

CONTROLLING SHAREHOLDERS AND CONTRACT THEORY: A REVIEW OF THE LITERATURE

ROBERTO FORTICH MESA*

In this survey I succinctly review the contract theory literature on the rebellious manager type of agency conflict. Freedom of enterprise, private property, and the incentives of businessmen to make profits are essential values of the capitalist economic system. When economic institutions that preserve these values are in place, capital circulates, businesses invest and the economy grows. Just as prices do not need to be intervened for markets to work, capital too can work when left alone: savings are transformed into investments, prospects of future cash flows are taken at present value, and small-investor distrust is overcome even in the face of unfamiliar risky enterprises.

That none of these features of capitalism requires central planning is not due to some invisible-hand miracle, but instead is the result of social arrangements engineered to inspire trust. The corporation was one of these legal artifacts. When firms started incorporating in the 18th century, a revolution was sparked: for the first time, outside investors could pool their savings and passively wait for a return. Their investments relied not just on pure faith but on the rule of law and its enforcement.

The main reason why corporations work is that stock buyers benefit from large-scale returns, while being kept protected by limited liability. Thanks to this financial invention, hundreds of thousands of investors can buy low stakes of firms in many capital markets around the world, injecting capital into the

* Roberto Fortich is Assistant Professor at the School of Economics and Business of the Universidad Tecnológica de Bolívar, in Colombia. Email: rfortich@utb.edu.co.

world economy. Putting aside the environmental-degradation dangers related to mischievous corporations, the economic literature overwhelmingly regards the corporation as vital for the development of capital markets.

The existence of a separate corporation persona has been advantageous for investors wishing to protect themselves from unwelcome liabilities. But this same legal independence feature has made it hard to understand who should be held accountable for the corporation's decisions and why it behaves the way it does. These two questions underlie this survey.

On the issue of who is to be held accountable for corporations, the answer is safely attributed to wealthy entrenched elites, since they are by far the most prevalent type of owners (Morck, *et al.*, 2005). This is evidenced in the vast majority of countries worldwide:¹ in Continental Europe the percentage of publicly traded firms with controlling shareholders is very high [65% as reported in Franc (Faccio and Lang, 2002)], or 19% of market capitalization being controlled by 10 families in Belgium (Morck, *et al.*, 2005, p. 667), as well as in Asia [in Indonesia 70% of publicly traded firms have controlling shareholders (Claessens, *et al.*, 2002, p. 2750)], and Latin America [in Colombia the mean of equity in hands of the largest four shareholders is 65% (Gutiérrez, *et al.*, 2008, p. 27)].

This high prevalence of controlling shareholders does not fit well into the modern-finance textbook view of corporations in which “corporate insiders need not act in the best interests of the providers of the funds” (Tirole, 2006, p. 15). The evidence of a world where concentrated control grows in the wild (and remains uncontested over time) leaves little space for wayward-managers.

Since controlling shareholders loom in the background of finance theory, most types of regulatory mechanisms addressing agency issues are framed with a loose manager in mind. As a consequence of this biased focus, the literature has abundant calls for “discipline”, “alignment of incentives”, “monitoring”, and “market-of-corporate-control corrections”. Legislation following these recommendations will be awkwardly implemented within control-based economies (countries where controlling shareholders are the norm).

¹ Exceptions to this pattern are the United States, the United Kingdom, and Australia, where large firms are widely dispersed.

I. CONTRACT THEORY IN FINANCE

The application of the theory of contracts to finance stresses that corporations host internal conflicts manifested in managers with huge bargaining power. Whereas in traditional contract theory the conflict lies in a boss having a worker who exerts little effort, in finance the informational asymmetries translate to shareholders and manager (here the agent is not a worker but instead the CEO). Managers that go unmonitored may “misbehave”, which could mean either that they openly divert funds from the firm or that maybe they just avoid making tough decisions (*i.e.* payroll cuts, imposing high-standards, saying no to high-risk business opportunities).

The crux of this agency conflict lies in the principal’s disinformation about the agent’s performance. Notice that the breach of ethics happens independently of the morality of the agent: he is a utility-maximizer that ends up (inadvertently) misbehaving. For sure, the agent is opportunistic from the standpoint of the principal, but he falls in this situation without any inner motives to wrong others. Consequently, to fix the problem involves reducing the disinformation of the principal, instead of increasing the honesty of the agent.

The insight that it was the design of the contract what turned otherwise honest people into dishonest behavior, and not the other way around, would probably have led to the coining of “moral hazard”. Certainly, the first to informally identify this were insurance agents at the turn of the 20th century.² Insurance companies are accustomed to prepare for the worst and, as long as they can assign a probability to a hazard, they think they can manage it. Perhaps the icy treatment of moral hazard in contract theory can be traced to its roots in the insurance industry.

In 1932, Berle and Means published their classic book on the problem of misbehaved managers in modern corporations (Berle and Means, 1932). Their work, which bonded moral hazard with management, was way ahead of their time. The finance literature did not catch up with it until many decades later.³ Since Berle and Means circumscribed their argument to the United States’ case of widely dispersed shareholders, the agency conflict of unmonitored managers is often dubbed “the Berle and Means corporation” (La-Porta, *et al.*, 1999).

² Not until 1963 was the idea imported into economics by Arrow (1963).

³ That moral hazard deserved much attention and that it was not just some curiosity was first proposed by Jensen and Meckling (1976).

