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On the impact of outside blockholders' voting power

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Abstract

Purpose – *The purpose of this paper is to complement existing research of the relationship between concentrated ownership and firm performance by theoretically exploring the impact of outside blockholders on the firm, primarily from the perspective of voting power.*

Design/methodology/approach – *This paper proposes theoretical propositions based on analyses and logical extension of results of the existing theoretical and empirical studies.*

Findings – *This paper proposes three theoretical predictions: First, voting power provides outside blockholders a necessary condition to pursue shared and private benefits of control, and it is positively correlated with blockholders' capability of influencing firm value. Second, everything else being equal, an outside blockholder is more (less) likely to pursue private benefits than shared benefits when the equity market is efficient and when the blockholder's voting power is less (more) than 50 per cent. Third, controlling outside blockholders can capitalize on their voting power to appoint managerial delegates and board representatives to the invested firms for the purpose of pursuing private benefits of control.*

Originality/value – *This paper tries to make two contributions to the corporate governance literature. First, this research relies on a new perspective to explore the relationship between ownership structure and firm value. Second, this paper presents the first theoretical argument which states that controlling outside blockholders rely on their managerial delegates and board representatives to pursue their private benefits of control.*

Keywords *Corporate governance, Ownership, Voting power*

Paper type *Conceptual paper*

Introduction

Existing literature has not established an unequivocal conclusion of the relationship between ownership structure and firm value (Dalton *et al.*, 2003). For example, recent empirical studies (Coles *et al.*, 2012) challenge the results of prior research regarding the relationship between managerial ownership and firm value (Morck *et al.*, 1988; McConnell and Servaes, 1990). Prior research also generally shows an insignificant relationship between outside blockholders' ownership and firm value (Demsetz and Lehn, 1985; McConnell and Servaes, 1990).

Two intriguing research questions, thus, arise: What is the impact of outside blockholders on the firm, if not firm value? What are the potential circumstances under which outside blockholders affect the firm?

To better understand the relationship between outside blockholders and the firm, this paper tries to "open the black box" to reveal possible underlying mechanisms that allow outside blockholders to influence the firm.

Outside blockholders, who are non-employees and who have at least 5 per cent ownership, are prevalent and heterogeneous around the world and have the incentive and ability to influence their invested firms (La Porta *et al.*, 1999; Villalonga and Amit, 2009). Outside blockholders can utilize their voting power to accomplish a variety of objectives. On the one

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hand, blockholders bring shared benefits to all shareholders by monitoring the management (Denis and McConnell, 2003; Pergola and Verreault, 2009); on the other hand, blockholders, especially those controlling ones with at least 20 per cent voting power, can obtain the exclusive power and ability to influence and control their invested firms and secure exclusive private benefits for themselves, even at the cost of other shareholders (Shleifer and Vishny, 1997; Holderness, 2003). Moreover, controlling outside blockholders can capitalize on their voting power to assign managerial delegates and board representatives to their invested firms (Holderness and Sheehan, 1988).

By exploring the substantial influences of outside blockholders, primarily from the perspective of voting power, this paper proposes three theoretical propositions to offer partial explanations to the questions related to the impact of outside blockholders: First, voting power provides an outside blockholder a necessary condition to pursue shared and private benefits of control, and it is positively correlated with an outside blockholder's capability of influencing firm value. Second, everything else being equal, an outside blockholder is more (less) likely to pursue private benefits than shared benefits when the equity market is efficient (Malkiel, 2003) and when the blockholder's voting power is less (more) than 50 per cent. Third, controlling outside blockholders can capitalize on their voting power to appoint their managerial delegates and board representatives to the invested firms for the purpose of pursuing private benefits of control. In summary, this paper argues that an outside blockholder's impact on firm value is jointly influenced by the blockholder's capability of and incentive to pursuing shared and private benefits of control. Moreover, an outside blockholder's managerial delegates and board representatives can enhance the blockholder's capability of pursuing private benefits.

By offering theoretical analyses that help explain the impact of outside blockholders on their invested firms and how they can ensure their influences from the perspective of voting power, this study makes two contributions to the corporate governance literature. First, this research uses existing agency theory studies of ownership structure (La Porta *et al.*, 1999) and shareholder conflicts (Villalonga and Amit, 2009; Holderness, 2003) to offer a new perspective of exploring the relationship between ownership structure and firm value. The analyses of this paper bear both theoretical and empirical implications. From the theoretical perspective, this paper, unlike prior studies that focus on the direct connection between ownership and firm value (Burkart *et al.*, 1997), emphasizes the underlining factors of blockholder's shared and private benefits of control that influence the relationship between ownership structure and firm value. In other words, this paper clearly identifies that the impact of outside blockholders' voting power on firm value may come from the combined effect of blockholder's shared and private benefits of control. Furthermore, this paper argues that outside blockholders' voting power is correlated with the large shareholders' capability of and incentives to pursuing private benefits and/or shared benefits which influence firm value. These theoretical arguments bear empirical implications which potentially help explain the lack of consistent findings of the relationship between ownership structure and firm value (Demsetz and Villalonga, 2001). These theoretical analyses effectively suggest that empirical studies of the relationship between ownership structure and firm performance should separate the impact of blockholder's shared benefits of control from that of private benefits of control and consider the joint effect of the large shareholders' capacity of and incentives to pursuing private benefits and/or shared benefits.

