Contracting Capital Resources

1. Introduction: Specialization and incentives in the capital structure of the firm

Contracting capital resources:

- *Equity*
    - Proprietorship
    - Partnership
    - Corporation
    - Cooperatives, mutual firms, etc

- *Credit*

- *Leasing, renting*

- *Common problem:*
    - Specialization advantages
        - Risk Bearing
        - Wealth Accumulation
        - Management Human Capital
    - versus Exchange costs caused by Separation of Ownership & Control
        - Credit: insolvency & asset substitution
        - Open Corporation:
          Managers abuse: e.g., excessive diversificaction
        - Closed Corporation: Majority abuses: No dividends; Minority blocks: No changes
        - Leasing: Asset abuse

1.6. Capital structure in finance theory

- *Miller & Modigliani's "irrelevance" theory*
  - Similar to Coase Theorem

- *Why financial structure matters: existence of transactions costs, mainly agency costs*

- *Examples of transaction costs of capital:*
  - Berle & Means' 1932 "separation of ownership and control" in large companies
  - Costs of contracting and enforcing credit
  - Abuse of assets under leasing
  - Difficulties to use land as collateral: failure of titling initiatives in many developing countries: mortgages economically significant in only a few countries, perhaps 25-30
  - Bankruptcy costs

2. Debt financing

2.1. Structure of the credit relation: option to borrower → asymmetry

2.2. Conflict between lender and borrower

- *Pre- and post-contractual conflict:*
  adverse selection and moral hazard

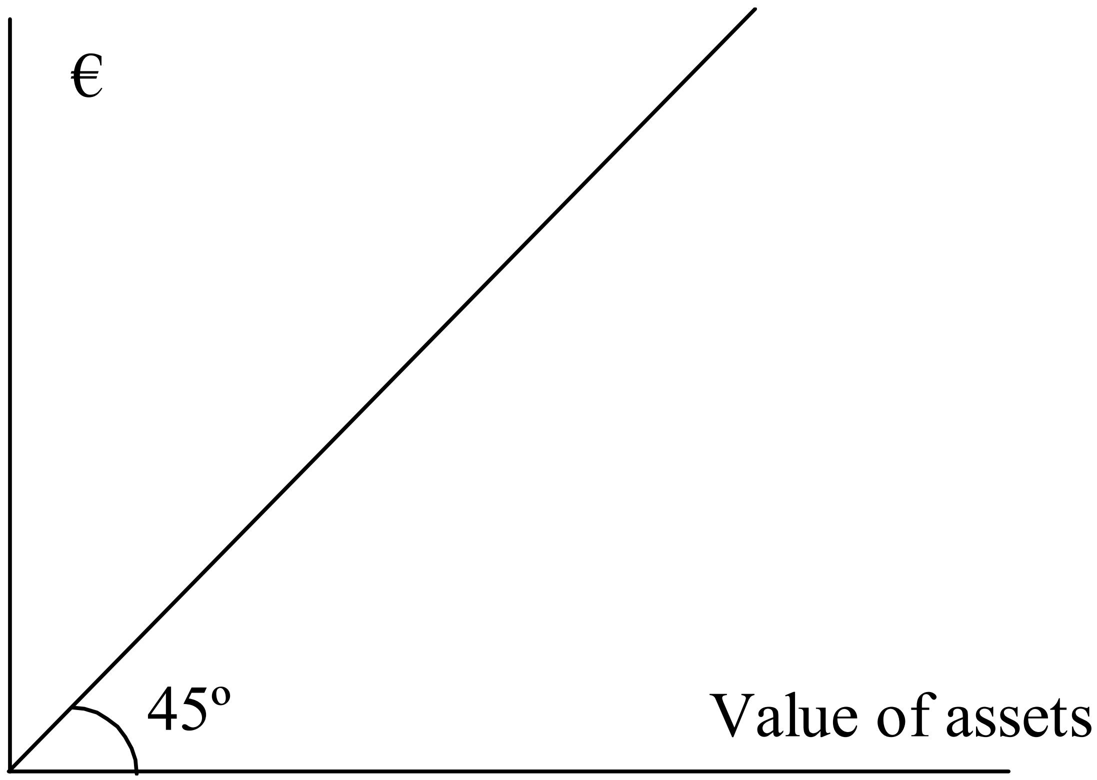
- *Kinds of moral hazards: higher probability of default triggered by unexpected ...*

