

Equity Proportionality in Corporate Voting: Linking Problems and Responses

Ronald J. Gilson
Columbia and Stanford Law School, ECGI

Better Regulation in EU Company Law, Helsinki,
Oct. 5, 2006

1

Voting Rights Disproportionate to Equity Holdings are Controversial

- Starting point: Disproportionate voting rights (“DVR”), whether due to formal structure (dual class common stock) or functional result (pyramiding), are controversial
 - Conflict between jurisdictions
 - Some jurisdictions constrain divergence between voting and equity
 - Some jurisdictions are characterized by divergence
 - No necessary parallel between constraint and frequency of use
 - U.S. has no limits but divergence remains unusual
 - Sweden has few limits but divergence is commonplace
 - Nations believe their own systems work – otherwise they would change (conditional on political frictions)

Better Regulation in EU Company Law, Helsinki,
Oct. 5, 2006

2

The Economics of DVR are Complicated

- Familiar economic principles conflict when applied to DVR
 - Freedom of contract favors diversity
 - Sophisticated entities and investors know what's good for them
 - Different kinds of corporations – e.g., human capital based versus industrial capital based – have different governance needs
 - *Policy implication:* allow DVR absent externalities

Better Regulation in EU Company Law, Helsinki,
Oct. 5, 2006

3

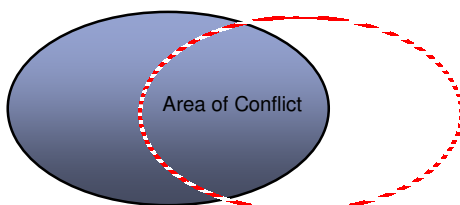
The Economics of DVR are Complicated

- DVR lower the control cost for concentrated monitoring
 - A controlling shareholders may be a better monitor than market mechanisms like takeovers and proxy fights
 - *Policy implication:* Allow DVR absent externalities
- DVR lower the cost of extracting private benefits of control
 - The smaller a controlling stockholder's equity share, the lower the cost to it of private benefits
 - *Policy implication:* prohibit DVR
- DVR shield the controlling shareholder from capital market discipline
 - *Policy implication:* prohibit DVR

Better Regulation in EU Company Law, Helsinki,
Oct. 5, 2006

4

Implications of Conflicting Principles



- Efforts to regulate area of conflict requires nuance – are we smart enough to eliminate problems without eliminating benefits?
- If not, then second best solution may be to do nothing

Better Regulation in EU Company Law, Helsinki,
Oct. 5, 2006

5

Today's Agenda

- Concern is the area where principles overlap
- Key is to focus on the link between the problem to be solved and equity proportionality
 - How does mandatory equity proportionality relate to the problem?
 - Is there a narrower way to address the problem?

Better Regulation in EU Company Law, Helsinki,
Oct. 5, 2006

6

Problem #1: DVR Increases the Profit from Self-Dealing

- Problem: Control gives power to extract private benefits of control
 - The less equity the controlling shareholder needs to hold, the greater its margin on extracting private benefits – keeps its share of the costs down
 - Some empirical evidence:
 - In both Europe and Asia, studies report that DVR decreases firm value
 - Cause of the effect is not as clear – could be increased private benefits of control; could be poor performance when founder is succeeded by an heir (a form of non-pecuniary private benefit of control)

Better Regulation in EU Company Law, Helsinki, Oct. 5, 2006

7

Link Between Mandatory Proportionality and Reducing the Profit From Self-Dealing

- Proportionality works in the sense that it decreases the margins from private benefit extraction
 - Control requires greater equity so shareholder bears a larger part of the costs of private benefits
- But is solution overbroad?
 - Concentrated control may provide better monitoring
 - Alternative to the market monitoring associated with dispersed shareholdings
 - DVR reduce the entry cost for concentrated monitoring
- Can we target private benefits through more focused mechanisms?

Better Regulation in EU Company Law, Helsinki, Oct. 5, 2006

8

Techniques to Reduce the Profit From Self-Dealing

- Empirical fact: concentrated control, whether or not proportional to equity, does not result in self dealing in all jurisdictions characterized by controlling shareholders

	Mexico	Italy	Sweden
PBC – difference in market price	36%	29%	1%
PBC – control block premium	34%	37%	7%

Dyck & Zingales (2004); Nenova (2003)

Better Regulation in EU Company Law, Helsinki, Oct. 5, 2006

9

Techniques to Reduce the Profit From Self-Dealing

- *Alternative one*: Prohibit private benefits instead of mandating proportionality
 - But is there a cost to restricting private benefits?
 - Concern: concentrated monitoring is costly to controlling shareholder in time spent and diversification foregone
 - How much private benefits are necessary to support controlling shareholder monitoring?
 - Concern is likely overstated
 - We observe controlling shareholders in jurisdictions with low private benefits
 - Increased ability to hedge firm specific risk through derivatives rather than through diversification
 - Gains from exercising control honestly exceeds opportunity costs

