Shareholder Activism and Ownership Structure

by

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September 2000
1 Direct control mechanisms: shareholder activism

Figure two illustrates, how this subsection is organized. Shareholders have a variety of ways to influence management. Small shareholders have the option to make voting proposals and vote themselves, they can delegate these tasks to a proxy solicitor, which may be an individual or an institution, or they can invest in the firm indirectly, and institutional investors will effect control. Proxy solicitors, institutional investors, and blockholders may try to influence management directly, which small shareholders cannot do due to their large number. The identity of large blockholders may be important: they can be individuals (professional investors or founding family members), firms, institutional investors investing on their own account, or the government. Management can set the voting agenda and try to influence procedures.

Figure 2: Shareholders’ possibilities of direct control over management

With a large number of shareholders, voting is superior to the consensus procedure due to communications costs. Thus, I first review the evidence on voting and proxy contests. Then, I turn to the issue of ownership concentration, and the impact of large blockholders depending on their identity. Since many companies are too large to accommodate significant owners, the role of institutional investors and proxy solicitors or “lobbying institutions” is examined. To shed more light on the detailed mechanics of shareholder activism, I finally review the available evidence on shareholder sponsored proposals.

1.1 Shareholder voting and proxy fights

Presumably for its linguistic proximity to democratic institutions, shareholder voting is a hotly debated issue carrying significant political overtones\(^1\). Shareholders, however, can be expected to

\(^1\) Epstein (1986) laments the myth of corporate democracy, and paints a worst-case scenario where the US corporate environment „would not be appreciably different from that of European socialism” (p. 42).
suffer a voting externality\(^2\): it doesn’t pay to get informed. Accordingly, one may ask, whether voting has value at all.

Rydquist (1992) provides an early survey to answer this question by focussing on dual class shares. When shares carry the same cash flow promise and differ only in their voting rights, any price difference should be interpreted as the value of a vote. Indeed, Rydquist identifies seven studies\(^3\) that find significant price differentials in many countries. Yet, surprisingly, the effect on share prices of announcements of dual class recapitalizations is mixed\(^4\).

While Rydquist points to a possible bias in the announcement effect due to concurrence of stock dividend announcements (generally positive impact on share prices), the results may also indicate that when there is little effect on overall firm value, price differences between share classes may reflect a redistribution of wealth between owners of voting shares and potential bidders for the firm. Compared to the case of new issues of voting shares, existing shareholders then do not lose in dual class recapitalizations (as observed), and the value of a vote is reflected in the issue price of non-voting stock, but not in the announcement effect of voting shares. This would be consistent with the data. Yet, a game between voting shareholders and potential bidders does not necessarily carry a corporate governance interpretation, as the previous section on takeovers suggested. The voting premium is – as of yet – an insufficiently explained phenomenon, both theoretically\(^5\) and empirically\(^6\). Is voting a meaningful device for the governance of the firm?

Epstein (1986) and Heard and Sherman (1987) find serious deficits in the US proxy system. By the number of contests performed\(^7\) and their success rate\(^8\), proxy voting doesn’t seem prominent as a successful corporate governance tool. Epstein (1986) likens corporate elections to ‘democracy’ in North Korea, since voters have only one alternative to ‘choose’ from.

Dodd and Warner (1983) find that proxy contests are usually not successful. Pound (1988) confirms that management has a vote getting advantage, that dissidents may be stigmatized due to the existence of ‘crank bids’, and that institutional investors may be subject to conflicts of interest. However, DeAngelo and DeAngelo (1989) find that even unsuccessful proxy contests are typically accompanied by management resignation and subsequent firm sale or liquidation.

Young, Millar and Glezen (1993) find that the ability to time communication with shareholders is a source of management control. However, Healy and Palepu (1995) find that accounting

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\(^2\) Demsetz’ (1982) talks about rational shareholder apathy.


\(^5\) Levy (1982) attributes price differences between voting and non-voting stock to the value of control, and finds no arbitrage possibilities in observed prices. Ruback (1988) explains the price differences with reference to an externality when there are many shareholders, which would weaken the argument that there is value in control.

\(^6\) Lease, McConnell and Mikkelson (1984) fail to identify any source of relative valuation. Gardiol, Gibson-Asner, and Tuchschmid (1997) find ownership structure and owner ship transfer regimes significant in Switzerland. Nicodano (1998) finds that holding companies carry a higher voting premium in Italy. Weber et al. (???) find the premium to be related to stock market turnover in Germany. Rydquist (1996) finds the premium in Sweden to be related to ownership and share characteristics.

