Optimal Balance of Financial Instruments: Long-Term Management, Market Volatility & Proposed Changes in Rights and Liabilities of Affected Parties

Nishant Choudhary, *The George Washington University*
Optimal Balance of Financial Instruments: Long-Term Management, Market Volatility & Proposed Changes in Rights and Liabilities of Affected Parties

An optimal mix of financial instrument can be structured to incentivize the management to focus on the long-term management. However there is not a single unique optimal mix available for all firms. It will vary on basis of firm, industrial characteristics and market. The choice of securities issued depends on few broad factors: (1) Existing mix of securities outstanding or prevalent and division of return amongst financial instrument, (2) Valuation by market of expected return and securities, (3) Distribution of return to the instrument holders, (4) Size of the firm and the amount to be raised, and (5) Cost associated with different source of funds.\(^i\)

The key question is whether firms can design an optimal capital structure that encourages efficient decision-making and restricts managerial myopia vis-à-vis upholding legal requirement and security holder’s interest. Managers typically do not have a stake in the firm; there is priori no reason to believe that they will act in best interest of shareholders.\(^ii\) Therefore managers may engage in value destroying mergers, indulge in perquisites (private jets, luxurious holidays etc.)\(^iii\), consequently managers should issue a “hard claim” like debt as a pre-commitment device to constrain themselves. The benefit attached with debt is tax deductibility, though too much debt results in bankruptcy, but accrued benefits can be used to trade-off bankruptcy costs.\(^iv\) Nolan (2002) develops a model to show how long-term debt negates myopic behavior by serving as an incentive to have high future earnings in order to avoid the costs of bankruptcy.\(^v\) In such a scenario, firms can issue long-term debt to ensure managerial commitment towards generating long-term earnings. This will also result in a lower volatility of firm’s cash flow. While debt
ought to be long-term, it should not be very high, i.e. debt-equity ratio should be as low as possible.

On the other hand, Bond-holders only have contractual rights, and are left at the mercy of interpretations of different boilerplates by the courts. Further despite being negotiable, most terms of the indenture are incorporated unanimously by the corporation and underwriters and bondholder are merely passive. Indenture covenant giving right of monitoring performance and representation in the management would be praise-worthy change. Incorporation of fiduciary rights and duties in the debt-indentures (prior to bankruptcy) will provide better safeguards and create investment incentives.

Debt cannot be used as an incentive mechanism across all industries; it also restricts managerial ability to make risky investments. Further stronger creditor rights inhibit corporate risk taking, thus it entails, that a different mix of financial instruments should be used to restrict managerial myopia. A simple solution is to structure their compensation contracts and to align their incentives with the long-term prospect of the firm. For instance, a portion of their compensation should include common stock with contractual binding to hold the stock for say 5 years. This encourage managers to undertake only those risky investments that maximize firm value and creates incentive for management to ensure long run performance of the firm. This goal can also be achieved by providing independent compensation/recompense upon performance of the corporation over a period of time and not temporary fluctuation. Further there should be provisions of claw-back (to pull back the benefit given to the managers) in the instruments and compensation agreement, contingent upon bad performance of management and/or corporation as a whole.
At the same time, long-term management can be achieved by providing *stock options* (having long expiration date) as managerial incentive, alongside the market. It aligns management’s interest with the performance of the corporation, for them to redeem the value at better performing market price. Though generally, in prevalent corporate practice, there is no corresponding pay reduction if the company did poorly. It may also lead to conflict of interest between management and investors, and may result in decisions driven by short-term benefits by temporary manipulation in movement of stock price. Nevertheless by designing stock options with a *lock-in period*, manipulation in movement of stock price can be avoided. This would also affect the speculation positively and reduce market volatility. Tying management with the equity performance will develop market confidence and security performance less volatile. Options have another downside especially for a firm in distress. Since, the value of the option is increasing in volatility; it might cause the management to take more risk. This is particularly important when the stock value of the firm dips below the stock *strike price* on the option. If the management is *given rights to lower the strike price* when stock price falls substantially, it may prevent the management from risk taking. Further the proportionate change in the strike price of option would stabilize its market.

Managerial short-termism is often driven by short-term investors who are in the game of ‘burn and run’ and force managers to make policy decisions based on shorter period of earnings statements. One potential solution is to encourage long-term equity ownership by giving loyalty dividends. The firm should hold on to excess cash and disburse it as dividends over longer time periods. Excess cash can further be invested as safer debt, and interest generated can be paid to shareholders as opportunity cost, over and above dividends. Moreover, given the positive stock price reaction to dividends, this also restrains managerial incentives to issue dividends to boost
short-term stock price even when the cash may be better used to invest in positive Net Present Value projects.\textsuperscript{vi}

There may also be established an independent ‘executive compensation committee’ approved by share holders vote.\textsuperscript{vii} Shareholders may also be given rights to vote, approving executive compensations on a yearly basis. In case of a merger or acquisition, shareholders may have right to vote and approve any underlying agreement regarding, executive compensation in relation to that transaction (golden parachute).\textsuperscript{viii} This will tie the managerial action, avoid waste and make managers more accountable to the Shareholders; will entail long-term management. This would bring about shareholders’ and market confidence in the management, thus effects will follow.

Though how close the board of directors come to meeting this optimum will depend on how educated their investment strategy is, as well as a number of other variables, some of which are beyond the control of the collective human element, making the decision.

Nishant Choudhary

LL.M., Business & Finance (The George Washington University)

\textsuperscript{iii} Id., at page 12.
\textsuperscript{iv} Id. note i, at page 226.
\textsuperscript{vii} Dodd–Frank Wall Street Reform and Consumer Protection Act, Section 952.
\textsuperscript{viii} Id., at Section 951.