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The role and effect of controlling shareholders in corporate governance

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Abstract This paper examines two potentially contradictory effects of the presence of controlling shareholders. Controlling shareholders have been shown to be beneficial, as they generally have a long-term interest in the firm and are willing and able to monitor the actions of senior managers closely and decrease agency costs between shareholders and management (agency costs of Type I). However, they are also in a position to expropriate the firm's assets, especially when they are actively involved in management (agency costs of Type II). More specifically, this article reviews how regulatory and legislative bodies have tried to curb the consumption of private benefits by controlling shareholders while preserving the beneficial aspects of their long-term interest and their monitoring role, the effect controlling shareholders on the application and effectiveness of corporate governance best practices as well as on the executive and board member remuneration.

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1 Introduction

Throughout its history, the Journal of Management and Governance has published several papers on controlling shareholders. However, it never devoted a Special Issue to the different management and governance issues that are specific to corporations in which a shareholder or a group of shareholders hold a controlling interest. The JMG decided to remedy that situation in 2015 by devoting the Fourth JMG Conference to this research area. This Special Issue is a consequence of the Conference held at the Free University of Bozen-Bolzano (Italy) on 16–17 July 2015. The entire conference was dedicated to the phenomena related to the existence and effects of controlling shareholders considering a wide spectrum of settings, including large capital markets (not necessarily European) and family firms. The title of the international conference, *The Role and Effect of Controlling Shareholders in Corporate Governance*, is based on the belief that firms controlled (directly or indirectly) by a small number of shareholders are common in most countries, in the form of state-controlled firms in China, dual-class firms in Canada, members of pyramidal groups in Turkey or of Keiretsu in Japan, etc. The conference also aimed at covering two somewhat contradictory effects of controlling shareholders. First, they are in a position to expropriate some of the firm's assets, especially when they are actively involved in management, a situation that requires special governance systems and structures to protect minority shareholders. On the other hand, controlling shareholders have been shown to be beneficial as they have a long-term interest in the firm and they can monitor the actions of managers closely and decrease agency costs between shareholders and management.

The Berle and Means (1932) widely-held corporation has long been considered as the optimal structure to ensure the efficient use of scarce resources in the production of goods and services. The seminal work of Jensen and Meckling (1976), which serves as the foundation of a large part of the research in Corporate Governance, is based on the idea of the firm as a nexus of contracts between different stakeholders, each pursuing his/her own interests and none of which having the control (or the responsibility) of what goes on in the firm. Jensen and Meckling (1976) and a long line of research have explored this concept and concluded that this structure leads to inefficiencies, *agency costs*, and that some control is necessary to align the interests of the various stakeholders to the firm and maximize the efficiency of the firm's operation, namely corporate governance.

The agency costs described in the early literature on corporate governance stem from the separation of ownership and management in widely-held corporations. Because of the fragmented ownership, none of the shareholders has the incentive or the means to monitor the actions and decisions of the managers, who may act in their own best interest rather than in the interest of the firm. In the most recent literature, this conflict of interest between shareholders and managers is said to generate agency costs of *Type I* (e.g., Rubino et al., in this issue).

However, the widely-held corporation is not the most common ownership structure around the world. The Family Firm Institute, publisher of the *Family Business Review*, estimates that 85% of firms around the world are controlled by

members of a family and that 70–90% of the global GDP is generated by family firms (FFI 2016). And these figures do not include firms which are controlled by a state or those where an important share of the control rights is concentrated in the hands of a group of individuals without family relationship.

Unlike the shareholders of widely-held entities, controlling shareholders have both the incentive and the means to monitor the managers. The incentive comes from the fact that they have an important part of their wealth invested in the firm, which makes them more exposed to firm risk than other investors. They are in a better position to monitor the actions and decisions of the firm's managers either because they are personally involved in the daily operations of the firm or because they have personally chosen and hired the top managers and have the power to fire them if they deem it necessary.

