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**The Agency Problem in the Merger of Vistula & Wólczanka Ltd.
and W. Kruk Ltd.**

Abstract

The article discusses the behavior of company bodies and possible conflicts of interests occurring among them during company takeover. In this context, the insider management model, popular in Poland, is discussed. Its implications have been presented using the example of the merger between Vistula & Wólczanka Ltd. and W. Kruk Ltd.

1. Introduction

In classic economic theory, the enterprise is identified with the entrepreneur, who performs the key functions of ownership and management of production factors. The market economy of developed countries proves this theory to be wrong, especially in big companies, due to the separation of management and ownership functions. Shareholders who provide capital, hire managers whose task is to run the company. Separating ownership from management may be explained as an effective form of economic cooperation within contracts in the enterprise (Fama 1980, p. 289). The agency problem describes the relations in this kind of a company.

The mentioned theory is also very helpful when explaining the relations and behavior in the face company takeover. A deteriorating economic situation in the world increases the probability of takeover transactions. Subjects with a strong eco-financial position may use the period of low stock-exchange quotations of their competitors or of companies which complement their market offer, and attempt to takeover such entities.

The aim of the article is to explain the relations between managers and shareholders in possible takeover situations. The first part of the article, being the base for further analysis, discusses the agency problem concept and essence, along with its evolution. The second part outlines conflicts of interests that may occur in the takeover bid. It also provides basic information on the techniques used by managers to defend companies against takeovers. The last point contains a description of the 2008 takeover of W. Kruk Ltd. by Vistula & Wólczanka Ltd., with particular attention paid to the emerging conflicts and defense methods used in this process.

2. The Agency Problem

The concept of agency problem emerged at the turn of the 60s and 70s of the last century. Initially, literature on the subject focused on the issue of business activity risk distribution. Attention was also paid to the variety of approaches to risk, characteristic for particular parties connected with the business. Later, the problem of the agent was introduced from the delegation of management of economic entities. The agency problem had been developed primarily by M. Jensen, M. Meckling and E. Fama⁵¹.

According to this theory, the company is perceived as a bunch of contracts connected with production factors. The parties involved in each contract are motivated by their personal interests, however they have to be aware of the threat of such behavior. The realization and duration of their contract is also dependent on the success of other contracts within the entity (Fama 1980, p. 289). Such an approach is fully grounded. A company is a very complex unit and it is necessary to achieve goals in all areas of activity to be able to compete with other entities. The most important contracts in an earning organization are those, which regulate in particular: 1) the claims of shareholders (capital givers) and 2) the allocation of the decision-making process. Such a contract differentiates a given company from other entities functioning within the sector and explain why this form of organization allows the company to survive and compete on the market (Fama, Jensen 1983b, p. 302).

⁵¹ See. M. Jensen, W. Meckling, *Theory of the Firm: Managerial Behavior, Agency Coasts, and Ownership Structure*, 'Journal of Financial Economics' vol. 3, 1976, pp. 305-360; E. Fama, M. Jensen, *Separation of Ownership and Control*, 'Journal of Law and Economics' vol. 26, 1983, pp. 301-325; E. Fama, M. Jensen, *Agency Problems and Residuals Claims*, 'Journal of Law and Economics' vol. 26, 1983, pp. 327-349

The agency problem concentrates on explaining the dependencies within the central contract. By a contract one of the parties (the principal) delegates decision-making powers to the other party (the agent), who provides labor to the principal (Ekanayake 2004, p. 49). Due to different objectives of the principal and the agent, and the opportunistic approach of the latter, a conflict of interests appears; it is called the agent problem. The parties also present different approaches towards risk. Capital givers expect an increase of invested capital and they have to take investment risk into account, however they have possibilities to diversify their investments. For managers, in turn, the contract is usually a single, non-diversified income source, so their approach is that of risk aversion.

