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CONSTRAINTS ON
LARGE-BLOCK SHAREHOLDERS

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ABSTRACT

Corporate managers who own a majority of the common stock in their company or who represent another firm owning such an interest appear to be less constrained than managers of diffusely held firms, yet their power to harm minority shareholders must be circumscribed by some organizational or legal arrangements. Empirical investigations reveal that boards of directors in majority-owned firms are little different from firms with diffuse stock ownership. Another source of constraints on a majority shareholders -- capital market activity -- also appears to be no different from firms with diffuse ownership. Finally, there is little evidence that new organizational mechanisms have evolved to constrain managers who own large blocks of stock. The frequency and associated wealth effects of reorganizations of majority shareholder firms, however, indicate that the law constrains managerial majority shareholders, both in their day-to-day management and when they redeem the ownership interest of minority shareholders.

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1. Introduction

There is a growing belief among both academics and practitioners that firm performance often can be improved by large-block shareholders. These can be either individuals or entities (such as other corporations or partnerships) that own large-percentage blocks of stock and work with or join management to improve firm performance. Concentrated ownership is viewed as ameliorating the separation of ownership from control that has been long seen as a bane for large public corporations.

There is a major potential problem with block investors, however, that is often overlooked. The very thing that gives large investors the ability to improve management, the voting power of block ownership, also gives them the power to consume corporate resources, either through poor management or by outright expropriation. Consider, for example, a chief executive who owns more than 50% of his firm's stock. What constrains this individual from maximizing the firm's expected cash flows and then expropriating those cash flows through excess compensation, consuming perquisites, borrowing from the firm at below-market interest rates, paying differential dividends, or the like? This apparently is what

Robert Maxwell did at two large public corporations. Likewise, what will stop a block investor's well-intended but ill-conceived management? This describes the path of Wang Laboratories into bankruptcy.

Block investors who do not join management pose a similar threat. For instance, management can place a block of "sweetheart" preferred stock with an block investor with the understanding that the investor will support management in control contests. The large-block investment made in Polaroid Corporation by Corporate Partners during an attempted takeover in the late 1980s appears to be such a case. Outside blockholders also have the capability to use their voting power to secure favorable contracts with the firm.

Legal scholars have long held that the law does not effectively constrain block shareholders. Rock (1993), for example, describes Delaware corporate law, federal securities law, and federal antitrust law as "rather toothless [for limiting] corrupt relational investing." Gilson (1986) summarizes that "the academic evaluation of [legal] limitations ... is unambiguous: ... The checks on unfair dealing by the parent are few. In theory, of course, the fairness of the parent's behavior is subject to the check of judicial review; but in practice such review is difficult even where the courts have the will to engage in it, and they often lack the will."¹ If such assessments are correct, the potential for block investors to improve firm performance would be more limited than currently acknowledged.

The pessimism over the potential of the law to constrain block investors is based on reading cases and statutes. We know of no empirical evidence on the subject. In this paper we empirically investigate whether the conventional wisdom on the ineffectiveness of legal constraints on block investors is warranted. We base most of our analyses on firms that presumably offer the most latitude for opportunistic behavior toward minority shareholders: firms in which one

¹Gilson (1986) p. 866 quoting in part Eisenberg (1976) p. 309. Although some such assessments are in the context of parent-subsidiary relations, commentators do not seem to distinguish corporate large-block shareholders from individual large-block shareholders.

shareholder owns more than 50% of the common stock. These firms should illustrate most clearly the constraints, if any, on block investors.

We start by documenting that firms with concentrated ownership are surviving and do not appear to trade at substantial discounts to firms with diffuse ownership. This suggests that something constrains block investors—minority shareholders are not totally at the mercy of their larger brethren. We next investigate if organizational mechanisms are strengthened or modified to counterbalance the power of block investors. If so, the perceived weakness of the law would be relatively unimportant, as minority shareholders would rely on organizational constraints.

Our empirical investigations reveal that boards of directors in majority-owned firms differ little from firms with diffuse stock ownership. Another potential organizational constraint on a majority shareholders, capital market activity, also appears to differ little from firms with diffuse ownership. Likewise, there is little evidence that new organizational mechanisms have widely evolved to constrain block investors.

Finally, we review the much-criticized legal doctrines applicable to large-block shareholders. We attempt to assess the effect of these constraints by examining the frequency and associated wealth effects for minority shareholders in mergers, going-private, restructurings, and liquidations of majority-shareholder firms. We find that minority shareholders on average receive premiums of 20% over pre-announcement stock prices when they are bought out by majority shareholders—approximately the same premiums shareholders in diffusely held firms receive when they are bought out. This suggests that the law prevents majority shareholders from using their voting power to freeze out minority shareholders at low prices. Despite these premiums, majority shareholders buy out minority shareholders at least as often as do firms with relatively diffuse ownership. These payments appear in part to be the price majority shareholders must pay to remove the threat of minority shareholder litigation. Additional evidence of legal constraints comes from the treatment of minority shareholders in reorganizations

that follow block trades and from comparing the United States experience with the New Zealand experience, which has few protections for minority shareholders. The totality of the evidence suggests that, counter to the opinion of many legal scholars, the law protects minority shareholders. Indeed, our findings raise the possibility that the law may be the primary constraint on large-block shareholders in public corporations.

2. The Survival and Value Effects of Block Investors

Some scholars have suggested that the sole protection for minority shareholders might be price protection. That is to say, the price at which minority shareholders buy their stock simply reflects the discounted value of the expected expropriation or incompetence of the firm's large shareholders.

Although price protection may exist, it can never be the sole protection for minority shareholders. If large-block shareholders are subject to neither organizational nor legal constraints, they could, through poor management or by outright expropriation, consume corporate resources without limit. Once this possibility became known, a "lemons" problem would arise, and individuals would refuse to become minority shareholders, at any price. Ultimately, firms with block investors would not survive. This is why Fama and Jensen (1983) conclude that firms in which chief executive officers own a majority of the common stock will not survive.

We start our analysis of the constraints on large shareholders by examining the existing empirical evidence on the extent of concentrated ownership. If large-block shareholders exist only infrequently, one might conclude that these are anomalous situations that are not destined to last. Next, we examine a variety of evidence on the effect of large shareholders on firm value. This will give us insights into the possible importance of price protection for minority shareholders.

2.1 The survival of firms with block investors.

The available evidence shows that many firms have concentrated ownership. Mikkelsen and Partch (1989) document that in approximately 30% of a random sample of 240 New York Stock Exchange (NYSE)- or American Stock Exchange (Amex)-listed corporations, the board and top officers control at least 20% of the votes. Holderness and Sheehan (1988) identify 663 NYSE- or Amex-listed firms with majority shareholders; they analyze 114 of these firms and document that in over 90% of them the majority shareholder or a representative of the corporate majority shareholder is a director or a top officer. They report that firms with majority shareholders appear to be surviving. Ritter (1981) documents that insiders on average retained 72% of the common stock in the 559 firm-commitment initial public offerings registered with the SEC between 1965 and 1973.²

Block investors have been around since the early days of the modern public corporation. J.P. Morgan, for example, played a key role in reorganizing bankrupt railroads at the turn of the century. To facilitate the sale of securities in the reorganized firm, he typically would serve as chairman of the company for several years, during which he and his representatives ran the firm. De Long (1989) estimates that one Morgan partner on a board increased the value of the firm's equity by approximately 40%. Goldman Sachs played a similar role with retail firms. Finally, Holderness, Kroszner, and Sheehan (forthcoming) find that average inside ownership among a large sample of United States exchange-listed firms increased from 13% of the common stock in 1935 to 21% in 1995.