What exactly is proposed by the agency conflict of opportunistic managers? First, shareholders are concerned that their firm generates profits at the end of the year and that the decision of what to do with them will be taken by someone else. Second, managers appointed by shareholders can only be held partially responsible for bad results, since they act in risky environments. Finally, there is a separation of ownership and control in which shareholders have the ownership, managers have the control, and the two need not be congruent.

Even if shareholders wanted to gather more information on the daily decisions taken by management, their stakes in the firm are so small as to end up abandoning any monitoring initiative. Each shareholder then becomes a “free rider” who hopes that someone else does the job of keeping an eye on the manager.

The formal characterization of the principal-agent model was honed in a series of papers by Holmstrom, Grossman and Hart in the late 1970's. They give credit to Mirrlees (1971) for coming up with the “single-crossing property condition” that made the theory tractable. Hart (1983, p. 4) sums up the broad-sourced origins of contract theory:

[...] the tools used to analyze optimal labor contracts under asymmetric information are very similar to those found in a number of other areas of “information economics”. In particular, there is a considerable overlap with the theories of optimal income taxation; non-linear pricing; signaling and screening; incentive compatibility; the principal-agent problem; price versus quantity instruments in planning problems; and optimal auctions. We will not spell out the connections, but we feel that it is appropriate to mention the paper to which our analysis owes the most: Mirrlees (1971).”

The standard solution to the moral hazard problem of managers was that a part of the shares of the firm had to be given to its executives. A practical consequence of this solution was that the issue of stock options skyrocketed in the United States. Also, empirical finance papers began examining the effects of “inside ownership”, or “managerial ownership”. A widely reached conclusion suggested either a positive relation with monitoring and firm value, or a non-monotonic, curvilinear association.

II. CONTROLLING SHAREHOLDERS ENTER THE PICTURE

Modern finance studies started to shift toward an interest in controlling shareholders in the late 1980's. Early attempts to account for controlling shareholders in the finance literature included them as one of many mechanisms to "discipline management". For instance, Hart (1995) defined five mechanisms for doing so, including boards of directors, proxy fights, large shareholders, hostile takeovers, and capital structure. Controlling shareholders reach here a place as important as an exogenous variable with the auxiliary function of "curbing mismanagement".

It was, indeed, necessary to separate the agency conflicts of rebel managers from those of controlling shareholders. To portray them as two opposite sides of a coin was a lost cause: According to Bebchuk and Weisbach (2010), "with a controlling shareholder, the fundamental governance problem is not opportunism by executives and directors at the expense of public shareholders at large but opportunism by the controlling shareholder at the expense of the minority shareholders". An excellent synthesis of this new classification of agency problems can be found in Villalonga, *et al.* (2015).

A promising new line of research is how controlling shareholders can have an advantage when dealing with corporate strategies as diverse as exports, R&D, global chain management, or commodity-extraction. We believe this demands a new approach to the agency conflict that is traditionally used in modern finance to accommodate for the costs and benefits of controlling shareholders.

REFERENCES

- Arrow, Kenneth (1963), "Uncertainty and the Welfare Economics of Medical Care", *American Economic Review*, Vol. 53, No. 5.
- Bebchuk, Lucian A., and Michael S. Weisbach (2010), "The State of Corporate Governance Research", *Review of Financial Studies*, Vol. 23, No. 3.
- Berle, Adolph, and Gardiner Means (1932), *The Modern Corporation and Private Property*, New York: Mac-Millan.
- Claessens, Stijn, Simeon Djankov, Joseph P. H. Fan, and Larry H. P. Lang (2002), "Disentangling the Incentive and Entrenchment Effects of Large Shareholders", *Journal of Finance*, Vol. 57, No. 6.
- Faccio, Mara, and Larry H. P. Lang (2002), "The Ultimate Ownership of Western European Corporations", *Journal of Financial Economics*, Vol. 65.

- Gutiérrez, Luis H., Carlos Pombo, and Rodrigo Taborda (2008), "Ownership and Control in Colombian Corporations", *The Quarterly Review of Economics and Finance*, Vol. 48.
- Hart, Oliver (1983), "Optimal Labor Contracts under Asymmetric Information: An Introduction", *Review of Economic Studies*, Vol. 50, No. 1.
- Hart, Oliver (1995), "Corporate Governance: Some Theory and Implications", *Economic Journal*, Vol. 105, No. 430.
- Jensen, Michael, and William Meckling (1976), "Theory of the Firm: Managerial Behaviour, Agency Costs, and Ownership Structure", *Journal of Financial Economics*, Vol. 3, No. 4.
- La-Porta, Rafael, Florencio López de Silanes, and Andrei Shleifer (1999), "Corporate Ownership Around the World", *Journal of Finance*, Vol. 54, No. 2.
- Mirrlees, James (1971), "An Exploration in the Theory of Optimum Income Taxation", *Review of Economic Studies*, Vol. 38, No. 2.
- Morck, Randall, Daniel Wolfenzon, and Bernard Yeung (2005), "Corporate Governance, Economic Entrenchment, and Growth", *Journal of Economic Literature*, Vol. 43.
- Tirole, Jean (2006), *The Theory of Corporate Finance*, Oxfordshire, NJ: Princeton University Press.
- Villalonga, Belén, Raphael Amit, María A. Trujillo, and Alexander Guzmán (2015), "Governance of Family Firms", *Annual Review of Financial Economics*, Vol. 7.