NEW SZÉCHENYI PLAN

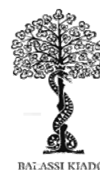
LAW AND ECONOMICS

Sponsored by a Grant TÁMOP-4.1.2-08/2/A/KMR-2009-0041
Course Material Developed by Department of Economics,
Faculty of Social Sciences, Eötvös Loránd University Budapest (ELTE)
Department of Economics, Eötvös Loránd University Budapest
Institute of Economics, Hungarian Academy of Sciences
Balassi Kiadó, Budapest

Authors: Ákos Szalai, Károly Mike

Supervised by Ákos Szalai

June 2011



LAW AND ECONOMICS

Week 12

Company law – Regulation

Ákos Szalai, Károly Mike

Structure of the week

I. Normative company theory: stakeholder vs. shareholder model
II. Legal personality
III. Distribution of power within company

I. Stakeholder vs. shareholder model

Whose interest should the management follow?
Normative problem (cf. last week: property vs. contractual model: positive model)

Stakeholder theory (CSR – Corporate Social Responsibility):
Why shareholder – one of the inputs, one of the stakeholders?
Similar to the logic of the contractual model (NOT THE SAME)

Shareholder theory – answer : because shareholders…

- …are the most homogenous group among stakeholder groups
  - Little internal conflict – easy definition of requirements vis-a-vis the management
  - Management cannot hide behind different requirements from several 'principals'
- …have interests that are hard to protect through contracting (vs. other stakeholders' interests)
  - Their return is not fixed, but risky: it depends on the profit of the company. Expected return determined by the market.

How theories have affected the law:

- Regulation of control and ownership (composition of boards, rights of shareholder meetings, etc.)
- Disclosure policy (who can demand what information from management, and when)

II. Legal personality

- Legal concept: ability to contract, assets under own name

- Economic view: affirmative asset partitioning –
  - Creditor of shareholder/owner cannot reach the corporate assets – to prevent liquidation.
  - Consequences: creditor of company has a safe position (no threat from creditor of owner)
- The own asset can be transferred, provided as security, etc.;
  - Vs. limited liability = defensive asset partitioning: creditor of company cannot reach the assets of owner/shareholder
  - Two at the same time: full partitioning of assets => reduces cost of capital.

- What is required for legal personality?
  - Requirements for starting a company (especially: forms of control and ownership)
  - Requirements for a working company (especially: regulation of information, accounting, etc.)

- Starting a company: mandatory or default rules
  - Arguments for mandatory rules: easy information about business partner…
  - Main objective: investor should understand the company.
  - BUT is this important? Could he not understand contracts? – Cf. most companies have 'syndicate contracts' beside the articles of association (based on mandatory rules)
  - Relevant argument: delegation of right to modify
    1. Company: long term contract with many players – hard but necessary to modify in the future
    2. Mandatory rules (regulation) = part of the contract; changes in regulation = changes in contract => easier way to modify
    3. Trust in regulator (changes only when and what efficiency requires)? Competition among company laws: choose that which will (most likely) modify its regulation according to the requirements of efficiency.

Operating company: information regulation

- Main argument: protection of third party by giving it information about the company.
- BUT: why not voluntary disclosure?
  - Voluntary disclosure: if information is verifiable and false information will be sanctioned, then all information will be disclosed voluntarily.
  - 1st step: best company interested in disclosure – better condition for contracting, investment, etc..
  - 2nd step: 2nd best company will want to distinguish itself from others…
  - Finally: 2nd worst company distinguishes itself from the worst one.

Assumptions:

1. Company knows information – partner is able to verify information
2. Sanction for false information.
3. Information (gathering and disclosure) not too costly.

- Standardized information – network externality: comparable among companies.
  - BUT market (especially institutional creditors, investors) are able to compare heterogeneous products (e.g. information) as well – if it is really important.

- Competition among regulators – leads to higher level of disclosure
  - NYSE high disclosure standards – many companies register even though they do not intend to issue shares in NYSE.
  - Why? Voluntarily accepted high standard = signal (enhances trust in company)

Enforcement: public (government, independent agency) vs. private (no / false information: suit)

  - LaPorta: standardization is important – enforcement makes no difference (private enforcement works)

III. Division of power within the company

Basic problem: principal – agent

- Classic agency problem (Berle and Means) between management and investors: many small investors
  - Free-riding: no control over management.
- Tunnelling, self-dealing – new form of problem: management + large shareholders (insiders) vs. small shareholders –
  - Self dealing contract: typically selling below or purchase above market price
  - Tunnelling capital of company to private ends – not through profit withdrawal which would benefit small shareholders, too.

Concentration (large shareholders): pros – cons?

Ability to control management vs. tunnelling capital …

  - Empirics: sometimes it enhances efficiency
    - E.g. Sweden (benefit not only from self-dealing but prestige)
    - Media: non-monetary benefit (e.g. prestige, influence on politics, etc.)

