

UNIVERSITY OF MARYLAND
The Robert H. Smith School of Business

BUFN 758G: Corporate Governance and Performance

Winter 2008

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Office Hours: Mondays, 3:30 – 5:00 pm and by appointment

Course objective: This is primarily a corporate finance course, and it deals with corporate governance and its impact on shareholder value. Divergence of interests between corporate insiders and providers of funds leads to “agency problems” which can impair corporate performance and shareholder value. The incentive conflicts arise in various forms: provision of low effort (e.g., insufficient effort to the oversight of subordinates), inefficient and extravagant investments (e.g., pet projects, empire building), overly aggressive or conservative risk investments that destroy shareholder value; excessive compensation; ill-designed compensation structure; and outright illegal and scandalous activities (e.g., back-dating stock options, manipulating accounting information). We will study various instruments of corporate governance – internal as well as external mechanisms - that can help align managerial incentives with those of outside investors, and hence help restore shareholder value. Thus, the course uses an agency theoretic framework to provide your in-depth understanding of real world issues in corporate governance and how they influence capital allocation and performance of corporations. Specific topics covered in this course include:

- ❖ Conceptual foundation for corporate governance
- ❖ The role and duties of the board of directors
- ❖ Indicators of board effectiveness and best practices
- ❖ Design features of executive compensation contracts
- ❖ The significance and prevalence of stock options
- ❖ The perverse incentives of stock options and controversy over compensation practices
- ❖ Corporate governance failures and anatomy of recent corporate scandals
- ❖ The essentials of the Sarbanes Oxley Act and other regulatory reforms
- ❖ Recent trends in corporate governance around the world
- ❖ The basics of mutual fund governance

Approach: The course adopts *an agency theoretic framework* in studying the evolution and consequences of corporate governance. The valuation consequences of governance are consistent with the overall *objective* of maximizing *shareholder wealth* in

financial decision-making. The pedagogy consists of lectures interspersed with case studies. You will work in a *team* to analyze the cases. Sections begin with lectures and discussions. *You should come to class fully prepared to engage in active discussion.*

Case Preparation and Presentation: The students will be organized into 4-5 team members. Each team is responsible to make *one* case presentation. Each team is assigned a *grade* for case preparation and presentation. The grouping provides an opportunity for *team work/learning* that is vital for your success in the finance profession. However, to mitigate “free ridership”, there will be *peer evaluation*. Each participant will rate the contribution of the other members of the group. These ratings will be used in the determination of the final grade for individual members. Note that your team’s preparation and presentation must be based on the effort of your own team members. You are *not* allowed to discuss the case with individuals in other teams.

Note: Teams should make either *transparency* or *Power point* presentations. Please submit an electronic version of PowerPoint slides (or regular transparency slides) a day in advance of your presentation. You are also encouraged to provide key handouts to your audience.

Case Briefs/Memos: Each team is required to turn in 2 brief case write-ups (“*case briefs*”), using the same guidelines for case preparation. These case briefs should not exceed two pages (single-spaced). You may attach relevant exhibits, such as graphs and tables, to the two-page briefs. You should only include exhibits that are referenced in the brief. You need not *rehash* the case situation in your write-up, but use your best judgment as to how much case material to include. You should, however, take a stand on the resolution of the case and provide recommended solutions after you provide a clear diagnosis and analysis of the salient issues in the case. You are expected to choose your own cases for the case briefs, but they should be dispersed *uniformly* through the semester.

Class Participation: While the case preparations and presentations are team effort, all the students are expected to read *all* the cases and be prepared to open *all* case discussions. In addition, you are all expected to engage in active *class participation* so as to maximize your own learning experience and contribute positively to your classmates. It is important that you attend *all* the classes, because an extensive portion of the learning in this course occurs in the classroom. If you miss class, your learning will be impaired. Equally important, you can’t add your unique insights to class discussion. Class participation constitutes a significant component of your grade (see below), and you will be evaluated based both on the *quality* and the *quantity* of your participation.

Assignments: There will be a couple of graded assignments (available through BlackBoard). You should be prepared to hand in these assignments on the due dates.

