Shareholder Rights and the Bargaining Structure in Control Transactions

Ryan Bubb, Emiliano Catan & Holger Spamann

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Question: What are SH's two types of rights for?

1. **Statutory rights** to:
   1.1 a SH "vote" (incl. tender); and
   1.2 appraisal.
2. **Fiduciary duties**: Judicially created rights to loyal conduct by management, enforced by SH suits (entire fairness).

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To avoid litigation, Del. courts curtail 2 in reliance on 1 (*MFW; Corwin; Glassman*).

→ Good idea? What does 2 do that 1 does not?

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3. Fiduciary duties potentially fix this. But:
   3.1 "No interference" doesn't help w/ single bidder: TIOLIO
   3.2 Anti-self-dealing & *Revlon* also induce entrenchment
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What this paper is not about

1. Mechanism design / contract theory: we take basic institutions menu as given
2. Bilateral bargaining b/w target and acquiror
3. Worse SH collective action problems (esp. two-tiered front-loaded bids)
4. "What courts really do"

Dispersed shareholders' key bargaining problem: inability to make counteroffers

Dispersed shareholders cannot make counteroffers

Mechanical consequence of SH dispersion: SH can't speak

- which SH would?
- why would that SH incur the cost?
- (some caveats two slides on)

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  - finite: backwards induction
  - infinite: Let $S_t \equiv \sup_{SPNE_t} \{SHsurplus\}$, and assume future payoffs discounted by $\delta \in (0, 1)$. Then we must have
    - $S_{t-1} = \delta S_t$: In eq'n at $t - 1$, SH must rationally accept δS_t, and thus M rationally mustn't offer more.
    - $S_{t-1} = S_t \equiv S$ because the game is stationary.
    - $S = \delta S \Rightarrow S = 0$.

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- Central bargaining agent → Principal-agent problem!
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Statutory Rights and Their Shortcomings

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- Vote: same result (see previous section)
- NB: bidder competition irrelevant bc poison pill
  - poison pill gives M control which deals to propose to SH
  - $\rightarrow$ M negotiates with bidders incl. side payments, takes package to SH

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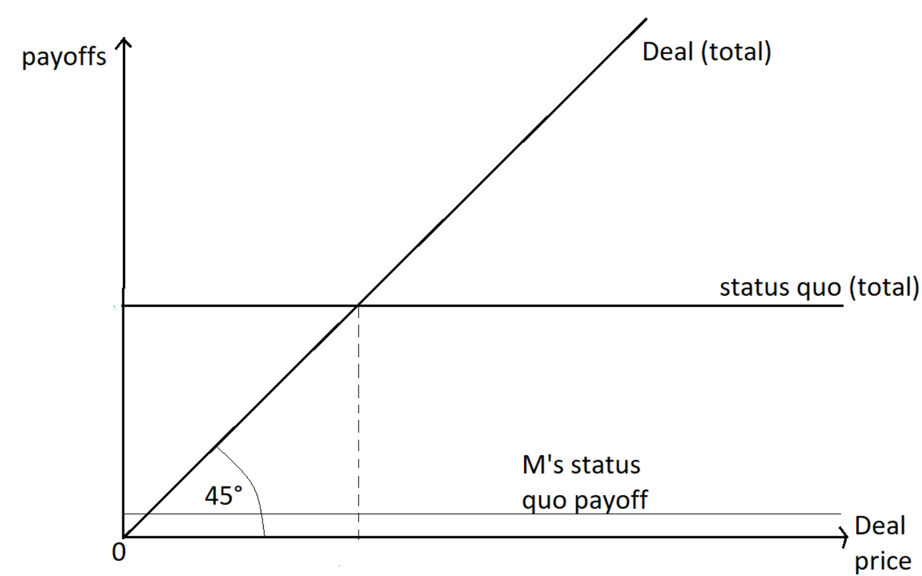
✘ **Ex ante investment**: inefficient

- intuition: less pledgeable investment returns
- trade-off: ex ante investment effect of pledging some deal surplus outweighs marginal ex post inefficiency

