EKONOMI OCH SAMHÄLLE

Skrifter utgivna vid Svenska handelshögskolan
Publications of the Swedish School of Economics
and Business Administration

Nr 127

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ESSAYS ON THE COSTS AND BENEFITS OF LARGE SHAREHOLDERS IN CORPORATE GOVERNANCE

Helsingfors 2004

Essays on the Costs and Benefits of Large Shareholders in Corporate Governance

Key words: Corporate governance, Ownership structure, Agency conflicts, Valuation, Controlling shareholders, Family firms, Multiple blockholders, Management turnover, Board turnover, Dividend policy

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http://www.hanken.fi

ISBN 951-555-829-8 (printed)
ISBN 951-555-830-1 (PDF)
ISSN 0424-7256

Yliopistopaino, Helsingfors 2004

Acknowledgements

I would like to thank my supervisors Professor Anders Löflund and Professor Eva Liljeblom, Head of the Department, for their guidance and insightful comments throughout the process of doing this research. I also wish to express special thanks to my co-author Anete Pajuste for the numerous discussions and debates on corporate governance issues.

I am grateful to my pre-examiners, Professors Marco Becht and Matti Keloharju, for their perceptive comments and suggestions. I was also fortunate to receive many insightful comments by Professor Tom Berglund.

This research was carried out at the Department of Finance and Statistics, HANKEN Swedish School of Economics. Visits to foreign universities and institutions in the early stages of my doctoral studies also shaped my thesis work. In particular, the courses on corporate finance and governance by Professors Erik Berglöf and Mike Burkart at the Stockholm School of Economics in fall 2000 greatly encouraged me to focus on corporate governance issues in my dissertation. The corporate governance topic turned out to be incredibly exiting.

I wish to thank all my colleagues at the Department of Finance. I had the pleasure to work with Mohammed Aba Al-Khail, Anders Ekholm, Olga Karakozova, Marko Maukonen, Alexander von Nandelstadh, Erkki Nikoskelainen, Daniel Pasternack, Jutta Rahikainen, Matts Rosenberg, Annika Sandström, Thomas Sandvall, and many others.

Financial support from Stiftelsen Svenska handelshögskolan, Stiftelsen för främjandet av värdepappersmarknaden i Finland, the OKO Bank Research Foundation, Finnish Academy of Sciences, Bergsrådet tekn. och ekon. doktor h.c. Marcus Wallenbergs stiftelse för företagsekonomisk forskning, Nordea Banks stiftelse, Nordisk Forskerutdanningsakademi, Emelie och Rudolf Gesellius fond is gratefully acknowledged.

Finally, I am grateful to my parents for their encouragement and support in this and all my projects.

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PART I: Theoretical framework and central findings

1. Introduction

A fundamental problem in corporate governance arises from trading off the costs and benefits of large shareholders.[1] The essential agency problem that stems from the separation of management and finance makes corporate governance mechanisms – such as e.g. large investors and the legal system – of significant practical importance.[2] Jensen and Meckling (1976) where among the first to formalize the idea of agency conflicts that arise when the entrepreneur sells a share of his fully owned firm.[3] Agency costs are incurred when the owner-manager departs from value maximizing decisions and when investors incur costs to monitor the manager. Following Jensen and Meckling (1976), the early generation of corporate governance research, mainly conducted on large US firms, focused on the conflicts between managers and dispersed shareholders. Taken together, corporate governance deals with economic and legal mechanisms to reduce agency problems.[4] Or, to put it another way: "Corporate governance is concerned with the resolution of collective action problems among dispersed investors and the reconciliation of conflicts of interest between various corporate claimholders" (Becht et al. (2002)).

