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# Too Close for Comfort: The Role of the Closely Held Public Corporation in the Canadian Economy and the Implications for Public Policy

Ronald Daniels

*University of Pennsylvania*, [president@jhu.edu](mailto:president@jhu.edu)

Paul Halpern

*University of Toronto*

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# Too Close for Comfort: The Role of the Closely Held Public Corporation in the Canadian Economy and the Implications for Public Policy

## **Abstract**

For several decades, American corporate scholars assumed the inevitability of the widely held Berle and Means' corporation. The argument was simple. In a rapidly developing industrial economy, economic prosperity dictated the infusion of massive amounts of capital into owner-managed corporations. Without ample capital, entrepreneurs would be unable to realize the scale economies or technological innovations necessary for industrial growth. The rub in the story, however, was that to raise the necessary capital, owner-managers had to sell off equity interests. Inevitably, the pressure for capital meant that ownership ended up being dispersed among numerous small stakes shareholders. With ownership fractured, sundry collective action problems subverted the capacity of shareholders to wield effective control over their managerial agents, which, in turn, meant efficiency losses from sub-optimal resource utilization.

Recently, however, recognition of the survival of concentrated share ownership corporations in other countries, namely Germany and Japan and even in the United States, has caused American scholars to reconsider their commitment to the evolutionary inevitability of the Berle and Means' corporation. No longer the byproduct of innate economic forces, the American corporation has of late been viewed by many as merely path dependent, more particularly the result of a confluence of political, historical and cultural factors. Perhaps the most important was the restriction barring financial intermediaries from holding or voting ownership interests in commercial companies. Had these barriers not been created, ownership may have come to reside in sophisticated large stakes shareholders, who were much more likely than retail investors to control managerial agents.

## **Disciplines**

Law

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# TOO CLOSE FOR COMFORT: THE ROLE OF THE CLOSELY HELD PUBLIC CORPORATION IN THE CANADIAN ECONOMY AND THE IMPLICATIONS FOR PUBLIC POLICY

*Ronald J. Daniels and Paul Halpern\**

## I. INTRODUCTION

For several decades, American corporate scholars assumed the inevitability of the widely held Berle and Means' corporation.<sup>1</sup> The argument was simple. In a rapidly developing industrial economy, economic prosperity dictated the infusion of massive amounts of capital into owner-managed corporations. Without ample capital, entrepreneurs would be unable to realize the scale economies or technological innovations necessary for industrial growth. The rub in the story, however, was that to raise the necessary capital, owner-managers had to sell off equity interests. Inevitably, the pressure for capital meant that ownership ended up being dispersed among numerous small stakes shareholders. With ownership fractured, sundry collective action problems subverted the capacity of shareholders to wield effective control over their managerial agents, which, in turn, meant efficiency losses from sub-optimal resource utilization.

Recently, however, recognition of the survival of concentrated share ownership corporations in other countries, namely Germany and Japan and even in the United States, has caused American scholars to reconsider their commitment to the evolutionary inevitability of the Berle and Means' corporation.<sup>2</sup> No

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\* Faculty of Law, University of Toronto, and Faculty of Management, University of Toronto, respectively. We acknowledge the able research assistance of Kelly Friedman, an associate at the law firm of Goodman Phillips & Vineberg, and of Wayne Bigby, third-year student of the Faculty of Law. We also appreciate the secretarial assistance of Pia Bruni in preparing this article. Finally, Jonathan Macey of the Cornell Law School and Ed Waitzer, Chair of the Ontario Securities Commission, provided thoughtful comments on an earlier draft of this article.

<sup>1</sup> Adolf Berle and Gardiner Means, *The Modern Corporation and Private Property* (New York, MacMillan, 1933).

<sup>2</sup> M. Roe, "Political and Legal Restraints on Ownership and Control of Public Companies"

longer the byproduct of innate economic forces, the American corporation has of late been viewed by many as merely path dependent, more particularly the result of a confluence of political, historical and cultural factors. Perhaps the most important was the restriction barring financial intermediaries from holding or voting ownership interests in commercial companies. Had these barriers not been created, ownership may have come to reside in sophisticated large stakes shareholders, who were much more likely than retail investors to control managerial agents.

Nevertheless, however intellectually exhilarating the American debate over corporate governance, it has always had a slightly sterile quality to the Canadian ear. Unlike its American counterpart, the concentrated share ownership structure of the Canadian corporation has proven itself much more resilient to the pressures of industrialization. Whereas the widely held corporation has long been the norm in the United States, it has only been the exception in Canada.<sup>3</sup> Moreover, high levels of share ownership concentration were able to flourish in Canada despite the fact that Canadian financial intermediaries never made major investments in corporate equities.

Yet, instead of celebrating the capacity of Canadian shareholders to ensure the fidelity of their managerial agents through ownership, several Canadian commentators have adopted a decidedly more ambivalent view of the merits of high share ownership concentration.<sup>4</sup> The concern is that ownership has not led to demonstrable gains in the performance of Canadian firms, and, in many cases, may have facilitated intra-shareholder redistributions of wealth.

In this article, we explore the effect of share ownership concentration on corporate performance in Canada from a law and

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(1990), 27 *Journal of Finance* 7, and "A Political Theory of American Corporate Finance" (1991), 91 *Col. L. Rev.* 10; Joseph Grundfest, "Subordination of American Capital" (1990), 27 *Journal of Finance* 89.

<sup>3</sup> In 1990, for instance, only 14% of the companies in the Toronto Stock Exchange 300 were widely held in contrast to 63% of the companies in the United States' Fortune 500. Of the remainder, 60.3% are owned by a single shareholder with legal control (greater than 50% of voting shares), 25.4% by one shareholder with effective control (20 to 49.9% of voting shares) or by two or three shareholders having the ability to combine and establish joint legal or effective control. See Ronald Daniels and Jeffrey MacIntosh, "Toward A Distinctive Canadian Corporate Law Regime" (1991), 29 *Osgoode Hall L.J.* 863 at p. 884.

<sup>4</sup> Daniels and MacIntosh, *ibid.* For a popular account, see Diane Francis, *Controlling Interests, Who Owns Canada?* (Toronto, Macmillan, 1986).

finance perspective. In Part II, we array the different and competing incentive effects of share ownership on firm value, with reference to the empirical literature. On the basis of this literature, we argue that while widely held companies pose obvious and well known accountability problems for shareholders, there are also severe accountability problems manifest to some degree in closely-held public corporations. We review the empirical literature investigating the relationship of ownership value and firm structure, and find that among closely-held public companies, these problems are most acute for managing shareholders who are either aging entrepreneurs or second generation heirs. We argue that for these corporations, the ability to extract non-pecuniary benefits from control may make these shareholders reluctant to surrender control, even if doing so generates tangible increases in economic wealth for the controller. This commitment is explained, in part, by the relatively low levels of utility that high income individuals derive from marginal increases in wealth, in contrast to non-pecuniary benefits derived from control itself, and to endowment effects.

We argue that certain efficiency gains could be realized by encouraging these large block holders either to take their companies private or to sell a large portion of their voting stock to other shareholders, ideally specialist monitors. In Part III, we speculate on why the Canadian economy has sustained high and durable ownership levels, implicating a number of disparate factors. In Part IV, we argue that for many types of closely-held Canadian corporations, trade and investment liberalization is unleashing powerful market forces that will promote the transformation of some closely held public companies to either private companies or deconcentrated public companies. Nevertheless, for the reasons alluded to above, individual or family controlled companies, especially those with dual class structures, are likely to be less susceptible to these pressures — at least in the short run — and we express concern about the efficiency losses from delayed de-concentration. In Part V, we canvass several different policy options for addressing majority-minority shareholder conflicts in the context of these laggard companies.

## II. THE EFFECT OF OWNERSHIP CONTROL ON FIRM VALUE

### 1. Convergence and Entrenchment

Berle and Means' concern with the effect of splintered ownership on managerial incentives was formally developed in Jensen and Meckling's theory of the firm.<sup>5</sup> In the Jensen and Meckling account, management enjoys delegated authority from shareholders, the firm's principals. However, owing to innate information problems, shareholders are unable to observe perfectly the efforts and conduct of their managerial agents, and rational managers will exploit these monitoring infirmities to favour their own interests at the expense of shareholders, creating so-called agency costs. In the Jensen and Meckling model, the accountability problems are most severe when shareholdings are widely dispersed. Typically, individual shareholders will refrain from making investments in managerial monitoring and discipline because the gains from such investment accrue to all shareholders (a quasi-public good), but the costs are borne by the activist shareholders alone.<sup>6</sup> To resolve this problem, collective action is required, whereby all shareholders contribute to monitoring and disciplinary activities in proportion to their shareholdings. However, here the shareholder activist confronts innate coordination problems. In the absence of coercion, shareholders will rationally decline to invest, preferring instead to free ride on the efforts of others. Of course, if this is rational for one, it is rational for all, meaning that effective shareholder activism never gets off the ground.

The result of attenuated shareholder control is clear: managers will be able to favour their own personal desires even though doing so conflicts with shareholder interests in maximizing the economic value of the firm. These costs, which are reflected in a reduced share price, come in three principal forms. First, managers may shirk, *i.e.*, refrain from expending their maximum effort on behalf of the firm's shareholders. For instance, managers may not spend the time and effort necessary to identify and select

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<sup>5</sup> Michael Jensen and William Meckling, "Managerial Behaviour, Agency Costs and Ownership" (1976), 3 *J. Fin. Econ.* 305.

<sup>6</sup> Unless the shareholder owns a block of shares that is large enough to allow the realization of benefits that exceed investment costs, such unilateral investment will not occur. For a model in which the conditions for unilateral activism hold, see Bernard Black, "Shareholder passivity reexamined" (1990), 89 *Michigan L. Rev.* 520.

those products yielding the greatest net present value for the firm. The managerial propensity to shirk reflects the fact that the marginal value of leisure to the manager exceeds the compensated value of their marginal product to the firm's shareholders. Second, because managers have high levels of non-diversified human capital investment in the firm, they will systematically adopt projects which reduce the riskiness of the firm's cash flow, even if they yield net present values that are lower than alternative projects with higher levels of firm specific risk that diversified shareholders would prefer them to select.<sup>7</sup> Third, through its utilization of the corporate machinery, management can divert corporate assets or income to itself at shareholders' expense. This can occur in a number of different ways. The most obvious, if not prosaic, is to funnel corporate resources into personal perquisites, such as lavish offices, club memberships, or executive jets. Take, for example, the RJR Nabisco Airforce, comprised of 10 executive jets and 31 pilots, under the former command of CEO Ross Johnson. Similarly, diversion can be achieved through bloated compensation arrangements that bear no relation whatsoever to the value of senior management's performance. Or, diversion can take the form of unbargained for self-dealing transactions, in which the manager transacts with the corporation on non-market terms.

In the Jensen and Meckling model, the antidote for managerial accountability problems is straight forward — increased managerial ownership. By increasing the level of financial investment in the firm, managerial agency costs are internalized. In other words, some proportion of the costs of managerial opportunism are reflected back onto managers as shareholders, and this cost increases directly with the level of equity ownership. The

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<sup>7</sup> These concerns are evaluated by investigating the pricing of risky debt and ownership concentration. When managerial ownership is low, increases in ownership lead to increases in the incentives to increase shareholder wealth at the expense of bondholder wealth. This is observed through a positive association between managerial ownership and bond return premia. As the ownership increases, managers become more risk averse and their incentives become closely aligned to those of the bondholders. There is an observed non-positive relation between ownership and bond return premia over this range. Evidence on the impact of ownership concentration on risk aversion behaviour of management is also observed in the relationship of ownership concentration and debt ratios. Since bankruptcy is costly and the risk is difficult to diversify, managers with highly concentrated holdings will reduce this risk through the debt-equity choice. See E. Bagnani, N. Milanos, A. Saunders, and N. Travlos, "Managers, Owners, and the Pricing of Risky Debt: An Empirical Analysis" (1994), 31 *Journal of Finance* 453.

result is that as share ownership increases, managers will think twice before passing up a valuable investment opportunity or diverting corporate wealth from shareholders to themselves. Under this model, the value of a company's shares should be expected to increase monotonically with increased managerial equity investment reflecting a closer alignment of shareholder and managerial interests. This implies that closely held public companies that are managed by controlling shareholders should be worth more than their widely held counterparts.

Nevertheless, the Jensen and Meckling model fails to account for the full range of effects unleashed by heightened managerial ownership. Unless a manager owns 100% of the outstanding equity of a company, he or she will still operate under an incentive to favour his or her own interests at the expense of shareholders. It is true that as the level of managerial ownership increases, the net gains from opportunistic behaviour decrease; nonetheless these gains will persist. The question is whether the gains from opportunistic behaviour exceed the costs of such behaviour as measured by the foregone proportional benefits obtained as a shareholder and the expected costs of getting caught and disciplined. The difficulty is that while the foregone level of shareholder benefits *increases* with the manager's equity investment, the expected costs of the penalty (probability of detection multiplied by the penalty imposed) *decreases* with additional investment, making the net effect of increased managerial ownership somewhat uncertain.

The diminution in expected costs of discipline that track increased share investment is attributable to two principal factors. First, as equity control increases, shareholders are better equipped to have their wishes translated into corporate action through more effective domination of the board of directors. A manager with a solid controlling block of voting shares can exert direct control over the board, a prerogative that may be unavailable to managers holding only a fractional equity interest.<sup>8</sup>

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<sup>8</sup> In this respect, it should be noted that since the costs of expropriatory behaviour are borne to a larger extent by the controlling shareholder as his or her holding increases, it is irrational for managers to assemble control blocks in excess of the minimum necessary to obtain control. The expected impact of entrenchment behaviour should be reflected in the company's share price. There may be no impact on the market price from holdings greater than the minimum needed to obtain control; in fact, the greater the holdings the greater is the cost borne by controlling shareholders and this may somewhat offset, the entrenchment behaviour. Controlling shareholders may want to have holdings above the minimum control holdings to provide them with flexibility to finance growth through new



It could be argued that the difference in the control wielded by managers over the board of directors differs little between a widely and closely held company once infirmities in the shareholder voting process are considered.<sup>9</sup> The argument is that through their domination of the proxy process, managers in widely held companies can just as easily secure a board of sympathetic directors as owner-managers in closely held public companies. However, while conceding a role for managerial influence in board appointments in the widely held company, it is important not to overstate the durability of managerial control over the corporate board. Support for this proposition is provided by the wave of board initiated ousters of senior executives of widely held companies that have occurred over the past several years — *eg.*, IBM, General Motors, Manufacturers Life, American Express and so forth. Thus, while a board in a widely held company can decide to flex its muscle to discipline corporate management in response to chronic corporate underperformance, the prospects for such activism are virtually negligible in the case of a company whose controlling shareholder is also the manager and has yet to decide that his or her time is up.<sup>10</sup>

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equity issues without being forced to purchase the new equity to maintain their proportionate holdings. They can issue the equity without purchasing new equity as long as they can maintain control.

