Social Costs and Benefits are difficult to quantify because ..

- Cannot know the unknown: They might not be known at the time of the decision. In other words, a firm may think that it is delivering a product that enhances society, at the time it delivers the product but discover afterwards that there are very large costs. (Asbestos was a wonderful product, when it was devised, light and easy to work with… It is only after decades that the health consequences came to light)
- Eyes of the beholder: They are 'person-specific', since different decision makers can look at the same social cost and weight them very differently.
- Decision paralysis: They can be paralyzing if carried to extremes.

A test of your social consciousness: Put your money where you mouth is…

- 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 a million dollars a year, but it will create much-needed employment in the area, and may help revitalize it.
- 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?

So this is what can go wrong...

STOCKHOLDERS

Have little control over managers

Managers put their interests above stockholders

Lend Money

BONDHOLDERS

Managers

SOCIETY

Significant Social Costs

Bondholders can get ripped off

Some costs cannot be traced to firm

Delay bad news or provide misleading information

Markets make mistakes and can over react

FINANCIAL MARKETS

Traditional corporate financial theory breaks down when ...

- Managerial self-interest: The interests/objectives of the decision makers in the firm conflict with the interests of stockholders.
- Unprotected debt holders: Bondholders (Lenders) are not protected against expropriation by stockholders.
- Inefficient markets: Financial markets do not operate efficiently, and stock prices do not reflect the underlying value of the firm.
- Large social side costs: Significant social costs can be created as a by-product of stock price maximization.

When traditional corporate financial theory breaks down, the solution is:

- A non-stockholder based governance system: To choose a different mechanism for corporate governance, i.e, assign the responsibility for monitoring managers to someone other than stockholders.
- A better objective than maximizing stock prices? To choose a different objective for the firm.
- Maximize stock prices but minimize side costs: To maximize stock price, but reduce the potential for conflict and breakdown:
  - Making managers (decision makers) and employees into stockholders
  - Protect lenders from expropriation
  - By providing information honestly and promptly to financial markets
  - Minimize social costs

I. An Alternative Corporate Governance System

- Germany and Japan developed a different mechanism for corporate governance, based upon corporate cross holdings.
  - In Germany, the banks form the core of this system.
  - In Japan, it is the keiretsus
  - Other Asian countries have modeled their system after Japan, with family companies forming the core of the new corporate families
- At their best, the most efficient firms in the group work at bringing the less efficient firms up to par. They provide a corporate welfare system that makes for a more stable corporate structure
- At their worst, the least efficient and poorly run firms in the group pull down the most efficient and best run firms down. The nature of the cross holdings makes its very difficult for outsiders (including investors in these firms) to figure out how well or badly the group is doing.

II. Choose a Different Objective Function

- Firms can always focus on a different objective function. Examples would include
  - maximizing earnings
  - maximizing revenues
  - maximizing firm size
  - maximizing market share
  - maximizing EVA
- The key thing to remember is that these are intermediate objective functions.
  - To the degree that they are correlated with the long term health and value of the company, they work well.
  - To the degree that they do not, the firm can end up with a disaster

III. 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,
  - managers taking advantage of stockholders has led to a much more active market for corporate control.
  - stockholders taking advantage of bondholders has led to bondholders protecting themselves at the time of the issue.
  - firms revealing incorrect or delayed information to markets has led to markets becoming more “skeptical” and “punitive”
  - firms creating social costs has led to more regulations, as well as investor and customer backlashes.