Analyzing the conflict of the contract parties' aspirations outlined above, one might question if it would not be more effective to give the roles of management and ownership to one entity, as it is done in the classic economic theory. Although there is no perfect answer to such a question, the analysis of developed capital markets indicates existing grounds for separating these functions. As early as 1924, Veblen claimed that capitalists were interested in creating shortages through monopolization, while engineers would set technical efficiency and internal growth as their goal (Veblen 2001, p. 45). Investors are keen on employing managers, whom they treat as highly specialized human capital to generate principal repayment. Managers, in turn, are unable to do without capital of the investors, necessary for current activity and development (Shleifer, Vishny 1997, p. 740).

It is worth pointing out that the contract concluded between the principal and the agent is asymmetrical (Urbanek 2005, p. 49). It mainly concerns access to information. An agent who runs the company has a wider spectrum of information on the eco-financial situation of the entity, and may use it, within legal boundaries, to have an advantage over shareholders. A principal, who has access to fragmentary information passed on by the agent may make wrong decisions and draw wrong conclusions.

The role of the agency problem is, among others, to provide recommendations as how to compensate the conflict of interests mentioned above and the informational asymmetry occurring between the contract parties. Among the most important mechanisms, one should include the contract mechanism and direct monitoring (Urbanek 2005, pp. 54-58).

The contract mechanism means concluding an agreement between the principal and the agent, which regulates the most important issues concerning the direction of the activity and the rules governing the use of the achieved financial results. An optimal situation from the principal's perspective would be the inclusion of agent behavior scenarios into the contract. However, this is not

possible due to the difficulty to describe and foresee future economic events (Shleifer, Vishny 1997, p. 74). An important element of the contract is risk distribution between the parties. Most often, it is carried out by means of the manager's rewarding system.

The aim of direct monitoring is to provide the principal with information on the actions and behaviors of the agent. Information is delivered via an information system, which may include budgeting procedures, a reporting system etc (Urbanek 2005, p. 56). However, mechanisms mitigating the conflict of interests and informational asymmetry mean additional expenses. Therefore, these mechanisms should be formulated and used in such a way that their overall cost would not be bigger than the probable missed opportunities which would arise for the principal as a result of the opportunistic approach of the agent.

An important factor influencing the behavior of the contract parties is the stake structure of the given subject. One may observe the following relations (Demsetz 1983, p. 375):

- Larger defragmentation of the owner's capital gives managers more freedom in their actions,
- Not every shareholder is able or willing to control company management, however those shareholders, in extreme cases, assume that there is one who owns a block of shares allowing him/her to control managers - in professional literature this phenomenon is known as the *free ride problem*.

The agency problem and company expenditure connected with it appear only in case of separating management from ownership. If the company manager is its only owner, the problem does not occur.

3. Mergers and Hostile Takeovers in the Light of the Agency Problem

The merger and takeover mechanism is a convenient background for the agent-principal relation. That is because in a company subject to a takeover or merger, conflicts often occur between its managers and shareholders. In such a case, it is also easier to observe the costs of the conflict for the company.

The aim of the merger and takeover processes is to gain control over the enterprise. Possessing the controlling block of shares enables one to obtain, apart from property and rights ascribed to every share, decision-making powers, to

which the ordinary or qualified majority is entitled⁵². Controlling block of shares ownership creates additional benefits and enables the owner to carry out organizational changes in the controlled entity.

The shareholders of the company being subject to a takeover bid should be given an opportunity to consider such proposals. This is because as long as they may diversify their investment on the capital market, they may view the takeover bid as profitable. From their point of view, it may also be seen as a solution to the owner - manager problem. This happens when the agent of the overtaking company seems to be a person more competent and efficient with higher target figures than the previous agent.

Managers of the company subject of the takeover bid in most cases have different goals than shareholders. Usually, they try to prevent the takeover. It results, first and foremost, from the above-discussed aversion to risk and fear of position loss. Managers usually try to convince shareholders that the bid provided by the bidder is inadequate. Such opinions are difficult to verify, due to the fact that company value is a subjective category; it is hard to confirm or deny this sort of statement on the part of the agent (Walking, Long 1984, p. 55).