<sup>9</sup> The claim is that management is able to influence the conduct of the board of directors through its *de facto* control of the nomination and agenda setting process. Through nominations, managers select only those individuals who appear to be predisposed to management's interests. More importantly, even if not sympathetic to management at the outset, recognition that the directors serve at management's pleasure is bound to fortify their sympathies to existing management. Through agenda setting, management is able to steer the board away from decisions that may encroach on their interests. In this manner, the strength of the board's external scrutiny is impaired. See Victor Brudney, "The Independent Director — Heavenly City or Potemkin Village?" (1982), 95 Harv L.R. 597; Myles Mace, *Directors: Myth and Reality* (Boston, Harvard University Press, 1971).

<sup>10</sup> For our discussion the salient question is, what is the marginal value of sizeable managerial ownership on the demonstrated capacity of the management of widely held corporations to manipulate the board. We would argue that ownership does not bolster management's control over nominations or agenda control, but it does undermine the board's interpretation of its objective function. With shareholders having multiple and divergent economic interests in the firm, the board's maximand, to maximize the value of the shareholder's residual claims, becomes clouded. Because managers are owners, the board becomes more deferential to management's views as to how shareholder wealth should be enhanced. The common refrain of the outside director in the closely held company is illustrative of this problem: "It's Joe's company, who am I to second guess his judgment?" And even if directors are sceptical of management's avowed objectives, they face the difficult and complex task of forging coherent tradeoffs among competing shareholder interests.

A second reason for declining expected discipline costs with ownership increases relates to the suppression of market mechanisms that operate to mitigate some of the accountability problems manifest in widely held companies. Perhaps the most important of these is the threat of managerial displacement through an unwanted takeover bid — the so-called “market for corporate control”.<sup>11</sup> Depending on the level of opportunistic behaviour and the costs of engineering a takeover, an acquiror can offer to purchase at a premium a controlling block of shares, and then utilize this control to oust existing management. Drawing on the disciplinary role of the takeover market, Stultz provides a foundation for a curvilinear relationship of corporate value and ownership concentration. The premium paid by a hostile bidder will increase with the fraction of equity owned by the controlling shareholder but the probability of success of a hostile bid is negatively related to this ownership proportion.<sup>12</sup> Thus, at low ownership percentages the bid will likely succeed at a premium lower than the maximum that would be paid by the bidder. As ownership increases, the probability of a successful bid decreases, and to obtain a successful bid at high ownership levels the premium paid must increase. As the size of the required premium increases, the willingness of acquirors to bid for control diminishes correspondingly. Beyond 50%, the probability of a hostile takeover is zero. Therefore, the value of the firm increases at low ownership levels, but then falls as ownership increases, reflecting the lower probability that a hostile bid will be successful at high ownership levels. At 50%, firm value reaches its minimum. Although Stultz’s conclusion that the value of the firm is minimized at 50% ownership is overstated, he is undoubtedly correct in demonstrating the general linkage between firm value and control market discipline.<sup>13</sup>

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<sup>11</sup> The term was coined by Henry Manne, “Mergers and the Market for Corporate Control” (1965), 73 *J. Pol. Econ.* 110.

<sup>12</sup> R. Stultz, “Managerial Control of Voting Rights, Financing Policies, and the Market for Corporate Control” (1988), 20 *Journal of Financial Economics* 25.

<sup>13</sup> The Stultz model is based on the takeover market only. The gains from a takeover and the maximum premium that can be paid will depend upon the performance of incumbent management and what the new management can do with the firm. In a number of instances takeovers or management buyouts do occur when there is highly concentrated ownership. W. Mikkelsen and M. Partch, in “Managers’ Voting Rights and Corporate Control” (1989), 24 *Journal of Financial Economics* 263, observe that completed acquisitions are unrelated to manager’s voting rights. However, they find that the higher the

The managerial accountability problems posed by increased share ownership are buttressed by the evisceration of other market instruments. The managerial market, for example, is unlikely to operate when managers wield sizeable ownership stakes. This market consists of both external and internal markets. As alluded to previously, the external market disciplines managers by tying the value of their human capital in alternative managerial positions to the firm's current performance. The internal market operates by encouraging lower level managers to utilize their firm specific information to monitor the performance of more senior managers. According to Fama, "lower managers perceive that they can gain by stepping over shirking or less competent managers above them".<sup>14</sup> However, neither of these markets are likely to operate in controlled companies. In the former case, managers discount the probability that they will ever face discipline (or "settling up") in the external managerial market. In the latter case, knowing that their efforts will be for naught, lower level managers refrain from either monitoring the performance of senior managers, or whistle blowing when lapses in managerial effort are detected.

A further complication for the analysis arises when the control group is dominated by a single person or family. Once individual or family control is accounted for, the behavioural analysis becomes much more complex. If the private benefits from control are exclusively pecuniary in character, the difficulty is that the controlling shareholders are more likely than not to be high income earners who will be less concerned with wealth losses resulting from corporate inefficiency than will less affluent investors because of the diminishing marginal utility of money.<sup>15</sup>

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management's holdings, the less likely there will be an offer or the acquisition of a block of shares. They also note that the higher the voting control, the more likely that a takeover offer will lead to a change in control. They also observe that the higher the management share of the equity, the more likely the firm will engage in a going private transaction at a premium to the prevailing market price. P. Halpern, R. Kieschnick and W. Rotenberg in "The Influence of Insiders on LBO Premiums" (1994), Working Paper, University of Toronto, find that the probability of a firm engaging in a levered going private transaction compared to either remaining a public firm or being taken over is positively related to insider ownership. They also observe that the premium in a going private transaction depends on the interaction of the ownership level and the degree of prior performance of the managers.

<sup>14</sup> Eugene Fama, "Agency Problems and the Theory of the Firm" (1980), 88 *J. Pol. Econ.* 288.

<sup>15</sup> The theory is that high income earners will value marginal increments of money less than

While these income effects may make controlling shareholders/managers less inclined to engage in diversionary behaviour, it also may make them more inclined to shirk. This is because while diversion and corporate wealth enhancement are activities that generate wealth increases for wealthy controlling shareholders, he or she may rationally refrain from doing either since the expended effort may outweigh the realized benefits. In these terms, the effect of income on controlling shareholder behaviour depends on the relative costs and benefits of engaging in either form of behaviour, and the relative sensitivity of each to income.

Another difficulty for the analysis involving family or individually controlled companies is posed by endowment effects.<sup>16</sup> Endowment effects cause individuals to refrain from selling certain goods that are in their possession even though the price offered for the good exceeds their reservation price for buying them. The effect may be traced to sentimental attachments that form with respect to a good over time. In the case of control blocks, the claim is that the existence of endowment effects will make controlling shareholders more reluctant to part with control, which, in turn, increases the premium required to effect a transfer. The existence of endowment effects is more plausible when an individual or family is the equity-holder rather than a large corporate bureaucracy.

In conjunction, income and endowment effects suggest that controlling shareholders dedicated solely to wealth enhancement may well decide to retain control even though it appears economically irrational to do so. That a controlling shareholder may decide to retain control even though the net present value of the pecuniary benefits is less than the control premium offered becomes even more likely when non-pecuniary benefits from control are taken into account. For instance, an aging entrepreneur may, because of pride or sentimental attachment, retain managerial control even if she no longer possesses the skills necessary to lead the company in its current state.<sup>17</sup> Alternatively,

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low income earners because it can bring them less additional pleasure given the wealth they have already amassed.

<sup>16</sup> For a review of the literature on endowment effects, see Daniel Kahneman, Jack L. Knetsch, and Richard H. Thaler, "Experimental Tests of the Endowment Effect and the Coase Theorem" (1990), 98 *Journal of Political Economy* 1325. The endowment effect explains the systematic differences observed between buying and selling prices for certain goods.

<sup>17</sup> That is, the firm grows to a point where the scale of organizational complexity outgrows

motivated by loyalty or paternal pride, the founder-entrepreneur may transfer control to a family member who is ill-suited for the job. In both cases, the utility losses that would accompany a control transfer are incommensurable with the pecuniary premium offered, which again results in the controlling shareholder retaining control even though the wealth losses exceed offered control premiums.

From this discussion, the effect of ownership on firm value can be conceived as the product of two competing incentives: convergence (those agency costs *reduced* by increases in share ownership) and entrenchment (those agency costs *facilitated* by increases in share ownership). Predictably, the value of the firm is maximized at the point(s) where the marginal cost of entrenchment is equal to the marginal benefit of convergence. However, in constructing these values it is important to maintain sensitivity to income and endowment effects, as well as to the possible divergences between wealth and utility.

## 2. Assessing the Effects of Concentrated Ownership on Firm Performance

### (a) Studies Based on Tobin's Q

Given the complexities inherent in framing strong *a priori* predictions of how the different incentives effects will interact in the context of specific firms, corporate finance scholars have turned to empirical techniques to attempt to identify any systematic relationship between share ownership and firm value. A number of empirical studies investigating the influence of

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the entrepreneur's decision-making capabilities. The theme that management of mature companies requires different skills than those possessed by the entrepreneur is discussed in Robert Buchele, *Business Policy in Growing Firms* (San Francisco, Chandler Publishing Co., 1967), Donald K. Clifford and R.E. Cavanaugh, *The Winning Performance* (New York, Bantam Books, 1985); Peter Drucker, *Innovation and Entrepreneurship* (New York, Harper and Row, 1985) at p. 201. For a contrary view, see Gary E. Willard, David A. Krueger, and Henry R. Feeser, "In Order to Grow, Must the Founder Go: A Comparison of Performance Between Founder and Non-Founder Managed High Growth Manufacturing Firms" (1992), 7 *Journal of Business Venturing* 181. They find no significant differences between founder-managed and professionally managed firms in a study of 155 mostly high tech firms taken from Inc.'s 1985, 1986, 1989, and 1990 lists of 100 fastest growing publicly held firms in the United States. Their study however, suffers from selection bias since it chooses companies which have succeeded; clearly this is not a random selection and the results are not generalizable to all entrepreneurial situations.

corporate share ownership on firm value use Tobin's Q (the ratio of a firm's market value to the replacement cost of its physical assets), which reflects the efficiency with which the firm is managed, and serves as a proxy for firm value.<sup>18</sup>

Morck, Shleifer, and Vishny relate Q ratios of a sample of 371 firms from the Fortune 500 to a set of control variables including board ownership, for the year 1980.<sup>19</sup> This sample has, on average, board ownership of 10.6% with 20% of the sample having holdings in excess of 20% and only 14 firms with holdings at least equal to 50%.<sup>20</sup> Morck *et al* observe that Q increases over the range of equity ownership by the board up to 5%, decreases until 25%, and then increases slightly. This observation is consistent with convergence of interests being the dominant incentive effect in the lowest and highest ownership levels but the entrenchment effect being dominant over the middle category.<sup>21</sup> The researchers also consider how the presence of the founder (or family) in the firm affects market value. Morck *et al* compared the value of Q for firms incorporated before and after 1950 where the founder or family member was still active in 1980. Not surprisingly, the value of founder involvement exerted a negative effect on Q for the pre-1950 cohort and was positive on the post-1950 cohort. This finding provides some empirical support for the claim that individual or family control tends to distort executive succession decisions from those informed by pure efficiency considerations.

Replications of the Morck *et al* methodology to other samples and time periods generate conflicting results.<sup>22</sup> As an example,

<sup>18</sup> This ratio should reflect the underlying characteristics of the firm on its value. It is high when the firm has valuable intangible assets such as growth opportunities, monopoly power, or effective managers who can generate rents for the firm. A value of unity suggests that the firm is just earning a normal rate of return on its investments.

<sup>19</sup> R. Morck, A. Shleifer, and R. Vishny, "Management Ownership and Market Valuation: An Empirical Analysis" (1988), 20 *Journal of Financial Economics* 293.

<sup>20</sup> While reflecting characteristics of firms from the Fortune 500 and companies listed on the NYSE, which imposes minimum liquidity constraints in order to be listed, this sample is unlikely to reflect ownership characteristics of a broader based set of equity securities.

<sup>21</sup> Nevertheless, Morck, *et al*, *supra*, footnote 19, caution that the turning points they identified are sample specific and other samples and time periods may provide different results.

<sup>22</sup> For instance, H. Chen, J. Hexter and M. Hu use the Fortune 500 firms as well and look at three sample periods, 1976, 1980, and 1984 ("Management Ownership and Corporate Value" (1993), *Managerial and Decision Economics* 335). They observe that Q increases with ownership in the range of 0 to 5-7%, falls with ownership levels to 10-12%, and then continues to fall in 1976 but rises slightly in both 1980 and 1984. These results in the two later time periods are consistent with Morck *et al*'s observations and the result in the first period is consistent with continued entrenchment.

Denis and Denis investigate firm performance for a sample of companies with managerial share ownership of at least 50% and a control sample for which managerial ownership levels are less than 20%.<sup>23</sup> The authors observe that there is no difference in financial performance between the firms with concentrated equity holdings and the control group of firms and conclude that firms choose efficient organizational structures. Similarly, Holderness and Sheehan considered large block holdings in which one individual or entity, usually another firm or trust, owns between 50% and 95% of the equity.<sup>24</sup> They compared the Q ratios for majority owned companies and for a matched control sample of companies with diffuse equity holdings, and found no significant differences in Q between the concentrated and diffuse holdings, although the mean and median values of Q were lower for the former. However, when they decompose the sample into individual versus corporate majority owners, an interesting result emerges: whereas the corporate majority owned sub-sample displays no significant difference in Q from the control group, the individual majority owned group has an average Q that is less than the value for the

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J. McConnell and H. Servaes also relate Q to control and ownership variables for the years 1976 and 1986 ("Additional Evidence on Equity Ownership and Corporate Value" (1990), 26 *Journal of Financial Economics* 595). The samples were large, 1173 and 1093 firms, respectively, with the companies listed on either the NYSE and AMEX. McConnell and Servaes find a non-linear relationship between Q and ownership, increasing at first and then falling; the turning point was at 49% inside ownership for 1976 and 37.6% for 1986. These results suggest that at higher ownership levels, entrenchment is an important problem. The differences between this study and Morck et al's and Chen *et al's* may be due to the use of a sample including companies on the NYSE and the AMEX and not restricting the sample to the Fortune 500 companies. The McConnell and Servaes sample will include a larger number of small companies which may be more likely to have concentrated holdings.

Finally, B. Hermalin and M. Weisbach also observe a non-linear relationship between Q and CEO stock ownership. They observe that above ownership levels of 20%, Q falls with increases in ownership but the relationship below 20% demonstrate both agency costs and alignment of interests depending on the ownership range ("The Effects of Board Composition and Direct Incentives on Firm Performance" (Winter 1991) *Financial Management* 101).

<sup>23</sup> D. Denis and D. Denis, "Majority Owner Managers and Organizational Efficiency" (1994), *Journal of Corporate Finance* 91. Of approximately 1700 firms on the Value Line Universe, the authors find only 72 firms for which ownership for the first quarter 1985 is in excess of 50%. For this sample, 80% of the firms have family involvement or are managed by the founder of the firm and for these firms 35% have dual class share structures.