2.2 Firm value and large shareholders.

Market-to-book studies. Several studies measure the impact of large-block ownership on a firm's market-to-book ratio (the ratio of the market value of a firm's assets to their replacement cost). In general, these studies offer little support for the

²Additional evidence on the extent of large-block ownership among managers is reported in Demsetz (1983), Demsetz and Lehn (1985), and Herman (1981). Denis and Denis (1994) contains further evidence on the history of majority-controlled firms.

proposition that block investors significantly reduce firm value, which they would if there were few constraints on them. Morck, Shleifer, and Vishny (1988a) report that for 371 Fortune 500 firms, the market-to-book ratio increases when managerial stockholdings go from 0% to 5%, decreases between 5% and 25%, and increases above that. McConnell and Servaes (1990) use a larger sample and find that in one year studied (1986) the market-to-book ratio increases until top management owns 40% or 50% of the stock, and declines thereafter. Holderness and Sheehan (1988) find no significant difference in the market-to-book ratios for a paired sample of majority-owned and diffusely held firms.

The strongest evidence that blockholders can reduce firm value comes from closed-end funds. Barclay, Holderness, and Pontiff (1993) find that the greater the managerial stock ownership, the larger are the discounts to net asset value (book value). Even here, discounts seldom exceed 25%, suggesting that there are significant constraints on even the largest blockholders in closed-end funds.

Equity carve-outs. An equity carve-out occurs when a parent corporation sells to the public partial ownership interest in a subsidiary. In most such reorganizations, the parent retains at least half of the common stock and therefore controls the carved-out subsidiary [Schipper and Smith (1983); Klein, Rosenfeld, and Beranek (1991)].

Klein, Rosenfeld, and Beranek (1991) report that the parent eventually reacquired the subsidiary's publicly held shares in 25 of the 83 carve-outs between 1966 and 1983. (In fourteen additional cases, the parent sold its block to a third party; nine of these buyers declared that they intended to buy the public's interest.) If block investors are unconstrained, it is unclear why individuals voluntarily invest in carve-outs and why parent corporations so often go to the expense of reacquiring the public's shares.

Klein, Rosenfeld, and Beranek (1991) further report that the announcements of these reacquisitions are associated with insignificant abnormal stock returns for the parent firms. In contrast, public shareholders in the subsidiary earn statistically positive abnormal returns which approximate those earned by target firms in arms-

length mergers and acquisitions. The authors interpret this evidence to suggest “that parents did not generally take advantage of their dominant positions to capture gains accruing to subsidiary shareholders.”

Thermo Electron. A final observation comes from Thermo Electron Corporation, a NYSE company which has done eight such carve-outs and still retains a majority stake in all. Thermo Electron publicly acknowledges that it controls the carve-outs by appointing directors and officers and by providing a variety of legal, accounting, and financial services.

As of 1998, the value of Thermo Electron’s shares in its subsidiaries exceeded the market value of Thermo Electron itself by 16% (about one billion dollars).³ This arguably understates the discount of Thermo Electron to its controlled subsidiaries because it places no value on Thermo Electron’s own operations. Thermo Electron thus offers no evidence that block investors substantially reduce firm value. Indeed, this one piece of evidence suggests that any subsidies go from the dominant parent to the subsidiaries.

2.3 Summary

Two points emerge from the above evidence. First, firms with large shareholders appear to be surviving. Second, the evidence on the impact of large shareholders on firm value is mixed. There is no evidence, however, that block investors have a large negative effect on firm value. In short, the evidence—from a number of studies, over different time periods, representing a cross section of industries—strongly suggests that large-block shareholders in public corporations are constrained and that the primary constraint is not price protection.

3. Organizational Constraints on Block Investors

³These figures come from Thermo Electron itself. They value the the publicly traded subsidiaries at closing prices as of June 22, 1998 and value wholly owned subsidiaries at 25x 1998 earnings. They also include the value of cash held by Thermo Electron net of debt and intercompany loans.

The widespread criticisms of the ineffectiveness of the law could still be correct, in spite of the above evidence on the survival and value effects of block investors, if the binding constraints are organizational, not legal. We therefore investigate whether organizational constraints are altered to counterbalance the additional power that comes with block large-block investors. We also search for evidence of innovative organizational constraints in firms with block investors.

Turner Broadcasting Corporation (one of the firms in our sample described below) illustrates how existing organizational mechanisms can be modified and new ones developed to constrain an block investor [Holderness and Sheehan (1991)]. Since taking his firm public in 1980, Ted Turner owned a majority of the common stock and relied primarily on debt and retained earnings to finance an ambitious expansion into cable television and satellite broadcasting. In early 1987 Turner Broadcasting had a debt-to-total-asset ratio of 0.72; by May of that year it was apparent that the company would have difficulty meeting its debt obligations. Accordingly, Turner contracted with a group of cable companies to purchase newly issued preferred stock. Among the conditions imposed by the cable companies as a condition of investing were: amendments to the bylaws enabling them to elect seven of fifteen directors, requiring supramajority approval by the board of major management decisions, restrictions on the alienability of the preferred stock so that its ownership stayed with the cable companies, and the right of first refusal to buy Ted Turner's stock. This agreement remained in force, despite Ted Turner's subsequent expressions of dissatisfaction, for the remainder of the time that Turner Broadcasting was a stand-alone public corporation.⁴ (Turner Broadcasting merged with Time/Warner Corporation in 1996.) Under these conditions, Ted Turner was effectively constrained by organizational mechanisms, his majority ownership of the common stock notwithstanding.

⁴For an example of this dissatisfaction, see *The Wall Street Journal*, April 21, 1993, p. A4. It should be noted that such dissatisfaction was voiced by the block investor, not by minority shareholders. Turner Broadcasting stock significantly outperformed the market while these constraints were in place. Holderness and Sheehan (1991).

3.1 Sample description

We use a sample of public corporations that have majority shareholders to investigate for constraints on large-block shareholders. We choose this sample for several reasons. First, these block investors presumably have the greatest latitude for opportunistic behavior toward minority shareholders. If there are constraints on majority shareholders, it is likely that the same constraints bind blockholders who own less than a majority of the stock. Second, we used this sample in Holderness and Sheehan (1988) to investigate the organizational role of large-block shareholders, specifically ones who hold a majority of the stock. A major conclusion of that research was that “the evidence is inconsistent with the proposition that individuals or corporations hold majority blocks of stock in publicly traded corporations primarily to expropriate or consume corporate resources” [Holderness and Sheehan (1988) p. 344]. It thus appears that the blockholders in this sample are constrained. In the current paper, we attempt to identify and analyze these constraints. Finally, we have no reason to believe that the constraints on large shareholders, whatever they are, have changed significantly since the sample was constructed.

To generate a sample of majority shareholder corporations, we search CDA Investment Technologies’s January 1980 Spectrum, which lists major shareholders in several thousand public firms. For inclusion in the sample, we require that a firm have a majority shareholder for at least two consecutive years.⁵ In the interests of data availability, we limit our sample to NYSE and Amex firms. This process yields 114 firms that had majority shareholders for approximately 500 firm-years between 1978 and 1984. Information about the block investors and their firms is collected from annual proxy statements and COMPUSTAT.

⁵Majority shareholders are defined as individuals or entities, which are typically other corporations but occasionally include charitable or voting trusts, that own at least 50.1% of a firm’s common stock.

