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Powering Preemptive Rights with Presubscription Disclosure

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Powering Preemptive Rights with Presubscription Disclosure

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This chapter draws heavily on joint work with Holger Spamann, for whose insights and collaboration I am extremely grateful. For valuable conversations and comments, I thank Michal Barzuza, Lucian Bebchuk, Bob Clark, John Coates, Bala Dharan, Allen Ferrell, Zohar Goshen, Gen Goto, Scott Hirst, Cliff Holderness, Mira Ganor, Robin Huang, Ehud Kamar, Louis Kaplow, Kobi Kastiel, Kon Sik Kim, Reinier Kraakman, Adam Levitan, Mark Roe, Guhan Subramanian, Barak Yarkoni, Baohua Zhang, and participants at the June and October 2017 author workshops on The Law and Finance of Related Party Transactions. Special thanks to Luca Enriques, Ron Gilson, Sang Yop Kang, Steve Shavell, and Tobias H. Tröger for detailed comments on earlier versions. Research assistance was ably provided by Eli Balsam, Virginia Haydee Cuerva, Nick Grant, Frederic Helsen, David Kirk, Sam Krawiecz, Sam Learner, Jean Lee, Da Lin, Richard Liu, Nithia Narayanan, Marina Limos Pires, Brandon Une, Kun Xue, Kevin Zeng, and Gilad Zohari. Any remaining errors are my own.

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Abstract

Preemptive rights can prevent cheap-issuance tunneling by a controller when outside investors know that the offered securities are cheap. But when outsiders cannot tell whether the securities are cheap or overpriced, preemptive rights fail to prevent such tunneling. Afraid of purchasing overpriced securities, outsiders may rationally refrain from purchasing (even when the securities are in fact cheap), and then suffer cheap-issuance losses. I put forward a mechanism to make preemptive rights more effective: requiring disclosure of a controller's subscription commitment, before outside investors must finalize their own, so that outsiders can choose to mimic it.

Keywords: Controlling shareholder, tunneling, equity issuance, equity issue, equity tunneling, preemptive rights, minority shareholders, public shareholders, rights offers, rights issues, private firms

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Powering Preemptive Rights with Presubscription Disclosure

JESSE M. FRIED

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I Introduction

Most corporations around the world have a controlling shareholder ("CS" or "controller"): control is concentrated in the hands of either a single shareholder or a small group of shareholders acting in concert. Almost every unlisted (private) firm is a CS firm. And many listed firms in the United States and most listed firms outside the United States – in Europe, Asia, and South America – are CS firms.[1]

[1] *See, e.g.*, Julian R. Franks & Colin Mayer, *Evolution of Ownership and Control Around the World: The Changing Face of Capitalism* 33, Working Paper (2017) (reporting the prevalence of CS firms around the world).

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In a CS firm, other investors ("outside investors" or "outsiders") are potentially vulnerable to tunneling transactions that shift value to the controller.[2] These transactions – which could involve the firm's assets, securities, or both[3] – are not uncommon.[4] Corporate and securities laws seek to limit tunneling, both to facilitate capital-raising ex-ante from outside investors[5] and to reduce ex-post operational distortions associated with value diversion.[6]

This chapter focuses on an important form of tunneling – the sale by the CS firm of cheap securities to the controller ("cheap-issuance tunneling"). More specifically, drawing on joint work with Holger Spamann,[7] I examine the widely held belief that preemptive rights can thwart cheap-issuance tunneling by a controller.[8] I explain that preemptive rights *can*

[2] *See* Simon Johnson et al., *Tunneling*, 90 AER PAPERS AND PROCEEDINGS 22, 22 (2000) (introducing the term "tunneling" to describe self-dealing transactions that harm outside investors).

[3] *See, e.g.*, Vladimir Atanasov et al., *Law and Tunneling*, 37 J. CORP. L. 1, 9 (2011) (providing a taxonomy of types of tunneling).

[4] *See, e.g.*, Jae-Seung Baek et al., *Business Groups and Tunneling: Evidence from Private Securities Offerings by Korean Chaebols*, 61 J. FIN. 2415 (2006) (reporting that equity issuances are used by Korean controllers to expropriate public investors); Yan-Leung Cheung et al., *Tunneling, Propping, and Expropriation: Evidence from Connected Party Transactions in Hong Kong*, 82 J. FIN. ECON. 343 (2006) (reporting that related party transactions between CS firms listed in Hong Kong and their controllers are used to expropriate public investors); Guohua Jiang et al., *Tunneling Through Intercorporate Loans: The China Experience*, 98 J. FIN. ECON. 1 (2010) (reporting that loans between CS firms listed in the PRC and their controllers are used to expropriate public investors).

[5] *See, e.g.*, Andrei Shleifer & Robert Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 743 (1997) (discussing constraints insiders subject themselves in order to facilitate capital-raising ex-ante). *Cf.* OECD, *Related Party Transactions and Minority Shareholder Rights* 11 (2012) (www.oecd.org/daf/ca/50089215.pdf) (emphasizing the damage to "market integrity" caused by unfair self-dealing transactions).

[6] *See* Luca Enriques, *Related Party Transactions: Policy Options and Real-World Challenges (with a Critique of the European Commission Proposal)*, 16 EUR. BUS. ORG. L. REV. 1, 8, 9 (2015) (noting that tunneling may lead to distortions in strategic and managerial choices as controllers run the firm in part to divert value rather than solely to maximize the size of the pie).

[7] *See* Jesse M. Fried & Holger Spamann, *Cheap-Stock Tunneling Around Preemptive Rights*, Working Paper (2018) (hereinafter, "Fried and Spamann, *Cheap-Stock Tunneling*") (offering a game-theoretic analysis of a controller's ability to engage in cheap-stock tunneling when outsiders have preemptive rights but less information than the controller about the value of the offered securities).

[8] *See, e.g.*, Reinier Kraakman et al., THE ANATOMY OF CORPORATE LAW 182 (3rd ed. 2017) ("preemptive rights ... discourage controlling shareholders from acquiring additional shares from the firm at low prices"); Djankov et al., *The Law and Economics of Self-Dealing*, 88 J. FIN. ECON. 430, 454 (2008) ("in the absence of preemptive rights, insiders may expropriate minority shareholders by offering shares to related parties, or even to themselves, at below-market prices").

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prevent cheap-issuance tunneling when outsiders know that the offered securities are cheap. However, I show that preemptive rights fail to prevent such tunneling when outsiders cannot tell whether the offered securities are cheap or overpriced. In particular, fear of buying overpriced securities will cause some outsiders to rationally refrain from purchasing, and these refraining outsiders will suffer losses if the securities are, in fact, cheap. On the flip side, *participating* outsiders will suffer losses from another type of mispriced-issuance tunneling ("overpriced-issuance tunneling") when the securities' price is, in fact, high.

I then demonstrate that outsider losses from cheap-issuance tunneling (and overpriced-issuance tunneling) could be substantially reduced by requiring the firm to disclose the controller's subscription commitment before outsiders must decide their own, thereby enabling outsiders to "mimic" the controller. I propose to impose this presubscription disclosure requirement on both unlisted and listed CS firms.[9]

The chapter's roadmap is as follows: Part II describes the potential power of preemptive rights to thwart cheap-issuance tunneling. Part III explains that a controller often has an incentive to offer securities at a price falling within the "zone of uncertainty" – the range of prices in which outsiders are uncertain as to whether offered securities are cheap or overpriced – as the use of an offer price within the zone increases a controller's expected gain from both types of mispriced-issuance tunneling. Part IV puts forward the presubscription disclosure rule and explains how it can substantially reduce a controller's ability to exploit information asymmetry to profit from both cheap-issuance and overpriced-issuance tunneling. Part V concludes.