Recent international empirical research on corporate governance, sometimes referred to as the second-generation research, has established the notion that corporate ownership structures and legal investor protection vary to a great extent around the

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[1] See Shleifer and Vishny (1997) for an excellent survey of corporate governance.
[2] See Hart (1995) for a discussion of why corporate governance matters when complete contracts are not feasible.
[3] Two classical studies, prior to the formal study by Jensen and Meckling (1976), are Adam Smith (1776) and Berle and Means (1932). Adam Smith gave an early warning of the problems with separation of ownership and control. Berle and Means returned to the problems with corporations being diffusely owned but controlled by managers in the US.
[4] Shleifer and Vishny (1997, p. 737) define corporate governance as follows: “Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment”. Denis and McConnell (2003, p. 2) define corporate governance as “the set of mechanisms – both institutional and market-based – that induce the self-interested controllers of a company (those that make decisions regarding how the company will be operated) to make decisions that maximize the value of the company to its owners (the suppliers of capital).

world.[5] Cross-country comparisons by Franks and Mayer (1995), European Corporate Governance Network (1997), La Porta et al. (1999), Barca and Becht (2001), and Faccio and Lang (2002) show that corporations outside the US and the UK typically are controlled by a few large shareholders, often the founding families or their offspring.[6] Moreover, the controlling shareholders often have managerial representation. La Porta et al. (1998) show that the patterns of corporate ownership vary with the degree of legal shareholder protection.[7] These studies highlight the potential conflicts of interest between controlling shareholders and other investors and stakeholders.[8] This problem may arise for two principal reasons. The first reason is that the law does not effectively protect the rights of minority shareholders. The second reason is that the governance structure in many countries potentially makes dominant shareholders – those with a majority of the votes and often managerial representation – impervious to takeover threats and monitoring (e.g., Gomes (2000)).[9] Stulz (1988) theoretically analyzes the impact of managers' control of voting rights and finds that an increase in the fraction of votes controlled by the management decreases the probability of a successful tender and, in so doing, reduces the effectiveness of internal monitoring efforts. On the other hand, large nonmanagement shareholders can facilitate takeovers, since even when they are not large enough to monitor the manager they can facilitate third party takeovers (Shleifer and Vishny (1986)).

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[5] The recent emphasis on the roles of large shareholders is a result of better data and new collection efforts. Improved international disclosure standards have made data on ownership outside the US more readily available. See Denis and McConnell (2003) for a comprehensive survey of international corporate governance.

[6] Faccio and Lang (2002) report that 44 % of Western European firms are controlled by families and 37 % are widely held, using 20 % of votes as the threshold for control. Barca and Becht (2001) report that in 50 % of the firms in Austria, Belgium, Germany, and Italy a single blockholder controls more than 50 % of the votes, whereas in half of the Dutch, Spanish, and Swedish firms the largest blockholder control about 44 %, 35 %, and 35 % respectively. In contrast, the largest block holds only 9.9 % (median) of the votes in UK firms.

[7] See La Porta et al. (2000a) for a survey of the role of investor protection in corporate governance.

[8] See Pagano and Röell (1998) and Gomes (2000) for theoretical studies on this conflict of interest.

[9] In certain situations other large shareholders may monitor the largest shareholder. See Maury and Pajuste (2004).

Large ownership stakes are motivated, despite the forgone benefits of diversification, for two main reasons.[10] On the one hand, there are shared benefits of having dominant shareholders in control. These benefits, enjoyed by all shareholders, arise from the improved monitoring of top managers. Theoretical models, such as Shleifer and Vishny (1986), emphasize the value of a large shareholder.[11] On the other hand, dominant shareholders enjoy private benefits from being in control. These benefits can be either non-pecuniary or pecuniary. Non-pecuniary benefits include for instance the amenity of being in control (Demsetz and Lehn (1985)). The pecuniary benefits from being in control can be described as expropriation of minority shareholders.[12]

One feature of large shareholders compared to other shareholders is that they often have more control rights than cash-flow rights. Such control enhancement can be arranged through high-voting share classes and pyramid control structures.[13] La Porta et al. (1999) argue that these kinds of control arrangements are particularly common in countries with lower shareholder protection. Claessens et al. (2002) empirically document that excess control rights can lead to entrenchment effects by showing that entrepreneurial control of voting rights is inversely related to valuation, while cash-flow rights are positively related to the valuation of firms in several East Asian countries.

