

UNIVERSITY OF SOUTHERN CALIFORNIA
MARSHALL SCHOOL OF BUSINESS

FBE 533
Spring 2015

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CEO PAY, CORPORATE GOVERNANCE, AND THE POLITICS OF FINANCE

COURSE DESCRIPTION

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The ongoing attack on wealth and income inequality have left many to question the legitimacy of profits made by both large corporations and the executives who run them. FBE 533 analyzes the objectives of corporations, and the role of corporate governance and incentive arrangements that help or hinder achievement of these objectives. The key players in the emerging drama include: (1) shareholders, primarily interested in increasing shareholder value (sometimes at the expense of other stakeholders); (2) executives, primarily interested in increasing their own utility; (3) directors, elected by but not perfect agents for shareholders; and (4) influential outside parties such as the government, labor unions, and the media with agendas far removed from shareholder-wealth maximization. The course traces how pay practices have evolved in response to economic, institutional, and political factors, and examines how the evolution has served to either increase or decrease the inherent conflicts of interest among the various players.

Particular attention is paid to analyzing problems with (and developing solutions for) top-executive compensation, including defective bonus plans and equity plans, the complacency of the board and compensation committee, misguided government policies (and the political process leading to them), and a general ignorance, confusion or indifference about how value is created and destroyed. Topics covered throughout the course include conglomerations and diversification, leveraged buyouts, downsizing, private equity, valuation, earnings management, tax rules, and accounting policies. In addition, we consider whether Wall Street pay practices led to excessive risk taking that triggered the recent financial crisis, and also focus on the cost, value and incentives from executive and employee stock options.

PREREQUISITES

This course requires only introductory finance and is open (and accessible) to both finance and non-finance majors.

EDUCATIONAL OBJECTIVE

Narrowly, the objective of this course is to provide a general framework for analyzing compensation, incentives, and governance in organizations. All organizations have explicit

or implicit incentive systems. My objective is to stress the importance of these systems in predicting organizational behavior, with particular focus on understanding (and correcting) systems that generate dysfunctional or unintended incentives or results.

More broadly, I use “compensation and incentives” as a platform to talk about a wide variety of topics and to develop and test your economic intuition. You should not expect to leave the course with a “cookbook” set of solutions or with an encyclopedia of institutional facts (though there will be plenty of these), but rather with a general way of thinking about organizational incentive problems and their solutions.

CAREER FOCUS

FBE 533 is particularly relevant for students pursuing careers in accounting, consulting, corporate finance, and general management, as well as for prospective owners and entrepreneurs.

REQUIRED AND RECOMMENDED READINGS

Copyrighted required readings and cases for the course are available in either “Reading Packet” from the USC Bookstore. Non-copyrighted or publicly available required readings – as well as supplemental “recommended readings” – are available for you to download from the class “Blackboard” website.

TEACHING PHILOSOPHY

My approach to teaching is to emphasize open classroom discussion and de-emphasize lectures. Cases and shorter “caselettes” will comprise about one fourth of the required readings. Additional assignments include notes, articles from the academic and business press, and computer exercises. Also, I will be distributing additional material such as problems, notes, relevant articles and examples when appropriate.

Because the course is discussion-oriented, it is critical for you to keep up with the readings, and to come prepared to each class. To assist in your preparation, discussion questions for each class session will be distributed weekly and posted on the class website. In the event that preparation levels sag, I reserve the right to resort to other “preparation facilitators” such as cold-calling. The first several sessions develop the basic theoretical “building blocks” used throughout the course. The material in the course is cumulative, so it is important to attend class, keep up with the readings, and take careful notes.

After the first few class sessions I would like you to sit in approximately the same seat each day. This helps me keep track of participation, and makes it easier for you to interact with each other during class discussions. I will create a seating chart after the class roster is fixed.

