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Discussing the Merits and Demerits of Stock Options
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The purpose of including stock options and restricted stock in a contract is to align management's incentives with the incentives of the shareholders of the company and to also mitigate the agency problem. The agency problem is caused by managers who act in their best interests instead of the interests of the owners of the company. Therefore stock options and restricted stock is issued as part of compensation packages of managers to incentivize them to work in the best interest of the company. If the company stock price raises their options and restricted stock will appreciate as well therefore aligning their interests with the rest of the shareholders.

The biggest advantage of restricted stock as opposed to stock options is that restricted stock has value. Stock options only have value if they are in the money and are exercised before they expire. Therefore restricted stock will retain its value if share price drops, however stock options will be worth zero if the share price is below the option strike price. Restricted stock has a period when the manager can not immediately sell it, called a vesting period which is used to keep the manager incentivized in the long-term. Restricted stock is more effective than stock options because stock options have expiration periods which cause managers to increase short term profits in expense of long-term shareholder value. Stock options can cause managers to be short-sided in their decision making, therefore restricted stock with a set vesting period is a better alternative. If there were to be a recession the manager's stock options could lose their entire value while the restricted shares have value which could be increased with better performance of the manager.

Another advantage of restricted stock over stock options is that with stock options CEOs may forego increasing dividends to try to increase the stock price. This tactic transfers wealth from shareholders to managers, and is not beneficial for the shareholders. CEOs who own stock options may also choose to take on higher risk projects if their options are underwater, in which case the bondholders of the company stand to lose if the company defaults on its debt. CEOs that own stock options may also try to time stock price movements to match the time horizons of their options therefore further benefiting. If stock prices are too far underwater the manger has no real incentive to work hard if he/she knows there is no way they could appreciate for him or her to benefit. Granting restricted shares instead of stock options fixes these problems by placing managers at an equal standing with shareholders.

A disadvantage of stock options is that they may reward bad managers if the economy is the case of the stock price going up instead of management oversight. Options could also put the company on a slippery slope when it comes to re-pricing previously issued options as in the case of the Apple director who had to resign due to public criticism. Stock option incentives could encourage short-term value increases such as in the case of Disney when Michael Eisner added little long term value while cashing out a considerable amount based on his appreciated stock options as a result of past management's long term focus. Stock options incentives could also encourage fraudulent activity by mangers such as insider trading of managers and manipulation of accounting statements such as in the case Xerox.

Investors have criticized stock options for not being reflected on the company's balance sheet although they could be huge potential cash outflow to the company. Because of these criticisms in 2005 regulation was introduced which requires companies to expense stock options. As a result of this regulation companies began issuing more restricted shares because it reduces the incentive to time the market and also lowers the number of shares issued. Restricted shares are a better alternative to stock options because as a liability they are more transparent than stock options. Stock options are more similar to an off balance sheet liability that could be potentially large if the stock price of a firm increases. Many start up firms suffered from the expensing of stock options requirement, because they are cash-strapped and grant most of their compensation in stock options. Therefore a better alternative for them is to grand stock and restricted shares which will make their liabilities more transparent and their managers more long-term oriented.

As was shown in the Sally Jameson case, stock options have a huge upside potential if the volatility of the company stock is high. This is another disadvantage of stock options to restricted stock because if the volatility of the company increases stock options will appreciate causing a further cash-outflow by the company. Stock options act as leverage. It has been shown that if an investor owns options of the same value compared to common stock, the options will gain a higher return. Because shareholders ultimately pay the cost of stock option compensation companies are better off awarding restricted stock which has a more predictable value than stock options.

Keeping Corporations Honest: The Players

From the various external monitors we have covered this semester, creditors are the most important external monitors by the fundamental fact that they have the most “skin in the game”.
Creditors have an invested interest in the company for the long term as opposed to investment banks who underwrite the securities of companies who are mostly interested in generating enough demand for those securities so they themselves are not left to carry them. The tech IPOs in the late 1990s were mostly substandard companies which were hyped by investment banks, because they would gain underwriting fees and large investment returns from their proprietary trading arms. Investment banks have also helped firms raise capital through non-traditional ways by manipulating earning such as in the case of Enron.

