on the New York Stock Exchange.

• George M. C. Fisher, the company's chief executive, said that the divestitures are complete, Kodak will be entirely focused on imaging, "When the divestitures are complete, Kodak will be entirely focused on imaging."

• When the divestitures are complete, Kodak will be entirely focused on imaging."

• An article in the NY Times in August of 1993 suggested that Kodak was eager to shed its drug unit.
Application Test: Who owns/runs your firm?

Look at: Bloomberg printout

HDS

for your firm.

Consider the following:

- Are managers significant stockholders in the firm?
- How many of the top 15 investors are individual investors?
- How many of the top 15 investors are institutional investors?
- How many of the top 15 stockholders in your firm are managers?
Disney's top stockholders in 2002
II. Stockholders’ objectives vs. Bondholders’ objectives

In theory: there is no conflict of interests between stockholders and bondholders.

In practice: Stockholders may maximize their wealth at the expense of bondholders.

- Borrowing more on the same assets: If lenders do not protect themselves, stockholders then take on riskier investments, lenders will be hurt.
- Increasing dividends significantly: When firms pay cash out as dividends, lenders become riskier without the cash. Because the firm becomes riskier without the cash, lenders to the firm are hurt and stockholders may be helped.
- Taking riskier projects than those agreed to at the outset: Lenders base interest rates on their perceptions of how risky a firm’s investments are. If stockholders then take on riskier investments, lenders will be hurt.
- Borrowing more on the same assets: If lenders do not protect themselves, a firm can borrow more money and make all existing lenders worse off.
Unprotected Lenders?
III. Firms and Financial Markets

In theory:

- Financial markets are efficient. Managers convey information honestly and truthfully to financial markets, and financial markets make reasoned judgments of true value.

- Stock price performance is a good measure of management performance.

- A company that invests in good long-term projects will be rewarded.

In practice:

- There are some holes in the Efficient Markets' assumption.

- Short-term accounting gimmicks will not lead to increases in market value.

- Financial markets are efficient. Managers convey information honestly and truthfully to financial markets, and financial markets make reasoned judgments of true value.
Managers control the release of information to the general public.

They sometimes reveal fraudulent information.
- Other news
- Bad earnings reports
- They delay the releasing of bad news
- They suppress information, generally negative information

There is evidence that
DO MANAGERS DELAY BAD NEWS?: EPS and DPS Changes by Weekday

Evidence that managers delay bad news.
Aswath Damodaran

Even when information is revealed to financial markets, the market value that is set by demand and supply may contain errors. Prices do not have any relationship to value. Financial markets are manipulated by insiders. Prices do not have any relationship to value.

Financial markets are short-sighted and do not consider the long-term implications of actions taken by the firm.

Financial markets overreact to news, both good and bad.

Did the true value of equities really decline by 20% on October 19, 1987?

Did the true value of equities really decline by 20% on October 19, 1987?

Prices are much more volatile than justified by the underlying fundamentals.

Prices are much more volatile than justified by the underlying fundamentals.
Are Markets Short Term?

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

I agree with this statement.

I do not agree with this statement.
Investment expenditure is generally positive.

The market response to research and development and

current earnings and cashflows enough and value future earnings

If the evidence suggests anything, it is that markets do not value

expected in the near future, that raise money on financial markets

There are hundreds of start-up and small firms, with no earnings

that they are not.

Are Markets Short Sighted? Some evidence
<table>
<thead>
<tr>
<th>Type of Announcement</th>
<th>Announcement Day</th>
<th>Announcement Month</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Announcements</td>
<td>0.355%</td>
<td>I, 4.12%</td>
</tr>
<tr>
<td>Capital Expenditures</td>
<td>0.290%</td>
<td>I, 4.56%</td>
</tr>
<tr>
<td>R&amp;D Expenditures</td>
<td>0.251%</td>
<td>I, 4.99%</td>
</tr>
<tr>
<td>Product Strategies</td>
<td>0.440%</td>
<td>-0.35%</td>
</tr>
<tr>
<td>Joint Venture Formations</td>
<td>0.399%</td>
<td>I, 4.984%</td>
</tr>
</tbody>
</table>
IV. Firms and Society

Q In theory: There are no costs associated with the firm that cannot exist.

Q In practice: Financial decisions can create social costs and benefits.

- There are no costs associated with the firm that cannot exist.
- Financial decisions can create social costs and benefits.

Examples of social benefits include:
- Quality of life costs (traffic, housing, safety, etc.)
- Environmental costs (pollution, health costs, etc.)

- Social costs or benefits are costs or benefits that accrue to society as a whole and NOT to the firm making the decision.

In theory: There are no costs associated with the firm that cannot exist.

In practice: Financial decisions can create social costs and benefits.

Examples of social costs or benefits include:
- Creating access to goods in areas where such access does not exist.
- Supporting development in inner cities.
- Creating employment in areas with high unemployment.
Social Costs and Benefits are difficult to quantify because...

