

This PDF is a selection from an out-of-print volume from the National Bureau of Economic Research

Volume Title: Concentrated Corporate Ownership

Volume Author/Editor: Randall K. Morck, editor

Volume Publisher: University of Chicago Press

Volume ISBN: 0-226-53678-5

Volume URL: <http://www.nber.org/books/morc00-1>

Conference Date: May 31-June 1, 1998

Publication Date: January 2000

Chapter Title: II. THE LAW AND CONCENTRATED CORPORATE OWNERSHIP
5. Constraints on Large-Block Shareholders

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Chapter URL: <http://www.nber.org/chapters/c9008>

Chapter pages in book: (p. 139 - 176)

Constraints on Large-Block Shareholders

Clifford G. Holderness and Dennis P. Sheehan

There is a growing belief among both academics and practitioners that firm performance can often 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 of large public corporations.

There is a major potential problem with large investors, however, a problem 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 percent 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-intentioned 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

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The authors have benefited from the comments of James Brickley, Linda DeAngelo, Gordon Hanka, Mark Huson, Randall Kroszner, Michele LaPlante, Claudio Loderer, Roberta Romano, Michael Weisbach, conference participants, and an anonymous referee.

with an investor with the understanding that the investor will support management in control contests. The large-block investment made in the 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 (1994, 989), for example, describes Delaware corporate law, federal securities law, and federal antitrust law as “rather toothless [for limiting] corrupt relational investing.” Gilson (1986, quoting in part Eisenberg 1976, 309) summarizes, “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 shareholder owns more than 50 percent 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 whether 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 of majority-owned firms differ little from those of firms with diffuse stock ownership. Another potential organizational constraint on majority shareholders, capital market activity, also appears to differ little between firms with concentrated and firms with diffuse ownership. Likewise, there is little evi-

1. Although some such assessments are made in the context of parent-subsidiary relations, commentators do not seem to distinguish corporate large-block shareholders from individual large-block shareholders.

dence 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 of and the wealth effects for minority shareholders associated with mergers, the going private, restructurings, and liquidations of majority-shareholder firms. We find that minority shareholders on average receive premia of 20 percent over preannouncement stock prices when they are bought out by majority shareholders—approximately the same premia that 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 premia, 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 that 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, from comparing the U.S. experience with the New Zealand experience (New Zealand has few protections for minority shareholders), and from evidence on the treatment of minority shareholders in other countries. 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.

5.1 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 owner-

ship. If large-block shareholders exist only infrequently, one might conclude that they are anomalies 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.

5.1.1 The Survival of Firms with Block Investors

The available evidence shows that many firms have concentrated ownership. Mikkelson and Partch (1989) document that, in approximately 30 percent of a random sample of 240 corporations listed on either the New York Stock Exchange (NYSE) or the American Stock Exchange (Amex), the board and top officers control at least 20 percent 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 percent 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 retained on average 72 percent of the common stock in the 559 firm-commitment initial public offerings registered with the Securities and Exchange Commission (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 time he and his representatives ran the firm. De Long (1991) estimates that one Morgan partner on a board increased the value of the firm's equity by approximately 30 percent. Goldman Sachs played a similar role with retail firms. Finally, Holderness, Kroszner, and Sheehan (1999) find that average inside ownership of the common stock among a large sample of U.S. exchange-listed firms increased from 13 percent in 1935 to 21 percent in 1995.

5.1.2 Firm Value and Large Shareholders

Market-to-Book Studies

Several studies measure the effect 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 proposition that block investors significantly reduce firm value, which they

2. Additional 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.

would do if there were few constraints on them. Morck, Shleifer, and Vishny (1988b) report that, for 371 Fortune 500 firms, the market-to-book ratio increases when managerial stockholdings go from 0 to 5 percent, decreases between 5 and 25 percent, and increases above 25 percent. 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 percent 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 percent, 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 partial ownership interest in a subsidiary to the public. In most such reorganizations, the parent retains at least half 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 twenty-five of the eighty-three 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, 457) 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 that approximate those earned by target firms in arm's-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 the Thermo Electron Corporation, a NYSE company that has done twenty-three carve-outs of publicly traded firms and still retains majority control in all. In SEC filings Thermo Electron 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 percent (about \$1 billion).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 evidence suggests that any subsidies go from the dominant parent to the subsidiaries.