\(^7\) 129 between 1981 and 1985. (Schrager (1986)).

\(^8\) 33% in favor of dissidents, 44% in favor of management, 23% other resolutions. (Schrager (1986)).
reports were insufficient to communicate value enhancing strategies at CUC International, Inc. Management is not the only side to be blamed for difficulties in the proxy process.

Brickley, Lease and Smith (1994) examine management sponsored anti-takeover amendments to find evidence consistent with both the hypothesis that management may be too entrenched for voting to matter, and that they may be motivated to act in the interest of shareholders because of the voting mechanism. Mulherin and Poulson (1998) find that proxy contests for board seats enhance shareholder value, but this is largely restricted to firms that are acquired, making it difficult to separate the effect from normal target gains in takeovers. Thus, we may conclude that there is some evidence that shareholder voting enhances management accountability, but that the value effects are comparatively small.

1.2 Ownership concentration

The problems surrounding the voting mechanism may suggest that it could be better if firms retained at least one significant owner that can either side-step the proxy process and communicate with management directly – in which case small shareholders would free-ride – or that can command or easily solicit a majority in proxy contests. Blockholders would fulfill a beneficial monitoring role, as argued by Shleifer and Vishny (1986), or Admati, Pfleiderer and Zechner (1992). Bebchuk (1999) argues that ownership concentration depends on the size of private benefits of control. However, block ownership may limit firm-specific investments, raise the agency costs of debt and also give rise to a new agency conflict between large and small shareholders.

Indeed, concentrated ownership is the dominating ownership form in most countries. Block trades and private equity sales that retain concentrated ownership seem to suggest that concentrated ownership enhances firm value. While Zeckhauser and Pound (1989) and Ang, Cole and Lin (2000) interpret their evidence as consistent with the notion that large blockholders reduce agency problems, Demsetz and Lehn (1985) found no evidence that ownership concentration affects long term firm performance.

McConnell and Servaes (1995) find mild evidence that ownership concentration is more important for low growth firms (with a potential free cash flow problem) than for high growth firms. Denis and Serrano (1996) show that management turnover of targets in unsuccessful control contests increases significantly when large blockholders acquire an ownership stake, and that such firms also show more restructuring activity relative to similar firms without a significant owner. Denis, Denis and Sarin (1997) similarly find that the probability of top executive turnover increases with the presence of an outside blockholder. In summary, the results

9 Burkart, Gromb, and Panunzi (1997). Shleifer and Vishny (1989) conversely argue that manager-specific investments lead to further entrenchment by managers. Obviously, there is a trade-off between the costs of entrenchment ad the value of manager-specific investments to the firm.
10 Inderst and Müller (1999).
12 Becht and Roell (1999), Thomsen and Pedersen (1999), La Porta, Lopez-de-Silanes and Shleifer (1999), Harm (1995) for Germany. The use of pyramidal group structures to maintain ownership control is documented by La Porta, Lopez-de-Silanes and Shleifer in many countries, by Bianca and Casavola (1999) for Italy, by van Hulle (1998) for Belgium, and – last not least – by Berle and Means (1932) for the USA at that time. DeAngelo and DeAngelo (1985) argue that the dominant means of retaining majority ownership in the USA today is the issuance of dual class shares.
14 Wruck (1989).
suggest that large shareholders perform an internal monitoring role. The long-run performance of firms with more or less concentrated ownership remains a subject for more research.

1.3 Does it matter, who the large shareholder is?

Owners have different incentives and abilities to perform efficient oversight over corporate affairs. Thus, there is a legitimate question, whether the identity of owners matters.

Government ownership is a case in point. Jones et al. (1999) analyze privatizations in many countries to conclude that political rather than revenue motives determine the process, which is in keeping with the theoretical predictions of Shleifer and Vishny (1994). Accordingly, Megginson et al. (1994) and D'Souza and Megginson (1999) find significant performance improvements of privatized firms. Megginson et al. (2000) show that newly privatized firms even outperform relevant benchmarks. These results should not come as a surprise, since the objective function of the firms change after privatization. The issue, whether political objectives in publicly owned firms can be justified on aggregate welfare grounds shall not be pursued here.