Second, this study extends traditional agency theory analyses of the relationships among shareholders, management and boards of directors by presenting the first theoretical argument which states that controlling outside blockholders can rely on their managerial delegates and board representatives to pursue private benefits of control. It enriches existing studies of the impact of large shareholders on management (Young *et al.*, 2008) by explaining why and illustrating how controlling blockholders can capitalize on their voting power to ensure that their managerial delegates serve the interests of their principals. It

challenges the traditional agency theory assumption that directors are obliged to monitor management on behalf of all the shareholders (Fama and Jensen, 1983) by theoretically arguing that shareholder conflict exists and the board representatives of controlling outside blockholders are poised to help their constituencies pursue private benefits of control.

The next sections of the paper review extant literature, develop theoretical propositions, discuss a few contingencies related to the theoretical arguments and conclude with a summary of the limitations of the paper and future research opportunities.

Literature review

Existing theoretical analyses posit that blockholders positively influence firm performance (Burkart *et al*., 1997; Shleifer and Vishny, 1986). However, empirical studies provide no consistent evidence that establishes a direct and significant relationship between blockholder ownership and firm performance (Dalton *et al*., 2003). Demsetz and Lehn (1985) argue that ownership structure and firm performance are endogenously determined. If this is the case, then ownership structure cannot be taken as exogenous, as existing theoretical models (Burkart *et al*., 1997) and cross-sectional empirical analyses (Morck *et al*., 1988) assume, not only because ownership structure and firm performance may mutually influence each other (Demsetz and Villalonga, 2001) but also because some unobserved factors may influence both ownership structure and firm performance simultaneously. Blockholder's shared and private benefits of control, which are conferred by blockholder's voting power, are important factors that potentially influence the relationship between ownership structure and firm performance.

Blockholder's shared benefits of control

Prior research suggests that large shareholders, especially blockholders who are defined as any investors with more than a 5 per cent equity stake in their invested firms (Connelly *et al*., 2010a), bring shared benefits to all shareholders. Blockholders have both the incentive and power to monitor and influence management such that cash flow is increased (Denis and McConnell, 2003). Holderness (2003) further proclaims that "the shared benefits of control arise from the superior management or monitoring that can result from the substantial collocation of decision rights and wealth effects that come with large-block ownership." Therefore, the most important shared benefits that a large shareholder can bring with its shared benefits of control should be enhanced firm value.

Existing studies provide two main theoretical arguments that support a generally positive relationship between concentrated ownership and firm value. First, bigger managerial ownership mitigates agency problems, and therefore, managers should have stronger incentives to enhance firm value (Jensen and Meckling, 1976). Second, large non-managerial shareholders have the incentive and power to monitor managers, so that managers can strive to improve firm performance (Burkart *et al*., 1997).

However, empirical investigations have yielded mixed results. For example, Morck *et al.* (1988) and McConnell and Servaes (1990) show that managerial ownership has a significant non-linear relationship with firm value. However, Demsetz and Lehn (1985) find no statistically significant relations between ownership structure and firm performance. Interestingly, empirical analyses based on the same data source sometimes yield different results (Demsetz and Lehn, 1985; Demsetz and Villalonga, 2001; Hill and Snell, 1988). In general, although several studies find evidence of various forms of shared benefits of control (Allen and Phillips, 2000; Barclay and Holderness, 1991; McConnell *et al*., 2008), the fact that scholars find mixed results for the association between concentrated ownership and firm performance confirms that concentrated ownership yields cost along with benefits (Denis and McConnell, 2003).

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Private benefits

The term of private benefits finds a variety of applications in economics (Pearce and Sturmey, 1966) and finance literature (Shleifer and Vishny, 1997). Pearce and Sturmey (1966) link shared benefits (social benefits) with private benefits and emphasize the appropriate characteristics of private benefits: "The production of a good or service yields a social benefit in so far as they are welfare-creating products. For some of the benefits a price is charged which appropriates the social benefits and yields private benefits to the appropriator."

Pearce and Sturmey (1966) suggest two characteristics of private benefits. First, private benefits are a cost to those who do not obtain the privileges. Second, private benefits accrue only to the entity which seeks them. Consistent with this rationale, agency theory suggests that managers have a tendency to seek private benefits (Denis *et al.*, 1997). Specifically, managers would opportunistically seek private benefits or self-interests (Williamson, 1988) because the profit-maximizing goal of shareholders and the utility-maximizing goal of managers do not always converge (Fama, 1980). Moreover, managers are capable of pursuing private benefits because they possess the administrative power to control the resources and direct the strategic actions of their firms (Fama and Jensen, 1983; Fama, 1980).

In summary, economics and finance literature suggests the following:

- Pursuing private benefits is a result of the opportunistic behavior of managers (Williamson, 1988) and the conflict of interest between shareholders and managers (Jensen and Meckling, 1976).
- Private benefits can be either pecuniary or non-pecuniary (Shleifer and Vishny, 1997; Denis *et al.*, 1997).
- The incentive and ability to pursue private benefits is closely associated with the identity of the appropriator (Dyck and Zingales, 2004).

The conclusion that private benefits are associated with the identity of the appropriator is particularly important because it is pertinent to the investigation of private benefits specific to those outside blockholders who exert substantial impact on their invested firms.

