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# Right to Inspect *Revised*

**CRETE 2024**

Milos, July 13th, 2024

# The Right to Inspect

- Shareholder inspection rights allow shareholders to access the relevant documents of the company in which they hold shares, to address the problem of *information asymmetry* and reduce the agency costs inherent in the corporate structure (Huang & Thomas, 2021).
- Despite some very general similarities, there are many significant differences in how these inspection rights are structured and exercised in various jurisdictions around the world.
- The last decade has witnessed an increase in such suits filed, especially in connection with mergers and acquisitions (Cox et al., 2023).

# The Right to Inspect

§ 220 (b) Delaware General Corporation Law:

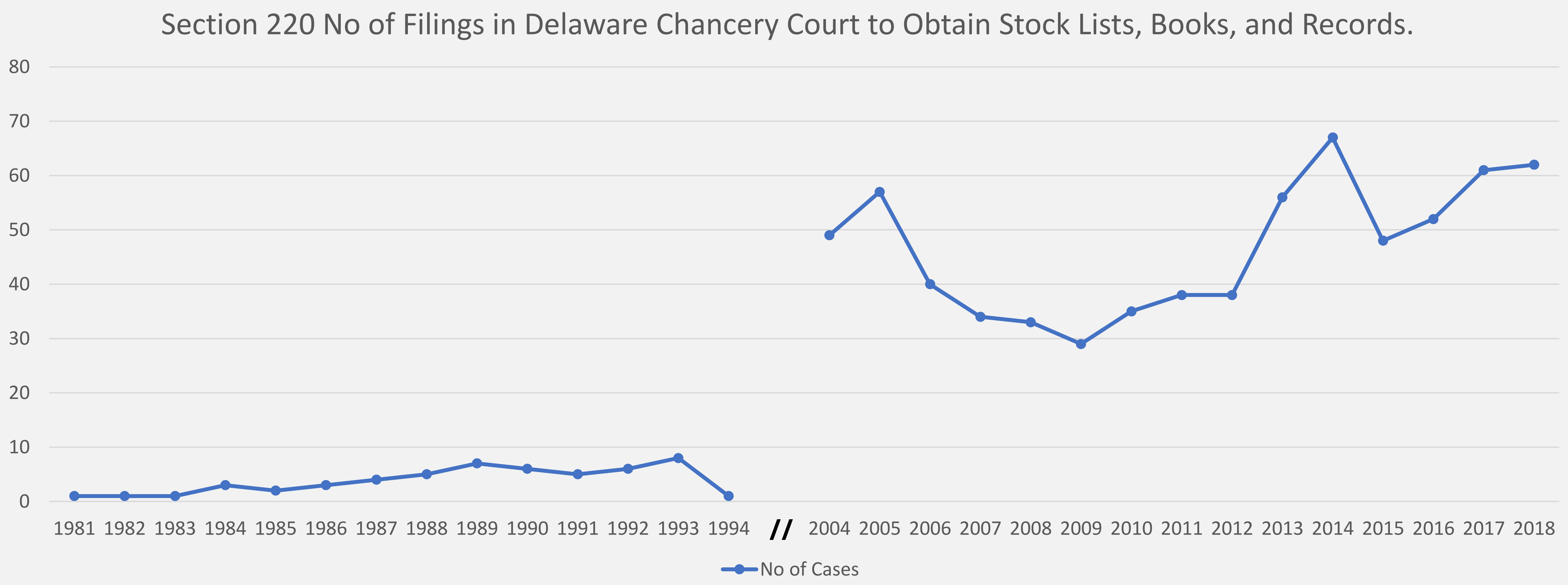
*“Any stockholder, in person or by attorney or other agent, shall, upon written demand under oath stating the purpose thereof, have* ***the right*** *during the usual hours for business* ***to inspect*** *for any* ***<u>proper purpose</u>****, and to make copies and extracts from:*

*(1) The corporation’s stock ledger, a list of its stockholders, and its other books and records; and*

*(2) A subsidiary’s books and records, […].”*

- This includes Board minutes, emails, list of telephone calls, etc.

# The Right to Inspect




- 1981-1994 data: Thomas & Martin (1997); 2004-2018 data: Huang & Thomas (2020).