II Cheap-Issuance Tunneling and the Promise of Preemptive Rights

Section A describes cheap-issuance tunneling. Section B explains how preemptive rights can, in theory, prevent it.

A Cheap-Issuance Tunneling

Suppose a controller causes a CS firm to sell securities that are "cheap": the controller knows the price is less than the post-issuance

[9] Although my focus in this chapter is on a CS firm, the analysis and proposed remedy would apply equally in the context of a non-CS firm that has either a dominant but noncontrolling shareholder (or shareholder group) or executives and directors who own a substantial amount of equity.

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value.[10] The cheap issuance transfers value to buyers ratably at the expense of current investors in aggregate (including the controller). The controller can profit at outsiders' expense by buying a disproportionate share of the securities.

For simplicity, consider a "basic" firm: one that, before and after the issuance, has only common stock outstanding and whose controller does not receive any private benefits from the issuance proceeds. A sale of cheap stock by a basic firm would transfer value to the buyers ratably from all existing investors pro rata, including the controller. If the controller buys more than her ratable portion of the offered stock, value shifts to the controller from outside investors. Consider Example 4.1 below.

EXAMPLE 4.1: Cheap-Issuance Tunneling

CS and Outsider each own one share of ABC Corporation (ABC).[11] Upon Liquidation Date, ABC's value will be distributed ratably to shareholders.[12] Assuming no equity issuance, ABC's Liquidation-Date value will be $30 and each of ABC's two shares will be worth $15 ($30/2).

[10] I assume throughout that the controller has the legal power to cause the CS firm to conduct a particular securities issuance. Under Delaware corporate law, the controller always has such power if she controls the board and a majority of the shareholder votes, but board control by itself often suffices. *See* Mira Ganor, *The Power to Issue Stock*, 46 WAKE FOREST L. REV. 701, 709 (2011) (describing approval requirements for issuances under Delaware law). In other jurisdictions, more shareholder votes might be needed. *See* Marco Venturozzo, *Issuing New Shares and Preemptive Rights: A Comparative Analysis*, 12 RICH. J. GLOBAL L. & BUS. 517, 530, 537 (2012–13) (explaining that in certain European countries approval by a supermajority of the shareholders voting is needed before a firm can issue additional shares).

[11] All examples assume, purely for expositional convenience, that CS and Outsider each initially own 50% of ABC's equity. Of course, if ABC's equity were one-share/one-vote and no other control-affecting arrangements were in place, CS would not control ABC. Thus, one can imagine that CS's share carries multiple votes (or, similarly, that Outsider's share has 0 votes); a shareholder-level voting agreement gives CS the right to control Outsider's vote; or Outsider is not a single shareholder, but rather a collection of many uncoordinated outside investors.

[12] In this and subsequent examples, "Liquidation Date" can be thought of as the future period when ABC has a liquidity event in which its assets are sold for a price equaling their actual value (which could be going-concern value) and the sale proceeds are ratably distributed to ABC's investors (CS and Outsider), terminating their equity investment in ABC. Purely for expositional convenience, I assume throughout that there is no diversion of value until Liquidation Date, except directly or indirectly via a securities issuance.

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EXAMPLE 4.1: Continued

CS has ABC offer two new shares for $10 each. Any issuance proceeds will increase ABC's Liquidation-Date value dollar-for-dollar.[13] Issuing two new shares for $20 in total will increase ABC's Liquidation-Date value from $30 to $50; each of ABC's 4 shares will thus be worth $12.50 ($50/4). Each new share, offered for $10, is thus cheap.

Outsider does not purchase any of the two new shares, because Outsider either does not know the shares are cheap or lacks preemptive rights, enabling CS to acquire both.[14] Outsider loses $2.50, as the value of its one (and only) share declines from $15 to $12.50. Pre-issuance, CS has one ABC share worth $15. Post-issuance, CS has three ABC shares worth $37.50 (3 x $12.50) in total, but $20 less cash (net total of $17.50). Cheap-issuance tunneling shifts $2.50 from Outsider to CS.[15]

In a basic firm, cheap-issuance tunneling economically dilutes outsiders by not increasing total equity value sufficiently to offset the reduction in outsiders' percentage equity ownership. In this setting, cheap-issuance tunneling has the same redistributive effect as a transaction in which the controller forcibly acquires a portion of outsiders' common stock for a cheap price.

B Preemptive Rights

Preemptive rights, which enable investors to participate pro rata in securities issuances, are the most widely used tool for preventing cheap-issuance tunneling.[16] They should, in theory, thwart such expropriation.[17]

[13] In this and subsequent examples I assume, purely for expositional convenience, that ABC's securities issuance does not create or destroy social value. That is, the total pie shared by the CS and Outsider is equal to the pre-issuance value of ABC's assets plus issuance proceeds.

[14] In this and subsequent examples I assume, purely for expositional convenience, that CS and Outsiders have sufficient cash to acquire as many of the offered securities as they are permitted and wish to purchase.

[15] The $2.50 corresponds to the difference between the price ($10) and value ($12.50) of the second cheap share in the offering, which CS acquires rather than Outsider.

[16] Of course, preemptive rights are unlikely to be the only tool used by a jurisdiction to prevent cheap-issuance tunneling. The controller and firm directors may also be subject to fiduciary duties and other restrictions that constrain the design and conduct of an issuance. But the continued widespread reliance on preemptive rights suggests that these other mechanisms, by themselves, are not seen as sufficient.

[17] In addition to countering cheap-issuance tunneling, preemptive rights can also *indirectly* protect outsiders from expropriation by preserving control rights that require maintaining a certain percentage ownership. Purely for expositional convenience, I abstract from this function of preemptive rights and (unless indicated otherwise) set aside the potential control-altering effects of issuances.

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1 Widespread Use of Preemptive Rights

Many jurisdictions around the world grant preemptive rights as a difficult-to-waive statutory default in unlisted and listed firms; opting out can require super-majority shareholder approval, be subject to judicial review, or lead to substantial limits on the issuance amount.[18] As a result, outside investors often have preemptive rights in an issuance. In listed firms, preemptive rights in equity issuances are implemented via rights issues (or rights offers) in which rights to buy additional shares are distributed ratably to shareholders.[19] The subscription price is usually set below the pre-offer market price, but may end up being higher or lower than the market price at the time shareholders must finalize their commitments.[20]

Under Delaware corporate law, which applies to most unlisted and listed corporations in the United States, preemptive rights are not mandated.[21] Instead, a securities issuance by a CS firm is regulated by open-ended fiduciary duties imposed on the controller and directors.[22] But this regulation tends to reflect the logic of preemptive rights: courts applying Delaware law are reluctant to review cheap-issuance tunneling claims by outside investors when the controller has permitted these outsiders to participate pro rata, an offer the controller may make to insulate the transaction from effective legal challenge.[23]

2 Preemptive Rights' Potential Power

If outsiders know the securities on offer are cheap, preemptive rights should prevent a controller from cheap-issuance tunneling: outsiders,

[18] *See* Kraakman et al., *supra* note 8, at 182–83 (discussing various approaches to preemptive rights); Ventoruzzo, *supra* note 10 (describing restrictions on the ability of unlisted and listed firms in Italy, Germany, and Spain to opt out of preemptive rights for particular issuances).

[19] *See generally* Clifford G. Holderness, *Equity Issuances and Agency Costs, The Telling Story of Shareholder Approval Around the World* 6, Working Paper (2017) (describing various types of equity issuances and the effect of shareholder approval on issuance quality); Massimo Massa et al., *Choices in Equity Finance: A Global Perspective* 10, Working Paper (2016) (describing various types of equity issuances).

[20] *See* Massa et al., *supra* note 19, at 13 (providing data on rights offers).