To ascertain whether organizational constraints are strengthened or modified in majority-shareholder firms, we attempt to pair each of the 114 majority-shareholder firms with a firm that has the same two-digit SIC industry code, is closest in total assets, and is listed on the NYSE or Amex. To identify differences associated with concentrated ownership, we require that no single shareholder owns more than 20% of the comparison firm's stock. Using these criteria, we are able to pair 101 majority-shareholder corporations. These paired comparisons are the basis for many of the tests in this section of the paper.

Two characteristics of majority-shareholder firms are pertinent to our analysis. First, corporations are majority shareholders in 50% of the firm-years in the sample, individuals own the blocks in 46% of the firm-years, and the remaining blocks are held by charitable or voting trusts. Many of the empirical regularities reported in Holderness and Sheehan (1988) differ for corporate and individual majority shareholders. Interestingly, some legal scholars have been particularly critical of judicial laxness in regulating the relations between parent corporations and partially owned, publicly traded subsidiaries. Accordingly, throughout this paper we differentiate between firms controlled by other corporations and those controlled by individuals.

The second regularity is that 90% of the individual majority shareholders and representatives of 94% of the corporate majority shareholders are either directors or officers. In other words, majority shareholders are block investors. Because most empirical regularities do not depend on whether a majority shareholder or a representative of a corporate majority shareholder is an officer or director and because those few majority shareholders who are not managers can become so at their option, our investigations are based on the full sample of majority-shareholder firms.

3.2 Boards of directors

Boards of directors are widely viewed as the central internal control mechanism in public corporations. It was the directors, for example, who engineered

the replacement of longstanding chief executive officers at General Motors, Westinghouse, and IBM. Academic research confirms the potential importance of directors. Gilson (1990), for example, finds that board turnover following financial distress is significantly greater than ordinary board turnover. Furthermore, the reconstituted board has more bankers, blockholders, and outsiders. Similarly, Byrd and Hickman (1992) find that announcement-day returns of bidders in tender offers are higher for firms with a majority of independent outside directors.

For the board to exercise control, however, it needs the power to constrain management. When managers' stockholdings are small, the board has this power because the managers have relatively few votes in the election of directors. The boards of majority-shareholder firms, by contrast, would seem to lack this power, because a majority shareholder has the votes to elect and fire directors unilaterally. Under the conditions described below and summarized in Tables 1 and 2, however, the board has greater power to constrain an block investor.

(Tables 1 and 2 go here)

Outside Directors: Outside directors are usually portrayed as being more independent of management and thus offering more protection for shareholders than inside directors, who, by definition, are employees of the firm.⁶ For example, press reports suggest that outside directors took the lead in the three prominent replacements of chief executive officers noted above. Rosenstein and Wyatt (1990) report that the appointment of outside directors on average produces a positive stock price response. Weisbach (1988) finds that poor stock-price performance is more likely to lead to CEO turnover as the ratio of outside directors to total directors increases. It seems reasonable that the independence of outside directors would be a constraining influence on managers who own large blocks of stock as well.

⁶Fama (1980) p. 293.

Table 1, however, reports that both the absolute number of outside directors and the ratio of outside to inside directors is lower in majority-shareholder firms than in their paired firms with diffuse ownership. These differences are largely attributable to firms with individual majority shareholders; little difference emerges in either the total number of directors, the number of outside directors, or the ratio of outside to total directors for firms with corporate majority shareholders and their paired firms.⁷ For neither subsample do we find systematic evidence of additional outside directors to counterbalance the power of majority ownership. In a similar vein, the probability of a recalcitrant director who, through his oversight of management and access to confidential firm information, can increase the costs to the block investor of acting against the minority, should increase with the absolute number of directors. The fact that majority-shareholder firms tend to have smaller boards than their paired firms is evidence that boards typically do not change to counterbalance the additional power of a majority shareholder.

Staggered Elections: Staggered elections of directors are viewed in the agency literature as reducing shareholder wealth because they can delay the election of directors more attentive to shareholders. But staggered elections also delay the firing of directors by a manager with large stockholdings. When a block investor elects directors who then prove to be too attentive to minority shareholders, under staggered elections he must wait before firing them. In the interim, those directors can monitor the investor. As seen in Table 2, however, staggered elections are used in fewer firms with majority ownership than firms with relatively diffuse ownership: in our sample, 7% versus 40% (p -value of less than 0.01 on the difference). This pattern holds when the sample is divided into individual and corporate majority shareholders.

Cumulative Voting: Cumulative voting increases directors' power to constrain managers who own large blocks of stock by increasing the likelihood that

⁷For analysis of percentages in Table 1 and throughout the paper we report the probability value of the two-tailed chi-square statistic used to test whether the paired samples are drawn from a homogeneous population.

minority shareholders will be able to elect representatives to the board. Gordon (1993) argues that cumulative voting can assist institutional investors in monitoring management. Although directors elected by minority shareholders lack the power to veto a majority shareholder's decisions, they nevertheless gain access to confidential firm information and are included in board deliberations. Moreover, if the manager acts counter to the interests of minority shareholders, the directors elected by the minority shareholders can take the lead in opposition, perhaps by initiating litigation. As reported in Table 2, however, cumulative voting is found less often in majority-shareholder firms than in their paired firms (16% versus 23%), although the p -value on the difference is only 0.24.

Subcommittees: Other potential board constraints on managers with large-block holdings are subcommittees of the board, in particular an audit subcommittee composed entirely of outside directors, a similarly composed compensation subcommittee, or a special subcommittee to monitor transactions between the firm and a dominant shareholder. As detailed in Table 2, both audit and compensation subcommittees are found in fewer majority-shareholder firms than paired firms (84% versus 91%, and 63% versus 72%), with the differences being marginally significant (p -value on both differences of 0.16).⁸ In addition, majority shareholders sit on these subcommittees significantly more often than do the largest shareholders in the paired firms, further reducing the probability that these bodies constrain majority shareholders.⁹ Finally, in the several hundred proxy statements and news articles we examined for our sample, there were no reports of special subcommittees to monitor a majority shareholder.

⁸More of the diffusely held firms are listed on the NYSE which, in contrast to the Amex, requires audit subcommittees. Because a majority shareholder can presumably choose the exchange listing, however, the difference between the samples remains noteworthy.

⁹Majority shareholders (or representatives of corporate majority shareholders) sit on 40% of the audit subcommittees and on 72% of the compensation subcommittees. In contrast, only 13% of the largest shareholders in the paired firms are on the audit subcommittee, and only 25% of them are on the compensation subcommittee. The p -values of the differences between the paired samples are less than 0.01.

3.3 Monitoring by nonmanager stockholders and debtholders

Although the board is typically viewed as the central organizational control mechanism, it is not the only one. It is well recognized that both nonmanager shareholders and debtholders have incentives to monitor top managers, especially when those managers have the additional powers that come with substantial stock ownership. Free-rider problems with small shareholders imply that large-block shareholders are likely to be more effective monitors [Shleifer and Vishny (1986)]. Our investigations, however, show that typically there are few large-block shareholders to monitor majority shareholders. In 75% of the approximately 500 firm-years in our sample, no shareholder other than the majority shareholder owns as much as 5% of the common stock. Likewise, 89% of the majority-owned firms have no directors (other than the majority shareholder) who own 5% of the stock. This is revealing in that the legal rights of directors lower monitoring costs.