# The Right to Inspect

- European Union's inspection rights

- EU Directive on Non-Financial Reporting 2014/95/EU, amending Directive 2013/34/EU
  - Non-financial reporting includes Market Shares, Quality Rankings, Executive Compensation, CSR Activities, Health & Safety, etc.
- EU Directive on the Encouragement of Shareholder Engagement 2017/828/EU, amending Directive 2007/36/EC
  - Facilitates transparency through the transmission of information between the firm and its shareholders

- All in all, laws and directives try to keep a balance between minority shareholder's rights and the protection of confidentiality and the protection of business conduct.

# The Right to Inspect

- However, the “Right to Inspect” is not **inherent**.
- The firm may plausibly object to such an Inspection on the grounds of competition and confidentiality.
- After all, what is a **proper purpose**?

§ 220 (c) Delaware General Corporation Law:

*“**If the corporation**, or an officer or agent thereof, **refuses to permit an inspection** sought by a stockholder or attorney, or other agent acting for the stockholder pursuant to subsection (b) of this section **or does not reply to the demand within 5 business days** after the demand has been made, **the stockholder may apply to the Court of Chancery for an order to compel such inspection.** The Court of Chancery is hereby vested with exclusive jurisdiction to determine whether or not the person seeking inspection is entitled to the inspection sought.”*

# The Right to Inspect

- **Proper purpose** could be for example (Palmer, 2015):

  - The firm is mismanaged, which can be shown by a divergence between the (a priori) financial projections and (a posteriori) actual results.

  - A sworn testimony from an “expert” identifying “red flags” in the firm’s financial statements.

  - Socially irresponsible ESG / CSR business actions.

  - Merge & Acquisition *(overlapping ownership**?**)* that might benefit or harm some stockholders.

  - Legal and Regulatory issues (*investigation from Competition Agency?)*

# The Right to Inspect

- Examples of firms in the same industry engaging in a section 220 case in Delaware.

- High River Ltd. Partnership versus Occidental Petroleum Corporation (2019). The Court denied the plaintiff's inspection demand.

- NVIDIA Corporation versus Westmoreland County Employees' Retirement Fund (2022). NVIDIA argued that the Fund also had stocks in its rival AMD, acting as an agent of AMD and not as a bona fide stockholder of NVIDIA. The Court granted the plaintiff's inspection demand.

# The Right to Inspect and Managerial Compensation

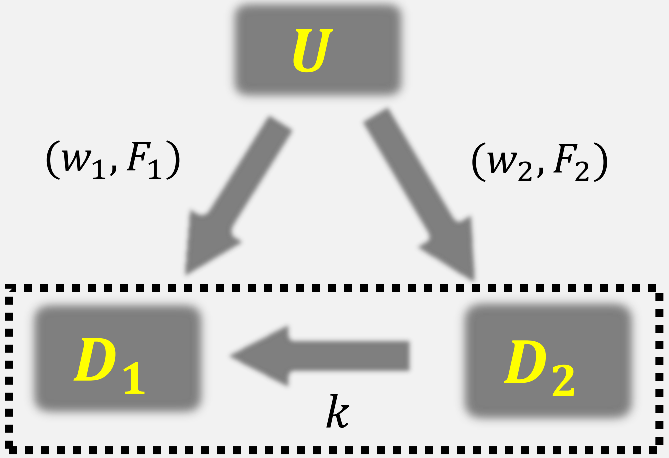
- Since the seminal work by Fershtman & Judd (1987), Sklivas (1987), and Vickers (1985), the literature on strategic delegation has shown that firms can use observable managerial compensation contracts as a commitment device to gain a competitive advantage in oligopolistic markets.
- Full observability of all contract details has been critically discussed in subsequent research (Kopel & Pezzino, 2018; Kopel & Putz, 2020).
- Since observable strategic delegation under strategic substitutes leads to increased competition and lower profits, it is still unclear why not firms keep their managerial contract information secret.

# Our Argument

- We argue that when Court decides on a "*Right to Inspect*" case, it should consider the economic impact on competition and welfare.
- When both the plaintiff and the defendant are:
    - competing in the same product market,
    - goods are strategic substitutes (Cournot), and
    - there exists a common supplier with relatively medium-to-low bargaining power
- Then, extending the "*Right to Inspect*" may increase welfare and competition in a way we will explain later.