Auditors make their fees from corporations which they audit which represents a clear conflict of interest. This has caused accountants to feel increased pressure to “manage earnings” to meet internal and external targets for earnings per share. They have engaged in “window dressing” financial statements to look more appealing in for the purpose of external financing. They have also engaged in “income smoothing” by the use of deferrals and reserve accounts in order to show a steady growth in profits quarter after quarter.

Historical events have show the conflicts of interest that auditing firms face such as engaging in consulting services with the firms which they audit such as the case of Arthur Anderson and Enron. These consulting relationships have deepened relationships with client firms. SEC investigations as part of SOX show that accounting firm competition in 1970s-1990s has been fierce which has caused auditing firms to not maintain their traditional “adversarial” role with their clients.
By reading an audit report one could notice that the auditing firm states that the financial statements are prepared according to accounting standards, but fails to fully guarantee their accuracy. Sarbanes Oxley Act of 2002 has done a good job to transfer some of the responsibility to management to certify those financial statements.

Security analysts are the analysts who often work in the research divisions of investment banks, but are separated by so called “Chinese Wall” from the investment banking division. In the past and especially during the dot-com bubble security analysts have been criticized for expressing overly optimistic to outright misrepresentative opinions about companies with which the investment banking division has sought business from. Analysts often compromise their integrity for the benefit of their employer’s investment banking business. Research studies have shown that 61% of research recommendations are a “buy” while 35% are a hold and 4.2% are a sell. This is simply impossible in the real world where more companies fail than the ones who succeed.

Analysts have been criticized for assigning too “conservative” forecasts so firms would beat them and their stock price would appreciate. Before the SEC enacted Regulation Fair Disclosure many analysts would communicate with managers of companies and gain inside information. Reg FD had eliminated this which has somewhat increased the effectiveness of analysts.

There is a common mentality among research analysts to heard around particular forecasts, or the so called consensus opinion. Many research analysts only focus on large corporations for which their research reports will generate revenues, while small companies which are less traded are left in the dark. Fundamentally looked at research analysts experience no consequence if their ratings are “average” while they could be adversely affected if their ratings are “negative”. This may come from the fact that it is difficult for an analyst to gain information from the firm if they assign bad ratings to the firm which is a clear conflict of interest.

Historically credit rating agencies have had influence on the companies they rate by the fact that stock prices react to the positive or negative ratings. However their prominent influence in the housing market credit bubble showed that their processes and credit rating mechanisms could easily be rigged by savvy investment bankers and other bond underwriters. Credit rating agencies rate the bonds of issuing companies by employing financial analysis of public and non-public information.
They are compensated by the corporations themselves who wish to have their credit risk evaluated which represents a conflict of interest. Rating agencies may act as consultants to companies in showing them how to structure their debt issue in order to achieve the highest credit rating which is defeats the purpose of their existence.

There is little discipline from competition with credit rating agencies, because there is regulated protection from competitors. A ratings agency must first be approved by the SEC as a Nationally Recognized Statistical Rating Organization. Credit rating agencies have also been exempt from disclosing their methodologies in assigning ratings, which was recently changed by the Dodd-Frank Act.

Creditors or largely corporate debt have proven to be most effective and important monitors of companies. Made up of both institutional lenders such as commercial banks and individual lenders such as bondholders creditors invest in the debt of companies. The reason why creditors are so important as monitors is because corporate debt itself acts as monitor. If company is making a large amounts of cash and that cash is not being utilized managers eventually begin to take advantage of it by treating themselves to with lavish perks such as golfing events, expensive corporate dinner or the use of a private jet for personal pleasure. If the company were to instead borrow money it has the legal obligation to deliver on the promised interest and principal, which reduces the cash flow available to management’s discretion and therefore reduces the agency problem.

Another monitoring mechanism is that if a company needs capital it has to raise in the capital markets which are monitored by creditors and will adjust the cost their lending depending on the risks associate with the borrower. To achieve a low cost of borrowing for their firms managers are incentivized not to take extremely risky projects which is a benefit to the shareholders. Another reason why creditors are the best monitors is that they introduce covenants in their lending contracts which monitor through the placing financial constraints, limits on freedom of managers incentivizing them to act in the best interests of the creditors. The largest creditors are often commercial banks which are meticulous in monitoring the companies to which they lend. In order for companies to achieve favorable financial terms they often try to build relationships with their bank lenders by the complying with lending covenants and by providing banks with private information.