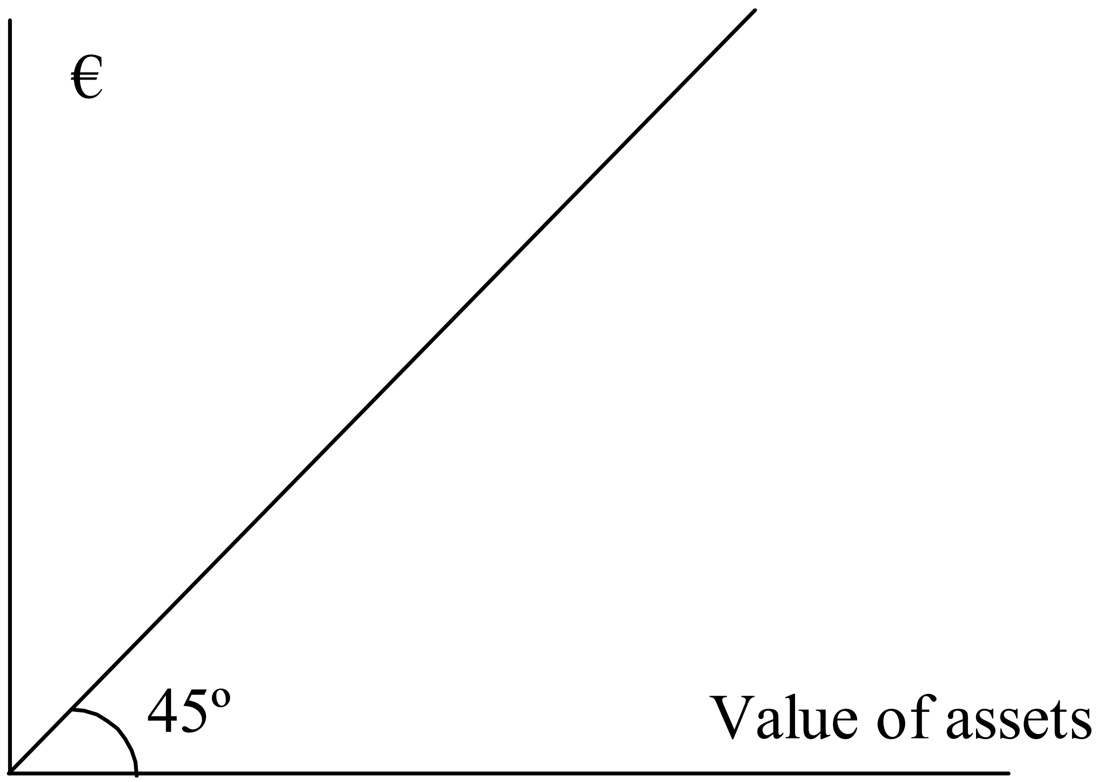
  - ... asset substitution:
    - Higher risk + asymmetry → expropriation:
    - With borrowed money, "casino" investment the best
  - ... dilution of senior debt
  - ... dividends
  - ... suboptimal investment

