The Business School for the World®

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INSEAD

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Ethics and Finance : a contractual approach

What is new at Insead ?

My new elective :

"Ethical Decision Making in Business"

Should finance profs teach ethics ?

No because they teach that firms should maximize shareholder value

Shareholder value maximization encourages **unethical behaviour** (*Smith and Ronnegard*, Journal of Business Ethics 2016)

Why not give the job to moral philosophers ?

Not obvious philosophers are more ethical

- Eric Schwitzgebel (2009) obtained the missing-book lists from university libraries. What did he find?

- Academic books on ethics, which are presumably borrowed mostly by ethicists, are more likely to be stolen or just never returned than books in any other area of philosophy.

An ethical dilemma in business

- You are investment banker advising acquirer A to make a bid for B
- Only if the deal goes through the bank will get a 1 % success fee and you will get 10% of this fee.
- B will only sell to A if you pay a 30 % takeover premium
- In order to justify such a bid price **you have to make an assumption in your DCF spreadsheet that free cash flows five years from now will grow at 10 % forever. You believe this very unlikely.**
- If the deal goes through 10% of the combined work force will be fired and will stay unemployed for at least a year.
- The management of the acquiring firm will get an acquisition bonus
- Bondholders of both companies will see their credit rating increase
- Shareholders of B will pay capital gains taxes

Remember the spreadsheet

Forecast - Income Statement/Balance Sheet/Cash Flows								
		Explicit Forecast Period						CV Period ->
		2008	2009	2010	2011	2012	2013	2014
Revenues		1,000	1,050	1,103	1,158	1,216	1,276	1,340
Cost of Goods Sold		(500)	(525)	(551)	(579)	(608)	(638)	(670)
Selling, General & Admin		(150)	(158)	(165)	(174)	(182)	(191)	(201)
Depreciation		(165)	(173)	(182)	(191)	(201)	(211)	(221)
EBIT		185	194	204	214	225	236	248
Taxes on EBIT		(65)	(68)	(71)	(75)	(79)	(83)	(87)
NOPAT		120	126	133	139	146	153	161
Depreciation		165	173	182	191	201	211	221
Increase in working capital		(9.5)	(10.0)	(10.5)	(11.0)	(11.5)	(12.1)	(12.7)
Capital Expenditures		(205)	(215)	(226)	(237)	(249)	(262)	(276)
Free Cash Flow		$\frac{71}{1.1}$ +	$\frac{74}{(1.1)^2}$ +	$\frac{78}{(1.1)^3}$ +	$\frac{82}{(1.1)^4}$ +	$\frac{86}{(1.1)^5}$ +	$\frac{90}{(1.1)^6}$	94
Discount Rate	10%							
PV(explicit forecast period)	345							
PV(CV)	966							
Present Value as of beginning 2008	**1,311**							

$$\frac{161(1 - .05/.12)}{(.1 - .05)/1.1^6}$$

Should you make the 10% growth rate assumption in your spreadsheet?

Traditional Ethics Courses

- Focus on “values”
- Values are highly subjective
- Driven by religion, politics

Religion : Leonardo Lessius (1554 - 1623)

"high interest rates are unethical"

Politics : Algirdas Semeta (1972 -) :
“aggressive tax avoidance is immoral”

Religion/politics: Socially Responsible funds

Exclude investing in “unethical activities”

- Gambling
- Alcohol
- Tobacco
- Defence
- Pornography
- …..

Democrat fund managers invest more in SRI than Republicans (Hong, Harrison and Kostovetsky (2012)

Redefining Business Ethics

Respecting implicit contracts to improve corporate governance

Corporate governance is value free

- Every transaction has two types of contracts: Explicit and implicit
- Explicit contracts are enforceable in a court of law
- Implicit are not.
- Corporate governance deals with the designing explicit and implicit contracts to reduce conflicts of interest between various stakeholders in the firm.
- Assumption : while people may have different values they should agree that respecting implicit contracts is the right thing to do

Why not make all contracts explicit ?

- Writing explicit contracts is costly
- They may creates unintended consequences
- They imply a **lack of trust**