The managers' or the controlling shareholders' expropriation of other investors is limited by two principal mechanisms.[14] First, the legal shareholder protection in a country as well as the enforcement of these laws function as a remedy to agency

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[10] Holderness (2003) surveys the literature on blockholders from a US perspective.

[11] Empirical studies on the monitoring role of large shareholders include, e.g., Morck et al. (1988), McConnell and Servaes (1990), and Wruck (1988).

[12] See Johnson et al. (2000) and La Porta et al. (2000a) for discussions of minority shareholder expropriation.

[13] See Bebchuk (1999) for a theoretical discussion of the ways to enhance control. Grossman and Hart (1988) and Harris and Raviv (1988) analyze the optimal allocation of voting and cash-flow rights in a firm.

[14] Other important mechanisms that can reduce the expropriation of minority investors, but that are unlikely to solve the governance problems alone, include product market competition and the manager's or controlling shareholder's reputation. See Shleifer and Vishny (1997) on the role of competition and Gomes (2000) on effects of reputation. Alternative control mechanisms include the board of directors (see Hermalin and Weisbach (2003) for a survey), executive compensation (surveyed by Murphy (1999), and, as proposed by Becht et al. (2002, p. 5), "clearly defined fiduciary duties for the CEOs together with class-action suits that either block corporate decisions that go against investors' interests, or seek compensation for past actions that have harmed their interests".

problems (La Porta et al. (1998)).[15] Second, the financial incentives associated with cash-flow ownership reduce the owner manager's or controlling shareholder's interest in expropriating other investors (e.g., Jensen and Meckling (1976)). Therefore, a good corporate governance system consists of some combination of large investors and legal protection of these large investors as well as small investors. These large investors include controlling shareholders, large creditors, and even takeovers. Empirical research shows that firms operating in countries lacking good legal investor protection often have more concentrated ownership structures (La Porta et al. (1998)), suggesting that large shareholders have a pronounced role when investors are less protected.

While the literature has gone far in showing the prevalence of large shareholders in many countries and stressing the importance of the legal investor protection for the governance of firms, a much lesser part of the literature has considered the role of different types of large-block owners and the interaction between such large shareholders. Holderness and Sheehan (1988) conclude that the identity of individual large shareholders is potentially important for understanding the concentration of corporate ownership. Although there are many models on how several large shareholders can influence the extraction of private benefits of control and consequently firm performance, little empirical evidence exists on how the contestability of control affects firm performance. To what extent different types of individual large shareholders affect the level of control contestability is also an undeveloped issue in the literature. Empirically, La Porta et al. (1999) and Faccio and Lang (2002) show that traded firms typically have one or a few controlling shareholders. Thus, a closer analysis on these individual large-block owners in control is warranted.

The thesis consists of four separate essays that focus on the costs and benefits of large-block owners in corporate governance in different contexts. In the first essay, I compare the performance and valuation of Western European family-controlled firms to

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[15] The legal protection of both outside shareholders and creditors is the highest in common-law countries and the lowest in French civil-law countries. German civil-law and Scandinavian civil-law countries fall between these two types. Moreover, the quality of law enforcement is the highest in the Nordic countries and German civil-law countries, followed by common-law countries, and it is the lowest in French civil-law countries.

the performance of firms with external controlling shareholders such as banks, corporations or the government. In particular, I investigate whether continued family control in publicly traded corporations hurt firm performance. This essay is based on a comprehensive and large data set on ultimate ownership in Western European firms.