# Market Structure

- To defend our argument, consider the following model.
- One common upstream firm $U$ supplies a crucial input to two downstream firms $D_1$ and $D_2$.
- $D$-firms use this crucial input in a "$1-1$" technology to produce their final (horizontally differentiated) product, which they sell to a continuum of consumers.
- $U$ has a constant marginal cost $c > 0$.
- $D$-firms' only cost is the one induced by the vertical two-part tariff contract with $U$.
- $D_i$s pay to $U$ a two-part tariffs contracts consisted of a fixed fee $F_i$ *plus* a wholesale price $w_i$ per unit purchased.
- $D_1$ is a minority shareholder of $D_2$, $0 < k < 0.5$.
- Quadratic utility function: Consumers prefer "more to less" and they "love variety". Gives rise to Linear Demand.




Demand

$$p_i = a - q_i - \gamma \cdot q_j$$

Gross Profits

$$\pi_U = (w_i - c) \cdot q_i + (w_j - c) q_j$$

$$\pi_{D2} = (1-k) \cdot (p_2 - w_2) \cdot q_2$$

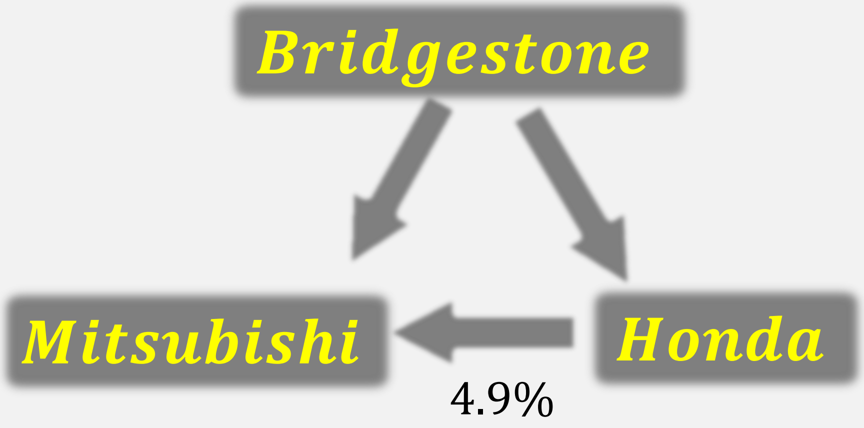
$$\pi_{D1} = (p_1 - w_1) \cdot q_1 + k \cdot (p_2 - w_2) \cdot q_2$$

