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Do executives benefit from shareholder disputes? Evidence from multiple large shareholders in Chinese listed firms

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ABSTRACT

Prior research documents that ownership by multiple large shareholders (MLS) could alleviate agency conflicts between controlling shareholders and small shareholders through improved monitoring. We provide evidence of a "dark side" to MLS. Using a sample of Chinese listed firms during 2005–2014, we find a positive association between the presence of MLS and excess executive compensation. Furthermore, excess compensation is greater in firms in which the different types of large shareholders have relatively equal voting power. Overall, these results imply that coordination friction among MLS reduces large shareholders' monitoring efficiency and exacerbates agency problems between shareholders and executives.

1. Introduction

A large body of existing research demonstrates the importance of multiple large shareholders (MLS)[1] in alleviating agency conflicts between controlling shareholders and minority shareholders (Attig et al., 2008; Bennedsen and Wolfenzon, 2000; Ben-Nasr et al., 2015; Laeven and Levine, 2008; Maury and Pajuste, 2005). According to these studies, the controlling shareholder is motivated to expropriate wealth from minority shareholders (Boubaker et al., 2014; Larrain and Urzúa, 2013), but competition for corporate control from other large shareholders may prevent the controlling shareholder from extracting private benefits. However, controlling shareholders have a two-sided role in corporate governance: while they may use their power to expropriate minority shareholders' wealth, they can also improve firm value by monitoring managers (Anderson et al., 2003; Jiang et al., 2017). This mixed role makes it important to determine if the presence of other large shareholders limits the controlling shareholder's monitoring efficiency. In this study, we attempt to answer this question by taking a different perspective and focusing on the impact of the potential coordination costs of MLS on corporate governance. Specifically, we investigate the relationship between MLS and excess executive compensation using a sample of Chinese listed firms.

The academic literature states that a controlling shareholder is an effective monitor of executives for two reasons. First, the controlling shareholder has a large amount of wealth invested in the firm and thus has a financial incentive to monitor executives because the potential benefits of monitoring likely exceed the associated monitoring costs. Second, the controlling shareholder has

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[1] CSMAR: China Securities Market and Accounting Research
CSRC: China's Securities Regulatory Commission
MLS: multiple large shareholders
SOEs: state-owned enterprises

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sufficient control rights to punish poorly performing executives. This absolute power in determining executives' fates guarantees their monitoring effectiveness.

However, when there are other large shareholders in addition to the controlling shareholder, executive monitoring may become less effective due to information asymmetry and potential conflicts between large shareholders. Unlike firms with only one controlling shareholder, among firms with MLS, even if a large shareholder finds sufficient evidence of executives' misbehavior, it does not has sufficient voting power to punish the executives. Thus, large shareholders in firms with MLS suffer high coordination costs to share information and negotiate with each other to reach an agreement on disciplining management (Chakraborty and Gantchev, 2013). This arguably increased monitoring cost potentially decreases large shareholders' monitoring efficiency. Even if such shareholders manage to share information and negotiate with each other, their efforts may still be in vain because different shareholders may have different objectives, and thus may be unable to reach an agreement (Liu and Lu, 2007; Lin et al., 2016). Moreover, executives can actively impede coordination among large shareholders by providing misleading information or offering private benefits to some shareholders and not others (Cheng et al., 2015).

Given these considerations, we propose that MLS will lead to higher shareholder coordination costs and reduce shareholders' overall monitoring efforts and effectiveness. With less shareholder monitoring, executives are more likely to be entrenched and extract more private benefits from shareholders (Shleifer and Vishny, 1989).

To examine the potential negative effects of MLS on the shareholder-executive agency problem, we employ a large sample of Chinese listed firms from 2005 to 2014. The Chinese capital market has several unique features and offers a powerful setting for this study. First, compared to firms in other developed countries, Chinese listed firms have much more concentrated ownership structures (Jiang and Kim, 2015), and thus provide a sufficient sample size of firms with MLS. This unique ownership structure also suggests that we have a sample of firms with large shareholders who are willing and able to design managers' compensation contracts. Second, China's Securities Regulatory Commission (CSRC) requires that listed firms in China provide detailed data on the top ten shareholders, including their shareholdings and identities, which enable us to examine the relative voting power of different types of shareholders. Third, since 1990, the Chinese government implemented reform of state-owned enterprises (SOEs) and encouraged state-owned firms to absorb private shareholders into their ownership structure. Thus, a large proportion of listed firms in China have both state shareholders and private shareholders (Lin et al., 2016). This particular type of firm allows us to examine whether a balance of power among different shareholder types is associated with the effectiveness executive monitoring.

Specifically, we study the negative effect of MLS on the shareholder-executive agency problem from two perspectives. First, following previous studies, we develop several measures of the presence and relative voting power of MLS based on the Shapley value and find that MLS is significantly positively correlated with excess executive compensation. The results are robust to different measures of excess executive compensation and ownership structure, and remain significant after different endogeneity and robustness tests. We define excess executive compensation as the part of total compensation that the firm's performance cannot explain. Previous studies view excess executive compensation as a major channel through which executives pursue their own interests at the cost of shareholders (Carter et al., 2016). As such, this result supports our hypothesis that MLS exacerbates the shareholder-executive agency problem.

Second, we separate large shareholders into state shareholders and private shareholders and find that excess executive compensation is higher in firms in which state shareholders and private shareholders have relatively equal voting power. State and private shareholders have distinct goals and interests, and this conflict significantly increases their coordination friction and reduces cooperation in monitoring executives (Boubakri et al., 2008; Chen et al., 2017; Khaw et al., 2016). This result offers further support to our hypothesis that the coordination cost among different shareholders will weaken the overall effectiveness of shareholder monitoring of executives.

Our study contributes to existing literature in three key ways. First, to the best of our knowledge, our study is the first to focus on the potential negative influence of MLS on the shareholder-executive agency problem. It adds a new dimension to the present literature and provides a better understanding of the governance role of MLS in firms.

Second, our study contributes to the very limited literature on shareholder coordination. Although previous studies reveal some evidence that shareholder activism is costly (Gantchev, 2013; Yermack, 2010), few empirical studies document the influence of poor shareholder coordination on firm policy (Chakraborty and Gantchev, 2013). Our study adds to this new academic field by providing new evidence of how poor shareholder coordination decreases shareholder activity efficiency and increases firm cost.

Third, by revealing a potential negative effect of the presence and different identities of MLS on corporate governance, our study also demonstrates that diversity is not always beneficial in corporate governance. The existing corporate governance literature generally suggests that firms will be better off with a diversified ownership structure, board of directors, and management team. Members with diverse backgrounds and knowledge bring fresh perspectives to corporate decision-making and are less likely to collude with each other (García-Meca et al., 2015; Maury and Pajuste, 2005; Perryman et al., 2016). However, these studies focus on the benefits of corporate diversity and overlook coordination friction between agents with diverse backgrounds. Diversity may also reduce a group's overall efficiency due to lower communication efficiency. Our study contributes to the discussion of the underlying advantages and disadvantages of diversity in corporate governance.

The remainder of this paper proceeds as follows. Section 2 reviews the prior literature and presents our hypotheses. Section 3 describes the sample, variables, and methodology for this empirical study. Section 4 reports the results of the empirical analysis and corresponding robustness tests. Section 5 concludes.

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