[21] DGCL 102(b)(3) ("No stockholder shall have any preemptive right to subscribe to an additional issue of stock or to any security convertible into such stock unless, and except to the extent that, such right is expressly granted to such stockholder in the certificate of incorporation.")

[22] *See generally* Jesse M. Fried, *Rights Offers Under Delaware Law*, Working Paper (2018) (hereinafter, "Fried, *Rights Offers*") (describing and critically analyzing the treatment of rights offers under Delaware law).

[23] *See generally* Fried, *Rights Offers, supra* note 22.

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happy to buy the cheap securities, would exercise their preemptive rights and participate pro rata, preventing expropriation. Consider Example 4.2, which replicates the scenario in Example 4.1 but then assumes the existence of preemptive rights.

EXAMPLE 4.2: Preemptive Rights Block Cheap-Issuance Tunneling

This example is setup in the same way as Example 4.1, except Outsider now has preemptive rights and is aware the shares are cheap. Outsider thus buys one of the two shares; CS purchases the other. Pre-issuance, Outsider and CS each own one ABC share worth $15. Post-issuance, Outsider and CS each own two ABC shares worth $25 (2 × $12.50), but $10 less cash (net total of $15). Each shareholder's wealth remains unchanged, and there is no transfer of value from Outsider to CS. Outsider's use of preemptive rights to buy its ratable portion of cheap securities thus thwarts cheap-issuance tunneling.

Practitioners and academics understand that preemptive rights cannot prevent cheap-issuance tunneling when procedures for exercising preemptive rights are unworkable,[24] outside investors lack adequate capital,[25] or outsiders suffer from "behavioral" limitations that undermine their ability to rationally use preemptive rights.[26] When these *non-informational* impediments are present, I refer to the outside investors (and their preemptive rights) as "impeded." However, I abstract from these impediments to focus on a different problem that, until now, has not been widely appreciated: the *informational* barrier to the effective use of preemptive rights caused by outsiders not knowing whether the securities offered by a CS firm are cheap or overpriced. To isolate this effect, I will generally assume that outsiders have *unimpeded* preemptive

[24] *Cf.* Vladimir Atanasov et al., *How Does Law Affect Finance? An Examination of Equity Tunneling in Bulgaria*, 98 J. FIN. ECON. 155 (2010) (describing the effect of fixing inadequate preemptive-right procedures on Bulgarian controllers' ability to engage in cheap-stock tunneling).

[25] Lack of capital is less likely to impede the exercise of preemptive rights in a listed firm than in an unlisted firm, particularly if the rights are easily tradable. However, rights are not always tradable. *Cf.* Massa et al., *supra* note 19, at 2 (reporting that out of approximately 8,000 rights offers made during 1995–2011 in countries where firms need not use tradable rights, firms decline to do so in almost 40% of the offers).

[26] *See* Clifford G. Holderness & Jeffrey Pontiff, *Shareholder Nonparticipation in Valuable Rights Offerings: New Findings for an Old Puzzle*, 120 J. FIN. ECON. 252, 253 (2016) (finding evidence that shareholders in US public companies often fail to exercise rights to purchase shares below their trading prices, even though the shareholders could clearly profit from doing so).

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rights. (Purely for expositional convenience, I will also generally assume that the controller is not capital constrained and that an issuance cannot affect the allocation of control.[27])

III Fear of Overpriced-Issuance Tunneling Can Sap Preemptive Rights' Power

Part II explained that a controller may seek to transfer value via cheap-issuance tunneling, but outsiders who are aware that the offered securities are cheap can prevent such expropriation. This part shows that outsiders cannot prevent cheap-issuance tunneling when the controller knows the offered securities are cheap, but outsiders do not.

Section A explains how a controller can gain from overpriced-issuance tunneling: luring outsiders into participating disproportionately in an issuance of overpriced securities. Section B discusses how information asymmetry creates a "zone of uncertainty" – a range of offer prices in which outsiders cannot tell whether the securities are cheap or overpriced, and thus whether they should participate or refrain. Section C shows that a controller seeking to extract value via cheap-issuance or overpriced-issuance tunneling when outsiders have unimpeded preemptive rights will choose an offer price within the zone of uncertainty, as pricing within the zone eliminates outsiders' ability to fully protect themselves from such tunneling. For completeness, Section D explains that a controller using an issuance for purposes other than mispriced-issuance tunneling may choose a price above or below the zone.

A The Possibility of Overpriced-Issuance Tunneling

A controller may cause a CS firm to offer securities that are "overpriced": the controller knows the price exceeds post-issuance value. Such an issuance would transfer value ratably from buyers to current investors, including to the controller. The controller's gain (if any) would be maximized if outsiders buy all of the offered securities.

In fact, controllers frequently use issuances to sell overpriced securities. A study focused on Chilean controllers finds that they sometimes use

[27] In Part III.D., I briefly consider scenarios in which outsiders are impeded, the controller is capital-constrained, or control can be affected by the issuance.

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issuances to sell overpriced securities disproportionately to outsiders, reducing the controllers' percentage ownership before relatively poor stock performance.[28] Another study examining 15,751 rights offers in 127 countries during 1995–2011 finds that rights offers are, on average, followed by negative abnormal returns.[29] This pattern is not surprising, given the considerable evidence that firms tend to sell equity when it is overpriced.[30]

For simplicity, consider again a basic firm (one that has only common stock outstanding and whose controller cannot get private benefits from the issuance). In such a firm, the sale of overpriced stock transfers value to all existing shareholders pro rata, including the controller, from buyers. If the controller buys less than her rateable portion of issued shares, value will be transferred to the controller from outsiders. Consider Example 4.3 below.

EXAMPLE 4.3: Sale of Overpriced Securities

CS and Outsider each own one share of ABC Corporation (ABC). Upon Liquidation Date, ABC's value will be distributed ratably to shareholders. Assuming no equity issuance, ABC's Liquidation-Date value will be $5 and each of ABC's two shares will be worth $2.50 ($5/2).

CS has ABC offer two new shares for $10 each. Any issuance proceeds will increase ABC's Liquidation-Date value dollar-for-dollar. If both new shares are purchased, ABC's Liquidation-Date value will increase by $20 to $25, and each of the four shares will be worth $6.25 ($25/4). If only one of the two shares is purchased, ABC's Liquidation-Date value will increase by $10 to $15, and each of the three shares will be worth $5 ($15/3). Thus, in either case, the shares are overpriced.

[28] *See, e.g.*, Borja Larrain & Francisco Urzúa I., *Controlling Shareholders and Market Timing in Share Issuance*, 109 J. FIN. ECON. 661, 662 (2013) (finding substantial negative abnormal returns following issuances by Chilean CS firms during 1990–2009 in which controllers do not ratably participate and their percentage ownership declines, and no abnormal returns when controllers participate pro rata).

[29] *See* Massa et al., *supra* note 19, at 9, 27 (reporting that excess returns after rights offers are negative, and that investors who buy tradable rights in rights offers and exercise them on average overpay for the acquired shares).

[30] *See generally* Richard G. Sloan & Haifeng You, *Wealth Transfers via Equity Transactions*, 118 J. FIN. ECON. 93 (2015) (showing that equity issuances are used to transfer a considerable amount of value to current shareholders of publicly traded US firms).

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EXAMPLE 4.3: Continued

CS and Outsider both have preemptive rights. CS refrains from subscribing, as buying even one share means losing.[31] Suppose Outsider, unaware the shares are overpriced, buys one share.[32] Pre-issuance, Outsider and CS each own one share worth $2.50. Post-issuance, Outsider owns two shares worth $5 each and has $10 less cash (net total of $0) and CS owns one share worth $5. Overpriced-issuance tunneling shifts $2.50 from Outsider to CS.[33]

B The Inevitable "Zone of Uncertainty"

Outside investors have much less information than the controller about the value of the firm and its securities, whether the firm is unlisted or listed.