5.1.3 Summary

Two points emerge from the evidence presented above. First, firms with large shareholders appear to be surviving. Second, the evidence of the effect 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.

5.2 Organizational Constraints on Block Investors

In spite of the evidence presented above of the survival and value effects of block investors, the widespread criticisms of the ineffectiveness of the law could still be correct if the binding constraints are organizational, not legal. We therefore investigate whether organizational constraints are altered to counterbalance the additional power that comes with 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 a large-block shareholder (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 pur-

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

chase newly issued preferred stock. Among the conditions imposed by the cable companies as a condition of investing were amending the bylaws to enable them to elect seven of fifteen directors, requiring supramajority approval by the board of major management decisions, restricting the alienability of the preferred stock so that its ownership stayed with the cable companies, and acquiring 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 the Time/Warner Corp. in 1996.) Under these conditions, Ted Turner was effectively constrained by organizational mechanisms, his majority ownership of the common stock notwithstanding.

5.2.1 Sample Description

We use a sample of public corporations that have majority shareholders to investigate 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. 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" (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 Technology'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.

4. 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).

5. Majority shareholders are defined as individuals or entities that own more than 50 percent of a firm's common stock. Entities are typically other corporations but occasionally include charitable or voting trusts.

Information about the block investors and their firms is collected from annual proxy statements and Compustat.

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 percent 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 percent of the firm years in the sample, individuals own the blocks in 46 percent 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 percent of the individual majority shareholders and representatives of 94 percent of the corporate majority shareholders are either directors or officers. In other words, majority shareholders are active 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 a 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.

5.2.2 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 long-standing CEOs 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 con-

Table 5.1 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 Percent of the Common Stock (1980–84)

Variable	Mean (Median) Value		p-Value		Sample Size
	Majority-Shareholder Firms	Diffuse-Ownership Firms	Difference in Means	Wilcoxon Signed-Rank Tests	
Full sample:					
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 (0.67)	0.68 (0.69)	0.01	0.02	97
Individual majority shareholders:					
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
Corporate majority shareholders:					
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

Sources: Data are from annual proxy statements.

Note: Outside directors are defined as anyone not currently an employee of the firm or (with corporate majority shareholders) the parent firm.

strain 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 5.1 and 5.2, however, the board has greater power to constrain a block investor.

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. For example,

Table 5.2 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 Percent of the Stock (1980–84)

Variable	Mean (Median) Value (%)		<i>p</i> -Value of χ^2 -Statistic Testing for Homogeneity of Populations
	Majority-Shareholder Firms	Diffuse-Ownership Firms	
Full sample:			
Firms having staggered elections for directors	7	40	< .01
Firms having cumulative voting for directors	16	23	.24
Firms having:			
Audit subcommittee	84	91	.16
Compensation subcommittee	63	72	.16
Individual majority shareholders:			
Firms having staggered elections for directors	3	32	< .01
Firms having cumulative voting for directors	15	22	.42
Firms having:			
Audit subcommittee	85	85	.96
Compensation subcommittee	51	63	.31
Corporate majority shareholders:			
Firms having staggered elections for directors	9	48	< .01
Firms having cumulative voting for directors	17	21	.59
Firms having:			
Audit subcommittee	89	96	.14
Compensation subcommittee	76	77	.82

Sources: Data are from annual proxy statements.

press reports suggest that outside directors took the lead in the three prominent replacements of CEOs 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.

Table 5.1, however, reports that both the absolute number of outside directors and the ratio of outside to inside directors are lower in majority-shareholder firms than in their paired firms with diffuse ownership. These differences can be attributed largely 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.⁶ 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 5.2, however, staggered elections are used in fewer firms with majority ownership than firms with relatively diffuse ownership: in our sample, 7 versus 40 percent (the p -value of the difference is less than 0.01). 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 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 5.2, however, cumulative voting is found less often in

6. For analysis of percentages in table 5.1 and throughout the paper, we report the probability value of the two-tailed χ^2 -statistic used to test whether the paired samples are drawn from a homogeneous population.

majority-shareholder firms than in their paired firms (16 vs. 23 percent), although the p -value of 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 5.2, both audit and compensation subcommittees are found in fewer majority-shareholder firms than paired firms (84 vs. 91 percent and 63 vs. 72 percent), with the differences being marginally significant (p -value of both differences of 0.16).⁷ 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.⁸ Finally, in the several hundred proxy statements and news articles that we examined for our sample, there were no reports of special subcommittees to monitor a majority shareholder.