Outside blockholder's private benefits of control

Prior studies show that heterogeneous blockholders enjoy heterogeneous private benefits conferred by their large shareholding positions (Barclay and Holderness, 1989; La Porta *et al.*, 1999; Faccio and Lang, 2002; Dyck and Zingales, 2004; Hoskisson *et al.*, 2002; Connelly *et al.*, 2010a; David *et al.*, 2010). For example, some blockholders can engage in self-dealing activities, such as tunneling (Johnson *et al.*, 2000). Blockholders from the financial industry (institutional blockholders), especially pension funds and mutual funds, can influence the strategies of their invested firms to better satisfy the interest of their primary constituencies or the shareholders of those funds rather than the rest of the shareholders in the invested firms (Hoskisson *et al.*, 2002; David *et al.*, 2010; Wright *et al.*, 1996). Blockholders which are corporations (corporate blockholders) enjoy certain private benefits not available to institutional and individual blockholders. For example, corporate blockholders enjoy synergistic benefits in terms of market collaborations between the purchasing firm and the invested firm (Allen and Phillips, 2000; Fee *et al.*, 2006), as well as favorable tax rate for dividend payouts (Barclay *et al.*, 2009).

In general, previous research shows that the conflict of interest between blockholders and small shareholders exist because the varying private benefits enjoyed by the blockholders sometimes are a cost to atomistic shareholders (Johnson *et al.*, 2000).

One of the most important, influential and non-pecuniary private benefits that some large blockholders can enjoy is to effectively control the invested firms. Dyck and Zingales (2004)

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describe private benefits of control as "[. . .] opportunities [. . .] not shared among all the shareholders in proportion of the shares owned, but enjoyed exclusively by the party in control". Holderness (2003) and Barclay and Holderness (1992) specifically point out that private benefits of control come from blockholders' voting power. In this study, an outside blockholder's private benefits of control are defined as the exclusive pecuniary and/or non-pecuniary benefits that the blockholder can obtain when it possesses enough voting power to influence and control the invested firm.

Voting power and outside blockholders

Control without being a majority shareholder

Although a blockholder gains more power as its shareholding position increases, the large shareholder can effectively control the firm without a majority ownership (La Porta *et al.*, 1999). In other words, although owning and controlling more than 50 per cent of the shares of a firm naturally result in absolute control in most cases (Holderness and Sheehan, 1988), prior research argues that 20 to 30 per cent of voting power or ownership is usually large enough to allow a blockholder to effectively control a firm (La Porta *et al.*, 1999).

Prior literature provides three possible reasons for this intriguing projection. First, under the widely adopted plurality voting rule for deciding the results of director elections (Cai *et al.*, 2009), a blockholder which owns the largest but below 50 per cent ownership of a diffusely held firm would have enough voting rights to influence the election of board of directors and consequently control the management (Shleifer and Vishny, 1997; Barclay and Holderness, 1992), even in the normal one share – one vote regime (Grossman and Hart, 1988).

Second, blockholders can possess voting power exceeding their ownership stakes or cash flow rights in a pyramid structure, which effectively allows the apex blockholder or ultimate owner to control firms at the lower levels of the pyramid with less than 50 per cent of ownership (Faccio and Lang, 2002), regardless whether the one share – one vote regime (Grossman and Hart, 1988) is implemented or not (Morck *et al.*, 2005).

Third, a blockholder can effectively control an invested firm with less than 50 per cent shareholdings when its proportional voting power exceeds its proportional ownership because shareholders and their corresponding representatives can possess superior voting stocks (DeAngelo and DeAngelo, 1985; Jarrell and Poulsen, 1988). It is also reasonable to expect that a blockholder can retrieve stronger private benefits of control when it possesses superior voting stocks which allow a blockholder to effectively control the invested firm with smaller ownership.

In general, an outside blockholder might be capable of influencing and controlling the invested firm to secure private benefits of control and/or obtain shared benefits of control with less than 50 per cent voting power.

Voting power and outside blockholders' capability of affecting firm value

Extant literature acknowledges that blockholders, especially controlling ones, can influence their invested firms with their shared and private benefits of control (Holderness, 2003). But prior studies are generally silent about the magnitude of the individual impact of shared and private benefits of control, even if shared benefits of control are defined to increase firm value and private benefits of control may allow controlling shareholders to pursue private benefits at the cost of firm value. Directly measuring the outcomes of blockholders' control of the firm encounters the difficulty of gauging the combined effect of shared and private benefits because they can be entwined with each other.

It is important to point out that voting power is a necessary condition for any large outside shareholders to provide shared benefits of control and pursue private benefits of control. Voting power is a necessary condition because outside blockholders can obtain neither shared benefits nor private benefits if they do not have enough voting rights. Without enough voting power, outside shareholders who are neither executives nor employees of

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the firm would have few capabilities of influencing the strategic actions of the firm and the composition of the board of directors. Therefore, outside shareholders would not be able to exert any substantial impact on the firm from the perspective of shared and private benefits of control. Voting power is a necessary but not sufficient condition because some outside blockholders may not have a strong motivation to influence the invested firms, even if they have enough voting power. For example, large outside shareholders such as pension funds may be unwilling to actively exercise their voting power to influence their invested firms because of legal concerns (Ryan and Schneider, 2002).

When outside blockholders have more control of the invested firms, they can pursue either shared benefits or private benefits. In some cases, blockholders can pursue private benefits and generate shared benefits simultaneously (Gilson and Gordon, 2003). These scenarios can be summarized as in Figure 1. In summary, an outside blockholder needs its voting power to influence its invested firm, regardless of whether it intends to directly influence the firm with its voting power or uses the mechanism of "exit" to impact the firm (Edmans and Manso, 2011).