- They are person-specific (different decision makers weigh them differently)
- They might not be known at the time of the decision (Example: Manville and asbestos)
- They can be paralyzing if carried to extremes
A Hypothetical Example

Assume that you work for Disney and that you have an opportunity to open a store in an inner-city neighborhood. The store is expected to lose about $100,000 a year, but it will create much-needed employment in the area, and may help revitalize it. The store is expected to open a store in an inner-city neighborhood. The store is expected to lose about $100,000 a year, but it will create much-needed employment in the area, and may help revitalize it.

Questions:
• Would you open the store?
  
  • Yes □
  • No □

• If yes, would you tell your stockholders and let them vote on the issue?
  
  • Yes □
  • No □

• If no, how would you respond to a stockholder query on why you were not living up to your social responsibilities?
  
  • Yes □
  • No □

Would you open the store?
As this is what can go wrong...
Traditional corporate financial theory breaks down when...

- The interests/objectives of the decision makers in the firm conflict with the interests of stockholders.
- Bondholders (lenders) are not protected against expropriation by stockholders.
- Financial markets do not operate efficiently, and stock prices do not reflect the underlying value of the firm.
- Significant social costs can be created as a by-product of stock price maximization.
When traditional corporate financial theory breaks down, the solution is:

To choose a different mechanism for corporate governance:

- Making managers (decision makers) and employees into shareholders
- By providing information honestly and promptly to financial markets

To choose a different objective:

- To maximize stock price, but reduce the potential for conflict and breakdown:
  - By providing information honestly and promptly to financial markets

Aswath Damodaran
Germany and Japan developed a different mechanism for corporate governance, based upon corporate cross holdings. The nature of the cross holdings makes it very difficult for outsiders (including investors in these firms) to figure out how well or badly the group is doing.

In Germany, the banks form the core of this system. At their best, the most efficient and best run firms in the group pull down the least efficient and poorly run firms in the group. At their worst, the least efficient firms in the group pull down the most efficient firms in the group. That makes for a more stable corporate structure.

In Japan, it is the keiretsus. In Germany, the banks form the core of this system. In Japan, the core of this system is the corporate welfare system that forms the foundation of the new corporate families. The role of the在日本，它是财团。在日本，它是财团。在日本，财团是这个系统的中心。在日本，它是财团。在日本，它是财团。在日本，它是财团。在日本，它是财团。在日本，它是财团。在日本，它是财团。在日本，它是财团。在日本，它是财团。在日本，它是财团。在日本，它是财团。在日本，它是财团。在日本，它是财团。在日本，它是财团。在日本，它是财团。在日本，它是财团。在日本，它是财团。在日本，它是财团。在日本，它是财团。在日本，它是财团。在日本，它是财团。在日本，它是财团。在日本，它是财团。在日本，它是财团。在日本，它是财团。在日本，它是财团。在日本，它是财团。在日本，它是财团。在日本，它是财团。在日本，它是财团。在日本，它是财团。在日本，它是财团。在日本，它是财团。在日本，它是财团。在日本，它是财团。
Firms can always focus on a different objective function. Examples would include

- maximizing EVA
- maximizing market share
- maximizing firm size
- maximizing revenues
- maximizing earnings

The key thing to remember is that these are intermediate objectives. To the degree that they do not, the firm can end up with a disaster.

To the degree that they are correlated with the long-term health and value of the company, they work well.

The different objective functions are:

- maximizing earnings
- maximizing revenues
- maximizing market share
- maximizing firm size
- maximizing EVA
Maximize Stock Price, subject to...

The strength of the stock price maximization objective function is its internal self-correction mechanism. Excesses on any of the linkages lead, if unregulated, to counter actions which reduce or eliminate these excesses.

In the context of our discussion:

- Firms creating social costs has lead to more regulations, as well as investor backlash.
- Managers becoming more "skeptical" and "punitive".
- Firms revealing incorrect or delayed information to markets has lead to markets becoming more "skeptical" and "punitive".
- Stockholders taking advantage of bondholders has lead to bondholders protecting themselves at the time of the issue.
- Managers taking advantage of stockholders has lead to a more active market for corporate control.
- Firms revealing incorrect or delayed information to markets has lead to markets becoming more "skeptical" and "punitive".

Notably, if unregulated, to counter actions which reduce or eliminate these excesses, managers have led to more regulations, as well as investor backlash.
Institutional investors such as CalPERS and the Lens Funds have become much more active in monitoring companies that they invest in. At annual meetings, stockholders have taken to expressing their displeasure with incumbent management by voting against their compensation contracts or their board of directors. Individuals like Michael Price specialize in taking large positions in companies which they feel need to change their ways (Chase, Dow Jones, Reader’s Digest) and push for change.