An environment for effective learning is one in which people are free to discuss energetically all relevant issues and ideas. As the instructor, I take responsibility for helping guide the discussion and, in particular, for limiting discussion of topics that will take us too far off

track. Productive discussions often involve emotional commitment, energy, and disagreements with the ideas of others (including the instructor's). There is a clear distinction between disagreeing with another person's ideas and criticizing him or her as a person. We all have responsibility for preventing the latter; it blocks learning and is therefore inappropriate for the classroom.

GRADING

The course grade will be based on homework assignments, class participation, a midterm examination, and a final examination. The weights for the final grade are:

Problem Sets	25%
Class Participation	10%
Midterm Exam (March 9)	25%
Final Exam (May 6)	40%

Daily Assignments (ungraded). Before each class, I will distribute (via Blackboard) required and recommended readings for the class, along with daily discussion questions. These assignments will not be submitted and will not be graded, but are designed to facilitate your preparation for the day's class.

Problem Sets. There will be approximately eight graded problem sets due during the quarter, focusing on the types of questions that will predictably appear on the midterm and final. While you are welcome to compare ideas and results with classmates, I expect students to hand in their own assignments at the beginning of class (on due dates).

Class participation. Because this is a discussion-oriented class, I expect all students to prepare and actively participate in classroom discussions. Participation scores will be based on both the quantity and quality of your classroom contributions. The "quantity" of participation will be determined objectively based on my (imperfect) recollection following each class. The "quality" dimension is based on both my subjective assessment and peer assessments of how your participation contributed to classroom learning. High quality participation does not necessary mean providing the right answer or "cracking" the case, but rather presenting views or analyses that provoke debate and stimulate additional discussion.

Examinations. The midterm and final examination will consist of short essay questions. Sample "practice questions" (in addition to those on the homework assignments) will be available on the course website.

OFFICE HOURS

I will generally be available on Wednesdays between 12:30pm and 1:45pm; additional office hours will be announced preceding exams. I will also attempt to answer questions via e-mail (kjmurphy@usc.edu) on a timely basis; this is often the best way to get in touch with me.

ACADEMIC CONDUCT

Plagiarism – presenting someone else’s ideas as your own, either verbatim or recast in your own words – is a serious academic offense with serious consequences. Please familiarize yourself with the discussion of plagiarism in *SCampus* in Section 11, *Behavior Violating University Standards* <https://scampus.usc.edu/1100-behavior-violating-university-standards-and-appropriate-sanctions/>. Other forms of academic dishonesty are equally unacceptable. See additional information in *SCampus* and university policies on scientific misconduct, <http://policy.usc.edu/scientific-misconduct/>.

Discrimination, sexual assault, and harassment are not tolerated by the university. You are encouraged to report any incidents to the *Office of Equity and Diversity* <http://equity.usc.edu/> or to the *Department of Public Safety* <http://capsnet.usc.edu/department/department-public-safety/online-forms/contact-us>. This is important for the safety of the whole USC community. Another member of the university community – such as a friend, classmate, advisor, or faculty member – can help initiate the report or can initiate the report on behalf of another person. *The Center for Women and Men* <http://www.usc.edu/student-affairs/cwm/> provides 24/7 confidential support, and the sexual assault resource center webpage <https://sarc.usc.edu/reporting-options/> describes reporting options and other resources.

SUPPORT SYSTEMS

A number of USC’s schools provide support for students who need help with scholarly writing. Check with your advisor or program staff to find out more. Students whose primary language is not English should check with the *American Language Institute* <http://dornsife.usc.edu/ali>, which sponsors courses and workshops specifically for international graduate students. *The Office of Disability Services and Programs* http://sait.usc.edu/academicssupport/centerprograms/dsp/home_index.html provides certification for students with disabilities and helps arrange the relevant accommodations. If an officially declared emergency makes travel to campus infeasible, *USC Emergency Information* <http://emergency.usc.edu/> will provide safety and other updates, including ways in which instruction will be continued by means of blackboard, teleconferencing, and other technology.

