Comment: Bubb, Catan & Spamann, Shareholder Rights and the Bargaining Structure in Control Transactions

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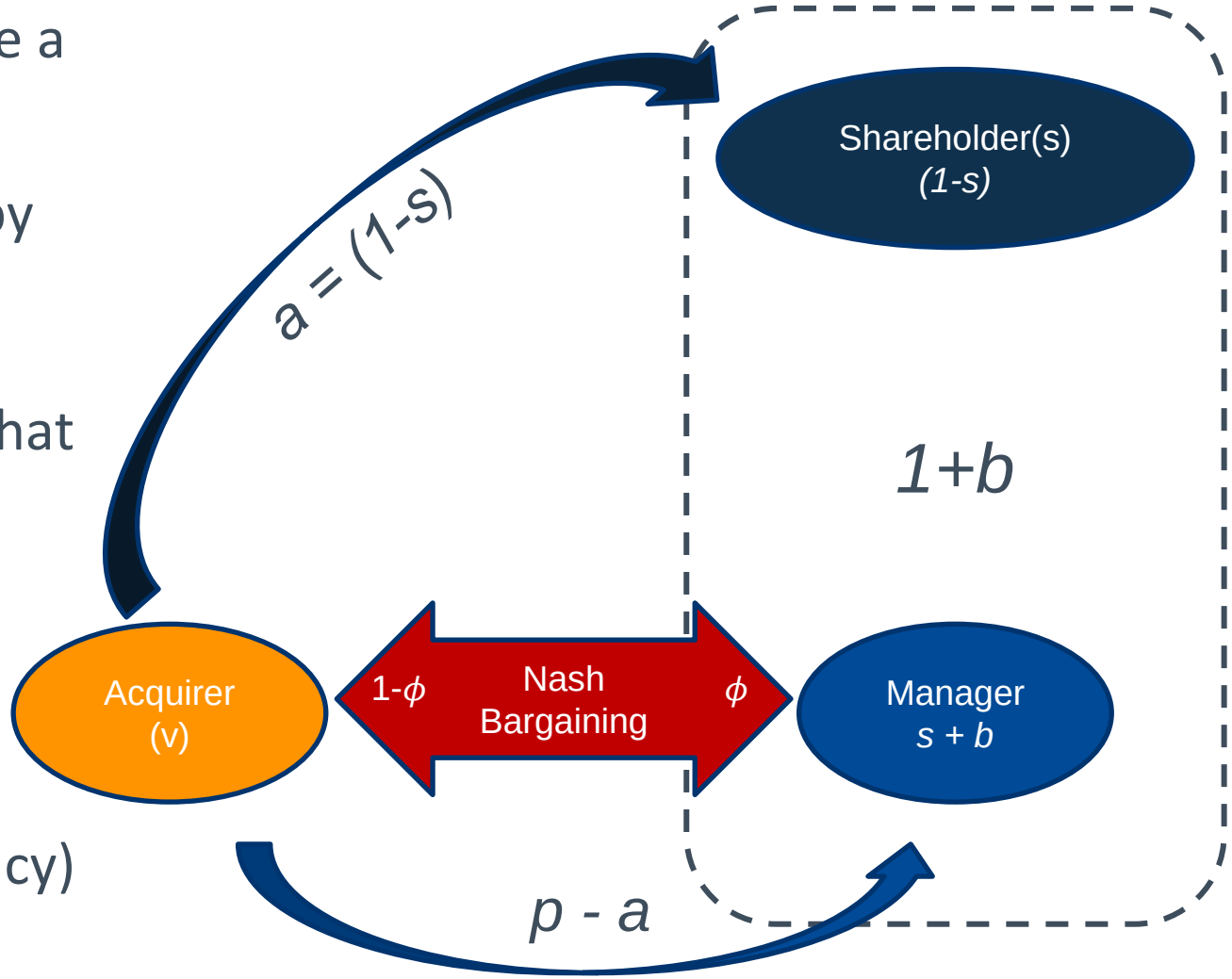
Outline of Comments

- Overview of Paper's Argument
- Three Things I Like
- Some Things that Need Attention
- Clarifications
- Extensions and Generalizations

1. Overview of Paper's Argument

1. Because SHs are dispersed, they don't have a "seat at the table" in M&A bargaining
   - Up/Down vote on any deal presented by Manager. Rationally will approve if offered at least status quo payoff.
2. Manager and Acquirer form a "coalition" that claims & splits the rest of any surplus
3. Result: ex post efficient deals, but may be inefficient ex ante (SH investment)
4. Certain SH protections proxy for SH bargaining power, enhancing ex ante efficiency (sacrificing some ex post efficiency)