Term/Winter Project: The term project is intended to provide an opportunity for real world analysis, and it is described *at the end* of the course outline. You should choose

this project with care, as it is expected that you will be spending considerable amount of time working on it. A team of 3-5 students should do the term project.

Current Events: You should keep abreast of current events that are relevant to the topics covered in the course (e.g., executive compensation, board independence, regulatory reforms, etc.). Be an aggressive consumer of such periodicals as the *Wall Street Journal*, *Financial Times*, *The Economist*.

Blackboard/web access: You should be able to access various course materials, announcements, and discussion notes through a blackboard environment via the following website: <http://bb.rhsmith.umd.edu>. To log on, you need your University Directory (LDAP) id and password. To find your login id and password, go to <https://www.ldap.umd.edu/cgi-bin/chpwd>. Your current e-mail address must be maintained in Testudo, since Blackboard uses this to send e-mail relating to the course. For further information about the Blackboard, consult: <http://www.rhsmith.umd.edu/blackboard>.

Text/Cases/Supplementary Readings: *Lectures* and *cases* are the primary source of material for the course. To help you in taking lecture notes, lecture aids will be available in advance of class through BlackBoard access (posted typically as a pdf attachment). There are also *readings* to supplement the required text. You should read the text and reading assignments (see the course outline below) before you come to class.

(a) Text: Monks, Robert A.G. and Nell Minow: *Corporate Governance* Third Edition, New York: Blackwell, 2004, ISBN1405116986 / 1405116994

Supplementary Text/Report: Interim Report of The Committee On Capital Markets Regulation (December 2006): <http://www.capmksreg.org/highlights.html#findings>. Highlights at: http://www.capmksreg.org/pdfs/highlights_final.pdf.

(b) Case packet: Cases are available as a CoursePack through XanEdu service. To access your CoursePack, you are advised by XanEdu to do the following:

1. Open the XanEdu "Login/Register" page at: <http://www.xanedu.com/login.shtml?PackId=274017>
2. If you have previously registered for another CoursePack, log in. If not, click the "Student Registration" button under the "New Users Register Here" banner. Complete the registration page, and click Continue.
3. Confirm your CoursePack Selection, and complete the purchase and shipping forms [Information on your CoursePack format "Digital access plus packaged print copy"]. You will have immediate access to your Digital CoursePack. Your packaged print copy will be shipped to you within five business days from purchase of your CoursePack. Shipping of a print copy is for valid U.S. addresses only. If you are outside the U.S., contact XanEdu Customer Service.
4. After completing the purchase, you will be taken directly to "My XanEdu" where you can access your digital CoursePack. Order ID: 111339
Questions? Please contact XanEdu Customer Service at 1-800-218-5971

© **Supplementary readings:** The additional readings, which are listed in the relevant sections of the course outline (see below), are largely non-technical and provide the essentials of academic research in an accessible way. They are intended to facilitate your understanding of the lectures and help you analyze the cases. The supplementary readings are available through BlackBoard (often as pdf attachments).

Grading: The overall grade will be determined on the basis of:

Case Preparation and Presentation	25%
Class Participation	20%
Case memoranda/briefs	10%
Graded Assignments and Exec Summary	20%
Final Project	25%

Academic Integrity: The University's *Code of Academic Integrity* is designed to ensure that the principles of academic honesty and integrity are upheld. All students are expected to adhere to this Code. The Smith School does not tolerate academic dishonesty. All acts of academic dishonesty will be dealt with in accordance with the provisions of this code. Please visit the following website for more information on the University's Code of Academic Integrity:

http://www.inform.umd.edu/CampusInfo/Departments/JPO/AcInteg/code_acinteg2a.html

On each exam or assignment you will be asked to write out and sign the following pledge. "*I pledge on my honor that I have not given or received any unauthorized assistance on this exam/assignment.*"

Special Needs: Any student with special needs should bring this to the attention of the instructor as soon as possible, but not later than the second week of class.