- *Firm's assets as a determinant of conflict*

  - Collateral value of real estate, movables and intangibles

Partitioning the Financial Pie





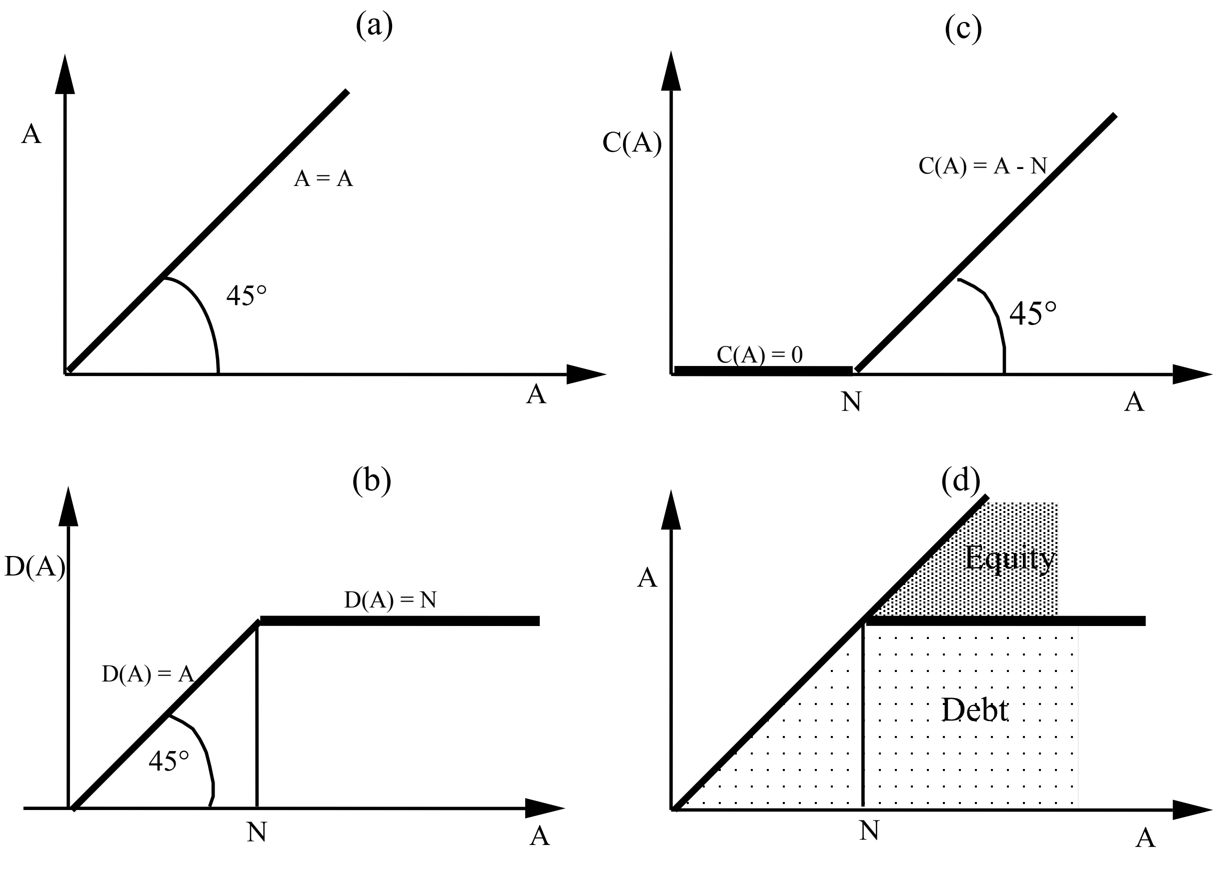
Structure of credit relationship

- **A**, value of the firm (assets)
- **N**, face value of debt (amount to be paid, discount debt assumed)
- Assets = Equity + Liabilities: **A = C(A) + D(A)**
- Value of debt, **D(A)** is:

$$D(A) = \begin{cases} = A & \text{if } A < N \\ = N & \text{if } A \geq N \end{cases}$$

- Value of equity, **C(A)**, is:

$$C(A) = \begin{cases} = 0 & \text{if } A < N \\ = A - N & \text{if } A \geq N \end{cases}$$



