



Who's Minding the Store? Corporate Rules to Align Interests

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Introduction

Finance, at its core, is about promises—commitments to provide money in the future in exchange for money today. These promises underlie most financial transactions and instruments. For instance, stocks promise a share of future profits, bonds promise repayment of loans with interest, and insurance promises compensation for potential future losses. The key question in finance is: what are these promises worth today?

We typically approach this question in two ways. The first, rational classical finance, assumes markets are efficient and participants are rational. It relies on models like Discounted Cash Flow (DCF), which calculate the present value of future cash flows, and comparative valuation methods like Price-to-Earnings (P/E) ratios. The second approach, the human side of finance, acknowledges that human behavior, trust, and even dishonesty play a role in financial markets. Fraud, incomplete contracts, and psychological biases often influence how promises are valued.

In this lecture series, we've been exploring how financial relationships can break down. This second lecture examines the conflicts between managers and shareholders. Shareholders expect managers to maximize the company's value, but managers often have their own priorities, like securing their jobs, increasing their salaries, or enhancing their prestige. For example, a CEO might approve an expensive new headquarters to boost their image, even if the funds could be better spent on research or dividends for shareholders.

Controlling the managers

What mechanisms can be used for controlling managers to align their interests with those of the shareholders?

A. Economic Controls:

1. *Performance-Based Compensation*

Tying managerial pay to the performance of the company is a direct way to align incentives. For instance, a CEO might receive bonuses based on achieving specific financial targets, such as revenue growth or return on equity. If these targets align with shareholder wealth maximization, managers are motivated to work in shareholders' best interests.

2. *Stock Options and Equity Ownership*

Providing stock options gives managers the right to purchase company stock at a predetermined price. If the company's stock price rises, managers benefit directly. This creates a personal financial incentive for managers to focus on activities that boost shareholder value. For example, companies like Tesla have granted significant stock options to their executives, which ties their wealth to the company's market performance.

3. *Long-Term Incentive Plans*

These plans reward executives based on long-term metrics, such as earnings growth or stock performance over several years, discouraging a focus on short-term gains. Companies like Apple and Meta use restricted stock units (RSUs), where shares vest gradually to retain executives and encourage long-term commitment. Often referred to as "golden handcuffs," these incentives tie financial

rewards to loyalty by requiring managers to stay with the company for a set period—such as five years—before accessing their benefits. This approach reduces turnover and aligns executives' interests with the company's long-term success.

B. Legal Controls

1. Oversight by the Board of Directors

The board acts as a governance mechanism to monitor and evaluate management. Independent directors on the board, in particular, provide objective oversight. For example, activist investors often pressure boards to hold management accountable for underperformance. For example, Elliott Management's 2020 activist campaign at Twitter led to significant governance changes and likely contributed to Jack Dorsey's eventual departure as CEO in late 2021.

2. Fiduciary Duties

Managers have legal duties to act in the best interests of shareholders. For instance, the duty of loyalty prevents self-dealing, while the duty of care ensures that managers make informed decisions.

3. Regular Financial Reporting Requirements

Public companies are legally required to disclose their financials regularly through filings like 10-Ks and 10-Qs. These disclosures allow shareholders and analysts to assess managerial performance. For instance, Enron's collapse revealed how fraudulent reporting and lack of transparency can undermine shareholder trust.

C. Market Controls

1. Threat of Takeover

If a firm's stock price falls too low due to poor management, it becomes an attractive target for acquisition. This threat incentivizes managers to maintain competitive stock performance. For example, the hostile takeover of RJR Nabisco in the 1980s highlighted how managers failing to maximize shareholder value could lose control of the firm. In this case, CEO F. Ross Johnson engaged in excessive spending and used company accounts for personal expenses. Under Johnson's leadership, the company's stock price languished despite spending \$1.1 billion on share buybacks. Johnson installed friends on the board and increased management compensation and perks, leading to high expenses and declining stock performance. KKR ultimately won control of RJR Nabisco for \$25 billion, outbidding Johnson's own LBO attempt. Johnson was fired after the takeover, though he still received a \$23 million golden parachute.