5.2.3 Monitoring by Nonmanager Stockholders and Debtholders

Although the board is typically viewed as the central organizational control mechanism, it is not the only one. 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 percent of the approximately five hundred firm years in our sample, no shareholder other than the majority shareholder owns as much as 5 percent of the common stock. Likewise, 89 percent of the majority-owned firms have no directors (other than the majority shareholder) who own 5 percent 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

7. More 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.

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

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, and corporate majority-shareholder firms have total debt-to-asset ratios that equal those of their paired firms.⁹ 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.¹⁰

5.2.4 Monitoring by Auditors

A firm's auditor can constrain block investors by identifying and exposing mismanagement or opportunistic behavior.¹¹ 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 (see DeAngelo 1981). In our paired years, 92 percent of the majority-shareholder firms and 87 percent of the comparison firms employ Big Six firms (*p*-value of 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 on the basis of these data that block investors trigger additional monitoring by auditors.

5.2.5 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 oppor-

9. Individual 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.

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

11. Events 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. At that time, Coated Sales said that 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" (Naj 1988, 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, CEO, and founder and a 12 percent blockholder. The board then retained another Big Six accounting firm to investigate Weinstein and several other top managers further. Shortly thereafter, Weinstein resigned.

tunistic behavior.¹² 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.

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.¹³ 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 honestly 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 percent 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 percent of the years (p -value of the difference of 0.24). This difference is more pronounced between firms owned by individuals and their paired firms (8 vs. 15 percent, p -value 0.33) than between corporate-owned firms and their paired firms (9 vs. 11 percent, 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 5.3, the dividend yield and the dividend payout ratio are lower in majority-shareholder than in 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 percent of their pretax earnings, whereas their paired firms distribute 25 percent, a difference that produces a p -value of 0.02; corporate majority-shareholder firms distribute 37 percent, whereas their paired firms distribute 26 percent, a difference that produces a p -value of only 0.61.

5.2.6 Time-Series Evidence of 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

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

13. Rozeff (1982) and Easterbrook (1984) analyze how frequent trips to the capital markets can result in the monitoring of management.

Table 5.3 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 Percent of the Stock (1980–84)

Variable	Mean (Median) Value		<i>p</i> -Value		Sample Size
	Majority-Shareholder Firms	Diffuse-Ownership Firms	Difference in Means	Wilcoxon Signed-Rank Tests	
Full sample:					
Dividends as a percentage of year-end stock price	2.3 (1.1)	3.2 (2.7)	.02	.05	94
Dividends per share divided by earnings per share	26.5 (9.9)	25.7 (25.7)	.98	.03	96
Individual majority shareholders:					
Dividends as a percentage of year-end stock price	1.9 (1.0)	3.0 (1.4)	.07	.24	41
Dividends per share divided by earnings per share	13.1 (9.4)	24.7 (23.1)	.02	.04	41
Corporate majority shareholders:					
Dividends as a percentage of year-end stock price	2.6 (1.2)	3.2 (2.7)	.20	.19	50
Dividends per share divided by earnings per share	36.6 (9.3)	25.9 (29.5)	.61	.24	51

Source: Data from Compustat.

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, a “before/after classification.” Second, we compare firms on the basis of the year relative to their becoming majority controlled, a “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. In

Table 5.4 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 (1978–84)

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	.42	.63	No change
Number of outside directors	.54	.48	Decrease
Ratio of outside directors	.61	.18	Decrease
Audit subcommittee	.99	.65	Increase
Compensation subcommittee	.54	.17	Increase
Cumulative voting	.91	.09	Increase
Staggered voting	.31	.02	Decrease
Big Six auditor	.99	.46	Decrease
Change in auditor	.94	.53	Increase
Debt-asset ratio	.87	.44	Decrease
Amount of financing	.08	.16	No change
Dividend yield	.95	.98	Increase
Dividend payout	.15	.01	Increase

Sources: Data from annual proxy statements and Compustat.

Note: 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 χ^2 -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.

contrast to the first time-series test, this test enables us to identify trends in relative time.

Table 5.4 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. As far as constraining majority shareholders, however, the direction of these changes 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 5.4 to mean that few dramatic changes occur in an array of potential organizational constraints when firms go in and out of majority ownership.