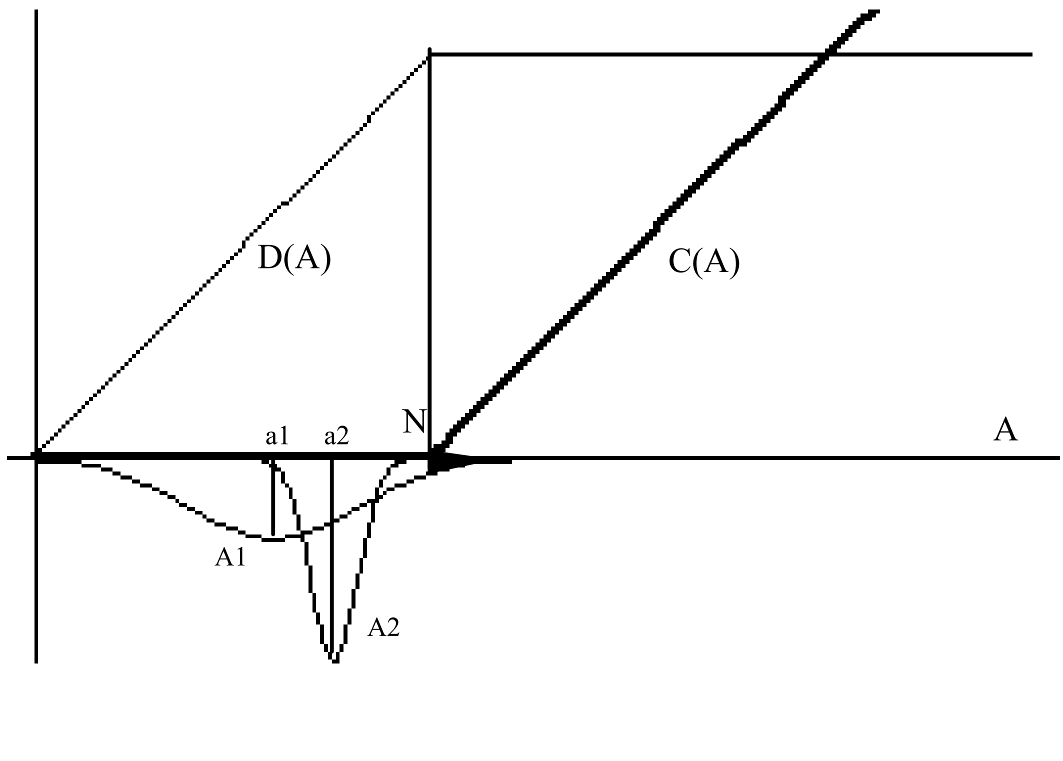
Analysis of some typical conflicts

- *How debt value changes with the volatility of asset value (assuming discount debt and one "lottery")*

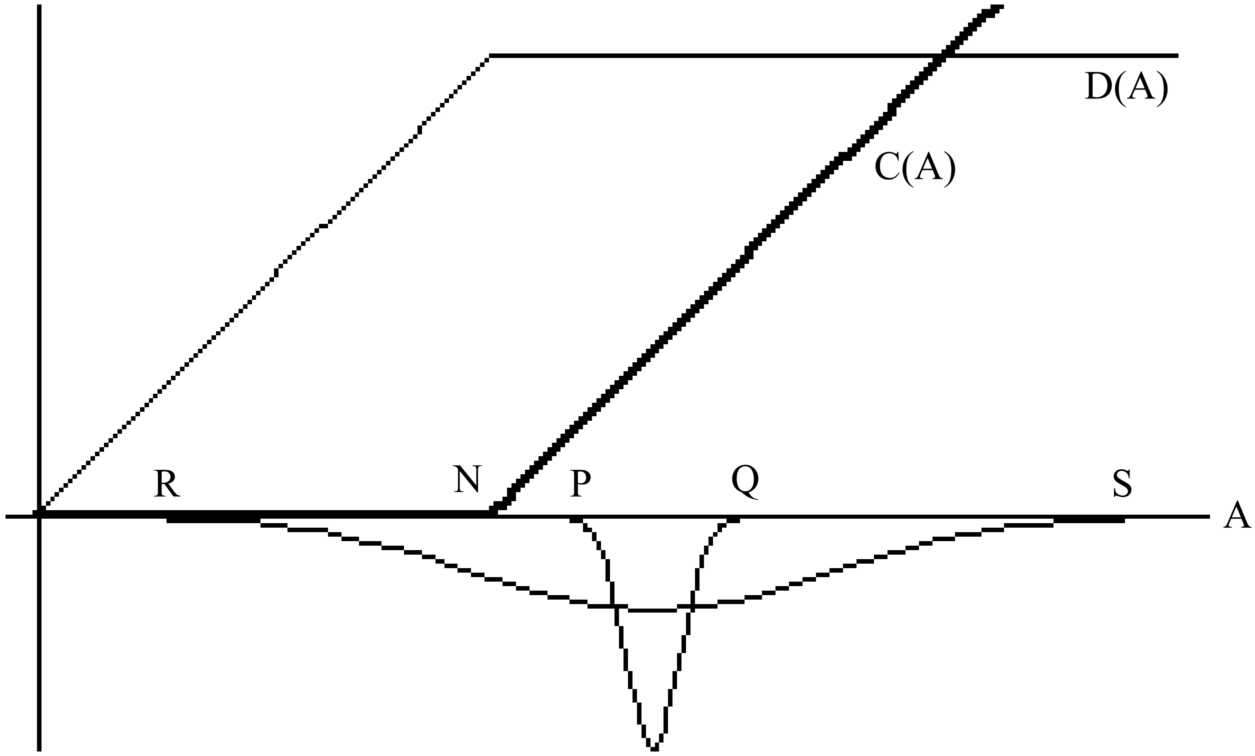
	Food processor			*Airlines*		
	*Down 1-**p**=.5*	*Up **p**= 0.5*	*Mean*	*Down 1-**p**=.5*	*Up **p**= 0.5*	*Mean*
Value of the firm, **A**	3	7	5	2	8	5
Value of debt, **D(A)**	3	4	3,5	2	4	3
Value of equity, **C(A)**	0	3	1,5	0	4	2
Std. Dev. Of firm value	4				9	

