

Ownership Structure

1. Introduction

Economists have argued recently that the public corporation is an outdated way of organizing economic activity. Michael JENSEN (1989), for example, posits that new organizational forms, without public ownership, will emerge. According to Jensen, these organizations will be more efficient because they avoid the main drawback of the public corporation: the conflict of interest between managers and shareholders over the use of corporate resources. Jensen's observation is particularly relevant since central and eastern European countries are moving from centrally planned economies to market economies, and must decide how to allocate stakes in government owned enterprises to the general public. The choice of ownership structure will significantly affect the development of these emerging economies.

A recent study by Morgan Stanley forecasts a \$100 billion wave of privatizations in western Europe.[1] This surge in the number of privatizations, both in the east and west, raises questions about the impact of ownership structure on the performance of the

firm. By privatizing state enterprises, decision-makers hope to achieve a more efficient allocation of scarce resources throughout the economy. With this perspective in mind, MEGGINSON/NASH/VAN RANDENBORGH (1993), compare the pre- and post-privatization performance of a sample of 61 firms from 18 countries that went private over the 1961-1990 period and find strong improvements in profitability and operating efficiency. Moreover, these improvements are achieved without adverse effects on employment and capital investment.

Obviously, privatizations represent by far the most dramatic change in ownership structure. The ownership structures of currently existing publicly traded corporations, however, are by no means similar. In this paper, we examine the effect of ownership structure on the value and performance of the firm. Evidence from studying ownership structure in market economies in general, and in the United States in particular, indicates that ownership structure has a critical impact on firm value. To keep the size of this article manageable, we focus on the ownership structure of U.S. firms and take other governance and control mechanisms (such as monitoring by the board of directors and takeovers of poorly performing firms) as given.

The remainder of this article is structured as follows. In section two, we discuss the relation between firm value and ownership by insiders (managers and directors). We also review and analyze the evidence on firms with dual classes of shares,

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Leveraged Buyout (LBO) organizations and leveraged recapitalizations. Dual class recapitalizations, LBOs and leveraged recapitalizations are important events because they typically lead to higher managerial ownership or control. In section three, we discuss the role of outside equity ownership and pay particular attention to the role of block owners, institutional investors and commercial banks. We also contrast the ownership structure of Japanese and American companies and comment on their relative strengths and weaknesses. Finally we discuss some evidence on new monitoring mechanisms by individual shareholders. We provide concluding comments in section four.

2. The role of inside equity

2.1 Theory of the firm

Financial economists view the modern corporation as an organization in which a number of atomistic shareholders (the principals) pool their resources, and contract with a manager (the agent). The agents allocate these resources to economic activities on behalf of the shareholders, with the purpose of maximizing shareholder wealth. In this context, FAMA (1980), and FAMA/JENSEN (1983a) emphasize the role of the outside directors as monitors of top managers. FAMA (1980), describes the firm as a collection of contracts between risk averse managers who make the firm's decisions, and risk neutral shareholders who bear the risk, and characterizes the outside members of the board of directors as the referees between these two parties. BERLE/MEANS (1932) suggested that such an organizational form is wrought by conflicts of interest between managers and shareholders. Managers, not being shareholders themselves, do not have the incentives to place the well-being of shareholders above their own, whereas shareholders are small and dispersed and, therefore, do not have the incentives to expend resources to monitor or discipline managers. BAUMOL (1959), MUELLER (1969), and JENSEN (1986), among others,

further develop this argument. They note that managers derive non-pecuniary benefits from growth, and thus refuse to disgorge cash that cannot be invested profitably to shareholders. Instead they invest it in projects that decrease shareholder wealth, but increase the size of the firm.

If managers own equity in the firm, however, managers' incentives may be more aligned with the shareholders', and the above agency conflict may be reduced. JENSEN/MECKLING (1976) analyze the impact of managerial share ownership on the value of the firm starting from the viewpoint of an entrepreneur who is selling a stake in the firm to outside investors. As the entrepreneur reduces her/his ownership stake in the firm, the cost of on-the job consumption to the entrepreneur declines proportionally. Outside investors, however, understand this cost and will reduce the value of the firm as the fraction offered for sale by the entrepreneur increases. In sum, their model suggests a positive relation between firm value and the fraction of shares owned by the entrepreneur. Jensen and Meckling argue that shareholders can monitor the entrepreneur, at a cost, to prevent her/him from consuming on the job, or, alternatively, that the entrepreneur can bond herself/himself not to engage in this behavior. Both mechanisms make firm value less sensitive to changes in insider ownership.

