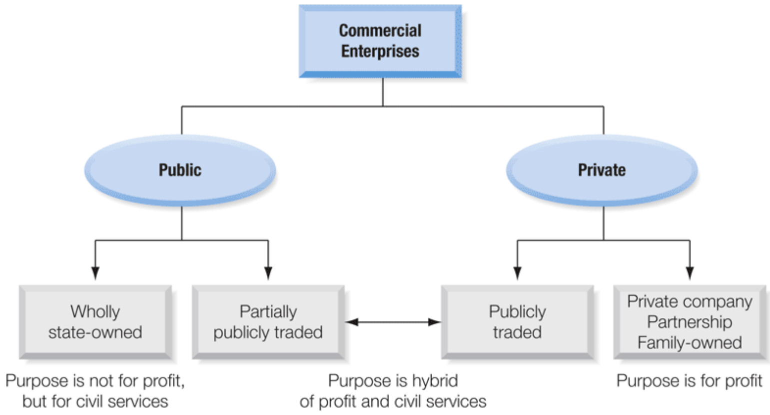
Law and Finance

Moqi Groen-Xu

Outline

1. **Ownership**
2. Governance
3. Law

A Taxonomy of Commercial Enterprises



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Recall: "agency problems"

- The problem of a widely held corporation
  - Managers are hired by owners to manage the business
  - Problem: align their interest
  - What are potential conflicts of interests?
- The problem of a closely held corporation
  - Do all owners have the same rights?

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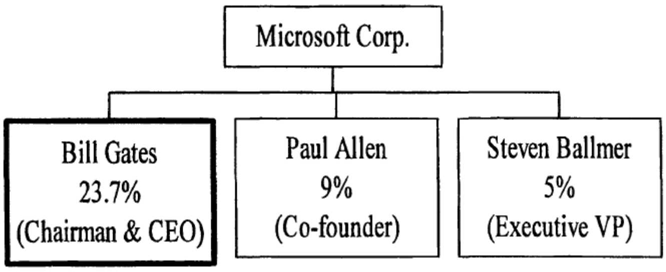
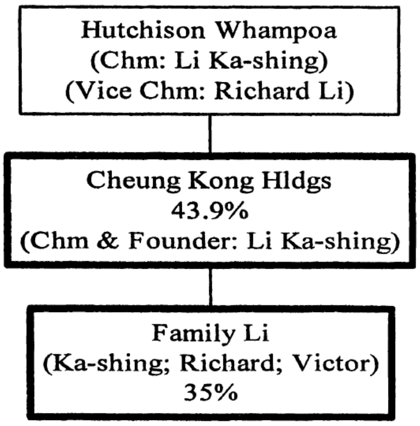
4

Ownership structure around the world

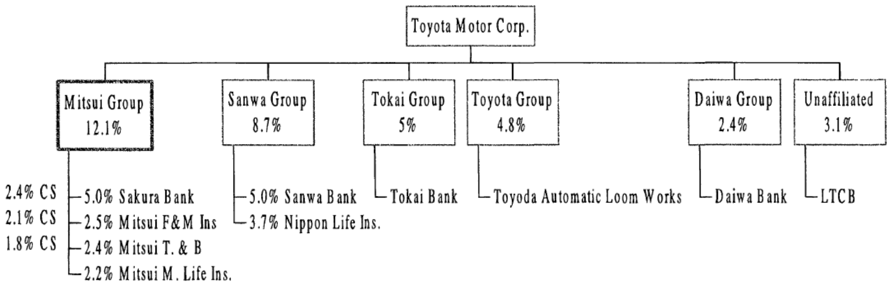


Source: LaPorta, Lopez-de-Silanes, Shleifer: Corporate Ownership around the world. Journal of Finance 54, 1999

Majority owners



Several blockholders



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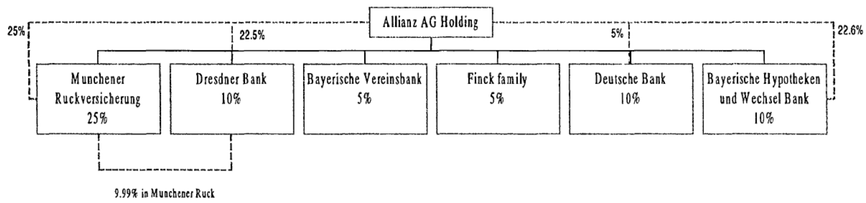
Mutual holdings



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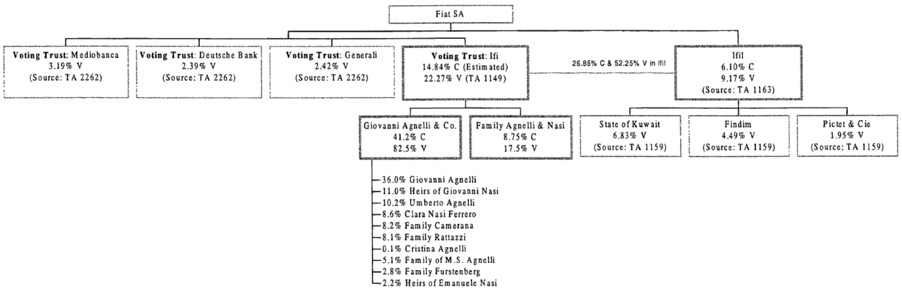
Ownership and voting rights