<sup>24</sup> C. Holderness and D. Sheehan, "The Role of Majority Shareholders in Publicly Held Corporations: An Exploratory Analysis" (1988), 20 *Journal of Financial Economics* 317. The sample firms were found on the NYSE and AMEX.

control sample although the difference lacked statistical significance. This result is consistent with individual concentrated holdings resulting in entrenchment and non-value maximizing decisions by managers. Holderness and Sheehan also investigated the sale of control blocks. They observe that when a majority block is sold, the abnormal stock price returns<sup>25</sup> are significantly different from zero when based on the identity of the seller but not on the identity of the buyer. For individual and corporate sellers of majority blocks, there is an abnormal return of 14.2% versus 5.1%, respectively, for the announcement day period and 23.8% versus 6.7% for a longer period surrounding the announcement day. This result provides support for the claim that the entrenchment effects respecting close ownership are most acute when the equity holder is an individual rather than a corporation, and means that utility maximization is less than perfectly related to wealth maximization.

(b) Event Studies Based on Abnormal Share Price Movements

Another way to gauge the impact of control of equity on firm value is to investigate the impact of unexpected changes in control (such as when a major blockholder dies) on share prices. Since such events give rise to an expectation that the control block will be transferred to another group, it offers an ingenious way to measure the blockholder's effect on firm value. If, for example, the blockholder's interests are aligned with those of shareholders, and their compensation generates no rents either for them or the shareholders, unexpected death should have no impact whatsoever on share prices. Indeed, if the managers are very efficient, and it is costly to replace them with individuals of equal ability, the company's share price should fall. Alternatively, if the managers were not efficient and replacement will not be difficult, or if they were entrenched and apparently not subject to the normal control of the labour market or the market for corporate control, the share price should increase.

Johnson *et al* have investigated the impact of unexpected deaths of senior executives on the share price of their companies.<sup>26</sup> For

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<sup>25</sup> Abnormal stock price return is the difference between the actual rate of return on the stock less the expected rate of return on the security over the same period. The expected rate of return is based on the normal relationship of the firm's rate of return to the return on a market index.

<sup>26</sup> B. R. Johnson, N. Nagarjan, and H. Newman, "An Analysis of the Stock Price Reaction



the overall sample, they observe that the abnormal return over the announcement period was slightly positive but not statistically significant. However, for the 15 cases involving the firm's founder, the abnormal return over the announcement period was 3.50% and statistically significant. For the non-founder group of 32 cases in which the death was not preceded by a brief illness, the share price fell by 1.16%, which was statistically significant. For the third group of cases in which there was a brief illness before death (6 cases), positive but insignificant abnormal returns of .94% were found. Thus, their study supports the conclusion that founders do behave in a non-wealth maximizing manner.<sup>27</sup>

A recent study by Slovin and Sushka focused on the relationship of the size of the control position of CEOs and founders who died suddenly and the share price reaction.<sup>28</sup> Slovin and Sushka concluded that the impact on the share price of the death of an inside blockholder relates to the individual's ownership in the equity and not the employment status or whether or not the individual is a founder. For the overall sample, they found a 3.01 percent positive abnormal return on the announcement date, a result consistent with entrenchment. They observed that for the lowest level of ownership, between 5 and 10 percent, there was a

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to Sudden Executive Deaths" (1985), *Journal of Accounting and Economics* 151. The primary reason for their study was to investigate the functioning of the labour market for managers. Their sample included 53 instances of unexpected deaths over the period 1971 to 1982; the companies were listed on the NYSE or AMEX. The senior executives were either chairs of the board of directors, chief executive officers, or individuals with both responsibilities. On average, the senior executives controlled 9.5 percent of the shares and in approximately 27 percent of the cases executives controlled in excess of 5 percent of the shares. In the sample, 28 percent of the cases involved founders who had above average holdings of shares (the correlation of founder status and share ownership was +.65).

<sup>27</sup> *Ibid.* This conclusion is reinforced in a cross sectional analysis of the announcement period cumulative abnormal return on firm/senior executive specific characteristics. The cumulative abnormal return was significant and positive when the senior executive was a founder.

<sup>28</sup> M. Slovin and M. Sushka, "Ownership Concentration, Corporate Control Activity, and Firm Value: Evidence for the Death of Inside Blockholders" (1993), 30 *Journal of Finance* 1293. Their sample period covers 1973 to 1989 and includes instances where individuals have greater than 5% shareholdings; the shares are traded either on NYSE, AMEX, or NASDAQ. This results in a sample with more concentrated holdings than found in Johnson; for example, the percentage of shares owned by the CEO or founder averages approximately 25% whereas for Johnson, the value is 9.5%. Whether the individual was a CEO, founder, or both appears to have no impact on the percentage holding. In all cases the mean values were below the median suggesting a skewed distribution of percentage holdings.

negative and insignificant excess return; the excess return was positive and significant for all other categories, although the impact starts to fall for ownership levels above 30 percent.

Slovin and Sushka also investigated the impact of CEO and founder status. The average impact for both a CEO death and non-CEO death were significant and positive, although their values were not statistically different. Similarly, for the founder/non-founder dichotomy, the abnormal return to both categories was positive and significant, although the average values for the founder and non-founder groups, respectively, were 4.01% and 2.12%. This observation suggests that it is ownership of the individual and not founder status or CEO status that determines the impact on the share price.<sup>29</sup>

### (c) Cross-Country Studies of Comparative Firm Performance

A final datum on the impact of closely-held ownership structures on firm performance is furnished by Morck and Stangeland's innovative study on the comparative performance of 327 public companies in Canada, stratified by share ownership structure, to their rival industries in the United States.<sup>30</sup> The researchers gauged the competitiveness of the Canadian firms by examining three different factors: profitability, sales growth, and job creation. Their principal findings are consistent with the general theory developed above: closely held Canadian firms are likely to be younger and smaller than widely held firms, demonstrating lower profitability, but higher sales and job growth than their U.S. rival industries. While low profits and high growth are typical for

<sup>29</sup> *Ibid.* Slovin and Sushka test this directly through a cross-section regression of the excess return on individual specific data. They find that when insider block ownership is introduced in a quadratic form it is significant and there is a smaller but positive share price reaction above ownership levels of 40%. The introduction of founder and CEO status and age of the individual have no impact. They also look at the CEO impact for a sample of events in which the CEO had less than 5% holdings and found that the impact was insignificant. A test of the difference in mean abnormal returns for events in which CEOs have ownership above 5% and those events with ownership below do not provide any significant differences. However, comparing the abnormal returns for samples of CEOs with less than 10% to CEOs with greater than 10% shows a significant difference of slightly greater than 2 percent. These results suggest that individuals with large ownership interests manage in ways consistent with entrenchment and an unexpected death leads to expectations of either a takeover or a change in control with improved operating performance.

<sup>30</sup> Randall K. Morck and David A. Stangeland, "Corporate Performance and Large Shareholders", draft article dated April 8, 1994 (on file with the authors).

young companies, Morck and Stangeland find that the lagging profitability of closely held Canadian firms persists even after firm age and firm size are taken into account.<sup>31</sup>

To explore further the impact of different types of closely held ownership on firm performance, Morck and Stangeland divided their sample of controlled firms into three different groups: founder controlled firms, heir-controlled firms, and firms having a dominant shareholder who is neither the founder nor heir (“non-family dominant shareholders”). While the profitability of founder controlled firms was similar to the U.S. industry baseline, both the heir controlled and non-family dominant firms’ performance (measured in terms of their median income per dollar of sales) was lower than their U.S. industry rivals, although the non-family dominant firms lagged behind U.S. rivals by less than half as much as the heir controlled firms.<sup>32</sup> On the basis of these data, the researchers concluded that: “founders concerned about the future performance of their firms should, upon retiring, see that control is transferred to non-family dominant shareholders or small shareholders rather than to family heirs”.<sup>33</sup>

### 3. Implications of Theory and Data on Optimal Ownership Structure

From the theoretical analysis we conclude that there are both convergence and entrenchment effects of inside ownership on the value of the equity of firms. The former relates to the confluence of interests between shareholders and management as inside ownership increases whereas the latter argues that as ownership increases the incentives for the majority owner to make decisions that do not maximize wealth of shareholders but instead maximize the utility of the controlling individual.

The empirical evidence is generally consistent with the entrenchment story but there remains some uncertainty as to whether this is due to founders with large equity positions, heirs of founders, or only the ownership position and not whether the blockholder is a founder or a CEO. However, the Canadian evidence appears to give more weight to founder status.

<sup>31</sup> *Ibid.* Interestingly, widely held Canadian firms have performance attributes that are statistically indistinguishable from those of matching U.S. industries.

<sup>32</sup> The researchers also found that non-family closely held firms have higher growth in margins than heir controlled firms, but lower than founder controlled firms.

<sup>33</sup> Morck and Stangeland, *supra*, footnote 30, at p. 26.

Given evidence that high share ownership concentration in public firms, particularly when individual or family ownership is involved, is correlated with reductions in firm value, the question is how best to increase firm value through ownership changes. At the individual level, one possibility is the going private or management buyout market. Many studies have demonstrated the success of this organizational form, despite the fact that the share structure after the transaction still displays concentrated equity holdings.<sup>34</sup> The benefits alleged for the going private transaction include improved monitoring by bond holders and other parties to the transaction and an improved alignment of interests of managers and other shareholders.<sup>35</sup> An alternative structure would be to have shares broadly held but in sufficiently large quantities to give individual investors an incentive to engage in meaningful monitoring and perhaps even active participation on the board. The goal is not necessarily to eviscerate insider ownership but simply to reduce it to a level where there is enhanced scope for meaningful monitoring and, perhaps discipline, by outside shareholders. Monitoring by blockholders and institutional investors has been investigated empirically in a number of contexts, and has generally supported the existence of shareholder gains from increased institutional ownership.<sup>36</sup>

### III. THE FACTORS MOTIVATING HIGH LEVELS OF SHARE OWNERSHIP CONCENTRATION IN CANADA

The demonstrated inability of high levels of managerial share ownership to ameliorate entirely the accountability concerns

<sup>34</sup> S. Kaplan, "The Effects of Management Buyouts on Operating Performance and Value" (1989), 24 *Journal of Financial Economics* 217, A. Smith, "Corporate Ownership Structure and Performance: The Case of Management Buyouts" (1990), 26 *Journal of Financial Economics* 143.

<sup>35</sup> Many of the going private transactions arise in firms which already have highly concentrated holdings and the transaction actually assists the original controlling shareholders to cash out on their holdings while maintaining high controlling interests in the equity of the new company see (R. Elitzur, P. Halpern, R. Kischnick, and W. Rotenberg, "Modelling the Going Private Transaction", University of Toronto, Faculty of Management Working Paper (1994); S. Kaplan and J. Stein, "The Evolution of Buyout Pricing and Financial Structure in the 1980's" (1993), 108 *Quarterly Journal of Economics* 313. The ability to engage in these transactions requires the functioning of a debt market which permits the use of high levels of leverage and custom designed repayment conditions.

<sup>36</sup> See Bernard Black, "The Value of Institutional Investor Monitoring: The Empirical Evidence" (1992), 39 *UCLA Law Rev.* 895.

raised by the delegation of authority from shareholders to managers, makes the dominance of the highly concentrated public company in Canada somewhat perplexing. If high levels of share ownership do not maximize the value of the firm in certain circumstances — particularly in those cases where high ownership stakes reside with aging founders or their chosen heirs — we would expect to observe less durability in the concentrated ownership structure of public Canadian corporations than is in fact the case. Stated differently, if ownership matters, is there a reason to be any less concerned about the dominance of closely held public corporations in Canada than are American commentators about the dominance of the widely held public corporation in the United States? In both cases, it is arguable that the dominant (and fairly durable) form of corporate ownership may not maximize firm value. If so, it is important to identify the factors which have impeded efficient adaptation.

In this part of the article, we explore this issue further by addressing the factors fuelling the dominance of the closely held public corporation in Canada. Specifically, we consider both market and political factors that affect corporate ownership structure. While we find that a number of factors could have contributed to the survival of the closely held public corporation in Canada, only a few factors are plausible. However, to form robust conclusions, further research in this area is required.

### **1. Concentration as a Function of High Levels of Firm Volatility and Small Firm Size**

Demsetz and Lehn have argued that share ownership concentration levels are directly related to the volatility of a firm's cash flows and inversely related to the aggregate size of the firm.<sup>37</sup> The former relationship holds because volatility in firm performance confounds the ability of external market constraints (*ie.*, the managerial or takeover markets) to discern and to discipline poor managerial performance. When cash flows are volatile, external monitors are unable to determine whether a reduction in firm performance is the result of factors within or outside of management's control. Inside monitoring by concentrated investors atten-

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<sup>37</sup> Harold Demsetz and Kenneth Lehn, "The Structure of Corporate Ownership: Causes and Consequences" (1985), 93 J. P. E. 1155.

uates these problems because large owners can elect directors to the board, which permits access both to real-time information respecting managerial performance and to levers of discipline over management. The relationship between firm size and concentration holds because as the value-maximizing size of the firm increases, the cost of acquiring a control block will also rise, which will deter control accumulation.

In the Canadian setting, the factors posited by Demsetz and Lehn may explain higher rates of corporate share ownership concentration. It could be argued that the resource based character of the Canadian economy creates higher levels of earnings volatility for Canadian firms than for firms whose activities are not subject to vicissitudes of resource pricing. Nevertheless, the link between a resource based economy, earnings volatility, and increased efficacy of share ownership as a control mechanism is not self-evident. Even if the resource based character of the Canadian economy makes the earnings of Canadian firms more volatile than their American counterparts, this fact does not by itself make heightened share ownership a more attractive managerial control mechanism than other available market instruments. So long as markets are capable of identifying firms subject to the same or similar market fluctuations, these outside market mechanisms should be able to control managerial misbehaviour. Indeed, to the extent that the resource based character of the Canadian economy has been associated with low levels of value added, this feature can be taken to increase managerial market accountability (with resource costs accounting for higher proportions of a firm's final product, evidence of managerial ineptitude should be more readily transparent).<sup>38</sup>

The association between the size of firms and ownership concentration may, however, be a more robust explanation for high levels of share ownership in Canada. The argument here is that the Canadian economy industrialized much later than the United States and, as a consequence, Canadian firms have not yet grown to a size where pressures for increased capitalization have caused firms to sell off equity stakes to new owners.<sup>39</sup> Although

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<sup>38</sup> From 1990 to 1993 there was an increase in the number of widely held companies on the TSE 300 Index. By far the largest increase came from the Oil and Gas sector where both the number of companies represented in the Index and the proportion of widely held companies in the sector increased. Unless there was a reduction in uncertainty in this industry, this observation is not consistent with the Demsetz and Lehn position.