Several authors argue that other mechanisms exist to align the interests of managers and shareholders in the absence of managerial share ownership. MANNE (1965) suggests that the external market for corporate control, i.e. the takeover market, will discipline managers if they perform poorly. That is, poorly performing firms are taken over and their managers are displaced. Other markets controlling managers are the managerial labor market (e.g., FAMA (1980)), product markets (e.g., HART (1983)) and capital markets (e.g., EASTERBROOK (1984) and ROZEFF (1982)). Competition in the labor market, for instance, ensures that the most capable managers eventually become chief executives. Should a manager deviate from shareholder wealth maximization, several other candidates will be waiting to take her/his job. Competition in pro-

duct markets ensures that the demand for products of less efficient firms will decline rapidly. This decline would force these managers to run the company more efficiently, and thus reduce agency costs.

DEMSETZ (1983) and FAMA/JENSEN (1983a, 1983b) extend this line of thought, and argue that the corporate structure we observe is the result of the tradeoff between the costs and benefits of different alignment mechanisms and, therefore, is optimal. That is, any change in ownership structure that could lead to an increase in the value of the firm has already been implemented. This reasoning implies, in turn, that the reallocation of a firm's share ownership will not increase the value of the firm. The argument that the ownership levels we observe are endogenous, is difficult to refute. It is possible, however, that the structure being observed maximizes the joint benefits of all parties involved, but that it does not necessarily maximize shareholder wealth. Instead, the structure may maximize the utility of the managers, personnel, or even local or national government officials (e.g., GRUNDFEST (1990)). The above arguments are based on the incentive effects of managerial ownership. More specifically, when managers own a larger fraction of the firm, the agency problems between managers and shareholders are reduced because the managers have a larger proportion of their wealth tied to the value of the firm's equity. Conversely, STULZ (1988) highlights the non-pecuniary benefits of control. These are, for instance, the use of corporate jets for personal benefit, the opportunity to invest in pet projects, and the ability to hire relatives and friends at inflated salaries. Stulz assumes that these benefits are large enough for managers to always resist a takeover. Under this scenario, firm value is determined by two counteracting forces. First, an increase in managerial ownership increases the premium that a potential acquiror has to offer to take over the firm. Second, holding the takeover premium constant, the probability that the offer is successful declines as managerial ownership increases. Stulz shows that the first effect dominates at low levels of managerial ownership, whereas the second effect dominates at

high levels. As a result, he predicts a curvilinear relation between managerial ownership and the value of the firm. This argument implies that even 100% managerial ownership does not guarantee firm-value maximization.

MORCK/SHLEIFER/VISHNY (1988) argue that higher managerial ownership aligns the interests of managers and shareholders. Simultaneously, higher managerial ownership increases managerial control over the firm and reduces the likelihood that the managers will be displaced. This is called managerial entrenchment. The first effect leads to a positive relation between firm value and managerial ownership, whereas managerial entrenchment has an adverse impact on firm value. According to Morck/Shleifer/Vishny, the range of ownership where one effect dominates the other is an empirical matter. It is to the empirical work that we now turn.

2.2 Empirical evidence on the relation between ownership by insiders and firm value

Several authors note that, for the average U.S. corporation, ownership by managers and directors (i.e. insiders) is not as low as one might initially believe. DEMSETZ (1983) finds that, on average, insiders control 2.1% of the shares in the ten largest Fortune 500 companies in 1975. For the ten smallest firms on the list, this percentage increases to 20.4%. MIKKELSON/PARTCH (1989) report that for a random sample of 240 industrial firms in 1973, 1978 and 1983, insiders control 19.6% of the votes. MC CONNELL/SERVAES (1990) find that average insider ownership for more than 1000 firms followed by the Value Line Investment Survey is 13.9% in 1976 and 11.8% in 1986.