5.2.7 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. Turner Broadcasting is the exception.

In the 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 who have 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 in comparison to diffusely held firms. This suggests the need to examine the legal constraints on large-block shareholders.

5.3 Legal Constraints on Block Investors

5.3.1 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.¹⁴ Among these are looting the firm; furnishing a house, buying expensive cars, and taking sizable cash advances at corporate expense;¹⁵ taking excessive compensation;¹⁶ diverting a business opportunity from the firm;¹⁷ selling property owned by a large shareholder to the firm at above-market

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

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

16. *Miller v. Magline, Inc.*, 76 Mich. App. 284, 256 N.W.2d 761 (1977).

17. *Guth 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).

prices;¹⁸ borrowing money from the firm at below-market interest rates or lending to it at above-market rates;¹⁹ 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;²⁰ paying differential dividends; increasing the marketability of the majority’s shares by decreasing the marketability of the minority’s shares;²¹ selling the control block to someone who plans to loot the firm;²² issuing stock at prices that dilute the value of the minority’s stock;²³ and making misrepresentations when issuing securities.²⁴ In general, these laws prevent non pro rata distributions of corporate assets (Barclay and Holderness 1992a). Remedies include 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.²⁵ Finally, there are potential causes of action under federal and state security laws.

Assessments of the Law’s Effectiveness

In spite of so many 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, 69–70) summary is representative:

The parent will inevitably exercise discretion—lawfully as well as unlawfully, but substantially undetectable—to divert assets to itself instead of

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

19. See 31 A.L.R.2d 671.

20. *Ibid.*

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

22. *Insuranshares Corp. v. Northern Fiscal Corp.*, 35 F. Supp. 22 (D. Pa. 1940); *Gerdas v. Reynolds*, 28 N.Y.S.2d 622 (County Ct. Term 1941).

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

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

25. In *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983), the Delaware Supreme Court 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” (p. 714).

sharing them, all to the disadvantage of the public stockholders of the subsidiary. . . . [T]here 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.

Cary's (1974, 679) 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."²⁶

The pessimistic assessment of legal scholars evidently 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.²⁷

We first assess the effectiveness of legal constraints on block investors 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

26. For a similar but more recent critique of Delaware law, see Rock (1994).

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

indicate relatively minor legal constraints. We then examine trades of large-percentage blocks of stock. We also compare how minority 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. Finally, we cite recent research on the lack of protections for minority shareholders in countries other than the United States.

5.3.2 Evidence from Corporate Reorganizations

Frequency of Reorganizations

Table 5.5 reports how often firms in our paired sample were acquired, taken private, or liquidated between 1980 and 1986. Over the seven years followed, 36 percent of the majority shareholders redeem the minority's shares. By comparison, only 29 percent of the paired firms are reorganized over the same period.²⁸ This evidence is consistent with Morck, Shleifer, and Vishny (1988a), which found 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.²⁹

Wealth Transfers to Minority Shareholders

The effect on minority shareholders' wealth associated with reorganizations is measured with a sample of forty-three 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 from the original sample of 114 that we were unable to pair; ten are identified by searching the annual company index of the *Wall Street Journal* line by line for the period 1978–82; and eight are identified from Austin Associates' database of tender offers between 1981 and 1984. All 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

28. Table 5.5 also shows that minority shareholders are bought out significantly more often by corporate majority shareholders (40 percent) than they are in similar firms with diffuse ownership (21 percent) (the difference is significant at the 0.05 level).

29. Klein, Rosenfeld, and Beranek (1991) report that the parent eventually reacquired the subsidiary's publicly held shares in twenty-five of the eighty-three 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.

Table 5.5 **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 Percent of the Common Stock**

	Full Sample (%)		Individual Majority Shareholder (%)		Corporate Majority Shareholder (%)	
	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*

Source: Data from Compustat and the *Wall Street Journal*.

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

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*.³⁰ 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 the 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 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 5.6 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 percent. 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 twenty days preceding through ten days after announcements of reorganizations, stock

30. The 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.

Table 5.6 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 (1978–84)

	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

Source: Data from the *Wall Street Journal*.

prices increase on average by 23 percent (*t*-statistic 9.0). Ninety-one percent of the abnormal returns over this period are positive.

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 percent.³¹

5.3.3 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 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 (1986, 468) sees "the equal treatment problem as . . . the salient problem posed by two-step acquisitions."