Graph: Payoffs over Deal Price



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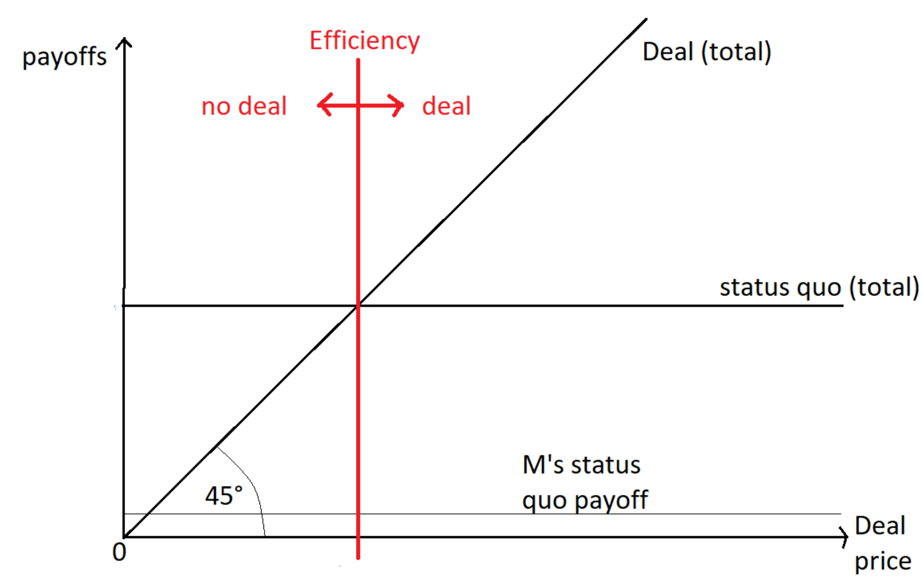
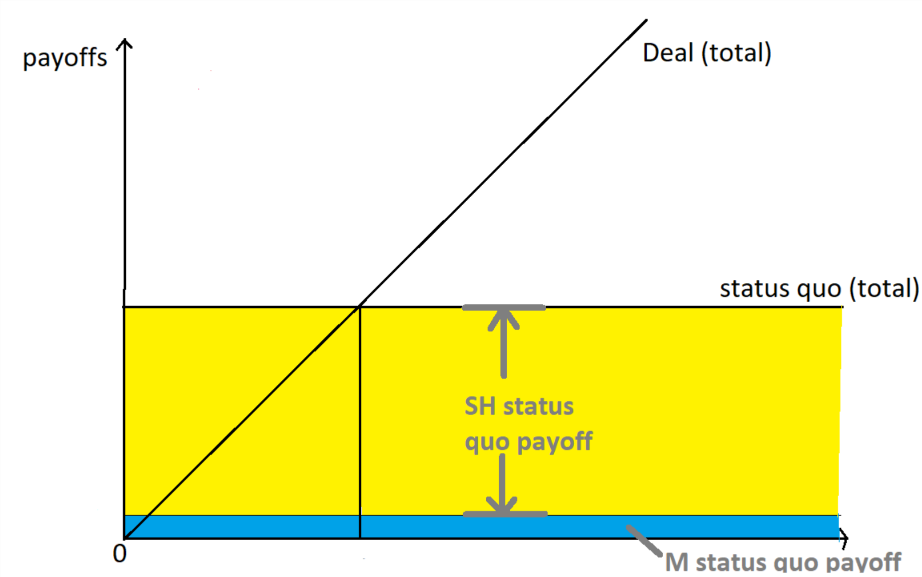
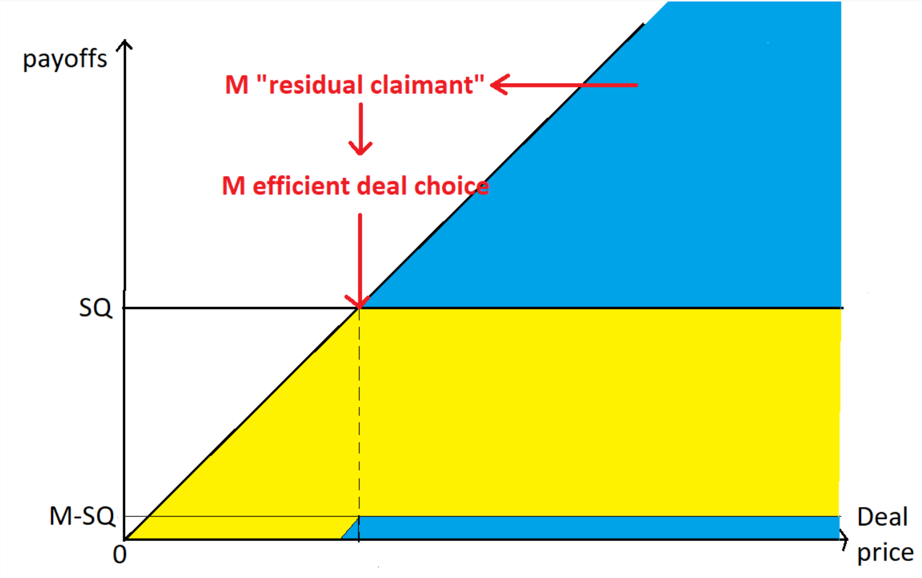