- Should bondholders constrain the investment policy of the food processor?
- How can they do it?

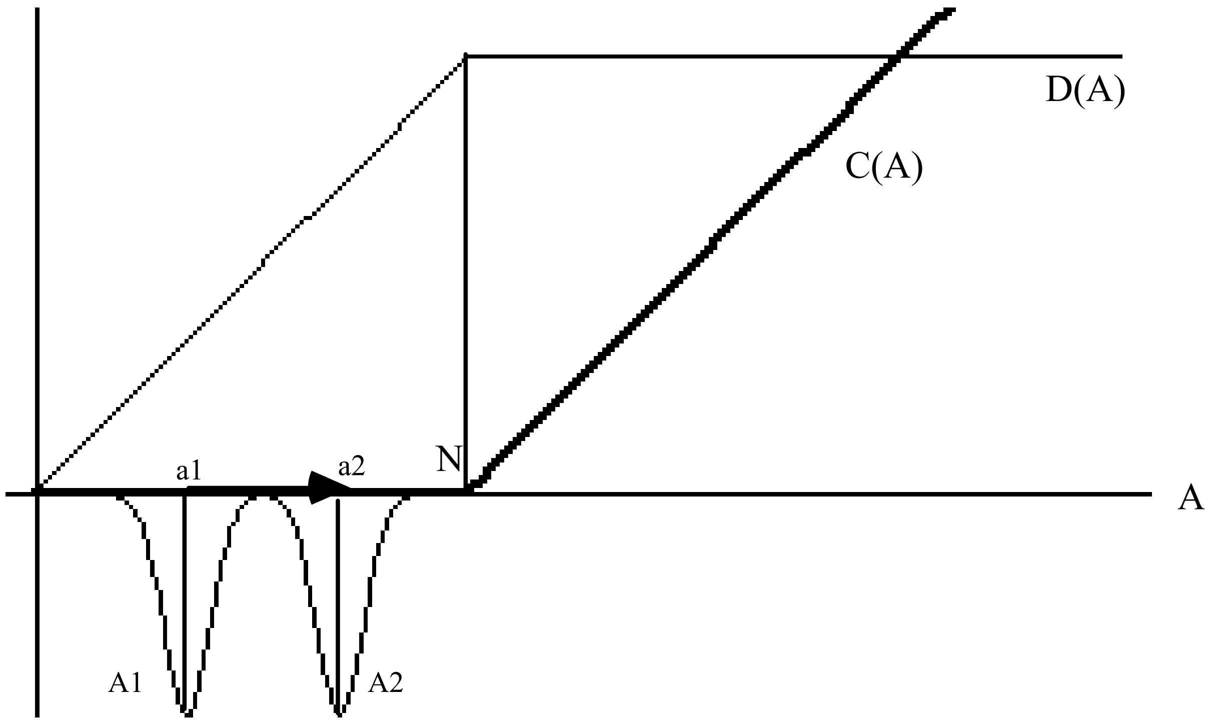
- *Variability of firm value: consequences for the value of debt and equity*



