

THE EFFECT OF MINORITY VETO RIGHTS ON CONTROLLER TUNNELING

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CHALLENGE OF PROTECTING MINORITY SHAREHOLDERS

- **Most public firms around the world have a controller.**
 - E.g., La Porta et al., 1999
- **It is important to protect their minority from controller tunneling.**
- **Independent directors and shareholder lawsuits are not enough.**
 - E.g., Bebchuk and Hamdani, 2017; Enriques et al., 2017.
- **Many countries currently trying to regulate related party transactions (RPTs).**
 - Some have adopted ex ante majority-of-minority (MoM) approval of RPT: Australia, HK, India, Indonesia, Mexico, Ontario, Delaware, UK and Israel

SHAREHOLDER VOTING

Although shareholder voting in various forms is increasingly being used around the world to protect shareholders, most academic studies of voting schemes focus on simple majority votes (in widely-held firms; mixed results).

Few studies examine whether majority of the minority (MoM) votes can constrain controlling shareholders; setup often involves identification problems.

VERY LITTLE IS KNOWN ABOUT MAJORITY OF THE MINORITY VOTES

- **Delaware:** Voluntary MoM approval of RPT's shields companies from litigation.
 - Firms self-select related party transactions for approval.
- **Canada:** MoM approval is mandatory in RPT business combinations of TSX firms.
 - All deals are subject to the same approval (no control group).
- **India, Nan Li (Columbia GSB dissertation):** Recent MoM approval requirement of RPT in India restrains tunneling

THE 2011 REFORM IN ISRAEL

Until mid-2011, a single approval by a third of the minority shareholders (ToM) was required for related party transactions, including executive pay of controllers and their relatives.

Two changes in mid-2011:

1. Now require approval every three years for long-term transactions.
2. Now require the support of a majority of the minority shareholders (MoM).

PRESS REPORTS: THE REFORM MADE A DIFFERENCE

Many press reports on controller executives having difficulty obtaining MoM approval for their pay, and sometimes leaving office or working without pay. Examples from 2011:

- Rami Levy, CEO of an eponymous supermarket chain, halved his bonus.
- Ilan Ben Dov, board chair of cellular firm Suny, forfeited most of his pay.
- Zvi and Moshe Borovitz, board chair and CEO of wireless technology firm MTI, announced their departure.

This implies that at least some MoM votes were not a formality.

A USEFUL SETUP FOR A STUDY

Israeli public firms must report annually the compensation of their highest paid executives in a standardized table (typically five exec's; non-compensation RPT's are less standard)

Most public firms have some executives who are controllers or their relatives (“controller executives”), so MoM approvals of their compensation are common.

It is possible to compare compensation changes following the 2011 reform (introduction of periodic MoM approvals) for “treated executives” (controllers and their relatives) with compensation changes for other (hired) executives (who constitute a viable control group, under some plausible assumptions).

EMPIRICAL DESIGN

DID regressions to examine whether there is a post-reform change in controller executives' pay, pay slice, and “disappearance rate” relative to those of other executives.

Logit and linear probability (LPM) regressions to examine whether the likelihood of pay reduction varies following MoM approvals, ToM approvals, and other approvals.

[Firm-level controls, executive- and year fixed effects (where possible), no background info on executives].

MAIN RESULTS

- 1. Controlling for other factors, controller executives enjoy a lower “compensation premium” after the reform.**
- 2. The likelihood that controller executives leave increases.**
- 3. MoM approvals play a role:**
 - On average, MoM approvals are followed by no change in pay (considerable variance). Other approvals (including ToM approvals) are followed by an increase in pay. This is natural as the firm selects their timing.
 - More than a third of the MoM votes end in a decline in controller executive pay. Other approval types (including ToM approvals) are much less likely to be followed by a decline in pay.
 - The likelihood that controller executives leave the firm seems to coincide with unmet MoM approval deadlines.

INTERPRETATION

Controller executives enjoying shareholder support can get a raise both before and after the reform.