Graph: Status Quo Payoffs



Graph: Manager's Deal Choice under Appraisal or Vote



Fiduciary Duties

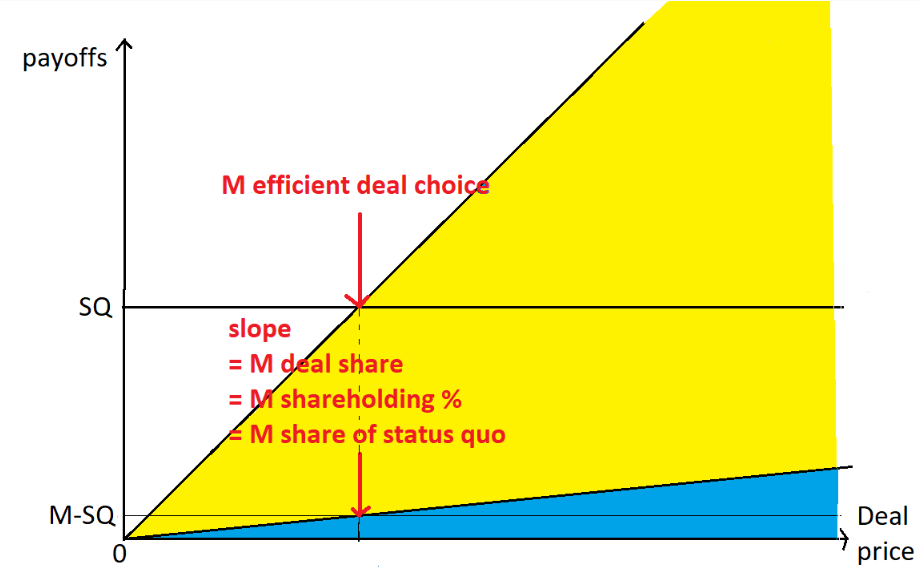
Non-Interference

- Idea: remove M's blocking power – let bidders go directly to SH
- Multiple bidders: competition gives *some* surplus to SH
- Single bidder (incl squeezeout): still no SH surplus – same as before!

Anti-Self-Dealing: The Ideal Case

- Anti-Self-Dealing = M can't take more than proportional share in deal
- If perfectly enforced, gets constrained first best:
  - M will choose deal only if total deal price > status quo firm value
  - M will exert equal marginal effort to improve either one
    - M effort reduction from sharing requirement (agency problem) equalized across two: optimal with symmetric convex effort cost
  - SH gets higher return → more projects financed ex ante

