



## Private benefits in corporate control transactions

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### ABSTRACT

This paper presents an analytical framework from which it can be inferred whether sellers or buyers in block transactions value private benefits highest. I am thus able to suggest an answer to the question: Are blocks of shares traded because the buyer has high security benefits, or because the buyer has high private benefits from the control rights that come with the shares? Using voting rights as the vehicle for private benefits, I find that the selling shareholders in block transactions attaches more value to private benefits than the buyers and that toeholds are insignificant for the premium paid.

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### 1. Introduction

The value of shares transacted, whether it is a minority or majority, is the sum of two components, namely the expected value of security benefits paid to all shareholders in proportion of ownership stake plus the expected value of private benefits that are in addition to security benefits. This distinction raises the question why blocks of shares are traded. Is it because the buyer has high security benefits or because the buyer has high private benefits? This question is relevant if private benefits are costly and reduce firm value, which we know they do. Adams and Ferreira (2008) for example find that control enhancing mechanisms reduce the value of outside equity and Albuquerque and Schroth (2010) find that each dollar of private benefits costs shareholders two dollars of equity value.

Private benefits have been documented in studies of block transactions (Barclay and Holderness, 1989; Dyck and Zingales, 2004), but not much is known about their significance relative to security benefits in block transactions. This paper develops an analytical framework from which it can be inferred whether sellers or buyers value private benefits highest. The advantage is that it reaches beyond the existing literature's more partial focus on the buyer's private benefits (two notable exceptions are Nicodano and Sembenelli, 2004 and Albuquerque and Schroth, 2010).

If selling shareholders attach more value to private benefits than buyers, I consider the transaction shareholder value maximizing in the sense that control is passed to shareholders who value the firm for its security benefits, which all shareholders profit from (positive externalities of control), and not private benefits, which expropriate other, typically small, shareholders (negative externalities of control). A successful transaction thus indicates that the buyer is able to produce enough security benefits to compensate the selling shareholder for giving up high private benefits without making the transaction unattractive. This paper is closely related to Nicodano and Sembenelli (2004) but differs in two important aspects, namely (1) the possibility that private benefits under the buyer differ from those under the seller and (2) the empirical specification.

Voting rights are the vehicle for private benefits. The key assumption is that private benefits are divisible and allocated to each shareholder according to the shareholder's voting power (Zwiebel, 1995). Voting power is the probability that a block of shares is pivotal for achieving control of a firm in a voting contest; it is not a measure of private benefits in itself. If the block holders' probability of being pivotal is high, their share of the fixed payoff available to the winning coalition, which is the same as their expected private benefits, is high. Private benefits therefore depend on the size of the block, but also on the distribution of the remaining shares. A minority shareholder has less influence when there is another large minority shareholder than when the remaining shareholders are small and dispersed.

Because I am concerned with block holders' potential expropriation, I use the Shapley–Shubik voting power index. Using the Shapley–Shubik

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index is analogous to stating that if a coalition is large enough to win, it should avoid accepting additional shareholders, since these new shareholders will demand a share of the payoff available to the winning coalition without contributing essential votes to the coalition. In other words, a smaller winning coalition is preferable because it has a larger group of shareholders from whom to expropriate (hence the Shapley–Shubik index captures the fundamental idea of the coalition formation effect introduced in [Bennedsen and Wolfenzon, 2000](#)).

My results are based on analyses using a transaction premium as the dependent variable. Using data on 179 U.S. block transactions, I find that the selling shareholders attaches more value to private benefits than the buyers. A positive abnormal stock market return lends further support to this conclusion, which is also robust to different definitions of the transaction premium, to different samples and to different assumptions about voting propensity and control abilities.

I proceed as follows. [Section 2](#) presents the framework of analysis. [Section 3](#) describes data sources, construction of variables and presents descriptive statistics of these variables. [Section 4](#) presents my results in more detail. [Section 5](#) concludes.

## 2. Framework of analysis

Consider a firm with an incumbent block holder owning a fraction  $w_1$  of the voting rights, the remaining  $(1 - w_1)$  being dispersed among many small shareholders. The firm is approached by a potential investor. Under the incumbent block holder, security benefits are  $y_S$  and private benefits are  $z_S$ . Under the potential investor, security benefits are  $y_B$  and private benefits are  $z_B$ .<sup>1</sup> It is a necessary and sufficient condition for a control transaction that the sum of expected security benefits and expected private benefits under the buyer's control is equal to or larger than the sum under the seller's.

Whether or not a control transaction will take place also depends on whether and to what extent the company law provides minority shareholders rights to participate in (or otherwise benefit from) the transaction. In the U.S., the general rule has been that minority shareholders do not have a right to participate ([Bebchuk, 1994](#)).