2. Competition in Product Markets

Managers must ensure the firm stays competitive in its industry. If poor management causes a company to lose market share, revenue, and profitability, it can impact shareholder value and lead to scrutiny or replacement. For instance, companies like Kodak, which failed to adapt to digital photography trends, saw managerial criticism escalate as market competition eroded value.

3. Reputational Concerns

Managers often care about their personal reputation and future career prospects. If they mismanage a company, their ability to secure future positions at other firms diminishes. For instance, after the collapse of Lehman Brothers in 2008, the reputations of its top executives suffered, reducing their chances of leading other firms. For example, CEO Dick Fuld, despite making \$529 million between 2000-2007, suffered a severely damaged reputation after Lehman's collapse. After Lehman's collapse, he maintained a very low profile, rarely making public appearances. Fuld also lost his estimated \$900 million in Lehman shares when the company went bankrupt. Many top executives from failed institutions during the crisis remained unemployed (though their substantial wealth meant they could live comfortably between mansions and leisure activities).

The idea is that by combining these economic, legal, and market controls, shareholders can create a system of incentives and oversight that encourages managers to act in alignment with their goals. Each mechanism plays a role in balancing managerial discretion with accountability, ensuring that shareholder interests remain the priority.

Subverting Economic controls

Economic controls like performance-based pay, stock options, and long-term incentive plans are intended to align managers' interests with those of shareholders. However, these mechanisms can be manipulated or inadvertently lead to outcomes that work against shareholders. Let's discuss how these controls can be subverted and their unintended consequences.

1. Subverting Stock Options

Option Repricing:

When a company's stock price falls, the value of previously granted options declines, potentially becoming worthless ("underwater"). Managers may pressure the board to reprice the options, effectively lowering the strike price to make the options valuable again. This undermines the original incentive structure, as managers are no longer punished for poor performance. For example, during the dot-com bust, several tech companies, including Amazon, repriced their options to retain executives. While this kept managers motivated, it also sets up a moral hazard problem (why work hard if you know the firm will reprice its options if the price drops?).

Option Backdating:

Option backdating involves altering the grant date of stock options to a prior date when the stock price was lower, making the options immediately more valuable. This practice provides unearned gains to managers and misaligns their interests with shareholders. Backdating is often concealed, leading to legal and reputational risks. UnitedHealth Group provides a notable example of option backdating, where grant dates were altered to coincide with lower stock prices, making options instantly more valuable. Over a decade (1994–2005), the company concealed more than \$1 billion in stock option compensation through falsified documents. This led to overstated net income by up to \$1.5 billion. The scandal forced CEO William McGuire to resign, repay \$468 million, and accept a 10-year ban from serving as an officer or director of a public company.

Gaming Short-Term Stock Performance:

Managers might engage in behaviors that temporarily boost stock prices to exercise their options at a higher value. For instance, they could cut R&D expenses, inflate earnings through accounting tricks, or engage in stock buybacks. These actions may boost short-term performance at the expense of long-term value creation.

2. CEO Overconfidence and Incentive Misalignment

Moral Hazard Solved, Adverse Selection Worsened:

Offering large option grants to CEOs can solve the moral hazard problem—ensuring they work hard to increase shareholder value since their wealth is tied to the stock price. However, it can exacerbate adverse selection. Overconfident CEOs are more likely to overestimate their ability to raise the stock price and therefore disproportionately apply for such compensation packages. My own research shows that overconfident CEOs often pursue risky or value-destroying acquisitions, underinvest in projects with uncertain payoffs, or take on excessive debt, which can lead to poor long-term performance.

3. Manipulating Long-Term Incentive Plans

Short-Term Focus Despite Long-Term Plans:

Although long-term incentive plans (LTIPs) are designed to encourage focus on sustainable growth, they can be manipulated. Executives may prioritize strategies that boost metrics tied to the LTIP (e.g., cumulative earnings growth or stock price over a three-year period) at the expense of other, more sustainable goals. For example, managers might push for aggressive cost-cutting or defer essential investments to meet LTIP targets, creating a "hollowed-out" company by the time the incentive plan ends.

