**Topic 1: Corporate Governance**

* **Every corporation needs an ultimate objective to specify what management is trying to achieve.**
* **Why do we need only one ultimate objective not many?**

Because we need a systematic way of decision making, competing objectives can be contradictory.

**Objective of Corporate Finance:**

Maximize firm value (Least restrictive)

Maximize shareholders wealth

Maximize share price (most restrictive)

The above objective/s is fine if the following assumptions are held:

* There is no conflict of interest between managers and shareholders
* There is no conflict of interest between shareholders and bondholders
* Market are efficient and investors are rational
* There are no social costs, and if any, they can be traced back to the company

1. **Relationship between managers and shareholders**

***Theory***: Managers work for the best interest of shareholders because they fear being fired or replaced by *shareholders voting in the annual general meeting* (AGM) or by the *board of directors* (BOD) who has fiduciary duty towards shareholders.

***Reality***: Stockholders have little control over the firms, managers put their interest first.

1. Minority Shareholders do not attend the AGM because they make no difference, and sometimes it does not make financial sense to do so. Proxies are rarely filled, and when filled, voting with management is the norm. Institutional investors tend to vote with their feet when they are unhappy with the management decisions.
2. Members of the BOD spend little time on the board issues, no expertise in the business, CEO can head the board, CEO selection, insiders are board members, little ownership percentage.
3. Ownership structure:

Voting rights: single class vs multiple classes of shares

Founder owner

Passive investors (mutual and pension funds) vs. active investors (hedge and private equity funds)

Stockholders with competing interests (government, employees as shareholders).

Corporate cross holdings (pyramid structure).

***Consequences***:

1. Fighting hostile takeovers via greenmail, golden parachute, poison pills
2. Anti-takeover amendments
3. Paying too much on acquisitions

***Remedies***:

How to reduce the agency problem?

* 1. Make managers think like shareholders by having equity stakes in the firm

(stock options 🡪 increases the risk)

Stock compensation with long term liquidation condition

* 1. Effective board members: Outsiders, limit the number of directorships, compensation, lead director, smaller boards, nomination committee, annual evaluation for CEO, CEO is not on board.
  2. Increase shareholder power by promoting activism and providing more updated information, having the major shareholder being part of management.
  3. Maintain the threat of takeover as a disciplinary mechanism.

1. **Relationship between stockholders and bondholders**

***Theory***: The lenders of the firm are fully protected from expropriation by stockholders

***Reality***: Bond holders are taken advantage of in three ways (mainly due to the differences in cash flow rights; creditors are fixed claimants on firm’s cashflow and do not share in the upside if projects succeed but bear a significant cost if firms fail. Shareholders are residual claimants on firms’ cash flows)

1. Investing in risky projects
2. Additional borrowing 🡪 probability of default increases (shareholder’s wealth increases at the expense of bondholders), when debt ratio increases, bond rating drops, the price of bonds fall to reflect the higher default risk.
3. Additional divided payment🡪 cash available to repay debt decreases🡪Debt is more risky. stock price (shareholder wealth tend to increase) while bond prices decreases (Bondholder’s wealth decreases)

***Consequences:***

Wealth transfer from bondholders to shareholders this also can affect the firm’s reputation.

***Remedies***:

1. Debt covenants that restrict the firm investment, divided and additional leverage policies.
2. Become shareholders (equity stake) via convertible bonds (at the option of the bondholder)
3. Puttable bonds
4. **Relationship between the firm and financial markets**

***Theory***: Managers of the firm do not mislead or lie to markets about the firms’ future prospects, investors in return are rational and able to assess all the information and thus the price reflects the value of the company

***Reality***: there are two problems:

1. Information problem: the price is based on public and private information. Sometimes information is delayed especially when it is bad news (publishing on Friday afternoon after market closure) or information can be misleading
2. Market problem: inefficient markets, overreacting, not assimilating information well into price.

***Consequences***: No guarantee that the market price will be unbiased estimate of true value.

***Remedies***:

1. Improve the quality of information either by laws or by creating market for information (analysts)
2. Enhance the market efficiency by lowering the trading cost, free access to information, earning reward when investing in good stock and pay the price when investing in a bad stock.
3. **Relationship between firm and society**

***Theory***: Social costs are trivial enough either that they can be ignored or that they can be priced and charged to the firm.

***Reality***: Social costs could be considerable but can not be traced to the firm. There is an ethical and moral dilemma; maximizing firm value vs. broader interest of society.

***Consequences***: Society pays a high price while socially irresponsible firms maximize their wealth.

***Remedies***:

1. Make it an economic interest to the firm to be a good citizen
2. Laws
3. Customer boycotting the products of firms that are not acting socially well
4. Investors boycotting the stocks/bonds of firms that are not acting socially well.