The following three essays explore the roles of large shareholders in Finnish traded corporations. In the second essay, we explore the impact of multiple large shareholders on firm valuation. The paper extends the model in La Porta et al. (2002) into a multiple controlling shareholder framework and tests the effect of different degrees of control contestability on firm valuation. In the third essay, I make an assessment of the efficiency of the Finnish corporate governance system by analyzing whether managers and board members are replaced in response to poor stock performance and low cash flows. I focus on the governance roles of different types of blockholders by distinguishing between insiders and outsiders as well as considering different types of outside shareholders. In the fourth essay, we extend the analysis of La Porta et al. (2000b), who relate a country's legal shareholder protection to firms' dividend payouts, by exploring the role of large shareholders on dividend policy. The essay focuses on the potential conflicts of interest between large shareholders and minority shareholders.

The rest of the introduction to the essays proceeds as follows. Section 2 presents a brief theoretical framework for each essay by reviewing important papers on each topic. Section 3 discusses the contribution of the thesis and presents the main results in the essays.

2. Theoretical background

This section presents a brief theoretical framework for each essay.

2.1. The performance of family-controlled firms

A large fraction of publicly traded firms in the world are controlled by their founding families, or the founders' families. Such family ownership is prevalent in Western Europe, Middle East, Latin America, and Africa (La Porta et al. (1999), Claessens et al. (2000), Faccio and Lang (2002)). Despite the fact that recent research shows how common family ownership is, little is known empirically on how family involvement in European corporations affects the way the firm is run and valued in the market.

Fama and Jensen (1983) suggest that family firms should have lower agency costs because family members have advantages in monitoring the management.[16] In particular, Fama and Jensen (1983, p. 7) propose, "family members have many dimensions of exchange with one another over a long horizon and therefore have advantages in monitoring and disciplining related decision agents". Since the founding family often has a large fraction of their wealth directly tied to the firm, family members have strong cash-flow incentives to monitor the firm closely (e.g., Jensen and Meckling (1976)). In addition, family members often have better information about business operations than outside investors. This information advantage makes it easier to monitor the firms' management and operations.

There are also potential costs to outside shareholders when a family stays in control of a public firm. First, large family owners, often with a large fraction of their wealth tied to the firm, may have private benefits of control that are not shared with outside shareholders (e.g., Shleifer and Vishny (1997)). Second, large shareholders, such

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[16] Anderson and Reeb (2003) find that firm valuation is higher for family than for nonfamily firms in the US.

as families, may stay in control of the firm although they are no longer competent to run the firm (Burkart et al. (2003), Shleifer and Vishny (1997)).[17]

2.2. Large shareholder interactions

Faccio and Lang (2002) show that 39 percent of Western European firms have at least two large shareholders holding at least 10 percent of the votes, and 16 percent of the firms have three large shareholders. Therefore, it is important to study the impact of large shareholder interactions on firm valuation. Existing literature discusses some aspects of multiple blockholder interactions. For instance, Gomes and Novaes (1999) argue that ex-post bargaining problems among large shareholders protect minority shareholders because these bargaining problems prevent large shareholders from undertaking actions that would harm minority shareholders. Bennedsen and Wolfenzon (2000) explore the formation of coalitions between large shareholders, and suggest that the best ownership structure is one with either a single large shareholder or shareholders of roughly the same size. In the model of Bloch and Hege (2001), two blockholders compete for effective control in a company. They argue that the relevant concept of control power is how contestable the leading shareholder's position is, and not only how concentrated the voting rights are. Bloch and Hege (2001) and partly Bennedsen and Wolfenzon (2000) argue on theoretical grounds that increased control contestability is beneficial for outside shareholders.

Pagano and Röell (1998) argue that the feasibility of cooperative behavior between several large shareholders depends on the regulatory environment. They claim that a stronger legal investor protection promotes cooperation among external shareholders, such as setting the optimal level of monitoring of management. Pagano and Röell (1998) also claim that a higher legal investor protection hinders collusion between the entrepreneur and potential monitoring shareholders. Thus the presence of large

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[17] In their study of Canadian firms, Morck et al. (2000) find that heir-controlled firms have lower performance than comparable firms. Perez-Gonzales (2001) present evidence that inherited control is inferior to professional management in a sample of 162 family transitions in the US.

minority shareholders may benefit dispersed shareholders in environments with better legal protection, and harm dispersed shareholders in countries with weaker shareholder protection.