2. Three Things I Like (About this Paper)

- Important Topic
  - M&A transactions (and fails) are one of the most celebrated areas of Corporate Law / Law & Finance
- Theory's Return from Exile
  - Too many untethered identification strategies
- Practical Insights
  - Key to understanding the institutions we have / should have is to understand what strategic roles they play

3. Needs some attention
a. Exposition

- At present, the paper is pretty hard to follow. Several contributing factors:
- Preliminary-ness (Preliminarity?) :
  - Many of the analytic arguments still being sorted out
- Audience:
  - Speaks to a narrow stripe of scholars who (a) know the takeover jurisprudence and statutory area pretty well, and (b) are ok at following abstract modeling.
- Narrative Presentation:
  - While model is not terribly complex, it meanders about
    - Lots of variables (by my count 20…see below)
    - Inconsistent framework (E.g., in Section 1 the winning bid p is split $(a, p - a)$ between SHs and Mgr; but in Section 2, the winning bid p is split $p(1 - s)$ and ps)
    - Lots of brief variations of the model (static / dynamic, single-bidder / multi-bidder) that enter briefly and then exit.
    - Not a lot of attention/motivation for info. structure – who knows what, and when?
    - No proofs offered, but some of the results aren't obvious.

Variable	Definiion	Page	Endog/Exog	Observable	Verifiable
s	Fraction of shares owned by mgr	4	Unclear	✓	✓
b	Mgr's private benefits under status quo	4	Exogenous?	✓	✓
1 (normalized)	Total value of firm under status quo (not including private benefits)	4	Exogenous?	✓	✓
v	Bidder's valuation	4	Exogenous	✓	✓
ϕ	Manager's bargaining power relative to bidder	5	Unclear	✓	✓
p	Total price paid by winning bidder	5	Endogenous ?	✓	✓
a	Payoff promised to SHs from deal	5	Endogenous ?	✓	✓
1	Manager's bargaining power relative to SHs (TIOLI)	5 (or 6)	Unclear	✓	✓
1	Number of distinct SHs	4	Unclear	✓	✓
δ	SH's discount factor (in short dynamic version)	7	Exogenous	✓	✓
M_t	Max continuation payoff of SH (in short dynamic version)	7	Endogenous ?	✓	✓
$v_1<v_2<\ldots<v_N$	Multiple bidders' ordered valuations	7	Exogenous	✓	✓
n	Fixed ex ante investment of SHs	8	Exogenous	✓	✓
F(n)	Ex ante distribution on n	8	Exogenous	✓	✓
G(v)	Distribution of single outside bidder's valuation SH invests	9	Exogenous	✓	✓
β	Unobservable private benefit fraction of price p	13	Endogenous ?	✗	✗
Δ	Manager's outside option to selling (status quo?)	13	Endogenous	?	?
O	Bidder's outside ption to buying	13	Endogenous	?	?
L	SH's Equilibrium payoff from squeeze-out	19	Endogenous	?	?
$\bar{\beta}$	Highest plausible value of b	14	Unclear	?	?

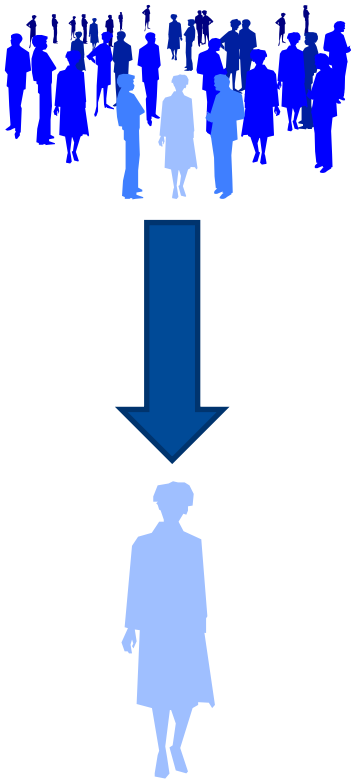
My Running Variable List (20 pages; 20 variables)

3. Needs some attention
b. Models and Assumptions

- Models are deliberate abstractions from the world
  - That's a good thing: By assuming away / simplifying orthogonal, noisy, or distracting factors they can reveal intuitions about the phenomenon being studied.
- That said, there are assumptions and there are *assumptions.* A reasonable organizational trope here is differentiating between critical and simplifying assumptions
  - Critical Assumptions: Those that are either central to the targeted phenomenon or inextricably intertwined with it
  - Simplifying Assumptions: Those that are peripheral to the targeted phenomenon and merely add complexity or noise.
- I'll single out two important ones here:
  i. "Representative Shareholder" framework
  ii. Legal limitations of "unobserved" managerial side payments