Agents' statement declaring the bid offer to be underpriced does not generate costs for the company, managers often use protective techniques which may mean considerable costs. The most frequent defense techniques against takeovers include (Gajdka, Stos 2004, pp. 200-202):

1. Staggered board;
2. Super majority provisions;
3. Fair price requirement;
4. Poison pill;
5. Dual-class recapitalization;
6. Targeted repurchase;
7. White knight;
8. Restructurization of assets;
9. Restructurization of liabilities;
10. Court proceedings.

Techniques 1-5 require adequate legal notations and have to be implemented before the possible takeover attempt. Their aim is to discourage the

⁵² The defense techniques described on the basis of: Gajdka J., Stos D., Wpływ metody obrony przed wrogim przejęciem na rynkową wartość spółki [in:] Duraj J. et al., Wartość przedsiębiorstwa Z teorii i praktyki zarządzania, Wyd. Naukowe Novum, Płock-Pekin-Łódź 2004, pp. 200-203

potential overtaking entity. The most popular technique is the poison pill. Its task is to prevent or hinder the takeover by a dramatic increase of costs, which the overtaking entity would have to bear (Davis 1991, p. 584). Most frequently, the purpose is achieved by means of new share emission for current shareholders with considerable discounts.

Techniques 6-7 are used when the takeover has been attempted. It usually is a bid addressed to one or several particular investors whom managers regard as friendly towards them and company strategy. The restructurization of assets means selling those assets which the overtaking entity wants most, while changes in liabilities may concern shares' repurchase for their remission.

Earlier research, carried out to verify the agency problem, done on mergers and takeovers, proved the following dependencies (Walking, Long 1984, p. 55; Argaval, Mendelker 1987, pp. 823-837):

- Companies where managers objected to the takeover had worse financial results before the takeover attempt,
- Manager's resistance is the key factor which determines the takeover expenditure,
- Managers being in possession of a considerable amount of shares object less to the takeover attempt.

These relations, despite a positive verification on the American capital market cannot be uncritically applied to the European market reality. This stems, firstly, from different views on the functions of the controlling bodies. Much as on the American market they are to represent the interests of shareholders, the supervisory board in European companies focuses mainly on the good of the company, which should presumably reflect the shareholders' interest (Lis, Sterniczuk 2005, p. 45). Secondly, the presented agency problem proves itself in companies where the functions of ownership and management are separated (outsider model). In case of the insider model, where one or a few dominant shareholders also perform managerial functions, the relationships within the contract are not as straightforward as in the outsider model.

If a shareholder is uncertain whether his/her interests are represented properly in the company, he/she may introduce a representative into the supervisory board. Such a shareholder (insider) has the task to provide capital for the company, as well as control the entity. Performing both these functions by one entity makes it difficult to ascribe the role of a principal to such an investor, since his/her behavior as a board member may be one of an agent.

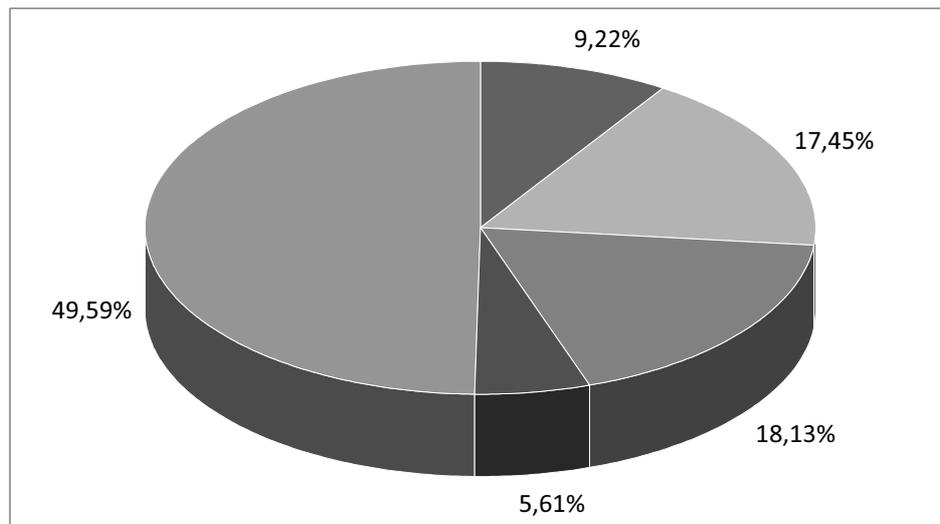
Providing security for dominant shareholders, visible in the insider model, may contradict the good of the minority shareholders. If the benefits gained by the insider from performing the controlling function are relatively bigger than those resulting from property rights, the decisions made by this person may be

