Available online at www.sciencedirect.com
SCIENCE DIRECT
ELSEVIER
Journal of Corporate Finance 10 (2004) 639–658
Journal of CORPORATE FINANCE
www.elsevier.com/locate/econbase

An analysis of a strategy for management to separate and reward supportive shareholders

James S. Ang[a,*], Elli Kraizberg[b]

[a] *Department of Finance, College of Business, Florida State University, Tallahassee, FL 32306, USA*
[b] *School of Business, Bar Ilan University, Ramat Gan 52900, Israel*

Received 29 September 2002; received in revised form 1 November 2002; accepted 16 December 2002

Available online 23 March 2003

Abstract

Managers prefer investors who share similar expectations of their firms' prospects. Instead of taking the distribution of investor types as given, we investigate the question of how the managers may be able to effect a change in the pattern of ownership in a world where outside shareholders hold heterogeneous expectations. Under the requirements that the mechanism is costless to the firm and involves no initial cash transfer among the shareholders, the solution is a menu of securities in the form of sidebets among the shareholders. Ex post, the mechanism allows the high-valuation investors to own a greater proportion of the firm and be rewarded with a greater share of the firm's wealth gains.

JEL classification: G32; D82; C79
Keywords: Heterogeneous expectations; Sidebets games; Agents to choose principal; Wealth transfer; Sorting shareholders

1. Introduction

This paper is an exploratory study of a new class of issues in corporate finance strategies. Rather than accepting the conventional view in economics and finance that the manager is an agent hired by the shareholders, we raise the issue of how the manager–agent can choose owners–principals.[1] We analyze, in a world of managers with superior

* Corresponding author. Tel.: +1-850-644-8202; fax: +1-850-644-4225.
E-mail address: jang@garnet.acns.fsu.edu (J.S. Ang).

[1] In recent years, managers pay more attention to the composition of their firms' investors, and a new industry has evolved where investor consultants can identify and help secure the desired investor clientele for their firms.

0929-1199/$ - see front matter
doi:10.1016/S0929-1199(03)00028-2

information and investors with heterogeneous expectations, a mechanism design that can help managers increase the percentage ownership of shareholders who hold high valuation of their firms.[2]

The topic is significant for several reasons. First, having the ability to concentrate a more homogeneous group of shareholders would give the manager greater unanimity to support the pursuance of value maximizing investments at a later date. Without the support (or confidence) of her shareholders, even a properly motivated manager with performance-based compensation plans may not be able to carry out her program of value-enhancing investments. The manager's investment decisions may have to be biased toward quick payoffs to impress investors of her ability in order to hold on to her job. Second, if a manager could change the composition of the shareholders to those that hold more favorable expectations of the firm's prospects, she would also change the shareholders' perception of her ability and effort. These shareholders are also the class of investors who are more likely to increase the manager's compensation package and other employment-related implicit contracts. Third, in the presence of asymmetric information, investors may conjecture that when the manager makes such an offer, it conveys favorable information. A shift to having more shares in the hands of the high-valuation shareholders, current or just converted, may accompany an increase in share price. Thus, such a mechanism may produce a costless credible signal as a by-product.[3] Fourth, a scheme that transfers shares from low- to high-valuation shareholders may provide a means for firms in the United States to attract a group of supportive, stable shareholders who hold the stock for extended periods of time. Fifth, and possibly the most significant though controversial implication, is that a share-transferring mechanism that increases the ex post value of the high-valuation shareholders' holdings would also transfer wealth to the high-valuation shareholders from the low-valuation shareholders. Thus, it may be considered as a means management can employ to reward supporters of their business strategies.

We introduce the notion of the 'side-bet' game as a mechanism design. We model a scenario in which there exists both asymmetric information between the firms and the investors, and heterogeneous expectations among the investors. Here, the management can make use of the existence of heterogeneous expectations among the investors to induce investors to make a side bet among themselves.

Firms are known to have sponsored side bets among their investors: pitting high-valuation investors against lower-valuation investors. For example, in 1988, Avon[4] offered all its investors two options: one group, presumably the low-valuation investors, was given the option to accept the newly issued preferred equity-redemption cumulative

[2] There may be other reasons for different valuations of the shares placed by different investors, due to their differences in risk aversion, the value of liquidity, and tax bases. Nevertheless, these differences should be reflected in their valuations of shares, and it is the difference in their valuations that is the basis of our analysis in this paper.

[3] Costless signaling models due to Bhattacharya (1980), Heinkel (1982), Brennan and Klaus (1984) and Franke (1987) exist, but have rather restrictive conditions or applicability.

[4] A detailed description of the Avon case can be found in Mason et al. (1995).