DEMSETZ/LEHN (1985) examine the relation between the fraction of the firm controlled by large shareholders (typically insiders) and firm profitability. They find no relation between accounting profits and different measures of ownership by large shareholders for 511 U.S. companies. MORCK/SHLEIFER/VISHNY (1988) argue, however, that the relation should be nonlinear. They examine the

relation between Tobin's Q (the market value of the firm divided by the replacement value of its assets) and insider ownership for 456 of the Fortune 500 companies in 1980. They find that as insider ownership increases from 0% to 5%, the interests of managers and shareholders are better aligned, and firm value increases. Between 5% and 25% insider ownership, the entrenchment effect dominates the alignment effect, and firm value drops. Finally, above 25% insider ownership, managers reduce perquisite consumption because they bear a larger portion of the costs. Consequently, firm value increases again with insider ownership.

MC CONNELL/SERVAES (1990) reexamine the relation between firm value and insider ownership for 1,173 firms in 1976 and 1,063 firms in 1986, and find a curvilinear relation between Tobin's Q and insider ownership. Firm value first increases with insider ownership up to an ownership level of about 40% and decreases afterwards. This relation is similar in spirit to the one proposed in the model by Stulz. Contrary to Stulz' prediction, however, McConnell/Servaes do not find that the value of the firm reaches a minimum at a 50% ownership level. A possible explanation for this disparity is that Stulz' model does not consider the incentive effects of ownership. Adding incentive effects to the model would tilt the curve upward, which may lead to McConnell/Servaes' findings.

In a recent paper, AGRAWAL/KNOEBER (1993) argue that MORCK/SHLEIFER/VISHNY (1988) and MC CONNELL/SERVAES (1990) find a relation between the value of the firm and the fraction of shares owned by insiders because they fail to take into account other monitoring mechanisms, such as the external market for corporate control and monitoring by the board of directors. For example, when managers own little stock in the firm, the board plays a more active role in reducing excessive perquisite consumption. Consistent with this argument, the relation between ownership and value disappears when AGRAWAL/KNOEBER (1993) control for these factors.

Another criticism of MORCK/SHLEIFER/VISHNY (1988) and MC CONNELL/SERVAES (1990)

is that the direction of causality runs from ownership to firm value in their studies. It is, however, possible to envision a scenario where causality is reversed (see KOLE (1990)). When managers who perform well are compensated with the firm's stock, a positive relation between insider ownership and firm value results, but with a reverse causality. Although this criticism is valid, it fails to explain the negative slopes in the relation between value and ownership reported for some ownership ranges by both Morck/Shleifer/Vishny and McConnell/Servaes.

LODERER/SHEEHAN (1989) also cast doubt on the direction of causality between managerial ownership and firm value. They observe that, as firms approach bankruptcy and their value plummets, managers do not materially decrease their ownership in the firm. This result is inconsistent with the claim that insider ownership relates to firm value. If insider ownership were an important determinant of firm value, one would expect managerial holdings to decline in the years preceding the bankruptcy filing. DENIS/DENIS (1993b) examine a sample of firms in which the managers control more than 50% of the votes of the corporation, and do not find that these corporations perform worse than a control sample of firms with insider ownership below 20%. This result does not necessarily imply, however, that firm value is unrelated to ownership structure. It is possible that firm value is higher in an intermediate ownership range, as documented by MC CONNELL/SERVAES (1990).

In sum, the current evidence suggests that the fraction of shares controlled by managers is related to firm value.

2.3 Does higher insider ownership lead to better decision making?

The previously mentioned studies focus on the cross-sectional relation between the value of the firm and the fraction of shares controlled by insiders. In this section, we analyze specific decisions made by corporations, and the relation between the

resulting stock price effects and insider shareholdings. For most corporate decisions, such an analysis is not meaningful, because each decision separately is too small to have a noticeable effect on stock prices. In takeovers, however, the wealth effects for shareholders and managers of both the target firm and the acquiring firm are substantial.