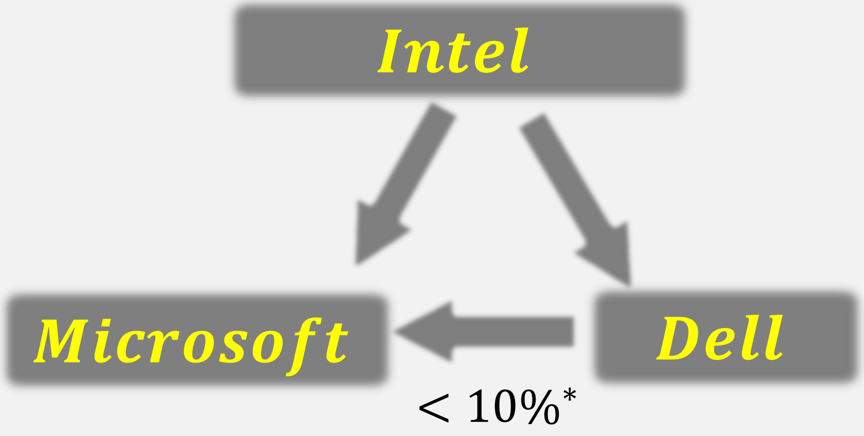
Net Profits

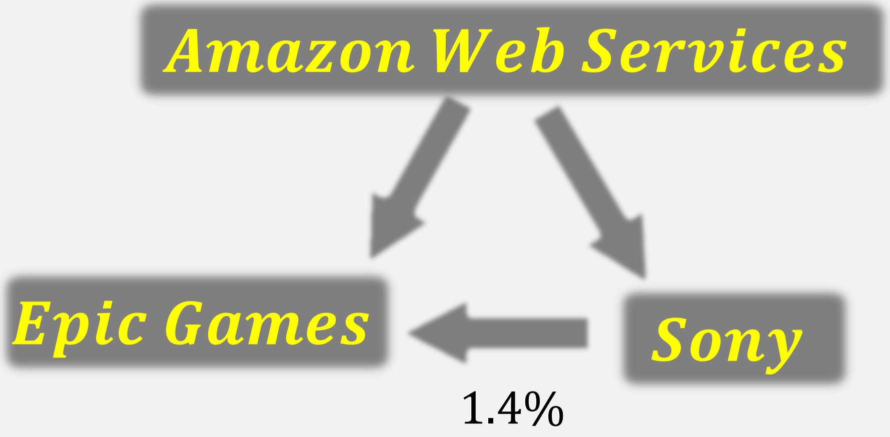
$$\pi_U + F_i + F_j$$

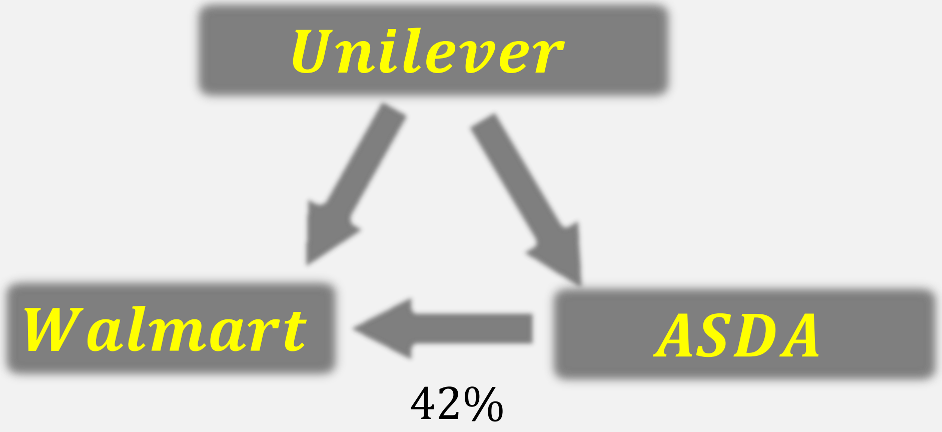
$$\pi_{Di} - F_i$$

# Real World Examples of our Model Structure (for 2023)



# Examples from the past

- From 2012 until 2024, Delta Airlines held 4.17% of Aero México’s shares
- From 1997 until 2003, Microsoft held 7% of Apple’s shares
- From 2009 until 2015, Volkswagen held 19.9% of Suzuki’s shares
- From 2015 until 2019, Disney held 27% of Vice Media’s shares
- From 2001 until 2021, Novartis held 33.3% of Roche’s shares

# Timing

- **Stage 1:** Agents representing the upstream supplier $U$ make secret, separate, and simultaneous negotiations with each downstream firm $D_i, i = 1, 2$.
- *The left-hand doesn't know what the right-hand is doing* (Smith and Thanassoulis, 2012).
- Ideal for *services* and *fast-moving consumer goods*.

$$\left(\pi_U\left(w_i, w_j, \tilde{q}_j\right) + F_i + F_j - d_i\left(w_j, \tilde{q}_j\right)\right)^{\beta} \cdot \left(\pi_{Di}\left(w_i, \tilde{q}_j; k\right) - F_i\right)^{1-\beta}$$

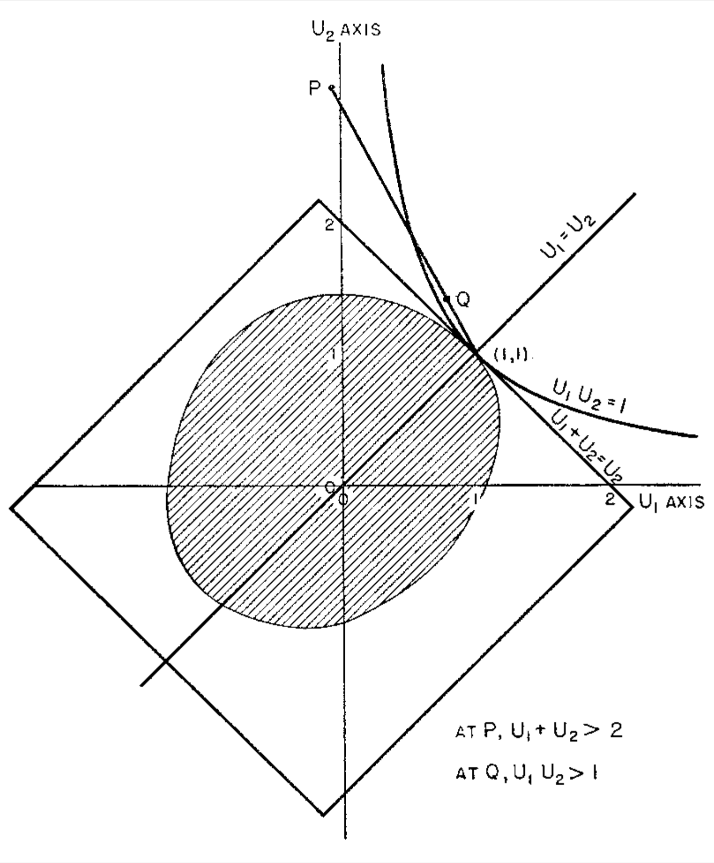
- **Stage 2:** $D_1$ exerts its "*Right to Inspect*" to disclose $D_2$s vertical contract terms. *If rejected*, $D_i$ hold the previous equilibrium results. *If accepted*, may trigger renegotiations.
- Renegotiation occurs only if it is in the mutual interest of both $U$ and $D_1$, keeping $D_2$'s contract terms constant