Graph: Manager's Deal Choice under Ideal Anti-Selfdealing



Anti-Self-Dealing: The Realistic Case

- M likely has **private benefits** in status quo and/or deal
  - status quo: perks, power, tunneling
  - deal: side payments (e.g., MBO participation), retirement, liquidity
- **Implication**: M's actual share $\neq$ nominal share.
  - Courts enforce equality of *nominal* shares
- **Effect** of M private benefits in
  - status quo: actual share higher in status quo $\rightarrow$ entrenchment
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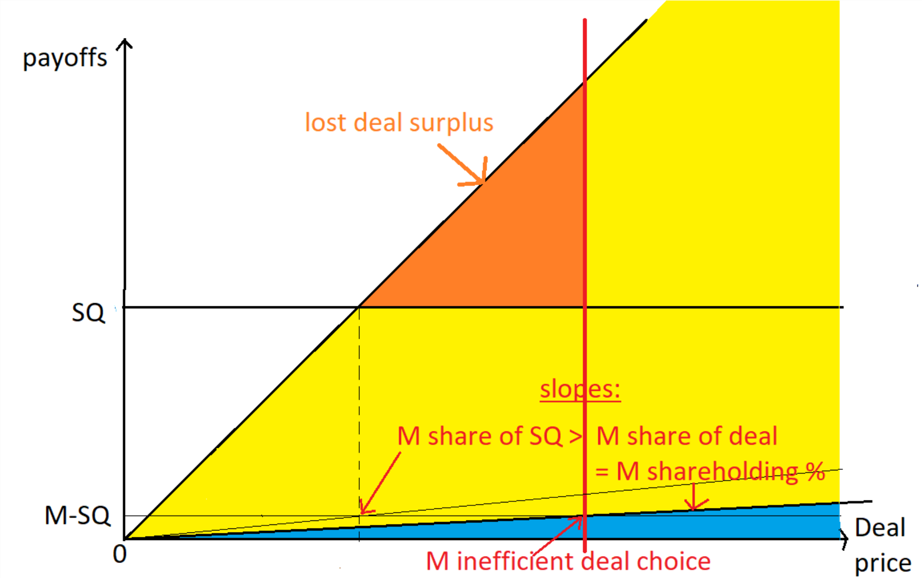

Anti-Self-Dealing: The Revlon Tweak

- *Revlon*: IF M sells, has to sell to highest bid to all SH
  - M can't prefer a bid that pays higher side payment to M but less to SH
- Consequence:
  - more entrenchment
  - but better selection of high bids (ex post efficiency; surplus sharing)

Re-Emergence of the Problem: "Cleansing"

- So far, we assumed fiduciary duties are enforced (esp by post-deal damages)
- However, in last decade, Del. courts have cut off fiduciary duty suits if SH vote approved deal
  - *Corwin*, *MFW*
- This gives SH choice of (no deal) or (this deal, no fiduciary duty remedies)
  - SH will accept if this deal better than no deal $\rightarrow$ knowing this, M will give SH zero deal surplus!

Re-Emergence of the Problem, cont'd: Injunction

- If fid. duties enforceable only by injunction by SH, same problem as "cleansing" vote
  - Intuition I: Injunction is strictly less than the vote: can only enjoin some deals
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- By contrast, a **plaintiff attorney (PA) will sue if and because PA doesn't care about deal per se**:
  - cares only about winning ($\rightarrow$fee award)
    - will win any time fiduciary duties not complied with
    - ex ante, this induces M to comply with fid. duties!

Re-Emergence of the Problem IIa: MFW

- *MFW* states that fiduciary duty remedies cut off if controlling shareholder (CS) commits (!) to submit squeezeout to SH vote
- This gives CS commitment power not to do a deal *at all* $\rightarrow$ SH BATNA is status quo even if unilateral squeezeout were better for SH
    - Without *MFW*, CS "threat" of no deal would not be credible: CS could do squeezeout unilaterally, then SH could sue for surplus owed under fiduciary duties!

Conclusion

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- Rules to protect SH in control transactions face tradeoff between ex post (allocation) and ex ante (investment) efficiency
- Bargaining structure puts SH at distinct disadvantage: receive TIOLIO $\rightarrow$ only fiduciary duties, enforced through monetary damages or PA, can generate deal surplus for SH
- In bargaining dynamic, rules can have counterintuitive effects
    - examples of misaligned PA (good), *MFW* restriction of M action (bad)