Cherry-Picking Peers for Relative Performance Metrics:

Some LTIPs use relative performance measures, where executives are rewarded based on how their firm performs compared to a peer group. Managers can subvert this by lobbying to include weaker peers in the group, making it easier to outperform and claim bonuses. This can lead to compensation that is not truly reflective of value creation.

4. Encouraging Risky Behavior

Risk-Shifting with Options:

Options inherently reward upside potential without penalizing downside risks. Executives might undertake highly risky projects because their personal wealth benefits disproportionately from success, while shareholders bear the brunt of failure. For example, before the financial crisis, some bank executives pursued high-risk mortgage-backed securities and leveraged positions, knowing their potential payouts were uncapped, while losses would primarily fall on shareholders.

Perverse Incentives from High Leverage:

If a firm is highly leveraged, executives may use their options as a form of a "lottery ticket." They might gamble on risky strategies that could either save the firm (and their compensation) or lead to bankruptcy (where the option value is already zero). Lehman Brothers' leadership demonstrated such behavior by doubling down on risky positions in its final years, amplifying shareholder losses. In its final years, Lehman's executives increased leverage to 44:1. Despite warnings about excessive risk in the mortgage market, they continued aggressive investment in real estate assets. Their stock options created incentives to "gamble for resurrection" since they would benefit from extreme upside but face limited downside.

5. Inflating Performance Metrics

Earnings Management:

When bonuses or incentives are tied to financial metrics like earnings per share or EBITDA, executives may manipulate accounting practices to meet targets. For instance, they might engage in revenue recognition tricks, delay expenses, or capitalize costs that should be expensed. Such practices inflate short-term results but can lead to long-term problems when the financials are eventually corrected.

Use of Non-GAAP Metrics:

Managers might rely on adjusted or non-GAAP financial metrics that exclude "one-time" expenses, even if these expenses occur regularly. By highlighting non-GAAP figures, executives can portray a more favorable view of the company's performance, increasing their incentive payouts even if underlying performance is weak.

6. Exploiting Compensation Structures

Golden Parachutes

Even if managers underperform, they may negotiate severance packages that reward them handsomely upon termination. For example, many CEOs receive multimillion-dollar golden parachutes regardless of company performance, reducing their incentive to truly align with shareholders' interests. When Carly Fiorina was fired from HP after a poor tenure, she walked away with over \$20 million in severance. Under Fiorina's leadership, HP's stock traded at about the same price as when she announced the Compaq merger. The company posted a \$903 million loss on \$56.6 billion in revenue in 2003. She oversaw massive layoffs of approximately 30,000 employees. Despite poor performance, Fiorina received a \$21.4 million severance package. This included \$50,000 for career counseling.

Too Much Focus on "Pay for Performance"

While linking pay to performance is generally seen as a positive control, it can backfire if too much of the compensation is tied to quantifiable metrics. Managers may neglect less tangible but equally important aspects of leadership, such as cultivating corporate culture, ensuring regulatory compliance, or managing long-term risks.

7. Encouraging Short-Termism from Activist Pressure

Even when economic controls are well-structured, external pressures from activist investors or quarterly earnings demands can create conflicts. Executives might prioritize meeting short-term targets to secure their bonuses, even if those decisions compromise long-term shareholder value. For example, cutting staff or slashing R&D budgets might improve margins in the short term but harm innovation and competitive positioning in the future.

Subverting Legal controls

Legal controls, like oversight by the board of directors and regular financial reporting, are meant to keep managers accountable. However, these mechanisms can be subverted when managers find ways to influence or manipulate the very structures designed to oversee them. How might managers subvert these controls?

1. Subverting the Board of Directors

Handpicking Directors ("Board Stacking")

Managers, especially powerful CEOs, can influence the composition of the board by recommending allies, former colleagues, or individuals unlikely to challenge their decisions. While boards are technically elected by shareholders, the management often has significant sway in nominating candidates, and shareholders typically vote based on management's recommendations. For instance, if a CEO surrounds themselves with directors who are friends or have a vested interest in staying on the board, oversight becomes a mere formality.