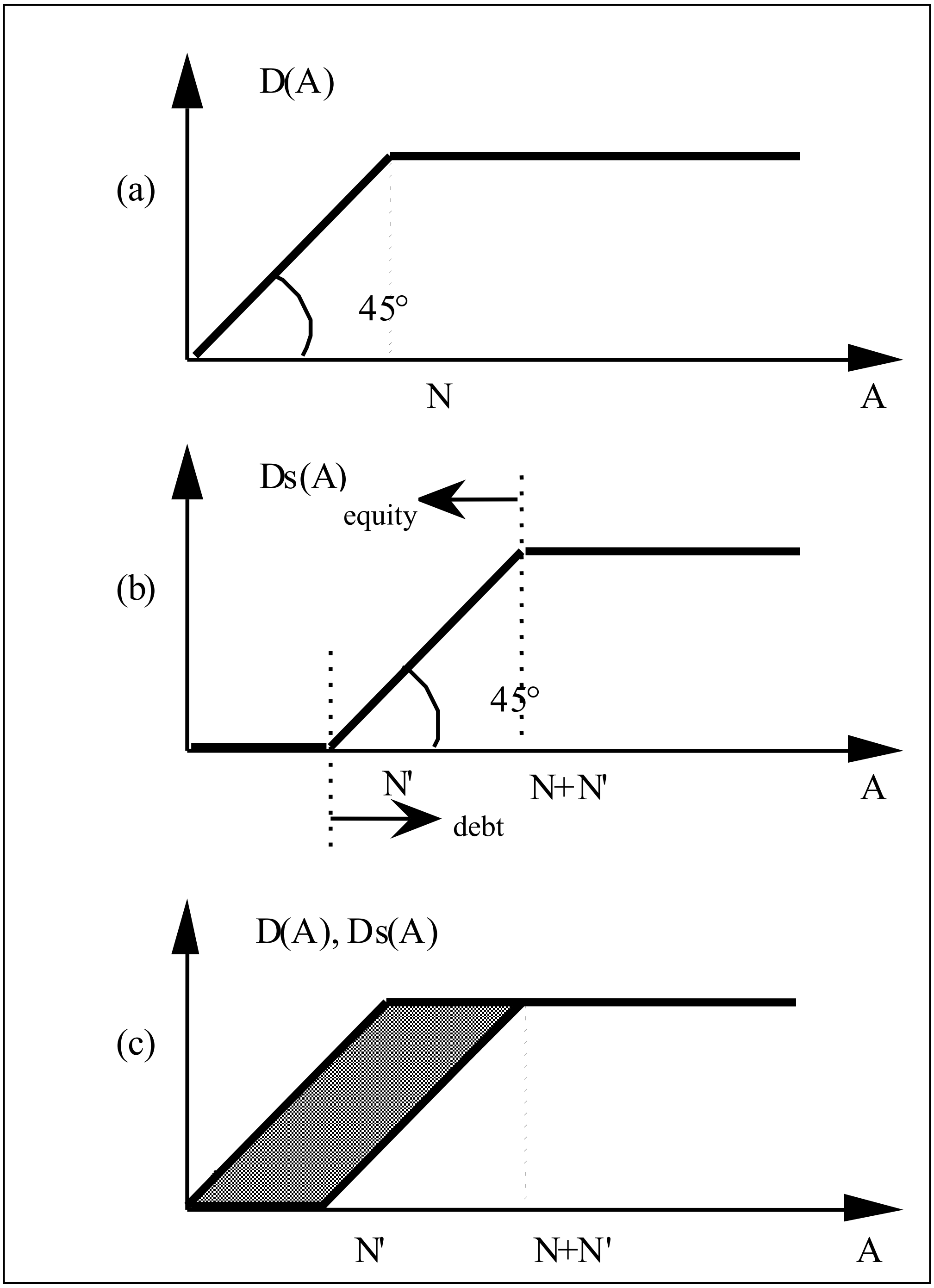
- *Variability of firm value and value of debt*



- *Conflict of interests on investment decisions that do not alter variance in the value of the assets*