Barclay and Holderness (1989, 1992a, 1992b) examine 106 trades of at least 5 percent 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

31. Similarly, Slovin and Sushka (1998) find that, when parent corporations merge with partially owned subsidiaries, shareholders in the subsidiaries receive approximately the same premiums as do shareholders in arm's-length mergers. 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 that approximate those earned by target firms in arm's-length mergers and acquisitions.

(1992a) find that, in 86 percent of these reorganizations, minority shareholders receive at least as much per share as did the block seller (unadjusted for market movements or inflation).

This equality of payments to majority and minority shareholders appears to be an example of an implicit legal constraint, as no law explicitly 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.

5.3.4 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 the Lion Corporation was taken over by the L. D. Nathan Corporation, minority shareholders received only 60 percent on a per share basis of what was paid to Fay Richwhite, a 35 percent blockholder in Lion. Similarly, when the James Smith Corporation was purchased by Mancorp Holdings, an 81 percent blockholder received twice as much per share as did other shareholders (Easton 1988, 40; see also Nathan 1986). 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.” 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” (Easton 1988, 40).

5.3.5 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 cannot 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.³²

32. For example, even if a blockholder has 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, chap. 2 in this volume).

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 that minority shareholders can impose on majority shareholders. To be sure, the removal of minority shareholders can result in additional benefits for majority shareholders, notably, elimination of the direct costs of complying with SEC regulations. These costs, however, are estimated to range between only \$75,000 and \$200,000 annually.³³ If they are capitalized (say, at a real rate of 5 percent), majority shareholders would save between \$1.5 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 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 percent of the votes.³⁴ 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.

Finally, one can also discern the constraining influence of the law from casual evidence, such as reports in the financial press and litigation insti-

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

34. To 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.

tuted 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 regarding the importance of the law as a protector of minority shareholders is also largely consistent with the finding of La Porta et al. (1997) 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 et al. (1997) further suggest that concentrated ownership is a partial response to inadequate legal protections for small investors. We have our doubts about this claim because of the possibility of large shareholders exploiting minority shareholders. There are certainly press reports of this happening, for example, in Asian corporations (“Asia’s minority shareholders have every reason to worry about how they are treated. . . . Dominant families, byzantine corporate structures and overly cozy political relationships leave minority shareholders at a disadvantage” [“Asia’s Stock Nightmare” 1997, 107]). In any event, an international analysis of the legal constraints on large shareholders is a topic worthy of future investigation.

5.3.6 Evidence of 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 a block investor might manage the firm in a way that drives down eventual payments for minority shareholders in a reorganization.³⁵ Specifically, the average stock-

35. Bebchuk (1985, 1712–13), e.g., argues, “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 takeover might by itself depress the market price of minority shares.”

price increase over the year preceding the reorganization (from day -250 through day -10) is 9.8 percent (*t*-statistic 1.4). Over the entire event period (from day -250 through day 10), abnormal returns average 30 percent (*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 that 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, 70). Payments to minority shareholders are in the tens and sometimes hundreds of millions of dollars and approximate those paid in arm’s-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 percent (median 16 percent), and shareholders in firms controlled by individuals experience wealth gains of 28 percent (median 23 percent). Both parametric and nonparametric tests yield insignificant differences. Similar results 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, 73).

5.4 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 of 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 are 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 that 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 that 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, especially legal prohibitions on non pro rata distributions of firm assets, is an important constraint on block investors. Our conclusion that the law effectively constrains blockholders, 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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Comment Mark R. Huson

Large percentage blocks of shares may be accumulated to improve management, to secure benefits that do not accrue to other shareholders, or both. In the first case, the blockholder monitors management in order to promote good decisions and/or prevent bad ones. In these instances, all shareholders share the benefits that arise. Such blockholders will be associated with higher firm values. In the second case, the blockholder uses his superior voting power to secure private benefits. Blockholders who acquire control positions in order to expropriate will be associated with lower firm values to the extent that they can actually consume private benefits. The paper by Clifford Holderness and Dennis Sheehan is concerned with the second case. In particular, it asks what prevents blockholders from diverting value to themselves at the expense of minority shareholders.