<sup>39</sup> Morck and Stangeland, *supra*, footnote 30. Support for their thesis is furnished by a

capitalization pressures may cause firms to sell off equity interests, the pace of ownership deconcentration in Canada is striking. For example, looking at the market capitalization of firms listed on the TSE 300 we observe for the period 1980 to 1990, the annual growth rate in the quoted market value of the TSE 300 firms increased by .8%. Over the same period, the number of widely held firms on the TSE 300 decreased from 92 in 1980 to 67 in 1985 to 60 in 1990. Over this period, real GDP increased at a rate of 3.5 percent per annum.<sup>40</sup> Thus, concentration appears to have increased while the market value of the companies on the index rose very little. However, the TSE 300 capitalization values are biased documents since they measure the float value of the companies. The float value excludes major blocks held by individuals or institutions. Thus, even if the market value of the companies was actually increasing, with an increase in concentration, the quoted market value that is observed can increase at a slower pace. This time period was one in which there was a growth in the use of dual class shares which would have the result of reducing the float weight market value of the companies on the TSE 300. Also, the growth in GDP over this period suggests that the TSE float weight market values were not a good indication of growth in firm size.<sup>41</sup>

Over the period 1990 to 1994, the float weight market value of companies on the TSE 300 grew in real terms by 12.7 percent per annum. For this period, there is information on the market value of the TSE 300 companies based on total shares outstanding, not just float weight. For this measure, the real growth per annum was less, at 7 percent. This is consistent with a reduction in concentration of firms on the TSE 300 and this is observed in the increase

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matched sample of similar sized firms in Canada and the United States, which found that large Canadian firms were not more closely held than American firms of similar size in the same industries.

<sup>40</sup> We defined widely held as the holding by an individual or group of less than or equal to 15 percent of the outstanding equity. As noted in a subsequent section, some of the observed increases in the number of widely held companies may not reflect a true change in control of companies since the change in status from a closely to a widely held company may reflect the sale by a company of a small (15 to 20 percent) portfolio interest in the previously defined closely held company. See footnote 105, *infra*.

<sup>41</sup> The TSE 300 Index started in 1977. Prior to this period there was an industrial index in which the number of firms in the index changed from year to year. In 1965 there were 87 companies in this index of which 64 were widely held. By 1975 there were 151 companies in the index and 74 were widely held. Unfortunately with the changing number of firms in the index, the market capitalization figures are not very useful. All data is obtained from various issues of the Toronto Stock Exchange Review.

in the number of widely held firms to 125. Surprisingly, this reduction in concentration occurred in a period of recession and retrenchment where companies were evaluating their operating strategies and restructuring their operations. The real growth rate in GDP over the period 1990 to 1994 was 1.3 percent which is much less than the growth rate for the period 1980 to 1990. This is not the scenario envisaged by Demsetz and Lehn in which the increasing size of firms will lead to decreased concentration.

This evidence suggests that ownership concentration increased over a period in which there was sustained economic growth and decreased when growth was reduced. Thus the pressures for increased capitalization that precede firm growth have been met in Canada but without any appreciable unbundling of voting interests.<sup>42</sup> Thus, the correlation between firm size and ownership concentration attracts some surface plausibility. However, the fact that public Canadian corporations have been able to achieve high levels of market capitalization without significant deconcentration and the fact that any deconcentration occurred in periods of low economic growth suggests that other factors are implicated in explaining the persistence of concentrated firms.

## **2. Rules Governing Downstream Investment Activities of Canadian Financial Intermediaries**

A second plausible explanation for the existence and durability of the high levels of share ownership concentration is based on Roe's political theory of the modern American corporation.<sup>43</sup> As discussed above, the theory posits that the emergence of the Berle and Means' corporation was not the product of innate evolutionary forces, but rather the direct result of a series of deliberate legislative choices that sterilized the capacity of pools of American financial capital to invest in or to vote the equities of American corporations. The concern, according to Roe, was that Wall Street would own Main Street, creating a level of concentrated economic and political power that was incompatible with American populism. But in Canada the concern over concentrated economic power was never as acute as in the United States. The imperatives of creating an integrated national economy in a country having

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<sup>42</sup> *Infra*, footnote 103.

<sup>43</sup> Roe, *supra*, footnote 2.



vast geographical space and only limited population accounted for a more permissive attitude toward concentration. Undoubtedly, Tory political traditions buttressed this view.<sup>44</sup> In the case of financial market structure, these imperatives supported the growth of large financial intermediaries, whose investment activities were not nearly as constrained as counterparts in the United States. The salient question is whether Canadian financial intermediaries exploited this clout by investing directly in the equities of commercial companies, nurturing the high levels of ownership concentration found in Canada.

Superficial review of the structure and history of legislation governing Canadian banks and insurance companies reveals that legislative prohibitions did not restrain investment activities.<sup>45</sup> If banks and insurance companies wanted to invest in commercial equities, the legislative framework was not a serious obstacle. Nevertheless, we conclude that Canadian financial intermediaries did not exploit their ability to invest in commercial equities, meaning that the source of concentration must reside elsewhere.

(a) Banks

The first general bank legislation was passed in 1871 in Canada, and placed no quantity restrictions on the purchase, sale or holding of shares by banks. The legislation did, however, include a prohibition on the banks' ability to "either directly or indirectly . . . engage in any trade whatever . . . except in such trade generally as pertains to the business of banking", a provision which has been preserved in each re-enactment of the Bank Act since 1871.<sup>46</sup> Although the prohibition could have been interpreted to limit downstream equity investments by Canadian banks, Canadian courts have consistently interpreted the restriction narrowly. This conferred broad power on the banks to

<sup>44</sup> Gad Horowitz, "Tories, Socialists, and the Demise of Canada", (May-June 1965), 2 Canadian Dimension 12; Seymour Martin Lipset, *The First New Nation* (New York, Basic Books, 1963).

<sup>45</sup> We focus in this discussion on the value of bank and insurance company investments. Banks accounted for 72.6%, 52.6%, 45.9%, and 28.9% of total Canadian intermediated assets in 1870, 1900, 1930, and 1968, respectively, while life insurance companies accounted for 2.4%, 13.1%, 26.0%, and 13.6% of total intermediated assets during the same time periods. In tandem, the assets of banks and life insurance companies were the most significant of any private intermediaries during these periods. E.P. Neufeld, *The Financial System of Canada* (Toronto, Macmillan of Canada, 1972), p. 52.

<sup>46</sup> S.C., 1871, c. 5, s. 40.

invest in commercial companies and to intervene in the business and affairs of the investee company in the event that such intervention was necessary to protect the value of the bank's investment.<sup>47</sup>

Nevertheless, the level of investments by Canadian banks in corporate securities was never large, and, as a consequence, they were never able to assert their voice in corporate affairs in the way that banks in other jurisdictions did.<sup>48</sup> The level of securities held by Canadian banks as a percentage of total Canadian assets was 6.6% in 1926; 6.8% in 1935; 4.7% in 1955; 5.0% in 1965; and 6.0% in 1980.<sup>49</sup> Neufeld attributes the lack of interest in equity securities

<sup>47</sup> See, for instance, *Northern Crown Bank v. Great West Lumber* (1914), 17 D.L.R. 593, 6 W.W.R. 528 (Alta. C.A.); *White v. Bank of Toronto*, [1953] 3 D.L.R. 118, [1953] O.R. 479 (Ont. C.A.). To fall outside of the prohibition, a bank needed to demonstrate a proper motive, *ie.*, that the bank's activities were not concerned with earning profits from trading, but with the safeguard of its security. However, this requirement did not appear to be onerous. So long as the company in which the bank had invested had some outstanding indebtedness to the bank, the restriction could be avoided. See discussion in I. Baxter, *The Law of Banking and the Canadian Bank Act*, 2nd ed. (Toronto, Carswell Co., 1968), p. 198. Indeed, in *White et al. v. Bank of Toronto et al.*, [1953] 3 D.L.R. 118 (Ont. C.A.), the court held, at p. 125, that it could find nothing in the provisions of the Bank Act

. . . to suggest that a bank may not "deal in" the stock of its corporate debtor just as freely as it might deal in the stock of a corporation not its debtor or, for the matter in bonds of the Dominion of Canada . . . The conduct of modern business inevitably leads to an infinite variety of situations not the least complicated of which may occur in the carrying on in this country "of such business generally as appertains to the business of banking" and it seems to me that this has been recognized throughout the numerous decennial revisions of the Bank Act by the use of broad and general terms in prescribing what a bank may do.

It was not until the re-enactment of the Bank Act in 1967 that quantitative restrictions on the equity participation of banks were introduced in the statute, a change which followed the recommendations of the Royal Commission on Banking and Finance of 1964 (the Porter Report). The ostensible concern for the prohibition was to "avoid concentration of power and to present the banks from engaging indirectly in trade or business". See Minister of Finance, "Canadian Banking Legislation (White Paper)", August 1976, p. 37.

<sup>48</sup> For a contrary and unsubstantiated view, see Frank and Libbie Park, *The Anatomy of Big Business* (Toronto, J. Lewis & Co., 1973), at p. 71:

It is through the control of financial institutions that the financial groups maintain their control of the wealth producing companies. . . . At the centre of this financial and industrial corporate structure lie the chartered banks . . . . Linked to the banks are trust companies, the life insurance companies, the loan and mortgage companies, the investments trusts, all in control of vast assets and contributing to the ability of the financial oligarchy to control the economy of the country.

The Park's concept of control appears to be wider than the ability to control through equity ownership. The Banks and other financial institutions have a significant impact on firms through their substantial debt holdings. This can be crucial if companies, in earlier periods, relied more heavily on financial institutions to finance growth since equity markets were not well developed.

<sup>49</sup> Data came from Bank of Canada Statistical Summary (selected years). The percentages

to the growing need for large scale government financing during the wars and the depression and the “banks’ sad (almost fatal in one case) experience with railway financing”.<sup>50</sup> An alternative explanation is offered by Jamieson; the banks’ concern with liquidity and stability skewed investment in securities to government backed debt.<sup>51</sup> And finally, Niosi argues that the banks’ disinterest in equity ownership reflected the “formative and otherwise pervasive influence of the British financial system on financial practices in Canada”, which placed a premium on traditional debt lending over various forms of equity investment that would facilitate a more vigorous and direct role for banks in the development and control of industry.<sup>52</sup>

(b) Insurance Companies

Although somewhat more complicated, the case of Canadian insurance companies reveals more lenient statutory investment rules for Canadian companies in comparison to their American counterparts, but, as in the case of Canadian banks, a reluctance of the part of the insurance companies to maximize the scope of permissible equity investment under these rules. While the initial scheme of federal insurance legislation, the Dominion Insurance Act (1868),<sup>53</sup> contemplated differential investment powers for insurance companies depending on their size,<sup>54</sup> by 1899, the

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are biased upwards because they do not discriminate between corporate and municipal securities. Nor do the figures take into account different types of corporate securities, *ie.*, bonds, debentures, and equities.

<sup>50</sup> *Supra*, footnote 43, at p. 113.

<sup>51</sup> See A.B. Jamieson, *Chartered Banking in Canada* (Toronto, Ryerson Press, 1953) pp. 184-87 for a discussion on the investment and securities department activities of Canadian banks. The argument is that mark to market accounting treatment of equities reduced the attractiveness of these investments in comparison to other, more fungible assets. This is because any writedown in the value of these assets would impact on capital levels, which, in the context of highly leveraged financial institutions, would dictate a contraction in assets. Further, to the extent that management bonuses are based on the market value of the portfolio, use of equities would increase the variability of bonuses.

<sup>52</sup> Jorge Niosi, *The Economy of Canada: A Study of Ownership and Control*, 2nd rev. ed. (Montreal, Black Rose Books, 1982), chapter 1.

<sup>53</sup> An Act Respecting Insurance Companies, S.C. 1868, c. 48.

<sup>54</sup> The 1868 statute remitted to the individual corporate charters of insurance companies the task of constraining investment activity. However, the two largest insurance companies, Canada Life and Sun Life, had no restrictions on their power to invest in equities. (Specifically, the charters provided that “it shall be lawful . . . for the said corporation to purchase and hold, for the purpose of investing therein, . . . the stocks of any of the banks

statute was amended to permit all life companies to invest in corporate securities. While most companies were reluctant to exploit fully the scope for permissible equity investment, there were notable exceptions. For instance, under the leadership of T.B. Macaulay, the Sun Life Assurance Company sought to make equity investments in newly emerging industries, such as electricity.<sup>55</sup> By 1923, the company owned and operated 55 utility companies through a holding company, Illinois Traction.<sup>56</sup> But, by the early part of the 20th century, American insurance companies were coming under increasing criticism from the press for a wide range of activities, the result of which was the adoption of legislation (the 1906 "Armstrong laws") barring equity ownership by American insurance companies.<sup>57</sup> Calls for reform spilled over to Canada; by 1906, the federal government had appointed the Royal Commission on Life Insurance to investigate the industry, which, despite having failed to discern levels of abuse comparable to the American experience, recommended the adoption of legislative reforms that closely paralleled the American model.<sup>58</sup> However, Parliament failed to adopt many of the reforms recommended by the Royal Commission. In the case of equity investments, the Insurance Act (1910) limited equity investment by insurance companies to a maximum of 30% of the stock of any one corporation, and only then subject to a 7-year dividend test of at least 4%.<sup>59</sup>

By 1927, the provisions contained in the 1910 insurance statute were relaxed, permitting insurance companies to invest in the common stock of commercial companies that had did not meet the

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or other chartered companies . . .") See An Act to incorporate "The Canadian Life Insurance Company", S.C. 1849, c. 168; and An Act to incorporate "The Sun Insurance Company of Montreal", S.C. 1865, c. 43. For a further discussion, see I.M. Drummond, "Canadian Life Insurance Companies and the Capital Market, 1890-1914" (1962), 28 *Can. J. Econ.* 204 at p. 205.

<sup>55</sup> G.H. Harris, *The President's Book: The Story of the Sun Life Assurance Company of Canada* (Montreal, Southam Press, 1928), p. 184. See also J. Schull, *The Century of the Sun* (Toronto, Macmillan of Canada, 1971).

<sup>56</sup> Schull, *supra*, footnote 53, at p. 45. The holding company was sold in 1923 for a substantial profit.

<sup>57</sup> H.R. Grant, *Insurance Reform* (Ames, Iowa, The Iowa State University Press, 1979); M. Keller, *The Life Insurance Enterprise* (Cambridge, The Belknap Press of Harvard University Press, 1963). Specifically, see Law of April 27, 1906, ch. 326, s.100, 1906 N.Y. Laws 763, 797.

<sup>58</sup> *Report of the Royal Commission on Life Insurance* (Ottawa, Queen's Printer, 1907).