2.3. Controlling shareholders and top management restructurings

One way to assess the quality of the corporate governance system in a country is to investigate the relationship between top executive turnover and firm performance. A necessary condition for a successful corporate governance system is that managers are replaced in response to poor stock performance and low earnings (e.g., Gibson (2003), Volpin (2002)). The first studies on the effectiveness of internal monitoring mechanisms to replace poorly performing managers in the US are Coughland and Schmidt (1985), and Warner, Watt, and Wruck (1988), followed by several international studies.

The ownership structure of the firm can affect the functioning of internal control mechanisms and the replacement of managers. Kaplan and Minton (1994) and Kang and Shivdasani (1995) show that Japanese firms with large shareholders are more likely to replace poorly performing managers than firms without them. Denis et al. (1997) show that US firms with an outside blockholder have higher turnover / performance sensitivity. Renneboog (2000) shows that large corporate and family shareholders increase top management turnover in Belgian firms. For Italy, Volpin (2002) finds that the sensitivity between executive turnover and performance increases with the ownership rights held by the largest shareholder. In addition, Volpin (2002) finds that turnover is more sensitive to performance when a voting syndicate controls the firm. Volpin (2002) suggests that the higher sensitivity is due to higher control contestability in case of a voting syndicate consisting of a coalition of shareholders. In sum, these studies suggest that large outside shareholders play an important monitoring role in corporate governance.

High levels of managerial ownership may make it difficult to replace poorly performing managers. For US, Denis et al. (1997) show that higher levels of executive ownership decrease the sensitivity of the performance / turnover relation. Volpin (2002) shows that firms whose top executives come from the controlling family experience lower management turnover in response to poor performance.

2.4. Large shareholders and dividend policy

Agency models of dividends set out to explain how agency problems affect the firm's dividend payout policy. The agency approach to dividends departs from Miller and Modigliani (1961), who showed that the dividend policy is irrelevant in a world without taxes, transaction costs, and market imperfections when investment policy is held constant, in two ways as argued by La Porta et al. (2000b). Firstly, the firm's investment policy cannot be viewed as independent of its dividend policy, and dividend payouts may even reduce the inefficiency of marginal investments. Secondly, the distribution of profits to shareholders on a pro-rata basis cannot be taken as given because insiders, such as controlling shareholders or managers, may treat themselves preferentially at the cost of outside shareholders by expropriating retained earnings even when investment policy is held constant. Therefore, outside shareholders may have a preference for dividends over retained earnings.

La Porta et al. (2000b) classify existing agency models of dividends into two groups: those considering dividends as an outcome of the agency problems on the one hand, and models taking the view that dividend policy is a substitute for agency problems on the other hand. In support of the outcome model of dividends, La Porta et al. (2000b) find that firms operating in countries with low shareholder protection pay lower dividends due to more agency problems between controlling shareholders and outside shareholders than in countries, such as the UK and the US, where investors are better protected. Faccio et al. (2001) find that another large shareholder mitigates agency conflicts in European firms, whereas multiple controlling shareholders intensify the agency problems in East Asian firms, because, as Faccio et al. (2001) interpret it, they tend to collude in expropriating outside shareholders by paying lower dividends. Gugler and Yurtoglu (2003) claim that dividend payouts decrease with an increase in the voting power of the largest shareholder, whereas the size of the second largest shareholder is positively related to dividend payouts in German listed firms.

According to the substitute model of dividends, dividend policy can be seen as a substitute for conflicts of interest between insiders and outsiders. Zwiebel (1996) argues that managers voluntarily pay dividends in order to avert challenges for control. In a

related paper, Myers (2000) proposes that managers can continue in their current positions only if outside equity investors believe that corporate insiders will pay future dividends.[18] Gomes (2000) claims that managers or controlling shareholders can develop a reputation for treating outside shareholders well, which would reduce the agency costs in the firm. Easterbrook (1984) proposes that dividends may keep firms in the capital market where the monitoring of managers is available at lower cost. The substitute models of dividends rely on the need for firms to utilize the external capital markets to raise funds. To be able to raise funds on attractive terms, the controlling shareholder or manager must establish a reputation for not expropriating outside investors.