The fact that creditors, particularly commercial banks have an invested interest in the companies they lend to makes them the most effective and important monitors. The importance of commercial banks is further justified through the policies of the Federal Reserve. If the Fed wants the economy to expand it simply decreases interest rates which enable commercial banks to engage in more lending to businesses.

Not All Shareholders are Equal: The Ford Motor Company Case

Shareholder activists would not be in favor of the Ford family being able to influence company decisions to such a large extent, because it could lead to the Ford family protecting their own interests at the expense of the rest of the shareholders.

Specific reasons why shareholder activists would not be in favor is that the through its 40% voting power the Ford family is able to influence the nomination and election of board directors, compensation of managers and the general strategic goal of the company. By being able to exercise influence on the nomination and election processes the Ford family is able to place people on the board that will defend their interests such as keeping its large voting power. Through controlling the compensation process the family could potentially reward its family members and close affiliates who are present on the board unreasonably high compensation and consulting fees.

No one is to say that the Ford family will make decisions which are adverse to the company, but as mentioned by Prof. Williams firms that have larger shareholder representation enjoy increased returns. The democratic process of the structure when all shareholders are equally represented decreases the perceived risk that large shareholders or an owning family can exercise their influence on the company.

As one might expect degree of activism differs between individual shareholders and the more sophisticated institutional shareholders. Although individual shareholders may nominate directors, vote on proxy or at annual meetings, submit proposals to be voted on they rarely do. If an individual investor decides to pursue any of the above he or she will face large costs in interpreting the wealth of company information or might own too little shares to be able to submit a proposal. It is also difficult and expensive for one shareholder to communicate with other shareholders to promote their proposal. Because most individual shareholders are passive they prefer to trust in management’s best judgment. There is a restriction to who has the right to submit proposals that could be voted on. The restriction is that the shareholder has to hold more than $2,000 worth or 1% of company stock on a continuous basis for at least a year which has been recently increased to owning 3% for at least prior 3 years. These regulations make it difficult for individual shareholders who own a small portion of shares to have their voice heard.

In contrast large individual shareholders may be effective monitors and act in the interests of minority shareholder as well. Managers who own large stakes in the company may also act in the best interest of shareholders due to their personal interest in maximizing their own stock value. However many firms especially in the U.S. do not have large individual shareholders, because many investors want to diversify their portfolios. In regards to this matter activist shareholders should be even more concerned because if the Ford family has 40% of the voting power but not 40% of the cash flow rights, the family does not stand to lose money if its decisions destroy value at Ford.

Fortunately institutional shareholders would be more effective in expressing their disagreement with the Ford family retaining such a large voting power in the company. Institutional shareholders have the economies of scale and sophistication to be able to monitor firms. Minority shareholders may benefit from the actions of large shareholders. With the advent of portfolio diversification and 401k defined benefits plans there has been a shift in funds allocation from households to institutional investors such as pension funds and mutual funds. By holding a larger portion of individual investor's money has made these types of shareholders more influential. CalPERS know for its activism has brought positive change to companies such as GE, Texaco and Avon by promoting better corporate governance.

Recent regulations have increased the voice of activist shareholders by introducing the right to a non-binding vote on executive pay and golden parachutes. The SEC has required companies to rationalize the structure of executive pay such as providing charts that compare compensation to stock performance over a 5-year period. The SEC has also reserved the right to grant shareholders proxy access to nominate directors. These improvements provide for a better accountability by firms and give a medium for individual and institutional shareholders to express their opinion on compensation.

Unfortunately there are limits to activism which prevent institutional shareholders to counter the Ford family's large voting power. For example actively managed funds trade in the short term, so they might not be motivated to engage in shareholder activism. Some might argue that it is better for Ford to own 40% of the voting power because actively managed funds trade for the short-term and do not commit to a long term value creation at the company, but an argument against that is most funds are passive and focus on the long term. Also private pension funds which are owned by their parent companies are not willing to employ activist fund managers because shareholder activism is not their main business. There are also many ownership restrictions for mutual funds and pension funds such as a limit on the percentage of the fund in a given stock, which limits the funds ability to become a large shareholder of given a company and therefore reduced the motivation for shareholder activism.

