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RETHINKING AGENCY THEORY IN COMPANIES WITH CONCENTRATED OWNERSHIP

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Abstract

This article aims to provide a commentary on the need of alternative theories on corporate governance in companies with concentrated ownership with the aim to identify the gap in this field. The main argument of the article is that concentrated ownerhip gives rise to agency problems when a manager who has superior information acts on behalf of a group of shareholders and neglecting the others. Thus, this kind of agency conflicts require different solutions from conflicts that appear in dispersed ownership. Since the agency conflicts in concentrated ownership renders the assumption that concentrated ownership reduces agency conflicts ineffective, it is neccessary to employ alternative theories to better understand agency conflicts in these companies.

Key Words: Agency Theory, Corporate Governance, Concentrated Ownership

JEL Code: G31,G34

I. INTRODUCTION

The purpose of this article is to provide a commentary on the need of alternative theories on corporate governance in companies with concentrated ownership. The existing literature on corporate governance suggests that concentrated ownership results in better corporate governance because agency cost is minimised in these companies. This happens because the existing literature mirrors corporate governance conducted in states which have developed economies, such as the UK and US, in which ownership and control of companies are often seperated. However, as the separation of ownership and control is not seen in companies with concentrated ownership, they do not face the same agency problems with companies that have widely disperse ownership structure. Even though it has an influential impact, agency theory is unable to provide sufficient understanding on corporate governance in concentrated ownership. Thus, alternative theories on corporate governance are occur for the need of concentrated ownership companies.

The first objective of this paper is to define agency theory. In order to better understand agency problem, it is essential to start from the phenomenon of separation of ownerhip and control. A brief historical overview of the separation of ownership and control, which resulted in the emergence of salaried managers will be given. This is followed by a section that provides a brief discussion on whether the assumption according to which states that agency problem is reduced in companies with concentrated ownership still applies. The two major aspects of separation of ownership and control are managerial control, where there is no shareholder large enough to control the company, and shareholder control, where a group of large investors, generally families, control the company's management. Conventional wisdom suggests that, regardless between which parties the agency problem is, the ownership relation brings to light the agency conflict. The last part discusses the limitations of agency theory when applies in corporate governance research in concentrated ownership companies, followed by concluding remarks.

II. THE EMERGENCE OF THE MODERN COMPANY

The vast majority of companies around the world were incorporated as family businesses in which the individuals were also the controllers (Morck, 2005). These businesses still predominate in states with a short industrial history (Morck, 2005). Originally, a group of investors, generally family members, pooled and risked their earnings and efforts to carry on the business and become the owners by holding a legal title of an enterprise. The main characteristic of these companies was that the owners also controlled their corporations.

At the beginning of the 19th century, there were three ways to establish a business: to engage in business as a sole trader, in a partnership or as an unincorporated body[1]. However, in each case the problem was that if the business became bankrupt, the owner was liable to the creditors until the owner became bankrupt. (Tricker, 2011) This was a disincentive for investors who wished to provide finance but not directly take part in managerial activities. At the turn of the 19th century, large-scale projects, such as transportation and communication technology, started to be financed by individual wealth. (Chandler ve Hikino, 2004) The building and operation of these projects were complex and required massive investment. During the same period, the developments in production technologies of the Industrial Revolution turned factories into the main form of production, and this separated control from the owners and workers. (Means, 1931) Large numbers of workers were brought under a management, and numerous individuals placed their savings under the same control. As the number of investors increased and became geographically dispersed, it became impossible for every owner to be physically involved in the process of managing and controlling the company for their own interests. This brought about the separation of ownership from management. Companies started to be operated by professional salaried managers. The owners were investors who had neither experience nor information nor the time to make decisions for the company. As a result, a new and enlarged type of entity was created. Consequently, the concept of the corporation changed.

A logical extension of the separation of ownership from control was that groups of shareholders engaged in a common activity attempted to simplify their activity by gaining legal personality for their enterprise. The creation of a separate legal personality limits the liability of shareholders for company debts. The reason behind the creation of limited liability was the ability to raise capital from the public. Even if companies with concentrated ownership were not in need of external sources of capital, wealthy families, which generally owned the companies, realised that becoming incorporated would limit their liability and protect them from the company's debts. This encouraged them to demand for external financing. Consequently, family owned companies started to receive external financing from new investors in exchange for ownership of their companies through the sale of shares to these new investors. Until the emergence of the above-mentioned developments, the combination of ownership and management was the dominant pattern in the area of corporate management. However, changes in the understanding of property and the size of corporations affected the concept of property ownership rights and the most notable change was that the personality of the individual owner was separate from the manager. (Berle, 1965) As the number of investors increased, claiming their rights and expressing their opinions became difficult. Therefore, investors were given a right to vote to appoint managers and have a voice in important decisions regarding the company.

