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Majority-Minority Relationships—An Economic View

*Kenneth Lehn**

A theory in economics has been cast in different versions by Harold Demsetz, Henry Manne, and Paul Rubin. Basically, the theory states that the common law evolves in a way that promotes economic efficiency and, from a reading of case law and from today's discussion, I have the strong impression that there is some confirmation of this theory with respect to the evolution of fiduciary law. Before I begin, though, I have learned that as a newcomer to the Securities and Exchange Commission ("SEC") I have to make a disclaimer before speaking. The views you are about to hear do not necessarily represent the views of the SEC, and if you are like the SEC lawyers, you will probably be very grateful for that.

The objective in this presentation will not be to review the cases or even the discussion, but to provide you with some guiding principles that economists use when looking at issues in corporate law. In essence, the issue in the present cases is to define the property rights of controlling shareholders vis-à-vis the property rights of noncontrolling shareholders and other security holders.

Generally, two issues are involved. One is a normative issue concerning fairness. Frequently economists are very silent on issues of fairness. In the area of securities law, economists do have something to contribute, but it is frequently lost in discussions concerning the efficiency versus fairness tradeoff. I think, though, that modern portfolio theory has some very specific things to say about the logic of the fairness issue. As much as we try to be purists, we are less interested in normative issues and more interested in the positive side: that is, we try to understand the implications of changing property right structures as the property rights of controlling shareholders are changed. What implications does that have for organizational structure? Additionally, does organizational structure have anything to do with economic efficiency?

There have been some dramatic changes in this area through the works of Alchian and Demsetz and Jensen and Meckling. The theory is far ahead of the empirical work right now, but the general conclusion is that organizational structure matters. As the property rights of various security holders change, the structures of organizations change and in turn affect the nature of what is produced, how it gets produced, etc.

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Ten years ago, economists would have had relatively little interest in these issues. The theory of the firm in economics was basically concerned with the firm maximizing profits subject to certain constraints. The bottom line was that marginal cost is somehow equated with marginal revenue. The only thing that affected the theory of the firm was whether the firm operated in a competitive market, a monopolistic market, or an oligopolistic market; this affected whether the slope of the demand schedule was downward, sloping, or perfectly elastic. The bottom line was that all of this information went into a constrained optimization problem: maximize profit subject to a production constraint. Firms had very little in the way of organizational discretion; business decisions were simply linear programming problems.

In 1972, Alchian and Demsetz wrote an article which revolutionized the way we look at firms.[1] My interpretation of their article is that, to a point, the theory of the firm—of equating marginal cost and marginal revenue—is very useful in understanding how a decentralized price system works. Yet it does not tell us anything about how firms work. It assumes away all the interesting questions, for example, that were raised by Berle and Means, in 1932, about the separation of ownership and control; the effect of that separation on managerial incentives; and the potential appropriation of wealth by majority shareholders from minority shareholders, from bondholders, etc. These questions were reductively answered by asserting that even though these problems may in fact develop, their effects are minimized by the competitive pressures that would force firm management to maximize profits.

But Alchian and Demsetz said to look deeper, to look at the raison d'etre of firms and view a firm as a very complex nexus of contracts in which there are shareholders, bondholders, employees, managers, suppliers, consumers and regulators, all contracting with an organization called "the firm." And the firm's raison d'etre is basically a transaction cost of coordinating all that activity among all of the actors comprising the firm.

In other words, if all the shareholders had to get together and contract with each other (as well as with all the bondholders, employees, managers, suppliers, and consumers) the costs of consummating all those transactions would kill that organizational form. Certain production would not occur. If all bondholders did the same contracting—with each other and all shareholders, employees, etc.—certain things would never be produced. Firms would continue to be small scale, cottage-industry type producers. Demsetz and Alchian looked into the nexus of contracts and argued that we need to probe behind the transaction costs of contractual relations in order to understand why certain organizational forms arise; why the corporation has arisen; why private firms exist; why

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1 Alchian & Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972).

nonprofits exist; and why partnerships exist. They provoked the body of literature that developed on those insights.

In 1976, Jensen and Meckling wrote an article[2] with a greater emphasis on the financial end of ownership structure and basically followed Alchian and Demsetz. That article picks up the flavor of modern economics in the theory of the firm area. They view the firm as a nexus of contracts between all of these parties. The notion is basically that production depends on more than simply technology and resource endowment. It is still frequently taught that the production frontier for any society depends only upon the resource endowment and the state of technology, which implicitly says that production is just a linear programming problem. But Alchian-Demsetz/Jensen-Meckling said it depends upon more. It depends upon a body of rules and laws and contracting rights that facilitates the deployment of these resources.

What follows from that observation is that there is a myriad of organizational forms that not only exist but survive in a competitive environment. If they exist and survive in a competitive environment, the logical premise is that they must be conferring net benefits on all the parties participating in that organization, because these parties are coming to the game voluntarily and are presumably better off participating than not participating.

