Equity Proportionality in Corporate Voting: Linking Problems and Responses

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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)

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

- 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

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

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?
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)

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?

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

<table>
<thead>
<tr>
<th>Mexico</th>
<th>Italy</th>
<th>Sweden</th>
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<tbody>
<tr>
<td>PBC – difference in market price</td>
<td>36%</td>
<td>29%</td>
</tr>
<tr>
<td>PBC – control block premium</td>
<td>34%</td>
<td>37%</td>
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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

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

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
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

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

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

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