JENSEN/RUBACK (1983), for instance, document that target shareholders gains are large when a takeover succeeds, whereas RUBACK (1988) documents that target shareholders lose when a takeover attempt fails. Conversely, target managers may experience wealth losses if they are displaced after a successful takeover, and cannot find a comparable position (e.g., WALKLING/LONG (1984), MARTIN/MC CONNELL (1991) and AGRAWAL/WALKLING (1993)). Because of their differential effect on managers and shareholders, and because of their economic importance, takeover attempts present a unique opportunity to study the impact of managerial ownership on decision making and shareholder wealth. COTTER/ZENNER (1994) argue that managers experience large wealth gains from a takeover because of capital gains on their equity ownership and golden parachute payments, but may lose if the takeover attempt succeeds and they are displaced. For 141 tender offers over the 1989-1990 period, they find that top executives of friendly takeover targets stand to gain \$15.8 million from their equity stake in the firm, whereas top executives of hostile targets stand to gain only \$4.4 million. Overall, they find that the capital gains on equity ownership strongly influence takeover-related decisions by managers.

Although the wealth effects associated with takeover announcements are smaller for the shareholders of acquiring firms than for shareholders of target firms, there is evidence that acquiring firm shareholders suffered losses at takeover announcements in the 1980s (e.g., JENSEN/RUBACK (1983), BRADLEY/DESAI/KIM (1988), LODERER/MARTIN (1990) and SERVAES (1991)). LEWELLEN/LODERER/ROSENFELD (1985) examine the relation between acquisition quality and managerial ownership and find that insider ownership is 10.4%

for firms that have a positive acquisition abnormal returns, and 7.4% for firms with negative returns. LODERER/MARTIN (1993) further examine the relation between acquisition performance and insider ownership for a sample of 202 large acquisition events over the 1978-1988 period. In general, they find a positive relation between insider ownership and the stock price reaction at the takeover announcement.

Overall, these results suggest that equity ownership can provide powerful incentives to align managers' with shareholders' interests when managers make acquisition-related decisions. In the following section, we discuss the interesting case where the fraction of the votes controlled by insiders is different from the fraction of the cash flows to which insiders are entitled.

2.4 Separating votes from cash flows

In this section, we examine instances in which the fraction of the votes managers control is larger than the fraction of the shares they own. These cases are important because they allow managers to boost control over corporate resources without having to bear all of the financial consequences. The practice of listing stock with different voting rights is common in Europe. Historically, this practice has not been widespread in the U.S., mainly because until 1986 the New York Stock Exchange declined to list companies with more than one class of shares outstanding. After 1986, the number of dual-class firms has increased, and today approximately 300 firms of the 7'200 exchange-listed firms in the U.S. have more than one class of shares outstanding (see RYDQVIST (1992)). In the U.S., the main difference between the shares of both classes is that one class has superior voting rights. In some countries, however, the other class is entitled to higher dividend payments.

Firms that want to add shares with different voting rights usually enter into a dual class recapitalization, in which shareholders have the opportunity to exchange their current shares for shares with lower

voting rights. PARTCH (1987) reports that insiders usually hold a disproportionate fraction of the voting equity after a dual-class recapitalization. As such, managers' control of votes exceeds their claims on the firms' cash flows. This implies that managers can vote to consume corporate cash flows, without a commensurate drop in the value of their shareholdings. LEASE/MCCONNELL/MIKKELSON (1983) examine the relative prices of shares with the same claims to cash flows and different voting rights, and find that stocks with superior voting rights trade at a 5% premium. This result indicates that holders of voting stock receive some non-pecuniary benefits since both shares are entitled to the same payoffs. Given that the issuance of dual-class shares enhances the opportunity of managers to expropriate wealth from shareholders, it is not surprising that JARRELL/POULSEN (1988) find that such recapitalizations are harmful to shareholders.

Another way for managers to increase their voting rights without affecting their claims to cash flows is through the adoption of an employee stock ownership plan (ESOP). In an ESOP, the employer contributes company stock to a trust for the benefit of the employees at their retirement. In general, ESOP trusts are under managerial control. CHANG/MAYERS (1992) find that stock prices increase by almost 1% when firms adopt an ESOP. Interestingly, the stock price reaction is positive when insider ownership is below 30%, but turns negative when it is above 30%. This result is consistent with STULZ's (1988) model.