2.5. Summary of research focus

The aim of this dissertation is to explore the role of large shareholders in corporate governance. One central theme in the essays is how the type of the controlling shareholder influences the operations and performance of the firm, and how multiple large shareholders interact with each other. I explore the impact of large shareholders in corporate governance by addressing four broad questions that have received little attention in the literature. First, are there systematic performance differences between family-owned and nonfamily-owned firms in Western Europe? Second, what is the empirical relation between the contestability of the firm's control structure and its valuation? Third, how do corporate governance forces, such as large shareholders and their type, as well as the degree of control contestability affect the sensitivity between top management turnover and firm performance? Fourth, how does the governance structure affect the dividend policy of firms?

[18] An alternative method to distribute cash is to repurchase shares.

3. Contribution and summaries of the main findings in the Essays

3.1. Overview of contribution

La Porta et al. (1999, p. 5) propose the following research agenda: "the theory of corporate finance relevant for most countries [such as the Nordic and Western European countries] should focus on the incentives and capabilities of controlling shareholders with large equity stakes to pursue strategies that benefit them at the expense of the minority shareholders". Holderness (2003, p. 10) suggests that because of the richness of blockholders "the literature on blockholders and corporate control will continue to grow, and with it our understanding of the modern public corporation will deepen". Accordingly, it is along these lines that this thesis provides new empirical evidence on the role of large shareholders in corporate governance. Moreover, the dissertation develops new concepts on the roles of multiple large shareholders in firms.

Essay 1 is the first paper to focus explicitly on the valuation and profitability of Western European firms that remain family owned and controlled. The paper is inconsistent with the general hypothesis that continued family control would hurt firm valuation as suggested by e.g. Morck et al. (2000) and Perez-Gonzales (2001). In contrast to that hypothesis, the results show that family-controlled firms outperform firms with nonfamily blockholders in Western Europe.

Essay 2 extends the theoretical model in La Porta et al. (2002) with some added features to illustrate the effects of interaction between multiple blockholders. The model discusses situations, holding the legal setting constant, when large minority shareholders may choose to collude with the entrepreneur / controlling shareholder and when they might monitor the controlling shareholder. The paper provides new empirical evidence on how increased control contestability of the leading shareholder's position can improve firm valuation.

Essay 3 is the first paper to provide evidence on the role of large shareholders in restructuring the top management in response to poor performance in Finnish traded firms. Large outside blockholders increase the CEO turnover sensitivity, while large CEO blockholdings reduces this sensitivity. Evidence of different external owners is also

provided. In addition, the paper shows that firm performance is a determinant of new board appointments. In sum, the ownership structure is important for the contestability of the incumbent top management's position.

Essay 4 sets out to test how the conflicts of interest between insiders and outside investors affect the dividend payout levels in Finnish firms. This study extends La Porta et al.'s (2000b) study on the relation between investor protection and dividends by providing new evidence on how large-block owners affect dividend payouts in Finnish traded corporations. The evidence supports the so-called outcome agency model of dividends by showing that potentially large conflicts of interest between controlling shareholders and minority shareholders are associated with lower payout ratios.

3.2. Main results in the essays

In the first essay, "Family Ownership and Firm Performance: Empirical Evidence from Western European Corporations", I analyze how firms that remain owned and controlled by families perform in relation to nonfamily block-owned firms in Western Europe. The study is motivated because the majority of Western European publicly held firms remain family-controlled (La Porta et al. (1999), Faccio and Lang (2002)). The founding families hold large equity stakes and frequently have executive representation. Despite the vast amount of capital these family owners administer, little is known about their impact on the valuation and profitability of public corporations.