The empirical challenge for economists (and this is where the empirical literature has really lagged behind the theoretical insights) is to explain why there is such a variation in organizational form. Furthermore, economists are beginning to conduct some natural experiments, when there are legal changes, to see what the comparative static implications are for affecting the organization.

The issue can also be looked at in a somewhat different light. The role of survival in a competitive environment suggests that we can view these firms as actually choosing a particular organizational form. Even though there was probably never a conscious decision to select the organizational forms which ultimately evolved, since they do exist and survive in a competitive environment, it is not inappropriate to view firms as choosing organizational forms that are "optimal" for their particular line of business. Moreover, just as we expect there to be competitive pressures in the capital market and the product market that will create pressures for firms to choose technologies that are cost efficient and enter into contracts with suppliers that are cost efficient, we would also expect firms to choose organizational forms that are cost efficient. The real challenge is to explain the variation in these various organizational structures.

We are concerned with the rules of the game concerning the rights of controlling shareholders. I was recently at a conference on industrial policy and someone who was sympathetic to industrial policy proposals

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[2] Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Capital Structure*, 3 J. FIN. ECON. 305, 306-11 (1977).

told a joke about economists: "How many economists does it take to change a light bulb? None— they rely on the market to do it." I run the risk here of falling into that trap.

Economists recognize that there is the potential for the appropriation of wealth by controlling shareholders from other claimants to the firm's assets. Appropriation can potentially occur, for example, from minority shareholders in freeze-outs, from bond holders through choice of investment projects or dividend policy, etc. But the question is whether particular rules of the game will allow individuals to contract to an organizational form that will mitigate that potential appropriation of wealth. Firms basically adopt quasi-constitutions that are designed to protect the rights of various claimants. A firm that chooses a constitutional form that does not protect the rights of certain claimants presumably will suffer through competitive advantage and will be pressured to change that organizational form in a way that allows it to raise capital at lower cost and produce goods and services at a lower cost.[3]

I think economists recognize that problems with this potential appropriation of wealth exist. However, the interesting point is that since these organizations survive, they must be doing something to mitigate these potential problems, either through loan covenants (with respect to credit agreements), through the charter amendment process, or through some other device. (In my first three months with the SEC I have become less sanguine about the charter amendment process, at least with respect to certain types of shark repellent antitakeover amendments.)

The study that I have recently completed with Professor Harold Demsetz of UCLA sheds some empirical light on the Berle-Means issue and has implications for the rights of controlling shareholders.[4] The first question to address with respect to the rights of controlling shareholders is whether the ownership structure of firms has any significance for the operation of that firm. Some people implicitly assume that the ownership structure of firms (some firms have concentrated ownership positions and others have highly diffuse ownership structures) is somewhat random. Berle and Means implicitly assumed this to a large extent.

The Berle-Means thesis assumed that diffuse ownership exists in corporations and, therefore, no individual shareholder has an incentive to monitor what goes on within the firm. Managers thus have de facto property rights to control the organization. But the question Berle-Means never asked was: Why was there diffuse ownership and why had that particular organizational form evolved?

What Harold Demsetz and I did was to gather ownership data and

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3 An article by Easterbrook and Fischel on corporate control transactions gives a good review of the economics literature in this area. *See* Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698 (1982).

4 Demsetz & Lehn, *Structure of Corporate Ownership: Causes & Consequences*, 93 J. OF POL. ECON. 1155 (1985).

ask the question: "What characteristics of firms, in terms of their particular lines of business, would give rise to ownership structures whereby some firms had very tight ownership structures (with controlling shareholders having more than 50% of the firm's common equity) and other firms had highly diffuse ownership structure (where the top shareholder might have less than 1%)?" What we were trying to show was that the evolution of these ownership structures followed a pattern which was very consistent with economic theory, particularly with the economic theory that I described pertaining to the Alchian-Demsetz and Jensen-Meckling material.

We looked at the ownership structure of 511 firms. These were mostly Fortune 500 companies, including some large banks, financial institutions, and utilities. A plot of the distribution of ownership structure showed that it followed a normal distribution pattern; the mean was about 25%. Looking at the percentage of equity controlled by the top five shareholders in the largest publicly traded firms in the country, we found that, on average, these shareholders own 25% of the common equity. In our study's sample, approximately half the sample was below that figure and half was above it. The range of that variable is between 1%-90%.

In terms of the modern theory of the firm, it is both interesting and relevant to study why some firms choose a particular ownership structure and others choose different structures. In our study we looked at a number of variables besides the regulation of the industry. The most relevant, for this discussion, is the importance of monitoring costs. Demsetz and I argued that where monitoring of corporate managers entails higher costs, there will be pressures for greater concentration of ownership. Ownership in those firms should be more concentrated, based on economic considerations.

Empirically, the question becomes how one measures the importance of monitoring costs. We used modern finance theory and regressed the returns of the firm on the returns of the market. We then took the unexplained variation in those firm returns—how much of the returns could not be explained by underlying market movements—and used that as a proxy for the importance of managerial discretion. We found that the variable is significantly related to the ownership structure of corporations.