In addition, the Industrial Revolution encouraged industrial capitalism, and this provoked more liberal economic systems along with open participation in international trade. (Jensen, 1993) The basis of the capital is the savings of individuals. Different states use different ways to accumulate and allocate capital, and this is closely related to how each state handles corporate governance issues. (Morck, 2005) The different understanding of the meaning of capitalism shaped different states' economies in different ways. For instance, in the US and the UK, capitalism is understood as a system in which a vast number of independent companies owned by millions of middle class shareowners compete with each other for customers. (Lowry ve Dignam, 2011) Individually, these shareholders are generally powerless. Only large outside investors can hold a large percentage of shares, and this gives them a voice in the management of the companies. On the other hand, in most of the rest of the world, capitalism created a system in which almost all corporations of the state are controlled by a handful of rich families. Family members, who wanted to safeguard their power in the companies hired professional managers to serve their interests.(Lowry ve Dignam, 2011) It can be stated that separate management emerged, but was not accompanied by dispersed ownership.

III. AGENCY PROBLEM

As ownership became more dispersed and investors more geographically spread, their links with the management of the companies became weaker. (Tricker, 2011) In limited liability companies, the owners of corporations had the role of managing enterprises, assigning managers for gaining profits, while managers were to operate the corporations in the interests of the owners. (Means, 1931) The problem that arises is whether those in control of the corporation would run it in the interests of its owners. In *The Wealth of Nations*, Adam Smith noted that the directors of joint-stock companies are the managers of other people's money, not of their own. It is expected that they will not watch over that money with the same anxious vigilance with which they watch over their own money. (Smith, 2010) Since the managers are not the major residual claimants, they may take actions that deviate from the interests of shareholders when effective control procedures do not exist.

Before the separation of ownership and control, the owner-worker had an interest in the entity, had power over it and acted with respect to it. However, after the separation, the owners fulfilled the first two functions only, while the third one was left to the professional managers. As a consequence, the group with interests in the enterprise began the 'owner' regardless of whether that group had power over it. After the separation of ownership from control, investors kept the right to receive residual rights and have a limited right to control, but the right to use, control and manage was given to the managers.

Berle and Means demonstrated that whenever there is separation between the shareholders and managers, agency problems arise. The governing body, which should protect the interests of the members, may instead abuse them. The relationship between shareholders and directors is perceived as an agency problem. It is argued that there is a possibility that agents seek to maximise their own benefits by taking actions that are advantageous to themselves but detrimental to shareholders. (Tricker, 2011)

The agency problem is a risk-sharing problem that arises when the parties to a contract have different attitudes toward risk. An agency relationship is a contract under which the managers (the agent) are engaged to fulfil some service on behalf of the owners (the principal) which includes delegating some decision-making authority to the agent.(Jensen ve Meckling, 1936) The agents' aim is to run the company successfully in the long-term. On the other hand, the aim of principals is to gain maximum profit. Consequently, the agents may take a different attitude towards risk than the principals. The actions taken by the agents can be beneficial for their goals but detrimental to the shareholders. The main difficulty is that, since the principal has less information than the agent, the principal cannot be sure whether the agent is performing as promised. In this case, the principals must trust to the agents' decisions and rely on the information provided to them. If the agents' decisions are detrimental to shareholders, this creates conflicts of interest within the corporation. It is difficult for the principal to verify whether the agent is actually acting in his best interests. Even though the principal can make some attempts 'the agency problems may be reduced, but not eliminated'.(Hart, 1995)

In corporations where there are controlling shareholders who possess the majority of shares and voting right, the conflict of interests is generally seen between managers and controlling shareholders. In such situations, agency problem arises when the manager acts on behalf of a group of shareholders but not for all investors.

IV. AGENCY PROBLEMS IN COMPANIES WITH CONCENTRATED OWNERSHIP

A company with concentrated ownership is partly owned by one or a group of shareholder who together control at least 20% of the total shares. (La Porta et al. 1999) Generally, the controlling shareholder is also the main decision-maker and the managers are expected to govern the company according to their decisions. In addition, the poor legal protection for minority investors exacerbates the corporate governance problems in companies with concentrated ownerhip. Thus, while it is accepted that corporate governance problems in widely held companies are serious, the agency problems that arise in concentrated ownership companies cannot be ignored.