To summarize shareholder activists would not be in favor of the Ford family owning 40% of the voting power because they would stand to lose if a decision is made that destroys value. While their activism has its limits institutional shareholders can be active monitors of companies which benefits individual shareholders as well. Recent regulations have added to the arsenal of ways for activist shareholders to become engaged in the corporate governance of companies.

Specifics of the International Paper Co. deal with Temple-Inland

The shareholder-rights plan is to be triggered if the hostile acquirer, International Paper Co. acquires 10% or more of the outstanding shares of Temple-Inland. Temple-Inland declared a dividend distribution of a preferred-share purchase right for each common share owned by an investor of Temple-Inland. Each right entitles shareholders to buy one one-hundgredth of a share of a new series of junior participating preferred stock at an exercise price of $120. These rights shares are designed to assure that Temple-Inland stockholders will receive a premium and will realize the long-term value of their investment in the company if the hostile acquirer were to purchase more than 10% of common shares.

The shareholder rights plan made Temple-Inland a less attractive takeover target because it allows current shareholders to buy new shares at a discount if the hostile acquirer buys more than 10% of the company's shares. Because the current shareholders are able to buy new shares at a discount this would as a result dilute the bidder's interest and would make the hostile acquisition more expensive. Because International Paper knows Temple-Inland to have such a mechanism it is incentivized to negotiate further with the board to agree on an acceptable acquisition value in order for Temple-Inland to disable the protective mechanism. Because Temple-Inland rejected International Paper's bid the poison pill is still effective if the acquirer decides to negotiate with the shareholders instead of the board.

Fighting Outside Competition

I agree with corporate governance advocates in disapproving the use of poison pills, because the practice acts as a deterrent and a limitation to a free market where value could be created if the transaction were to be allowed to proceed. In the case of Temple-Inland it seems that the goal of International Paper is to limit competition between paper firms by buying a competitor and therefore reducing the excess production capacity that has kept producers from gaining pricing power over their customers. In this case an anti-trust regulator would prove a better judge of the deal. Even if the acquisition price were high enough to create value for the company, it would cause society as a whole to lose value in the long term due to monopolistic power of the combined company in the corrugate-packaging industry.

Another reason against the use of defensive tactics is that historically the stock price of a company has dropped on the announcement that a firm has adopted a defense mechanism. This means that the market does not view favorably the policy of the company. Investors as a whole see that the introduced defense mechanism could rob shareholders of value created through the strategic merger of two companies. If managers are also stockholders they should be incentivized to allow mergers, however they are also driven by the incentive to keep their job as CEO, CFO or COO. When a merger or a buyout occurs managers are not certain if they will keep their positions therefore they are adverse to such a transaction.

An argument why poison pills do not increase the quality of corporate governance is that many times the acquiring firm could add value through synergies such as reducing the target firm's costs, improving operation efficiency or eliminating bad managers at the target firm. Although research indicates that value may not fully be recovered by the acquirer who often pays a large premium, the company could always benefit from the involvement of a fresh perspective. The pervious shareholders will of course benefit from the premium purchase price.

As a result the possibility of a hostile takeover can serve as a monitoring mechanism to corporate governance. It would incentivize managers to act in the best interests of the shareholders if they wish the company to not become a takeover target. The possibility of a takeover is greatly reduced by the

adoption of a takeover defense policy, which diminishes the effectiveness of M&A as a monitor and could destroy shareholder value in the long run.
Aside from serving as a governance mechanism M&A activity takes advantage of synergies between the two merged companies such reducing costs and increasing revenues.

Countries in which financial markets are most developed such as the U.S. and U.K. have the most anti-takeover laws, but also have the most M&A activity. This signifies that amount of anti-takeover laws is a direct result of the amount of M&A activity. In bank centered financial systems banks play a larger role in which firms merge which is probably not the best alternative, because there is not a free market for M&A. It is better to have a developed M&A market with some defense mechanisms than have an undeveloped M&A market with little selling and buying activity.