Controller executives not enjoying shareholder support could avoid votes before the reform but face shareholder scrutiny after the reform, sometimes resulting in pay cuts or departure.

The effectiveness of voting *appears* to depend (no direct evidence) not only on the required majority, but also on the vote being mandatory (Shareholders are asked to express their opinion on management every three years).

THE SAMPLE

Hand collected data on executives (typically five per firm), both controller executives and others, their pay approval types and dates (annual reports and proxy statements)

Roughly a quarter of the reported exec's are controllers or controller relatives

Financial statement data (size and ROA)

About 13,600 observations: about 600 firms and about 4,500 executives in the years 2009–2015

SOME SAMPLE STATS

The sample consists of an unbalanced panel of 4,507 executives from 591 Israeli public firms in the years 2009–2015. Panel A reports annual firm-level data. Firm-level financial variables are from commercial provider A-Online. Other data come directly from firms' annual reports. All monetary values are in New Israeli Shekels (about 4 NIS per 1 USD).

Definition	Units	Mean	Std.	25%	50%	75%	Firms
Total Assets	Millions of NIS	3,341	13,200	106	349	1,160	591
ROA	Annual operating profits to assets, in percent	-0.2	16.6	-1.4	2.4	6.5	591
Equity Held by Individual Controller Executives	In percent	23	25	0	16	39	590
Number of Reported Executives		5	2	5	5	6	591
Number of Reported Controller Executives		1.35	1.35	0	1	2	591

SOME SAMPLE STATS (2)

The sample consists of observations on 4,522 executives from 591 Israeli public firms in the years 2009–2015. Panel B reports the annual compensation of each executive based on annual reports. All financial values are in NIS (about 4 NIS per 1 USD).

Definition	Units	Mean	Std.	25%	50%	75%	Obs.
Total Compensation (reported value of all compensation components)	Thousands of NIS	1,333	3,323	427	808	1,448	13,576
Total Compensation of Controller Executives	Thousands of NIS	1,540	2,378	505	989	1,774	3,429
Non-Equity Compensation (Total Compensation excluding equity-based components)	Thousands of NIS	1,185	3,126	410	776	1,354	13,576
Non-Equity Compensation of Controller Executives	Thousands of NIS	1,460	2,143	491	967	1,731	3,429
Partial Employment	Equals one if an executive is employed for less than a full year or less than full-time	28.7%					13,576

SOME SAMPLE STATS (3)

The sample consists of observations on 4,507 executives from 591 Israeli public firms in the years 2009–2015. Panel C reports, for each of those years, pay approvals for controller and non-controller executives in our sample. All variables are based on annual reports and proxy statements.

Approval Type	Definition	2009	2010	2011	2012	2013	2014	2015	Total
MoM Approval	Majority of the minority approval of a controller executive's pay (after mid-2011)	N/A	N/A	183	130	114	191	65	718
ToM Approval	Third of the minority approval of a controller executive's pay (before mid-2011)	70	108	27	N/A	N/A	N/A	N/A	205
Other Approvals	Various approvals by the board or shareholders of the pay of non-controller executives (all years)	206	341	276	250	240	186	155	1654

PAY BEFORE AND AFTER THE 2011 REFORM (DIFF-IN-DIFF)

COLS 1 AND 4: TOTAL COMP; COLS 2 AND 5: TOP TWO EXEC'S; COLS 3 AND 6: NON-EQUITY PAY

$$\text{Log (Total Compensation)}_{ijt} = \alpha + \beta * \text{Controller Executive} * \text{Post Reform} + \text{Firm-Level Controls}_{jt} + \text{Executive Fixed Effects} + \text{Year Fixed Effects} + \varepsilon,$$