<sup>59</sup> The Insurance Act, 1910, R.S.C. c. 32, s. 59.

previously stipulated dividend test so long as they had paid out \$500,000 in dividends in a given year.<sup>60</sup> Because of concern over the deflection of managerial talent and energies from the internal management of the insurance company to management of downstream investee companies, some companies placed self-imposed restrictions on the scope of their investment in commercial equities.<sup>61</sup> Following the market crash of 1929, the statutory investment restrictions were tightened to limit the amount of permissible equity investment to 15% of the total investment portfolio.<sup>62</sup> Yet this constraint was seldom binding; buffeted by losses sustained during the depression, and fearful of the regulatory consequences of mark to market accounting treatment of stocks, insurance companies refrained from making significant investments in equities during the post-War period.<sup>63</sup> Indeed, even though the 15% limit on equity investment was raised to 25% in 1965, the change had no appreciable effect on investment activity by the insurance companies.<sup>64</sup>

Thus, when one compares the actual level of equity investments made by major Canadian intermediaries with the level of permissible investments, the growth of the concentrated company in Canada cannot be explained by the role of large pools of financial capital. That is, Canadian controlling shareholders were able to cement their control over commercial companies without having to enlist equity support from Canadian banks and insurance companies.<sup>65</sup>

<sup>60</sup> Neufeld, *supra*, footnote 43, at p. 240.

<sup>61</sup> For instance, Sun Life decided to adopt the principle that it would not acquire "more than 10 per cent of the common stock of any one company, no matter how strong and prosperous it might be" Harris, *supra*, footnote 53, at pp. 195-96.

<sup>62</sup> Porter Report, *supra*, footnote 45, at p. 249.

<sup>63</sup> W.M. Hood and O.W. Main, "The Role of the Canadian Life Insurance Companies in the Post-War Capital Market" (1956), 22 Can. J. Econ. 467 at p. 478.

<sup>64</sup> S.C. 1964-65, c. 40, s. 5(5). The legislation enacted a number of other changes designed to increase the attractiveness of equity investment to insurance companies. Yet, according to one commentator, the life insurance industry was "scarcely galvanized by the new rules. Total industry investment in common stocks stood at about 4% of portfolio between 1961 and 1964 and there was not upward change in 1965, even though the life firms have been badgered by critics to 'abandon the depression complex' " See B. Lee, "Insurance, The Magic of Averages", *The Globe and Mail*, 1966 at p. 52.

<sup>65</sup> Other researchers have also concluded that Canadian financial intermediaries played only a marginal role as equity investors in the development of non-financial companies. Niosi, for instance, *supra*, footnote 50, at p. 63, states that: "the traditional picture of Canadian finance, one of abstention (by Canadian financial intermediaries) from the founding, reorganization and control of non-financial corporations, has remained unchanged."

### 3. Low Costs of Borrower Screening and Monitoring Experienced by Canadian Banks

Another possible reason for the persistence of high levels of ownership concentration is the existence of debt monitoring economies that may have lowered the costs of debt to Canadian borrowers, enabling controlling shareholders to obtain capital for industrial expansion through high levels of debt rather than through sale of equity. In this vein, Daniels and Triantis argue that bank debt possesses several important governance characteristics that contribute to the control of managerial agency problems.<sup>66</sup> In Canada, debt monitoring economies reflected the dominant role of the major banks in the Canadian financial system, particularly in contrast to the more fragmented banking system of the United States. For instance, Shearer *et al* report that, in 1984, there were 7,457 bank branches in Canada, with the five largest banks having over 1,000 branches each, whereas in the United States there were 15,000 separate banks having 39,000 branches, or no more than 2.6 branches each.<sup>67</sup> Whereas the growth and consolidation of unit banks in the United States was hobbled by a range of legislative restrictions (most importantly, restrictions on inter-state banking), the expansion of Canadian banks was facilitated by a permissive regulatory environment that, among other things, did not limit inter-provincial branching.<sup>68</sup> Not only did inter-state branching restrictions inhibit American banks' ability to realize monitoring economies, but it also made them less stable than their Canadian counterparts because of limits on the geographic diversification of their asset base.

The monitoring economies realized by the major Canadian banks were manifest in two principal ways. First, the large *absolute* size of the Canadian banks facilitated the realization of operational scale economies that permitted the fixed cost of investment in monitoring mechanisms to be spread over more transactions, resulting in lower costs per transaction. Second, buttressing this effect, the large *relative* role of the Canadian banks

<sup>66</sup> R. Daniels and G. Triantis, "The Role of Debt in Interactive Corporate Governance" (1995), 83 *University of California Law Rev.* 5.

<sup>67</sup> R. Shearer, J. Chant and D. Bond, *The Economics of the Canadian Financial System*, 2d ed. (Scarborough, Ontario, Prentice Hall Canada Inc., 1984), p. 225.

<sup>68</sup> For a discussion of the legislative history of the McFadden Act (The National Bank Act, 44 Stat. 1228, 12 U.S.C. ss. 36 (c)(1) and (2), see *First National Bank of Logan v. Walker Bank & Trust Co.*, 385 U.S. 252 (1966)).

in the economy lowered *ex ante* screening and *ex post* monitoring costs for lenders. Screening costs were reduced by the more efficient reputational markets for borrowers that operated in Canada. With control over lending concentrated in a handful of lenders, the opportunities for banks to exchange information regarding borrower misbehaviour were heightened in relation to the opportunities enjoyed by banks in the United States. The existence of these informal communication networks made the sting of reputational sanctions faced by opportunistic borrowers more severe in Canada than the United States. For example, with these informal communication networks in place, opportunistic borrowers whose credit lines had been cut off by one Canadian bank would find it extremely difficult to obtain alternative financing by simply "crossing the street" to another bank. Monitoring costs were lowered by the higher levels of trust that Canadian banks placed in the integrity of each other's monitoring effort, enabling lenders to rationalize monitoring effort for borrowers.<sup>69</sup>

Building on the Canadian banks' superior monitoring capabilities was the absence of any disabling constraint on the exercise of bank voice when dealing with financially distressed borrowers. In the United States, the bankruptcy doctrine of equitable subordination limits the degree of control that a lender can exercise over the business and affairs of a failing borrower, which undermines the degree of effective discipline that can be imposed on borrowers.<sup>70</sup> Under the doctrine, the court is authorized to subordinate a lender's claim if the lender obtains an advantage at the

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<sup>69</sup> In cases where multiple banks have lent funds to a single debtor, only one bank should be responsible for the monitoring effort. Otherwise, banks will be making duplicative investments in the same monitoring activity. But the difficulty is that in the absence of trust, banks having delegated their monitoring responsibility to a lead bank will fear that the bank will utilize its access to information to obtain an advantage (such as a priority) should the lender encounter financial difficulty. While there are a range of contractual solutions to this problem, the ability to rely on fair treatment by the lead lender is perhaps the most attractive solution. See the discussion in Daniels and Triantis, *supra*, footnote 64.

<sup>70</sup> Bankruptcy Code, §510(c). Most courts have required that the lender in control (an insider) engaged in inequitable conduct that resulted in injury to other creditors or conferred an unfair advantage to the lender. *Benjamin v. Diamond (In re Mobile Steel Co.)*, 563 F. 2d 692 (5th Cir. 1977). If the lender does not have sufficient control to be viewed as an insider, the courts have imposed a stricter requirement of egregious conduct such as fraud or misrepresentation. See *In re Osborne*, 42 Bankr. 988, 997 (W.D. Wis. 1984).

expense of other creditors as a result of its control over the borrower's management. The clearest case of control is a lender who holds a majority block of voting shares of its borrower, either directly or through a pledge of the shares.<sup>71</sup> However, the equitable subordination doctrine recognizes also the leverage that stems from instruments other than equity voting rights. Hence, bankruptcy courts also scrutinize the behaviour of a lender who controls its borrower's cash flow: for instance, by holding an assignment of accounts receivable or signing authority on the debtor's current account.<sup>72</sup> A lender with the requisite degree of control may be held accountable for its actions under a fiduciary standard.<sup>73</sup> Therefore, if the lender uses its control over the borrower to obtain an advantage at the expense of other creditors, its claim may be subordinated to unsecured claims.<sup>74</sup> In contrast, Canadian courts have refrained from adopting the equitable subordination doctrine, allowing Canadian banks to utilize real-time firm specific information gleaned from their monitoring activities to support a more vigorous role in the business and affairs of a borrower experiencing financial distress.<sup>75</sup>

The significance of these bonding and monitoring economies,

<sup>71</sup> *Process-Manz Press Inc. (Re)*, 236 F. Supp. 333 (N.D. Ill., 1964) (lender held voting rights in 90% of borrower's common stock); *American Lumber (Re)*, 5 Bankr. 470, 478 (D. Minn. 1980) (lender had right to vote pledged shares in the borrower).

<sup>72</sup> Along with voting control, control over cash flows appears to be the most prominent indicia of control. See *Process-Manz Press, Inc. (Re)*, 236 F. Supp. 333 (N.D. Ill., 1964) (lender held assignment of receivables, collected the proceeds and supplied the funds for payroll and other expenses); *American Lumber (Re)*, 5 Bankr. 470, 478 (D. Minn. 1980) (lender foreclosed on its security interest in the debtor's receivables and contract rights, and refused to honour the debtor's payroll checks).

<sup>73</sup> See, e.g., *Teltronics Services (Re)*, 29 Bankr. 139, 170-71 (Bankr. E.D.N.Y., 1983).

<sup>74</sup> So, for instance, if a controlling lender receives a new security interest (*American Lumber (Re)*, 5 Bankr. 470, 478 (D. Minn., 1980) (controlling lender received new security interests in inventory and equipment from its distressed borrower); *Beverages International Ltd. (Re)*, 50 Bankr. 273 (Bankr. D. Mass., 1985) (creditor delayed in obtaining and recording a blanket security interest to encourage third parties to extend credit to the debtor or benefits from an increase in the value of an existing security interest at the expense of unsecured creditors, (for example, through its control over the disbursements of the debtor, a lender allowed only those payments that were likely to enhance or preserve the value of its collateral: *American Lumber*) it may have its claim subordinated in a subsequent bankruptcy proceeding.

<sup>75</sup> In *Canada Deposit Insurance Corp. v. Canadian Commercial Bank* (1992), 97 D.L.R. (4th) 385, [1992] 3 S.C.R. 558, Justice Iacobucci, *in dicta*, refused to consider whether the equitable subordination doctrine should exist in Canada, at p. 609 S.C.R.: "As I see the matter, however, it is not necessary in the circumstances of this case to answer the question of whether a comparable equitable doctrine should exist in Canadian law and I expressly refrain from so doing".



coupled with greater latitude for the exercise of voice, may be more difficult to sustain as financial markets in Canada become more susceptible to entry by domestic and foreign financial and market intermediaries. Nevertheless we believe that the banks' historic dominance in the Canadian economy constitutes a plausible, partial explanation for high levels of ownership concentration among Canadian commercial companies. Ultimately, however, to substantiate this proposition, a time series analysis of the capital structure of Canadian public companies against matched companies in the United States. Such a study would confirm whether Canadian closely held companies were more highly leveraged than their American counterparts, reflecting our thesis that debt was a less expensive means of raising capital in Canada than equity.<sup>76</sup>

#### 4. Regulatory Distortions

A final reason for the persistence of concentrated ownership in Canada is the existence of sundry regulatory distortions. In some cases, regulatory distortions provide an explanation for other phenomena discussed previously in this part of the article. For instance, it is arguable that the mercantilist industrial policies pursued by a succession of Canadian governments created a highly protected product market that allowed Canadian manufacturers to enjoy high profits with small scale, high cost production facilities that focused on manufacturing a diverse set of products for local consumption.<sup>77</sup> In the absence of any impetus to sell their goods and services into more competitive export markets, manufacturers faced less incentive to raise risk capital (through equity sales) for the purposes of investment in production economies.

But regulatory intervention effected concentration levels in ways other than by distortions in firm growth and performance. The same mercantilist policies that skewed domestically owned corporations towards small scale, high cost production also

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<sup>76</sup> Here, we should note that recent comparative work by Rajan and Zingales of the capital structure of companies in G-7 countries in the 1980s reveals a surprising level of convergence of leverage ratios. Raghuram G. Rajan and Luigi Zingales, "What Do We Know About Capital Structure? Some Evidence From International Data" (1994), Working Paper No. 4875, National Bureau of Economic Research, Inc. Working Paper Series.

<sup>77</sup> The literature on this point is reviewed in Richard G. Harris, *Trade, Industrial Policy and Canadian Manufacturing* (Toronto, Ontario Economic Council, 1984).

exerted a similar effect on foreign firms wishing to sell into the Canadian market. To surmount the high tariff barriers protecting Canadian industry, foreign firms were forced to enter the Canadian market through partially owned foreign subsidiaries whose production was keyed to the demands of the Canadian market. Because these firms were sheltered from external competition by the same barriers that protected domestically owned firms, the incentives for efficient production were similarly dampened.<sup>78</sup> Complicating matters was the fact that Canadian tax and foreign investment policy encouraged the sale of minority equity blocks in these firms to public shareholders, nurturing the managerial entrenchment problems discussed earlier.<sup>79</sup>

However, restrictions on the inward flow of goods, services, and capital were not the only culprits. Canadian governments also established restrictions on the outward flow of investment which conferred excessive bargaining power on Canadian issuers in domestic capital markets. Perhaps the most important restriction was the foreign property rule which penalized investment portfolios having in excess of 10% of their value in foreign assets.<sup>80</sup> These restrictions enabled domestic issuers to raise equity capital without having to part with voting control over the corporation's assets.

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<sup>78</sup> This point is persuasively made in H.C. Eastman and S. Stykolt, *The Tariff and Competition in Canada* (Toronto, Macmillan, 1967). See also E. Safarian, *Foreign Ownership of Canadian Industry*, 2nd ed. (Toronto, University of Toronto Press, 1973), p. xxii: "It is fairly convincingly established that the most important ultimate determinants of this inefficient industrial structure have been Canadian and foreign protection against trade, a lack of effective competition (partly because of tariffs and a weak anti-combines policy), and badly devised government industrial policies on research and other matters".

<sup>79</sup> Several examples can be cited. The tax incentives contained in the 1963 federal budget which lowered withholding taxes on dividends from 15% to 10% for companies beneficially owned by Canadians to the extent of at least 25% of their voting stock, and also where the parent company and its associates held no more than 75% of the voting shares and the stock of the subsidiary was listed on a Canadian exchange; the establishment of the Foreign Investment Review Agency in 1974 and its attention to Canadian share ownership as one of the criteria necessary for entry into Canada; and the incentives set out in the Trudeau government's National Energy Program for Canadian ownership.

<sup>80</sup> S.C., 1970-71-72, c. 63, s. 206. The restriction now stands at 20% following a statutory amendment made in 1991. See discussion in Daniels and MacIntosh, "Toward a Distinctive Canadian Corporate Law Regime", *supra*, footnote 3, and in B. Smith, B. Amoako-Adu, and J. Schnabel, "Characteristics and Trends of Restricted Shares Listed on the Toronto Stock Exchange", Working Paper No. NC 89-10, and B. Smith and B. Amoako-Adu, "Financing Canadian Companies with Restricted Shares" (1991), *MCMRD Monograph Series*, University of Western Ontario.

