Journal of Corporate Finance 18 (2012) 904–918

Contents lists available at ScienceDirect

Journal of Corporate Finance

journal homepage: www.elsevier.com/locate/jcorpfin

Private contracting and corporate governance: Evidence from the provision of tag-along rights in Brazil

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ARTICLE INFO

Article history:
Received 14 September 2010
Received in revised form 10 March 2011
Accepted 16 March 2011
Available online 8 April 2011

JEL classification:
G32
G34
G38

Keywords:
Private contracting
Corporate governance
Brazil
Emerging markets

ABSTRACT

We identify two opposing effects of issuing equity with tag-along rights that secure an equal price in the event of a takeover. First, the anti-self dealing effect commits controlling owners to sell only to new owners that increase shareholder value. Second, the rent transfer effect shifts rents to existing unprotected minority owners. The institutional setting in Brazil's stock market allows us to test this trade-off. We find that announcements of tag-along rights are associated with an average cumulative abnormal return of around 5%, and that the probability of issuing shares with tag-along rights increases with the cost of self-dealing and decreases in the share of existing unprotected minority investors. Overall, our analysis confirms that private contracting can mitigate the economic costs associated with the inadequate legal protection of investors in emerging markets.

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1. Introduction

Investor protection is a key to continued financial development and economic growth in South America and other emerging markets (Beck et al., 2000; King and Levine, 1993; La Porta et al., 1997, 1998; Mahoney, 2001). Prior literature demonstrates that investor protection on the country level is shaped by institutions, such as legal origin and colonization. However, little is known about the efficiency of private contracting in mitigating firm-level distortions arising from inadequate protection of minority investors. In this study, we analyze controlling owners' incentives to voluntarily give up the right to future expropriation of minority owners by focusing on why firms issue shares with tag-along rights. A tag-along right is the private contracting equivalent to an equal (or fair) price provision, which is absent in the takeover legislation of many emerging countries (Nenova, 2006).[1]

We theoretically identify two opposing effects of issuing shares with tag-along rights. First, the controlling owner's benefit arises from the *anti-self dealing* effect. In the absence of tag-along rights, a bidder who creates less shareholder value may offer a premium to the controlling owner in order to expropriate minority owners. The threat of such future expropriation reduces the current security price and, therefore, lowers the revenue from equity issues against the interests of the controlling owner. Thus,

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[1] Countries without equal or fair-price provisions include: Armenia, Azerbaijan, Brazil, Chile, Columbia, Ecuador, Egypt, Ghana, Jordan, Kenya, Kuwait, Nigeria, Pakistan, Romania, Spain, Uruguay and Venezuela.

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doi:10.1016/j.jcorpfin.2011.03.007

tag-along rights benefit the controlling owner by being a commitment device to avoid future self dealing. Second, the controlling owner's cost is captured by the *rent transfer* effect. Tag-along rights transfer rents from the controlling owner to existing – and otherwise unprotected – minority owners.

The institutional setting in Brazil's stock market allows us to test the implications of our theoretical analysis using data from equity offerings. We find that announcements of tag-along rights give rise to a positive abnormal return of approximately 5%. The value of tag-along rights in the event of a takeover is significantly higher because the announcement return equals the product of the probability of a takeover attempt and the expected takeover premium.

We also provide evidence of the theoretical trade-off. Tag-along rights are beneficial when the anti-self dealing effect dominates the rent transfer effect. This occurs when the group of existing minority owners is small relative to the size of the equity issue. Consistently, we find that companies that issue shares with tag-along rights have smaller groups of existing minority owners, offer larger claims and are more likely to issue new shares (primary offerings) than companies offering shares without tag-along rights. In cases where there are no existing minority owners, we document that firms always issue shares with tag-along rights.