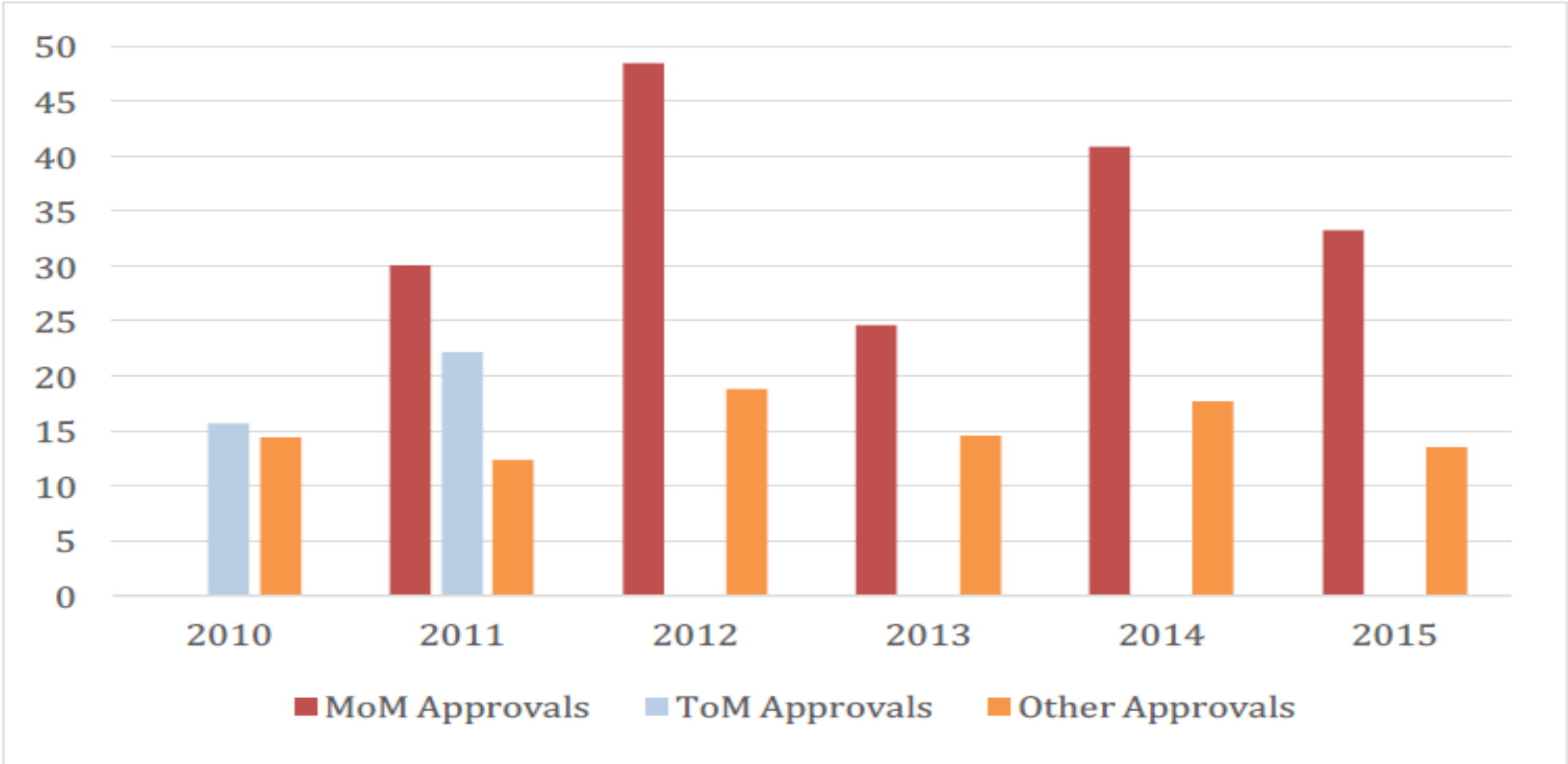
	(1)	(2)	(3)	(4)	(5)	(6)
Controller Executive*Post Reform	-0.12** (0.04)	-0.10*** (0.04)	-0.13*** (0.03)	-0.10*** (0.03)	-0.07** (0.03)	-0.11*** (0.02)
Partial Employment				-0.36*** (0.03)	-0.19*** (0.05)	-0.35*** (0.02)
Log (Total Assets, in thousands of NIS)				0.20*** (0.02)	0.19*** (0.03)	0.19*** (0.01)
ROA				0.02 (0.12)	0.28** (0.12)	0.14*** (0.05)
Year Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes
Executive Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes
Observations	13,576	5,198	13,530	13,576	5,198	13,530
R-Squared	0.88	0.91	0.87	0.89	0.91	0.89