The Stockholder Backlash
The typical target firm in a hostile takeover has
- a return on equity almost 5% lower than its peer group
- had a stock that has significantly under performed the peer group over the previous 2 years
- has managers who hold little or no stock in the firm

In other words, the best defense against a hostile takeover is to run your firm well and earn good returns for your stockholders

Conversely, when you do not allow hostile takeovers, this is the firm that you are most likely protecting (and not a well run or well managed firm)
An Update in 2002: The Power of Stockholder Pressure

Waste Management: After emerging from an accounting scandal in 1998 and acquisition by USA Waste in the same year, the company has improved. Eight new members, all independent, are on the nine-member board, and the audit committee is headed by Jack Pope, former CFO at United Airlines and American Airlines. Side deals between directors and company are banned. An independent governance expert has been hired to advise board.

Lucent: Gees low marks from governance experts because of a $679 million revenue restatement and a $200 billion loss in market cap since December, 1999. Performance is still in the tank, but the company has taken steps to improve a reputation for lousy governance. Under pressure, the board pushed to eliminate staggered board elections after a shareholder proposal failed.

Computer Associates: Having landed on the Worst Boards list two years ago for awarding top execs a massive pay package, this company has made improvements. It hired Harvard's Jay Lorsch to advise it on governance. Then put him on the board, recruited former SEC chief accountant Walter P. Schuetze for its audit committee. Prohibits directors from selling stock until they leave. Added two independent directors and has plans for three more.

Walt Disney: Finally taking steps to improve a reputation for lousy governance. Under pressure from director Stanley P. Gold, manager of the Disney family fortune, and other shareholders, the company has landed on the Worst Boards list. Two years ago for awarding top execs a massive pay package, this company has made improvements. It hired Harvard's Jay Lorsch to advise it on governance. Then put him on the board, recruited former SEC chief accountant Walter P. Schuetze for its audit committee. Prohibits directors from selling stock until they leave. Added two independent directors and has plans for three more.

Cendant: Moved to upgrade governance after an accounting scandal in 1999 and acquisition by USA Waste in the same year, the company has improved. Eight new members, all independent, are on the nine-member board, and the audit committee is headed by Jack Pope, former CFO at United Airlines and American Airlines. Side deals between directors and company are banned. An independent governance expert has been hired to advise board.
The Bondholders’ Defense Against Stockholder Excesses

More restrictive covenants on investment, financing and dividend policy have been used. This allows bondholders to become equity investors, if they feel it is in their best interests to do so.

More hybrid bonds (with an equity component, usually in the form of a conversion option or warrant) have been used. This allows bondholders to become equity investors, if they feel it is in their best interests to do so.

New types of bonds have been created to explicitly protect bondholders against sudden increases in leverage or other actions that increase lender risk substantially. Two examples of such bonds increase lender risk substantially. Two examples of such bonds increase lender risk substantially.

• Puttable Bonds, where the bondholder can put the bond back to the firm and get face value, if the firm takes actions that hurt bondholders.

• Ratings Sensitive Notes, where the interest rate on the notes adjusts to that appropriate for the rating of the firm.

More hybrid bonds (with an equity component, usually in the form of a conversion option or warrant) have been used. This allows bondholders to become equity investors, if they feel it is in their best interests to do so.
When firms mislead markets, the punishment is not only quick but it is savage.

The market (see Scholastic) easier to trade on bad news. In the process, it is revealed to the rest of

As information gets out to markets, becoming much more difficult for firms to control when and how

As information sources to the average investor proliferate, it is revealed (at least to a limited group of investors)

firm is large enough that such news is eagerly sought and quickly

recommendations, the payoff to uncovering negative news about a

While analysts are more likely still to issue buy rather than sell

The Financial Market Response.
If firms consistently flout societal norms and create large social costs, the governmental response (especially in a democracy) is for laws and regulations to be passed against such behavior.

- e.g.: Laws against using underage labor in the United States.

For firms catering to a more socially conscious clientele, the failure to meet societal norms (even if it is legal) can lead to loss of business and value.

- e.g.: Specialty retailers being criticized for using underage labor in other countries (where it might be legal).

Finally, investors may choose not to invest in stocks of firms that they view as social outcasts.

- e.g.: Tobacco firms and the growth of “socially responsible” funds.

(7)
The Counter Reaction

FINANCIAL MARKETS

- More skeptical investors and analyses become misleading
- More laws
- New types of covenants

BONDHOLDERS

- Protect themselves
- 2. Hostile takeovers
- 2. More activist investors

MANAGERS

- More citizen constraints
- More notice
- 2. Hostile takeovers
- 2. More activist investors

STOCKHOLDERS

- Managers of poorly run firms are punished
- Managers of poorly run firms are put on notice
- 1. More activist investors
- 1. More laws

SOCIETY

- Corporate Good Citizen Constraints
- Investor/Customer Backlash

Aswath Damodaran
So what do you think?
For publicly traded firms in reasonably efficient markets, where bondholders (lenders) are not fully protected:

- Maximize firm value; this will also maximize stockholder wealth, though stockholder wealth and stock prices may not be maximized at the same point.

For publicly traded firms in inefficient markets, where bondholders are not fully protected:

- Maximize stockholder wealth; this will also maximize firm value, but

For privately traded firms, maximize stockholder wealth (if lenders are protected) or firm value (if they are not).