Outside investors of unlisted firms are often completely in the dark. In the United States, such firms are generally not subject to mandatory periodic disclosure requirements either under the federal securities laws or state corporate law.[34] Even when a sophisticated outside investor in an unlisted firm carefully negotiates informational rights, these rights are not self-enforcing; the investor may need to engage in expensive litigation to get access to the most basic information, including the identities of the firm's officers and directors, the firm's balance sheet and income statement, and the firm's capital structure.[35]

[31] Unless otherwise indicated, the examples assume that the allocation of control rights within the firm and parties' private benefits are not directly affected by whether a party participates in an issuance. In other words, I assume that the pre-issuance allocation of voting power is such that there is no scenario in which the issuance can shift control. In Example 4.3, for instance, one might imagine that CS maintains control even if her equity falls to 25% or 33% because CS's share of stock carries multiple votes (or, similarly, other shares have 0 votes) or a shareholder-level voting agreement gives CS the right to control Outsider's vote. This assumption, made solely for simplicity, enables me to focus on the direct value-shifting effects of a mispriced issuance. Of course, when the securities being issued have voting rights, a controller's desire to maintain control may well limit the size of an issuance when the controller knows she will purchase less than her pro rata portion.

[32] Outsider will not seek to buy two shares, as the second would be available only if CS refrains because the stock is overpriced.

[33] Outsider overpays by $5 for one new share whose price is $10 and whose value is $5, but 50% of the value transferred to existing investors flows back to Outsider through its original one share.

[34] *See* Jesse M. Fried, *Firms Gone Dark*, 76 U. CHI. L. REV. 135, 138–40 (2009) (describing mandatory periodic disclosure requirements imposed on firms trading on the New York Stock Exchange and Nasdaq).

[35] *See, e.g., KT4 Partners LLC* v. *Palantir Technologies, Inc.* (Delaware Chancery Court, C.A. No. 2017-0177-JRS) (February 22, 2018) (major investor in Silicon Valley "unicorn" sues for – and is granted – right to inspect the firm's books and records under Section 220 of the Delaware General Corporation Law, after the firm failed to hold several annual stockholder meetings mandated by Delaware law and refused to provide financial information allegedly required under the parties' Investors Rights Agreement).

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Listed firms, subject to mandatory disclosure and more vigorous enforcement of anti-fraud laws, do typically provide more information to outside investors. But even in the United States – a jurisdiction with relatively stringent disclosure provisions and tough insider-trading laws – information asymmetry persists, as made clear by the abnormal profits executives make trading in their own firms' shares.[36] The reason is simple: even if a firm could be compelled to disclose all "material" facts, insiders would still have unique access to "sub-material" facts and other "soft" information (such as their own plans for how to run the firm) that often give them a much better sense of firm value.[37] Information asymmetry may be particularly severe in a listed CS firm, as a controller can and will use her power to manipulate the flow of information from the firm to depress or increase the stock price, in accordance with her interests.[38]

Information asymmetry in both unlisted and listed firms leads to a "zone of uncertainty" – a range of prices in which outsiders cannot tell whether securities offered by a CS firm are cheap or overpriced.[39] As asymmetry increases, this range of prices widens. Prices far enough beyond the boundaries of the zone will be sufficiently high or low that outsiders can easily figure out whether the offered securities are overpriced or cheap. But within the zone, outside investors will be uncertain. Suppose, for example, that outsiders in an unlisted CS firm believe that the firm's shares are worth between $5 and $15 each. If the controller has the firm offer additional shares for $10 each,

[36] *See, e.g.*, Lauren Cohen et al., *Decoding Inside Information*, 67 J. FIN. 1009 (2012) (finding that executives generate abnormal returns via opportunistic insider trading).

[37] *See* Jesse M. Fried, *Insider Trading via the Corporation*, 162 U. PENN. L. REV. 801, 808–10 (2014) (explaining how the interpretation and enforcement of Rule 10b-5 under the securities laws often enables insiders to trade legally and illegally on important private information).

[38] *See, e.g., In re Dole Food Co., Inc. Stockholders Litigation* (Delaware Chancery Court, C.A. No. 8703-VCL) (August 27, 2015), 104 (finding that Dole Food controller and board chair David Murdock, who was also CEO, and another director, who was also President, COO, and General Counsel, took steps to drive down Dole's stock price prior to a merger by which Murdock took Dole private).

[39] Recall that "cheap" ("overpriced") means that the controller knows that the offer price for a security is below (above) post-issuance value. Of course, there may well be issuances that are neither cheap nor overpriced: the controller either knows the price is fair, or lacks enough information to assess the relationship between price and post-issuance value. But I ignore such issuances, as they do not systematically transfer value from outsiders to the controller, and focus on situations in which the securities on offer are either cheap or overpriced.

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outsiders will not know whether the offered shares are cheap or overpriced.[40]

For outsiders facing an offer, the zone of uncertainty might shrink if the firm or the controller discloses the controller's subscription commitment before outsiders must finalize their own, as this disclosure would reveal some of the controller's private information about the securities' value. Suppose that, absent such a disclosure, outside investors believe that the shares on offer for $10 each are worth between $5 and $15 apiece. If the controller discloses that she is subscribing for a large number of shares, outsiders might come to believe the shares are worth more than $10 each, thus shrinking the zone.[41]

But for unlisted firms, there appears to be no jurisdiction that requires advance disclosure of the controller's planned participation in a securities issuance.[42] And for listed firms, it appears that only one jurisdiction (the People's Republic of China) requires some disclosure from the controller, at least for certain kinds of equity issuances.[43] In other major markets – including the United States, the United Kingdom, Hong Kong, Japan, Korea, Singapore, and Germany – the controller of a listed firm is not obligated to disclose her subscription commitment before outside investors must decide theirs.[44] And controllers that are not required to

[40] If outsiders know that the issuance could affect control, outsiders might be able to infer whether the securities are cheap or overpriced. Consider the scenario in which the controller owns 51% of the firm's voting securities and the firm is offering additional voting securities for $10 each. Outsiders will assume that the controller wishes to preserve control and will thus seek to buy at least 50% of the issued securities. If the controller intends to buy that many securities, outsiders can infer that the securities are unlikely to be overpriced and in fact are likely to be cheap. In this scenario, the zone of uncertainty will no longer be between $5 and $15, but rather between $10 and $15. But unless indicated otherwise, I continue to abstract from the possibility that control might shift if a particular party does not participate pro rata in an issuance.

[41] In Part IV, I discuss in more detail outsiders' ability to draw inferences about the value of a firm's shares from a controller's disclosed subscription commitment. *See infra* Parts IV. A. and C.

[42] Over the last several years, at my direction, a number of very capable and diligent Harvard LLM students (most of whom practiced corporate law in their home countries) have investigated the regulation of issuances and preemptive rights in CS firms in a variety of European, Asian, and South American countries. None of these jurisdictions was found to impose an advance disclosure requirement on the controller of an unlisted firm conducting an issuance.

[43] *See* Jianfu Chen & Robin Hui Huang, *Chapter CN: Securities Regulation in the People's Republic of China*, in INTERNATIONAL SECURITIES REGULATION (Rosen, Robert C. general ed.), Section 53 (March 2018).

[44] If a controller of a listed firm agrees to backstop a rights offer, the firm may well be required to disclose that arrangement, and such disclosure in turn may enable outsiders to infer some information about the securities' value.