COURSE OUTLINE

I. INTRODUCTION: Separation of Ownership and Control

Text: Ch. 1; Overview reading: Berk/Demarzo. "Corporate Governance".

[January 7, 2008]

II. AGENCY PARADIGM AND INCENTIVE PROBLEMS: Conceptual Foundation for Corporate Governance*

[January 7-8, 2008]

- A. The public corporation as a network of contracts: Classifying agency/incentive problems
- B. Incentive problems and financial contracting
- C. Rationalizing complex features in corporate securities
 - a. Option characteristics of corporate securities
 - b. Basics of valuation of a convertible/callable bond
 - c. The role of call provisions and conversion features in resolving agency problems

The following readings serve as background readings for Section II:

Barnea, R. Haugen, and L. Senbet, "Market Imperfections, Agency Problems, and Capital Structure." Financial Management, Summer 1981

Ross, et al. "Options and Corporate Finance", Problems #21, 22

** Assignment: Bronson Electronics Case (Valuing a convertible bond)*

III. THE BOARD OF DIRECTORS

[January 9, 12]

Text: Ch. 3

- A. Managerial agency costs: *basic rationale for board monitoring*
 - B. Board duties and functions
 - C. Board structure and size: best practices
 - D. Board effectiveness: the available evidence
- K. John and L. Senbet "Corporate Governance and Board Effectiveness", Journal of Banking and Finance, anniversary issue, 1998

** Cases: The Perfect CEO (CoursePack)
 Delphi Corp (CoursePack)*

IV. EXECUTIVE COMPENSATION AND CONTEMPORARY PRACTICES

[January 12 (Sat), Jan 15]

Text: Ch. 4

- A. Compensation size and structure: *salary, bonus, stocks, options*
- B. Pay for performance: *understanding pay-performance sensitivity*
- C. The perverse incentive of stock option contracts and controversy over compensation practices
- K. John and L. Senbet, “Executive Compensation: Issues and Reform Proposals”, background piece for the Financial Economists Roundtable [FER] (July 2003) [*Sections on issues*]

B. Hall and K. Murphy. “The trouble with stock options”, *Journal of Economic Perspectives*

Harvard case/note: “What You Need to Know About Stock Options” (CoursePack)

Guest Speaker: Industry/Academic Expert on Executive Pay - TBA

- * **Cases:** *Executive Compensation at GE [And B] (CoursePack)*
Al Dunlap at Sunbeam (CoursePack)

V. SHAREHOLDER ACTIVISM AND MARKET DISCIPLINE

[January 16]

Text: Ch. 2

- A. Ownership pattern and shareholder activism
- B. Role of institutions and interface with mutual fund governance
- C. Proxy contests, takeover markets, and antitakeover measures
- D. Measuring quality of corporate governance and performance
 - a. Corporate governance ratings: The G-index, the ISS CG Quotient
 - b. Does quality governance matter?: Evidence from investor protection

Gompers, Paul A., Joy L. Ishii, and Andrew Metrick. “Corporate Governance and Equity Prices”, *Quarterly Journal of Economics* (February 2003).

K.J. Martijn Cremers and Vinay Nair> “Governance Mechanisms and Equity Prices”, *Journal of Finance* (December 2005)

- E. Other stakeholders: debtholders, employees, government, etc

*** Guest Speaker: Sean Quinn, Institutional Shareholder Services (ISS)**

- * **Cases:** **General Motors (Text, p. 344)**
The Hermitage Fund: Media and Corporate Governance in Russia (CoursePack)

VI. GOVERNANCE FAILURES: Cases of Spectacular Corporate Scandals

[January 19 (Sat), Jan 22]

Text: Ch. 6

A. Academic foundation and evidence

B. Holmstrom and S. Kaplan. “The State of US corporate governance: What is right and what’s wrong?” *Journal of Applied Corporate Finance* (Spring 2003).