Hence, the effects of the conflict of interest between managers and shareholders can be kept under control by the dominant shareholder(s) and agency costs of Type I can be minimised. Another type of conflict arises, however, between majority and minority shareholders, especially when a part of the shares of the firm are traded on public stock markets. The two groups of owners do not have the same objectives and the first group is in a position to extract private benefits from the firm, to the detriment of the second group. This conflict of interest can generate what is referred to as agency costs of *Type II*.

After this general presentation of the issues related to controlling shareholders, we first review how regulatory and legislative bodies have tried to curb the consumption of private benefits by controlling shareholders while preserving the beneficial aspects of their long-term interest and their monitoring role. It turns out that this evolution has varied widely across jurisdictions and has not always been linear. The second section briefly reviews the effect controlling shareholders on the application and effectiveness of corporate governance best practices, while the third section examines executive and board member remuneration in the presence of a (group of) dominant shareholder(s). In the last section of this introduction to the Special Issue, we present the papers that were chosen to be part of the issue from those presented at the Fourth JMG Conference.

2 Controlling shareholders and law quality

What explains the persistence of controlling shareholders around the world? During the second part of the 1990s and the beginning of this century, a series of much quoted and very influential papers argued that the efficiency of stock markets and the dispersion of shareholders are causally linked to the quality of law (La Porta et al. 1997, 1998). The argument was that when legal systems do not adequately protect minority shareholders, controlling shareholders can extract private benefits of control and investors are conversely discouraged from investing their money in companies (Johnson et al. 2000). Those papers classify legal systems into families and generally consider common law jurisdictions to be better, at least in terms of investor protection, than those with civil law systems. This classification generated an extended legal and economic literature on the scientific foundations and the

appropriateness of the distinction between the two types of legal systems (Dam 2007), so much so that some of the authors revisited the topic a decade after their first publications (La Porta et al. 2008).

The law and finance literature had a great impact on legislators. Many jurisdictions, some of them in the wake of a large scale Continental scandal concerning controlling shareholder's behaviour (Ferrarini and Giudici 2006; Melis 2005), introduced investor protection mechanisms that were considered to be particularly investor-friendly, even though many reforms looked more like a cosmetic attempt to change the law on the books than the law in practice (Armour et al. 2009; Giudici 2009). The introduction of the derivative action in Italy, aimed at improving Italy's position in corporate governance indexes, is a case in point (Giudici 2009).

But the equation between "bad law" and "controlling shareholder" and exploitation of minority investors faces a few problems. It is well known that some of the most efficient and less corrupted jurisdictions on earth lie around the Baltic Sea. In those jurisdictions the difference in value between controlling and minority blocks—a difference attributable to rents associated with private benefits of control (Dyck and Zingales 2004)—is very low. Yet, in those jurisdictions controlling shareholder are surviving pretty well, and dual class shares are very common (Nenova 2003), with dominant shareholders keeping control of the company through classes of shares with multiple voting rights.

Another facet of the Anglo-American corporate governance system is the "one share one vote" rule. International institutional investors do not like multiple voting rights, or other devices aimed at holding control and reducing corporate contestability and which are common in Continental Europe (Burkart and Lee 2008; Ferrarini 2006). Yet, those devices are recurrent in jurisdictions that would never be considered as weak from the point of view of the protection of minority shareholders. The migration of Fiat-Chrysler from Italy to the Netherlands, where multiple voting rights are allowed while they were not (at the time) in Italy, is a signal that there is another corporate governance world. This world is not disappearing under the force of evolution—as many law and finance devotees initially supposed—but it is surviving, and pretty well, at least in some countries (the Netherlands are not considered as a country with bad or ineffective laws). Nervous legislators reacted once again to the news. The realization that a big firm was migrating in order to offer to its controlling shareholders multiple voting rights seemed to contradict what the Italian government believed was the right direction to investor protection. Accordingly, after the ineffective introduction in 1998 of an Italian-style derivative action, the Italian legislator introduced the possibility of double voting rights for "loyal shareholders" in listed companies, and multiple voting shares for shareholders in private corporations, which could be kept in case of listing (basically adopting a dual class stock structure). This is just one example of the fact that regulations on corporate governance in Continental Europe are a mixed bag.