Using a sample of 1452 publicly traded Western European listed firms, I present cross-sectional evidence on the performance of Western European family-controlled corporations. The results show that corporations that are family-owned and family-controlled perform significantly better measured by both profitability (ROA) and market valuation (Tobin's q) than firms controlled by more distant owners such as widely held banks and corporations, or the government. The results also show that the higher valuation of these family firms is not sensitive to whether we consider family ownership or family management. However, the superior profitability of family firms compared to firms with other types of large shareholders appears to be driven by family owners with managerial ties. Moreover, family-managed firms are more profitable than family-

controlled firms in which the family does not have managerial representation. When the sample is divided into countries with below median shareholder protection, and median level and above, the results show that family involvement in the management of the firm is more beneficial in countries with low legal shareholder protection. Indeed, this is the legal environment where management often stays within the controlling family (see, e.g., Burkart et al. (2003)).

Prior research offers some explanations of why family control might be beneficial in firms. First, large shareholders, often with executive representation, have advantages in disciplining and monitoring the management team (e.g., Demsetz and Lehn (1985), Shleifer and Vishny (1997)). Second, family controlling owners are less likely to forgo valuable investment projects in favor of short-term profits due to their long-term presence in the firm (e.g., James (1999), Stein (1988, 1989)). Taken together, the positive effect of family-controlled firms found in Western Europe suggests that family firms are better controlled in general than firms with other types of owners and that the benefits with large family shareholders outweigh the costs with potential conflicts of interest between them and outside shareholders, employees, and managers.

In the second essay, “Multiple Controlling Shareholders and Firm Value”, I and Anete Pajuste explore the impact of multiple controlling shareholders on firm valuation. The basic model in the paper, which is an extension of the model in La Porta et al. (2002), focuses on control contestability. The model generates three testable hypotheses. The first hypothesis states that an increase in the contestability of the controlling coalition’s control power should increase firm value. The second hypothesis implies that a higher divergence between votes and cash-flow rights held by the controlling coalition should lead to lower valuations. The last hypothesis states that firm value should decrease if the controlling coalition is formed by blockholders who can jointly reduce the marginal cost of extracting private benefits. We test the implications of the model using a sample of 136 nonfinancial Finnish listed firms with at least one controlling shareholder during the period 1993 to 2000.

When measuring control contestability with Herfindahl indices, we find that lower concentration of control rights and smaller differences in the blocks of the largest shareholders are associated with higher firm valuations. We also find that the Shapley

value of the largest shareholder is negatively related to firm value. Using a dummy variables approach, we document that the presence of a third blockholder is positively related to firm value when control in the firm is to some extent contestable, i.e. when the two largest blocks cannot form a voting majority. In addition, we investigate the impact of having votes in excess of cash-flow rights on firm value, and find that firm value decreases with the amount of excess control rights held by the largest shareholder. This could mean that the lower firm value is due to potential agency problems that are associated with higher control rights (more discretion in the extraction of private benefits) and lower cash-flow rights (less interest in security benefits) by the largest shareholder.

To examine to what extent our results are driven by the type of the large shareholder, we differentiate between family and nonfamily firms and owners. We find that a higher voting stake held by another family owner penalizes firm value in family-controlled firms, whereas a higher voting stake held by another nonfamily owner improves firm value in family-controlled firms. These results suggest that the incentives to collude with the controlling shareholder or to monitor the controlling shareholder are affected by the type of the individual owner. Moreover, these results suggest that different types of large minority shareholders seem to have different costs for extracting private benefits.

The evidence presented in this paper expands our understanding of the link between a firm's control structure and its performance by showing that multiple large shareholders may play an important role in corporate governance. The relative size and type of blockholders appear to be important cross-sectional determinants of firm value. This issue is important because the presence of multiple controlling blocks is common in Finland and the rest of Europe with the exception of the UK (Faccio and Lang (2002)). Taken as a whole, our results suggest that the contestability of the leading shareholder's position can limit the expropriation of dispersed shareholders.