Companies can themselves have controlling shares in other companies. Given the ability and incentives of corporate managers to control their domain of influence, such participations should not be treated differently from units within the corporate empire, and the question should turn to the optimal degree of “focus” in the corporation15. Vijh (1999) finds that equity carve-outs do not underperform their benchmarks, which he attributes to increased focus and a continuing monitoring stake of the former parent in the firm. On the reverse transaction, Slovin and Sushka (1998) find positive restructuring effects in parent-subsidiary mergers. Both studies together suggest that the results may be driven by their sample selection routine, and that corporate owners “know what they are doing”, an issue we’ll return to below16.

More difficult is the subject of corporate cross-holdings. Osano (1996) argues that cross shareholdings may counter managerial myopia in the face of takeover threats. Prowse (1992) shows that ownership concentration in Japan is linked to the value of control over management in independent firms, but not in keiretsus in which firms own each others shares. Ownership concentration and cross-holdings may thus be substitutes, which is also observed by Bøhren and Norli (1997) in Norway. Yet, they find that cross-ownership occurs mostly in firms with large free cash flows, suggesting an entrenchment motive. This is also hypothesized by Adams (1999) for the German case.

Family and individual owners may reap the benefits from close control over management, but they may lack monitoring expertise, and are subject to the problem of generational change. Denis and Denis (1994) examine a sample of owner-manager controlled firms – largely individuals and families – and cannot find any evidence that they perform poorly. Smith and Amoako-Adu (1999) find that management appointments in the course of the generational succession in family controlled firms is greeted by stock price declines to the order of 3.2% in Canada, but this is explained largely by the (young) age of the successor rather than the ownership form. A special form of family ownership is a trust with family heirs as beneficiaries. Typically, such trusts leave little to no control on the side of the beneficiaries. Thus, there is no economic incentive emanating from shareholders, and this corporate form should show inferior performance. Yet, Thomsen (1996) finds no evidence for underperformance in such firms in

15 John and Ofek (1994).
16 According to Hansman (1988), ownership structure is situation-contingent and therefore endogenous.
Denmark, and Hermann (1996) presents similar results for Germany. Similar to the conclusion reached above for executive stock options and ownership titles, this evidence casts significant doubts on the pecuniary incentive motivation theory. Management in such companies has a virtually unlimited reign, but negative performance effects are hard to find. Intrinsic motivation?

1.4 Institutional investors as activist shareholders

In today’s large corporation, closely held ownership becomes ever more difficult to achieve, be it due to diversification incentives by owners or the sheer size of the stakes required to have meaningful influence. Thus, there has been some hope that the institutions that collect and invest the savings of millions of investors in equity titles could come to the rescue. Institutional investors could perform a meaningful monitoring role in lieu of large blockholders.

The modern institutions of capital accumulation are insurance companies, banks, mutual funds, and pension funds. These institutions could serve a monitoring function. Anecdotal evidence is provided by Bruner (1999), who documents that institutional investors were vital to halt the destruction of shareholder value in the once proposed merger between Volvo and Renault. Generally, Del Guercio and Hawkins (1999) find a monitoring role for US institutional investors.

The performance effects of institutional investors activism are more mixed. Nesbitt (1994) and Smith (1996) find positive performance effects in CalPERS activism. Karpoff, Malatesta and Walking (1996) and Wahal (1996) find no performance increases due to institutional investors' activism. Faccio and Lasfer (2000) examine UK occupational funds, concluding that these funds neither add value, nor do the firms they invest in comply with the governance Code of Best Practice. Most notably, Duggal and Millar (1999) recognize that institutional ownership itself is determined by other variables. When they accommodate this endogeneity in the regression specification, all results between institutional ownership and firm performance break down. This is symmetric to the analysis by Himmelberg, Hubbard and Palia (1999) with respect to managerial ownership.

To be sure, there is a long list of papers arguing that institutional investors are not made to be activists. The ‘Wall Street Rule’ to be quiet and exit when discontent (Heard and Sherman (1987)) seemingly has a long tradition. Institutions shun anti-management activism because of conflicts of interest, or because even they are not large enough to overcome the free-rider problem. Bhide (1993), Bolton and von Thadden (1998), and Maug (1998) argue that less liquid markets mitigate the monitoring externality. Supporting an activist stance would be that their holdings are too large for the exit option in that they would move prices too much, or because they may index their holdings. Suto (2000) expresses hopes that the recently documented shift in Japanese household portfolios from individual ownership to investment funds could unleash similar forces in Japan as in the USA.

There is significant heterogeneity among institutional investors. Van Nuys (1993) supports the contention that US banks and insurance companies tend to vote with management. Peck (1996) documents that – during MBOs – professional investors (Carl Icahn etc.) work more in the interest of shareholders than institutional investors. We need to turn to the microstructure of shareholder control over management.