An argument could be made that a takeover law might be necessary for a company to achieve its long term goals without the distraction of having to battle corporate raiders. The fact is that often companies which become takeover targets have destroyed shareholder value either through the management team not maximizing shareholder value or the board not monitoring in a way that maximizes value. M&A activity also creates a faster turnover of money in an economy which stimulates its expansion, especially in times of recession or depression.

After all shareholders have the right to determine the best offer that will create the most value for them. Companies who employ defenses such as supermajority rules, golden parachutes, the help of a white knight acquirer or seek protection under government anti-takeover laws do not give their shareholders a choice. Companies which do not give them this right will most likely suffer from capital flight or underinvestment.

American Versus German Corporate Governance Systems

The German Corporate governance system is quite different from the one in the U.S. in regards to different components of corporate governance. These components include shareholders, managers, board of directors, external monitors and corporate control.

The first component is the shareholders of the two systems. The U.S. shareholder base is known to be market-based where ownership is dispersed among many shareholders and because of that equity markets are thought to be most efficient. The German shareholder base is known to be bank based where banks and families tend to be the largest shareholders. As a result of that there is less transparency to minority and common shareholder in Germany in contrast to the high transparency in the U.S. In the U.S. the one share one vote rule is common meaning that or voting power is proportionate to your share ownership while in Germany this is not necessarily the case. The minority shareholders often do not have any voting power in the German system while in the U.S. system control rights are often equal to cash flow rights. In the American corporate governance system agency problems occur because stakeholders such as employee unions, creditors, and owners have different objectives. Also since U.S. ownership is so widely dispersed most owners are non-active and atomistic. In contrast in Germany aside from banks there are large non-bank blockholders. Banks in Germany can have unlimited ownership in contrast to the U.S. where banks play a very small role in owning publicly traded companies due to regulation that prohibits U.S. banks from taking on too much risk. In the U.S. where institutional investors are becoming more active in governance, banks in Germany are the primary creditors. Stock prices in the U.S. tend to be more voletile due to the shortsidednes of owners while in Germany stock prices are more stable due to long term bank ownership. The shareholders of U.S. companies tend to signal their approval of management while in Germany the owning bank could get involved me directly. Banks in Germany could also have larger influence on companies through their crossholdings as was demonstrated by Prof. Williams with the pyramidal ownership of Daimler-Benz. Dispersed ownership in the U.S. makes it more difficult for a single shareholder to exercise influence. The advantage is definitely on the side of the U.S. corporate governance system, because it includes a more dispersed group of shareholders, and therefore is more transparent in its reporting. There is also a prevalent conflict between minority and controlling shareholders in the German system where in order for the minority shareholders to receive equal rights the controlling shareholders have to give up some of their control rights. In contrast concentrated ownership is rare in the U.S. There is also a large difference in the law systems where Germany is under the civil law system while the U.S. is under the common law system. It is also proven that firms under the civil law system such as firms in Germany invest less in governance than do U.S. firms, which is a clear disadvantage of the German system.

The second component is role of managers in each system. The Vodafone case clearly explained that because of different compensation structures, CEOs and top management in German companies are not usually large shareholders in the company. They do not have the large amount of stock options or golden parachutes like U.S. executives have. This goes along with the idea that Germany is more focused on overall stakeholder value rather than shareholder value like the U.S. The U.S. follows the shareholder maximization model while Germany follows the stakeholder wealth maximization model. This has clear implications on the type of compensation structures managers receive. Another difference is that managers in the U.S. are much more mobile between companies, while managers at German companies stay in the same company for longer. There is a large market for executives in the U.S. which is clear benefit to U.S. firms, because it makes it easier for a firm to change its managers if they are not performing well. The lower turnover of managers in Germany could be due to high costs of searching for talent because there is not an established market for executives, which puts German companies at a disadvantage. If German managers are not compensated enough compared to their American counter parts and are difficult to fire then German companies will probably create less value in the long run.