Correspondingly, an outside shareholder's capability of influencing firm value is the results of the interactions among the key factors such as shareholder's voting power, blockholder's shared benefits of control and private benefits of control. When an outside shareholder does not have enough voting power, it possesses neither private benefits of control nor shared benefits of control and has few capabilities of influencing firm value, as Scenario A of Figure 2 describes. As shown in Scenario B of Figure 2, an outside shareholder starts gaining control of its invested firms with some voting power, and it begins having the capability of positively influencing firm value when it starts to generate a low level of shared benefits of control by monitoring the management (Holderness, 2003). Yet the blockholder does not have enough voting power to pursue private benefits of control. Scenario C in Figure 2 shows that when an outside blockholder's voting power increases and, therefore, its control of the invested firms strengthens, it is capable of influencing firm value with either a comparatively higher level of shared benefits of control or a lower level of private benefits of control or a combination of those two. In Scenario D, when an outside blockholder has enough power to become the controlling blockholder with 20 per cent or more of voting power, the blockholder is capable of controlling the invested firms exclusively and obtaining comparatively more private benefits of control, along with full shared benefits of control. Therefore, the blockholder is capable of influencing firm value to an even higher degree. Scenario D1 is different from Scenario D2 because of the voting power of the controlling outside blockholder. In Scenario D1, in which the controlling blockholder has

Figure 1 Possible outcomes of blockholder's control of invested firms

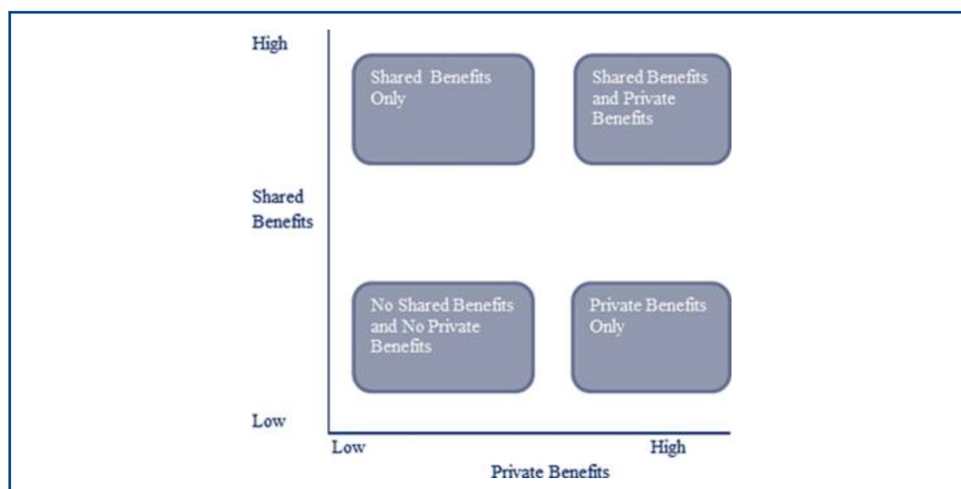
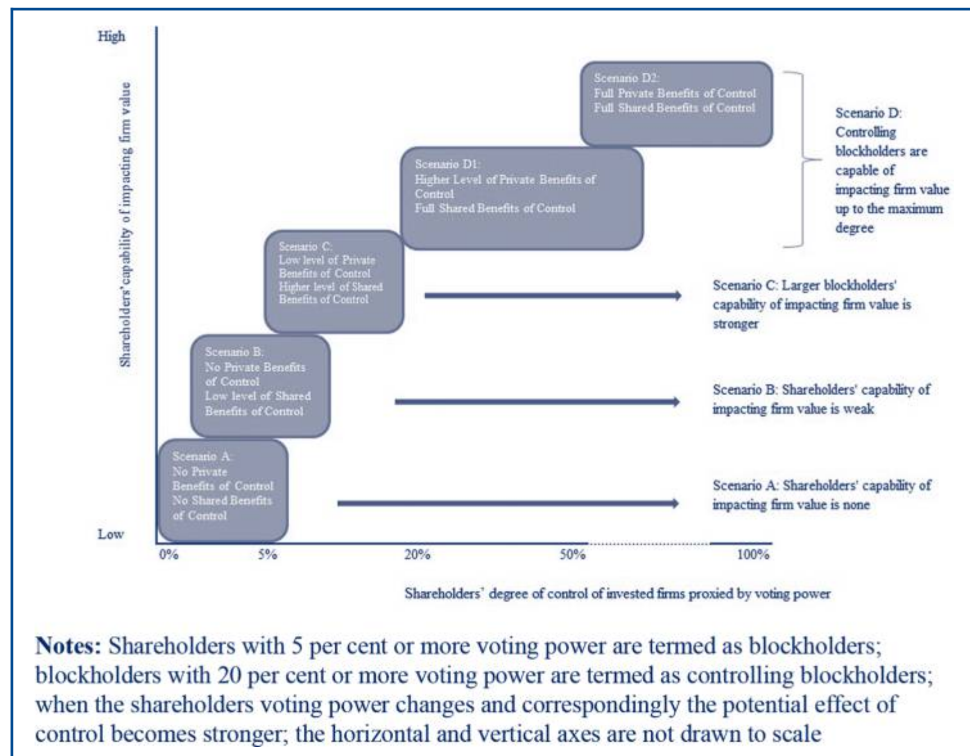