2.5 Leveraged buyouts and the LBO organization

The LBO organization has dramatically changed the role of inside equity in many U.S. corporations during the 1980s. A leveraged buyout (LBO) has three key features: (i) a public company is taken private and all outstanding equity is acquired by the LBO organizers; (ii) the main source of financing is debt, often in the form of junk bonds; (iii) the

management of the pre-buyout firm often ends up controlling a sizable fraction of the equity of the new firm (in which case we refer to management buyouts or MBOs). It is this last characteristic of LBOs that makes them interesting for our purposes since it allows for a further investigation of the impact of inside equity ownership on firm value.

Both KAPLAN (1989) and SMITH (1990) document that a firm's operating cash flows increase after an LBO. Kaplan suggests that these gains are due to reduced agency costs in the new firms. The high levels of debt force the firms to disgorge cash that cannot be invested profitably, whereas the increase in managerial equity ownership creates improved incentives to maximize shareholder wealth. Although the fraction of equity controlled by managers increases for LBO firms (from 6% to 23% in Kaplan's sample), the dollar amount of this fraction actually declines (from \$13 million to \$4 million). JENSEN (1989), however, suggests that the fraction of shares owned, not the dollar amount, is important in aligning managers' with shareholders' interests. In other words, the increase in executive ownership for LBOs results in a pay-for-performance relation that is an order of magnitude larger than the pay-for-performance relation in the typical corporation. Indeed, JENSEN/MURPHY (1990) document that the median public company CEO's wealth increases by only \$3.25 when shareholder value increases by \$1000. In Kaplan's LBO sample, however, the chief executive officer alone holds 3.6% of the firm's equity. This implies that if he creates \$1000 in shareholder value, he will increase his personal wealth by \$36 in the process. JENSEN (1989) argues that firms in low or declining growth industries operate more efficiently when they are part of, what he calls, LBO organizations. LBO organizations are organized as partnerships, such as Kohlberg, Kravis, Roberts (KKR) or Forstmann Little. The organization controls a number of business units, which are firms that it has taken private. Each business unit also has its own debt and equity outstanding. The debt is financed by the public or by financial institutions, whereas the equity is owned by the LBO organization and by the

managers of the business unit. The key distinctions between these organizations and conglomerates are: (i) stronger managerial incentives; (ii) decentralization; (iii) high leverage; and (iv) lack of cross-subsidiations across business units.

In some cases, a publicly traded corporation offers to exchange a major fraction of its equity for debt, or pays out a large debt financed dividend. These transactions, called leveraged recapitalizations, are similar to LBOs, except that a fraction of the shares remains publicly traded. DENIS/DENIS (1993a) investigate the pre- and post-recapitalization performance for a sample of 29 transactions and find strong evidence of improved performance. As a consequence of these transactions, managers and directors also increased their ownership stake in the firm from 5.2 % to 7.7%. Even though the ownership increase in this sample is much smaller than for LBOs, the improvements in firm performance are consistent with the improved incentives of higher managerial ownership.

Although evidence on LBOs and leveraged recapitalizations indicates that these firms experience efficiency gains as managerial ownership increases, some managers may use these transactions to enhance their control over the firm. After an LBO or a leveraged recapitalization, managers are better protected from disciplinary takeovers. Indeed, many of the firms undergoing LBOs and leveraged recapitalizations were potential takeover targets and used the LBO or leveraged recapitalization to ensure the benefits of control by increasing their ownership in the firm. The appendix of DENIS/DENIS (1993a), for instance, provides anecdotal evidence suggesting that many of the firms in their sample of leveraged recapitalizations were potential takeover targets.

3. The role of outside equity

In this section, we take a closer look at the relation between outside equity and firm value. Outside equity consists of all equity holders who, under normal circumstances, are not involved in corporate

decision making. In some cases such as lackluster performance, however, they do take a more active role in the governance of the firm. Therefore, we summarize the role of outside equity with an emphasis on large shareholders in the US and Japan, commercial banks and individual shareholder associations.