Suggestive evidence of the bargaining power exerted by Canadian issuers is furnished by the number of public Canadian corporations having dual class share structures.<sup>81</sup> Under a dual class share structure, control is held by an individual or related group through their ownership of the voting (superior voting) shares which need not be listed for trading on a stock exchange.<sup>82</sup> This control block, however, represents a small proportion of the total equity of the firm.<sup>83</sup> This dual class structure can lead to a deleterious impact on shareholder wealth since the control group can entrench itself while owning only a small proportion of the firm's total equity.<sup>84</sup> These structures are most problematic when they are implemented through midstream amendments to the firm's capital structure, which many commentators regard as coercive.<sup>85</sup> Nevertheless, to the extent that regulatory distortions

<sup>81</sup> Smith, Amoako-Adu, and Schnabel, (*ibid.*), note that as a proportion of market value of the TSE 300, dual class shares rose from a low of approximately 3% in 1979 to a high of 15% in 1989. As of July of 1993, 179 out of some 1,502 issues listed on the Toronto Stock Exchange were restricted voting shares. On the TSE 300, 68 companies utilized restricted voting shares. The TQMV (total quoted market value) of the 68 companies was \$45.6 billion, or 14% of the TSE 300's TQMV. Further underscoring the role of restricted shares is the fact that they comprised \$37.4 billion, or 82% of the issuers' TQMV (the data was furnished by J. Schmid, November 1, 1993). Smith and Amoako-Adu also report that the growth of this share structure was concentrated in the early to mid-1980s. As of 1989, 40% of the listed firms in the transportation, communications and merchandising groups had dual class share structures. There were 160 firms with dual class shares on the Toronto Stock Exchange of which 67 had both classes of shares listed on the exchange; the majority listed only the inferior voting share with the superior voting share being privately held. For those shares which had both classes listed on the exchange, the single largest shareholder or group of related shareholders owned approximately 50% on average of the voting shares.

<sup>82</sup> There are a number of other countries in which dual class shares are found. These include Israel, Britain and Sweden among others. Dual class shares can have different voting attributes. For example, they can be either voting/non-voting shares or superior/inferior voting shares.

<sup>83</sup> Total equity is defined as the sum of the voting (superior voting) shares and non-voting (inferior voting) shares.

<sup>84</sup> When the control group owns the same percentage of the voting shares and of the total equity, non-shareholder maximization behaviour by the management/control block group is reflected as a cost to management; this will provide some restraint on the non-shareholder wealth maximizing behaviour of management. However, under dual class shares, the link between ownership and voting rights is severed, meaning that control block holders do not bear the full cost of their non-wealth maximizing behaviour. Thus, the concentrated voting share ownership permits entrenchment behaviour while the costs of this behaviour are shared among the total share holdings, both voting and non-voting. In this vein, Richard Ruback has argued that "dual-class plans may be the most effective universal antitakeover device ever invented" in "Coercive dual-class exchange offers" (1988), 20 *Journal of Financial Economics* 153.

<sup>85</sup> Dual-class share recapitalizations can occur in a number of different ways. The first is via

have artificially increased the market power of Canadian issuers, these structures may be problematic even when implemented by way of initial offering.<sup>86</sup> These concerns have been validated by an empirical analysis of the market price effect to the announcement of dual class share structures. In a study of 62 dual class firms listed on the Toronto Stock Exchange, Jog and Riding found that 67% of the firms in the sample had negative price effects over the period 1 day prior to and 1 day subsequent to the announcement of dual class transactions.<sup>87</sup>

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an exchange transaction in which shareholders approve the creation of a new class of super voting common shares that have dividend payments below the rates of pre-existing common stock and are subject to various transfer restrictions. Following the creation of this class of shares, existing common shareholders are then provided with an opportunity to tender their shares in exchange for the newly created class of shares. Alternatively, they can retain their existing shares. Typically, only the inside management group will opt for the newly created shares because of the restrictions on share transfer. The second technique involves special stock dividends. In this case, the corporation dividends out the newly created shares to existing common stock holders; however, because the superior voting rights of the new class of shares are nullified on subsequent transfers, the inside control group (which does not transfer its shares) ends up bolstering its initial control position. The third technique is a modification of share voting rights in which superior voting rights are issued to only those shareholders whose ownership of existing common shares exceeds some minimum prescribed amount. See discussion in Jeffrey N. Gordon, "Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice" (1988), 76 California L.R. 1, at pp. 40-42. After the creation of the dual class share structure, the consolidation of control is further buttressed by heavy reliance on subordinate voting shares in subsequent transactions (such as stock splits and dividends, acquisitions, convertible bond issues, and public offerings). In Canada, Smith *et al.*, *supra*, footnote 78, report that 71.95% of the percentage of total equity created after the formation of a dual class share structure is in the form of restricted shares and only 26.77% in the form of superior shares. Further consolidation was achieved by conversion of voting to restricted shares and by corporate stock repurchases. In Canada, the issuance of dual class share structures by way of midstream amendment is governed by Ontario Securities Policy 1.3 ("Restricted Shares" (1984), 7 O.S.C.B. 5357) which provides for, among other things, minority shareholder approval of the creation of a dual class share structure by a broad array of means.

<sup>86</sup> Several American commentators have challenged the claim that there is any salient distinction between initial and mid-stream introduction of dual class share structures. See, for instance, Louis Lowenstein, "Shareholder Voting Rights: A Response to SEC Rule 19c-4 and to Professor Gilson" (1990), 31 Corporate Practice Commentator 595 at p. 597; Joel Seligman, "Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy" (1986), 54 Geo. Wash. L. Rev. 687. For a contrary view, see Ronald Gilson, "Evaluating Dual Class Common Stock: The Relevance of Substitutes" (1987), 73 Virginia L.R. 807.

<sup>87</sup> Vijay M. Jog and Allan L. Riding, "Market Reactions of Return, Risk and Liquidity to the Creation of Restricted Voting Shares", *RCSA/CJAS*, March 1989, p. 62. The researchers also found that the risk (as measured by betas) of restricted voting shares was approximately twice that of superior voting shares, and that this result was significant at the 5 % level 40 days after the date of listing. They claim that the increased risk of the stocks reflected the differential control wielded by superior and restricted voting share-

Against the shareholder exploitation view of dual class recapitalizations, several researchers have argued that these structures are efficiency enhancing for firms with high growth opportunities.<sup>88</sup> Specifically, if the value of the firm's potential projects cannot easily be communicated to or observed by outside shareholders, managers will be forced to provide additional investment in the firm and that increases their non-diversifiable firm specific risks. Dual class capital structures reduce the risk of displacement in the event that the investment sours, making management more amenable to undertaking these investments.

In the United States, there is some evidence that companies with dual class share structures do, in fact, experience high post-transaction rates of growth and that this growth is fuelled by external equity financing.<sup>89</sup> In Canada, the results of the Morck and Stangeland study offer some weak support for the efficiency hypothesis; firms with dual class share structures showed faster sales growth than American rivals, but this growth did not carry over to job creation.<sup>90</sup> However, militating against this claim is the fact that Canadian dual class firms exhibited profitability significantly below their U.S. rival industries and Canadian "one-vote-per-share" firms.

## 5. Conclusion

This survey reveals that several different factors may explain the persistence of high levels of share ownership concentration in Canada. On balance, we favour a multi-factor explanation that draws on the delayed effects of industrial development, the distortionary effects of government trade and investment protection policy, and, to a lesser degree, on the role of the Canadian banks in efficient debt monitoring. We do, however, discount the impact that liberalized investment rules governing bank and insurance company equity investment have had on the formation of large

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holders over management and the fact that the latter would be more sensitive to market effects.

<sup>88</sup> Harry DeAngelo and Linda DeAngelo, "Managerial ownership of voting rights: a study of public corporations with dual classes of common stock" (1985), 14 *Journal of Financial Economics* 33; and, Gilson, *supra*, footnote 84.

<sup>89</sup> Kenneth Lehn, Jeffrey Netter and Annette Poulsen, "Consolidating Corporate Control: Dual-class recapitalizations versus leveraged buyouts" (1990), 27 *Journal of Financial Economics* 557.

<sup>90</sup> Morck and Stangeland, *supra*, footnote 30.

numbers of concentrated companies — a result that contradicts Roe's emphasis on the regulatory structure of financial intermediaries as a determinant of industrial structure. Nevertheless, our work is preliminary in character, and we strongly endorse the need for further research to explore these matters in a more systematic fashion.

#### IV. THE MARKET AND DE-CONCENTRATION

Having recognized a number of possible causes for high levels of corporate share ownership concentration in Canada, we now discuss the existence of certain market and regulatory trends eroding the impact of these factors, ultimately resulting in the de-concentration or privatization of Canadian share ownership. We first array the trends reducing concentration, and then consider their impact on specific types of closely held companies.

##### 1. Market and Regulatory Trends

For the last several decades, the level of effective protection realized by Canadian industry has been steadily eroded through liberalized trade policies, such as the North American Free Trade Agreement and the GATT Uruguay Round. As measured by the level of real trade flows, Canada is now one of the most open economies of the world. This openness has intensified the product market pressure on Canadian corporations, and has stimulated the rationalization and restructuring of Canadian firms.<sup>91</sup> Although it is difficult to predict the impact of product market pressures on specific firms, we believe that this discipline has special import for closely held corporations given the long standing suppression of other market mechanisms on managerial behaviour. Perhaps most importantly, the liberalization of these markets underscores the need for fragmented, small scale, multi-product firms to narrow their corporate focus and to lower production costs through the realization of scale economies. As production is reorientated, we would predict two effects: (i) the rationalization of foreign controlled Canadian subsidiaries in a

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<sup>91</sup> Like their foreign competitors, many Canadian suppliers have shed unnecessary hierarchical layers and have increased the degree of product focus. The trend toward rationalization in response to trade liberalization is discussed in Richard G. Harris, *Trade, Industrial Policy and International Competition* (Toronto, University of Toronto Press, 1985).

continental market; and (ii) a corresponding increase in demand for equity capital.

Accompanying the steady decline in trade protection instruments has been the dismantling of many, though not all, foreign investment restrictions.<sup>92</sup> This trend is illustrated by the change in the mandate of Investment Canada, from its original role as the guardian for national control of domestic industry, to foreign investment monitor, to its current role as foreign investment promoter.<sup>93</sup> More lenient investment restrictions will likely increase the depth of the Canadian capital market, while permitting foreign owned corporations to determine whether or not the partially owned subsidiary (particularly when it is confined to producing goods and services for the Canadian market) is the most efficient way to service the Canadian and perhaps continental market.

A further important regulatory change is the relaxation of the foreign ownership rule for retirement funds to 20%. Although this constraint still distorts Canadian capital flows, it expands markedly the opportunity set for Canadian investors, and should mitigate the market power of Canadian issuers, particularly in terms of their ability to raise capital through restrictive equity instruments. In fact, there have been a few recent instances in which companies eliminated their non-voting shares and then issued common shares since the market discount on a new restricted voting share issue was too severe for the company to accept.

## **2. Expected Impact of Trends on Concentrated Canadian Corporations**

In tandem, the changes we have enumerated can be expected to accelerate the splintering or privatization of closely held public companies, yielding significant efficiency gains for the Canadian economy. We discuss the impact of these market changes in three different closely held corporate contexts.

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<sup>92</sup> Certain "sensitive" Canadian industries like telecommunications remain subject to foreign investment restrictions.

<sup>93</sup> This transformation is discussed briefly in Lorraine Eden, "Multinationals as Agents of Change: Setting a New Canadian Policy on Foreign Direct Investment", Industry Canada Discussion Paper Number 1, November 1, pp. 15-17.

## (a) The Foreign Owned Subsidiary

Liberalization of trade and investment flows has led to the privatization of a number of partially foreign-owned subsidiaries. Since 1987, several high profile minority buyouts have been consummated, including: Westinghouse Canada Inc (1987); Nabisco Brands Ltd. (1988); CIL Inc. (1988); General Electric Canada Inc. (1990); Inglis Ltd. (1990); Campbell Soup Co. Ltd. (1991); and Goodyear Canada Inc. (1993).<sup>94</sup> The reason for these buyouts is straightforward. In the absence of artificial entry barriers, foreign corporations will be less inclined to establish or to support subsidiaries designed to service the Canadian market, especially when differences in the home and host country environments are relatively insignificant (implying that country or location specific advantages from producing in the host country were less important than artificial entry barriers in encouraging the parent corporation to establish the subsidiary in the first place).<sup>95</sup> The savings from privatization of the partially-owned subsidiary are significant, and include: enhanced organizational efficiency from hierarchical de-layering, realization of economies of scale from expanded production in the company's primary facilities, and reduced filing, accounting, and legal costs related to securities regulation for companies whose shares are traded in public markets. We would expect these pressures would be felt most acutely by widely held foreign parents whose product lines are experiencing product market pressure and who are themselves subject to intense capital market scrutiny in their home jurisdiction.

Despite these benefits, taking a partially-owned subsidiary private has proven to be fairly difficult to realize in practice. Majority buyouts are governed by stringent securities and corporate law requirements. Ontario Securities Policy 9.1, for instance, requires that an issuer proposing a going private transaction to obtain approval of a majority of minority shareholders and to secure a valuation.<sup>96</sup> Further, issuers proposing such trans-

<sup>94</sup> John Saunders, "Head office flexes its might", *Globe and Mail*, Tuesday, January 18, 1994, p. A1.

<sup>95</sup> The theory of the multi-national enterprise is developed in Richard E. Caves, *Multinational Enterprise and Economic Analysis* (Cambridge and New York, Cambridge University Press, 1982). See also John Dunning, *International Production and the Multinational Enterprise* (London, George Allen and Unwin, 1981) chapter 3; Alan Rugman, *Inside the Multinationals: The Economics of Internal Markets* (London, Croom Helm, New York, Columbia University Press, 1981).

<sup>96</sup> Ontario Securities Policy 9.1, "Disclosure, Valuation, Review and Approval Require-



actions are instructed to “consider and if reasonable to do so” to adopt special committee review which contemplates disinterested directorial review of the proposed transaction. In addition to the procedural review requirements contemplated by securities law, directors approving going private transactions are also subject to corporate law fiduciary duties and to the oppression remedy. Unfortunately, however, courts have not been consistent in the way in which they have interpreted directorial responsibilities in a going private transaction under these provisions. In *Alexander v. Westeel-Rosco Ltd.*, the court granted an interim injunction against an amalgamation squeeze-out transaction on the basis that the transaction discriminated against minority shareholders.<sup>97</sup> However, in other cases, the courts have permitted these transactions to be implemented so long as the controlling shareholder pays fair value to the minority.<sup>98</sup>

This line of cases has produced two significant problems for directors in a going private transaction. First and foremost, the decisions have created considerable uncertainty as how directors should navigate among the shoals of conflicting judicial precedents. Although strong arguments exist that amalgamation squeeze-outs (especially when the majority are offering fair value for the minority's shares) should not be deemed oppressive or illegal per se, the jurisprudence is not clear on this point.<sup>99</sup> These problems are exacerbated when one considers the interaction of the oppression remedy with securities law requirements, such as Ontario Securities Policy 9.1.<sup>100</sup> Would, for instance, it still be

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ments and Recommendations for Insider Bids, Issuer Bids, Going Private Transactions and Related Party Transactions” (1991), 14 O.S.C.B. 3345. Insofar as going private transactions are concerned, the policy closely tracks the approval regime prescribed in the Ontario Business Corporations Act, s. 189.