CEO as Chairperson

Many companies allow the CEO to also serve as the chairperson of the board. This dual role enables the CEO to control the board's agenda, suppress dissent, and limit the board's ability to independently evaluate their performance. For example, a CEO-chairperson might prevent certain topics—like executive compensation or strategic failures—from being discussed in meetings.

Excessive Compensation for Directors

Managers can ensure board loyalty by offering generous compensation packages for directors. Directors who receive significant pay, perks, or benefits may become reluctant to challenge management out of fear of losing their lucrative positions. In extreme cases, directors may also receive consulting fees or business from the company, further aligning their interests with management rather than shareholders.

Board Ineffectiveness Through Overcommitment:

Managers can nominate high-profile individuals for board seats who are already overcommitted, sitting on multiple boards or managing their own companies. These directors might lack the time or energy to thoroughly evaluate management decisions, leading to rubber-stamping of policies. For instance, during the 2008 financial crisis, several high-profile board members at major banks were criticized for failing to act on warning signs due to their limited engagement.

Manipulating Information Flow to the Board

Managers often control the flow of information to the board. By selectively presenting data or framing issues in ways that favor their perspective, they can influence board decisions. For example, if a company is underperforming, managers might focus on short-term improvements while downplaying systemic risks. Directors, without independent access to internal operations, may not realize they're being misled.

2. Subverting Regular Financial Reporting Requirements

Earnings Management ("Cooking the Books")

Managers can manipulate financial statements to present a rosier picture of the company's performance. Techniques include:

- *Revenue recognition tricks:* Recognizing revenue from future periods early to inflate current earnings.
- *Deferring expenses:* Capitalizing operating expenses to spread costs over several years instead of recognizing them immediately.
- *Channel stuffing:* Pushing excess inventory to distributors to boost sales figures temporarily.

Enron's collapse is a classic example of how aggressive earnings manipulation can mislead shareholders and regulators.

Use of Non-GAAP Metrics

While companies are required to report under Generally Accepted Accounting Principles (GAAP), managers often highlight non-GAAP metrics like “adjusted EBITDA” or “pro forma earnings.” These metrics exclude certain expenses, such as restructuring costs or stock-based compensation, which managers argue are non-recurring. However, by consistently excluding “one-time” charges year after year, managers can obscure poor performance and mislead investors.

Delaying Bad News

Managers may delay disclosing negative events or losses until they can package them with positive news to soften the blow. For instance, they might bundle a significant write-down with an unrelated announcement, such as a new product launch, to distract from the bad news. This tactic buys them time and avoids immediate shareholder backlash.

Use of Complex Financial Instruments

Managers can structure complex financial instruments or off-balance-sheet entities to hide liabilities or risks. For example, during the 2008 financial crisis, companies like Lehman Brothers used “Repo 105” transactions to temporarily remove liabilities from their balance sheet before reporting periods, creating the illusion of lower leverage.

Influencing the Audit Process

Auditors play a critical role in ensuring accurate financial reporting, but managers can influence them in several ways:

- *Auditor Shopping*: Hiring audit firms that are more lenient or willing to overlook aggressive accounting practices.
- *Pressure on Auditors*: Threatening to replace the audit firm if they question management’s decisions or issue qualified opinions.
- *Consulting Conflicts*: Offering lucrative consulting contracts to the audit firm, which can create a conflict of interest and reduce their willingness to challenge management. This was a significant issue in the Enron scandal, where Arthur Andersen acted as both auditor and consultant.

Burying Disclosures in Complexity

While public companies are required to disclose detailed financial information, managers can overwhelm investors and regulators with overly complex or opaque reporting. For example, a company might bury critical disclosures in footnotes or obscure them in legal jargon, making it difficult for even sophisticated investors to understand the true state of the business.