We believe that the utilization of tag-along rights in Brazil serves as an important example of private contracting for at least four reasons. First, tag-along rights are a voluntary instrument commonly used by controlling owners to increase investor protection for minority owners in South America and many other emerging markets.[2] Second, most private contracts are hard for researchers to observe because of the difficulty of obtaining data. In Brazil, however, equity issues with tag-along rights are publicly announced. Third, Brazil is known to have poor investor protection (Djankov et al., 2008) and high private benefits of control (Doidge, 2004; Dyck and Zingales, 2004; Nenova, 2003). Together, these factors increase the scope for contractual corporate governance. Fourth, recent regulation of the governance system in Brazil has created an almost ideal laboratory for the study of private contracting as a substitute for legal investor protection. Prior to 1997, Brazilian corporate law included a mandatory offer provision requiring an equal price for all voting shares. In 1997, the mandatory offer provision was revoked. After pressure from institutional investors, the mandatory offer provision was partially reinstated in 2000 with an 80% equal price threshold. In response to these changes, the Brazilian stock exchange, BOVESPA, introduced tiered listing requirements that incorporate the possibility of extending tag-along rights to minority investors.

Two cases illustrate controlling owners' ability to expropriate non-controlling owners in the absence of an equal price provision or tag-along rights. The first is from Brazil. In November 2000, the Brazilian government, which was the controlling owner of Banespa bank (66.7% of voting shares and 33.3% of the total cash flow rights), decided to sell its stake to the Spanish bank Banco Santander Central Hispano. Banco Santander's offer for the voting shares was 912% above the current share price. The lack of mandatory tender offer and equal-price provisions in the Brazilian legislation made it possible for Banco Santander to make a tender offer for the government's shares only, excluding the residual voting shareholders and the preference shareholders.[3]

The second example is Endesa España's takeover of Chile's largest private energy sector holding company, Enersis S.A. In August 1997, Endesa made a tender offer to Enersis shareholders for the purchase of voting shares for USD 253.34 per share[4] and of non-voting preference shares (with high dividend rights) for USD 0.30 per share. Prior to the tender offer, Enersis was controlled by five investments funds, which themselves were controlled by the former management and employees of Enersis. These funds held the voting shares, which represented 0.06% of the cash flow rights. However, Endesa España's proposed takeover offer would split the value of Enersis, with 84% going to the controlling owners and 16% to the minority owners.[5]

Collectively, these examples highlight the vulnerability of minority investors in the absence of tag-along rights. To compensate for potential expropriation, minority investors require a discount on the share price up front. Thus, these examples also serve to illustrate the potential benefit of the anti-self dealing effect of tag-along rights.

The paper proceeds as follows. Section 1 presents a review of research to date on contractual corporate governance, while Section 2 builds a simple model that provides testable results characterizing a controlling owner's incentive to issue shares with tag-along rights. Section 3 describes our empirical data and tests the implication of our model. Section 4 presents our conclusions.

1.1. Related literature on contractual corporate governance

Our theoretical analysis is closely linked to Chemla et al.'s (2007) analysis of shareholder agreements. Chemla et al. use option arguments to suggest a rational economic explanation for many common clauses in shareholder agreements, including put and call options, tag-along and drag-along rights, demand and piggy-back rights, and catch-up clauses. In their model – as in our model below – tag-along rights are given when the founder internalizes all future distortion in resource allocation. Our approach differs primarily in that we develop and test the economic implications of this theoretical model.

[2] A search of Factiva and Lexis-Nexis provides evidence of tag-along rights being granted to minority investors of publicly held firms in Argentina, Brazil, Columbia, Kuwait, Mexico (prior to the 2002 reform), Romania, Russia and Venezuela.

[3] Other examples of takeovers in Brazil in which minority investors suffered the same fate include the 2002 takeovers of the brewing group Quilmes by Ambev of Brazil and the takeover of the natural resource group Perex Companc by Petrobas.

[4] Holders of voting shares were also offered options to purchase shares in Endesa España at a discount. For simplicity, we ignore the value of these options.

[5] The voting shares are entitled to 0.06% of the cash flow rights and are offered 253.34 USD per share. Similarly, non-voting preference shares are entitled to 99.94% of the cash flow rights and are offered 0.3 USD per share. For each million of outstanding shares, Enersis would have to pay $0.0006 \cdot 253.34 = 1.520$ million USD to the controlling group and $0.9994 \cdot 0.3 = 0.298$ million USD to the preferred shareholders. Thus, the firm value would be split 84%/16% in favor of the controlling group.

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