SAME USING PAY SLICE

(SHARE IN TOTAL PAY EXCLUDING ONE EXEC PER FIRM)

	(1)	(2)	(3)	(4)
Controller Executive*Post Reform	-0.010* (0.006)	-0.011 (0.009)	-0.013** (0.006)	-0.013 (0.009)
Partial Employment			-0.027*** (0.006)	-0.010 (0.009)
Log (Total Assets, in thousands of NIS)			-0.026*** (0.003)	-0.021*** (0.005)
ROA			0.022* (0.013)	0.010 (0.022)
Year Fixed Effects	Yes	Yes	Yes	Yes
Executive Fixed Effects	Yes	Yes	Yes	Yes
Observations	11,025	5,198	11,025	5,198
R-Squared	0.79	0.82	0.80	0.82

APPROVALS ENDING IN NON-EQUITY PAY REDUCTION (%)



THE DETERMINANTS OF PAY REDUCTIONS

	(1) Logit	(2) LPM	(3) Logit	(4) LPM	(5) Logit	(6) LPM
Any Approval	-0.71*** (0.07)	-0.14*** (0.02)	-0.56*** (0.11)	-0.15*** (0.03)	-0.68*** (0.08)	-0.11* (0.02)
MoM Approval	0.50*** (0.12)	0.09** (0.04)	0.41** (0.16)	0.10** (0.05)	0.50*** (0.12)	0.07* (0.04)
ToM Approval	0.09 (0.26)	0.06 (0.05)	0.17 (0.33)	0.08 (0.08)	0.07 (0.26)	0.05 (0.05)
Log (Total Assets in Thousands of NIS)	0.04*** (0.01)	-0.00 (0.01)	0.03 (0.02)	-0.01 (0.02)	0.01 (0.01)	-0.01 (0.01)
ROA	-0.22 (0.15)	0.00 (0.08)	-0.21 (0.24)	-0.16 (0.13)	0.09 (0.16)	-0.06 (0.08)
Negative ROA	0.11* (0.06)	0.03 (0.02)	0.07 (0.09)	0.04 (0.04)	0.03 (0.06)	0.02 (0.02)
Partial Employment	0.08* (0.05)	0.04** (0.02)	-0.09 (0.08)	0.05 (0.04)	0.07 (0.05)	0.06** (0.02)
Controller Executive	0.38*** (0.05)	N/A	0.21*** (0.08)	N/A	0.44*** (0.05)	N/A
Year Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes
Executive Fixed Effects	No	Yes	No	Yes	No	Yes
Observations	11,681	11,681	4,418	4,418	11,681	11,681
R-Squared	N/A	0.36	N/A	0.41	N/A	0.35