Debtholders could also play an important role in constraining block investors, either through board membership or through covenants that limit the investors' discretion. A necessary (but not sufficient) condition for bondholders to exercise additional control rights would be a substantial debt ratio. Individual majority-shareholder firms, however, have significantly lower total debt-to-asset ratios than their paired firms,¹⁰ and corporate majority-shareholder firms have total debt-to-asset ratios that equal those of their paired firms. The low debt levels further suggest that the need to meet debt obligations typically does not discipline managers with majority ownership any more than it does managers with smaller ownership interests.¹¹

¹⁰Individual majority-shareholder firms have an average debt-to-asset ratio of 0.18 (median 0.16) compared with an average ratio of 0.26 (median 0.26) for their paired firms. The p -value of a t -test on the difference in means is 0.02 (the p -value of the Wilcoxon-signed rank test is 0.01). Corporate majority-shareholder firms have an average debt-to-asset ratio of 0.22 (median 0.20) compared with an average ratio of 0.22 (median 0.22) for their paired firms. Both parametric and nonparametric tests show the samples to be indistinguishable.

¹¹Jensen (1986) discusses the disciplinary role of debt.

3.4 Monitoring by auditors

A firm's auditor can constrain block investors by identifying and exposing mismanagement or opportunistic behavior.¹² Because Big Six accounting firms have the most valuable reputations to lose if information about low-quality audits is exposed, they should offer higher quality audits and thus more protection for minority shareholders than do smaller, less well known accounting firms.¹³ In our paired years, 92% of the majority-shareholder firms and 87% of the comparison firms employ Big Six firms (*p*-value on difference of 0.29). (This comparison changes little when the sample is divided into individual and corporate majority-shareholder firms.) Accordingly, it is difficult to maintain from this data that block investors trigger additional monitoring by auditors.

3.5 Reputation as a constraining influence

Finally, block investors could be constrained by reputational considerations. Individuals, for example, might restrain themselves for this reason, or they could be restrained by relatives' monitoring to prevent harm to the family's reputation, as might occur with inept management or opportunistic behavior.¹⁴ Similarly, corporate block investors will find it more costly to transact with others if they develop a reputation for acting opportunistically toward minority shareholders in partially owned subsidiaries.

¹²Events at Coated Sales Inc. illustrate how auditors can constrain block investors. In 1988 Peat Marwick resigned as the firm's auditor, "saying that it wasn't satisfied with representations" made by the company. Coated Sales at that time said the dispute involved a \$6 million payment, but Wall Street analysts were "puzzled that an auditing firm would lose an account over a dispute of this nature." *The Wall Street Journal*, June 1, 1988, p. 12. A special committee of the board was formed to investigate the reasons for Peat Marwick's resignation. Several weeks thereafter, the committee found evidence of a false \$6 million transaction, and the board suspended Michael Weinstein, who was the chairman, chief executive officer, founder, and 12% blockholder. The board then retained another Big Six accounting firm to investigate Mr. Weinstein and several other top managers further. Shortly thereafter, Mr. Weinstein resigned.

¹³See DeAngelo (1981).

¹⁴Fama and Jensen (1983) and DeAngelo and DeAngelo (1985) suggest intrafamily monitoring in other corporate settings.

Although it is important to acknowledge these possible constraints, it is difficult to measure their effectiveness. We can, however, test whether majority shareholders are constrained by the expectation of trips to the capital markets.¹⁵ When capital-market participants observe opportunistic behavior toward minority shareholders, they will demand a premium for investing (if they invest at all). In contrast, a reputation for acting fairly toward minority shareholders will enable a majority shareholder to raise capital on more favorable terms.

If past trips to the capital markets are a reasonable proxy for future trips, it is noteworthy that in only 9% of the firm-years in our sample do majority-shareholder firms issue public debt or equity. Their paired firms, on the other hand, go to the capital markets in 15% of the years (p -value on the difference is 0.24). This difference is more pronounced between individual-owned firms and their paired firms (8% versus 15%, p -value 0.33), than between corporate-owned firms and their paired firms (9% versus 11%, p -value 0.88).

A firm's payout policy offers complementary insights into potential monitoring by capital-market participants, on the theory that high payouts to shareholders increase the probability of external financing, *ceteris paribus*. High payouts also signal a block investor's good faith to minority shareholders. As detailed in Table 3, the dividend yield and the dividend payout ratio are lower in majority-shareholder than diffusely held firms. Following the pattern of several of the previous tests, the statistical significance (but not the point estimate) is somewhat more pronounced for firms with individual than with corporate majority shareholders. For instance, individual majority-shareholder firms distribute to shareholders an average of only 13% of their pretax earnings, whereas their paired firms distribute 25%, a difference which produces a p -value of 0.02; corporate majority-shareholder firms

¹⁵Rozeff (1982) and Easterbrook (1984) analyze how frequent trips to the capital markets can result in monitoring of management. In a similar vein, Donaldson (1961) argues that reliance on internal funds enables management to escape "the glare of publicity and shareholder attention" that accompanies external financing. Baumol (1965) writes that "a company which makes no direct use of the stock market as a source of capital can, apparently, proceed to make its decisions confident in its immunity from this type of punishment by the impersonal mechanism of the stock exchange."

distribute 37%, whereas their paired firms distribute 26%, a difference which produces a p -value of only 0.61.

(Table 3 goes here)

3.6 Time-Series Evidence on Changes in Organizational Constraints

We supplement the preceding cross-sectional evidence with an analysis of organizational changes in our 114 majority shareholder firms between 1978 and 1984. Large and systematic changes associated with changes in ownership concentration would suggest that firms adapt internally to reduce agency problems associated with majority ownership. Using time series data, we conduct two tests. First, we compare the averages for a variable (say, the ratio of outside to total directors) for the firm-years before and after a corporation becomes majority-controlled, “before/after classification.” Second, we compare firms on the basis of the year relative to their becoming majority controlled, “relative-year classification,” by defining the year in which a firm becomes majority-controlled as year 0 and calculating our statistics by stratifying on years relative to year 0. This test, in contrast to the first time-series test, enables us to identify trends in relative time.

Table 4 summarizes the time-series tests by reporting the p -values of the test statistics and the direction of the difference in the point estimate of a variable using the before/after classification. Most of the relative-year tests lack statistical significance. In addition, we are unable to perceive any economically meaningful trends in the averages or medians of the variables in relative time. The before/after tests, in contrast, reveal some statistically reliable differences. The direction of these changes as far as constraining majority shareholders, however, is inconsistent. For example, more firms use cumulative voting after becoming majority-owned, but the use of staggered voting declines. Dividend payout ratios increase, but the amount of external financing is essentially unchanged. Other variables do not show strong statistical differences. We interpret the evidence in

Table 4 to mean that few dramatic changes occur in an array of potential organization constraints when firms go in and out of majority ownership.

(Table 4 goes here)

3.7 Summary

Four patterns emerge from the empirical investigations in this section. First, the primary organizational mechanisms that the agency literature and the financial press view as constraining management do not appear to be altered to counterbalance the power of managerial majority stock ownership. Indeed, if anything, the data seem to point to fewer organizational constraints on management in majority-controlled firms. Second, this tendency toward fewer organizational constraints is more pronounced when individuals rather than corporations are majority shareholders. Third, time-series analysis reveals little evidence that movement from relatively diffuse to majority ownership is associated with dramatic or systematic changes in organizational constraints. Finally, we find few examples of unusual or innovative organizational constraints on block investors. The constraints at Turner Broadcasting are the exception.