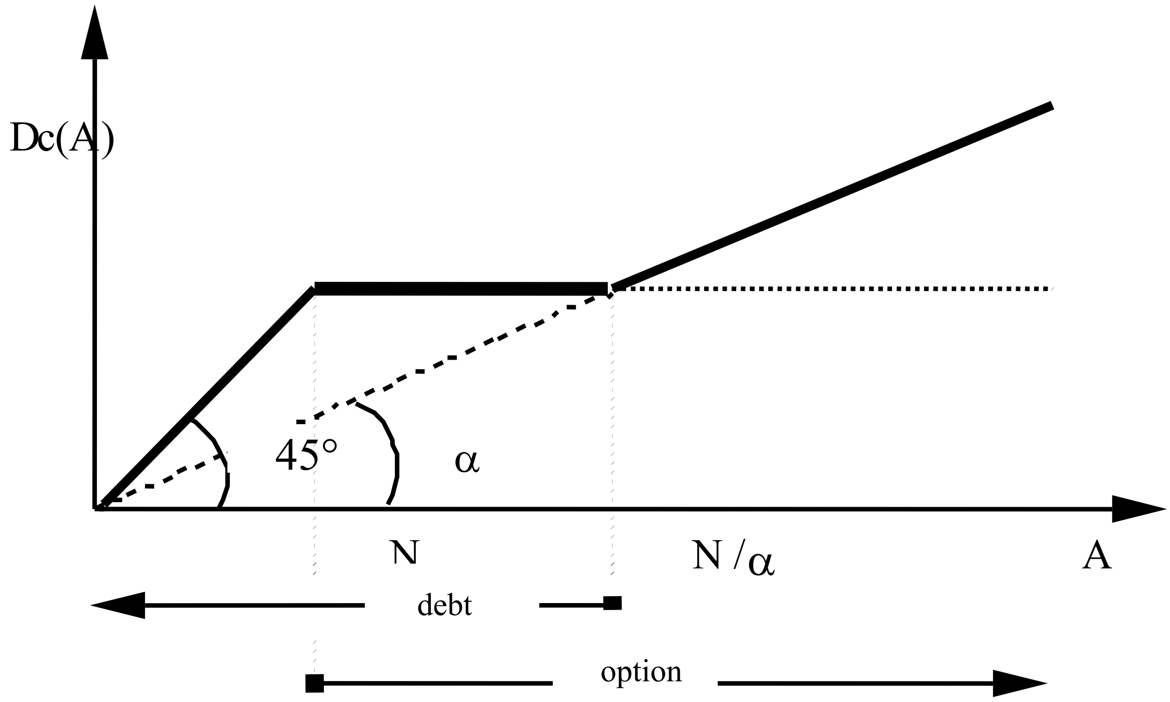


- *The double nature of subordinated debt — Dilution of debt of face value* ***N*** *after issuing senior debt of face value* ***N’***



Source: Adapted from Smith (1979, p. 97).

- *The nature of convertible debt*



Source: Adapted from Smith (1979, p. 94).

2.3. Safeguards

- *Screening*

- *Contractual design*

  - Periodic reporting
  - Alarm covenants

- *Collateral: rights* in rem

  - Crucial legal distinction:
    - Personal claims: personal debt (mere 'contractual' rights)
    - *In rem* claims ('property' rights): mortgage, secured debt
  - rights 'in rem' separate 'fixed' assets to secure specific debts →
  - benefit: better enforcement of secured debt
  - two problems:
    - conflict between classes of creditors
    - information asymmetry when selling → publicity required
  - Which kind of assets? real estate, identifiable movables, etc. Why?

- *Microcredit*

  - collective responsibility
  - reeducation, religion, etc.

- *Accounting*
    - The contractual role of accounting numbers
    - Conflict between economic valuation and objectiveness
- *Auditing*
    - Auditing as renting of reputation
    - The role of “professional judgment”
        - How to convey non-verificable information to the market?
    - The “expectations gap”
    - Who should judge audit failures: the court of the market?
    - Auditing as insurance: the discussion on auditors’ liability

3. Leasing

3.1. Rationales

- *Linked to taxation*

- *Linked to lessors' moral hazard*
  - motivate maintenance
  - safeguard obsolescence-related moral hazard

- *Linked to lessees*
  - price discrimination
  - when deep in debt, leasing provides better assurance to asset supplier, who keeps ownership
    - → potential conflict of interest with senior creditors
  - allows accounting games

- *Linked to the characteristics of assets*
  - specificity
  - susceptible to abuse
  - useful life—in the hand of the lessee (e.g., car rentals)

3.2. Contractual technology of leasing: Standards clauses

- *Deposits, bonds, etc.*
- *Constraints on subleasing*
- *Service included*
- *Termination at will (of whom? → different incentives)*
- *Purchase options*
    - Role ?
    - graph ?
    - what exercise price?