The third component is the structure and focus of the board of directors. In the American system the board of directors is elected solely by owners to monitor management. In contrast in Germany the board is two-tiered. A supervisory board and a management board where 50% of the supervisory board is elected by employees representing non-owner stakeholders. This shows that the focus of German boards is more towards stakeholders of the firms instead of just the shareholders as in U.S. firms. The German structure has a disadvantage, because due to its separation, actual proposals that are to increase shareholder value might be rejected by the board, because they could be seen as decreasing stakeholder value of the workforce. This leads to an agency problem in German firms, which as a result decreases their value, because investors would not like to invest in company that might choose stakeholder interests over owner interests. In contrast in the U.S. the board remains independent of management which serves as an effective mechanism against the agency problem. The Sarbanes Oxley Act prohibits a firm's managers or agents to benefit at the expense of owners.

The fourth component is the importance of external monitors. In the U.S. the most prevalent external monitors are creditors, investment banks, securities analysts, credit rating agencies and regulators. In Germany these external monitors do not play such a large role and instead are replaced by the internal monitors like the board of directors, stakeholders and the large creditor banks. As a result of the large internal monitors German companies are less transparent to the public which is a clear disadvantage from the perspective of potential investors who would not be able to acquire any information. In contrast because of the dispersed ownership of U.S. companies their financial statements and dealings are readily available through the financial information services and the financial press. In fact U.S. companies dealings are quite public while German companies business dealings are only known by insiders. This lack of transparency in Germany does not promote foreign investment in German companies by small stockholders. In contrast the U.S. prides itself in its established shareholder rights that enable foreign investors to invest in U.S. companies.

U.S. external monitors enjoy an equal influence on U.S. companies while German regulators or non-owning outsiders have little influence on the German companies. This leads to the reason why regulatory agencies such as the SEC have higher influence on U.S. companies than do German regulatory agencies which are mostly unknown. The reason for higher involvement of regulatory agencies in the U.S. could be because of the greater dispersement of U.S. investors while Germany investors or mostly limited to banks and large family owners. The U.S. system is better because it provides for the mixed monitoring by many parties. German system could be prone to not considering differentiating opinions assessing the risks of German companies which could lead to poor decisions and loss of shareholder value.

The fifth component of corporate governance is the influence of corporate control. In the U.S. the threat of a takeover is an effective governance mechanism if poorly performing firms become takeover targets. The German corporate governance system however makes it more difficult for a hostile takeover to succeed, because M&A activity in Germany is not hostile, but is done via large blockholders. In contrast the United States has a very well developed M&A market where when a company is "taken on the block" for sale it is a widely known public event. The advantage of having a public sale or auction of a company is that it promotes competition between interested parties therefore creating the most shareholder value for the seller. The German corporate governance system is at a disadvantage because if large blockholders such as banks and owning families are able to privately negotiate an M&A transaction, there is no competition and shareholders could lose value. The German system is anti-competitive and does not promote fair trade in the M&A market. For example a large bank who is an owner of Daimler-Benz could negotiate a private sale of the company to Fiat of Italy which maybe is not the best acquirer. The major difference in the U.S. is that the M&A market acts a governance mechanism and disciplines managers to perform to the best of their abilities. The managerial discretion of U.S. firms is controlled while in Germany discretion is completely left to German managers and other stakeholders. In the U.S. system a manager acts to maximize shareholder value under the pressure of potential takeover and ultimately mitigates the agency problem. The German proponents of their system might argue that acquirers in the U.S. system end up paying too much for a target, however this is consistent with maximizing shareholder value of the sellers. Because of the undeveloped M&A market in Germany M&A is not able to serve as governance mechanism which is further supported by the lower ranking of Germany in M&A activity compared to the U.S. and U.K.

Public opinion about the M&A market could also prove to work against the corporate control mechanism. As we saw in the Vodafone's proposed acquisition of Mannesmann there was a wide public disagreement about Vodafone a U.K. company acquiring Mannesmann a German company. The German chancellor Schroeder went so far as to say, "Hostile takeovers destroy corporate culture." If there are such public disagreements in Germany the German government could feel compelled to react and further limit the governance control mechanism. In contrast M&A activity in the U.S. is exciting and promotes increased quality of corporate governance through the corporate control mechanism.