3.1 Institutional investors, blockholders and other active investors

Potential monitors of the firm can be subdivided into several groups. The first group consists of shareholders who are not managers, but who control a substantial stake of the firm. SHLEIFER/VISHNY (1986) argue that large shareholders have strong incentives to monitor managers and take over the firm if managerial performance is poor. In most instances, this takeover threat suffices to keep managers on their feet. When managerial performance is mediocre, however, the large shareholder steps in, takes over the firm and fires the managers.

During the 1980s, large, active shareholders in the U.S. received relatively little attention, because public opinion focused on the booming takeover market. When the junk bond market collapsed at the end of the 1980s, so did the takeover market. Since then, active investors have received renewed attention, with particular focus on institutional investors. Institutional investors can be grouped into three broad categories: pension funds, insurance companies and mutual funds. Together with banks, these investors control a large fraction of all institutional assets in the U.S. Commercial banks, however, are prohibited from holding equity in the U.S., and the other institutional investors are severely restricted from taking an active monitoring role (see ROE (1990)). Until recently, if institutional shareholders coordinated their actions to influence a firm's management, this could not be done without substantial administrative costs imposed by the Securities and Exchange Commission. Moreover, they would become liable for illegal actions taken by the firm. As a consequence, the most common way for insti-

tutions to voice their disapproval of management was to sell their stock (i.e., vote with their feet). Notwithstanding these restrictions, some pension funds have openly expressed their displeasure with the management of firms they have invested in and have had some success in influencing corporate policy. The California Public Employees Retirement System (Calpers) is, perhaps, the most active and visible corporate shareholder among state and private pension plans. Calpers owns approximately \$75 billion in total assets of which about \$23 billion are invested in U.S. corporate equities. It uses its financial resources and voting power to initiate lawsuits challenging management decisions that reduce shareholder wealth. WAHAL/WILES/ZENNER (1993) discuss how Calpers influenced the decision of Pennsylvania firms to opt out of a state law that made non-friendly takeovers prohibitively expensive. To this purpose, Calpers sent letters to 16 of the 23 Pennsylvania firms it owned stock in, to "strongly encourage [them] to opt out" of the Pennsylvania anti-takeover law, since the law would "be harmful to both Pennsylvania companies and their shareholders." Wahal/Wiles/Zenner report that Calpers did not reduce its ownership significantly more in firms that did comply with its request than in firms that did not comply.

The empirical work on the relation between institutional ownership and firm value is limited. MC CONNELL/SERVAES (1990) find a positive relation between Tobin's Q and institutional ownership. The causality problem mentioned before is more serious in this analysis, however, because there are no non-linearities in the relation. It is plausible that institutions simply purchase stocks that have performed well in the past. LODERER/MARTIN (1993) also examine whether firms with high institutional ownership or firms in which a non-insider blockholder is present, are more likely to make better acquisitions. Their results do not support this conjecture. Institutional investors may be better skilled than individual investors in monitoring management, but they may also cooperate with managers in expropriating wealth from minority shareholders (see POUND (1988)). Some institutional investors,

such as insurance companies or bank trust funds, may be engaged in other business relations with the firm and may side with management to protect these relations. In other words, they may support managerial proposals that reduce shareholder wealth. Even though this support reduces the value of their own stake in the firm, it ensures a continuing profitable business relation. In a similar vein, institutions may be confronted with agency problems in their own organization: The managers of institutions may well prefer consuming the resources of companies they invest in, together with the management of these companies, rather than working to maximize the value of their stake in these firms. Corporate executives may allow the managers of institutions to share in their perks and provide them with front-row tickets to sporting events, the use of corporate jets, the use of apartments in exclusive resorts, etc.

Several studies have taken a systematic look at the role of block and institutional investors. Both MIKELSON/RUBACK (1985) and HOLDERNESS/SHEEHAN (1985) find that the share prices of firms increase when another firm or an individual obtains control of more than 5% of the equity of these firms. Further stock returns, however, are very much dependent on the actions taken by the large blockholder. When the blockholder remains passive, stock returns decline to the pre-acquisition level, implying that the returns are mainly caused by expectations of a complete takeover. Consistent with this result, MC CONNELL/SERVAES (1990) and HOLDERNESS/SHEEHAN (1988) do not find a relation between the stake owned by large outside shareholders and firm value.