Hence, the history of company law is still evolving, and the controlling shareholder will continue to exist in the foreseeable future. Controlling shareholders are part of a trade-off between Type I and Type II agency costs. They can reduce

Type I agency problems through increased monitoring while increasing minority investors' exposure to private benefit extraction (Type II). There is no straightforward optimal solution, because controlling shareholders are different, depending on the legal environment and the industrial context (Gilson 2006; Gilson and Gordon 2003).

Thus, the existence of controlling shareholders cannot be simply explained as the consequence of bad law, but must to be studied, and the elements that influence the trade-off must be understood. The literature on controlling shareholders' costs and benefits is flourishing, both in Law and in Management and Governance journals (Faccio et al. 2010, 2011; Gilson and Schwartz 2013, 2015; Gutiérrez and Sáez 2015; Sáez and Gutiérrez 2015).

3 Controlling shareholders and corporate governance best practices

Codes of corporate governance best practice have been introduced in more than 90 countries since 1992 with the objective to minimize the effects of both Type I and Type II conflicts of interest (Cuomo et al. 2016). Although these codes vary in their specific aims and scopes, according to the specific environment of each country, some recommendations are common to a large portion of them. These include a combination of executive and independent members in the board of directors, the creation of committees to discharge some of the board's responsibilities in specific areas such as audit, nomination, and remuneration, the separation of responsibilities between chairperson and CEO, the rotation of board members and several other practices aimed at increasing board accountability and effectiveness, such as executive and board member remuneration schemes.

Most of these recommendations aim at protecting shareholders from potential opportunistic behaviour by managers (i.e., Type I agency problems) and it is not clear whether their implementation in closely-held firms is efficient. For example, by holding a majority of voting rights the controlling shareholder can unilaterally nominate all of the members of the board of directors and of the various board committees. These nominations can even be consistent with best practice recommendations about the independence of the board and its committees if the nominated members are neither managers of the firm nor part of the controlling shareholder's family but are linked to him/her by friendship or otherwise. In such circumstances, the "independent" board could approve decisions and transactions that are beneficial to the majority shareholders but detrimental to the minority shareholders.

Related party transactions are a real problem however, because it is often through related party transactions that controlling shareholders extract wealth from the firm (Enriques 2015; Enriques and Volpin 2007). Complex group transactions constitute an important part of this problem because, through operational control over the managerial decisions concerning group transactions, the controlling shareholder can move assets from one company to the other, favouring a group company where he holds 100% of the capital at the expense of group companies where minority shareholders are present. Corporate governance codes and, more generally, listing

rules in Continental Europe are therefore paying attention to the approval process and the disclosure of related party transactions.

It is therefore clear that the presence of controlling shareholders renders some of the standard best practice unnecessary because of the monitoring function that they can exercise through their direct involvement in the firm's operations, but it can also make other governance guidelines ineffective in curbing the rent extraction by some shareholders to the detriment of others.

Remuneration schemes have often been proposed as a way to align the interests of managers and directors to those of the firm and its shareholders, although their effectiveness is often put in doubt (e.g., Bebchuk and Fried 2005). We now examine their application in closely-held firms.

4 Controlling shareholders and remuneration schemes

The rapid increase of CEO remuneration in the US since the early 1980s has attracted considerable public scrutiny (Murphy 2013) and executive remuneration has become a popular topic in the business media as well as in the popular press. The recurring questions as to whether top executives, and especially CEOs, are over-paid and as to the best approaches to align their interests with those of the firm, its shareholders, and possibly its stakeholders, has also attracted the multidisciplinary attention of academic scholars.

Executive remuneration practices still vary around the world in terms of amount and design. US CEOs tend to get the highest levels of compensation, although only modestly more than their European counterparts after controlling for firm ownership, and board characteristics. Their remuneration is generally more tightly linked to firm performance than in most of Europe and Asia. A large part of the difference in cross-continental pay levels is attributable to the higher use of stocks and options in the United States (Murphy 2013).

