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Journal of Financial Intermediation 15 (2006) 1–31

Journal of Financial Intermediation

www.elsevier.com/locate/jfi

Agency conflicts, ownership concentration, and legal shareholder protection

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Received 1 September 2003

Available online 17 March 2005

Abstract

This paper analyzes the interaction between legal shareholder protection, managerial incentives, monitoring, and ownership concentration. Legal protection affects the expropriation of shareholders and the blockholder's incentives to monitor. Because monitoring weakens managerial incentives, both effects jointly determine the relationship between legal protection and ownership concentration. When legal protection facilitates monitoring better laws strengthen the monitoring incentives, and ownership concentration and legal protection are inversely related. By contrast, when legal protection and monitoring are substitutes better laws weaken the monitoring incentives, and the relationship between legal protection and ownership concentration is non-monotone. This holds irrespective of whether or not the large shareholder can reap private benefits. Moreover, better legal protection may exacerbate rather than alleviate the conflict of interest between large and small shareholders.
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JEL classification: G34

Keywords: Monitoring; Ownership structure; Corporate governance; Law and finance

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doi:10.1016/j.jfi.2004.12.004

1. Introduction

Following the pioneering work by La Porta et al. (1997, 1998), a growing literature argues that cross-country differences in corporate governance, and more broadly in financial systems, are shaped by the quality of legal rules protecting outside investors. Examples of documented regularities are that better legal investor protection is associated with increased breadth and depth of capital markets, a faster pace of new security issues, and a greater reliance on external financing to fund firm growth (for surveys see La Porta et al., 2000b; Denis and McConnell, 2003). One prominent issue in this recent literature is the relation between cross-country ownership patterns and legal rules. Empirical studies indicate that ownership is on average more concentrated in countries with poor legal shareholder protection. This finding leads La Porta et al. (1998) to argue that "with poor investor protection, ownership concentration becomes a substitute for legal protection, because only large shareholders can hope to receive a return on their investment." By contrast, investors are willing to take minority positions and finance companies in countries where legal rules are extensive and well enforced.[1]

This paper scrutinizes the commonly accepted argument that legal shareholder protection and outside ownership concentration are substitutes (see, e.g., Denis and McConnell, 2003, p. 21). To this end we analyze the interaction between legal shareholder protection, managerial incentives, monitoring, and ownership in a model where shareholder control comes with costs and benefits. As emphasized in the law and finance literature, legal protection has an impact on the ease with which the manager, possibly in collusion with the blockholder, can divert corporate resources. There is, however, another channel which this literature has overlooked: the quality of legal rules also shapes the large shareholder's incentives to monitor. This effect matters for the relationship between the law and the ownership concentration because monitoring, like legal protection, weakens managerial incentives. Moreover, the impact of legal rules on the relation between ownership concentration and monitoring intensity is not uniform but depends on how legal rules interact with monitoring. While some rules tend to complement monitoring, others are more likely to be substitutes. Overall, we find that outside ownership concentration and legal shareholder protection are not necessarily substitutes. In particular, when the law is a substitute for monitoring, legal protection and ownership concentration can be complements. Thus, our model can also account for a non-monotone relationship between ownership concentration and legal protection as for instance Aganin and Volpin (2003) document for Italy.

We consider a firm with a large shareholder and otherwise dispersed ownership. The firm has the prospect of a valuable project which realizes with some probability only if the manager exerts effort. Given that the project is undertaken, the manager decides how much of the proceeds to pay out as dividends to the shareholders and how much to extract as private benefits. Managerial private benefit extraction involves no deadweight loss, but is subject to monitoring and legal constraints. More precisely, we assume that the law puts an upper bound on private benefit extraction and that monitoring lowers this bound further.

[1] As regards inside or managerial block ownership, an argument based on Jensen and Meckling (1976) comes to the same conclusion. When legal investor protection is insufficient, entrepreneurs are forced to maintain large positions themselves to align their incentives with other shareholders (Shleifer and Vishny, 1997).

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