Their paper does several things. First, it documents that firms with majority ownership survive and that they do not trade at substantial discounts to firms with diffuse ownership. Next, it looks to organizational mechanisms that might control a majority holder's ability to consume perquisites. Finally, it looks to the law as a constraint on the behavior of blockholders. This last exercise is in a way the central focus of the paper. The authors look at this issue in the light of what they see as a pessimistic view held by legal scholars about the effectiveness of laws designed to control blockholders.

Blockholders, Survival, and Discounts

While reading the section on the survival of majority-ownership firms, I was reminded of William H. McNeill's *Plagues and Peoples* (1976), which discusses disease vectors and their effects on populations. What made me think of this book was the idea that majority owners who accrue private benefits are a lot like parasites. McNeill's book discusses virulent and nonvirulent parasites. Nonvirulent parasites "realize" that they depend on their hosts for survival and do not consume the host to the point of its demise. If majority owners are of the nonvirulent nature, it is not surprising that the firms they control survive. I discuss this issue more when I deal with the legal constraints on blockholders.

As far as discounts for majority-controlled firms, it is not clear a priori whether they should be expected. Consider a majority owner who both monitors and consumes. In this case, the positive effects of increased monitoring will offset the negative effects of perquisite consumption. The net effect of this on firm value is ambiguous. Even if majority owners either

monitor or consume, this problem affects the examination of average discounts. The positive effects that monitors have on some firms will be offset by the negative effect of self-dealing in other firms.

What might be more informative is an examination of the dispersion in discounts of majority-owned firms relative to the dispersion of discounts in diffusely owned firms. Such an analysis might point to firms where the consumption effects are stronger than the alignment effects. Finally, a stronger test might come from looking at marginal Q -ratios. What I have in mind is an analysis of the market reaction to acquisitions made by majority-owned firms and diffusely held firms. If majority-held firms make acquisitions to benefit the majority owner at the expense of the other shareholders, the market should react more negatively to announcements by these firms. Huson (1998) finds differential market responses to announcements of acquisitions and divestitures by firms under different governance regimes.

In their summary of the evidence regarding survival and discounts, Holderness and Sheehan conclude that there is no evidence that block investors pronouncedly decrease firm value. Given the possible offsetting effects of monitoring and consumption and the problem with averages mentioned above, this conclusion is strong. They go on to say that majority owners must be constrained. However, there is evidence consistent with the proposition that majority owners do consume. For example, Barclay and Holderness (1989) document an average control premium of 20.4 percent associated with the exchange of blockholdings.¹ They interpret this premium as representing the anticipated (net) private benefits of the control stake. Additionally, Holderness and Sheehan report various instances of majority owners who have been caught consuming. The nature of the constraint, therefore, must be that of an upper bound on self-dealing.

Organizational Mechanisms to Counter Self-Dealing

In this section of the paper, we are introduced to a sample of majority-owned firms and their two-digit-SIC- and size-matched control firms. This section looks at differences in organizational constraints on self-dealing between the majority-owned firms and the diffusely held firms. The sample of majority-owned firms consist of firms that have a single holder of at least 50.1 percent of a firm's common stock. I will make two comments about this sample and then discuss the results of the analysis.

First, suppose that the constraints on self-dealing are constant. The benefits of self-dealing are decreasing in ownership. Perhaps a more powerful sample design would include firms with effective control, say, owner-

1. Additional evidence that majority owners consume private benefits comes from Bradley (1980) and Meeker and Joy (1980).

ship stakes between 30 and 40 percent. It would be reasonable to expect more self-dealing in these firms. These firms could be compared with the majority-owned firms. This comment is made with consideration of the arguments put forward in Morck, Shleifer, and Vishny (1988).

The second point deals with the identity of the majority shareholder. Holderness and Sheehan are careful to separate individual blockholders from corporate blockholders. This is an important distinction since people, not corporations, make decisions. If diffusely held corporation X holds a majority stake in corporation Y, the CEO of X would have little incentive to loot Y since the benefits would accrue to the shareholders of X, not to the CEO.² Also related to the identity of the majority owner is the issue of founders. Ritter (1981) documents that insiders retain 72 percent of the common stock in the 559 firm-commitment IPOs between 1965 and 1973. This raises the question of how many majority-owned firms in this sample are “young” and founder controlled. It might be worth examining the different types of majority owners in more detail and considering the effect of relative firm age on the relation between firm value and ownership concentration.