How does that relate to this discussion concerning the rights of controlling shareholders vis-à-vis non-controlling shareholders? If we create disincentives for individuals to become controlling shareholders, based on considerations of fairness, then for certain lines of business it will put them at a competitive disadvantage. The costs of a particular organizational structure that connotes benefits to particular firms will now become more costly. This has very strong implications for our view of the law here. Considering the Demsetz-Manne-Rubin theory of the evolution of the common law, one could argue, based on the cases, that the law has evolved in a way that has created incentives for efficient organizational forms to arise. To summarize, I think economics does speak to the importance of organizational form and the need for a body of law that facilitates the formation of efficient organizations.

Evidence concerning the benefits of particular organizational firms is contained in the summer, 1984 issue of *Midland Corporate Finance*. This is a periodical written for practitioners, particularly practitioners in the investment banking community. It summarizes academic research on various issues in the area of financial economics. This particular issue, entitled "The Restructuring of Corporate America," summarized academic research on the importance of organizational form providing incentives to all the parties that comprise the organization. There are discussions about spinoffs, liquidations, sale of assets, going private transactions, leveraged buy-outs, and a very excellent discussion of the way in which those contractual forms and changes in organizational structure can actually create wealth and facilitate production of certain goods and services.

There is another recent issue which has come up in a number of contexts in the United States, not the least of which is greenmail: the notion of fairness and the role it plays in many of these discussions. The major point is that the issue of fairness almost exclusively revolves around the ex post distribution of rents accruing to the production of certain goods and services. For example, most of the resistance to greenmail, on grounds of fairness, is that when a company buys back shares from a raider at a premium which is available only to the raider, it disadvantages other shareholders in that firm and is, therefore, unfair. Certainly it is not surprising that shareholders in those firms should resist the payment of greenmail.

On the other hand, to the extent that corporate raiders provide a discipline of corporate managers—through closely scrutinizing the activities of various firms—then clearly, if we increase the cost of paying greenmail through legislation or regulations (I am speaking for myself and not the SEC here), that is likely to affect the ex ante incentives for corporate raiders to undertake the activities that they undertake. So a shareholder, who loses through payout to a greenmailer by a firm which feels that is the best solution for that particular firm, may be gaining in other firms in which he has holdings to the extent that the raider does monitor the activities of firms.

Economics provides a different light on the issue of fairness (though it may not say what is fair and unfair) through modern portfolio theory which strongly suggests that individuals, ex ante, can diversify some risk. Wealth appropriated in particular firms because of a particular organizational structure (such as entrenched management or a squeeze-out situation, where there is a controlling block with more than 50%) is a risk that can be diversified away. This means that, in the greenmail example, if raiders provide a service which collectively increases the value of corporate equity by monitoring corporate managers, then from an economic point of view a case could be made that, though losses occur to shareholders in particular firms, the net effect is positive. Since shareholders can, ex ante, diversify that risk, it should be in the collective interest of shareholders to allow that activity to occur. Empirically, we have no idea how elastic the supply of "raiding" is with respect to the payment of greenmail. Conceptually, however, it does provide another way of looking at the issue of fairness.

The same situation occurs in the issue of minority freeze-outs. The SEC is presently doing a study of minority freeze-outs and going-private transactions. We have done an event study, which looks at the stock price reaction net of the market after the first Wall Street Journal announcement that a firm is going private. There is also an article by DiAngelo, DeAngelo and Rice which does basically the same thing.[5] Both studies found that there were substantial premiums accruing to shareholders by announcement of the going-private transaction. DiAngelo, DeAngelo and Rice found a 30% premium net of market; the SEC is finding about 24%. I think the market discipline that exists is the potential for competing bids. However, if management has more than a 50% block, then obviously they can resist a bid.

But, in this large sample, the SEC found no evidence that shareholders are disadvantaged through the announcement of a going-private decision. One could argue that they were disadvantaged vis-à-vis what they would like to have, given the intrinsic value of the firm as a private organization. But there is the problem that if one focuses exclusively on the rights of the minority, strong disincentives for ex ante investments and for information that would provide managers with rewards for undertaking activities (such as an organizational restructuring which would create value) are created. This is very similar to patent rights. Once an invention is made we would like to see it available at zero marginal cost. But if that undermines the ex ante incentives to create inventions in the first place, then obviously there is a trade-off between the static allocation and the dynamic incentives. That occurs in many of these securities issues.

To conclude, economists bring two issues to the problems of this discussion. The first is to examine both the implications that different property-right arrangements have for the structure of corporate ownership, and the implications that changes in the ownership structure have on organizational efficiency and the ability to produce goods and services at relatively low costs. The second issue is the issue of fairness. I think that there is something to be said for modern portfolio theory and ex ante opportunities to diversify firm-specific risk that frequently gets lost in the fairness debate.

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[5] DiAngelo, DeAngelo & Rice, *Going Private: Minority Freezeouts and Stockholder Wealth*, 27 J.L. & ECON. 367 (1984).