Three reasons can be inferred from the model of Jensen, Meckling and Fama that justify why companies with concentrated ownership do not deal with significant agency problems. Firstly, in widely dispersed companies, it is difficult to align the interests of shareholders and managers. However, in companies with concentrated ownership, the dominant shareholders are actively taking part in the management. Therefore, it is much easier to align the interests of shareholders and the amount of risk that shareholders would accept that the decisions of the management entails. This would naturally reduce agency costs in companies with concentrated ownership. (Fama ve Jensen, 1983) The second reason is that the use of property rights is mostly restricted to internal decision-makers, who are mostly controlling shareholders. Therefore, their involvement in the management will ensure that the wealth of the shareholders will not be expropriated.(Fama ve Jensen, 1983) Lastly, since the shares are held by controlling shareholders, the shareholders have a close relationship with the decision-making agents and they have the opportunity to monitor the agents' decisions. This close relation between the principal and agent allows the agency problem to be controlled.

The conclusion from these three arguments is that companies with concentrated ownerhip are controlled by owner-managers, which results in minimised, but not eliminated, agency costs and less costly governed corporations compared to widely held companies. Since often the managers of the company and controlling owners are the same persons, it is more possible to protect shareholders' interest against managerial abuses. Thus, concentrated ownership results in better corporate governance.

However, concentrated ownership can give rise to its own set of agency problems. (Morck, R. ve Yeung, 2003) A set-off problem may arise when these companies obtain equity financing. The family business group companies can use a pyramidal ownership structure to separate ownership from control.(Morck, R. ve Yeung, 2003) This ownership structure is used to provide capital to the company without losing the majority control of any company in the business group. In this case, the managers who have specific knowledge about the company may act for the benefits of controlling shareholders, but not for the all shareholders. This case is even more serious in companies with concentrated ownerhip than in widely held ones, as it is not possible to oust a controlling shareholder and allow the efficient transfer of control.

A result of pyramidal ownership structure is a divergence between the cash flow rights and the control rights of these controlling shareholders. In this case, the family is entrenched in all the companies of the group by their voting power and this results in the assignment of managers who act beneficially for the controlling shareholder. Since the interests of controlling shareholders and other shareholders are not aligned, there is the possibility that an agency problem arises because managers may act in the best interests of the controlling shareholders and ignore the interests of minority shareholders. Thus, the agent is not held directly accountable to all shareholders. In addition, if the manager is a family member, the judgment about the appropriateness of manager's decisions can be biased because of emotions and family bonds.(Gomez-Mejia et al., 2001) These situations create less transparency and render monitoring ineffective. In addition to this, under limited rationality and information asymmetries, it may not be possible to designate performance criteria for the agent. In this case, the decision-makers can favour a certain group of shareholders' interests by using information not known to the other shareholders. (Van Den Berghe ve Carchon, 2003)

Financial scandals in diffused ownership companies usually differ from those companies with concentrated ownership.(Enriques ve Volpin,2007) In order to inflate stock prices and gain from their equity and options holdings, widely held company managers engage in earnings manipulation and accounting irregularities. In concentrated ownership, employing the pyramid structure to a family business group, enables the controlling shareholders to expropriate corporate resources especially if investor protection is poor. (Volpin, 2002) When investors are not protected properly, controlling shareholders can be very protective of company specific information. Such secrecy can be very harmful for shareholders, as this increases information asymmetry. For instance, controlling shareholder can extract benefits from the company it controls via non-transparent activities such as tunnelling, which is a way for insiders to misappropriate minority investors' wealth. In a family business group, individual companies controlled by the same family obtain their goods/services and financial needs from each other. This may give an opportunity to controlling shareholders to artificially increase the prices of goods or services and transfer the profit from a company in which they have small cash flow rights to another in which they have large cash flow rights. Correspondingly, the group can transfer profit from the seller company to the buyer company through artificially low prices of goods and services. The advantage obtained by using corporate resources via tunnelling is likely to drive a wedge between the value of a company for the controlling shareholders and the minority shareholders. Therefore, the conflicts of interest between a controlling shareholder and other shareholders exhibits a particular corporate governance problem in relation to companies with concentrated ownership which requires high quality monitoring and auditing of the controlling shareholder.