Boards of Directors

The first organizational constraint on self-dealing examined is the board of directors. In particular, the paper looks at differences in board composition between majority-owned and diffusely owned firms. Evidence of an organizational adaptation would be a higher proportion of outside directors in majority-owned firms. The second characteristic is the incidence of staggered boards. Holderness and Sheehan argue that staggered boards would help prevent self-dealing at majority-owned firms.

The evidence reported indicates that majority-owned firms have fewer outside directors and use staggered boards less frequently than do the control firms. In the paper, this is interpreted as evidence that internal mechanisms have not evolved to constrain self-dealing. There are other possible interpretations. First, this could indicate that the majority holding sufficiently aligns incentives. Since holdings are in excess of 50.1 percent, the holdings could be a bonding mechanism. If this were the case, there would be less need for outside directors to monitor. There would also be no need for a staggered board to insulate the manager from wronged shareholders. Another interpretation is that the majority owner is a looter and does not want to be watched. In this case, keeping outsiders off the board and maintaining the ability to fire directors is crucial if self-dealing is to be concealed. Finally, if the sample of majority-owned firms com-

2. Since Holderness and Sheehan do not find large differences between corporate majority-owned firms and diffusely held firms, the remainder of my comments will refer to the results for the individual majority-owned firms.

prises young, founder-run firms, the status of the boards could be a function of the firms' investment opportunity sets. Perhaps expertise is more valuable than monitoring in these firms.

Capital Markets

Constraints may also come from capital markets. Debtholders could monitor via covenants that limit self-dealing. Additionally, external financing would be prohibitively expensive for a firm with a reputation for self-dealing. In examining the role of debtholders, Holderness and Sheehan consider a substantial debt ratio to be a necessary (but not sufficient) condition for bondholders to exercise additional control rights. I do not think that the magnitude of the debt load is as important as the nature of the debt load. All else equal, a firm that has \$10 million in short-term debt is more constrained than a firm that has \$10 million in long-term debt. Additionally, for similar levels of similar maturity debt, differences in covenant structures play a role in constraining activity.

Examination of trips to the capital markets shows no significant difference between majority-owned firms and their controls. However, the point estimates show that majority-owned firms go less often. When paired with the statistically lower dividend-payout rates for majority-owned firms, this lends some support for the proposition that capital markets provide some monitoring of majority owners.

Evidence to help us understand the monitoring of capital markets might come from an analysis of the terms that govern new security issues by majority-owned firms. Holderness and Sheehan (1991) point to constraints put on Ted Turner when he went to the capital markets. It would be interesting to see whether other majority-owned firms must agree to similar constraints or whether they have a "high" cost of capital.

The conclusion of this section is that organizational constraints have not evolved to limit the consumption of private benefits. The lack of organizational constraints and the survival of majority-owned firms lead Holderness and Sheehan to the law as the constraint on self-dealing.

Legal Constraints on Majority Shareholders

Holderness and Sheehan point to numerous cases where majority owners have violated the laws and been called on it. In spite of this evidence that the law constrains blockholders, it is reported that legal scholars generally conclude that the law does not significantly constrain block investors. This section of the paper attempts to supply empirical evidence that, on average, majority owners do not engage in self-dealing. The laboratory for this analysis is a sample of reorganizations where majority owners redeem the minority's shares. The supposition is that, if the law were no

constraint, such reorganizations would be infrequent and that, when they did occur, minority shareholders would receive small payments.

The reported evidence indicates that there is little difference in the reorganization frequencies of majority-owned and diffusely held firms.³ Additionally, it shows that the buyouts involve significant wealth transfers from majority owners to minority shareholders. One possible benefit to taking out the minority shareholders is the savings on direct costs of complying with SEC regulations, which are estimated to be worth between \$1.5 and \$4 million. This is considered briefly but readily dismissed as being too small. If we choose \$2.5 million as the savings, this represents about 7 percent of the median market capitalization of the firms controlled by individuals and over 10 percent of the median wealth transfer to minority shareholders. While not the sole determinant of the premia, these savings are not trivial.

This still leaves the question of why premia are paid at all if the majority owner is unconstrained and whether the treatment of minority holders in mergers is evidence that the law constrains majority owners in their day-to-day management. I think that Holderness and Sheehan are correct in concluding that it is fear of legal action that prevents majority owners from freezing out minority shareholders. Around the time from which their data are taken, there was a great deal of uncertainty as to the legal standing of minority shareholders. Gilson (1986) reports that, although the letter of the law provided minority shareholders with little protection, there was opportunity for interpretation that would benefit minority shareholders. He goes on to discuss the risk aversion of the lawyers structuring the deal relative to that of the majority owner. He suggests that the lawyers might have suggested paying off minority owners rather than face the likelihood of being associated with a failed or stalled deal.

