OWNERSHIP CONCENTRATION, MONITORING AND OPTIMAL BOARD STRUCTURE

by

Clara Graziano and Annalisa Luporini

Abstract

Recently, in the wake of corporate scandals like Enron, the reform of internal governance mechanisms has been a highly debated issue. In particular, the structure of board of directors has been under scrutiny and several reform projects have been proposed. Despite the debate, the theoretical literature on boards of directors is still very limited (See for example the survey by Hermalin and Weisbach (2001)). Furthermore, the few theoretical models of how board of directors function are implicitly cast in a dispersed ownership setting where no shareholder has the incentive to monitor the CEO. However, recent studies on corporate governance systems in both rich and developing countries have suggested that the presence of a large shareholder active in firm's management is much more common than previously thought. Contrary to what happens in public company with dispersed ownership, a major problem when ownership structure is concentrated is an "excessive" involvement of owners in firm's management rather than lack of monitoring.

The present paper is a first attempt to provide a model that examines the optimal structure of board of directors with a controlling shareholder actively involved in corporate governance. It analyzes the choice between a one-tier structure and a two-tier structure of board of directors in a firm where ownership is concentrated in the hands of a large shareholder who sits on the board. The main finding is that a two-tier structure can be optimal because it reduces the large shareholder's incentive to interfere with the manager's initiative without affecting her incentive to monitor the manager's ability. Thus, the paper suggests that a two-tier structure of board may be a valuable option in Continental Europe where firms' ownership (including large corporation) is concentrated. Furthermore, it offers support to some recent reform projects like, for example, the proposal of the High Level Group of Company Law expert of the European Commission that recommended that listed companies have the option to choose between one-tier and two-tier structure of boards.

The paper is related to two streams of literature. The first one focuses on CEO monitoring by board of directors. In this literature the ability of the CEO is unknown and the board is in charge of assessing CEO quality in order to decide whether to retain or dismiss him. Monitoring is regarded as the most important task performed by the board. See for example Hermalin and Weisbach (1998), Hirshleifer and Thakor (1998), and Warther (1998). Hirshleifer and Thakor study the impact of takeover threat on the board's decision whether to retain or dismiss the CEO and they show that the possibility of a takeover makes the board stricter in the sense that CEO dismissal is more likely. Hermalin and Weisbach analyze a situation where CEO and directors bargain over CEO compensation and over the level of independence of the board. Their main result is that board's independence is decreasing in CEO' ability and tenure, and that in the long run boards will be "captured by the CEO". Warther instead, shows that the board of directors is an important source of discipline, despite the lack of debate and apparent passivity.

A broader view on the tasks of boards of directors is taken by Graziano and Luporini (2003) and Adams and Ferreira (2003). These papers analyze models where boards of directors have more than one task. Graziano and Luporini, study the board's retention/dismissal decision in a setting where the board is in charge first of selecting the CEO and then, of deciding whether to confirm or replace
him. The paper shows that the collusive behavior between board and CEO may emerge as an attempt to hide the board's inability to accomplish the first task (CEO selection) by distorting the second task (CEO retention/dismissal decision). Adams and Ferreira (2003) consider the advisory role of the board as important as the monitoring role and focus on the trade-off between these two tasks. On the one hand, if the manager shares his information with the board he can get better advices from the directors. On the other hand the information provided by the manager increases the risk to be fired. Although the sole board structure in their model is the first-best solution, in a sole board the CEO may restrain from sharing information with the board. Hence, the authors conclude that there are cases in which it is better to separate advisory and monitoring role using a dual board structure.

The second stream of literature related to our work analyzes the incentive problems arising from the conflicting interests of manager and large shareholder and the role of ownership concentration as a commitment device for large shareholder not to interfere with manager's decision. Recently, a few studies have pointed out that the ownership structure can serve as commitment device for large shareholder not to interfere with manager's initiative in project selection. Burkart, Gromb and Panunzi (1997) show that interference in the project selection by a large shareholder reduces managerial discretion and prevents the manager from appropriating private benefits. However, "managerial discretion comes with benefits" because it can induce the manager to make firm-specific investment. For example, the manager can exert effort to select a new investment project. In this case, the large shareholder's right to reverse manager's decision and in general to interfere with his initiative, can destroy manager's incentive to take initiative and to make uncontractible investments. An appropriate ownership structure can alleviate this problem because, by decreasing her own stake in the firm, the large shareholder decreases her incentive to interfere with manager's decision and this, in turn, can restore the manager's incentive to make firm-specific investment. Another theoretical paper that deals with the advantages of manager's discretion in project selection is Inderst and Muller (1999). They show that managerial discretion can alleviate the agency problem between shareholders and debtholders because the manager may avoid the excessive risk taking in project selection that characterize shareholders’ behaviour when project is financed by debt. Then, as in the previous paper, ownership structure can be a useful commitment device to leave the manager with discretion in project choice.

The negative effects induced by an "excessive control" are documented in an experiment conducted by Falck and Kosfeld (2004) who analyze the interaction of motivation and control in a principal-agent setting where the principal decides whether to leave a choice to the agent's discretion or to limit the agent's choice set. They show that "the decision to control significantly reduces the agent's willingness to act in the interest of the principal. Explicit incentives backfire and performance is lower if the principal controls compared to if he trusts." (Falck and Kosfeld, 2004, page 1)

The present model analyzes the optimal board structure building on the intuition that there are cases in which it is better to separate the advisory and the monitoring role. It investigates how the separation of the two tasks can alleviate the problem of large shareholder's interference underlined by Burkart, Gromb and Panunzi. In particular, it shows that a two-tier structure can restore the manager's incentive to exert effort and get informed without reducing the large shareholder's incentive to monitor the manager. To this end the paper compares a one-tier structure where all tasks are performed by the sole board controlled by the large shareholder, with a two-tier structure where some tasks are allocated to the management board\ and other tasks to the supervisory board. In a one-tier board, project selection is discussed in board's meeting and the large shareholder can impose the project preferred by her. After the project is selected, the board/large shareholder also performs its monitoring task and decides whether to replace him. In a two-tier board, the management board chooses the project and the supervisory board has the task to monitor the
manager. We focus on the case in which large shareholder controls the supervisory board but not the management board. The two boards act independently and their behaviour reflects the different objectives of their members.

We show that manager can exert more effort in the dual board case where he can choose the investment project without interference by the large shareholder. This in turn, leads to higher expected profits in a two-tier structure. The difference in profits can be sufficiently high to induce the large shareholder to prefer a two-tier board despite the fact that in this case the manager chooses his preferred project rather than the project preferred by the large shareholder.