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SYLLABUS

Session 1
January 12

THE POLITICS OF PAY

Joann S. Lublin, “The Boss Makes How Much More Than You? Controversial New Rule Would Make Companies Disclose Data,” *Wall Street Journal* (November 25, 2014)

Kevin J. Murphy, “The Politics of Pay: A Legislative History of Executive Compensation,” Chapter 1 in Randall S. Thomas and Jennifer G. Hill, editors, *The Research Handbook on Executive Pay*, Edward Elgar Publishers, 2012.

Session 2
January 14

THE GOVERNING OBJECTIVE

Steve Denning, “The Dumbest Idea in the World: Maximizing Shareholder Value,” *Forbes* (November 28, 2011).

Milton Friedman, “The Social Responsibility of Business is to Increase its Profits,” *New York Times Magazine* (September 13, 1970).

James M. McTaggart, Peter W. Kontes, and Michael C. Mankins, “The Governing Objective,” Chapter 1 from *The Value Imperative: Managing for Superior Shareholder Returns*, The Free Press, New York, 1994. **(RP)**

*James Montier, “The World’s Dumbest Idea” GMO White Paper (December 2014).

*Michael C. Jensen, “Value Maximization, Stakeholder Theory, and the Corporate Objective Function” (October 2001).

*Michael C. Jensen and William H. Meckling. 1976. “Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure.” *Journal of Financial Economics*, Vol. 3, No. 4: October, pp. 305-360

*-denotes “recommended” (rather than required) readings. Readings designated **(RP)** are available in the course reading packet; all other readings are available on Blackboard.

Session 3 **AGENCY COSTS OF EQUITY AND DEBT**

January 21

Michael C. Jensen and Kevin J. Murphy, "CEO Incentives: It's Not How Much You Pay Them, But How" *Harvard Business Review*, May/June 1990, reprint #90308.

Session 4 **TAXES AND THE (FIRST) RISE AND FALL OF STOCK OPTIONS**

January 26

Kevin J. Murphy, "Executive Compensation: Where we are, and how we got there," Chapter 3 in George Constantinides, Milton Harris, and René Stulz (eds.), *Handbook of the Economics of Finance*. Elsevier Science North Holland (2013), Sections 3.1 – 3.5.

Harwell Wells, "U.S. Executive Compensation in Historical Perspective," Chapter 2 in Randall S. Thomas and Jennifer G. Hill, editors, *The Research Handbook on Executive Pay*, Edward Elgar Publishers, 2012.

Session 5 **PAYING FOR PERFORMANCE**

January 28

Carlton, Jim, "Commission Clash: A Real-Estate Chain Riles Competitors By Breaking the Rules," *Wall Street Journal* September 10, 1991.

Kevin J. Murphy, "H.J. Foods Management Incentive Plan," Marshall School Case Study.

Kevin J. Murphy and Michael C. Jensen, "CEO Bonus Plans and How to Fix Them," Section 2, Working Paper (November 2011)

Session 6 **BUDGETS AND BONUSES**

February 2

"The Case For and Against 'Managing by the Numbers'" s

Kevin J. Murphy and Michael C. Jensen, "CEO Bonus Plans and How to Fix Them," Sections 3-4, Working Paper (November 2011)

*Michael C. Jensen, "Paying People to Lie: the Truth about the Budgeting Process," *European Financial Management*, Vol. 9(3), 2003.

*Kevin J. Murphy, "Performance Standards in Incentive Contracts" *Journal of Accounting and Economics* (2000)

*Robert Gibbons and Kevin J. Murphy, "Relative Performance for Chief Executive Officers," *Industrial and Labor Relations Review*, Vol. 43 No. 3 (February, 1990), pp. 30-51.

Session 7
February 4

HOW MUCH IS TOO MUCH?

Michael C. Jensen and Kevin J. Murphy, "Compensation at Lexerd Systems." HBS Case N2-494-066. **(RP)**

Steve Swartz, "Why Gary Gilligan Stands to Qualify for Guinness Book," *Wall Street Journal*, March 31, 1989.