Academic research on the topic of executive remuneration has a long history. Gomez-Mejia and Wiseman (1997) identify its origin in an empirical study by Taussig and Baker (1925) published in the *Quarterly Journal of Economics*. Although the academic literature has adopted multiple and diverse theoretical frameworks regarding executive remuneration, including institutional, stewardship and tournament theories, agency theory remains the most frequently adopted conceptual framework on the remuneration schemes (Boyd et al. 2012; Cuomo et al. 2016). On the one hand, some labour economists conceptualize executive compensation as being optimally designed by taking into account the perspective of shareholders' value (e.g., Hall and Liebman 1998; Murphy 2002; Gabaix and Landier 2008). On the other hand, corporate governance scholars often adopt a managerial power perspective that views the increasing difference between executive and average worker compensation levels in many countries (e.g., Cyert et al. 2002), the lack of a significant relationship between executive remuneration and firm performance (e.g., Bebchuk et al. 2002), and the relationship between poorly designed remuneration packages and lack of independence in the board's decision-making process in the design of the remuneration, as signs of corporate

governance failure (Bebchuk et al. 2002; Melis et al. 2012). Some of the most recent literature points out that these two theoretical perspectives do not necessarily represent competing explanations but ‘points on a continuum of types of contracting arrangements that can be encompassed within agency theory’ (Van Essen et al. 2015, p. 187).

While the literature on executive compensation is very rich, studies on independent non-executive director remuneration are relatively more recent and much more scarce (e.g., Boyd 1996; Goh and Gupta 2016; Mallin et al. 2015). The relatively few empirical studies are unable to disentangle the impact of the independent director’s advisory and monitoring roles on pay (Goh and Gupta 2016). Further studies seem required in the area of remuneration at the board level, as the incentives for improving the performance of board members as advisors are potentially different from those for serving the role of independent monitors effectively.

The early agency literature on executive remuneration generally assumes that the board of directors represents the shareholders as principals, without explicitly taking into account the relation of various board functions to remuneration (Kumar and Zattoni 2016). However, as there is no reason to assume that senior managers and executives automatically act in the shareholders’ interest, there is no reason to expect that directors will either (Bebchuk et al. 2002). Collusion between members at the ‘upper tiers’ does occur (Tirole 1986). For this reason, the most recent academic literature recognizes the self-interest of board members and the potential collusion between executives and directors, by setting up a ‘hierarchical’ agency problem with conflicts of interest between executives and shareholders as well as conflicts of interest between directors and shareholders (Cyert et al. 2002; Certo et al. 2008; Mallin et al. 2015; Kumar and Zattoni 2016).

The presence of a controlling shareholder seems to influence those conflicts and remuneration at the board level, as this shareholder is generally willing and able to wield power and monitor executives. This monitoring could reduce the need for incentives (i.e. cash-based or share-based remuneration) in the remuneration package of executives as well as constitute a constraint to ‘pay for luck’ (Bertrand and Mullainathan 2001). The presence of a controlling shareholder also seems to lead to a lower amount of pay for independent non-executive directors, who could be expected to exert less effort and bear less responsibility as monitors of the executives (Mallin et al. 2015).

However, the presence of a controlling shareholder could also exacerbate the agency problem as this shareholder could be willing and able to appoint him/herself as executive and use his/her power to extract private benefits from control, at the expense of minority shareholders. The remuneration received as executive could be a legal rent-extraction tool (Barontini and Bozzi 2011; Melis et al. 2012). In a similar perspective, an independent non-executive director’s remuneration could signal his/her collusion with the controlling shareholder, rather than his/her performance as independent monitor at the board level (Mallin et al. 2015). Therefore, executive and director remuneration can be the solution to an agency problem, but it can also contribute to the conflict of interest of Type II in firms whose ownership and control structure is characterized by the presence of a

controlling shareholder. More research is needed on how the presence of a controlling shareholder could influence this area of corporate governance, where there is a conflict of interest between executives, directors and shareholders.

Research in this area is likely to have important theoretical implications, but also practical (for both companies and investors) as well as policymaking implications, since closely-held firms are pervasive outside the few countries with a tradition of dispersed share ownership (US and the UK). Agency theory represents the underlying logic upon which the recommendations on corporate governance best practices are developed in the various codes of corporate governance worldwide (Cuomo et al. 2016).