$$\left(\pi_U\left(w_i^d, w_j^*\right) + F_i^d + F_j^* - d_i\left(w_i^d, w_j^*\right)\right)^{\beta} \cdot \left(\pi_{Di}\left(w_i^d, w_j^*; k\right) - F_i^*\right)^{1-\beta}$$

- **Stage 3:** D-firms make their output decision $\max_{q_i} \pi_{Di}\left(q_i, q_j^*; k\right)$

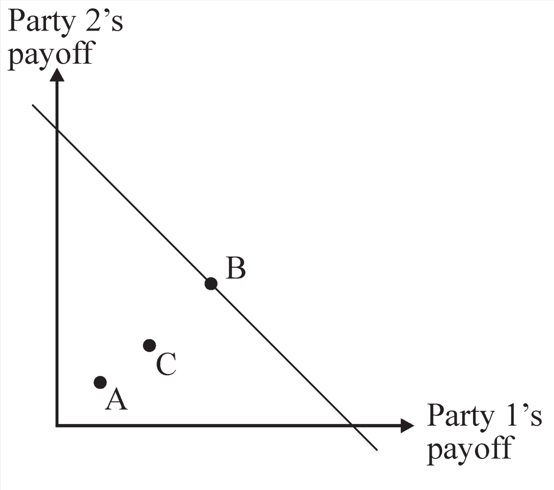
# Solution Concept

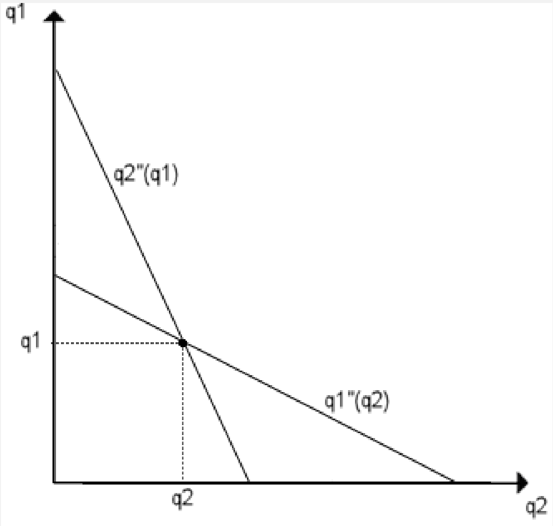
- To solve this dynamic game, we use the *subgame perfect Bayes-Nash equilibrium over pure strategies*.
- In particular, to solve **Stage 1** we employ the “*Nash-in-Nash*” solution concept (Collard-Wexler et al., 2019).
- “*Nash-in-Nash*”: Nash equilibrium in Nash bargains.
- Our bargaining outcome is the best response to the outcome of the rival bargains.
- Caveat: we don’t account for multi-lateral deviations.



# Solution Concept

- To solve **Stage 2**, we employ the "*renegotiation-proofness*" concept (Fudenberg & Tirole, 1988).
- The renegotiation is triggered due to changed circumstances (disclosure).
- Both players should agree to replace Stage 1's contract with a Pareto optimal (given the rival contract).
- Renegotiation is considered costless.
- To solve **Stage 3**, we employ the standard Cournot-Nash equilibrium.