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disclose their subscription plans are unlikely to volunteer these plans when they seek to engage in mispriced-issuance tunneling, in part because such disclosure would reduce their mispriced-issuance tunneling profits.[45]

C *Mispriced-Issuance Tunneling via Offer Prices in the Zone*

A controller seeking to transfer value from unimpeded outsiders via a mispriced-issuance must choose an offer price within the zone of uncertainty. When the objective is mispriced-issuance tunneling against such outsiders, a price outside the zone will simply not work. If the controller chooses an offer price that is clearly cheap, outsiders will participate pro rata and thwart cheap-issuance tunneling. Similarly, an obviously high price would cause outsiders to refrain, and there would be no issuance.[46]

But an offer price within the zone enables a controller to put outsiders between a rock and a hard place, as it forces outsiders to choose between two options, each of which (in expectation) leads to expropriation: First, exercise their preemptive rights to subscribe, risking overpriced-issuance tunneling. Second, refrain, risking cheap-issuance tunneling. Because there is a risk of cheap-issuance tunneling *and* a risk of overpriced-issuance tunneling, there is no surefire way to protect against expropriation. Outside investors must decide which risk they fear most and fully expose themselves to the other. Those outsiders most fearful of cheap-issuance tunneling will choose to subscribe, putting themselves at risk of buying overpriced securities. Those most fearful of buying overpriced securities will not subscribe, eliminating *that* risk, but then making themselves vulnerable to cheap-issuance tunneling. If the price is actually cheap, and at least some outsiders refrain, cheap-issuance tunneling occurs.[47]

In a "game" between a rational controller and rational outside investors, it can be shown that there is only one possible equilibrium: the offer price is at least sometimes cheap and at least some outside investors refrain from participating, enabling cheap-issuance tunneling.[48] To see

[45] *See infra* Part IV.

[46] In Part IV.D, I explain why a controller conducting an issuance for a different purpose (a goal other than mispriced-issuance tunneling against unimpeded outsiders) might use an offer price below or above the zone of uncertainty.

[47] *See generally* Fried & Spamann, *Cheap-Stock Tunneling, supra* note 7.

[48] *See generally* Fried & Spamman, *Cheap-Stock Tunneling, supra* note 7.

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why, consider the only possible strategy for avoiding cheap-issuance tunneling: always subscribing. But if the controller knows that outside investors will always subscribe, the controller will always sell overpriced securities, expropriating value from outsiders in every issuance.[49] Consider Example 4.4, involving a basic firm.

EXAMPLE 4.4: Cheap-Issuance Tunneling or Overpriced-Issuance Tunneling?

CS and Outsider each own one share of ABC Corporation (ABC). Upon Liquidation Date, ABC's value will be distributed ratably to shareholders. Assuming no equity issuance, it is equally likely that ABC's Liquidation-Date value will be $30 ("Hi") or $5 ("Lo"). In Hi, each of ABC's two shares is worth $15 ($30/2). In Lo, each is worth $2.50 ($5/2).[50]

Then CS learns whether ABC is Hi or Lo, but Outsider does not. CS arranges for ABC to offer two shares for $10 each, regardless of whether ABC is Hi or Lo. Any issuance proceeds will increase ABC's Liquidation-Date value dollar-for-dollar. The sale of both shares would increase ABC's Liquidation-Date value by $20, from $5 to $25 in Lo and from $30 to $50 in Hi. Per-share value would be $6.25 ($25/4) in Lo, and $12.50 ($50/4) in Hi. But in Lo, CS buys zero shares, so at most one share is issued. (As in Example 4.3, Outsider will not seek to buy two shares, as the second share would be available only if CS refrains because the stock is overpriced.) The sale of one new share for $10 makes per-share value $5 ($15/3). The $10 shares are overpriced by $5 in Lo and underpriced by $2.50 in Hi.

Should Outsider exercise its preemptive rights and purchase one share? Outsider knows CS will seek to buy both shares in Hi and refrain in Lo. If Outsider buys one share, Outsider avoids $2.50 of cheap-issuance tunneling losses in Hi but suffers $2.50 of overpriced-issuance tunneling losses in Lo ($5 overpayment minus $2.50 increase in the value of Outsider's existing share). If Outsider refrains, it suffers $2.50 of cheap-issuance tunneling losses in Hi but avoids $2.50 of overpriced-issuance tunneling losses in Lo.

Outsider is indifferent between buying one share and refraining. If Outsider chooses randomly, there is a 50 percent likelihood it will avoid a loss and a 50 percent likelihood it will lose $2.50 from either cheap-issuance or overpriced-issuance tunneling. Outsider could avoid cheap-issuance tunneling by buying one share. But then Outsider faces a 50 percent likelihood of losing $2.50 to overpriced-issuance tunneling; expected losses are unchanged. Outsider can do nothing to avoid or reduce mispriced-issuance tunneling losses.

[49] For a similar analysis of controller–outsider interactions around repurchase tender offers (RTOs) by listed US firms, *see generally* Jesse M. Fried, *Insider Signaling and Insider Trading with Repurchase Tender Offers*, 67 U. CHI. L. REV. 421, 453–69 (2000) (hereinafter, "Fried, *Insider Signaling*").

[50] In other words, Outsider faces a 50/50 chance of being in either the Example 4.2 or Example 4.3 scenario.

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If the firm is listed, the setting gets slightly more complex. A listed firm is likely to implement preemptive rights via a rights offer, in which it distributes to current investors pro rata rights to purchase additional securities at the offer price. These rights might be nontradable or tradable. However, if the rights' offer price is within the zone of uncertainty, outsiders face the same problem as in an unlisted firm, regardless of the tradability of the rights. Consider both scenarios.

Outsiders' rights are nontradable:[51] If the rights are nontradable, outsiders must decide whether or not to exercise their rights by determining which risk – cheap-issuance tunneling or overpriced-issuance tunneling – they fear most. If outsiders forfeit their rights, the controller (directly or indirectly via related parties) can typically exercise them,[52] and will do so if and only if the offer price is cheap.

Outsiders' rights are tradable: When the rights are tradable, outsiders may have a third option (besides exercise or forfeiture): selling the rights to a buyer. Of course, finding a buyer might be difficult if the issuer does not create a market for the rights.[53] But even if there is such a market, any noninsider party considering purchase of these rights faces the same difficulty as outsiders: figuring out whether the rights' offer price is low or high. Potential noninsider buyers of the rights, who will generally also be unable to tell whether the offer price is low or high, are likely to refrain from purchasing the rights. As a result, markets for rights are highly illiquid[54] and there is substantial underpricing.[55] If outsiders sell their rights and the offer price is in fact low, outsiders suffer loss. And if it is the controller that buys these rights, the outsiders' loss will be the controller's gain.

[51] In certain jurisdictions, rights need not to be made tradeable. *See* Massa *et al., supra* note 19, at 15–16 (reporting that jurisdictions not mandating tradability of rights include Hong Kong, Singapore, the United Kingdom, Australia, New Zealand, the United States, and Switzerland).

[52] *See* Massa et al., *supra* note 19, at 14 (reporting that generally, after the subscription period, the issuer can sell unexercised rights to a standby buyer, which is often the controller or a related party).

[53] *See* Massa et al., *supra* note 19, at 14 (reporting that regulators in Germany, Austria, Belgium, and the Netherlands mandate the tradeability of rights, but do not require that the issuer make a market in them).

[54] *See* Massa et al., *supra* note 19, at 29 (reporting that markets in trading rights are highly illiquid, with bid-ask spreads averaging 28%, seven times the average spread of the underlying shares, and on average 30% of days see no trading).

[55] *See* Massa et al., *supra* note 19, at 30 (estimating that rights around the world trade for less than half their estimated value, a result consistent with several single-country studies).