In the third essay, "Corporate Performance, Controlling Shareholders, and Top Executive Turnover in Finland", I examine the impact of corporate governance forces and firm performance on top executive restructurings in Finnish listed companies. The analysis starts with assessing the relationship between top executive turnover and firm performance in Finnish listed firms. Then, I evaluate how the firm's corporate

governance structure affects the sensitivity of the relation between performance and top executive turnover. The corporate governance structure is measured by the presence of large shareholders, the degree of control contestability, and the separation of ownership and control. In addition, I analyze the link between board turnover and firm performance to further shed some light on the role of large shareholders. In this study, the focus is on the balance of power among corporate insiders and the power of insiders in relation to outside investors.

Empirically, I document an increase in CEO, top management, and board turnover in response to poor stock price performance and operating income losses. Furthermore, I find that outside blockholders, who are not top managers or board members, significantly increase the stock performance / CEO turnover sensitivity. This effect is mainly due to institutional and corporate blockholders. This result suggests that large outside shareholders perform a monitoring and disciplinary role in Finnish listed firms. In contrast to the monitoring role by outside blockholders, CEO blockholdings and family blockholdings are associated with lower CEO turnover following poor performance.

I also find an inverse relation between operational management board restructurings and firm performance. However, the ownership structure had little impact on the sensitivity of the performance / operational top management turnover relation. In addition, I document an increase in new board appointments following performance declines. This relation is strongest for firms with outside blockholders.

This paper can be summarized as follows. First, there is an inverse relation between CEO, management, and board turnover and firm performance. Thus the Finnish corporate governance system is not inefficient, because badly performing executives and director are likely to be replaced. Second, the ownership structure of the firms is especially important for the CEO replacement decision. Outside blockholdings increase, while CEO blockholdings decrease, the performance / turnover relation. Hence, the contestability of the incumbent CEO's position is important for the functioning of the governance system. Large outside shareholders seem to serve an important governance role.

In the fourth essay, “Controlling Shareholders, Agency Problems, and Dividend Policy in Finland”, I and Anete Pajuste analyze the impact of large-block owners on dividend payout ratios in Finnish traded corporations. A key idea in the agency approach to dividends is that unless a firm’s cash is paid out to shareholders on a pro-rata basis, corporate insiders – such as managers and controlling shareholders – may divert it in ways that benefit themselves only to the detriment of minority shareholders.

We start our analysis by describing the ownership and control structures of Finnish firms. We show that the median voting power of the largest shareholder is 33.2 percent which is much higher than in common law countries such as the UK (9.9 percent) and the US (5.4%), but slightly lower than in eight continental European countries (44%).[19] We also find that the most common controlling owner category is private persons. In many cases these private owners have managerial and/or board representation, which suggests that they have a strong say in deciding what proportion of earnings to pay out as dividends. Therefore, the minority shareholders are potentially the victims of controlling shareholders’ potential interest in diverting the firm’s profits into private benefits instead of paying them out on pro-rata basis.

Using a sample of 127 publicly traded Finnish firms, we provide cross-sectional evidence on the impact of the ownership structure on dividend payout ratios. We find that the concentration of votes is significantly negatively related to the firm’s dividend payout ratio. In addition, we find that the voting stake of another large shareholder – if it holds 20% or more – is negatively related to dividend payout levels. Thus, the results indicate that the largest and second largest shareholder may collude in extracting private benefits of control.

Our results also suggest that the type of the controlling shareholder affect the dividend policy differently. When the CEO is among the three largest shareholders the firm has lower dividend payouts. However, ultimate private controlling shareholders in general tend to be associated with higher dividend levels.

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[19] Comparative figures are from Barca and Becht (2001).

We conclude that a firm's ownership and control structure affect the dividend payout policy in Finnish listed firms. In addition, lower dividend payout levels that are associated with high control concentration suggest that there are private benefits of control that are not shared with minority shareholders. Taken together, our results suggest that dividend payouts are lower in firms with potentially high agency problems between corporate insiders and outside investors. This essay appeared in the *Finnish Journal of Business Economics* 1, 2002.

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