BARCLAY/HOLDERNESS (1990) analyze a sample of firms in which a large block of shares changes hands privately. They follow these firms after the block trade to examine whether a corporate control transaction (e.g., a takeover, a management change, a proxy fight) takes place. In 80% of the cases, the firm ends up being acquired or the CEO is replaced. Both of these events are associated with an increase in the firm's stock price. The stock prices of the firms in which no control change takes place decline to their pre-block purchase level. This

finding suggests that the mere presence of a blockholder does not have a permanent effect on the value of the firm.

Further evidence on the role of block equity holders is presented by WRUCK (1989), who examines 128 private placements of equity and finds that they are associated with stock price increases of 4.5%, on average. Wruck's findings contrasts sharply with earlier research on public sales of equity which are usually associated with a negative stock price reaction of about 3% (e.g., ASQUITH/MULLINS (1986), MIKKELSON/PARTCH (1986)). Wruck documents an interesting regularity: the stock price reaction to the private placement depends on the effect that the private placement has on ownership concentration, defined as the ownership stake of the six largest shareholders. When the private placement results in less than 5% ownership concentration, the change in ownership concentration does not affect the stock price. When concentration increases to between 5% and 25%, however, there is a negative relation between the change in concentration and the change in the value of the firm. Above 25% the relation turns positive. In general, these results suggests that it is beneficial for a corporation to have a blockholder in place, except in the 5% to 25% concentration range, in which advantages of having a block shareholder are outweighed by the possibility that this shareholder becomes entrenched. Above 25% concentration, however, it is too expensive for the blockholder to take actions that reduce shareholder wealth. At the same time, she/he has strong incentives to monitor management, which may explain the positive impact on firm value.

Overall, these results suggest that blockholders and institutional investors may have an impact on the value of the firm, but only when they become active in corporate governance. The mere presence of a large investor among a firm's shareholders does not seem to be sufficient to affect corporate value.

3.2 Bank monitoring and ownership structure in financial distress

Commercial banks as a group control more assets in the U.S. than any other category of institutional investors. They cannot monitor the firm as a large shareholder, however, because they have been prohibited from holding equity since the 1934 Glass Steagall Act. Nevertheless, CAMPBELL/KRA-CAW (1980), RAMAKRISHNAN/THAKOR (1984), and DIAMOND (1984), show that banks can act as monitors for small depositors who want to finance economic activity. As such, banks impose restrictive covenants to limit managerial flexibility and entrenchment.

More importantly, banks sometimes hold equity in a firm when the firm is in financial distress. Situations of distress form an exception to the Glass-Steagall prohibition.[2] GILSON (1990) documents that banks form the single largest class of shareholders after the claims to the corporation have been reorganized. For 111 companies that restructure their debt, either privately or through formal bankruptcy, Gilson finds that banks end up with approximately one third of the equity. He also documents that blockholders more than double their ownership over the three-year period surrounding the restructuring and end up with 28% of the shares. In contrast, ownership by officers and directors declines from 22% to 17%. Overall, ownership becomes more concentrated in the hands of outsiders, suggesting increased monitoring after financial distress. Unfortunately, Gilson provides no direct evidence on the relation between bank shareholdings and subsequent firm performance.

3.3 The keiretsu system in Japan

Keiretsus are industrial groups that consist of several companies with cross-shareholdings that are organized around the main commercial bank of the group. This bank is the largest single provider of funds to the keiretsu firms in the form of debt and equity. Until 1987, banks were allowed to purchase

up to 10% of a firm's shares; since then this fraction has been reduced to 5%. PROWSE (1990) documents that Japanese commercial banks held 65% of all corporate debt and 20% of all corporate equity in 1984. Since the banks also own equity in the keiretsu firms, many of the agency conflicts between debtholders and equityholders can be avoided. In other words, managers may undertake projects that increase the risk of the company and the value of equity, while reducing the value of the debt. If the debtholders are also equityholders in the firm, the managers are less likely to engage in this type of behavior. This would suggest that bank share ownership has a positive impact on firm performance.