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Indeed, there is evidence of controllers of listed firms exploiting information asymmetry to use rights offers to engage in mispriced-issuance tunneling. Outsiders participate only partially in rights offers, tending to purchase less than their pro rata share,[56] behavior consistent with an inability to tell whether the offered shares are cheap or overpriced.[57] Controllers use these offers sometimes to increase their percentage ownership and other times to decrease it.[58] And controllers tend to acquire fewer shares in the rights offer when subsequent stock-price movements suggest that the shares were overpriced at the time of the offer.[59]

D Why Controllers May Use Offer Prices Above or Below the Zone

As Section C explained, a controller conducting an issuance for the purpose of engaging in mispriced-issuance tunneling around preemptive rights will choose an offer price within the zone of uncertainty. The analysis there assumed that outsiders are unimpeded, the controller is not capital constrained, and control could not be affected by the issuance. When any of these assumptions is relaxed, the controller may well use an offer price that is clearly cheap or clearly overpriced. For completeness, I describe such out-of-the-zone issuances later.

1 Offer Price Above the Zone

To focus on mispriced-issuance tunneling, I have abstracted from the possibility that an issuance might directly affect control rights (and thus, indirectly, private benefits). But such considerations could affect a controller's choice of offer price and might lead the controller to use an offer price above the zone of uncertainty.

Consider a "quasi-controller": a large shareholder that currently dominates a firm but is potentially vulnerable to a control challenge (because,

[56] *See* Wai-Ming Fong & Kevin C. K. Lam, *Rights Offerings and Expropriation by Controlling Shareholders*, 41 J. BUS. FIN. ACC'TING 773 (2014) (describing data on outsider participation in rights offers by CS firms in Hong Kong).

[57] Outsiders' behavior is, of course, also consistent with the existence of noninformational impediments to exercising preemptive rights.

[58] *See* Fong & Lam, *supra* note 56, at 780 (finding, among several hundred rights offers in Hong Kong between 2003 and 2010, that controllers sometimes increase their percentage ownership and other times decrease it); Larrain & Urzúa I., *supra* note 28, at 667 (reporting a similar finding in a sample of issuances by Chilean CS firms between 1990 and 2009).

[59] *See, e.g.*, Larrain & Urzúa I., *supra* note 28, at 667.

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for example, they control 30 percent of the voting power, and another large shareholder owns 20 percent). The quasi-controller might seek to increase their power by having the firm issue voting securities and acquiring a disproportionate amount. To achieve this outcome, the quasi-controller may use an offer price that is clearly high (or at least appears high) to deter other investors, including any potential rival, from participating.[60]

2 Offer Price Below the Zone

To focus on mispriced-issuance tunneling, I have assumed that the controller is not capital constrained and that outsiders are unimpeded. If either the controller is capital constrained or outsiders are impeded, the controller might use an offer price below the zone.

a Controller Is Capital Constrained Consider the scenario in which the controller needs outsiders to participate heavily in the issuance because the controller wishes to ensure the firm raises a certain amount of capital[61] and is unable or unwilling to contribute the entire amount herself.

If substantial outsider participation is required, using an offer price within the zone of uncertainty is risky: too many outsiders may refrain for fear of buying overpriced securities, leading to an insufficient capital

[60] A relatively recent case from the Delaware Court of Chancery provides an instructive example. *See OTK Associates, LLC* v. *Friedman* (Delaware Chancery Court, C.A. No. 8447-VCL) (February 5, 2014). In March 2013, the board of publicly traded Morgans Hotel Corporation ("Morgans") approved a series of transactions with its quasi-controller Yucaipa Companies, LLC ("Yucaipa"), the investment vehicle of billionaire Ron Burkle. The transactions included a common-stock rights offer for approximately 16.7 million shares at $6 per share (proceeds of $100 million) that was backstopped by Yucaipa. *Id*. at 22. At the time Yucaipa proposed the offer, the $6 offer price was 26% over the then-current market price of $4.73. *Id*. at 10. Yucaipa was facing a control challenge by another large shareholder (OTK), and the offer was structured to discourage OTK and other investors from participating so that Yucaipa could emerge with effective voting control. *Id*. OTK successfully sued to enjoin the Morgans-Yucaipa transactions, including the rights offer. *Id*. at 1. Yucaipa's (attempted) use of a premium rights offer illustrates a point I will return to later: a controller will buy overpriced securities when issuance-generated private benefits offset the loss that she suffers from overpaying for the securities. *See infra* Part IV.C.2.

[61] The additional capital might be used entirely for value-increasing purposes, or partially (or solely) to extract more private benefits. *Cf.* Jesse M. Fried & Holger Spamann, *Expropriation via Financing*, Working Paper (2018) (hereinafter, "Fried & Spamann, *Expropriation*") (explaining how issuances can divert value from outsiders other than through mispricing).

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raise. To avoid this undesirable outcome, a controller might use a clearly cheap offer price. Outsiders, if they are unimpeded, will then participate pro rata alongside the controller.[62] For example, the controller of a listed firm could conduct a rights offer at a price expected to be much lower than the post-offer market price.[63] Any current shareholder would be better off participating in the offer than not participating, as any shares acquired in the offer could be sold at the higher market price.

b Outsiders Are Impeded The analysis has so far assumed that outsiders are unimpeded in their ability to exercise preemptive rights: the procedures are workable, and outsiders have adequate capital and sophistication. If outsiders are impeded (for one or more of these reasons), they will not respond to the clearly cheap price by participating pro rata. Thus, a controller seeking to engage in cheap-issuance tunneling against impeded outsiders might use a clearly cheap offer price rather than a price in the zone of uncertainty.

****

In sum, when controllers conduct an issuance for a purpose other than mispriced-issuance tunneling around unimpeded preemptive rights, they may use an offer price that is above or below the zone of uncertainty. But for a controller seeking to engage in mispriced-issuance tunneling around such rights, the sweet spot for the offer price is squarely within the zone.

IV The Proposed Presubscription-Disclosure Rule

This part puts forward a mechanism for reducing a controller's ability to engage in cheap-issuance tunneling which, happily, also reduces her ability to engage in overpriced-issuance tunneling. Section A describes the proposal: a presubscription disclosure rule requiring a CS firm to reveal the controller's subscription commitment before outside investors must decide their own. Section B explains how presubscription disclosure completely protects outsiders from both types of mispriced-issuance tunneling when outsiders learn the controller will refrain. Section C explains how

[62] If outsiders are impeded, and do not participate pro-rata in the clearly cheap issuance, the controller will (in addition to raising capital) reap cheap-issuance tunneling profits.

[63] Rights offers are typically (but not always) priced at a discount to the pre-offer market price, although a decline in the market price during the course of the offer can eliminate the discount. *See, e.g.*, Holderness & Pontiff, *supra* note 26, at 252, 255 (providing data on rights offers in the United States).

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presubscription disclosure will reduce (and in some cases eliminate) both types of mispriced-issuance tunneling when outsiders learn that the controller will subscribe. Section D summarizes.

A The Rule

I propose that, whenever outside investors in a CS firm have preemptive rights, the firm be required – by applicable securities laws, listing rules, or corporate law – to disclose the subscription commitment by the controller (and related parties) before the outsiders' subscription-commitment deadline. Outside investors in CS firms, when deciding whether to buy offered securities, should know what the "smart money" is doing so that they can mimic it.[64] Of course, if outsiders believe that the transaction (and other possible) costs associated with presubscription disclosure outweigh the benefits, they should be free to collectively opt out of the rule.[65]

The presubscription disclosure rule would be enforced by requiring the firm to disclose, after an issuance is completed, the controller's actual subscription. If the controller fails to fulfill her commitment, the issuance would be cancelled and funds would be returned to participating investors.[66] If the controller indicates she is refraining (that is, not subscribing for any securities), but then somehow acquires securities in the issuance, the controller's purchases would be rescinded.