M. Jensen. “Agency Costs of Overvalued Equity”, *Financial Management* (Spring 2005)

L. Bebchuck and Jesse Fried. “Pay Without Performance”, *Journal of Applied Corporate Finance* (Fall 2005)

E. Lie. “Does Backdating Explain the Stock Price Pattern Around Executive Stock Option Grants?”, *forthcoming*, *Journal of Financial Economics*

***Cases:** *The Enron Collapse (Text: CD-ROM)*
 Accounting Fraud at WorldCom (CoursePack)

B. Regulatory reforms and trends in corporate governance

***Case/Note: The Sarbanes-Oxley Act (CoursePack)**

Guest Speaker: Kathleen Hanley, Securities and Exchange Commission

K. John and L. Senbet, “Executive Compensation: Issues and Reform Proposals”, background piece for the Financial Economists Roundtable [FER] (July 2003) [*Sections on reform proposals*].

Also, see the FER statement: “The Controversy Over Executive Compensation” (December 2003) [global press coverage].

Interim Report of the Committee on Capital Markets Regulation (December 2006):
<http://www.capmksreg.org/highlights.html>; <http://www.capmksreg.org/pdfs/highlights>

VII. GOVERNANCE AROUND THE WORLD

[January 22, 23]

Text: Ch. 5; Appendix

A. Globalization of corporate governance and codes of best practices

B. Governance and US capital market competitiveness

Read pp. 24-58 of the Interim Report of the Committee on Capital Markets Regulation (December 2006).

***Case: PetroChina: International Corporate Governance with Chinese Characteristics (CoursePack)**

Winter Project

Now it is time for a term project. The purpose of this project is to give you an opportunity to conduct a real world analysis on issues pertaining to corporate governance. This project will determine 30% of your grade. The report can vary in length, but it should not exceed 30 pages, including exhibits. It should be double spaced with normal margins.

I suggest the following topics for the project, but you are not limited to them. In the event that you choose another topic, you would need to get my permission by providing me a project proposal in advance (not exceeding 2 pages).

- A. **Critical Review of the Interim Report of the Committee on Capital Markets Regulation:** The review should reflect the insights that you have obtained from the course, and it should be done in a systematic fashion: <http://www.capmksreq.org/research.html>
- B. **Case Analysis of General Motors (Text, p. 343):** There are guideline questions on p. 379, but you are not limited to them and you can bring your own unique perspectives to the case analysis.
- C. **A Study of the Governance System of a Particular Company:** This project is based on a company of your choice. In fact, you may find it convenient to choose one of the Washington area companies; eg., *Marriott International*, *Lockheed-Martin*, *US-AIR*, etc. This will afford you an opportunity to consult executives or directors in person to improve your analysis and gain additional insights.

Cases and Basic Guidelines

The CoursePack includes the following HBS cases and notes. Five of the cases require team preparation and presentation. The two notes facilitate your understanding of the issues discussed in the course, namely executive stock option contracts and the regulatory reforms. There will be a couple of assignments that require individual effort, and they are available via BlackBoard. One of them is the Bronson Electronics case on valuation of a convertible bond.

Cases:

The Perfect CEO
Delphi Corp
Executive Compensation at GE [And B]
Al Dunlap at Sunbeam

The Hermitage Fund: Media and Corporate Governance in Russia
The Enron Collapse (Text: CD-ROM)
Accounting Fraud at WorldCom
PetroChina: International Corporate Governance with Chinese Characteristics

Notes:

“*What You Need to Know About Stock Options*”

“*The Sarbanes-Oxley Act*”

“*The Sarbanes-Oxley Act: Details and Evaluation*”

Guideline questions for the cases will be posted on BlackBoard before the cases are due. While analyzing the cases, you should be aware that there are no absolute right answers to the issues raised. However, there are good and bad arguments, and the case preparation and class discussion, as well as the case briefs (write-ups), should help distinguish between sensible and senseless arguments. Generally your presentations should include: (a) clear statement of the problem and the salient issues raised in the case, (b) clear analysis, and (c) recommended solutions or actions. You should consider yourself as a *consulting group*, and your audience (the class) is the *management team* or *the board of directors* of the company. Your continued employment as consultants will be critically dependent on your ability to *communicate* clearly, the rigor in your *analysis*, and clear and forceful *justification* for the recommended actions.