No protection for small investors => financing not from capital market but from relational finance (credit)

Legal solution: listing tasks of management

- Explicit list: hard to define – fiduciary tasks (e.g. work in the interests of investors)
- Liability insurance of management – moral hazard: great problem
- Disgorgement

Regulation: ownership and control

- Auditor (information to shareholders, third parties) + boards
- Board: separation from general meeting of shareholders:
  - Lower cost of control
  - If appropriate members – information not only to large investors but small shareholders (and other stakeholders) as well
- Composition of boards:
  - Many members – controlling each other
  - Insider (management) and outsider members: different incentives – outsiders have lower stakes in continuing current actions
  - BUT outsiders nominated by insiders (often insider in company A, outsider in company B, and vice versa)
- Approval needed for self-dealing contracts? E.g. auditor, general meeting of shareholders.

Market solutions: Capital market – takeovers

- Basic logic: bad companies (small profit, risk-averse decisions, etc.) => low share prices => threat of takeover (and firing of current management)
  - Why don't actual shareholders fire the management?
  - Proxy fight: management use (corporate) resources to persuade shareholders to vote against motion?
  - Why is there anti-takeover regulation?
    1. Concern about market competition
    2. Capital market is imperfect: share price depends on short-term profit (not long-term prospects) => incentives for management are also short term.

Forms of takeover – role of the company structure (ownership, control), articles of incorporation

- Free market:
  - Mandatory disclosure?
  - Requirements of approval (by regulator) in advance : e.g. above 25% unless another shareholder is above 10% (then the limit is 33%)
  - Minimum price?
  - Separation of ownership and voting right: no voting right even if own share (other requirements)
- Block-purchase – through negotiation with large shareholders (buying their shares).

- Tender-offer: open offer for purchase of shares above market value – but only if a minimum number of shares are available (maximum may be defined, too)
  - How long is the offer open? => time for management to take defense (from corporate resources)
  - Poison pill = if tender offer: shareholders' right to purchase newly issued shares below the market price => if there are more shares, more shares are necessary to reach the desired level of influence; takeover is more costly.
  - Tag-along: obligation to purchase other shares above a certain limit. At what price?
  - Drag-along: force other shareholders to sell their shares above a certain limit.
- Negotiation with current management
  - Golden parachute: high level of compensation for management if takeover and dismissal.
  - Lock-up agreement: compensation for unsuccessful takeover (from corporate resources).

Protecting small investors

- Voting rules: increase required number of shares
  - BUT 20 century deregulation: reducing the number of required shares.
  - Moreover, shareholder acceptance vs. managing decision - e.g. Delaware: timing of share issuance, once accepted, is decided by the management.
- Voting rule – vote only personally?
  - Increased cost of voting – advantageous for large shareholders.
- Voting rule: share in deposit before voting?
  - Increased cost of voting – advantageous for large shareholders.
  - Vs. easier control over voting rights.
- Voting rule: giving up the 'one share – one vote' rule: less votes by large shareholders.
- Regulation against concentration – higher cost of takeover, e.g. *tag-along* rule.

- Suit against management
  1. Who has the right to sue (how many shares are necessary)?
  2. Is the transaction which is challenged stopped?
  3. Burden of proof: evidence collected by court or by plaintiff (shareholder) – what information
     must be disclosed?

Protecting small investors

- Information: contents of balance sheet, books, annual reports
    1. payment for managers (premium),
    2. shareholder structure,
    3. shares in the hands of management,
    4. contracts outside the main field of the company,
    5. self-dealing contracts.

- Non-legal allies
    – publicity, media (reputation of management),
    – competition in product market (self-dealing is harder because prices are clear),
    – tax authority (against tax avoidance – i.e. tunnelling),
    – trade unions? Why on the side of small investors (against large shareholders)?

Practice

Company law: main issues

Hansmann–Kraakman:

1. legal personality;
2. limited liability;
3. transferable shares;
4. separation of ownership and control;
5. ownership by contributor of capital

Revision

- Stakeholder vs. shareholder model
- Legal personality
  - Affirmative asset partitioning
  - Why not contracting?
  - Pros and cons?
  - Why mandatory rules? (delegation)
- Within the company
  - Agency problem – among whom?
  - Task of management
  - Forms of control
  - Effects of takeovers (through capital market)
  - Defense against takeover

Problem

In a legal system, majority shareholders of a corporation have no right to force minority shareholders to sell their shares to them. However, a proposed new law would state that if a shareholder holds at least 75 percent of a company's shares, he may demand that the other shareholders sell their shares to him.

Minority shareholders must fulfil the request. If they debate the share price offered, the court decides the price, on the basis of the company's value on the books.

Evaluate the proposed new law.

Solution

- Basic issue: drag-along
- Easy take-over – pros and cons
- Why takeover?
- When is takeover efficient? (Assumptions about capital market?)

Revision

- Mandatory or default rules
  - Meaning, definition
  - When mandatory rule?
- Public or private enforcement
  - Meaning, definition
  - Pros and cons?
- Standards vs. rules
  - Meaning, definition
  - Pros and cons?
- Non-legal sanctions, enforcement