<sup>97</sup> (1978), 93 D.L.R. (3d) 116, 4 B.L.R. 313 (Ont. H.C.J.). Injunctions have been granted in other cases involving amalgamation squeeze-outs on the basis that the proposed transactions were oppressive. *Ruskin v. Canada All-News Radio Ltd.* (1979), 7 B.L.R. 142 (Ont. H.C.J.); *Burdon v. Zellers Ltd.* (1981), 16 B.L.R. 59 (Que. Sup. Ct).

<sup>98</sup> See, for instance, *Neonex International Ltd. v. Kolasa* (1978), 84 D.L.R. (3d) 446 (B.C.S.C.), and, *General Accident Assurance Co. of Canada v. Lornex Mining Corp.* (1989), 40 B.L.R. 299, 66 O.R. (2d) 783 (H.C.J.).

<sup>99</sup> Despite apparent good faith conduct of the directors of an offering issuer, the courts may enjoin these transactions on the basis that they are unfair or prejudicial to minority shareholders.

<sup>100</sup> The recent notice by the Director of the Canada Business Corporations Act (Policy Statement 11.21, “Notice of Revised Policy on Going Private Transactions”, dated September 22, 1994) that going private transactions are permitted under the CBCA so long as the substance of the transaction is not oppressive or unfairly prejudicial to or

open to minority shareholders to commence an oppression action for a transaction that had been vetted and approved by directors and minority shareholders pursuant to Policy 9.1?

Second, however, is the question of whether the securities and corporate law regime in respect of going private transactions confers excessive bargaining power on minority shareholders that allows them to hold up value maximizing transactions on the grounds that fair value has not been offered for their shares.<sup>101</sup> Given the size of the required premium necessary to take these companies private, many majority shareholders have simply refrained from privatizing these corporations, despite the clear efficiency gains to be realized. And although it is arguable that some degree of rationalization of North American operations could be achieved while maintaining the partially-owned subsidiary (*ie.*, by changing the multi-product character of production for the Canadian market in the subsidiary's plant(s) to single product production for the continental market), aggrieved minority shareholders may, in fact, argue that these changes constitute a breach of their original investment expectations and, as such, are actionable under the oppression remedy.<sup>102</sup> Indeed this was the essence of a recent claim made by minority shareholder GSW (20%) in a dispute with the majority shareholder in Camco, General Electric Canada (51%). GSW argued that GE owed a duty to the minority shareholders to keep Camco in

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unfairly disregards the interests of a person whose interest in a participating security is being terminated without his or her consent is a step in the direction of ameliorating the uncertainty that exists in respect of the interaction of corporate and securities law. The policy statement provides that "in the case of offering corporations, compliance with established indicia of fairness will, as a general rule, be viewed by the Director as sufficient". Nevertheless, the Director's position is not dispositive of the validity of the transaction under corporate law; that is a matter remitted to the courts. And, as the Policy Statement indicates, the case law "does not offer definitive direction". Thus, in the absence of judicial clarification, considerable uncertainty still exists.

<sup>101</sup> This concern is more than academic. In the recent privatization of Goodyear Canada, the company first offered a premium that was 22% over market value, and minority shareholders refused the offer. One year later, the company revised its offer to 67% over the pre-transaction market price of the shares, which the shareholders accepted. The difficulties surrounding the privatization of foreign owned subsidiaries are discussed in a proactive article by John Kazanjian, "Problems in Governance: Dealing with Canadian Minority Shareholders in an Integrating North American Business Environment" (1994), 2:2 *North American Corporate Lawyer* 58.

<sup>102</sup> Shifting production activity, however, does not enable the parent company to realize the economies from more streamlined organizational structures nor of reduced transactions costs that would accompany the elimination of public shareholders.

business as a manufacturer, with long-term purchase commitments from GE, instead of moving toward Camco becoming a mere Canadian distributorship for GE products.<sup>103</sup> While the issue of what the minority is actually entitled to on a going private transaction is complex, we would argue that the driving force behind the privatization of these companies has generally been the desire to undertake economically beneficial restructuring and rationalization stimulated by the liberalization of trade protection policy in Canada and the United States, not malign shareholder redistribution. Viewed in this frame, it is not obvious as between diversified parent and subsidiary shareholders who should bear the risks of a secular change in government trade policy that renders the Canadian subsidiary structure uneconomic. If so, it may be worth considering modifications to the substantive and procedural rights of minority shareholders under the securities and corporate law regime which would limit their capacity to hold parent companies to ransom, particularly when the quest for these gains will retard the timely rationalization of dysfunctional organizational structures.

(b) The Subsidiary of a Widely Held Canadian Company or Conglomerate

Like its foreign counterpart, we predict that widely held multi-division Canadian companies will also experience increased pressure to de-concentrate through spin-offs or sell-offs of controlled subsidiaries. These subsidiaries can either be wholly owned or majority owned with publicly traded minority positions. De-concentration can refer either to the creation of a new widely held company or the sale of a control position in the subsidiary. In both cases there will be an increase in the number of widely held companies in the capital market but only in the former will a new company be created.

Concerns have been expressed about the impact on shareholder value of the existence of subsidiary operations in areas distinct from the focus of the parent corporation. These concerns relate to

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<sup>103</sup> The claim was settled out of court. See Scott Feschuk, "GE sued by GSW to live up to deal: Camco's survival feared in jeopardy", July 14, 1992, *Globe and Mail*, p. B1; "GE files claim to end GSW pact", Sept. 29, 1992, *Globe and Mail*, p. B5; "Camco dispute ends at court's door", Sept. 14, 1993, *Globe and Mail*, p. B11.

the low ownership levels of management and hence the agency costs of equity and the use of the conglomerate structure as an internal capital market which insulates the parent company from capital market discipline through review when new funds are sought. Typically conglomerate firms generate large cash flows and, without strong monitoring by investors, these cash flows can be spent on non-shareholder value increasing investments such as the acquisition of subsidiaries in unrelated fields. The conglomerate structure can be motivated by inefficient financial or product market diversification objectives. A good example of this phenomenon is the formation and restructuring of Bell Canada Enterprises (BCE), Canada's largest corporation.<sup>104</sup>

Pressures for restructuring of these firms will emanate from both capital and product markets. On the capital market side, institutional investors will agitate for voluntary restructuring by the firm to enhance shareholder value. Where possible, takeover bids for the firm will be made which have as their main goal the sale of some of the subsidiaries of the firm to achieve greater focus, for example, the recent takeover bid for Labatt by Onex. On the product market side, pressure may result from poor performance of one or more subsidiaries of the firm which causes management to remove the subsidiary from the overall structure.

The actual choice of a spin-off or sell-off will depend upon tax considerations. In the former transaction, the shares of the subsidiary are typically issued to shareholders of the conglomerate as a dividend; this results in a new publicly traded company. In the sell-off, the subsidiary can be acquired either as a management buyout or an acquisition by another firm; in this situation ownership concentration is unaffected.

Unfortunately not all changes in ownership structure will positively effect management behaviour. For example, there are instances where a company has acquired a significant but non-controlling position in the equity of a firm as a portfolio investment. For example, a company may own 15% to 20% of the equity of another company and under most definitions the latter company would not be defined as widely held. Recently, due to a

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<sup>104</sup> P. Halpern and V. Jog, "Bell Canada Enterprises: Wealth Creation or Destruction?" forthcoming in R. Daniels and R. Morck, eds., *Corporate Decisionmaking in Canada* (Calgary, Univ. of Cal. Press, 1995). However, for a more agnostic view of the conglomerate structure, see R. Daniels, R. Morck, and D. Stangeland, "In High Gear: A Case Study of the Hees-Edper Corporate Group" in Daniels and Morck, *op. cit.*

number of factors, including the need for funds to pay down debt to finance investments or to improve strategic focus, these portfolio positions have been liquidated and as long as the portfolio investment is not purchased as a block by another firm or investor, the company will be defined as widely held. With a number of these transactions occurring in the Canadian capital market, the TSE 300 appears less concentrated currently than it has in previous years.<sup>105</sup> However, to the extent that these non-controlling portfolio positions previously have little or no impact on decision making, the observed change in concentration may overstate the potential impact on managerial behaviour.

(c) The Individual or Family Controlled Company

While various market pressures will operate to accelerate the privatization or de-concentration of closely held subsidiaries of foreign or domestic widely held companies, we suspect that the pace of transformation for companies which are under tight individual or family control will be much more sluggish. The slower pace of transformation of these firms can be attributed to two principal factors. The first relates to the suppression of various market mechanisms that alert shareholders and management to the existence of corporate performance problems (*e.g.*, capital, control, and management markets), leaving shareholders and managers dependent on product market discipline which, unfortunately, occurs too late to permit any corrective action.<sup>106</sup> Given positive bankruptcy costs, late stage discipline has particularly

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<sup>105</sup> Riedl and Mackenzie, "Broader Canadian Ownership Puts Greater Focus on Corporate Governance" (1993), 5:2 *Corporate Governance Review* 4. The sellers of blocks of shares have been foreign parent firms, Canadian families in conglomerate firms, and portfolio holdings by firms. Riedl and Mackenzie observed that over the six-month period ending in February 1994, controlling shareholders have distributed shares broadly to both institutional and individual shareholders. Defining a company as widely held when no one person or group owns over 20% of the shares or votes for dual class shares, 25% of the firms on the TSE 300 and 60% of the firms on the TSE 35 were widely held in February 1994. However, this cutoff defining widely held is still high and companies defined as widely held may in fact be effectively controlled by an inside group. In addition, the data are not presented to identify whether dual class shares have become widely held. Since it defeats its purpose, it is unlikely that the controlling shareholders of the voting shares have sold off their blocks.

<sup>106</sup> The problem is that product market discipline usually triggers financial distress, a situation that heightens incentives for opportunistic risk-taking by managers and which requires tight creditor control of managerial decision-making, that limits the scope for creative managerial action.

disturbing implications for the efficiency of the Canadian economy.

The second reason for sluggish transformation relates to the existence of dual class share structures. While the motivation for these structures is now primarily a matter of interest to economic historians, we are interested in the feasibility of unwinding these structures in response to various market pressures.<sup>107</sup> To be sure, restructuring the share capital of a dual class company to a single class of voting shares would in most instances reduce share ownership concentration and result in larger institutional block holdings since these investors are major holders of the restricted voting shares. Nevertheless, there have been very few instances where this restructuring occurred in Canada.<sup>108</sup>

There are two reasons why dual class structures have proven so resilient. First, with the use of the restricted voting shares to finance growth, converting the restricted to superior voting shares is likely to alter the ownership control of the initial major shareholder. To the extent that the initial majority owner used the dual class structure to 'cash out' by selling his or her restricted voting shares, the ownership proportion and potential control position could be severely diluted by the rearrangement of the share structure. Moreover, with the large holdings of non-voting shares by institutional investors, under the rearranged share structure there would be large blocks of voting shares held by institutions. To the extent that these investors are becoming more active in corporate governance issues, the management of the company will no longer be in a position of unquestioned control.<sup>109</sup>

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<sup>107</sup> As we discussed earlier, we are sceptical that the adoption of these structures by many Canadian companies was motivated primarily by efficiency objectives. But even if these structures were put in place to support expansion in rapidly growing industries (the Gilson efficient selection process), the maturing of these firms raises doubts about their ongoing rationale. In fact it may be the need to raise new equity and the concomitant discount on the non-voting shares which are to be issued that may lead growing firms to eliminate their non-voting share structures.

<sup>108</sup> From 1989 to 1994, there have been seven companies that undertook this restructuring: four introduced poison pills in an attempt to limit the scope for control market discipline; two had control positions in both the superior and restricted voting shares and hence would not have their control position affected under the single class structure; and the final company converted to single class since the dual class share structure was introduced to finance short-term growth and had a sunset provision.

<sup>109</sup> We note that although companies eliminating dual class share structures may adopt a poison pill, the pill is not as effective an entrenchment mechanism as the dual class share structure since there are mechanisms by which the pill can ultimately be rendered ineffective. This is particularly relevant in light of two recent decisions rendered by the

Second, as noted in all research in this area, the superior voting shares sell at a premium to the restricted voting shares. Investors who purchased the superior voting shares will oppose the restructuring since they expect that there will be a loss in their wealth as the share price of the superior voting shares falls after the restructuring. However, superior voting share prices need not necessarily fall in response to an elimination of dual class voting structures. To the extent that this share structure facilitated entrenchment behaviour and did not permit effective monitoring, then a restructuring which would ameliorate these issues could in fact result in an increase in share price.<sup>110</sup> Thus opposition by superior voting shareholders to any restructuring should be based upon the expectation of resulting changes in monitoring and alignment of incentives of management to other shareholders.

In summary, any change to a single voting share class must be of net benefit to the control block — particularly in the case of individual or family controlled firms. However, to be successful, the net benefit offered will have to match, and most likely probably have to exceed, the present value of the expected future stream of private pecuniary benefits associated with control in light of the endowment, income, and non-pecuniary benefit effects discussed earlier. That is not to say that there are no costs to the controlling blockholder from dual class share structures. These costs include lower share prices due to agency and entrenchment costs, a higher cost of capital due to lower prices on non-voting shares, reduced liquidity, and, in some cases, a higher dividend paid on the non-voting (inferior voting) shares.<sup>111</sup> The

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Ontario Securities Commission which appear to limit the ability of management to “just say no” to a takeover bid: *In the Matter of the Securities Act, R.S.O. 1990, Chapter S.5, as amended and In the Matter of MDC Corporation and Regal Greetings & Gifts Inc.* (1994), 17 O.S.C.B. 4971; and *In the Matter of the Securities Act, R.S.O. 1990, Chapter S.5, as amended and In the Matter of Lac Minerals Ltd. and Royal Oak Mines Inc.* (1994), 17 O.S.C.B. 4963.

<sup>110</sup> With the introduction of dual class shares, there is an overall loss of wealth as documented by Jog and Riding, *supra*, footnote 85, which reflects the agency costs of equity when the voting shareholders control the firm and have a small proportion of the equity. If the restructuring eliminates the agency cost, then the overall value of the equity of the firm will rise and although the two classes of shares will have the same price, it will be at a higher value.

<sup>111</sup> The higher cost of capital and resulting dilution in the event of a new issue of non-voting shares will be a cost to the control group, but once again they only bear a proportion of the total dilution cost. Ultimately, the strongest motivation to move to the single share class may be the desire of the controlling shareholder to sell the company and this may be easier to achieve when there is one class of shares.

only point is that these costs will have to be significant before they exceed the private benefits from control which are biased upwards.