Figure 2 Outside shareholder's capability of impacting firm value



Notes: Shareholders with 5 per cent or more voting power are termed as blockholders; blockholders with 20 per cent or more voting power are termed as controlling blockholders; when the shareholders voting power changes and correspondingly the potential effect of control becomes stronger; the horizontal and vertical axes are not drawn to scale

power from 20 to 49 per cent, the blockholder is capable of generating full shared benefits of control but does not necessarily have all the power to obtain maximum private benefits of control. In Scenario D2, where the voting power of a controlling outside blockholder is 50 per cent or more, the controlling blockholder can capitalize on both its full scale of private benefits of control and shared benefits of control to influence firm value to the maximum degree:

> *P1.* The voting power of an outside blockholder is a necessary condition for the large shareholder to pursue shared and/or private benefits of control. As a result, an outside blockholder's voting power is positively correlated with the blockholder's capability of affecting firm value.

In general, it is important to emphasize that although an outside blockholder's *capability* of affecting firm value is positively associated with voting power, the total effect of blockholders' voting power on firm performance is unclear, as prior empirical findings documented (Demsetz and Lehn, 1985; Demsetz and Villalonga, 2001). The lacking of a significant relationship between the ownership structure and firm value might be jointly influenced by the offsetting effect of blockholders' shared and private benefits of control as well as the blockholder's motivation of pursuing either shared or private benefits.

Voting power and outside blockholders' incentive to pursue private benefits versus shared benefits

It is important to emphasize that voting power provides an outside blockholder the capability of pursuing shared and private benefits of control, but voting power itself does not necessarily motivates the outside blockholder to choose between pursuing shared benefits and private benefits. Whether an outside blockholder has the incentive to pursue shared benefits versus private benefits is partially influenced by what the blockholder can obtain from pursuing shared benefits or private benefits. Shleifer and Vishny (1997) posit that blockholders "prefer to use firms to generate private benefits of control that are not

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shared by minority shareholders" once their ownership of the target firms "gets beyond a certain point". In other words, an outside blockholder may intentionally pursue private benefits at the cost of other shareholders or even firm value rather than pursuing shared benefits that enhance the wealth of all shareholders, if it concludes that the wealth generated by pursuing private benefits outweighs the wealth derived from pursuing shared benefits.

It is possible to demonstrate that when the stock market is efficient (Malkiel, 2003) and the one share – one vote regime (Grossman and Hart, 1988) is implemented, an outside blockholder would benefit more from pursuing private benefits than shared benefits when its voting power is below 50 per cent and everything else is assumed to be equal.

A simplified example can illustrate why an outside blockholder can benefit from pursuing private benefits even if the action can hurt firm value. Let us assume that an all-equity firm values at $100 and an outside blockholder owns 20 per cent of the firm which is $20. If the blockholder pursues and obtains private benefits of $10, then its total wealth is enhanced by $10. In the meantime, the blockholder may suffer a reduction of its wealth invested in the firm because an efficient market (Malkiel, 2003) may value the firm at $90 after the expropriation. Accordingly, under the one share – one vote regime (Grossman and Hart, 1988), the wealth of the blockholder invested in the firm now becomes $18 which is 20 per cent of $90. As a result, the total wealth of the blockholder becomes $28 after the blockholder expropriates $10 from its invested firm, which is a 40 per cent increase. The $10 reduction of firm value due to the blockholder's pursuit of private benefits only affects the appropriator negatively with $2 rather than the total $10. The negative effect of remaining $8 is shared by other smaller shareholders.

In comparison, the result of pursuing shared benefits might be less appealing to an outside blockholder because the potential wealth increase is shared with all shareholders. In the same hypothesized company discussed above, a $10 wealth increase as the result of the blockholder's pursuit of shared benefits is shared by all shareholders. In other words, the blockholder only receives 20 per cent of the increase which is $2. Pursuing shared benefits might enhance the wealth of the blockholder by merely 10 per cent rather than 40 per cent which is the case of pursuing private benefits.

In general, what motives an outside blockholder to pursue private benefits rather than shared benefits is the fact that the blockholder may reap all the private benefits and let other shareholders share the negative effect of its action.

It is also possible to demonstrate that when the stock market is efficient (Malkiel, 2003) and the one share – one vote regime (Grossman and Hart, 1988) is implemented, an outside blockholder would benefit less from pursuing private benefits than shared benefits when its voting power is above 50 per cent and everything else is assumed to be equal.

A simple model can provide a more general verification of the analyses above. Let us assume that an outside blockholder owns α ($0< \alpha <100$ per cent) of an all-equity firm and possesses the same ratio of voting power under the one share – one vote regime (Grossman and Hart, 1988). Let us also assume that the firm value is V, the private benefits that the blockholder can expropriate is P and the shared benefits that the same blockholder can obtain is S. Accordingly, the blockholder's wealth becomes $\alpha (V - P) + P$ when the blockholder pursues private benefits instead of shared benefits. Alternatively, the blockholder's wealth would be $\alpha (V + P)$ when the blockholder obtain shared benefits rather than private benefits. When P is equal to S, it is easy to prove that when $\alpha < 50$ per cent, $\alpha (V - P) + P > \alpha (V + P)$; When $\alpha > 50$ per cent, $\alpha (V - P) + P < \alpha (V + P)$; and when $\alpha = 50$ per cent, $\alpha (V - P) + P = \alpha (V + P)$.