The Stockholder Backlash

- Activist Institutional investors have become much more active in monitoring companies that they invest in and demanding changes in the way in which business is done. They have been joined by private equity firms like KKR and Blackstone.
- Activist individuals like Carl Icahn specialize in taking large positions in companies which they feel need to change their ways (Blockbuster, Time Warner, Motorola & Apple) and push for change.
- Vocal stockholders, armed with more information and new powers: At annual meetings, stockholders have taken to expressing their displeasure with incumbent management by voting against their compensation contracts or their board of directors

The Hostile Acquisition Threat

- 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)

In response, boards are becoming more independent…

- Boards have become smaller over time. The median size of a board of directors has decreased from 16 to 20 in the 1970s to between 9 and 11 in 1998. The smaller boards are less unwieldy and more effective than the larger boards.
- There are fewer insiders on the board. In contrast to the 6 or more insiders that many boards had in the 1970s, only two directors in most boards in 1998 were insiders.
- Directors are increasingly compensated with stock and options in the company, instead of cash. In 1973, only 4% of directors received compensation in the form of stock or options, whereas 78% did so in 1998.
- More directors are identified and selected by a nominating committee rather than being chosen by the CEO of the firm. In 1998, 75% of boards had nominating committees; the comparable statistic in 1973 was 2%.

Disney: Eisner's rise & fall from grace

- In his early years at Disney, Michael Eisner brought about long-delayed changes in the company and put it on the path to being an entertainment giant that it is today. His success allowed him to consolidate power and the boards that he created were increasingly captive ones (see the 1997 board).
- In 1996, Eisner spearheaded the push to buy ABC and the board rubberstamped his decision, as they had with other major decisions. In the years following, the company ran into problems both on its ABC acquisition and on its other operations and stockholders started to get restive, especially as the stock price halved between 1998 and 2002.
- In 2003, Roy Disney and Stanley Gold resigned from the Disney board, arguing against Eisner's autocratic style.
- In early 2004, Comcast made a hostile bid for Disney and later in the year, 43% of Disney shareholders withheld their votes for Eisner's reelection to the board of directors. Following that vote, the board of directors at Disney voted unanimously to elect George Mitchell as the Chair of the board, replacing Eisner, who vowed to stay on as CEO.

Eisner's concession: Disney's Board in 2003

Board Members	*Occupation*
Reveta Bowers	Head of school for the Center for Early Education,
John Bryson	CEO and Chairman of Con Edison
Roy Disney	Head of Disney Animation
Michael Eisner	CEO of Disney
Judith Estrin	CEO of Packet Design (an internet company)
Stanley Gold	CEO of Shamrock Holdings
Robert Iger	Chief Operating Officer, Disney
Monica Lozano	Chief Operation Officer, La Opinion (Spanish newspaper)
George Mitchell	Chairman of law firm (Verner, Liipfert, et al.)
Thomas S. Murphy	Ex-CEO, Capital Cities ABC
Leo O'Donovan	Professor of Theology, Georgetown University
Sidney Poitier	Actor, Writer and Director
Robert A.M. Stern	Senior Partner of Robert A.M. Stern Architects of New York
Andrea L. Van de Kamp	Chairman of Sotheby's West Coast
Raymond L. Watson	Chairman of Irvine Company (a real estate corporation)
Gary L. Wilson	Chairman of the board, Northwest Airlines.

Changes in corporate governance at Disney

1. Required at least two executive sessions of the board, without the CEO or other members of management present, each year.
2. Created the position of non-management presiding director, and appointed Senator George Mitchell to lead those executive sessions and assist in setting the work agenda of the board.
3. Adopted a new and more rigorous definition of director independence.
4. Required that a substantial majority of the board be comprised of directors meeting the new independence standards.
5. Provided for a reduction in committee size and the rotation of committee and chairmanship assignments among independent directors.
6. Added new provisions for management succession planning and evaluations of both management and board performance
7. Provided for enhanced continuing education and training for board members.

Eisner's exit… and a new age dawns? Disney's board in 2008

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

But as a CEO's tenure lengthens, does corporate governance suffer?

1. In 2011, Iger announced his intent to step down as CEO in 2015 to allow a successor to be groomed.
2. The board voted reinstate Iger as chair of the board in 2011, reversing a decision made to separate the CEO and Chair positions after the Eisner years.
3. There were signs of restiveness among Disney's stockholders, especially those interested in corporate governance. Activist investors (CalSTRS) starting making noise and Institutional Shareholder Services (ISS), which gauges corporate governance at companies, raised red flags about compensation and board monitoring at Disney.