Session 8
February 9

THE RESTRUCTURING OF CORPORATE AMERICA

Daniel Fischel, "The Restructuring of Corporate America" Chapter 1 from *Payback: The Conspiracy to Destroy Michael Milken and his Financial Revolution*, Harper Business, 1995. **(RP)**

"The Rise of Drexel and Michael Milken," excerpted from James B. Stewart, *Den of Thieves*, Simon & Schuster, 1992, pp. 48-67, 527-529. **(RP)**

Kevin J. Murphy, "Executive Compensation: Where we are, and how we got there," Sections 3.5–3.6.

*Michael C. Jensen, "The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems," *Journal of Finance*, July 1993, pp. 831-847.

Session 9
February 11

TAKEOVERS AND THE MARKET FOR CORPORATE CONTROL

"Dividend News: Sealed Air Plans Special Cash Dividend Totaling \$40 a Share," *Wall Street Journal*, April 28, 1989.

Michael C. Jensen, "The Takeover Controversy: Analysis and Evidence," *Midland Corporate Finance Journal*, 4(2) (Summer 1986).

Session 10
February 18

LEVERAGED RECAPITALIZATION AND BUYOUTS

Michael C. Jensen and Brian K. Barry, "Gordon Cain and the Sterling Group (A)." HBS Case 9-492-021. **(RP)**

Session 11
February 23

THE ECLIPSE OF THE PUBLIC CORPORATION?

Prologue from Bryan Burrough and John Helyar, *Barbarians at the Gate: The Fall of RJR Nabisco*. Harper & Row, New York (1990) **(RP)**

Michael C. Jensen, "Eclipse of the Public Corporation," *Harvard Business Review*, September/October, 1989. HBR Reprint #89504. **(RP)**

Session 12 **VALUE-BASED COMPENSATION***February 25*

Chasan, Emily. "Stock Loses Some Sway on Pay," *Wall Street Journal* (October 30, 2012), B4.

Shawn Tully, "The Real Key to Creating Wealth," *Fortune*, September 20, 1993. **(RP)**

Kevin J. Murphy and Michael C. Jensen, "CEO Bonus Plans and How to Fix Them," Section 5, Working Paper (November 2011)

Session 13 **PERFORMANCE MEASUREMENT***March 2*

Peter S. Goodman and Gretchen Morgenson, "By Saying Yes, WaMu Built Empire on Shaky Loans," *New York Times* (December 27, 2008).

Kevin J. Murphy and Michael C. Jensen, "CEO Bonus Plans and How to Fix Them," Section 6, Working Paper (November 2011)

*Kerr, Steven, 1975, On the Folly of Rewarding A, While Hoping for B, *Academy of Management Journal* 18, 769-783.

Session 14 **ACCOUNTING VS. STOCK-BASED PERFORMANCE MEASURES***March 4*

Kevin J. Murphy and Michael C. Jensen, "CEO Equity Plans and How to Fix Them," (sadly, not yet written)

Session 15 **MIDTERM***March 9***Session 16** **MIDTERM DEBRIEFING***March 11***Session 17** **GENEROUS DYNAMICS***March 23*

Kevin J. Murphy and Jay Dial, "Compensation and Strategy at General Dynamics (A)." HBS 9-494-048. **(RP)**

Session 18

March 25

INCENTIVES TO DOWNSIZE

Kevin J. Murphy, "The Executive Compensation Controversy and the Modern Industrial Revolution," *International Journal of Industrial Organization* (1997).

Kevin J. Murphy, "CEO Pay and Downsizing: The Social Consequences," in *CEO Pay: A Comprehensive Look*, American Compensation Association, 1997.

Session 19

March 30

INTRODUCTION TO STOCK OPTIONS

Kevin J. Murphy, "Primer on Stock Options and the Black-Scholes Formula"

Session 20

April 1

STOCK OPTIONS AND THE BLACK-SCHOLES FORMULA

Stock Option Valuation Exercise (*Excel spreadsheet downloadable from class website*).