In light of these four patterns and because some prominent control devices— notably hostile control activities—are inoperable in the face of a large block of stock held by a block investor, we conclude that organizational mechanisms are likely to impose fewer constraints on managers who own large blocks than on managers with small stockholdings. Nevertheless, individuals are still willing to invest in firms controlled by block investors, and firms with block investors do not appear to trade at significant discounts to diffusely held firms. This suggests the need to examine the legal constraints on large-block shareholders.

4. Legal Constraints on Block Investors

4.1 Overview

Potential Legal Constraints: The breadth of potential common law, statutory, and administrative constraints on large shareholders is evident from examples of day-to-day management decisions by large-block shareholders that have violated the law.¹⁶ Among these are: looting the firm; furnishing a house, buying expensive cars, and taking sizable cash advances at corporate expense;¹⁷ taking excessive compensation;¹⁸ diverting a business opportunity from the firm;¹⁹ selling property owned by a large shareholder to the firm at above-market prices;²⁰ borrowing money from the firm at below-market interest rates or lending to it at above-market rates;²¹ paying dividends that leave the firm strapped for cash; preventing dividends from being paid to “force” minority shareholders to sell their shares to the blockholder at “depressed” prices;²² paying differential dividends; increasing the marketability of the majority’s shares by decreasing the marketability of the minority’s shares;²³ selling the control block to someone who plans to loot the firm;²⁴ issuing stock at prices that dilute the value of the minority’s stock;²⁵ and making misrepresentations when issuing securities.²⁶ Remedies include

¹⁶For a more extensive review of the legal doctrines applicable to block investors, see Magnuson (1984) and O’Neal (1975).

¹⁷Corbin v. Corbin, 429 F. Supp. 276 (M.D. Ga. 1977).

¹⁸Magline, 76 Mich. App. 284, 256 N.W. 2d 761 (1977).

¹⁹Guth v. Loft Inc., 23 Del. Ch. 255, 5 A.2d 503 (1939); Blaustein v. Pan American Petroleum & Transport Co., 174 Misc. 601, 21 N.Y.S.2d 651 (1940).

²⁰Efron v. Kalmanovitz, 226 Cal. App.2d 546 (1964).

²¹See 31 A.L.R. 2d 671.

²²Id.

²³Jones v. H.F. Ahmanson & Co., 1 Cal. App.3d 93 (1969).

²⁴Insuranshares Corp. v. Northern Fiscal Corp., 35 F.Supp. 22 (D. Pa. 1940); Gerdes v. Reynolds, 28 N.Y. S.2d 622 (1941).

²⁵See Annotation, 38 A.L.R.2d 1366 (1954).

²⁶Thomas v. Duralite Co., Inc., 386 F.Supp. 698 (D.N.J. 1974).

disgorged profits, money damages, and injunctive relief; in extreme cases large-block shareholders can be ordered to return all compensation to the firm.

Many of the legal doctrines applicable to block investors' management decisions, in particular common law fiduciary obligations, also apply when the minority's shares are redeemed through mergers, going-private restructurings, and liquidations. In such transactions additional legal doctrines become relevant, notably the appraisal remedy, which allows shareholders who dispute an offer price to seek judicial valuation of their shares. When fraud or overreaching is alleged, minority shareholders may also seek equitable relief.²⁷ Finally, there are potential causes of action under federal and state security laws.

Assessments of the Law's Effectiveness: In spite of such numerous decisions against majority shareholders, legal scholars have widely concluded that the law does not significantly constrain block investors. The cases in which block investors are constrained apparently are viewed as anomalies. Brudney's (1978) summary is representative:

...the parent will inevitably exercise discretion—lawfully as well as unlawfully, but substantially undetectable—to divert assets to itself instead of sharing them, all to the disadvantage of the public stockholders of the subsidiary...there is no doubt that the probability of a parent overreaching in self-dealing or appropriating opportunities for itself improperly but without being successfully challengeable is real. No less real than the probability of the parent thus exploiting the subsidiary on a continuing basis is the probability that it will force a merger of the two companies on terms which are disadvantageous to the subsidiary. As the parent's ownership of the subsidiary's stock increases—e.g. from 15 to 20 percent—the likelihood that it will exercise that power increases, not merely because it is more feasible but because of the temptation to eliminate at modest cost the nuisance value represented by so small a minority.²⁸

²⁷The Delaware Supreme Court in *Weinberger v. UOP, Inc.*, 457 A.2d 701 (1983) held that the appraisal remedy is the primary relief for minority shareholders disputing the price offered for their shares. The court noted, however, that it did "not intend any limitation on the historic powers of the Chancellor to grant such relief as the facts of a particular case may dictate. The appraisal remedy we approve may not be adequate in certain cases, particularly where fraud, misrepresentation, self-dealing, deliberate waste of corporate assets, or gross and palpable overreaching are involved." *Id.* at 714.

²⁸Brudney (1978) pp. 69-70.

Cary's (1974) critique of Delaware is similar:

The Delaware courts have tended to encourage freedom of action on the part of parent companies incorporated in that state and have indicated little concern over the fairness of dealings with subsidiaries. The consistent philosophy favors controlling shareholders and leaves fiduciary questions to the business judgment of an indentured board. The old concept that each party is "entitled to what fair arm's length bargaining would probably have yielded" has been enveloped in a new and labyrinthine rationale.²⁹

The pessimistic assessment of legal scholars apparently comes from interpreting case and statutory law. To our knowledge, the law's critics have cited no empirical evidence. This approach has a potentially serious flaw. Even if one concedes that there are only a "few anomalous" cases in which block investors have been constrained, it does not follow that the law is ineffective. As Gould (1972) explains, no lawsuit on an issue is consistent both with a law that is totally ineffective and with one that is totally effective. In the latter case, all parties realize that the law is perfectly enforced; they rationally avoid the prohibited act; and no lawsuits are therefore ever filed.³⁰

We assess the effectiveness of legal constraints on block investors first by evaluating the frequency of reorganizations in which majority shareholders redeem the minority's shares. If block investors—especially majority shareholders—can do whatever they want, there would appear to be little reason to buy out minority shareholders. Reorganizations of majority shareholder firms would be rare. We next examine the wealth transfers from the majority to the minority shareholders. Small payments would indicate relatively minor legal constraints. We then examine trades of large-percentage blocks of stock. Finally, we compare how minority

²⁹Cary (1974) pp. 663-679. See Rock (1993) for a similar but more recent critique of Delaware law.

³⁰We could find no reports in the Dow Jones News Retrieval Service or in Standard and Poor's News Reports for the period 1979 through September 1986 of any lawsuits contesting management decisions of majority shareholders in our sample of 114 firms. This finding is consistent with the proposition that minority shareholders perceive they have no legal protection, as well as with the contrary proposition that all parties perceive the law as perfectly protecting minority shareholders.

shareholders fare in reorganizations in the United States, which at least has laws on the book to protect minority shareholders, with anecdotal evidence on how minority shareholders fare in New Zealand, which has no such laws.

4.2 Evidence from corporate reorganizations

Frequency of Reorganizations: Table 5 reports how often firms in our paired sample were acquired, taken private, or liquidated between 1980 and 1986.