# Equilibrium Results; **Rejecting** the "Right to Inspect"

- Say that $D_2$ *rejects* $D_1$'s "*Right to Inspect*".
- Stage 1's equilibrium results sustain in equilibrium.
- We follow O'Brien & Shaffer's (1992) two-step maximization procedure.

$$\left(\pi_U(w_i, w_j, \tilde{q}_j) + F_i + F_j - d_i(w_j, \tilde{q}_j)\right)^{\beta} \cdot \left(\pi_{Di}(w_i, \tilde{q}_j; k) - F_i\right)^{1-\beta}$$

- Secret two-part tariffs lead to marginal cost pricing (Hart & Tirole, 1988).

$$w_1^* = w_2^* = c$$

- $U$ uses $F_i$ to expropriate part of $D_i$'s profits according to its bargaining power $0 < \beta < 1$.

$$F_1^* = \beta \cdot \pi_{D1}, \;\; F_2^* = \frac{\beta}{1-k} \cdot \pi_{D2}$$

- Comparative statics: an increase in minority shareholding $k$ harms welfare and softens competition.

$$\frac{\partial Q}{\partial k} < 0, \; \frac{\partial CS}{\partial k} < 0, \; \frac{\partial PS}{\partial k} > 0, \; \frac{\partial TW}{\partial k} < 0$$

# Equilibrium Results; **Accepting** the "Right to Inspect"

- Now, say that $D_2$ *accepts* $D_1$'s "*Right to Inspect*".
- $D_2$'s contract is disclosed $w_2^* = c$, $F_2^* = \frac{\beta}{1-k} \cdot \pi_{D2}$.
- $D_1$ and $U$ secretly investigate a mutually profitable re-negotiation of the initial contract, given $D_2$'s contract.
- Comparative statics: the same negative effect on competition and welfare holds.