Therefore, an outside blockholder would be motivated to pursue either private benefits or shared benefits as predicted below:

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P2a. Ceteris paribus, an outside blockholder is more likely to pursue private benefits than shared benefits when the equity market is efficient and the blockholder's voting power is less than 50 per cent.

P2b. Ceteris paribus, an outside blockholder is less likely to pursue private benefits than shared benefits when the equity market is efficient and the blockholder's voting power is more than 50 per cent.

Facilitators of outside controlling blockholders' shared and private benefits of control

Heterogeneous blockholders and their influences

Blockholders can be categorized as family, state, financial and corporation (La Porta *et al.*, 1999; Faccio and Lang, 2002). Traditionally, the family category encompasses a family or an individual or a firm unlisted on any stock exchange (Faccio and Lang, 2002). The state blockholder normally is a national government or local authority (Faccio and Lang, 2002). Some scholars broadly define the financial category as firms such as banks, insurance and real estate companies (Faccio and Lang, 2002). Other studies categorize some financial firms, such as mutual funds and pension funds, as institutional investors (Hoskisson *et al.*, 2002). Non-financial firms are defined as the corporation type. Moreover, blockholders who are employees of the firm are considered inside blockholders. Outside blockholders are non-employee large shareholders which can be state, financial, corporation and even individuals. In general, heterogeneous blockholders widely exist, and blockholding brings benefits, potentially both shared and private, along with possible costs (Thomsen *et al.*, 2006) to shareholders both large and small.

A blockholder's capability of influencing the firm is closely related to blockholder heterogeneity. Although blockholders have the incentive and ability to pursue private benefits of control for themselves (Shleifer and Vishny, 1997) and can generate shared benefits of control for all shareholders (Holderness, 2003), an outside blockholder cannot directly conduct ordinary business decision-making for its invested firm, even if the blockholder is a controlling owner (Ertimur *et al.*, 2010). Therefore, heterogeneous outside blockholders can exert their influence more easily if they have their own agents in the invested firms, even if they can negotiate privately with the management or submit a proposal in the annual shareholder meeting (Ryan and Schneider, 2002; Gillan and Stark, 2000). Particularly, a controlling blockholder can directly conduct or influence business decision-making with a managerial delegate in the invested firm. Alternatively, a controlling outside blockholder can establish a board representation at the invested firm to monitor and influence the management and guard its own interest, which includes its private benefits of control (Burkart *et al.*, 2003). Consequently, facilitated by their managerial delegates and/or board representations, controlling outside blockholders can use various and yet not necessarily mutually exclusive means to try capturing and safeguarding their private benefits of control, as well as generating shared benefits of control for all shareholders (Faccio and Lang, 2002; Ryan and Schneider, 2002; Dyck and Zingales, 2004).

Blockholders' managerial delegates

A controlling blockholder can engage in control-enhancing mechanisms such as assigning a delegate to be an executive of the invested firm to exert direct influence and control (Holderness and Sheehan, 1988). A controlling blockholder can choose to be the executive and manage the firm directly. For example, prior studies related to family blockholders or pyramid structure demonstrate that it is a common practice for the controlling family blockholder to assign a family member to take an executive position of its invested firm (DeAngelo and DeAngelo, 1985; Faccio and Lang, 2002). In this case, the executive is expected to represent the interest of the family blockholder (including individual

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blockholders by definition) because she is either the individual blockholder or at least one of the large shareholders.

On the other hand, controlling outside blockholders such as corporate and financial (institutional) blockholders often send professional managers to their invested firms (Holderness and Sheehan, 1988; Barclay and Holderness, 1991). In this case, the controlling blockholders should be confident that those delegates will act on behalf of the blockholders even if those delegates are professional managers with little shareholdings rather than blockholders themselves and they are supposed to be the agents of all shareholders (Fama and Jensen, 1983; Fama, 1980).

The controlling outside blockholders expect to control their managerial delegates because they have the power to remove their managerial delegates if those delegates do not represent their interest. More specifically, although controlling outside blockholders cannot directly fire those dissident delegates, they can force the board of directors to execute the removal if needed, because they can elect the board and remove board members if necessary (Black, 1990; Barclay and Holderness, 1992; Cronqvist and Fahlenbrach, 2008).

As a result, controlling outside blockholders not only can ensure their control by sending their delegates to become the officers of their invested firms (Denis and McConnell, 2003) but also can rely on those delegates to facilitate pursuing their private benefits of control.

Prior research suggests that blockholders have the incentive to pursue their private benefits of control even at the cost of other shareholders (Holderness, 2003). Controlling outside blockholders have three non-exclusive possible options to rely on their managerial delegates to realize their private benefits of control. First, a controlling outside blockholder's managerial delegate can make managerial decisions which directly provide private benefits to the blockholder. For example, a firm with a controlling corporate blockholder's delegate as a high-level officer may propose to increase its cash dividend. Such a corporate policy is mostly favored by large corporate investors rather than small shareholders because a corporate blockholder enjoys a lower tax rate for its dividend income than an individual investor (Barclay *et al.*, 2009). Second, controlling outside blockholders have the ability to effectively initiate management-sponsored proxy voting for major issues such as charter amendments of shareholder voting rules at annual shareholder meetings (Bhagat and Jefferis, 1991). Third, a controlling corporate blockholder's managerial delegate may facilitate establishing business collaborations, including alliances between the corporate blockholder and the invested firm (Allen and Phillips, 2000).

