

*The Insurance Theory of
Shareholding as Applied to
Share Repurchases*

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The Berle-Means Corporation



- Advance from „classical“ firm which is defined
- by a unity of capital ownership, entrepreneurship and control over the hierarchy
- Myth of „unity of control and liability“ as a salutary basic mode of economic organization
- „division of ownership and control“
- which leads - in conventional terms - to an agency problem where the shareholder-principals monitor the manager-agents
- This view obscures the function of shareholding



Principal-Agent Theory in a Nutshell

- Smart principals hire smarter agents
- Smart principals hire specialist agents
- Smart principals seek diversification
- Does capital hire labor?
- Who hires what in the firm?
- What is the function of the shareholders?
- What is the function of the managers?
- Who performs entrepreneurial functions?
- Monitoring – supplemented by screening!



Shareholders are Insurers

- Why are shareholders different from other stakeholders?
- They capture the **residual** – what is the residual? Why?
- They **insure** the firm against residual loss
- (they can diversify, but so can lenders)
- They make a daily „insurance“ commitment – the premium being the daily pay off in the stock market (which may be negative)
- Shareholder investment is day-to-day investment; shareholders underwrite a share of risk which includes (in Knightean terms) both uncertainty and risk, hence it goes beyond classical insurance



The Protocol

- The daily exercise of investment and divestment opportunities in share capital monitors the managers' performance
- By their observable action shareholders produce a **protocol** that signals to all other stakeholders (who have all stickier, mostly long-term commitments) what their stake is worth, or more precisely, how high their stake is insured
- In a normative sense, the *insurance* function and the associated *protocol* should be kept as „clean“ as possible



The “Discipline” of the Stock Market

- The managers and other stakeholders will observe the protocol, and adjust their commitments accordingly
- Voting is no necessary feature of stockholding; it may be a convenient attribute
- Voting only works as accumulated voting, most effectively in blocks; here it matters – it is the exercise of an entrepreneurial function which should be kept analytically separated from the insurance function
- Entrepreneurship means the effective exercise of influencing the corporate opportunities – it is vested in voting blocks, and, by delegation, in the managerial function



The Moral Hazard Problem of Blockholders

- Blockholders are as shareholders insurers, as voters they reformulate the corporate opportunities, hereby affecting, possibly manipulating, the insured risk. This agency problem is the classical instance of „moral hazard“
- The agency problem is partially cancelled out by the mechanism that worsening the risk affects the insurance contract of the block proportionally; but the minority may be hurt, if selling options are reduced
- A simplified solution for minority protection would be that the majority offers exit to the minority one day after the vote, with compensation for the difference to the stock price of the last trading day before the vote was taken



The Ideal Setting of the Shareholder Corporation

- Split ownership
- Underwriting of a limited risk
- Background diversification options
- Entrance and exit on any trading day at low transaction cost
- A clean protocol
- Specialized management



Is the Shareholder an Owner?

Ownership is the comprehensive title for use and disposition
over a resource



Although the shareholder is an owner in this legal sense,
shareholder–ownership is confined by the terms of a special
pooling contract mainly concerning the underwriting of a
tradable risk



Exit by sale in the „market for shares“ is central, use by
voting is peripheral, if not organized in blocks, thereby
creating a new market: **a market for „corporate control“**
(Henry Manne)





Own Shares – Introduction

Shareholders do not own a fraction of the corporate assets but a tradable commercial paper representing a certain set of specified rights



If the corporation repurchases shares this does not cancel this set of rights; the transaction is no final capital reduction



Trading with own shares is primarily affecting the liquidity of the corporation: repurchases lower liquidity, sales increase liquidity





Own Shares – Introduction

- Trading affects the “insurance pool” of the corporation
- Repurchases lead to proportional “self-insurance”
- Repurchases increase the risk of all stakeholders in the nexus of contracts
- But they also increase the leverage of the outstanding shares, provided the stakeholders remain indifferent, thereby making the outstanding shares more valuable
- This, in turn, stabilizes the expectations of the other stakeholders, because the pool is restored





Own Shares – Advantages

- Shareholders receive a **signal** from the closest insiders, the managers
- ...That it makes sense to use liquidity for buying own shares instead of investing in new projects (which presumably have a lower internal rate of return)
- ...That the creditors will remain indifferent because they do not fear an increase of their risks of default
- ...That the company will trade a higher leverage of the single outstanding share (risk) for a higher yield (premium)
- Which means that the managers consider the shares to be undervalued





Own Shares – Evidence

Announcement of share repurchases has highly significant positive effects on stock prices:



*Studies: Gerke et al. 2003; Schremper 2003;
Seifert and Stehle 2003; Hackethal and
Zdantschouk 2005*



Market seems to neglect (or to discount?) the risk of misrepresentations, fraud, and insider trading





Own Shares – Limits

Legal and Factual Limits

- **Legal limits**

§ 71 subsec. I No. 8 AktG:

- Maximum of 10% of legal capital; authorization of general meeting limited to 18 months; public announcement; mandatory reserves
- Special clause for banks: § 71 subsect. I No. 7 AktG includes “trading”
- Narrow reading of the clauses by some law professors
- SLIM initiative will liberalize the options on EC level





Own Shares – Limits

- Factual Limits

- Game could be played until there is only one remaining shareholder; creditors would be indifferent if she/he would command over unlimited wealth
- There are “pragmatic virtues” in prescribed percentages – but they could also be contained in a publicized charter
- Important limitation is liquidity – in view of the accounting requirement of corresponding reserves





Own Shares – Precautions

Insider problem is real: US studies by Fried 2000, 2005

Remedies:

- Ad hoc reporting
- Temporary reporting about status and moves
- Daily reporting on homepage about status and moves (Franke)
- Screening of gatekeepers: informed market reaction by professionals
- Do we need tight capital market regulation as proposed by new EC law?



Discussion

