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The role of institutional shareholders as owners and directors and the financial distress likelihood. Evidence from a concentrated ownership context☆

Montserrat Manzaneque [a, *], Elena Merino [b], Alba María Priego [a]

[a] University of Castilla-La Mancha, Facultad de Ciencias Sociales, Avda. de los Alfares, 44, 16002 Cuenca, Spain
[b] University of Castilla-La Mancha, Facultad de Ciencias Jurídicas y Sociales, Cobertizo de San Pedro Martir s/n, 45071 Toledo, Spain

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ABSTRACT

Previous studies of corporate governance and the likelihood of business failure have focused on the role of large shareholders as owners; especially on the role that institutional shareholders play in management control. However, scant attention has been paid to the role of institutional shareholders as board members. To contribute towards an understanding of this issue, our study examines experimentally the role of institutional shareholders in business financial distress likelihood within the contexts of ownership concentration. We study not only the different roles of institutional shareholders as owners and board members, but also consider the diverse set of institutional shareholders' interests, categorised into pressure-resistant and pressure-sensitive. We find that directors appointed by pressure-resistant institutional shareholders, such as investment funds, pension funds, venture capital and holding firms, have a negative impact on the likelihood of business failure. This result indicates that institutional owners insist on directorships when the firm is important to them or when they judge they can keep a firm from going into distress, particularly in the context of concentrated ownership. In particular, the risk of failure acts as a catalyst to trigger reactions from the pressure-resistant institutional shareholders in the form of organizational changes in the firm. In contrast, directors appointed by pressure-sensitive shareholders have no impact on the likelihood of business failure.

This finding supports the debate on the diversity of corporate governance structures, and particularly the role of pressure-resistant shareholders in the avoidance of the firm's financial distress.

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1. Introduction

In the context of the economic crisis of recent years, the literature and declarations by international organizations have highlighted the influence of firms' governance structure on financial distress. This question is important because differences in corporate governance appear to have important implications for business decisions (Judge & Zeithaml, 1992), especially when the business has a high risk of failure (Dowell, Shackell, & Stuart, 2011). In fact, previous researchers have shown that corporate governance attributes, such as ownership and board structures, have a different impact on financially distressed firms compared with firms that are not in financial distress (Chaganti, Mahajan, & Sharma, 1985; Chang, 2009; Daily & Dalton, 1994a, 1994b; Deng & Wang, 2006; Donker, Santen, & Zahir, 2009; Fich & Slezak, 2008; Lajili & Zéghal, 2010; Manzaneque, Priego, & Merino, 2015). Within this line of research, the existing literature to date shows prolific analysis of the relationship between the structure of the board of directors and the likelihood of business failure. However, a study of the ownership influence on financial distress likelihood is limited

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* Corresponding author.
E-mail addresses: Montserrat.MLizano@uclm.es (M. Manzaneque), Elena.Merino@uclm.es (E. Merino), AlbaMaria.Priego@uclm.es (A.M. Priego).

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and inconclusive (see Daily & Dalton, 1994a; Deng & Wang, 2006; Donker et al., 2009; Lajili & Zéghal, 2010; Mangena & Chamisa, 2008).

Specifically, the literature of corporate governance shows two different arguments about the role of the blockholders and ownership concentration in the business failure process. On the one hand, some authors argue that blockholders could play an important role as an internal control mechanism to monitor management and prevent business failure (Elloumi & Gueyie, 2001; Wang & Deng, 2006) and reduce opportunistic behaviour of owners (Fama & Jensen, 1983). On the other hand, arguments also exist in the literature that excessive ownership concentration has a harmful effect. So, blockholders could use their power to transfer assets of the firm to finance other businesses (Dahya, Dimitrov, & McConnell, 2008), reducing the firm's value.

Additionally, special interest has arisen in previous literature about the role played by institutional blockholders in management control (Daily & Dalton, 1994a; Donker et al., 2009; Lee & Yeh, 2004; Lehmann & Weigand, 2000; Mangena & Chamisa, 2008; Morck, Shleifer, & Vishny, 1988). The implication is that more institutional blockholders could enhance the ability of firms to overcome financial distress situations (Daily & Dalton, 1994a).