3. Using Timing to Avoid Accountability

Strategic Timing of Announcements

Managers might release bad news on Friday afternoons or during holiday periods when investor attention is low, minimizing the fallout. Conversely, good news is often announced early in the week to maximize media coverage and investor enthusiasm.

Quarterly Earnings Game

Managers often focus on beating short-term earnings expectations, even if it harms long-term value. They might manipulate quarterly results to meet analyst forecasts, knowing that markets reward firms for even slight earnings beats. This short-term focus can lead to a cycle where managers prioritize optics over substance.

Control Over Internal Whistleblowers

Managers can discourage internal whistleblowing by fostering a culture of fear or retaliation. Employees who might otherwise flag fraudulent practices or poor governance may stay silent if they fear losing their jobs or being blacklisted in the industry.

4. Undermining Shareholder Influence on Reporting

Lobbying Against Disclosure Rules

Managers and their companies often lobby regulators to weaken reporting requirements or delay the implementation of stricter rules. For example, some firms have pushed back against ESG (Environmental, Social, and Governance) reporting standards, arguing that they are too burdensome or costly.

Selective Disclosure

While full disclosure is a regulatory requirement, managers might engage in selective disclosure, providing key information only to preferred analysts or institutional investors. This creates an uneven playing field and allows managers to maintain control over the narrative.

Subverting market controls

Managers can also be surprisingly adept at subverting market controls, using creative strategies to insulate themselves from the pressures of the takeover market or reputational risks. Let's discuss some of these strategies in detail, focusing on how they avoid the natural disciplining forces of the market.

1. Avoiding the Pressures of the Takeover Market

Poison Pills

Managers can implement shareholder rights plans, or "poison pills," that make takeovers prohibitively expensive or unattractive. For example, a poison pill might allow existing shareholders (but not the acquiring firm) to buy additional shares at a discount, diluting the acquirer's stake. While this protects shareholders from hostile bids, it often entrenches management by discouraging most bidders. A famous example is Netflix's use of a poison pill to thwart Carl Icahn's attempt at a takeover. In November 2012, Netflix adopted a stockholder rights plan (poison pill) specifically in response to Carl Icahn acquiring a 10% stake in the company. The poison pill was designed to make any hostile takeover attempt prohibitively expensive by allowing Netflix to flood the market with new shares if an individual or group acquired 10% or more of the company without board approval.

Staggered Boards

By structuring the board so that only a fraction of directors is up for re-election each year, managers can slow down an acquirer's ability to take control of the board. This gives management time to negotiate terms favorable to themselves or to rally opposition to the takeover. A staggered board can delay a hostile takeover by years, even if shareholders favor the acquisition.

White Knight Acquirers

When faced with a hostile takeover, managers can seek out a "white knight" acquirer—a friendly buyer who will agree to keep the current management in place. In 2013, Air Liquide acted as a white knight when it acquired Airgas for \$13.4 billion, offering a premium of over 50% above the stock price before the previous hostile takeover attempt by Air Products and Chemicals.

Overleveraging to Make the Company Undesirable

Managers may increase a company's debt to deter potential buyers, using a tactic called "leveraged recapitalization." This involves borrowing heavily and using the funds to pay dividends or repurchase shares, rewarding shareholders in the short term. However, the added debt makes the company more financially risky, reducing cash flow and leaving less room for growth. While this strategy can temporarily fend off takeovers, it often compromises the company's long-term financial stability.

Influencing Shareholder Votes

Hostile takeovers often require shareholder approval, so managers may work to sway the vote in their favor. This could include lobbying institutional investors, offering special deals to key shareholders, or using corporate resources to run public campaigns against the acquirer. Managers might even exploit

the passivity of retail investors, knowing they are less likely to participate in votes, and rely on default outcomes that favor the status quo.

2. Mitigating Reputational Concerns

Controlling the Narrative

Managers can hire public relations firms or engage in media campaigns to shape public perception of their leadership and the company's performance. By controlling the narrative, they can downplay scandals or underperformance.