(Table 5 goes here)

Over the seven years followed, 36% of the majority shareholders redeem the minority's shares. By comparison, only 29% of the paired firms are reorganized over the same period.³¹ This evidence is consistent with Morck, Shleifer, and Vishny (1988b), who find that the probability of a Fortune 500 firm's being acquired between 1981 and 1985 increased with the percentage of common stock owned by its top two managers. Our evidence is also consistent with the frequency with which parent firms reacquire the public's shares in partially owned carve outs.³²

Wealth Transfers to Minority Shareholders: The effect on minority shareholders' wealth associated with reorganizations is measured with a sample of 43 mergers, going-private restructurings, and liquidations of majority-shareholder firms. Twenty-two of these reorganizations are drawn from the sample of 101; three involve firms that we were unable to pair from the original sample of 114; ten are identified by searching the annual company index of *The Wall Street Journal* line-by-line for the period 1978-1982; and eight are identified from Austin Associates's

³¹Table 5 also shows that minority shareholders are bought out significantly more often by corporate majority shareholders (40%) than in similar firms with diffuse ownership (21%) (the difference is significant at the 0.05 level).

³²Klein, Rosenfeld, and Beranek (1991) report that the parent eventually reacquired the subsidiary's publicly held shares in 25 of the 83 carve-outs between 1966 and 1983. In fourteen additional cases, the parent sold its block to a third party; nine of these buyers declared that they intended to buy the public's interest.

data base of tender offers between 1981 and 1984. All of the reorganizations involve NYSE or Amex firms, announcements reported in *The Wall Street Journal*, and a majority block in place at the time of the offer to minority shareholders.

We use standard event-study methodology to measure stock-price reactions associated with the initial public announcement that a majority-shareholder firm is being acquired, taken private, or liquidated. The market model is estimated to adjust for general movements in stock prices. The intercept and slope are estimated from a sample of approximately 100 trading days, beginning 351 days before the event day, which is the day the reorganization is announced in *The Wall Street Journal*.³³ Using these estimated parameters, we generate predicted returns for 250 trading days before through 10 trading days after the event day. Abnormal returns are calculated as the difference between the actual and predicted returns. The abnormal returns are next averaged across events, that is, across initial announcements of the reorganizations, to form a portfolio abnormal return:

$$AR_t = \sum_{i=1}^n \frac{AR_{it}}{n}$$

where AR_{it} is the abnormal return for firm i at time t , and n , which is constant over all days in the event period (250 days before through 10 days after the event day), is the number of firms. Finally, cumulative abnormal returns are formed by summing the daily abnormal returns over the event period

We use a standard t -test to measure the statistical significance of the abnormal returns associated with the announcement that a majority shareholder is buying out minority shareholders. The standard deviation of the average abnormal returns is computed over the comparison period. Under the null hypothesis of zero abnormal returns, the ratio of the event-period abnormal return to the standard deviation is treated as a unit-normal random variable. The variance of the

³³The actual number of observations in the estimation period varies because not all securities trade on all days. If a security did not trade on a particular day, that day is passed over for both the firm's and the market return.

cumulative return is generated by summing the sample variance of the abnormal returns over the number of days contained in the cumulative return; a similar procedure is followed for the event-day returns (days $-1, 0$, where day 0 is the day of the initial *Wall Street Journal* announcement of the transaction).

Table 6 summarizes the cumulative returns and t -statistics for various periods surrounding these announcements. Minority shareholders experience substantial wealth gains when their ownership interest is redeemed by majority shareholders. At the announcement itself (days $-1, 0$), stock prices increase on average by 12%. The null hypothesis of a zero abnormal return over these two days can easily be rejected (t -statistic 19.6). Stock-price increases immediately preceding the announcements suggest that the event-day returns understate the wealth effects for minority shareholders (possibly because of leakage of information). From 20 days preceding through ten days after announcements of reorganizations, stock prices increase on average by 23% (t -statistic 9.0). Ninety-one percent of the abnormal returns over this period are positive.

(Table 6 goes here)

Payments to minority shareholders in these reorganizations approximate those made in reorganizations in general. For instance, Jensen and Ruback (1983) summarize a number of empirical studies and report that premiums to shareholders in friendly mergers average approximately 20%.³⁴

4.3 *Evidence from block-trades*

As part of the perceived ineffectiveness of the law, some scholars warn that small shareholders will be taken advantage of by larger shareholders in

³⁴Similarly, Klein, Rosenfeld, and Beranek (1991) find that when parent firms reacquire the public's interest in an equity carve-out, the minority shareholders in the acquired firm earn abnormal returns which approximate those earned by target firms in arms-length mergers and acquisitions.

reorganizations. Although under federal securities law, all shareholders must receive the same price per share in a tender offer, in other circumstances there is no requirement of equal treatment. Thus, the way is seen as open for someone to purchase a large block, wait a short period, and then purchase the minority's interest at a lower price per share. Robert Clark sees "the equal treatment problem as ... the salient problem posed by two-step acquisitions."³⁵

Barclay and Holderness (1992) examine 106 trades of at least 5% of the common stock of exchange-listed corporations. After 51 of these trades, the firm is acquired, typically by the block purchaser. Contrary to the fears of legal scholars, Barclay and Holderness (1992) find that in 86% of these reorganizations minority shareholders receive at least as much per share as did the block seller (unadjusted for market movements or inflation).³⁶

This equality of payments to majority and minority shareholders appears to be an example of an implicit legal constraint, as no law requires equal payment in reorganizations that follow block trades. Implicit constraints will be overlooked if (as the legal critics have apparently done) one interprets only reported case law and fails to examine the empirical evidence.

4.4 *New Zealand Comparison*

The treatment of minority shareholders in reorganizations in the United States appears quite different from the experience of minority shareholders in New Zealand, which has few legal protections for minority shareholders. In New Zealand, minority shareholders typically receive substantially less in reorganizations than do large-block shareholders. For example, when Lion Corporation was taken over by L. D. Nathan Corporation, minority shareholders received only 60% of what was paid to Fay Richwhite, a 35%

³⁵Clark (1986) p. 468.

³⁶The first reorganization in which minority shareholders receive less than the block seller transpires 263 (calendar) days after the block trade; the second occurs 556 days after the block trade.

blockholder in Lion. Similarly, when James Smith Corporation was purchased by Mancorp Holdings, an 81% blockholder received twice as much per share as other shareholders.³⁷ Despite public outcries over such inequality, many defend it. For example, the chairperson of a major New Zealand corporation “said that small shareholders would be naive to expect the same treatment as larger holdings.”³⁸ In 1984, the New Zealand Treasury announced its opposition to a “proposal to give small shareholders more rights in takeovers because it would attenuate property rights to the proceeds of investments in controlling blocks of shares and investments in information.”³⁹

4.5 Assessment of the evidence

It is difficult to reconcile the evidence reported above with the widespread belief that the law does not constrain block investors. If minority shareholders can not constrain block investors, majority shareholders—who should be the least constrained of all block investors—would have little reason to reorganize their firms to eliminate minority shareholders.⁴⁰ These buyouts are neither isolated events nor insignificant wealth transfers from majority to minority shareholders.

The payments to minority shareholders suggest a lower bound on the constraints minority shareholders can impose on majority shareholders. To be sure, removal of minority shareholders can result in additional benefits for majority shareholders, notably elimination of the direct costs of complying with SEC

³⁷Easton (1988) p. 40. See also Nathan (1986).

³⁸Easton (1988) p. 40.

³⁹Easton (1988) p. 40.

⁴⁰For example, even if a blockholder had nonpublic, favorable information about the firm’s expected cash flows, it would still be irrational for him to buy out minority shareholders if they were powerless to constrain him. In this case, he could simply expropriate the higher-than-anticipated cash flows through opportunistic behavior. On the other hand, if minority shareholders can constrain the blockholder, then such asymmetry of information could provide the impetus for a buyout of minority shareholders. See Bebchuk and Zingales (1998).

regulations. These costs, however, are estimated to range between only \$75,000 and \$200,000 annually.⁴¹ If they are capitalized (say at a real rate of 5%), majority shareholders would save between \$1.5 million and \$4 million, far less than the transfers we observe which average \$313.1 million (median \$20.5 million).

