In all but a few advanced countries most publicly listed corporations are closely held, with the main shareholder typically playing an active role in management. In emerging markets firms with active owner-managers provide effective business solutions where business environments are characterized by corruption and weak contract enforcement. But they also pose a significant risk of asset expropriation for minority shareholders. To promote investor confidence and develop successful securities markets, this risk must be mitigated. Some policy analysts argue that the way to do this is to restrict ownership concentration. Such a step could cause serious harm. This Note argues instead for mitigating risk by strengthening corporate laws to safeguard minority shareholdings, ensuring that markets for corporate control work, and enforcing disclosure requirements for firms and ethical standards for public officials.

Modern publicly traded corporations are commonly perceived to have widely dispersed ownership and a separation of ownership and control, with the control delegated to professional managers. The owners of the firm rely on the board of directors to supervise the managers, voting only on major strategic decisions. The key issue of corporate governance in this situation is to ensure that managers act in the best interest of the shareholders. The board therefore plays a pivotal role.

In reality, in all but a few advanced markets most publicly traded firms are closely held, with the principal shareholder typically playing a very active role in management. The principal shareholder often serves as the chief executive officer or chairman of the board and has the decisive vote in major corporate decisions. In this setting the key issue of corporate governance is more complex: how to prevent the insiders—those who own a large stake and control the firm—from expropriating the assets of minority shareholders.

A study of the world’s top twenty-seven stock markets finds that only 36 percent of the largest publicly traded firms are widely held—that is, with no shareholders controlling more than 20 percent of the votes (La Porta, Lopez-de-Silanes, and Shleifer 1999). Most of these widely held firms are concentrated in a few advanced markets, especially the United Kingdom, Japan, and the United States (figure 1). Most large publicly traded firms (64 percent) have a controlling shareholder, which may be a family (30 percent), the state (19 percent), or another firm (15 percent). Among smaller companies the share of closely held firms is higher still.

In most closely held firms ownership is not separated from control. For more than two-thirds (69 percent), a nominee or relative of the controlling shareholder ranks among the top executives (La Porta, Lopez-de-Silanes, and Shleifer 1999). In some emerging Asian markets (such as Indonesia, the Republic of Korea, and Malaysia) that share is about 80 percent (Claessens, Djankov,
Protecting Minority Shareholders in Closely Held Firms

and Lang 1999b). Insiders use a variety of instruments to acquire and entrench their position, including debt, pyramid schemes, cross-holding of shares within a business group, and corporate poison pills (Leechor forthcoming).

The risk of insider expropriation

With ownership concentrated among a few large shareholders who also manage the firm, potential investors are naturally concerned about the risk of insider expropriation. The firm’s business could be structured to serve the insiders’ interest. The compensation paid to insiders could be excessive. Profits could be diverted to the insiders—easily done in most markets. And business transactions may not be at arm’s length: sales to related parties might be underpriced, and purchases from them overpriced.

Some self-serving actions by insiders may be perfectly legal. For example, many jurisdictions allow freeze-outs of minority shares—where the controlling shareholder or an acquirer “takes the company private” and pays the minority shareholders a market price that does not reflect the new value arising from acquisition. Some jurisdictions allow the controlling shareholder to issue new shares through private placement and thereby dilute the voting power of outside shareholders.

In response to the risk of insider expropriation, outside investors refrain from investing in closely held firms, or demand a discount on the securities as compensation for the risk (Claessens, Djankov, and Lang 1999a). Where the risk is not adequately checked, the discount can be dramatic, ranging from 82 percent (Zingales 1994) to nearly 100 percent. In advanced securities markets with stronger protection for outside investors, the discount tends to be smaller but still significant (6 to 20 percent). Such discounts depress the valuation of firms’ securities, increasing the cost of funds and weakening insiders’ incentive to reduce their ownership stake.

The preponderance of closely held firms in most markets has important implications for the development of securities markets. Outside investors have few attractive investment options. In addition, with depressed securities valuation, the firms find it more attractive to rely on the banking system, where they can contain the cost of funds through collateral. Moreover, limited interest in marketable securities hampers the emergence of a deep and liquid market. So foreign investors, often large and prepared to deal with the risk, may nonetheless be unable to invest.

Targeting the risk, not ownership

Despite the risk, the ownership concentration in closely held firms is not necessarily a bad thing. Often it is a response to a variety of business and corporate governance problems.

Ownership concentration eases the job of monitoring and directing corporate management.
With just a few large shareholders, changing management or strategic direction becomes more manageable. And in a difficult business environment—with a murky legal framework, uneven ethical standards among public officials, and inadequate transparency among business partners—direct operational involvement of the major shareholders can safeguard against losses.