With respect to this role of institutional blockholders, although the existing literature related to this underlines their role as investors, scant attention has been paid to the influence they might have on the decisions within the boards of directors. In this sense, the role of the boards of directors is different in concentrated and dispersed contexts. For instance, in contexts with dispersed ownership, where the predominant problem is principal–agent conflicts of interest (Jensen & Meckling, 1976) - such as the US and UK - board members could have more intense incentives to turn a distressed firm around because they face a high risk of losing their jobs (Fich & Slezak, 2008). Conversely, in contexts with concentrated ownership, such as most continental European countries, including Spain, and Asian countries like Japan, the problem known as principal–principal (large against minority shareholders) is more frequent and the role of the composition of the board of directors in controlling large shareholders' actions may be essential to avoid removal of wealth from minority shareholders and, consequently, failure of the business. In these contexts, the presence of institutional blockholders on the board in the figure of proprietary directors[1] could influence positively on corporate governance decisions related with business failure, because they are supposed to act actively in monitoring managerial behaviour and align the interests of minority and large shareholders (Bethel & Liebeskind, 1993; Pound, 1992).

Following this argument, we complement previous studies by exploring the role of institutional shareholders when they may influence board decisions through the appointment of directors as representatives of their interests. We argue that, according to the growing literature on corporate governance underlining the activism of the board of directors - time dedication and board meeting frequency - as an indicator of their effort and ability to exert effective governance (see Adams & Ferreira, 2008; Andreas, Rapp, & Wolff, 2012; Davila & Penalva, 2006, among others), institutional directors' ownership could align their interests with other shareholders making them more active in avoiding business failure, especially in contexts of concentrated ownership.

According to above arguments, this paper analyses the impact of institutional shareholders as owners and board members (through the aforementioned figure of the proprietary director) on the likelihood of financial distress in a context where ownership is concentrated.

To address this issue we have chosen the Spanish context to carry out this study because it provides an interesting scenario for analysis of certain issues which still need addressing concerning the effect of corporate governance on the likelihood of financial distress. Unlike the US and UK, where most studies have been carried out, blockholders in the Spanish context have an important role in management control through their participation on the board.

So, based on the characteristics of the Spanish context, this study provides empirical evidence of how the role of institutional shareholders as owners and directors affects business failure likelihood. Although we found that institutional shareholders as owners do not influence financial distress likelihood, the results of this study show the negative influence of pressure-resistant[2] institutional shareholders on financial distress likelihood, when they can appoint directors to the board. This finding points to the risk of failure as a catalyst for triggering the reactions of pressure-resistant institutional shareholders in the form of organizational changes in the firm. This finding is consistent with previous research showing that institutional shareholders are a diverse set of organizations and, in particular, the long-term orientation of pressure-resistant shareholders may have the means to influence managers' decisions in order to avoid financial distress. We may think that pressure-resistant institutional shareholders insist on appointing directors to the Board when the firm is important to them or when they judge they are able to avoid the distress of the firm.

This result contributes to corporate governance and business failure literature. On the one hand, with respect to corporate governance literature, this result contributes to the debate about the role of pressure-resistant institutional shareholders in exerting control over the firm (Almazán, Hartzell, & Starks, 2005), helping in the strategic decision-making process (Hoskisson, Hitt, Johnson, & Grossman, 2002) and monitoring the firm's policies or putting pressure on managers to operate efficiently (Pound, 1992). On the other hand, this paper also attempts to help business failure literature by predicting that some firms' corporate governance structures – with the presence of pressure-resistant institutional shareholders on the board – could improve their situation in order to avoid failure under financial and economic difficulties.

The rest of the article is organised as follows. First, the review of the literature is given and the hypotheses studied are explained. The study design and methodology are then presented and the main findings discussed. The final section contains the conclusions.

2. Background and hypothesis development

The literature dealing with the study of financial distress likelihood has found support for different hypotheses concerning the relationship between the role of institutional shareholders' as owners and directors and the financial distress likelihood (see Table 1).

[1] That is directors who own an equity stake above or equal to 3% of the stock capital (significant holdings), or otherwise appointed due to their status as shareholders and those representing these kinds of shareholders (CNMV. Spanish Securities Markets Commission, 2006 p. 35. English version).

[2] Institutional shareholders are usually split into pressure-sensitive and pressure-resistant institutional shareholders. Pressure-sensitive shareholders are those institutions, such as financial institutions, which have commercial relationship with the firm where they are shareholders. The pressure-resistant shareholders term refers to those institutions such as investment and pension funds, with no potential business links with the firms in which they invest. See Background and Hypothesis Development for details.

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