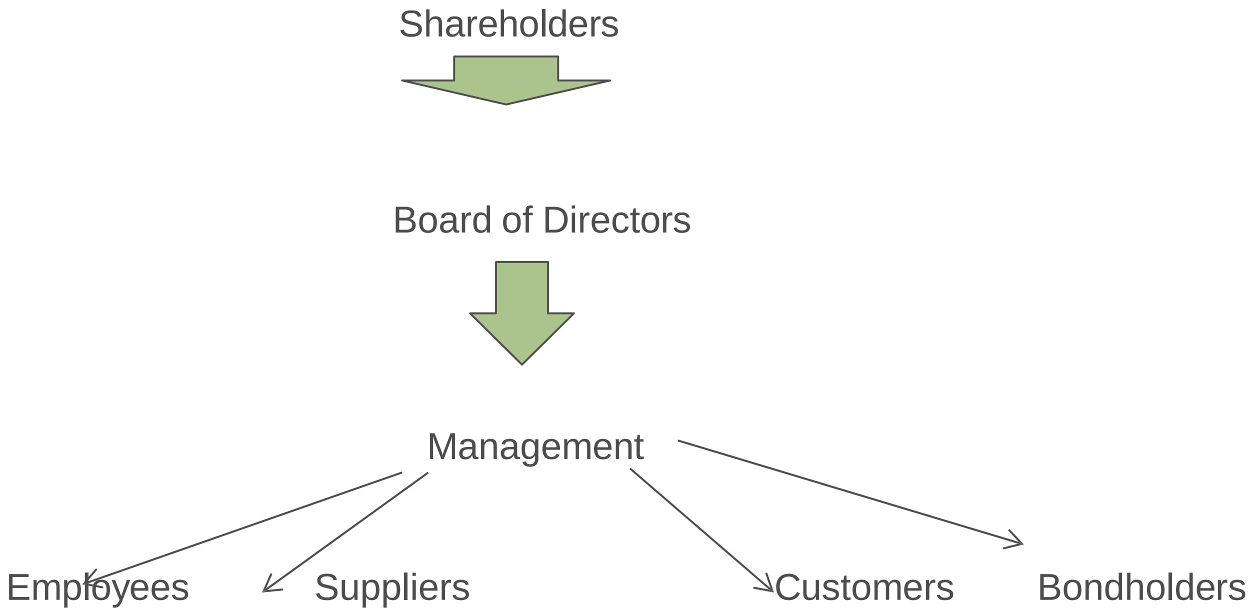
Explicit contracts can be unromantic

- “Love Contracts that make requirements on sex, weight, cheating are increasingly common, experts say. One agreement specified that the future mother-in-law won’t be joining them on long trips, the groom will not watch more than a specific time in front of TV and the bride agreed not to replace her pet when it passes on”

New York Daily News, June 2013

Corporate governance and contracts

- Corporate governance deals with design and management of the **explicit** and **implicit** contracts between various stakeholders in the firm so that firm value is maximized



Explicit features of business contracts

Board	CEO	CEO	CEO	CEO
CEO	**Employees**	**Customers**	**Bondholders**	**Suppliers**
Compensation	Compensation	Warranties	Interest rate	Payment
Severance payment	Severance payment		Principal	Interest rate
Performance targets	Performance targets		Seniority	
			Covenants	

Contracts of shareholders:largely implicit

- Shareholders have no legal right to dividends or repayment of investment
- Shareholders have voting rights and in theory can appoint the board
- However, Board members are at an informational/ skill disadvantage to judge whether a decision creates “firm value”
- Moreover, private benefits from control means that minority (small) shareholders and controlling shareholders objectives may diverge
- Minority shareholders have basically pure implicit contracts