Blame External Factors

When performance falters, managers can attribute poor results to external factors beyond their control, such as economic downturns, supply chain disruptions, or regulatory changes. This shifts the focus away from their own decisions and onto broader market conditions. For instance, during the COVID-19 pandemic, many companies attributed declining revenues to the pandemic, even when mismanagement played a role.

Rotating Between Companies

Executives facing reputational damage may leave their current roles and reemerge at other firms after a cooling-off period. This "corporate carousel" allows them to escape the consequences of their actions while leveraging their networks to secure new positions. For example, executives involved in the 2008 financial crisis resurfaced in leadership roles at other firms within a few years.

Crisis Diversions

Managers might use major external crises to mask their own failures. For example, during periods of political instability, economic downturns, or industry-wide challenges, they may blend into the chaos, avoiding individual scrutiny. By positioning their failures as part of a broader trend, they can protect their reputations.

Charitable and ESG Initiatives

Launching high-profile corporate social responsibility (CSR) or environmental, social, and governance (ESG) initiatives can help distract from managerial failures or unethical practices. For instance, a company embroiled in controversy might emphasize its environmental sustainability efforts or community outreach programs, shifting attention to its "positive" impact. This strategy is often referred to as "greenwashing."

3. Entrenching Management Through Structural Changes

Dual-Class Share Structures

Managers can implement dual class share structures, giving themselves shares with superior voting rights. This ensures that even if they own a minority of the company's equity, they maintain control over major decisions. For example, Mark Zuckerberg controls Meta through a dual class share structure, making him nearly immune to shareholder activism or takeover attempts.

Delisting or Going Private

To escape market pressures entirely, managers might advocate for taking the company private. By delisting, they no longer have to meet quarterly reporting requirements or deal with activist investors. Michael Dell's 2013 decision to take Dell private allowed the company to restructure outside of public scrutiny, giving management more freedom to operate without worrying about stock performance.

4. Undermining Market Competition

Influencing Competitors

Managers might form informal agreements or tacit understandings with competitors to limit competitive pressures. While outright collusion is illegal, softer forms of coordination, such as avoiding price wars or

refraining from entering certain markets, can help managers avoid the pressure to innovate or improve efficiency.

Dominating Niche Markets

Managers may focus on building dominance in niche or less competitive markets, where the threat of takeover or competition is lower. By avoiding direct competition with larger players, they reduce external pressures on their performance.

5. Exploiting Institutional Investor Passivity

Reliance on Passive Investors

With the rise of index funds and ETFs, a significant portion of shares is now held by passive investors who are less likely to challenge management. Managers can exploit this by focusing on short-term performance metrics that satisfy passive funds' benchmarks without addressing deeper strategic or governance issues.

Building Relationships with Institutional Investors

Managers might form close relationships with large institutional investors, such as pension funds or mutual funds, to secure their support during critical votes. By offering exclusive access to favorable terms, they can ensure these investors back them in the face of market pressure or shareholder activism.

What can we conclude?

The mechanisms designed to align managerial behavior with shareholder interests—economic, legal, and market controls—are often susceptible to subversion by creative or opportunistic managers. While these controls are meant to ensure accountability and value creation, they can be manipulated in ways that undermine their effectiveness, ultimately protecting managerial interests at the expense of shareholders.

Economic controls like performance-based compensation and stock options can be gamed through practices such as option repricing, backdating, or inflating short-term metrics at the expense of long-term performance. Legal controls, such as board oversight and financial reporting, are similarly vulnerable to manipulation. Managers can influence board composition, control the flow of information, or obscure critical disclosures through complex reporting. Market controls, including the threat of takeovers and reputational risks, can also be sidestepped. Managers may adopt defensive tactics like poison pills, staggered boards, or PR campaigns to insulate themselves from accountability or maintain their positions.

These strategies highlight the inherent tension in corporate governance: while mechanisms like incentives, regulation, and market pressures are designed to align managerial actions with shareholder interests, they often fail without robust oversight, transparency, and enforcement. In the world of corporate governance, as in so many other parts of finance, the rule is *caveat emptor*.