Even in the most advanced markets concentrated ownership is found in many leading firms. Here ownership concentration can be important in facilitating corporate restructuring and industry consolidation, which seldom occur at the initiative of existing management, but more often through mergers and acquisitions (Jensen 1993). In addition, securities analysts generally regard significant share ownership by corporate insiders as a sign of commitment—an assessment that enhances the firm's value. Some of the world's most admired companies are closely held, including Microsoft and Berkshire Hathaway (Fortune, March 1, 1999).

The prevalence of closely held firms indicates the effectiveness of ownership concentration as a business solution. Thus as long as the risk of insider abuse can be controlled, outside shareholders stand to benefit. So closely held firms pose a policy challenge: the risk of insider abuse must be guarded against—while preserving the many advantages of ownership concentration.

Many policymakers and analysts have suggested that the risk should be controlled by restricting ownership concentration in publicly held firms. But that would be a costly mistake:

- The incentive of a large shareholder to provide intensive monitoring and early strategic redirection would be lost.
- Owners of firms in the dynamic growth phase, reluctant to give up a substantial ownership stake and control, might not sell shares to the public to raise funds for expansion.
- Most critical, restrictions on ownership concentration hamper the market for corporate control. Potential deal-makers might not be allowed, or might find it too costly, to acquire the ownership stake necessary to control and restructure target firms. The threat of a hostile takeover—an external source of discipline for management—would weaken. And corporate governance would suffer.

Experience shows that the risk of insider abuse can be mitigated without limiting ownership concentration.

**How to reduce the risk**

Mitigating the risk of insider abuse can make a difference—to the investor, the closely held firm, and the securities market. The prospect of more secure returns enhances investors' confidence. Securities markets become more viable, giving insiders an incentive to build the reputation their firm needs to access the markets. As more equities are issued to the public, ownership of firms becomes more dispersed.

Several mechanisms can reduce the risk of insider abuse.

**Duty of loyalty**

A key tool in reducing the risk is a legal presumption of the duty of loyalty owed by insiders to outside investors. Guided by this doctrine, the judiciary would expect corporate directors to put the interest of the firm, including its outside investors, before their personal interests. For example, no insiders would be allowed to vote on transactions in which they have a personal stake. The relationship between outside investors and corporate insiders is akin to a long-term contract in which the insiders' obligations cannot be precisely delineated in advance. The duty of loyalty addresses this basic difficulty.

This legal principle works best in an established legal system in which members of the judiciary are honest and competent. Developing such a legal system can take many years, but is nonetheless well worth the effort. The duty of loyalty, as a tool for enhancing corporate governance, can be strengthened by rigorous enforcement of contracts and bankruptcy procedures. Since all
business obligations represent more senior claims than those of shareholders, corporate insiders face strong external pressures to be prudent.

Market for corporate control

A functioning market for corporate control also provides a powerful tool for mitigating the risk of insider abuse. Dissatisfied shareholders, active institutional investors, and takeover specialists could all acquire an ownership stake sufficient to remove existing insiders. But the control market can be curbed by anti-takeover devices, including rights plans (poison pills), intercorporate cross-holding of shares, restrictions on business combination, and control share rules (Leechor forthcoming). The policy challenge is to review the impact of anti-takeover tools and devise remedies.

Transparency

Another safeguard is transparency in corporate affairs, often achieved through disclosure requirements. Transparency helps investors make informed decisions and deters questionable actions by insiders. Adequate disclosure requires compliance with accepted financial accounting standards (IASC or FASB for firms listed on the New York Stock Exchange) and auditing standards, as well as the coverage of material facts, including significant changes in ultimate corporate ownership. But compliance is not always enforced.

Transparency requires the active participation of professional watchdogs and reputational agents, including securities analysts, credit rating agencies, and knowledgeable financial media. Where these services are not available domestically, they can often be imported by liberalizing the financial service industry, allowing local firms to be listed abroad, and permitting local asset managers to invest in foreign securities.

Strong ethical standards

The integrity and professional judgment of insiders are sometimes compromised by political influences. To comply with political directives, corporate insiders may make poor investment decisions or take excessive risks. Enforcing stringent ethical standards and conflict-of-interest laws applicable to public officials can help. In particular, public officials should be prohibited from deriving personal gains or giving preferential treatment to others through the exercise of official power. But this safeguard requires a strong legal tradition and democratic restraints (such as a free press) on the use of political power.

Market liberalization

In some cases ownership concentration reflects broader policy issues, such as protectionism and barriers to entry. These policy distortions could lead to misguided investment, market power, and unusual concentration of wealth. Policy reforms to correct these weaknesses—antimonopoly laws and liberalization of trade, foreign ownership, and market entry—can foster market competition and broaden the dispersion of wealth and corporate ownership.

References


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