18 Chan and Lakonishok (1993).
1.5 Shareholder sponsored proposals

What do institutional investors do? There is widespread agreement that institutional investors cannot be experts on corporate policies in all industries, in which case they would contradict available evidence on the poor performance of conglomerates. Gillian and Starks (2000) note that the activism by institutional investors centers on governance rather than management issues. Do these initiatives create value? Which initiatives create value?

In general, shareholder sponsored proposals in proxy contests are evidence of significant shareholder frustration with management. Karpoff, Malatesta and Walking (1996) show that shareholder sponsored proposals are concentrated in poorly performing firms. Yet, they find no evidence that operating returns improve after proposals. Strickland, Wiles and Zenner (1996) on the other hand document a positive effect of shareholder proposals initiated by the United Shareholders Association (USA). Moreover, Carleton, Nelson and Weisbach (1998) find that TIAA-CREF successfully negotiate with management directly so that shareholder voting turns out to be unnecessary in 30% of the examined cases.

To shed some light on different institutional investors’ role, Gillian and Starks (2000) examine the relative merits of governance proposals sponsored by different groups of shareholders, examining both voting outcomes and market reactions. They find that institutions are typically more apt to garner support for their voting proposals than individuals. However, the stock market reaction to such proposals is typically small. Proposals by individuals show small positive announcement effects, while proposals by institutional investors are associated with small but measurable negative impacts on stock prices.

The latter result may be explained by the fact that institutional investors like TIAA-CREF tend to negotiate issues directly with management prior to an actual vote. In that case, the announcement may signal that private negotiations have failed. To distinguish between the real and information effect in all corporate announcements is a general problem as argued by Jensen and Warner (1988). Thus, Chidambaran (2000) examines only withdrawn proposals to conclude that they tend to add value, if sponsor and management end up compromising on the issue. If the sponsor forces the issues on management they have negative value.

Forjan (1999) finds that shareholder sponsored proposals imply for the largest part negative value effects. Only those proposals that are supported by management, where management negotiates a settlement, or where the proposal passes at the annual meetings actually have positive value implications.

Romano (2000) concludes that many shareholder sponsored proposals have no value effect because they do not address issues that have empirically been demonstrated to contribute to firm value. I would tend to follow this line of argument here with one important exception: while Romano suggests that fund managers should improve their scrutiny to identify value enhancing proposals, the objective of this survey is to document that most governance mechanisms individually have only limited empirically discernible performance effects on firms. The search for globally efficient governance mechanisms is likely to be frustrated by the nature of governance and supervision, which – in this case – explains the limited value of shareholder proposals trying to improve on the governance regime through marginal adjustments of individual mechanism designs.
1.6 Summary on shareholder activism

Observers of the US situation conclude that voting contributes to management accountability, but that the issuance of non-voting stock does not seem to be penalized by the market, which may cloud the performance-enhancing role of voting. Similarly, it has been established that large blockholders and institutional investors perform a monitoring role, but the performance effects of such activities still tend to be camouflaged by various measurement errors.

These are likely due to the endogeneity problem. Crutchley, Jensen, Jahera and Raymond (1999) provide evidence that institutional ownership and insider ownership are endogenous variables. Danielson and Karpoff (1998) document that various different governance provisions are interrelated. Hansmann (1988) argues that corporate ownership structures in general are endogenous to a firm’s market environment. These issues severely complicate the problem of empirical support, and throw many of the studies mentioned in this section into doubt.

While it is safe to argue that ownership structures and governance matter, it is not entirely clear why and how they matters. CalPERS, the expert institutional investor on governance matters, has declared General Motors as a benchmark case that conforms with best practice in governance matters. Did that help General Motors? We can safely conclude that institutional investors such as CalPERS are not intending to imitate conglomerates. While Coffee (1991) thinks that limitations on diversification requirements on institutional investors’ portfolios could end the quagmire of these institutions by being allowed to settle for more active control, the evidence on conglomerates would not look favorably on such a development. The ambiguity in all acts of supervision as derived in chapter two is consistent with institutional investors restricting themselves to the implementation of a governance regime they view as appropriate. Whether such governance innovations – especially alterations at the margin – are apt to create lasting value has not been conclusively demonstrated in the empirical literature.


La Porta, Rafael, Florencio Lopez-de-Silanes and Andrei Shleifer (1999): “Corporate ownership around the world”, 54 Journal of Finance 471-517.