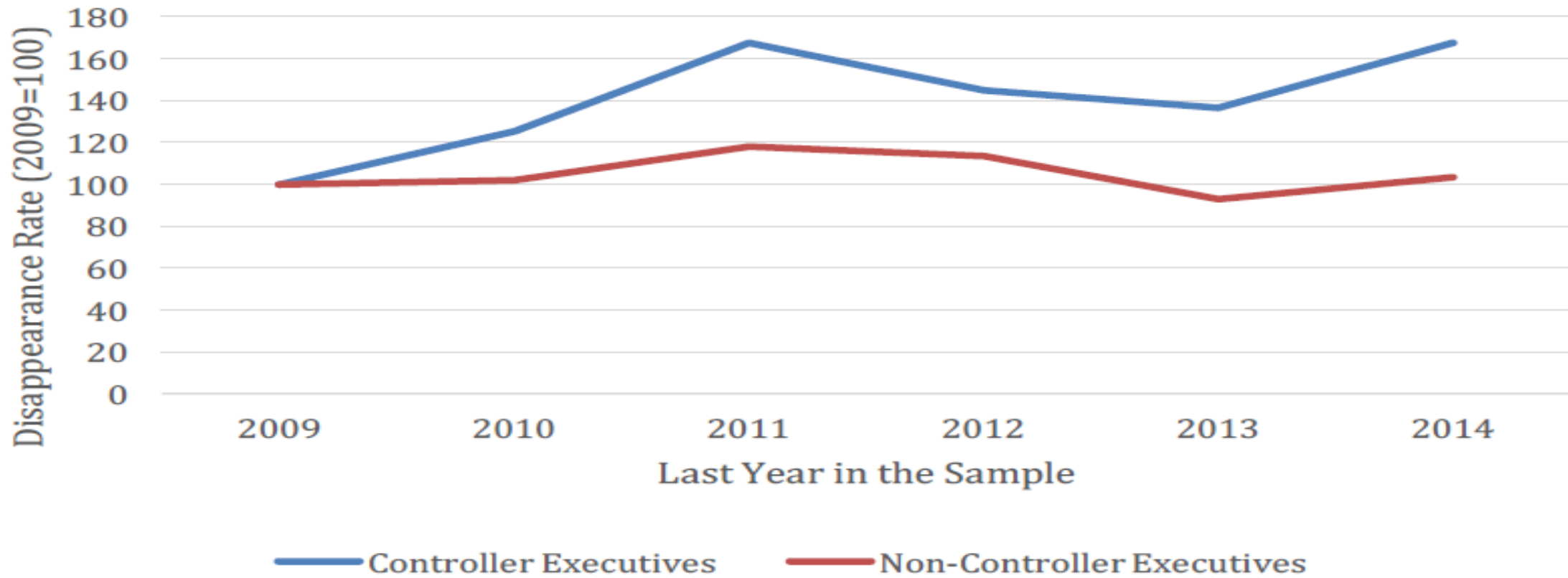
SUMMARY

Most types of approval are associated with pay increases because firms choose when to seek approval.

MoM approvals are different (mandatory nature?):

- Some MoM approvals are non-events:
 - No change in pay – neither the executive nor shareholders wanted a change
 - A raise – the executive would have sought a raise anyway.
- But other MoM approvals are associated with pay cuts.
 - This would not have happened but for the approval deadline.

DISAPPEARANCE RATES OF CONTROLLER EXECUTIVES AND NON-CONTROLLER EXECUTIVES (2009 RATE = 100)



EXECUTIVE DISAPPEARANCE BEFORE AND AFTER THE REFORM (DIFF-IN-DIFF LOGIT REGRESSIONS)

	(1)	(2)	(3)	(4)
Controller Executive	-1.13*** (0.12)	-1.16*** (0.12)	-1.66*** (0.10)	-0.90*** (0.07)
Controller Executive *Post Reform	0.23* (0.14)	0.22 (0.14)		
MoM Approval Due			0.71*** (0.16)	
MoM Approval Obtained				-0.60*** (0.18)
Partial Employment		0.62*** (0.05)	0.62*** (0.06)	0.62*** (0.06)
Log (Total Assets in thousands of NIS)		0.03* (0.01)	0.03* (0.01)	0.03* (0.01)
ROA		-0.97*** (0.14)	-0.91*** (0.15)	-0.97*** (0.14)
Year Fixed Effects	Yes	Yes	Yes	Yes
Executive Fixed Effects	No	No	No	No
Observations	11,855	11,855	11,476	11,855

WHERE DID THE DISAPPEARING CONTROLLER EXECUTIVES GO? (INCOMPLETE)

Some were replaced by hired executives with no control changes (about 30 cases out of 300 disappearances). Virtually unheard of before the reform. Real corporate change in these companies?

About 50 continue to hold their positions but are no longer on their firms' lists of top paid exec's because they work for free or little pay (regression results under-estimate the true effect of the reform); About 20 moved to lower paid positions.