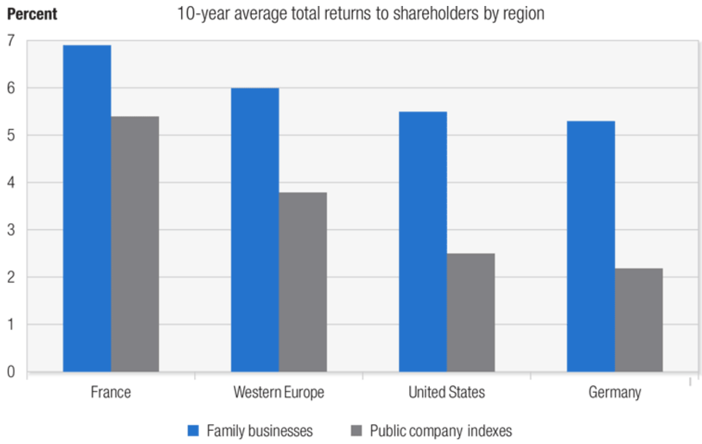
Ownership concentration around the world

Country	Widely Held	Family	State	Widely Held Financial	Widely Held Corporation	Miscellaneous
Argentina	0.00	0.65	0.15	0.05	0.15	0.00
Australia	0.65	0.05	0.05	0.00	0.25	0.00
Canada	0.60	0.25	0.00	0.00	0.15	0.00
Hong Kong	0.10	0.70	0.05	0.05	0.00	0.10
Ireland	0.65	0.10	0.00	0.00	0.10	0.15
Japan	0.90	0.05	0.05	0.00	0.00	0.00
New Zealand	0.30	0.25	0.25	0.00	0.20	0.00
Norway	0.25	0.25	0.35	0.05	0.00	0.10
Singapore	0.15	0.30	0.45	0.05	0.05	0.00
Spain	0.35	0.15	0.30	0.10	0.10	0.00
U.K.	1.00	0.00	0.00	0.00	0.00	0.00
United States	0.80	0.20	0.00	0.00	0.00	0.00

Family ownership around the world

Country	Family	%Mkt Fam	Firms/Avg Fam	Management	Pyramids
Argentina	0.65	0.5258	1.18	0.62	0.00
Australia	0.05	0.1218	1.00	1.00	0.00
Canada	0.25	0.2770	1.25	1.00	0.20
Hong Kong	0.70	0.6342	1.56	0.86	0.50
Ireland	0.10	0.0417	2.00	1.00	0.00
Japan	0.05	0.0287	1.00	1.00	0.00
New Zealand	0.25	0.1511	1.00	0.60	0.40
Norway	0.25	0.1327	1.00	0.80	0.00
Singapore	0.30	0.1514	1.20	0.67	0.67
Spain	0.15	0.1697	1.50	0.67	0.33
U.K.	0.00	0.0000	.	.	.
United States	0.20	0.1827	1.00	0.75	0.00

Performance of Family Firms



Source: Author presentation based on data presented in "The Five Attributes of Enduring Family Businesses," Christian Caspar, Ana Karina Dias, and Heinz-Peter Elstrodt, *McKinsey Quarterly*, January 2010, p. 7.
Index of public companies by region: France, SBF120; Western Europe, MSCI Europe; United States, S&P500; Germany, HDAX.

Outline

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Governance

- **Shareholder rights.** Shareholders are the owners of the firm, and their interests should take precedence over other stakeholders.
- **Board responsibilities.** The board of the company is recognized as the individual entity with final full legal responsibility for the firm, including proper oversight of management.
- **Equitable treatment of shareholders.** Equitable treatment is specifically targeted toward domestic versus foreign residents as shareholders, as well as majority and minority interests.

Corporate Governance cont.

- **Stakeholder rights.** Governance practices should formally acknowledge the interests of other stakeholders—employees, creditors, community, and government.
- **Transparency and disclosure.** Public and equitable reporting of firm operating and financial results and parameters should be done in a timely manner, and available to all interests equitably.

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Potential Responses to Shareholder Dissatisfaction

What counts is that the management of a publicly quoted company, and its board of directors, know that the company can become the subject of a hostile takeover bid if they fail to perform. The growth of equity and hedge funds in the United States and elsewhere in recent years has strengthened this threat as leveraged buyouts are once again common.