Session 21

April 6

STOCK OPTIONS AND THE BLACK-SCHOLES FORMULA, PART II

Binomial Option Formula

Session 22

April 8

STOCK OPTIONS FOR UNDIVERSIFIED EMPLOYEES

Stock Option Valuation Exercise, Part II. (*Excel spreadsheet downloadable from class website*).

Peter Coy, "Funny Money, or Real Incentive?" *Business Week* (January 15, 2001), p. 71-72.

Brian J. Hall and Kevin J. Murphy, "Option Value Does Not Equal Option Cost," *WorldatWork Journal*, Second Quarter 2001.

Flanigan, James, "It's Time for All Employees to Get Stock Options," *Los Angeles Times* (April 21, 1996).

Brian J. Hall and Kevin J. Murphy, "The Trouble with Stock Options," *Journal of Economic Perspectives*, Vol. 17(3) (Summer 2003), 49-70.

*Hall, Brian J. and Kevin J. Murphy. 2002. Stock Options for Undiversified Executives, *Journal of Accounting and Economics*, 33(1), 3-42.

Session 23 **ACCOUNTING FOR THE OPTION EXPLOSION (AND IMPLOSION)***April 13*

Kevin J. Murphy, "Executive Compensation: Where we are, and how we got there," Section 3.7.

Session 24 **EXPLAINING (AND ASSESSING) CEO PAY***April 15*

Lucian Arye Bebchuk and Jesse M. Fried, "Executive Compensation as an Agency Problem," *Journal of Economic Perspectives*, 17(3) (Summer 2003): 71-92.

Frydman, Carola, and Dirk Jenter, "CEO Compensation," (MIT Working Paper, November 2010).

Kevin J. Murphy, "Executive Compensation: Where we are, and how we got there," Section 5.

Session 25 **THE EARNINGS MANAGEMENT GAME: ARE OPTIONS TO BLAME?***April 20*

Michael C. Jensen and Kevin J. Murphy, "The Earnings Management Game." Working Paper, December 2011

Session 26 **OPTION OPPORTUNISM***April 22*

Kevin J. Murphy, "Executive Compensation: Where we are, and how we got there," Sections 2.4 and 3.8.

Fried, Jesse M., 2008. Option Backdating and Its Implications. *Washington and Lee Law Review*, 853-886.

*Yermack, David, 1997. Good timing: CEO Stock Option Awards and Company News Announcements, *Journal of Finance*, 52(2), 449-476.

*Aboody, David and Ron Kasznik, 2000. CEO Stock Option Awards and the Timing of Corporate Voluntary Disclosures, *Journal of Accounting and Economics*, 29(1), 73-89.

*Lie, Erik, 2005. On the Timing of CEO Stock Options Awards, *Management Science*, 51(5), 802-812.

Session 27*April 27***BANKING BONUSES AND THE FINANCIAL CRISIS**

Kevin J. Murphy, "Pay, Politics, and the Financial Crisis," in *Economic Lessons from the Financial Crisis*, Russell Sage Foundation (2012).

Kevin J. Murphy and Michael C. Jensen, "CEO Bonus Plans and How to Fix Them," Section 7, Working Paper (November 2011)

*Kevin J. Murphy, "Compensation Structure and Systematic Risk," Testimony to the U.S. House of Representatives (June 11, 2009).

*Fahlenbrach, Rudiger and Rene M. Stulz, "Bank CEO Incentives and the Credit Crisis," Ohio State University working paper (January 13, 2010).

Session 28*April 29***THE DODD-FRANK CEO PAY REFORM ACT**

The Dodd-Frank Wall Street Reform and Consumer Protection Act

Kevin J. Murphy, "The Politics of Pay: A Legislative History of Executive Compensation," in *The Research Handbook on Executive Pay*, Edward Elgar Publishers (2012).

May 6**FINAL EXAMINATION (11:00AM – 1:00PM)**