3b(i) "Representative Shareholder" framework

- The paper flags dispersed ownership as its centerpiece motivation:
  - "Our focus is on the case of dispersed shareholders…" (Abstract)
  - "A key theme of our analysis is that the inability of dispersed shareholders to make counter-offers…" (p.2)
  - "Our analysis in this section introduces a basic economic problem that motivates the rest of our analysis: dispersed shareholders' inability to make counter-offers…" (p.3)
  - "We are interested in the case in which the public shareholders are dispersed…" (p.4)
  - Similarly, see pp. 5, 7, 10, 18
- But then follows with:
  - "[T]o simplify *we model this with a representative Shareholder* and capture collective action problems in reduced form by assuming restrictions on what the Shareholder can do…" (p.4)
  - I disagree (I think): the model actually seems to assume a single shareholder, not a representative one



Is this a Simplifying or Critical assumption?

- Seems critical to me 🤔, which in turn raises several issues:
- Direct tension with assertion that SHs can't bargain:
  - Single SH ⇔ Low Transaction Costs ⇔ Ability for SHs/Mgr/Bidder to strike bargains
  - Dealing with this requires adding another assumption (no SH bargaining allowed)
- Excludes other theoretical/doctrinal implications of SH dispersion
  - Collective Action:
    - Even SHs with identical preferences (the true "representative SH" case) need not generate rational vote outcomes.
    - Easy to generate voting equilibria where (e.g.) SHs vote unanimously to reject any deal that pays them less than a*
  - Preference Heterogeneity
    - SHs may disagree about relative merits of status quo / competing offer (tax, ESG, risk, etc.)
    - SH Governance as a form of Preference Aggregation
  - Undercuts analysis of cleansing (MFW; Corwin):
    - Key requirement that SH vote must be non-coerced

3b(ii) "Unobserved" Managerial Side Payments

- Sections 2.2-2.4 assume winning bidder can make a side payment of β to the manager that is "unobservable to courts"
  - Many real world examples (post-closing consultation agreements)
- Yet paper also assumes that courts will step in and stop a deal on Fiduciary Duty grounds if SHs receive less than $(1-s)(1-\beta)p$
  - Argue for an "optimal" level of permissible side payments.
- Not clear to me how this works. If β is unobservable to courts, how do they go about implementing an optimal value for β (or any value, for that matter). Section 2.4 doesn't help much here.

3. Clarification Wishlist

- It's not clear what managers "do" in this model
  - Are they indispensable to operation? If so, then is their reservation payoff = b? And is that available to them after sale?
  - Alternatively, does manager expend effort to promote / grow company and attract suitors?
  - What are the managerial participation and incentive compatibility constraints
- What's first best and/or optimal managerial contract?
  - The model does not characterize either; doing so would provide a helpful benchmark
- Competing-bidder analysis: Price = $v_2 + \phi(v_1 - v_2)$
  - The idea here (I think) is Nash bargaining with highest valuer v_1 s.t. seller's outside option to auction to buyers $v_2 \ldots v_N$ (cf Binmore, Rubenstein & Wolinsky 1986)
  - But shouldn't *that* continuation game yield v_3?
  - If so, is it turtles all the way down: Working through this logic would yield a price paid by highest bidder of $v_N + \phi(v_1 - v_N) \gtrless v_2$

4. Extensions and Generalizations

- Appraisal: Paper adopts a mechanical appraisal right at *(1-s)p.* But one can easily show *in this model* there exist appraisal right values exceeding *(1-s)p* that better balance ex ante and ex post concerns
  - See Choi & Talley (2018)
- Private Costs of Control: Assumes that Mgr incurs private benefits (b>0), but another form of agency cost involves managers too eager to sell (b<0)
  - E.g., *Smith v. Van Gorkom; In Re. MindBody*
- Information Structure: Paper makes a seemingly strong assumption that all bidders in auction have commonly-known valuations, while conceding (p 16) that private valuations make more sense. Why not simply model as an IPV and/or CV auction?
  - Cf Choi & Talley (2018)
- Nash Core: Might be interesting to model the sale against an n-person bargaining model benchmark.
  - E.g, Okada (2007; 2011); Compte & Jeheil (2010)

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