Although it would be inappropriate to attribute these reorganizations and transfers solely to minority shareholders' legal rights to constrain majority shareholders, our evidence that organizational constraints appear to be less important in majority-owned firms than in diffusely held firms makes the case for the influence of law compelling.

The influence of the law is further suggested by the conceptual differences between offers to acquire diffusely held firms and offers to acquire the minority's stock in a majority-shareholder firm. Although the determinants of offer premiums are not yet well understood, several reasons why acquirers typically offer substantial premiums to acquire publicly held corporations have been advanced: to match alternative bids, to induce the tender of more shares when the supply curve slopes up (perhaps reflecting different tax situations among the firm's shareholders), to reduce managerial resistance, and to overcome free-rider problems that can cause atomistic shareholders not to tender their shares. All of these considerations are less relevant with majority-shareholder firms than with diffusely held firms. Theoretically, majority shareholders can unilaterally approve most reorganizations because they control more than 50% of the votes.⁴² Moreover, through side payments for majority blocks, majority shareholders and acquirers should be able to avoid sharing with minority shareholders the benefits of deploying corporate resources to more productive uses. Yet in spite of these differences, minority shareholders in majority-owned firms receive approximately the same premium for their shares as shareholders in diffusely held firms.

⁴¹DeAngelo, DeAngelo, and Rice (1984) p. 372 report the estimates of a number of corporations on the direct costs of SEC compliance to arrive at this range.

⁴²To be sure, majority shareholders sometimes choose not to vote in reorganizations. But this raises the question, why? As courts often look to this factor in appraisal proceedings, it appears that the decision of majority shareholders not to vote in reorganizations is one result of legal constraints.

Finally, one can discern the constraining influence of the law also from casual evidence, such as reports in the financial press and litigation instituted by minority shareholders, as well as from the difference between the treatment of minority shareholders in the United States and New Zealand. In the absence of alternative explanations or contradictory evidence, the case for the influence of law appears persuasive.

Our finding on the importance of the law as a protector of minority shareholders is largely consistent with La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1997). They find that legal protections for small shareholders in public corporations vary substantially across countries, with the greatest protection coming in common law countries such as the United States. Although we do not make systematic international comparisons, our finding that the law protects minority shareholders from large shareholders in the United States is consistent with their finding that the common law protects small investors. The apparently greater protection for minority shareholders in reorganizations in the United States compared with New Zealand raises the possibility of important differences in the legal protections for minority shareholders among common law countries (a possibility not explored by La Porta, et al.).

La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1997) further suggest that concentrated ownership is a partial response to inadequate legal protections for small investors. On this claim, we have our doubts because of the possibility of large shareholders exploiting minority shareholders. There are certainly press reports of this happening, for example, in Asian corporations. (For example, see *The Economist*, December 20, 1997, pp. 107-108. "Asia's minority shareholders have every reason to worry about how they are treated. ...Dominant families, byzantine corporate structures and overly cosy political relationships leave minority shareholders at a disadvantage.") In any event, an international analysis of the legal constraints on large shareholders is a topic worthy of future investigation.

4.6 *Evidence on additional concerns about block investors*

Our evidence also addresses other concerns that have been raised about block investors. Here again, the pessimism of legal scholars is not supported by the evidence.

Management prior to acquiring minority's interest: Our evidence is inconsistent with the suggestion that an block investor might manage the firm in a way that drives down eventual payments for minority shareholders in a reorganization.⁴³ Specifically, the average stock-price increase over the year preceding the reorganization (day -250 through day -10) is 9.8% (*t*-statistic 1.4). Over the entire event period (day -250 through day 10), abnormal returns average 30% (*t*-statistic 4.1).

Magnitude of payments to minority shareholders: Although size, of course, is in the eye of the beholder, one must question whether the payments we document are consistent with the claim that large-block shareholders often choose “to eliminate at modest cost the nuisance value represented by so small a minority.” Brudney (1978) p. 70. Payments to minority shareholders are in the tens and sometimes hundreds of millions of dollars and approximate those paid in arms-length mergers.

Potential problems with corporate blockholders: The wealth gains for minority shareholders are statistically similar whether individual managers or corporations redeem the shares, despite underlying differences in the nature of the restructurings. From day -20 through day 10, shareholders in corporate-controlled firms experience abnormal gains of 24% (median 16%), and shareholders in individual-controlled firms experience wealth gains of 28% (median 23%). Both parametric and nonparametric tests yield insignificant differences. Similar results

⁴³Bebchuk (1985 pp. 1712-1713), for example, argues that: “The acquirer [of a substantial percentage of a firm’s common stock] might also manage the target’s operations so as to lower further the elements of the appraisal remedy. For example... the acquirer might depress the target’s market price in that period by using its control over both the target’s dividend policy and its release of information. Finally, it is worth noting that the prospect of a future takeout might by itself depress the market price of minority shares.”

are documented at the announcement of the reorganization. This evidence and the evidence that payments to minority shareholders approximate the acquisition payments to shareholders in diffusely held firms are inconsistent with the assertion that premiums in parent/subsidiary mergers will “not [be] as much as in arm’s-length mergers or overhead take-overs.” Brudney (1978) p. 73.

5. Conclusion

There is a widespread belief that the law does not effectively constrain large-block shareholders. Such a conclusion presents a challenge to those who maintain that large shareholders can improve corporate performance. The empirical evidence presented in this paper—which to our knowledge is the first evidence on constraints on block investors—calls into question the widespread pessimism about the power of the law to constrain block investors. We base this conclusion on three broad empirical regularities.

The first regularity is that firms with block investors are surviving. This is evidenced by the number of firms with blockholders and by data showing that these firms are decreasing in neither size nor numbers. Moreover, concentrated ownership does not appear to decrease firm value significantly. We would not observe these regularities if block investors were unconstrained. Given their voting power, there simply would be too much latitude for opportunistic behavior and inept management.

The second regularity is that managers who own majority blocks of stock appear to be less constrained by organizational mechanisms than managers with small stockholdings. Most majority-shareholder boards lack features such as cumulative voting and a preponderance of outside directors that would help them constrain majority shareholders effectively. Likewise, because majority-shareholder firms typically have lower debt-to-equity ratios than similar firms with diffuse ownership, it seems unlikely the debtholders monitor majority shareholders to a greater extent than they monitor managers with smaller stockholdings. A pattern of internal financing suggests that trips to the capital markets do little to augment

other reputational considerations that may constrain majority shareholders. Finally, we find few examples of innovative organizational constraints counterbalancing the power of large-block ownership.

The final broad empirical regularity we identify is that the law appears to constrain majority shareholders both in their day-to-day management and when they redeem the ownership interest of minority shareholders. In mergers, going-private restructurings, and liquidations, minority shareholders receive premiums similar to those paid when more diffusely owned corporations are reorganized, suggesting that the law prevents block investors from using their voting power to freeze out minority owners at low prices. Despite these premiums, majority shareholders buy out minority shareholders at least as often as firms with relatively diffuse ownership are similarly reorganized. In addition, although the law does not explicitly require it, small shareholders receive the same amount per share in acquisitions that follow block trades as do block sellers. These payments appear in part to be the price majority shareholders must pay to eliminate the constraint of minority shareholder litigation.