Examples of implicit contracts

- Maximize shareholder value

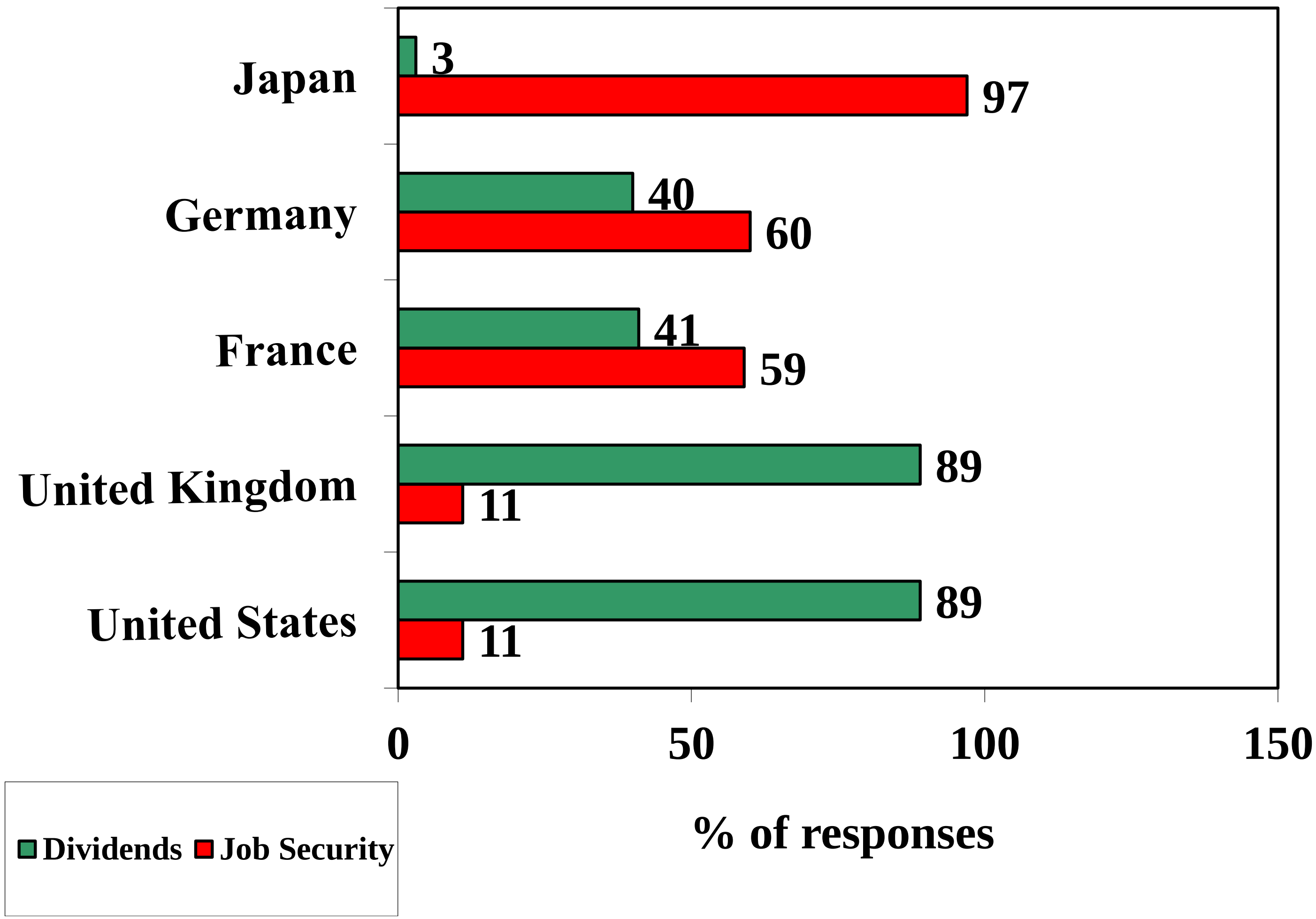
- Maximize shareholder value subject to constraints

- Non Profit : minimize shareholder value

- Maximize stakeholder value

What is more important? Jobs or paying dividends?

The same question put to professional managers in 5 countries



** Survey of 399 managers from 5 countries. Which is more important...jobs or paying dividends?

Are Japanese, German, French managers behaving unethically?

Should you make the 10% growth rate assumption in your spreadsheet?

- If the implicit contract is to maximize stakeholder value??

Impact of a successful acquisition

- The shareholders of the acquiring firm (-)
- The shareholders of the target firm (+)
- The workers of both companies (-)
- The CEO of the buyer (+)
- The bondholders of acquiring firm (+)
- The investment bank's shareholders ?
- The investment banker (+)
- The government (+)

Should you make the 10% growth rate assumption in your spreadsheet?

- If the implicit contract is to maximize shareholder value?

What is shareholder value ?

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Impact on bank shareholder value ?

- Negative : short term success fees will come at the consequence of long term reputation

- Positive :

    -Investment banks are hired to complete deals.

    -Managers (clients) are held responsible for the decision to merge.

What is the empirical evidence ?

- Raghu Rau :"Investment bank market share , contingent fee payments and the performance of acquiring firms", JFE 2002
- Completion hypothesis : bank's market share is driven by ability to complete deals
- Client performance hypothesis: bank's market share is driven by performance of acquirer : reputation risk !

What determines Investment Banks market share ?

- Percentage of deals completed in the past (+)
- Market share and tier in previous year (+)
- Long-term abnormal returns of clients in past acquisitions (0)

Consistent with the completion hypothesis

Other applications

- Ethics in IPOs
- Ethics in share buybacks
- Ethics in dividend policy
- Ethics lending (The Big Short)
- Ethics in asset management
- ………….


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TEMPTATIONS
VIVID CABARET
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HOOPS CABARET
KAPPA MEN'S CLUB
Scarlett's MIAMI
Scarlett's ST. LOUIS
THE SEVILLE
SILVER CITY CABARET
Tootsie's Cabaret

Takeaways

- Business ethics should be about respecting implicit contracts in the organisation
- *To the extent that investors who buy shares are led to believe that the implicit contract is to maximize shareholder value,* doing otherwise is unethical
- Important is to specify and communicate what these implicit contracts are in advance
- Avoid conflicts between explicit contracts (bonus based on profits) and implicit contracts (maximize shareholder value)