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United States

- Board
  - Affinity for outside directors; does not mirror commercial or financial relationships
  - Directors are accountable to shareholders, under threat of litigation
- Ownership
  - Institutional owners dominate the market and trading
  - Tax and legal rules favor dispersed ownership → institutional owners rarely represented on board
- Increasing shareholder activism (say on pay)
- Proxy fights
- The market for corporate control

Japan

- Keiretsu: affiliation of related companies
  - General tendency to engage in tight, long-term commercial relationships
  - Largest firms tend to operate in networks
- Board
  - Outside directors are rare: most directors are in management or have commercial relationships to the firm
- Ownership
  - Reciprocal ownership
  - Banks are active in governance

Germany

- Two-tiered Board
  - Management = “Vorstand”
  - Supervisory board = “Aufsichtsrat”: membership mirrors stakeholders
- Ownership
  - Banks and insurance firms used to own large stakes in most of the largest firms, gradually selling them off
  - Family firms dominate the mid-tier sized firms
- Market for corporate control
  - Hostile takeovers were unheard of in the 90s and more and more common now

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Introduction

- Classical Finance Theory
  - perfect systems of contract enforcement

- Reality
  - imperfect enforcement of contracts. In enforcement dependent on legal system.

Legal system differences

- Consequences of legal system differences:
  - First-order effects: differences in transactions costs associated with legal system
  - Second-order effects: differences in the behavior of corporate insiders
  - Third-order effects: differences in the ability of firms to attract outside capital at affordable rates.
  - Fourth-order effects: development of secondary markets for securities, role of family businesses.

Classical Finance Theory

- Legal system perfectly enforces all contracts dividing cash flows between claimants.
- All operating decisions that effect claim value can be costlessly contracted at the time claims are issued.
- Financial markets are competitive: investors will never be forced to pay more for a claim than what the claim is worth.

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Real financial markets

- Shareholder rights
  + proxy voting/vote by mail?
  + preemptive rights?
  + call an extraordinary meeting?
  + Shares "blocked" before meeting?
  + Minority shareholders can sue for "oppression" in court?

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Real Financial Markets

- Creditor rights:
  + trustee or old management runs firm in bankruptcy?
  + Can creditors block reorganization petition?
  + Who has first claim on bankrupt firm: state, workers, or creditors?
- Efficiency of enforcement
  + Rule of law
  + Corruption
  + Efficiency of judicial system

What accounts for the differences?

- Legal Traditions
  - Common Law (British Company Act)
    + Examples: India, U. S., Israel, New Zealand
  - Civil Law
    + French Civil Law (Napoleonic Code, 1804)
      - Examples: Portugal, Mexico …
    + German Civil Law (Bismarck's code of 1896)
      - Examples: Germany, Japan, Austria, Korea
    + Scandinavian Civil Law
      - Examples: Finland, Sweden.

Why these effects?

- La Porta (et al.) argue that the difference between French Civil Law and Common Law countries originates from superior efficiency of common law dispute resolution.
  - RDR (regulation of dispute resolution)
    - + La Porta (et al.) show that common law countries use much less formal and cumbersome procedures for dispute resolution.
- Low RDR leads to much more efficient dispute resolution. Controlling for RDR, almost all other common/civil law differences lose economic significance.

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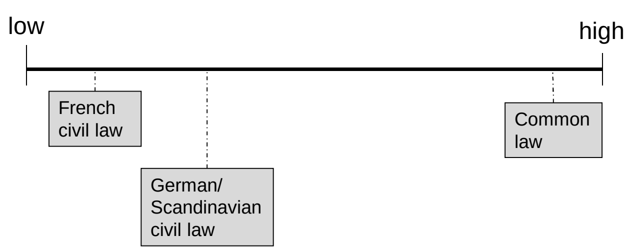
Differences in Legal Systems

Protection of shareholder rights



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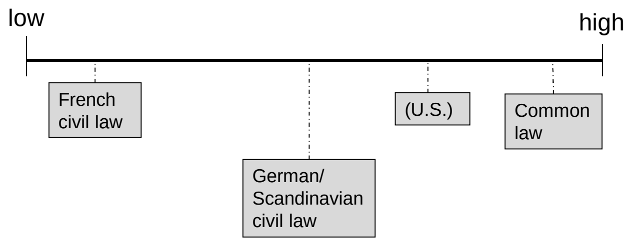
Differences in Legal Systems

Protection of creditor rights



Consequences of System Differences

- First order effects:
  - direct costs of the legal system vary across systems
    - + Lower enforcement costs reduce transactions costs of economic activity.
- Second-order effects:
  - Corporate insiders will consider protection of minority shareholders and creditors when they
    - + determine dividend policy
    - + deal with other insider-controlled companies
    - + Determine CEO/insider compensation
  - Weak protection will lower the value of outsiders' holdings.

Second Order Effects

- Second order effects (cont.)
  - The protection of creditor rights will affect the willingness of insiders to
    + petition the courts for reorganizations
    + honor debt covenants
    + convey assets through dividend payments, self-dealing
    + increase risk of operations to lower debt value.
  - Weak protections will lower the value of debt contracts held by outsiders.

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Third-order effects

- Third-order effects:
  - If protection of outside shareholders is weak:
    + Issuing outside equity will become more difficult and costly
  - If creditor protection is weak
    + Issuing outside debt will become more difficult.

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Fourth-order effects

- Fourth-order effects
  - If outside equity financing is difficult/expensive, firms will issue little outside equity. Therefore:
    - + Secondary markets for equity will not develop
    - + Financing from family members will become more important.
  - If outside debt financing is expensive
    - + Secondary debt markets will not develop
    - + Corporations will attempt to rely on debt financing adjudicated by foreign legal systems.

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