viewed by others as ungrounded or harmful. The possibility of such a situation shows the need to protect minority shareholders against the dominant position of the insiders.

4. Vistula & Wólczanka Ltd. and W. Kruk Ltd. Merger vs. the Agent Problem

The Vistula & Wólczanka Limited liability company came to being in 2006, as a result of a merger between Vistula Ltd. and Wólczanka Ltd. Its area of activity is production and sales of men's and women's wear, as well as distribution of global brands. In its portfolio, the company has brands recognized and valued on the Polish market: Vistula, Wólczanka, Letterfeld and Andre Renault. Figure 1. presents the company stakeholders before the merger. It consists mostly of financial investors, while about a half of the stakeholders were entities with less than 5% of the share capital.

Figure 1. Ownership structure of Vistula & Wólczanka share capital, 15.05.2008

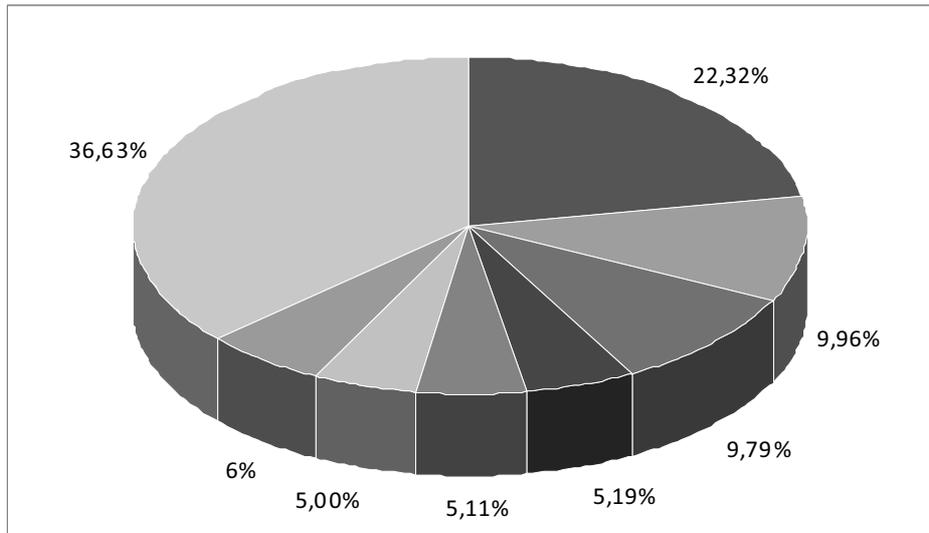


Source: own study, based on www.vistula.pl.

W. Kruk Ltd. is one of the oldest jewelers on the Polish market. Its founders were the predecessors of Wojciech Kruk the current majority shareholder of the company. Its area of activity focuses on production,

manufacturing and distribution of jewellery and distribution of watches. The entities dependent on the company are: Jubilart Ltd. and DCG Ltd. The main shareholder of the company and the head of its board of directors was Wojciech Kruk. There were also several institutional shareholders.