In a listed firm, anti-circumvention measures may be needed, as the controller could seek to "undo" a subscription commitment by sales in the open market (or by entering into hedging transactions). If outsiders believe the controller *might* circumvent in this manner, presubscription disclosure will be a less informative signal about the value of the offered securities. To make presubscription disclosure effective at curbing cheap-

[64] For a similar proposal in the context of RTOs by listed CS firms, *see* Fried, *Insider Signaling*, supra note 49, at 470–73. In a similar vein, I have long argued for an advance disclosure requirement on officers and directors of listed *non-CS* firms with respect to all their transactions in firm shares, including trades in the open market. *See* Jesse M. Fried, *Reducing the Profitability of Corporate Insider Trading Through Pretrading Disclosure*, 71 S. CAL. L. REV. 303, 348–64 (1998).

[65] For example, presubscription disclosure might be a default rule that outsiders could opt out of, on a one-time or permanent basis, through a fully informed and undistorted majority-of-the-minority (MOM) vote.

[66] The PRC uses this approach for certain issuances. *See* Chen & Huang, *supra* note 43, at Section 53.

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issuance tunneling (as well as overpriced-issuance tunneling), regulators must ensure that the controller's disclosed plan – whether it is to subscribe or to refrain – provides an accurate picture of her overall transactions in the firm's securities. For example, regulators could bar controllers from offsetting or hedging transactions for a particular period of time around the issuance.[67]

Presubscription disclosure will substantially reduce a controller's ability to engage in cheap-issuance (as well as overpriced-issuance) tunneling by forcing the controller to indirectly share some of her private information about the securities' value. In some situations, outsiders can simply mimic the controller and avoid expropriation; in other cases, outsiders can use presubscription disclosure to reduce their risk of loss. Below in Section B, I start with the scenario in which outsiders learn that the controller will refrain. I then turn in Section C to the scenario in which outsiders learn that the controller will participate (and learn the details of her subscription commitment).

B Controller-Refrain Scenario

Consider the scenario in which outsiders learn that the controller will refrain from purchasing any securities on offer. There can be no cheap-issuance tunneling in this scenario. Even if the securities are cheap, the controller will not acquire any of them, let alone a disproportionate share. Of course, this felicitous outcome would probably not be *caused* by presubscription disclosure; a controller that refrains under the rule would presumably have refrained in its absence.

However, in the controller-refrain scenario, presubscription disclosure will curb overpriced-issuance tunneling. When outside investors learn that the controller is refraining, they will infer that the securities are not cheap:[68] the controller would not offer cheap securities to others while refraining from purchasing. Rather, investors can surmise that the securities are overpriced.[69] Outsiders will thus mimic

[67] *Cf.* Fried, *Insider Signaling, supra* note 49, at 470–73 (recommending a similar type of anti-circumvention mechanism when proposing that a controller be required to disclose her participation in an RTO).

[68] Again, by "cheap" ("overpriced") I mean that the controller knows that the securities' price is less (greater) than their post-issuance value.

[69] As noted earlier, for simplicity I assume that the offered securities are either cheap or overpriced. In the real world, there may well be offers in which the controller does not know whether the securities' price is below or above post-issuance value. Outsiders learning that the controller is refraining would thus infer that the controller does not

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the controller and also refrain, thereby eliminating the possibility of overpriced-issuance tunneling (as there will be no issuance). The reduction in outside losses from overpriced-issuance tunneling in the controller-refrain scenario would be a collateral benefit of the presubscription disclosure rule – above and beyond its salutary curbing effect on cheap-issuance tunneling in the controller-subscribe scenario, to which I now turn.

C *Controller-Subscribe Scenario*

Now consider the scenario in which outsiders learn that the controller commits to subscribe (and are informed about the details of that commitment). For simplicity, assume that the controller commits to subscribe for her pro rata share of the offered securities and any securities not purchased by outsiders.[70] Unlike in the controller-refrain scenario, cheap-issuance tunneling can occur. And it will occur if the securities are cheap and outsiders fail to participate pro rata.

Outsiders' ability to protect themselves in the controller-subscribe scenario depends on whether they can reliably infer from the controller's subscription commitment that the securities are cheap. I first assume they can draw such an inference, and then consider the situation in which they cannot.

1 When Outsiders Can Reliably Infer the Securities Are Cheap

Suppose outsiders *can* infer from the controller's disclosed commitment that the securities are cheap. When outsiders can infer that the offered securities are cheap, they will participate pro rata and thereby thwart cheap-issuance tunneling. Consider Example 4.5, which starts with the scenario in Example 4.4 but then adds the presubscription-disclosure rule.

know that the securities' price is less than their value, and the controller either knows the securities' price exceeds their value or does not know the relationship between their price and value. Outsiders would thus not know that the securities are overpriced, but rather that the offer price exceeds the *expected value* of the securities.

[70] Presubscription disclosure would reduce mispriced-issuance tunneling regardless of the actual amount of securities the controller commits to purchase, as long as outsiders can mimic the controller's commitment and thereby participate pro rata with the controller.

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EXAMPLE 4.5: Elimination of Mispriced-Issuance Tunneling in a Basic Firm

The setup is the same as in Example 4.4, except ABC now must disclose CS' subscription commitment before Outsider decides. If ABC discloses that CS is seeking to buy one or both of the offered shares, Outsider knows that ABC's value is Hi and Outsider should mimic CS. Outsider participates pro rata with CS in buying underpriced shares, thwarting cheap-issuance tunneling. If ABC announces that CS is not seeking to buy any shares, Outsider again mimics CS and refrains from buying. There is no issuance, and thus no overpriced-issuance tunneling.

2 When Outsiders Cannot Reliably Infer that the Securities Are Cheap

Unfortunately, outsiders cannot always infer from the controller's subscription commitment that the securities are cheap. Below, I explain why outsiders may not be able to draw such an inference and how the ability of presubscription disclosure to thwart cheap-issuance tunneling in this situation is reduced (but not eliminated).

a The Possibility of Issuance-Generated Private Benefits Outsiders cannot infer from the controller's subscription commitment that the securities are cheap when the controller might get nontrivial private benefits from the issuance.[71] For example, the arrival of fresh cash might increase the controller's ability to tunnel value out of the firm through related party transactions (e.g., purchasing assets or securities at inflated prices from the controller).[72] Any such benefits would generate a per-share "rebate" on the price paid for the securities by the controller, reducing the securities' *effective* price (for the controller).[73] In this situation, the controller's participation will fail to clearly signal that the securities are cheap, as the securities could be overpriced but, after the rebate, still *effectively* cheap for the controller. Consider Example 4.6A below.

[71] *See generally* Fried & Spamann, *Cheap-Stock Tunneling, supra* note 7.

[72] In Hong Kong and China, controllers of listed firms often use the proceeds of issuances to engage in related party transactions (RPTs) that appear to involve tunneling. *See* Fong & Lam, *supra* note 56, at 774 (study of CS firms listed in Hong Kong); E. Han Kim et al., *Tunneling Proceeds from Seasoned Equity Offering: The China Experience*, 16–21, Working Paper (2015) (study of CS firms listed in PRC).

[73] *See generally* Fried & Spamann, *Cheap-Stock Tunneling, supra* note 7.