There were also two new weapons added to minority shareholders' arsenal at this time. In *Singer v. Magnavox* (1977), the cost of litigating perceived self-dealing in mergers was reduced.⁴ Prior to *Singer*, shareholders had to act individually. *Singer* allowed for class actions. Additionally, in 1979, the SEC passed rule 13e-3, which required officers to state whether they believed the offer to minority shareholders to be fair. Making such statements opens the majority owners to possible legal actions.

Holderness and Sheehan consider the lack of self-dealing in merger transactions to be evidence that majority owners are constrained. If the null hypothesis is that the law is entirely toothless, self-dealing should be

3. An exception is that mergers are more likely for firms with corporate majority owners than for the control firms. A possible explanation for this is that many of the firms in this sample were carved out to facilitate an eventual merger. It would also include the firms that are eventually merged back into the parent company.

4. *Singer v. Magnavox Co.*, 380 A.2d 969 (Del. 1977).

as obvious in merger decisions as anywhere else. However, this is an arena where legal scrutiny is likely to be very great. This increases the likelihood that self-dealing will be detected and at least undone. Majority owners must also consider externalities such as reputation effects. This is not the most powerful experiment for detecting self-dealing.

Evidence that majority owners do not fleece minority owners when they redeem the latter's shares in mergers is not evidence that majority shareholders are constrained in their day-to-day management. Perhaps better evidence comes from the case law anecdotes. In fact, these instances of majority owners being caught with their hands in the till suggest that majority owners are constrained by the law. That is, there are certain activities that are not permitted.

Since the effectiveness of a law can be measured only with respect to instances of its application, the effectiveness of the law may well be a secondary consideration when the self-dealing propensity of majority owners is examined. Suppose that the law is fully effective. That is, in the event of exposed self-dealing, the majority owner is forced to pay damages and banned from ever owning a publicly traded firm again. You might think of Victor Posner, the former chairman of the DWG Corporation. In these cases, becoming a noticeable self-dealer is not necessarily the optimal course. Rather, a majority owner may decide to be less virulent and base consumption decisions on the likelihood of discovery and how much he is taking from minority shareholders. He can consume to the point where it is in no individual shareholder's interest to incur the costs of preventing it.

When we look at discovered self-dealers, we are observing the outcome of a process that equals one if they are caught and zero if they are not. However, self-dealing is not a discrete and dichotomous event. Think of it in the following context:

$$\begin{aligned} Z &= 1 && \text{if } z^* \geq L, \\ Z &= 0 && \text{if } z^* < L. \end{aligned}$$

The amount of self-dealing is given by z^* . The event that a self-dealer is caught and has legal actions directed against him corresponds to $Z = 1$. Whether the self-dealing is enough to trigger legal action depends on L , the level of self-dealing high enough to warrant legal action. This level of self-dealing will be a function of the gains that accrue to minority shareholders from ending the self-dealing and the costs of bringing legal action.⁵

Majority owners have a wide latitude of behaviors in which they can engage to their own benefit if L is high. L would be high if, for example,

5. This assumes that the minority shareholders act in concert. If they cannot act in concert, then the relevant gains are those to the largest holder in the minority-shareholder group.

class actions are not allowed or if the self-dealing is difficult to identify. In the latter case, I have in mind hiring your cousin's consulting firm to do some research, which would be difficult to classify as self-dealing, as opposed to buying your cousin a new yacht with corporate funds, which would be easy to classify as self-dealing. The problem with mergers is that L is probably low since the price paid to the minority can be compared to the price paid to the majority owner. This makes the law relatively effective in this case. A test of the effectiveness of this through time might be of interest. Examination of the levels and types of self-dealing that are caught would show whether L has been changing through time.

Holderness and Sheehan conclude that, while the law is not a perfect constraint, it is an important constraint on majority owners. I think that the law provides an upper bound on expropriation. Majority owners who stay below this bound will survive. The legal scholars' view that the law does not significantly constrain majority owners may just be a comment about their perception of where the upper bound should be. Holderness and Sheehan provide us with some evidence of where it is, which should help move the debate forward.

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