$$w_1^d > c$$

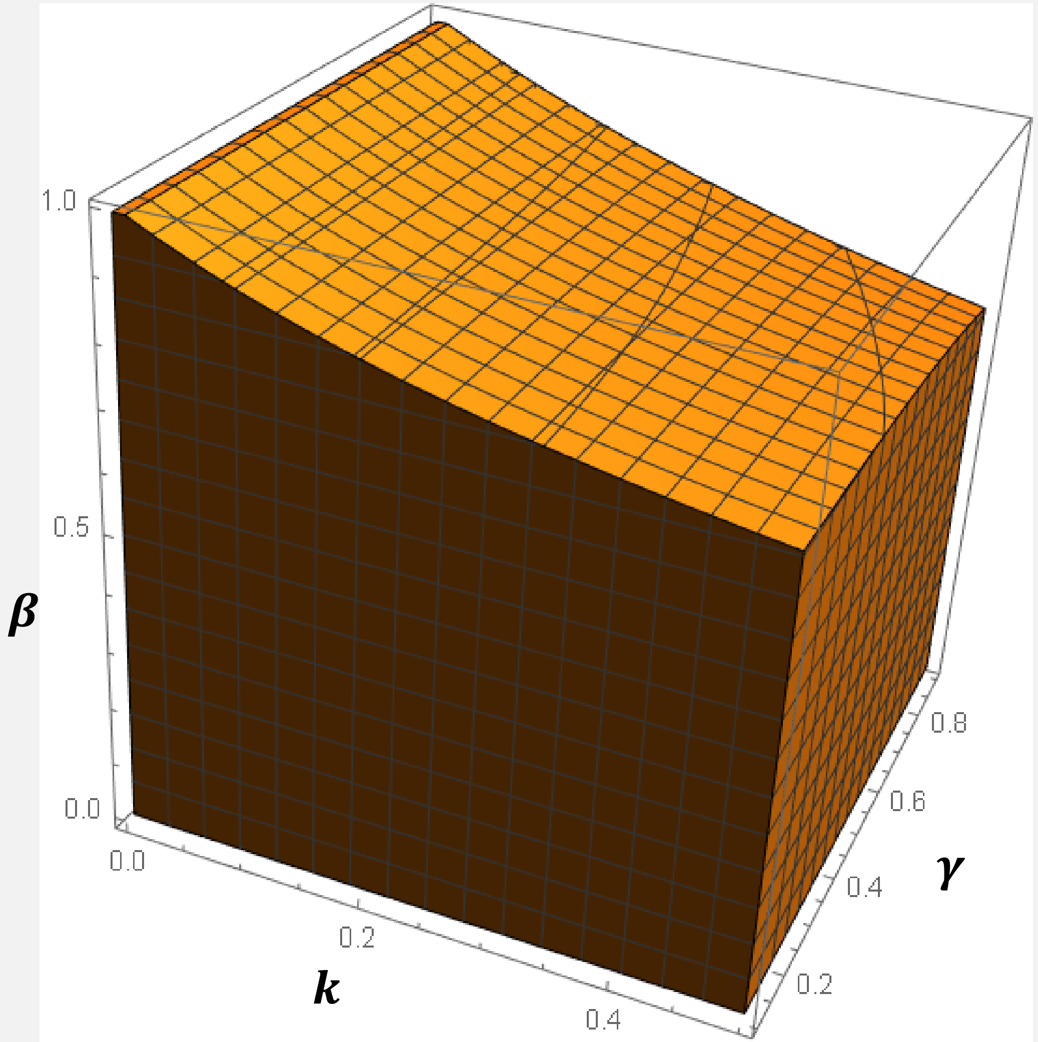
$$F_1^d > \beta \cdot \pi_{D1}$$

$$\frac{\partial Q^d}{\partial k} < 0,\ \frac{\partial CS^d}{\partial k} < 0,\ \frac{\partial PS^d}{\partial k} > 0,\ \frac{\partial TW^d}{\partial k} < 0$$

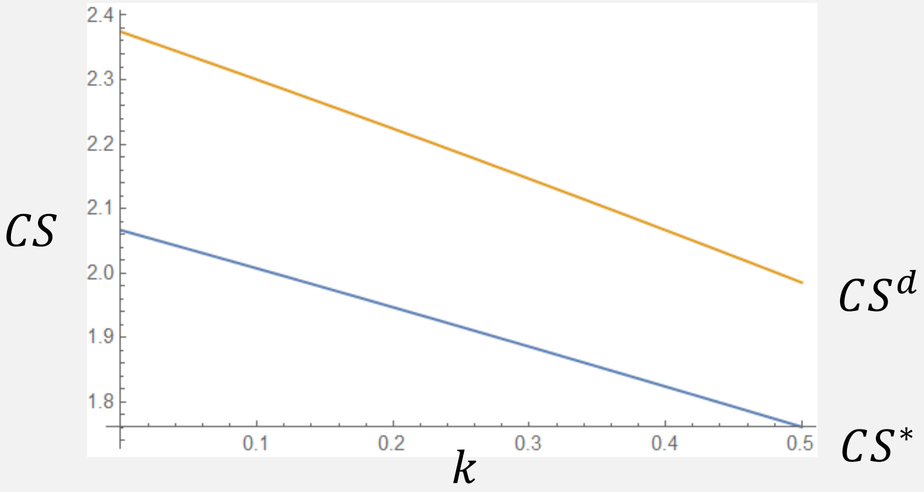
# Equilibrium Results; To Renegotiate or Not?

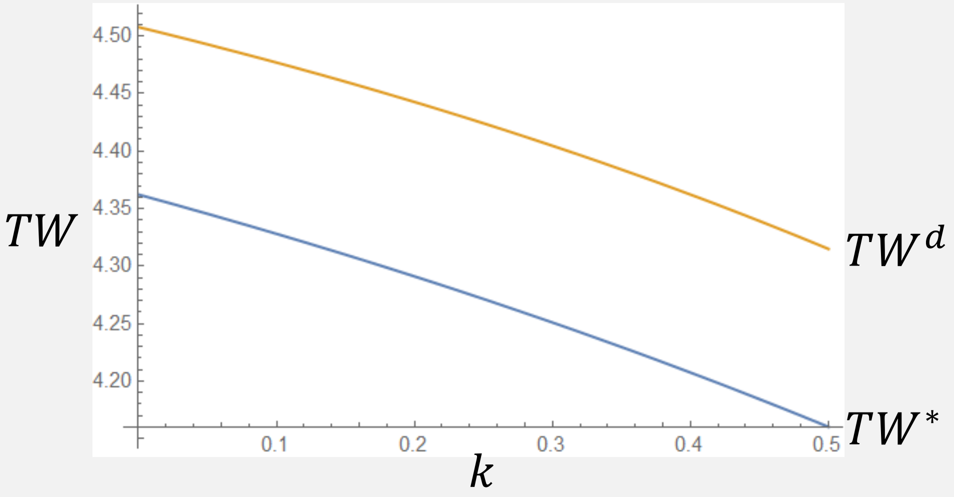
- $U$ is *always* better off when renegotiating $(w_1, F_1)\uparrow$.
- $D_1$ wishes to renegotiate only when $U$ is not too strong and products are not very differentiated, $\beta < \beta_{crit}(\gamma, k)$.
- The 3D Plot resembles the area where the net profits of **both** $D_1$ **and** $U$ are **higher** *under renegotiation*.