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EXAMPLE 4.6A: Private Benefits and the Signal Sent by Presubscription Disclosure

Unlisted DEF Corporation (DEF) has two shareholders: CS and Outsider. Suppose that DEF offers common shares for $10 apiece to Controller and Outsider pro-rata, and both Outsider and Controller know that $2 of the issuance proceeds will flow exclusively to Controller through post-issuance tunneling.[74] Suppose that, taking into account these transactions, each share's post-issuance value will be $V. For Outsider, the zone of uncertainty is between $5 and $15. That is, Outsider knows that $5 < $V < $15. For Outsider, it costs $10 to acquire a share worth $V. But for CS, post-issuance tunneling creates a $2 rebate on the $10 offer price, lowering its *effective* price to $8. If DEF discloses that CS commits to subscribe, Outsider cannot infer that the stock is cheap (i.e., $10 < $V < $15). All Outsider can infer is that $V exceeds Controller's *effective* price of $8 (i.e., $8 < $V < $15).

b Presubscription Disclosure's Diminished but Continued Ability to Reduce Cheap-Issuance Tunneling When outsiders cannot reliably infer from the controller's subscription commitment that the securities are cheap, presubscription disclosure cannot eliminate cheap-issuance tunneling; outsiders know the securities are effectively cheap for the controller, but may suspect that they are overpriced. As a result, outsiders may refrain from participating. If the securities are in fact cheap, outsiders will then suffer cheap-issuance tunneling. Consider Example 4.6B below.

EXAMPLE 4.6B: The Possibility of Cheap Issuance Tunneling Despite Presubscription Disclosure

Setup is the same as Example 4.6A: Outsider learns that CS commits to subscribe for the $10 shares, and thus that $V exceeds $8 (CS's effective price after the $2 rebate). If Outsider mimics CS and subscribes, and $V happens to be between $8 and $10, Outsider will purchase overpriced shares and suffer a loss. Fearful of such a loss, Outsider might refrain. But if Outsider refrains, and $V exceeds $10, Outsider suffers cheap-issuance tunneling.

Nevertheless, presubscription disclosure should still substantially reduce a controller's ability to engage in cheap-issuance tunneling in the

[74] Obviously, in real-world settings outsiders are unlikely to know the precise amount of the rebate to be received by the controller. Thus, outsiders would need to form an estimate of (or determine the range of plausible values for) the rebate, based on the information available to them.

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controller-subscribe scenario. By revealing that the controller is subscribing rather than refraining, the disclosure informs outsiders that the securities are not so overpriced that, even taking into account any rebate from issuance-generated private benefits, they are effectively overpriced for the controller. Outsiders can thus form a more accurate (and lower) estimate of the expected loss from buying overpriced securities. This, in turn, increases the likelihood of their participation, which would reduce expected losses from cheap-issuance tunneling.[75] Consider Example 4.6C below.

EXAMPLE 4.6C: Presubscription Disclosure's Continuing Ability to Reduce Cheap-Issuance Tunneling

Setup is the same as Example 4.6A and 4.6B, but now consider DEF's $10 share offer under two different regimes: "No-Disclosure" (Outsider does not know CS's subscription commitment in advance) and "Disclosure" (Outsider does know it). As before, the zone of uncertainty for Outsider is between $5 and $15, and Outsider knows that CS will divert $2 of every $10 of issuance proceeds so that CS's effective price is $8.

No-Disclosure Regime: Outsider knows that CS will subscribe if $V exceeds $8 – CS's effective price. But Outsider, when deciding whether to participate, does not know if CS will subscribe or refrain. Because DEF shares could be worth as little as $5, Outsider might be quite reluctant to buy shares. If Outsider refrains, and $V happens to exceed $10, Outsider suffers cheap-issuance tunneling.

Disclosure Regime: Outsider learns whether CS commits to buy shares in the $10 offer before Outsider makes her own decision. If Outsider learns that CS will subscribe, Outsider will know that $V exceeds $8. Thus, the zone of uncertainty will no longer be between $5 and $15, but rather between $8 and $15. The most Outsider can lose from buying a $10 share is now $2 ($10–$8), not $5 ($10–$5). Less fearful of buying overpriced shares than in the No-Disclosure Regime, Outsider is less likely to refrain and thus more likely to avoid cheap-issuance tunneling.

[75] To the extent outsiders are more likely to participate in the controller-subscribe scenario, they are less likely to suffer from cheap-issuance tunneling but *more* likely to lose from buying securities that are overpriced (but effectively cheap for the controller). However, outsiders' expected combined losses from cheap-issuance tunneling and buying overpriced securities will be lower when outsiders have more information about the value of the firm's securities (*see generally* Fried & Spamann, *Cheap-Stock Tunneling, supra* note 7), which presubscription disclosure provides.

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D *Presubscription Disclosure: Summing Up*

Presubscription disclosure forces a controller of a CS firm to indirectly share some of the controller's private information about firm value to outsiders before outsiders must decide whether to exercise preemptive rights in a securities issuance. The rule thus reduces the controller's ability to transfer value from outsiders via cheap-issuance tunneling (as well as via overpriced-issuance tunneling).

If the controller will derive no (or minimal) private benefits from the issuance, presubscription disclosure effectively eliminates the controller's ability to engage in either type of mispriced-issuance tunneling against unimpeded outsiders, who can simply mimic the controller. If these outsiders learn that the controller will refrain, they will refrain too; there will be no issuance (and thus no mispriced-issuance tunneling). If outsiders learn that the controller will subscribe, they can infer that the securities are cheap and will participate pro rata alongside the controller, thereby eliminating the possibility of cheap-issuance tunneling.

If the controller may (or will) derive substantial private benefits from the issuance, presubscription disclosure can reduce, but not eliminate, the controller's ability to engage in mispriced-issuance tunneling. Outsiders can still safely mimic the controller when they learn she will refrain, and thereby avoid any type of mispriced tunneling in the controller-refrain scenario. But it will be less safe to mimic a subscribing controller, as outsiders cannot infer from the controller's participation that the securities are in fact cheap; issuance-generated private benefits might create a rebate for the controller that makes it worthwhile for her to subscribe even if the securities are overpriced. Nevertheless, presubscription disclosure still benefits outsiders in the controller-subscribe scenario by shrinking the zone of uncertainty, increasing the likelihood of outsider participation, and thereby reducing outsiders' expected losses from cheap-issuance tunneling.

My analysis of presubscription disclosure has assumed that outsiders are unimpeded: they do not face any noninformational impediments to exercising preemptive rights. To the extent that some outsiders are impeded, and thus ignore or cannot use the information generated by presubscription disclosure, the rule's effectiveness will be diminished. However, presubscription disclosure is still likely to generate considerable benefits. If a CS firm has any unimpeded outsiders and the controller uses an offer price within the zone of uncertainty, presubscription disclosure will reduce the controller's ability to extract value from *these* investors.

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V Conclusion

Preemptive rights are widely viewed as being effective at preventing a controlling shareholder from engaging in cheap-issuance tunneling. They can indeed prevent such tunneling when outside investors know that the offered securities are cheap. I have explained, however, that when outsiders cannot tell whether the securities are cheap or overpriced, preemptive rights cannot thwart cheap-issuance tunneling. Fearing that the securities are overpriced, outsiders may rationally refrain even when the securities are in fact cheap, and then suffer cheap-issuance tunneling. If outsiders exercise their preemptive rights, and the securities are in fact overpriced, they then suffer from overpriced-issuance tunneling.

I put forward a mechanism to make preemptive rights more effective at reducing cheap-issuance tunneling: requiring disclosure of a controller's subscription commitment before outsiders must decide their own. This presubscription disclosure rule, I have shown, would substantially reduce a controller's ability to engage in cheap-issuance (as well as overpriced-issuance) tunneling. In essence, the rule forces a controller to indirectly share some of her private information about firm value, reducing the amount of information asymmetry that the controller can exploit to divert value from outsiders via issuances. I hope that my analysis and proposal will be useful to regulators, legislatures, courts, practitioners, and researchers seeking to better understand and improve the governance of securities issuances by listed and unlisted firms.

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