[Other cases: replacement by other controller executives, partial or full control changes, court appointed receivership, etc.]

EXTENSIONS AND ROBUSTNESS TESTS

EARLY VS. MANDATORY MOM APPROVALS (SAME SPECIFICATIONS AS BEFORE, CONTROLS NOT SHOWN)

	(1) Logit	(2) LPM	(3) Logit	(4) LPM	(5) Logit	(6) LPM
Any Approval	-0.73*** (0.07)	-0.13*** (0.02)	-0.60*** (0.10)	-0.15*** (0.03)	-0.71*** (0.07)	-0.11*** (0.02)
Non-Early MoM Approval	0.72*** (0.14)	0.10** (0.04)	0.61*** (0.18)	0.13** (0.06)	0.73*** (0.13)	0.08* (0.04)
Early MoM Approval	0.63*** (0.17)	0.08 (0.06)	0.63*** (0.23)	0.09 (0.08)	0.70*** (0.17)	0.08 (0.06)
ToM Approval	0.11 (0.25)	0.06 (0.05)	0.22 (0.33)	0.08 (0.08)	0.10 (0.26)	0.05 (0.05)

LPM PAY REDUCTION REGS BY MOM APPROVAL ROUND (2011-2013 VS. 2014-2015)

	(1) LPM	(2) LPM	(3) LPM
Any Approval	-0.14*** (0.02)	-0.15*** (0.03)	-0.11*** (0.02)
MoM Approval*2011–2013	0.10** (0.04)	0.13** (0.06)	0.08** (0.04)
MoM Approval*2014–2015	0.07 (0.05)	0.05 (0.07)	0.05 (0.05)
ToM Approval	0.06 (0.05)	0.07 (0.08)	0.05 (0.05)
Log (Total Assets in thousands of NIS)	-0.00 (0.01)	-0.01 (0.02)	-0.00 (0.01)
ROA	0.00 (0.08)	-0.16 (0.13)	-0.06 (0.08)
Negative ROA	0.03 (0.02)	0.04 (0.04)	0.02 (0.02)
Partial Employment	0.05** (0.02)	0.05 (0.04)	0.06** (0.02)
Year Fixed Effects	Yes	Yes	Yes
Executive Fixed Effects	Yes	Yes	Yes
Observations	11,681	4,418	11,681
R-Squared	0.36	0.41	0.35

THE RESULTS ARE ROBUST

Subsample	N	Coef.
Firms with controller execs on hi-paid list	9,174	-0.12***
Firms with controller execs with 2011 MoM deadline	2,970	-0.18***
Execs in office until the end of the sample period	13,278	-0.06*
Execs in office throughout the sample period	3,655	-0.11***
Full-time execs	9,680	-0.12***

ADDITIONAL TESTS

No evidence that –

- related-party transactions replace pay as a channel for tunneling.
- dividends replace pay as a way to extract cash.
- minority uses veto right when Q/ROE are lower or pay is higher.
- reform or pay cuts affect Q (quantitatively the change in pay is small).

We are collecting data on 2007–2008 to verify –

- Pre-reform parallel trends in pay (probably exist)
- Pre-reform disappearances
- Pre-reform frequency of ToM approvals

WHY DO WE FIND THIS INTERESTING?

- **Evidence on (what is perceived as) tunneling through pay (not a big surprise).**
- **Evidence on the impact of MoM approvals (in a relatively clean setup, it can “work”).**
- **Extension of SoP and RPT lit to the context of controlling shareholders and binding MoM.**
- **Evidence on the effect of exogenously imposed periodic voting.**

IMPLICATIONS AND CONCLUSION

The reform seems to have had some effect:

- Via the mandatory vote every three years.
- Possibly also via the higher majority requirement.

Welfare implications? Is such a reform desirable?

Not clear: Increase in other (indirect) forms of tunneling? Loss of value-increasing RPT/exec's? Change in other corporate policies?