The outcome is that, contrary to Meckling and Fama's views, a ownership concentration is not an efficient way to reduce agency problems. When there is no separation of ownership and control, there are less agency problems. When a group of shareholders are controlling the company, generally the owner also happens to be the manager. Information asymmetry and different incentives are not an issue anymore. However, such ownership structure gives rise to agency problems when a manager who has superior information acts on behalf of a group of shareholders and neglecting the others. Professional managers are hired by controlling shareholders. The lack of separation of ownership and control in real terms in companies with concentrated ownership may lead the professional managers to serve the controlling shareholders. The interests of controlling shareholder become different to those of other shareholders. If the interests of these shareholders can be aligned, the agency problems can be reduced. However, as long as the managers act on behalf of the controlling shareholders, agency problems will continue to rise in companies with concentraetd ownerhip structure.

V. IMPLICATIONS

Agency theory aims to highlight how the related parties, principal and agents, should behave in order to manage the company better. However, as far as its practical application is concerned, there can be some challenges. The basic challenge is how to ensure the agents act solely in the interest of the principals. In addition, the interests of diversified shareholders are not homogeneous. Therefore, the focus has always been on agency issues which occurs between the agent and the principal in widely held companies. Ownership concentration is assumed to be a remedy for this conflict. However, limiting the focus to dispersed ownership is too narrow. Agency conflict in concentrated ownership companies is an important but overlooked problem in corporate governance. The conventional agency theory is based on the conflict between the self-interested management and weak shareholders. Contrary to the assumption in agency theory, concentrated ownerhip can also give rise to agency problems. Across the world, concentrated ownership is still common and conflicts in these companies require different solutions than the solutions the agency theory generates. Viewed in these terms, there is no perfect overlap between corporate governance and the reduction of agency cost in companies with concentrated ownership. Thus, it would be a mistake to assume that owner-management is a remedy for agency problems.

The problem of Berle and Means’ agency theory is that it underestimated the number and importance of concentrated ownership companies around the world. In widely held companies, the concern is that professional managers may act for the benefit of the growth and continuity goals of the company but to the detriment of other shareholders. Similarly, in companies with concentrated ownerhip, managers may act for the controlling shareholder, but not for the shareholders in general. The conflict of interests between and within controlling shareholders, managers and other shareholders increases agency problems. Fan and Wong argue that it is difficult to mitigate agency conflicts between controlling and non-controlling shareholders in companies with concentrated ownership through conventional corporate governance mechanisms, such as board of directors, due to their comparatively weak institutions. (Fan ve Wong, 2005) Thus, conventional agency theory becomes highly unrepresentative for companies with concentrated ownership. In conclusion, it is seen that concentrated ownership does not eliminate agency problems. It is obvious that concentrated ownership does not replace the costly control mechanisms that publicly held companies use to reduce their agency costs. Therefore, there is a good reason for concentrated ownership companies to become the focus of the corporate governance debate because concentrated ownership raises the need for monitoring, transparency, accountability and fairness.

VI. CONCLUDING REMARKS

In the last two decades, corporate governance has emerged as a means to mitigate the harmful effects of asymmetric information, monitor managers and align the interests of managers and owners. In states, where widely dispersed ownership is seen, the system entrusts professional managers with the governance of companies and shareholders with the monitoring of the quality of governance. However, in states, where concentrated ownership constitute a large percentage of the companies in the market, controlling shareholders wishing to protect their status in the company can undermine the quality of governance. Therefore, the utilization of agency theory should be questioned.

Differences in the institutions create differences in the implementataion of corporate governance. (Gibson, 2003) Thus, when making corporate governance policies, the institutional differences, such as ownership structure, should not be ignored. This paper argues that corporate governance in concentrated ownership does not resemble the conventional agency theory model. The agency conflicts in companies with concentrated ownership differ from the conventional principal-agent conflict. (Young et al. 2008) Thus, while agency theory is dominant and pivotal in explaining corporate governance, it is unable to provide sufficient understanding on the conflicts between controlling and non-controlling shareholders in companies with concentrated ownership. Agency theory is not the sole possible solution to the conflicts seen between controlling and non-controlling shareholders and agency problems are not the exclusive target of corporate governance. Therefore, alternative perspectives are needed in explaning the corporate governance issues in these companies.

This article links the literature on corporate governance, especially agency theory, to the literature on the concentrated ownerhip companies. It extends the research to focus more on theories other than agency theory in general and on ownership concentration in particular and flesh out the significance of the conflicts seen among the controlling and non-controlling shareholders in these companies.

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