#### V. STRATEGIES FOR PROMOTING THE DECONCENTRATION OR PRIVATIZATION OF CLOSELY HELD INDIVIDUAL OR FAMILY CORPORATIONS

A central theme of this article is that ownership structure matters when it comes to ensuring managerial accountability in the modern corporation. Whereas commentators in the United States have focused on the agency problems found in widely held corporations, the accountability problems in closely held public corporations may be equally severe, and merit close attention. These latter problems are of special interest to policy-makers in Canada given the traditional domination of the closely held corporation in the Canadian economy. While the data show that widely held corporations containing several large blockholders may, on average, maximize the value of the firm, we refrain from urging the adoption of policies that aim to thrust a standard template of share ownership on the Canadian corporation. After all, the corporation's status as a core institution of modern capitalism is based on its inherent flexibility and adaptability. Although it may be true that firm value is on average maximized through diffuse large stakes ownership, the measure neglects the value of firm structures that deviate from the mean. As long as the scope for artificial regulatory constraints to be imposed on corporations is constrained, we believe that shareholders are likely to prove themselves remarkably adept in adjusting to, and drawing on the benefits of, alternative ownership structures. We would no sooner subject all Canadian public corporations to one form of ownership (even if it were possible) than we would to one standard marketing or distribution strategy.<sup>112</sup>

Given our agnosticism on the issue of what constitutes an optimal ownership structure for the Canadian corporation, the question then is what, if any, policy prescriptions fall from our study? While ambivalent about ownership per se, we are less so

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<sup>112</sup> This is especially so when the life cycle of the firm is taken into consideration. Simply put, more concentrated ownership structures may have greater economic force in the corporation's early stage of development, but the role for these structures may diminish as the corporation grows in size and complexity.



about the governmental policy distortions that have systematically skewed Canadian corporate structure towards an artificially excessive reliance on the closely held public corporation. In this respect, the first policy prescription is one of vigorous and accelerated market liberalization. As noted earlier, product and capital markets have been opened considerably by several recent reforms, and this opening has had a salutary effect on the structure and performance of many Canadian corporations. Nevertheless, several distortions still remain, and command close attention by policy-makers. Of these, perhaps the most important is the continued existence of the foreign property rule and the sundry entry restrictions that still operate on financial and market intermediaries wishing to enter the Canadian market. In this respect, we strongly endorse the value of open and vibrant capital and product markets as the preferred means for ensuring rational organizational choice.

However, while we are confident that market pressures will promote organizational vitality and efficiency, we remain concerned with the prospects for efficient organizational adjustment in the context of the closely held family or individually controlled firm. It is here that government barriers on investment outflows had their most pernicious effects by allowing controlling shareholders to solidify their control position through the creation of dual class share structures. With these capital structures in place, controlling shareholders were able to reduce their economic investment in the firm without affecting their ability to wrest private benefits from control. In this respect, the effect of dual class share structures was profound; by facilitating capital disinvestment, the private costs to equity holders of control were reduced, while the private benefits that could be extracted from control were unchanged. We believe that these problems are most severe in settings where the income, endowment, and non-pecuniary benefit effects discussed above are likely to be salient — the family or individually controlled firm, where control resides with aging entrepreneurs or second generation heirs.

Unfortunately, it is far easier to identify the problem of the closely held family firm than it is to implement nuanced and effective strategies to rectify the problem. On the basis of both efficiency and equity criteria, Morck endorses the adoption of an inheritance tax that is designed to make inter-generational control transfers more difficult to effect.<sup>113</sup> The difficulty, however, is that

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<sup>113</sup> Randall Morck, "On the Economics of Concentrated Ownership", *post*, p. 63-85.

these taxes are enormously easy to evade.<sup>114</sup> In this vein, it is worth recalling that the federal government did impose a tax on inheritances in the period from 1941 to 1971, but abandoned the tax because of its high administrative costs and low revenue yield.<sup>115</sup>

In light of the infirmities surrounding inheritance taxes, what other options remain? One alternative is to adopt regulatory prohibitions on dual class voting structures or to require the insertion of sunset provisions which require a shareholder vote to continue the dual class structure. Another option is a tax on ownership structure that would vary in accordance with the proportion of voting stock held by large block shareholder groups. Alternatively, securities regulators could raise the costs of control transfers by limiting access to the private agreement exemption.<sup>116</sup> The last two options are designed to reduce the formation of control blocks by increasing the costs of either holding or transferring control.

Nevertheless, all of these instruments suffer from a lack of nuance. An outright prohibition on dual class shares would deter the use of restricted voting shares in circumstances and on terms that are Pareto efficient. The same claim could be made in relation to progressive capital taxes. Our determination to accelerate the transformation of such poorly performing family controlled companies such as Birks, Peoples Jewellers and Dylex, before the product market discipline imposes costs through financial distress, should not adversely affect such proven performers as Power Corp.

Different concerns are raised in respect of restrictions on

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Morck notes that Canada is one of the few industrialized countries to lack an inheritance tax. However, he ignores the fact that death is a deemed disposition under the Income Tax Act, and therefore subjects the deceased's assets to capital gains treatment.

<sup>114</sup> Jonathan Kesselman, "Improving Tax Fairness" in Allan Maslove, ed., *Issues in the Taxation of Individuals* (Toronto, University of Toronto Press, 1994), pp. 80-1. In the same volume, James Davies and David Duff in "Wealth Tax Proposals: Distributional Impacts and Revenue Potential" at pp. 187-88, assemble data which show that revenue from wealth transfer taxes has steadily declined from the period 1970 to 1980 (from .92 to .43% of total tax revenue), but then increased slightly in the period 1980 to 1990 (to .52% of total tax revenue).

<sup>115</sup> Davies and Duff, *ibid.*

<sup>116</sup> The private agreement exemption is set out in s. 93(1)(c) of the Ontario Securities Act. It permits controlling shareholders to sell their control blocks to five or fewer purchasers so long as the value of consideration does not exceed 115% of the base market price. In the absence of such an exemption, controlling shareholders are subject to an equal opportunity rule which requires that any premia from control be distributed pro rata among all shareholders of the same class of shares.

control block alienability. While it is true that such restrictions might deter the acquisition of such blocks, they may also have the perverse effect of encouraging inefficient control block holders to retain their shares in order to wrest the maximum personal value from the firm. If shareholders are required to share the control premium (which reflects the capitalized value of future private benefits) on disposition, they will seek to retain control for as long as possible so as to fully appropriate the private benefits.<sup>117</sup>

Given the bluntness of these instruments, we suggest an alternative strategy for dealing with concentration that is based on an enhanced role for the board of directors. As mentioned above, the board of directors in the closely held corporation is often viewed as imposing little real constraint on the conduct of inside shareholders. But given the suppression of market instruments in the closely held corporation, we would regard the board's monitoring role, particularly the outside directors', as *more* rather than less important than in widely held companies. The goal is to align inside and outside shareholder interests through effective monitoring and the discipline of agency costs. Through active vigilance, the board could constrain the appropriation of shareholder wealth by inside shareholders through bloated compensation, un-bargained for and unfair self-dealing transactions, and ill-conceived executive succession strategies. After all, in comparison to outside shareholders, the board has both the access to real time firm specific information and the clout to constrain shareholder opportunism.

This recommendation is founded on the success of the private corporation in which management has a major equity stake and the other shareholders and suppliers of risky debt capital undertake in depth monitoring to ensure that shareholder and manager interests are aligned. In the closely held company, monitoring by shareholders is not sufficient due to their small numbers and it is left to the board of directors to provide this overview.

Recently, the Toronto Stock Exchange Committee on Corporate Governance in Canada (the "Dey Report") proposed

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<sup>117</sup> The incentive effects of a more restrictive equal opportunity rule on the inclination to assemble a control block in the first place is more ambiguous. An acquiror may refrain from assembling the block because of restrictions on subsequent alienability. On the other hand, if significant control benefits can be wrested pre-disposition, then the restriction might have only a modest incentive effect.

the adoption of guidelines for board behaviour and composition that would, among other things, require a majority of directors of the board to be unrelated to management, but, for the purposes of the guidelines, unrelated directors were defined to include directors related to substantial shareholders.<sup>118</sup> While we believe that the institutional environment in which directors operate can enhance the integrity of corporate decision-making, ultimately we believe that frailties in the boardroom require greater attention to the role that markets can play in bolstering the board's central function.<sup>119</sup> Essentially, it is our belief that vibrant and efficient

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<sup>118</sup> "Where Were the Directors? Guidelines for Improved Corporate Governance in Canada", Report of the Toronto Stock Exchange Committee on Corporate Governance in Canada, December, 1994. One of us — Daniels — was a member of the TSE Committee. In its interim report, the Committee had recommended that a majority of directors be unrelated to either management or to substantial shareholders. In light of public comments received expressing concern with sterilizing the controlling shareholders' capacity to control the corporation, the Committee relaxed that component of its recommendation. Nevertheless, despite the Committee's retreat on its earlier structural recommendation, it continued to emphasize the legal duty of all directors to exercise independent judgment irrespective of their relationships to the company or the shareholders.

<sup>119</sup> The widespread concern is that the dynamics of the board as a group will subvert the capacity of individual directors to go against the wishes of managers or controlling shareholders who are engaging in opportunistic behaviour. The psychological literature on groups validates these concerns. Group psychology is concerned with understanding "how individuals are influenced by the groups to which they belong or with whom they are involved, and how these groups are in turn influenced by their members"; see P. Paulus, "An Overview and Evaluation of Group Influence", in P. Paulus, ed., *Psychology of Group Influence* (Hillsdale, New Jersey, Lawrence Erlbaum Associates, 1989), chapter 1, p. 1. Commonly, it is assumed that group discussion allows problems to be solved more effectively than could an individual working alone. The diversity of perspectives and expertise within groups, as well as opportunities for probing discussion and analysis, are implicated. Nevertheless, numerous studies of group behaviour reveal defects in the group's capacity to solve complex problems. First, contrary to conventional views, group discussion often fails to tease out diverse perspectives on complex problems. Typically, group members tend to discuss information which is common to all, while withholding information that is unique. (Garold Stasser, "Pooling of Unshared Information" in Stephen Worchel, Wendy Wood and Jeffrey Simpson, eds., *Group Process and Productivity*, (Newbury California Sage, 1992), chapter 2. See also Stasser and Taylor and Hanna, "Information Sampling in Structured Discussions of Three and Six Person Groups" (1989), 57 *Journal of Personality and Social Psychology* 67; Stasser and Titus, "Pooling of Unshared Information in Group Decision Making: Biased Information Sampling During Group Discussion" (1985), 48 *Journal of Personality and Social Psychology* 1467. And, even if revealed, this information tends to be heavily discounted by the group. The tendency of groups to focus on shared information at the expense of unshared information is particularly disconcerting when the unique information has significant value for the problem under consideration. Further exacerbating the difficulties for group resolution of complex problems is the pervasive problem of groupthink. (The term is attributable to I.L. Janis, *Victims of Groupthink* (Boston,

markets are a far more effective means for ensuring board effectiveness than the range of structural modifications that have so far dominated the corporate governance agenda.

There are a number of ways in which markets can be made to operate more effectively in the system of corporate governance. Enhanced (though cost-effective) disclosure of information to market participants is one obvious mechanism for improving market performance. In this respect, we endorse the amendments to the executive compensation disclosure regulations adopted by the Ontario government that mandate augmented disclosure both of the nature and level of individual compensation earned by senior managers and of the board processes used to produce these compensation packages.<sup>120</sup> We also support efforts to improve the operation of the continuous disclosure system — though we caution against the adoption of measures which invite irresponsible and essentially frivolous shareholder suits frequently observed in the United States.<sup>121</sup> However, in a setting where sundry legal barriers have arguably impeded the ability of institutional investors to exercise measured voice, we worry that reforms

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Houghton Mifflin, 1972).) The more difficult the task confronted by the group, the stronger the consensus within the group, the more value that individual members derive from group membership, the less likely it is that individuals will deviate from majority views, even if those views do not accord with the individual's personal viewpoint. See S.E. Asch "Opinions and Social Pressure" (1955), 193 *Scientific American* 31; L. Festinger, "A Theory of Social Comparison Processes" (1954), 7 *Human Relations* 117. Research shows that conformity pressures can operate on outsiders, although the individual status, intensity of commitment to initial positions, and degree of expertise mitigate the pressures for conformity. A third and related problem for groups is the tendency of group membership to diffuse individual responsibility for collectively made decisions. See discussion in R. Baron, N. Kerr, and N. Miller, *Group Process, Group Decision, and Group Action* (Buckingham, Open University Press, 1992), chapters 3 and 4. The spectre for these problems increases with the size of the group. Diffused responsibility causes two main problems for groups: (i) the reduction of average product of the group through shirking; and, (ii) the creation of group shift or polarization problems that make individual and group opinions more extreme relative to their pre-discussion values (typically along the risk dimension).

<sup>120</sup> Regulation to Amend Regulation 1015 of the revised regulations of Ontario, 1990 Made Under the Securities Act (October 13, 1993). The changes to the regulation are discussed in Ronald Daniels, "Executive Compensation: Perhaps Company Managers Aren't Paid Enough. . ." (1994), 7 *Canadian Investment Review* 41.

<sup>121</sup> Roberta Romano's work on the limited efficacy of the shareholder suit, "The Shareholder Suit: Litigation Without Foundation?" (1991) 7 *Journal of Law, Economics & Organization* 55; and Joseph Grundfest's recent reforms designed to limit access to the derivative suit, "Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority (Securities and Exchange Commission)" (1994), 107 *Harvard Law Review* 961.

aimed at enhancing the dissemination of timely and accurate information to the market are not enough.<sup>122</sup> Here, we would favour greater legislative attention to some of the more egregious and ill-founded constraints hobbling responsible institutional voice, but, as a quid pro quo for relaxation of these barriers, advocate enhanced transparency both of the beneficial level of investment held by Canadian institutions in downstream companies and of any significant forms of activism taken in relation to these investments.

These policy prescriptions to address the continuing problem of the closely held corporation, especially in the context of dual class share structures, are by design muted. Intervention in the operation of markets and in the ownership structures of corporations can lead to severe distortions. In fact, we argue for the elimination of those regulatory restrictions that currently exist. We believe in the vibrancy of capital, product, and takeover markets to resolve many of the problems associated with agency costs and poor alignment of shareholder and manager incentives. Changes in operations and structures of companies have occurred with the opening of capital markets and the liberalization of trade. In the closely held corporation, including dual class shares, we not only rely on the discipline of the product market but also endorse effective monitoring by institutions and the boards of directors.

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<sup>122</sup> For a discussion of the legal and organizational barriers impacting Canadian institutional investors, see Ronald Daniels and Edward Waitzer, "Challenges to the Citadel: A Brief Overview of Recent Trends in Canadian Corporate Governance" (1994), 23 C.B.L.J. 23; and, R. Daniels and J. MacIntosh, *supra*, footnote 3.