Blockholders' board representatives

Individual (family) and corporate blockholders should be able to rely on their representatives on the boards of their invested firms to pursue their private benefits of control. Prior research has established that blockholders can secure board representations in the invested firm to exert their influence and control over the management (Barclay and Holderness, 1991). Yet the argument that family and corporate blockholders can rely on their board representatives to pursue their private benefits of control and generate the shared benefits of control depends on two premises.

The first premise is that the boards of directors can influence corporate strategic actions. Prior research emphasizes that boards of directors play important monitoring and advising roles (Daily *et al.*, 2003; Johnson *et al.*, 1996). The advising role of the board may even have a direct impact on corporate strategy because boards set the premises of managerial decision-making (Mizruchi, 1983) and may involve in strategy formulation (Judge and Zeithamal, 1992; Stiles, 2001; Baysinger and Butler, 1990; Baysinger *et al.*, 1991).

Therefore, the board representatives of blockholders are capable of influencing corporate decision-makings.

The second premise is that certain directors may prioritize the interest of some shareholders rather than equally advocating for the interest of all shareholders. This argument departs from the traditional view which considers boards of directors a relative homogeneous institution that represents the interests of all shareholders (Fama and Jensen, 1983). Although prior studies have extensively investigated the impact of board composition and have usually maintained that outside/independent directors monitor management better than inside directors (Daily *et al.*, 2003), they pay relatively little attention to board heterogeneity caused by blockholders (Baysinger and Hoskisson, 1990). Therefore, the argument that directors do not equally represent the interests of all shareholders must be verified first with the existence and impact of the heterogeneity of boards. If boards of directors were homogeneous, then it would not be unreasonable to expect the directors to behave similarly.

Existing research clearly documents the heterogeneity of the boards of directors. The direct evidence of board heterogeneity is recorded by various studies which analyze board compositions related to inside directors and outside or independent directors (Coles *et al.*, 2008; Johnson *et al.*, 1996), as well as gender and ethnic diversity of boards (Carter *et al.*, 2010). For example, prior research usually defines directors who are firm employees as inside directors and considers non-executive/employee directors as outside ones (Coles *et al.*, 2008). However, some executives/directors may or may not own stocks of their only employers, while others may be family blockholders who own fewer shares of their primary employers than their other investments (Faccio and Lang, 2002). Meanwhile, some individual blockholders who are outside directors may own more shares than their insider counterparts do. In comparison, some outside directors with little personal investments in the invested firms may be assigned with the board memberships by their primary employers who are large blockholders of the invested firms (Barclay and Holderness, 1991). In other words, the simple distinction between inside/outside directors may not fully reveal the implications of the heterogeneity of the board of directors.

Therefore, one of the key determinants of board heterogeneity is the fact that directors may represent different shareholders. Particularly, blockholders, especially those with controlling blockholding positions (La Porta *et al.*, 1999), are entitled to have representatives on the boards (Cronqvist and Fahlenbrach, 2008) and they usually do (Barclay and Holderness, 1991). Furthermore, heterogeneous blockholders such as family and corporate blockholders, which possess either controlling or significant minority shares, all have the incentive and ability to exert substantial influence through their board representatives (Zald, 1969), regardless whether these directors are considered outside directors (Jensen and Warner, 1988) or not.

Prior studies also facilitate the exploration of the impact of board heterogeneity (Adams *et al.*, 2010) from the perspective of the conflict of interest between management and directors (Jensen and Meckling, 1976), as well as among heterogeneous blockholders (Cronqvist and Fahlenbrach, 2008). For example, the conflict of interest between directors and firm executives as a result of agency problems has been analyzed extensively (Adams and Ferreira, 2007). Meanwhile, although extant research explores less vigorously of the conflict of interest among heterogeneous directors, which is a possible consequence of blockholder heterogeneity (Hoskisson *et al.*, 2002; Wright *et al.*, 1996), prior studies suggest that heterogeneous blockholders can influence their invested firms (Shleifer and Vishny, 1986). Particularly, "large shareholders can influence firms directly through electing directors, voting on changes to the corporate structure or charter, or proxy contests and shareholder proposals." They can also affect polices directly through informal negotiations and governance discussions with the incumbent management (Cronqvist and Fahlenbrach, 2008).

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Furthermore, it is important to note that individual (or family), corporate and institutional blockholders might have divergent interests and objectives which result in their different inclinations toward corporate strategies, such as innovation, risk-taking, executive compensation and dividend policy (Hoskisson *et al.*, 2002; Wright *et al.*, 1996; Cronqvist and Fahlenbrach, 2008; Barclay *et al.*, 2009). Therefore, the influence of blockholders on corporate strategy, which is carried out through board representation, reflects the heterogeneous interests of different blockholders (Holderness and Sheehan, 1988).