Better Regulation in EU Company Law, Helsinki, Oct. 5, 2006

10

How to Prohibit Private Benefits

- Improve enforcement
 - Problem is not substantive law, but extent of public and private enforcement
 - Hard to do quickly since proactive judiciary and prosecutors take time to develop
 - Justification for EU level enforcement
 - Hard for companies in bad law jurisdiction to credibly signal low private benefits
 - Think about enforcement schemes that involve opt-in at the company level. E.g.,
 - opt in to EU level commercial court
 - Enforceable arbitration in corporate charter

Better Regulation in EU Company Law, Helsinki, Oct. 5, 2006

11

Techniques to Reduce the Profit From Self-Dealing

- *Alternative Two*: Prohibit sale of control at a premium
 - If can't prohibit the flow of private benefits, at least prohibit sale of their capitalized value
 - Advantage: Easier to enforce
 - Sale of control at a premium more observable than extraction of private benefits
 - Disadvantage: In bad law jurisdictions (where controlling shareholders do extract significant private benefits), prohibition reduces incentive to transfer control to more efficient operator

Better Regulation in EU Company Law, Helsinki, Oct. 5, 2006

12

Tentative Conclusions

- Prohibiting private benefits of control is potentially a more focused approach than prohibiting DVR
 - None of the benefits from DVR are lost
 - Implementation may be difficult
 - Best bet: opt in regime at company level that allows effective signaling in high private benefits jurisdictions

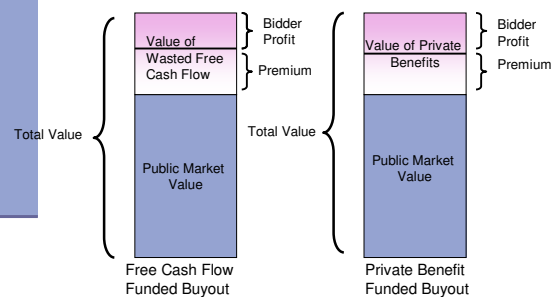
Techniques to Reduce the Profit From Self-Dealing

- **Alternative three:** attack private benefits through the market by a break through rule
 - Different justification than the theme in the 13th Directive
 - Idea is that technique distinguishes in practice between jurisdictions with large and with small levels of private benefits extraction
 - In jurisdictions with large private benefits, break through if bidder gets high equity percentage allows a private benefit funded buyout analogous to free cash flow motivated buyout

Private Benefit Funded Buyouts in High Private Benefit Jurisdiction

- In free cash flow funded buyout, target stockholders share in gain from redeploying wasted free cash flow through premium paid
- In private benefit funded buyout (which requires a break through rule), target stockholders share in gain from eliminating private benefits – a kind of misuse of free cash flow – through premium paid to secure the equity position necessary to break through.
- No effect in jurisdiction with low private benefits of control

Private Benefit Funded Buyouts



Conclusion: Reducing Private Benefits

- Large private benefits are unqualifiedly bad; reducing them is desirable if feasible
- Addressing private benefits directly is a more focused approach than prohibiting DVR through mandating proportionality
 - DVR left in place where private benefits are not large
- Alternatives techniques
 - EU level company opt-in enforcement regime
 - Prohibiting premium for control
 - Break through facilitated private benefit funded buyouts
- Not addressing difficulties of definitions or politics of adoption

Problem #2: DVR Restrict Capital Market-Imposed Monitoring

- A second cost related to concentrated monitoring is more troublesome
- Even if a controlling shareholder extracts no private benefits, in practice may prove to be ineffective manager or monitor, which DVR protects from market pressure
- Result is an externality
 - Puts stakeholders and economy generally at risk
 - Because of DVR, capital market can not cause control to move to better manager/monitor

DVR Restrict Capital Market-Imposed Monitoring

- Examples
 - Controlling shareholder may over invest in existing businesses because lacks skills to react quickly to changing environment
 - Family controlling shareholder may transfer management to an heir rather than professional managers
 - Over time, the gravity of generation reduces performance
 - Empirical evidence reports that on, average, performance deteriorates in next generations
 - Prevents public/private/public virtuous cycle
 - Private equity acquires badly performing company
 - Private governance facilitates fixing the problem
 - Company returns to the public market

Better Regulation in EU Company Law, Helsinki,
Oct. 5, 2006

19

Tradeoffs with Capital Marketing-Imposed Monitoring

- Pro: DVR can support stability necessary to firm specific human capital investment
 - Argument for Japanese style corporate governance
 - Short term oriented market can threaten stability
- Con: DVR can prevent fast adaptation to industry change
 - Outsiders may see industry wide changes faster than insiders burdened with the blinders of experience
- Tradeoff depends on your view of the future
 - Faster change that devalues current firm capabilities increases the external costs of DVR
- Problem ameliorated by natural deterioration of family control

Better Regulation in EU Company Law, Helsinki,
Oct. 5, 2006

20

Where Does the Analysis Leave Us?

- The problems associated with DVR can be addressed by more focused techniques than mandatory proportionality
 - Restricting private benefits of control should not be controversial, at least conceptually
 - EU level opt-in enforcement regime may be necessary to allow good companies to signal their type in jurisdictions that support large private benefits
 - Break through rule addresses private benefit problem as well as capital market monitoring problem
- Even focused interventions may founder on difficulties of implementation and on politics

Better Regulation in EU Company Law, Helsinki,
Oct. 5, 2006

21