Figure 2. Ownership structure of W. Kruk LTD. share capital, 15.05.2008



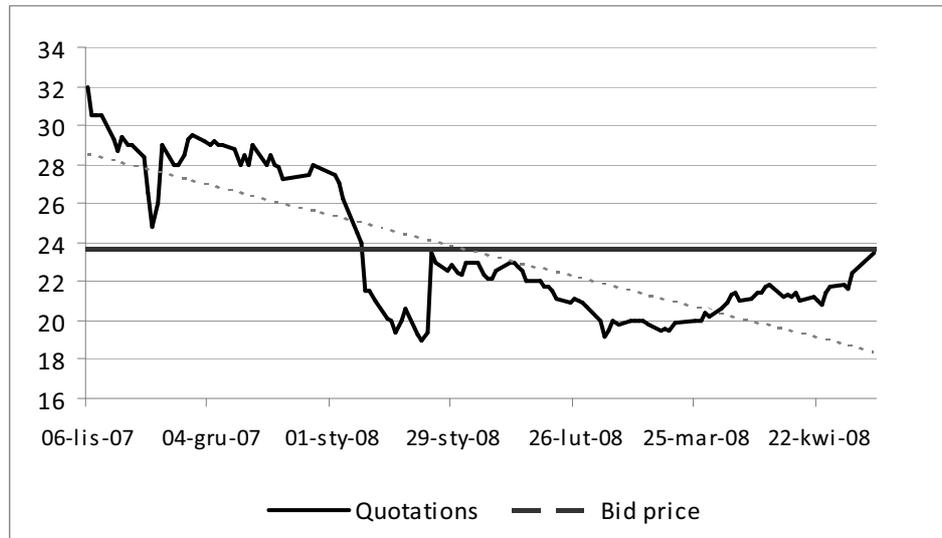
Source: own study, based on www.wkruk.pl.

On May 5, 2008, Vistula & Wólczanka announced a bid call for W. Kruk Ltd. shares, with a subscription period from May 14 to May 27. The aim of V&W was to purchase the counterfoil share block comprising from 51% to 66% of the total number of votes at the shareholders' general meeting. The announced takeover attempt resulted from V&W investment strategy, which assumed creating a capital group which would concentrate entities dealing with retail sales in the premium segment. According to the V&W management board, the merger would especially reduce operating costs of network, logistics management and expenses for administration. It would also enable synergy between the target groups of particular brands⁵³.

⁵³ Call for W. Kruk PLC share sales subscription from 05.05.2008

The V&W board bid the price of 23.70 PLN per share. According to legal regulations, the minimum possible bid price was 23.50 PLN per share⁵⁴. At the same time, a falling tendency of W.Kruk Ltd. share value was observed (see Figure 3). In the light of the above, the bid was considered as moderate.

Figure 3. Share quotations of W. Kruk LTD. in six months prior to the call



Source: own study.

In response to the bid call, the management board of W. Kruk Ltd. issued a statement in which share investors were not recommended to sell the shares in the V&W call for bid. In the statement, attention was drawn primarily to the following:

- The fact of takeover premium pretermission,
- Very limited management cost reduction opportunities due to dispersed localizations of entities,
- Threat to the development strategy adopted by W.Kruk,
- The risk of breach of contract by business partners in the event of Wojciech Kruk leaving the company.