More specifically, just as blockholders are heterogeneous, directors representing heterogeneous constituencies may encounter a conflict of interest more often than not (Hoskisson *et al.*, 2002). For example, a firm may acquire a minority stake of the invested firm and become a corporate blockholder to evaluate further investment opportunity, including alliance or acquisition (Allen and Phillips, 2000; Choi, 1991). A pension fund may invest in the same company for its financial stability (Hoskisson *et al.*, 2002). Therefore, the director assigned by a corporate blockholder may prefer certain corporate strategies not favored by a board member representing the interest of a pension fund. In other words, directors who represent the heterogeneous interests of blockholders are exposed to a variety of interest conflicts. In turn, although the boards of directors have the fiduciary duty to shareholders as a whole (Johnson *et al.*, 1996), blockholder heterogeneity may prevent certain directors from taking care of the interest of all shareholders when a conflict of interest rises directly between certain blockholders and the rest of shareholders, regardless of the antecedents of the conflict of interest. In fact, prior literature suggests the “clientele” effect of boards of directors (Hoskisson *et al.*, 2002; Wright *et al.*, 1996; Connelly *et al.*, 2010b; Thomsen, 2004). In other words, certain members of the boards of directors may prioritize the interest of those shareholders who are their primary constituencies rather than equally representing the interest of all shareholders (Thomsen, 2004).

Taken together, because outside controlling blockholders can utilize their voting power to appoint boards of directors who can influence corporate strategic actions and certain directors may prioritize the interest of their constituencies rather than equally advocating for the interest of all shareholders, those dominant blockholders can rely on their board representatives in their invested firms to pursue their private benefits of control, even at the cost of other shareholders:

> *P3*. Controlling outside blockholders capitalize on their voting power to appoint managerial delegates and board representatives in their invested firms so that those agents of the blockholders play an instrumental role in the blockholders’ pursuit of private benefits of control.

Discussion and conclusion

Outside blockholder heterogeneity and the pursuit of shared and private benefits of control

It is important to point out that the validity of *P1* does not depend on the identity of an outside blockholder. In other words, even if different types of outside blockholders may have different tendencies to pursue either shared benefits of control or private benefits of control (Pergola and Verreault, 2009), outside blockholders, as a whole, need their voting power to influence the firm first and foremost. Moreover, as the voting power of an outside blockholder increases, the blockholder is capable of pursuing shared and private benefits of control at the same time, irrespective of the identity of the large shareholder. An outside blockholder’s motivation to either pursue shared or private benefits of control individually or pursue shared and private benefits of control simultaneously should depend on the perceived benefits that the blockholder obtains from its actions.

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Directors as agents of outside blockholders

P3 argues that the board representatives of controlling outside blockholders can represent the interests of the large shareholders. It is important to acknowledge that CEOs or the management also have the opportunity to influence those agents of the controlling outside blockholders. However, the influence of the principal–agent relationship between outside blockholders and their board representatives is likely to be stronger than the influence of CEO or management on those directors. Board members are ultimately elected by shareholders, but the rights to nominate board member are often controlled by the management and large blockholders (Bebchuk, 2007). Whereas an outside director may be nominated by the CEO and thus may feel a sense of loyalty to the sponsor (Wade *et al.*, 1990), the director appointed by a corporate or family blockholder would assume little, if any, emotional attachment to the management of the invested firm. A director representing a corporate or family blockholder may have the incentive to act in favor of its own constituency or its primary employer and its corresponding shareholders (Thomsen, 2004), rather than fulfilling the fiduciary duty to the rest of shareholders. On the other hand, the director may be more inclined to succumb to the pressure which he/she sustains as an executive in the investing firm. Consequently, the outside director who primarily represents the interest of the outside blockholder can promote certain corporate strategies to seek private benefits for its primary employer, the investing firm. These arguments about the relationship between a controlling outside blockholder and its board representatives extends prior principal–agent-related research (Jensen and Meckling, 1976; Fama, 1980).

Limitations and future research opportunities

This paper has several limitations which summon for future exploration. In discussing *P2*, this study assumes that an outside blockholder pursues either private benefits or shared benefits at a single point of time and the value of private benefits is the same as that of shared benefits. Further analyses can relax these assumptions and explore the case when an outside blockholder pursues private benefits and shared benefits that have different values at the same time. Future theoretical research can build on the discussions of blockholder's shared and private benefits of control to explore fully the antecedents of blockholding. Future empirical studies can brave the challenge of determining the joint effect of an outside blockholder's capability of pursuing private benefits and incentive to carry out the expropriation. Future theoretical and empirical studies can examine the conflict of interest among corporate blockholders, family blockholders and other heterogeneous institutional investors when they pursue heterogeneous private benefits.

Conclusion

This research aims to explore the impact of outside blockholders on the firm and the potential circumstances under which outside blockholders impact the firm. By theoretically examining the impact of outside blockholders' voting power, this paper shows that the impact of an outside blockholder on firm value is jointly influenced by two underlying factors: The first is the blockholder's capability of pursuing private and shared benefits of control; the second is the blockholder's incentive to pursue private benefits versus shared benefits. Moreover, this paper argues that voting power is a necessary condition for an outside blockholder to pursue shared and private benefits of control, and it is positively correlated with blockholders' capability of influencing firm value. Whether an outside blockholder has more than 50 per cent voting power influences whether pursuing private benefits provides the blockholder more benefits than pursuing shared benefits. These theoretical arguments suggest a new perspective to explore the relationship between ownership structure and firm value.

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This paper further argues that the voting power of controlling outside blockholders provides the large shareholders the capability of appointing their managerial delegates and board representatives to the invested firms. Moreover, those powerful agents of the controlling outside blockholders can play an instrumental role in the large shareholders' pursuit of private benefits of control. These arguments extend prior research of principal–agent relationships (Jensen and Meckling, 1976) and present the first theoretical argument which states that controlling outside blockholders rely on their managerial delegates and board representatives to pursue their private benefits of control.

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