Although the keiretsu organizational structure has won a lot of praise internationally, its importance in Japan is dwindling. Prior to the early 1980s, firms were severely restricted from issuing debt publicly. The removal of these restrictions has led many firms to tap the bond markets, thereby forsaking their banking ties. Since bank relationships tie keiretsu firms together, the decline in the importance of bank lending may reduce the role of keiretsus as an organizational form in Japan. Some critics compare the keiretsus to the U.S. conglomerates of the 1970s. Business units that are part of a conglomerate are less cash constrained because cash balances can easily be transferred among different units. This cross-subsidization may relax the units' budget constraints, which, in turn, leads to suboptimal investment decisions. HOSHI/KASHYAP/SCHARFSTEIN's (1990) finding that distressed keiretsu firms do not cut investment supports this claim.

3.4 New monitoring mechanisms

The decline of the external market for corporate control has also triggered the development of new control mechanisms. The United Shareholders Association (USA), for example, provides a conduit through which small shareholders can combine their resources to monitor management, thus offering an alternative to large shareholder monitoring

and the external market for corporate control. The USA attempts to negotiate agreements with target firms to modify their corporate governance structures, to improve firm performance, and to make it more responsive to shareholder interests. GORDON/POUND (1993) and STRICKLAND/WILES/ZENNER (1993) document the impact of this new development. Gordon/Pound examine voting outcomes on shareholder-sponsored proposals to alter corporate governance structures during the 1990 proxy season. These proposals are usually opposed by the firm's management. Gordon/Pound find that outside shareholders are less reluctant to vote against management when target firms performed poorly. Strickland/Wiles/Zenner examine USA's influence on large corporations over time. They report that the average percentage of shares voted in support of USA-sponsored proposals increased annually from 39% in 1991, to 41% in 1992 and finally to 44% in 1993. In addition, USA has successfully negotiated corporate governance changes covering proposals before those proposals were submitted for inclusion in proxy statements. The removal of poison pills and golden parachutes and the adoption of confidential voting are the most common corporate charter changes obtained by USA. Overall, these results suggest that once atomistic individual shareholders unite, their actions may affect a firm's value and its corporate governance structure.

4. Conclusion

The evidence on the relation between ownership structure and firm performance provides some insights on how ownership may affect corporate value, but it also raises many questions. In this paper, we provide an overview of the role of inside and outside ownership. One finding confirmed by many studies is the nonlinear relation between firm value and inside ownership. The ranges of ownership in which this relation is positive or negative, however, vary with the studies. These differences are probably due to study-specific differences in the sample selection and analysis. One plausible inter-

pretation for this nonlinear effect is that increases in managerial ownership strengthen the alignment of interests between managers and shareholders but also lead to higher managerial entrenchment. During the 1980s, financial economists also paid a lot of attention to the impact of large outside shareholders on firm value. It appears, however, that large shareholders increase shareholder wealth only if they become active in monitoring the firm's management. The effect of the takeover market as a monitoring mechanism has declined significantly since the end of the 1980s, due possibly to the collapse of junk bond financing and the enactment of state anti-takeover laws (see JENSEN (1993)). This decline had decreased the importance of active large shareholders that make takeover bids for a firm (i.e., raiders), but has increased the importance of monitoring by other outside shareholders, more specifically institutions. These large shareholders do not make takeover bids, but exercise direct pressure on corporate boards and discuss governance issues with the CEO. Overall, the role of institutional owners seems ambiguous. There appears to be a positive relation between institutional ownership and firm value, but this relation is consistent with two possible explanations: Institutions monitor firms in which they own equity and as a result corporate performance improves, or, alternatively, institutions own more equity in firms that perform well.

Changes in the legal and competitive environment of the corporation are likely to affect the role of inside and outside equity in the future. New proxy rules requiring better disclosure of the structure of compensation contracts, and the public pressure to increase the sensitivity of executive compensation to firm performance, may lead to wider use of equity ownership to compensate managers. The resulting increase in inside ownership is likely to affect firm behavior and firm value.

Footnotes

- [1] See Financial Times, Privatisation wave sweeps across Europe, June 24, 1993.
- [2] Banks need to divest their equity holdings approximately two years after the resolution of distress.

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