Absent a mandatory bid rule, the two parties are not obliged to let the small shareholders participate in the block transaction, and control can be transferred through a privately negotiated block transaction on mutually agreeable terms. Hence, a necessary and sufficient condition for a block transaction is that the block has a higher value under the buyer's control than under the seller's, or formally that  $w_1 y_B + z_B \geq w_1 y_S + z_S$  holds. This is the result from [Bebchuk \(1994\)](#) and [Burkart and Panunzi \(2003\)](#). Both assume that the block provides effective control of the firm and thus that all private benefits accrue to this block.

The assumption that all private benefits accrue only to the block holder is common in the corporate governance literature; it comes from the persistent view that ownership is dispersed. However, even in the U.S., where publicly traded firms stand out as having more widely dispersed ownership structures, many firms have significant block holders ([Gadhoun, Lang, & Young, 2005](#); [Dlugosz et al., 2006](#)).

Drawing on [Zwiebel \(1995\)](#), I assume that private benefits do not accrue only to the block holder, that private benefits are in fact divisible, and that they are allocated to each member of the controlling coalition according to voting power. In this case, the necessary and sufficient condition is that  $w_1 y_B + \phi_1 z_B \geq w_1 y_S + \phi_1 z_S$ , or equivalently that

$$w_1(y_B - y_S) + \phi_1(z_B - z_S) \geq 0 \tag{1}$$

<sup>1</sup> In the spirit of [Grossman and Hart \(1988\)](#) and [Harris and Raviv \(1988\)](#), this is a two-sided private benefits framework.

where  $\phi_1$  is the voting power of the block, and thus the expected share of the private benefits going to the block. It is important to recognize that the size of the block and thus the voting power is constant, which is true only if neither has a toehold – an assumption that I will discuss later. Private benefits of the buyer and seller can differ because of different expectations to the fixed payoff available to the winning coalition.<sup>2</sup> If the block holder's fraction of the voting rights exceeds a simple majority of 50% plus one vote, then  $\phi_1 = 1$  and I get the same result as [Bebchuk \(1994\)](#) and [Burkart and Panunzi \(2003\)](#). Eq. (1) is only different when minority blocks are traded. The significance of private benefits relative to security benefits is then less than what it would otherwise be.

My interest in this paper is exactly the significance of private benefits relative to security benefits. The transaction price, and thus the transaction premium, is a solution to a bargaining game between the seller and the buyer, the lower bound being the seller's valuation of the block and the upper bound being the buyer's valuation of the block. This game does not take into account that a block transaction might cause negative externalities, i.e., that it might be detrimental to the small shareholders. It only depends on the two parties' expected security benefits and private benefits. The buyer may therefore be a less efficient monitor of the firm with less value attached to security benefits, but with sufficiently large private benefits, the transaction can happen anyway.

Divide Eq. (1) by  $w_1$  and define the block's relative voting power as  $\Phi_1 \equiv \phi_1/w_1$ . By rearranging, the necessary and sufficient condition for a block transaction becomes

$$y_B - y_S \geq \Phi_1(z_S - z_B) \tag{2}$$

If the buyer is indeed a less efficient monitor of the firm with less security benefits but more private benefits, then both sides of the inequality in Eq. (2) are negative. A transaction would require the difference in security benefits to be less than the difference in private benefits, which depends directly on  $\Phi_1$ . Notice that  $\Phi_1$  tells us something about the marginal values, because the expected benefits depend on  $\phi_1$  and the expected costs depend on  $w_1$ . When  $\Phi_1 > 1$ , the costs of private benefits are not fully internalized. In other words, they are dissipative (negative externality on the small shareholders). When the block's relative voting power is larger than 1, preference thus goes to private benefits. On the contrary, when it is smaller than 1, then preference goes to security benefits.

Now, consider the situation in which  $\Phi_1 < 1$  and  $z_S < z_B$ . Preference goes to security benefits and the buyer's expected private benefits are larger than the seller's. In this situation, a transaction could happen even when the expected security benefits are lower, i.e.,  $y_B < y_S$ . However, because the marginal value of security benefits is higher than the marginal value of private benefits, the difference in security benefits has to be lower than the difference in private benefits. Thus, the buyer may be a less qualified owner of the firm, less shareholder value maximizing, but with sufficiently high private benefits it can be profitable to take over the block anyway. If the relative voting power is higher, if  $\Phi_1 > 1$ , preference goes to private benefits and it can be profitable to take over the block when the expected security benefits are even lower, i.e.,  $y_B \ll y_S$ .

With more security benefits, the buyer *ceteris paribus* has more to offer the seller and the observed price premium or transaction premium should thus be higher. With this relationship in mind, the first hypothesis follows from Eq. (2).

**Hypothesis 1.** Absent toeholds, the transaction premium increases (or decreases) in the block's relative voting power if  $z_S < z_B$  ( $z_S > z_B$ ).

<sup>2</sup> Sources of payoff include self-dealing such as transfer pricing, self-served financial transactions such as directed equity issuance, or, if the large shareholder is also the firm's management, excessive compensation ([Djankov, La Porta, Lopez-de-Silanes, & Shleifer, 2008](#)).

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