Iger’s non-exit and the Domino effect

1. In 2015 but Disney’s board convinced Iger to stay on as CEO for an extra year, for the “the good of the company”.
2. In 2016, Thomas Staggs who was considered heir apparent to Iger left Disney. Others who were considered potential CEOs also left.
3. In 2017, Disney acquired Fox and announced that Iger’s term would be extended to 2019 (and perhaps beyond) because his stewardship was essential for the merger to work.

- Now, what?

What about legislation?

- Every corporate scandal creates impetus for a legislative response. The scandals at Enron and WorldCom laid the groundwork for Sarbanes-Oxley.
- You cannot legislate good corporate governance.
  - The costs of meeting legal requirements often exceed the benefits
  - Laws always have unintended consequences
  - In general, laws tend to be blunderbusses that penalize good companies more than they punish the bad companies.

Is there a payoff to better corporate governance?

- In the most comprehensive study of the effect of corporate governance on value, a governance index was created for each of 1500 firms based upon 24 distinct corporate governance provisions.
  - Buying stocks that had the strongest investor protections while simultaneously selling shares with the weakest protections generated an annual excess return of 8.5%.
  - Every one point increase in the index towards fewer investor protections decreased market value by 8.9% in 1999
  - Firms that scored high in investor protections also had higher profits, higher sales growth and made fewer acquisitions.
- The link between the composition of the board of directors and firm value is weak. Smaller boards do tend to be more effective.
- On a purely anecdotal basis, a common theme at problem companies and is an ineffective board that fails to ask tough questions of an imperial CEO.

The Bondholders' Defense Against Stockholder Excesses

- More restrictive covenants on investment, financing and dividend policy have been incorporated into both private lending agreements and into bond issues, to prevent future "Nabiscos".
- 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
  - 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.

The Financial Market Response

- While analysts are more likely still to issue buy rather than sell recommendations, the payoff to uncovering negative news about a firm is large enough that such news is eagerly sought and quickly revealed (at least to a limited group of investors).
- As investor access to information improves, it is becoming much more difficult for firms to control when and how information gets out to markets.
- As option trading has become more common, it has become much easier to trade on bad news. In the process, it is revealed to the rest of the market.
- When firms mislead markets, the punishment is not only quick but it is savage.

The Societal 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.
- 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.
- Finally, investors may choose not to invest in stocks of firms that they view as socially irresponsible.

The Counter Reaction

STOCKHOLDERS

1. More activist investors
2. Hostile takeovers

Managers of poorly run firms are put on notice.

Protect themselves

BONDHOLDERS ⟷ **Managers** ⟷ SOCIETY

Corporate Good Citizen Constraints

1. Covenants
2. New Types

1. More laws
2. Investor/Customer Backlash

Firms are punished for misleading markets

Investors and analysts become more skeptical

FINANCIAL MARKETS

So what do you think?

- At this point in time, the following statement best describes where I stand in terms of the right objective function for decision making in a business
  a. Maximize stock price, with no constraints
  b. Maximize stock price, with constraints on being a good social citizen.
  c. Maximize stockholder wealth, with good citizen constraints, and hope/pray that the market catches up with you.
  d. Maximize profits or profitability
  e. Maximize earnings growth
  f. Maximize market share
  g. Maximize revenues
  h. Maximize social good
  i. None of the above

The Modified Objective Function

- For publicly traded firms in reasonably efficient markets, where bondholders (lenders) are protected:
  - Maximize Stock Price: This will also maximize firm value
- For publicly traded firms in inefficient markets, where bondholders are protected:
  - Maximize stockholder wealth: This will also maximize firm value, but might not maximize the stock price
- For publicly traded firms in inefficient markets, where bondholders are not fully protected
  - Maximize firm value, though stockholder wealth and stock prices may not be maximized at the same point.
- For private firms, maximize stockholder wealth (if lenders are protected) or firm value (if they are not)

THE INVESTMENT PRINCIPLE: RISK AND RETURN MODELS

"You cannot swing upon a rope that is attached only to your own belt."

First Principles