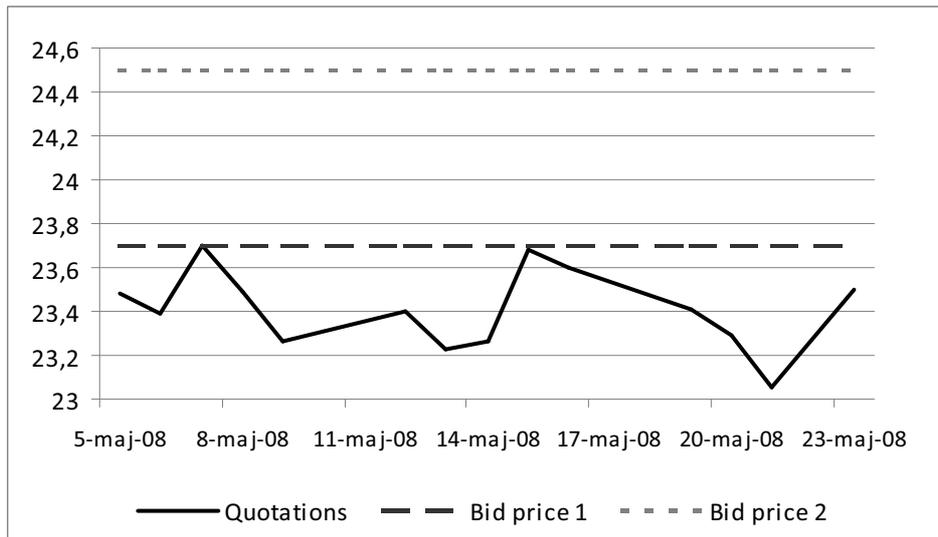
⁵⁴ According to art. 79, par. 1-2 of the July 29 2005 Bill on public offer and conditions of implementing financial instruments into organized circulation, and on Public Limited Company, (Dz. U. 2005, no. 184, pos. 1539 with later changes) the price offered in the bid call, for the shares of the company being the subject of takeover on the regulated market cannot be lower than the average stock market price of these shares from 6 months prior to the call.

The standpoint of Wojciech Kruk, performing the function of the Head of the supervisory board was analogical to the statement of the board of directors.

A representative of one of W. Kruk's institutional investors, Millenium TFI, had a positive view on the possible merger of the entities. In his opinion, the goods offered by the companies were to some extent complementary and aiming at similar target groups (Laskowska 2008, pp. 3-4). Other W. Kruk financial investors would not comment the call, excusing themselves with a professional secret.

The V&W bid became even more attractive on 23.05.2008, when the company board announced raising the price by nearly 3.5% - up to 24.50 PLN per share. As seen on figure 4, the bid was higher than W. Kruk quotations from the call period.

Figure 4. Share quotations of W. Kruk LTD. between 05.05.2008 and 23.05.2008



Source: own study.

The action scheme of W. Kruk managers and shareholders may be represented by the agency problem mechanisms.

The board of directors, for which risk and fear aversion for the loss of personal gains is a typical characteristic feature, recommends rejecting the bid of V&W investors. It is difficult to unambiguously assess the V&W bid drawbacks presented by the Board of W.Kruk. It seems that the objection concerning the

pretermisssion of the takeover premium should be discussed from the shareholders' not managers' point of view. The raised bid price offered by V&W was 3.4% higher than the highest quotation of the company from the bid period. A dispersed localization of the companies does not hinder probable administrative cost reduction. After the possible merger, company headquarters may be moved to one of the premises. The danger concerning the breach of contracts, which are strategic for W. Kruk, in the event of a change of stake, included in the board statement, should not arise if we consider the absence of such remarks in the earlier periodical financial reports of the company. The doubtful valuation of W. Kruk does not change the fact, however, that the reaction of the board was a good example of the agent's behavior.

It is more difficult to analyze the approach of the main shareholder of the W. Kruk company – Wojciech Kruk. As a shareholder and control person in the company, his probable intention was to maximize personal benefits⁵⁵. Wojciech Kruk's negative opinion indicates that the usefulness of performing the controlling function was greater than the usefulness of being a shareholder. Evidence supporting the thesis might be the level of Wojciech Kruk's fee for performing the function of the head of the supervisory board. In 2007 it amounted to 976 000 PLN, while in the first half of 2008 – 519 000 PLN⁵⁶. For comparison, the salary of the other members of the board was 24 000 PLN in 2007 and 12 000 PLN in the first half of 2008. The real threat of losing control over the company founded and developed by Wojciech Kruk's ancestors was not without meaning as well. These circumstances caused Wojciech Kruk to behave like an agent.

Other shareholders, playing the role of the principal in the company in accordance with the agency problem, analyzed the V&W bid in terms of benefits which might be drawn from 1) downturning the possible investment 2) company development in the capital group. One cannot assess the shareholder's attitudes in one way because of their individual preferences, however attention should be paid to two facts: first of all the falling tendency on the stock market, and consequently the need of massive bond redemption by investment fund groups, could make the V&W bid a good opportunity to partly withdraw from or quit the investment, with the price level higher than the stock- quotations. Secondly, the shares of W.Kruk were characterized by low fluency. Therefore, one might assume that the call bid was favorable, especially for investors.