5 The fourth JMG conference in Bolzano and the special issue

The prevalence of controlling shareholders in corporate ownership structures poses interesting research questions in the areas of Accounting, Corporate Law, Finance, Management, Organization Behavior, just to name a few. The multidisciplinary JMG Conference has been an ideal setting to discuss these issues, confront research findings and create new synergies for future research.

The Conference was proposed as an opportunity to discuss a large variety of issues under the same theme such as Corporate Governance, Dual-class shares, Director independence, Governance in family firms, Related party transactions disclosure, Minority shareholder protection, State-owned firms, as well as Gender issues in corporate governance and Shareholder activism.

The Conference was a complete success and a perfect environment to discuss the papers included in the program. Based on the call for papers, more than 30 papers were selected for presentation. The more than 50 participants (from three continents) had the chance to present and discuss their own paper and to profit from the relevant insights of the two plenary sessions: "Executive Remuneration and Controlling Shareholder" by Guido Ferrarini from the University of Genoa (Italy) and "Controlling Shareholders and Corporate Governance: an overview" by Jean Bédard from Laval University (Canada).

The Special Issue was initiated at the Conference in Bolzano and allowed us to select and review the four papers included here. It is a clear evidence of the richness and the variety of topics and approaches related to the issue of controlling shareholders. In our view, the four papers composing this Special Issue represent a good synthesis of the most relevant topics on the controlling shareholder phenomenon, such as executive remuneration, family firms, or firm performance.

In particular, Barontini, Bozzi, and Ferrarini have centered their analysis on the relationship between conformity to executive remuneration standards, corporate ownership, and the level and structure of CEO compensation for large European listed companies. From their findings, it emerges that controlled corporations conform to executive remuneration standards less than widely-held firms, but that weaker compliance is associated with lower CEO pay and more cash-based incentive structures. The authors conclude that the conformity gap reflects a lower

need for managerial incentives, given the monitoring by controlling shareholders, rather than the latter's willingness to extract private benefits of control.

The second contribution is centered on CEO turnover in family firms. In their study, Rizzotti, Frisenna, and Mazzone examine the impact of family ownership on the CEO turnover-performance sensitivity, examining two potential factors that can affect the ability of the family owners to ensure a prompt replacement of an underperforming CEO. The authors' findings support the hypothesis that family owners are able to ensure a prompt replacement of an underperforming CEO only when the CEO is not a family member but rather an outside professional.

Rubino, Tenuta, and Cambrea are also interested in family firms and they examine the effects of board characteristics on firm performance, through a comparison between family and non-family businesses. Using a multi-theoretical approach, they analyze the role of the board of directors in influencing the value of Italian listed firms over the period 2003-2013. The findings show that the presence of CEO duality and busy directors has a positive effect on the value of family firms, while gender diversity has a negative impact on value when a member of the family leads the family firm. Conversely, they find that the size of the board positively affects the value of non-family firms. They conclude that their main findings suggest the prevalence, in family firms, of the benefits of the board structure argued by stewardship and resource dependence theories rather than the disadvantages expected from agency theory.

In the last paper of the issue, Battistin, Bortoluzzi, Buttignon, and Vedovato examine the issue of controlling shareholders from the point of view of the investor who decide whether to acquire a majority in a private firm or to take only a minority position. They study the effects on performance and governance of the stakes acquired by the Private Equity investor. The findings suggest that Private Equity investments have a positive effect on profitability, sales, and employment but that the effects are larger for minority than for majority investments. This result seems to contradict the idea that controlling (majority) shareholders are beneficial for firm value.

Some other studies which have been proposed under the call for papers for the Special Issue will emerge as additional contribution to the debate as articles in the coming issues of the Journal of Management and Governance. This is another signal confirming the need to develop and stimulate a debate on the phenomena related to controlling shareholders that is far from exhausted. In this respect, we think that this Special Issue can draw the attention of scholars and encourage them to contribute in this area by submitting papers on the issues not yet covered.

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