4. Corporations

4.1. Types: “open” and “closed”

4.2. Open corporations

- *Advantages: specialization*
  - Financial: Risk Bearing
  - Management or control
- *Conflicts and agency costs*
  - Perquisites, shirking, etc.
  - Risk avoidance
- *Solutions*
  - Limited liability → No need to monitor managers and other partners’ wealth
  - Right to sell → Voting with feet
- *Contractual solutions: General Meeting of Shareholders and Board of directors*
  - Absenteeism because
    - Specialization
    - Collective action
  - ¿what is the efficient degree of individual shareholders’ participation? ¿What about ‘institutional’ shareholders?

- *Market solutions: Stock market*
  - Information useful to monitor
  - liquidity → “voting with feet”

- *Market solutions: Takeover market*
  - Folklore: ‘hostile’ takeovers; sharks, raiders; tender offers, white knights, etc. — “Wall St.” 1987 movie
    - Gordon Gekko’s “Greed is Good” address to Teldar Paper Stockholders: http://www.americanrhetoric.com/MovieSpeeches/moviespeechwallstreet.html
    - Food for thought: Does the movies represent the moral complexity of businesses or a Manichean perspective?
  - Typical operations
    - Hostile tender offer
    - Leveraged buyout—“Self-takeover”
    - To evaluate: “Golden parachutes”—Fair?—Incentives?
  - Evidence
    - Profits go to targets, not to bidders
    - De-conglomeration
    - Efficiency or redistribution?
    - Debt: no effect except for new cases (e.g., Nabisco) that triggered contract changes
    - Labor: Headquarters versus production plant workers
    - Labor: Expropriation of specific assets (i.e., quasi-rents) or expropriation of rents?
  - Europe
    - All kinds of legal constraints
    - Negative effect on competitiveness of European firms?
    - eternal ‘new’ directive would make M&As easier

- *The increasing role of "private equity:"*
  - Market or organization?
  - Why?
  - See "Kings of Capitalism: A Survey of Private Equity," *The Economist*, November 27, 2004.

4.3. Closed corporations

- *Nature*
  - Importance of personal element
- *Advantages:* some *degree of specialization*
  - Funding, risk and control
  - But without stock market
- *Conflicts and agency costs*
  - Mainly, potential expropriation of minority shareholders
- *Solutions*
  - Need of flexibility in legal framework
  - Importance of exit rules, to make conflict solving easier
  - Important decisions by qualified majority → risk of too much power to minority → 'blocking' minority
  - Non proportional allocation of
    - Decision rights: e.g., shares with multiple votes
    - Economic rights (dividends)

5. Cooperatives

5.1. Introduction

5.2. Limitations and success

- *Non-specialization of*

  - Capital
    - limited resources—more difficult: in some industries, with globalization
    - No possible to sell → Horizon problem → Under investment
    - Risk concentration → Under investment

  - Control
    - Lack of incentives → Free riding in control
    - Specialized controllers employed by controlled
    - Measurement of net product to share (varies with industries—e.g. fishing)
    - Costly *political* decision process (e.g., assembly)

- *Success:*

  - professional services
    - but when capital needed, go public floating shares (Goldman Sachs, KPMG, E&Y-Cap Gemini)
    - Revise previous limitations for different industries: professional firms, fishing, car manufacturing, etc.

  - Political market → tax breaks, subsidies (in Spain, even in the 1978 Constitution)

5.3. Palliatives and solution

- *Palliatives: returns based on accounting numbers*

- *Solution: need to specialized ownership and control → incorporation*

    - Mondragón

    - Employee Stock Ownership Plans, ESOPs
        - Attenuates cooperative dimension

6. Mutual firms: control by clients

6.1. Introduction

6.2. Adaptability to environment

6.3. "Cajas de ahorros" = US Savings and Loan Associations (SLAs)

6.4. NGOs