$$\frac{\pi^d_{D1} - F^d_1}{\pi^*_{D1} - F^*_1} > 1 \quad \textbf{\textit{AND}} \quad \frac{\pi^d_U + F^d_1 + F^*_2}{\pi^*_U + F^*_1 + F^*_2} > 1$$



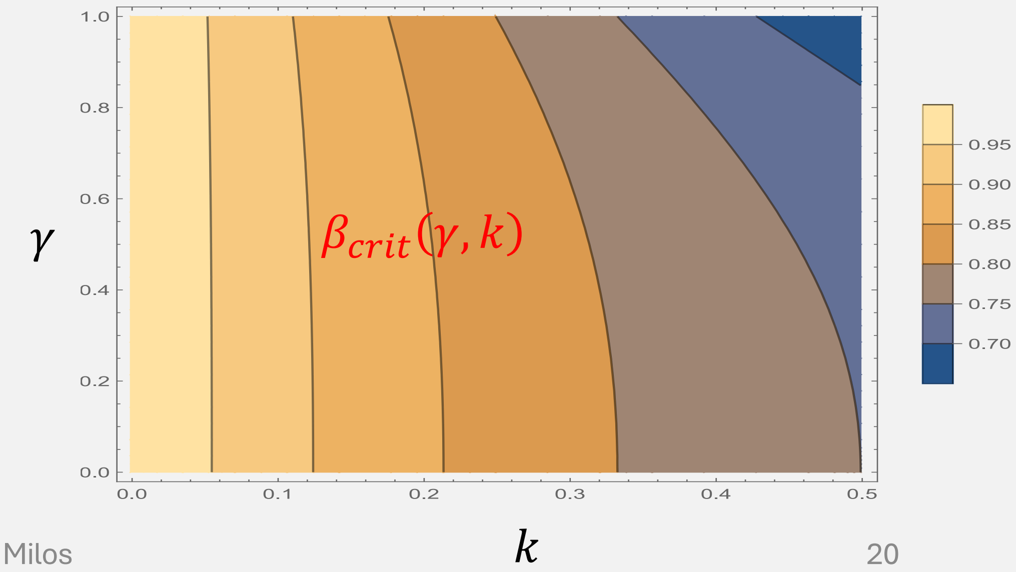
# Equilibrium Results; Effects on Welfare




- Also...
- Contract renegotiation leads to
  - *lower* retail prices,
  - *higher* aggregate output $Q^d$,
  - *higher* consumer surplus $CS^d$, and
  - *higher* total welfare $TW^d$.
- But, since $w_1^d > c = w_1^*$ and $w_2^* = c$,

how can this be possible?



# Intuition

- $D_1$ originally used its $k$ −minority shareholdings in $D_2$ to collude.
- As $k\uparrow$, we were moving from Cournot outcome $Q^* = \frac{2\,(a-c)}{3}$ to the monopoly outcome $Q^* = \frac{a-c}{2}$ (joint profit maximization), always having $q_1^* < q_2^*$.
- The "*Right to Inspect*" offers $D_1$ a *better mechanism* (than collusion) to increase its profits.
- Since $D_2$'s contract $(w_2^*, F_2^*)$ is carved in stone, $D_1$ could become a monopolist *over the residual demand*.
- $D_1$'s scope is now different: as $k\uparrow$, instead of reducing its output to increase its profits, $D_1$ chooses to increase its output (*even above* $q_2$) to expand the residual market in which $D_1$ is a monopolist.

# Extension; Price Competition

- To check the robustness of our results, we consider the case of price competition downstream (à la Bertrand).
- It turns out that $D_1$ *never* has incentives to re-negotiate. So, why to exert its Right?
- An increase in $w$ triggers an increase in both $p$'s, shrinking the market.
- So, the "*Right to Inspect*" is not much effective as a collusive device as minority holdings are.
- We argue that ***strategic substitutability*** or ***strategic complementarity*** (Bulow et al., 1985) plays a crucial role in the effects of the "*Right to Inspect*" in welfare and competition.

# Future steps

- Consider how and why market expansion could affect the result (Shubik-Levitan demand system).
- Consider how and why the curvature of the demand affects the pass-through rate of wholesale prices (demand system à la Lopez and Vives, 2019).
- Add a third downstream competitor to increase product market competition and decrease the collusive horizontal effect of overlapping ownership.
- Consider other vertical contract types (linear tariffs?) and upstream market structures (cvc's?).
- How does the "Right to Inspect" affects *managerial compensation* or *CSR activities*?