⁵⁵ See more: M. Aluchna, *Mechanizmy corporate governance w spółkach giełdowych*, Szkoła Główna Handlowa w Warszawie – Oficyna Wydawnicza, Warszawa 2007, pp. 45-49

⁵⁶ W.Kruk Ltd. Annual Report 2007; W.Kruk Ltd. Semi-Annual Report 2008

The recommendation given in the statements of W.Kruk Board of Directors and W. Kruk himself might have been insufficient to convince investors not to sell their shares. For defense against takeover, discouraging techniques should have been used, for the V&W board to withdraw. The only protective mechanism applied earlier was a notation in the W. Kruk statute. According to its content, Wojciech Kruk and his family were given power to assign two members of the supervisory board as long as their involvement was above 25% of the share capital⁵⁷. The statute would also grant powers for Wojciech Kruk to appoint the head of the supervisory board for as long as his share does not fall below 10%. Therefore, if the bid had been carried out without the Kruk family consent, they would still have two seats guaranteed in the company's supervisory board.

The declarations of Wojciech Kruk, being evidence of his talks with investors for the purpose of takeover prevention, were not fulfilled. The first sign of capitulation was early company annual report publishing. Such actions allowed for shortening the closed period⁵⁸. Having published the report, the board members were able to freely dispose of the shares in their possession. Lastly, on 26.05.2008, Wojciech Kruk declared a significant reduction of his involvement in the company.

The decision for Wojciech Kruk to accept the bid was most probably caused by two factors: Firstly, defense against takeover would require huge expenses. One of the probable scenarios, considerably hindering the process would be the purchase of about 10% of the company shares. The Kruk family would then possess a block of about 40% of the total share and the takeover would have been significantly hindered. However, such transactions would require spending about 40 million PLN, which he would have to obtain within a short period of time. Secondly, a huge chance for company control loss in the event of a takeover carried out without Wojciech Kruk's consent. Despite two seats in the board, guaranteed by statute, Wojciech Kruk would lose benefits driven from performing the function (such as an exceptional salary).

The call to sell the shares of W.Kruk announced by V&W was realized. Shareholders who disposed of more than two thirds of capital of the company responded to it. The General Assembly of shareholders decided to take the whole property of W.Kruk and change the name of the company into "Vistula

⁵⁷ §17 pkt 2 Statutu W. Kruk Spółki Akcyjnej z siedzibą w Poznaniu, uniform text, as on the day of the administrative court decision on the statutory changes, May 22, 2007

⁵⁸ See: Art. 156 of the 29 July 2005 Bill on financial instruments circulation (Dz.U. 2005 nr 183, poz. 1538 with later changes)

Group S.A.” In connection with the fusion from 30th December 2008 the quotation of W.Kruk on Warsaw Stock Exchange were stopped.

5. Conclusion

The separation of the management function and property in the company is obvious in the conditions of a well-developed capital market. In order to understand the relations between these areas it is necessary to know the relations between them.

The agency problem is one of the most influential theories that describe this range of activity of the company. Its adequacy was verified mainly on the basis of the American market, where the function of management and property is in the majority of cases divided.

The analysis of the fusion of Vistula&Wólczanka Ltd. with W.Kruk Ltd. was to signalize the possibilities to use the agency problem in companies with the so called insider shareholders and to present the mechanisms which takes place during the takeover. The behaviors of insiders are difficult to verify. Depending on the usefulness and benefits they bring they can act both as the agent and the principal. The role of the insider can be very influential in the context of success or failure or the costs of the possible takeover or fusion. Although the usefulness of the agency problem was proved in the description of the corporation behaviors, one can formulate some objections. The most important is the separation of the theory from the social context of management. Such factors like the labor market and goods and the problem of the ethic behaviors of the managers are not taken into consideration.

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