We do not conclude that the evidence suggests that the law perfectly constrains block investors. Examples of block investors who have led their firms into financial distress, such as the Wang family, show this not to be the case. Nor do we conclude that the law is a greater constraint on block investors than are organizational factors. Instead, we conclude that the law is an important constraint on block investors. This, however, conflicts with the prevailing academic view. Logic, however, supports it. The fundamental difference between the law and most internal organizational constraints on managers who own large blocks of stock is that the law is largely beyond the influence of those who are to be constrained. This is the essence of a constraint.

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Table 1

Comparisons of board membership of majority-shareholder firms on the NYSE or Amex and a paired sample of firms with diffuse ownership in which no shareholder owns more than 20% of the common stock (1980-1984). Outside directors are defined as anyone not currently an employee of the firm or (with corporate majority shareholders) the parent firm. Data from annual proxy statements.

Variable	Mean (Median) Value for Majority- Shareholder Firms	Mean (Median) Value for Diffuse- Ownership Firms	<i>p</i> -value of Difference in Means	<i>p</i> -value of Wilcoxon Signed Rank Tests	n
<i>Full Sample</i>					
Number of Directors	9.5 (9)	10.2 (10)	0.18	0.09	97
Number of Outside Directors	6.2 (6)	7.1 (7)	0.03	0.04	97
Ratio of Outside to Total Directors	0.62 (.67)	0.68 (0.69)	0.01	0.02	97
<i>Individual Majority Shareholders</i>					
Number of Directors	8.4 (8)	9.4 (9)	0.15	0.18	40
Number of Outside Directors	4.8 (4)	6.3 (6)	0.03	0.03	40
Ratio of Outside to Total Directors	0.54 (0.50)	0.64 (0.64)	0.01	0.01	40
<i>Corporate Majority Shareholders</i>					
Number of Directors	10.4 (9)	10.8 (10)	0.53	0.28	54
Number of Outside Directors	7.4 (7)	7.8 (7)	0.52	0.73	54
Ratio of Outside to Total Directors	0.69 (0.72)	0.71 (0.71)	0.51	0.62	54

Table 2

Comparisons of methods of electing directors and the frequency of board subcommittees for 101 majority-shareholder firms on the NYSE or Amex and a paired sample of firms with diffuse ownership in which no shareholder owns more than 20% of the stock (1980-1984). Data from annual proxy statements.

Variable	Mean (Median) Value for Majority- Shareholder Firms	Mean (Median) Value for Diffuse- Ownership Firms	<i>p</i> -value of Chi-Square Statistic Testing for Homogeneity of Populations
<i>Full Sample</i>			
Firms having staggered elections for directors	7%	40%	<0.01
Firms having cumulative voting for directors	16%	23%	0.24
Firms having:			
Audit Subcommittee	84%	91%	0.16
Compensation Subcommittee	63%	72%	0.16
<i>Individual Majority Shareholders</i>			
Firms having staggered elections for directors	3%	32%	<0.01
Firms having cumulative voting for directors	15%	22%	0.42
Firms having:			
Audit Subcommittee	85%	85%	0.96
Compensation Subcommittee	51%	63%	0.31
<i>Corporate Majority Shareholders</i>			
Firms having staggered elections for directors	9%	48%	<0.01
Firms having cumulative voting for directors	17%	21%	0.59
Firms having:			
Audit Subcommittee	89%	96%	0.14
Compensation Subcommittee	76%	77%	0.82

Table 3

Comparisons of payments to shareholders for majority-shareholder firms on the NYSE or Amex and a paired sample of firms with diffuse ownership in which no shareholder owns more than 20% of the stock (1980-1984). Data from Compustat.

Variable	Mean (Median) Value for Majority- Shareholder Firms	Mean (Median) Value for Diffuse- Ownership Firms	<i>p</i> -value of Difference in Means	<i>p</i> -value of Wilcoxon Signed Rank Tests	n
<i>Full Sample</i>					
Dividends as a percentage of year-end stock price	2.3% (1.1)	3.2% (2.7)	0.02	0.05	94
Dividends per share divided by earnings per share	26.5 (9.9)	25.7 (25.7)	0.98	0.03	96
<i>Individual Majority Shareholders</i>					
Dividends as a percentage of year-end stock price	1.9 (1.0)	3.0 (1.4)	0.07	0.24	41
Dividends per share divided by earnings per share	13.1 (9.4)	24.7 (23.1)	0.02	0.04	41
<i>Corporate Majority Shareholders</i>					
Dividends as a percentage of year-end stock price	2.6 (1.2)	3.2 (2.7)	0.20	0.19	50
Dividends per share divided by earnings per share	36.6 (9.3)	25.9 (29.5)	0.61	0.24	51

*Calculated as dividends as a percentage of year-end stock price.

Table 4

Time-series analyses of changes in organizational constraints on top management associated with the realization of majority ownership for 114 NYSE- or Amex-listed corporations. Before/After test compares the values of the variables by splitting the observations into a period before the firm is controlled by a majority shareholder and the period in which it is controlled. Relative year test stratifies the sample by the year in relation to when a firm becomes majority owned. The *p*-value is for the chi-squared statistic if the variable is categorical or for the Wilcoxon signed rank test (or Kruskal-Wallis test) if the variable is continuous. Direction of change denotes the change in the median of the variable using the Before/After classification. Data from annual proxy statements and Compustat, 1978-1984.

Variable	Relative Year <i>p</i> -value	Before/After <i>p</i> -value	Direction of Before/After change associated with majority ownership
Number of directors	0.42	0.63	No change
Number of outside directors	0.54	0.48	Decrease
Ratio of outside directors	0.61	0.18	Decrease
Audit subcommittee	0.99	0.65	Increase
Compensation subcommittee	0.54	0.17	Increase
Cumulative voting	0.91	0.09	Increase
Staggered voting	0.31	0.02	Decrease
Big Six auditor	0.99	0.46	Decrease
Change in auditor	0.94	0.53	Increase
Debt/asset ratio	0.87	0.44	Decrease
Amount of financing	0.08	0.16	No change
Dividend yield	0.95	0.98	Increase
Dividend payout	0.15	0.01	Increase

Table 5

Frequency of reorganizations between 1980 and 1986 for 101 majority-shareholder firms on the NYSE or Amex and a paired sample of 101 firms with diffuse ownership in which no shareholder owns more than 20% of the common stock. Data from Compustat and *The Wall Street Journal*.

	<i>Full Sample</i>		<i>Individual Majority Shareholder</i>		<i>Corporate Majority Shareholder</i>	
	Majority-Shareholder Firms	Diffuse-Ownership Firms	Majority-Shareholder Firms	Diffuse-Ownership Firms	Majority-Shareholder Firms	Diffuse-Ownership Firms
Merger	25%	18%	12%	19%	33%*	16%*
Going Private	6%	7%	5%	5%	5%	5%
Liquidation	5%	4%	12%	12%	2%	0%
None	64%	71%	71%	64%	60%*	79%*

* *p*-value of <0.05 for a test of equality between proportions of the two samples.

Table 6

Summary of abnormal stock-price returns for various periods surrounding the initial *Wall Street Journal* announcement that a majority-shareholder firm on the NYSE or Amex is being acquired, taken private, or liquidated (1978-1984). Data from *The Wall Street Journal*.

	250 days before through 10 days after the initial announcement of a reorganization	Initial public announcement of a reorganization	20 days before through 10 days after the initial public announcement of a reorganization
Average abnormal stock return	30%	12%	23%
<i>t</i> -statistic	4.1	19.6	9
Sample size	43	38	43