European Finance Review **1:** 165–168, 1997.

Comment on 'Monitoring, Implicit Contracting, and the Lack of Permanence of Leveraged Buyouts'

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This paper provides a theory of equity ownership structure which explains the observed high ownership concentration during LBOs and the subsequent partial reversal to a more diffuse ownership. The tradeoff which determines the optimal degree of concentration is due to two agency problems: (i) The manager of the firm may engage in empire building, thereby reducing expected cash flows and (ii) employees may shirk and underinvest in effort. Ownership concentration has opposite effects on the significance of these two agency problems. Intuitively, it mitigates the first agency problem but it tends to make the second one more severe.

Both features are due to the fact that a more concentrated ownership structure internalizes more of the benefits from monitoring and thus increases the amount of monitoring that takes place. On the one hand this reduces the amount of empire building by the manager since active shareholders disallow projects which only serve to create private benefits to the manager. On the other hand, increased shareholder monitoring has a negative effect on the effort invested by employees. This effect is slightly more complicated. To provide incentives for employees to expend effort, they are promised a fraction α of future cash flows. This compensation cannot be fixed contractually, so that, after the effort choice has been made, the shareholders face the possibility to reduce α. The manager is assumed to be averse to conflict and would rather honor the implicit contract. However, increased shareholder monitoring forces the manager to breach the implicit contract and reduce α. If anticipated by employees, this creates adverse incentives ex ante. Thus, summarizing, increased monitoring has a positive effect due to reduced empire building but also a negative effect since it limits the possibility of implicit contracts. This tradeoff may create an interior degree of optimal ownership concentration.

Moreover, this tradeoff can explain a change from diffuse ownership structures to highly concentrated ones observed during a leveraged buyout and then a reversion back to a more diffuse ownership structure. This occurs if initially a concentrated ownership structure is desirable to reduce empire building by the manager and to breach existing contracts with employees. After this restructuring it becomes optimal to switch to a more diffuse ownership structure to make implicit contracts feasible.

This paper is part of a new strand of literature which extends the traditional work on capital structure which mainly addressed the question how to split up the firm's cash flows between debt- and equity-holders. This new body of literature focuses more on the structure of ownership within classes of securities. For example, within the security class of debt, the effects of the mix of public versus private debt, long-term versus short-term debt on investment decisions and bankruptcy costs etc. have been analysed.

Most recently, emphasis has been placed on the influence of equity ownership structure on firm value. There are several channels through which equity ownership structure may affect firm value. First, equity ownership concentration may influence the liquidity in the secondary market for the firm's shares and thus its value. This idea has been explored, for example, by Bolton and von Thadden (1997), Pagano and Roell (1997), and Chemmanur and Fulghieri (1997). Second, equity ownership concentration may affect the amount of shareholder monitoring. Generally, more concentrated ownership creates more incentives to monitor management. Admati, Pfleiderer and Zechner (1994), Huddart (1994), Mello and Parsons (1996) and Stoughton and Zechner (1997) analyse the tradeoff between value-increasing monitoring and value-decreasing underdiversification due to concentrated equity ownership.[1]

Other literature focuses on the tradeoff between value-increasing and value-decreasing effects of shareholder monitoring. In a paper related to Hart and Moore (1990), Burkhart, Gromb and Panunzi (1997) point out that excessive monitoring may, ex ante, create suboptimal incentives for the management. In a similar vein, Pagano and Roell (1997) and Brennan and Franks (1996) argue that it may be optimal to limit the degree of ownership concentration since the monitoring decision of the outside-shareholders does not take into account the private benefits of control to the owner-manager.

Habib (1997) contributes to this recent literature. By modelling not only shareholders and managers but also another group of stakeholders, namely employees, the paper identifies an interesting tradeoff due to increased monitoring. As discussed above, shareholder monitoring generally mitigates the possibility to engage in implicit contracts with employees. This so-far unmodelled effect offers new insights, especially with regard to dynamic changes of ownership concentration.

A number of research directions may be persued to extend the existing work on ownership structure. First, most existing analyses model corporate governance in a reduced form rather than modelling the specific activity that shareholders may engage in when monitoring. This makes empirical tests difficult. To overcome this weakness, more specific links between ownership concentration and corporate decisions need to be modelled. A particular avenue which has not yet been sufficiently explored is the link between ownership structure and the product market.

[1] In a related paper, Maug (1996) analyses the effect of insider trading regulation on shareholder monitoring.

Presumably, different product market structures require different ownership structures. Specific models of the effects of ownership structure on the firm's competitive behavior in the product market are likely to generate interesting and empirically testable insights.

Second, existing models of equity ownership structure only consider the simplest equity security, namely common stock. A promising direction for future research efforts is to expand the set of securities which are considered. In reality different classes of equity are issued. Frequently firms issue options, preferred shares, convertible bonds etc. The effect of the choice of security design on ownership structure and corporate governance are yet to be analysed systematically.

Third, models of equity ownership should explicitly recognize that active shareholders are frequently institutional investors as opposed to wealthy single individuals. Institutional investors exhibit an interesting second layer of agency problems since the manager of the institution must be motivated and/or monitored.

Fourth, models of equity ownership structure generally only model one large active shareholder or simply assume that there is no conflict of interest when there are several large shareholders. In reality it seems that the coordination of monitoring activities and the alignment of interest between shareholders is a non-trivial problem. The degree to which there are conflicts of interest between shareholders will generally depend on the institutional environment. For example, different equity ownership patterns should emerge depending on whether or not minority shareholders are well protected, whether or not super majorities are required for certain corporate decisions or not etc. Modelling the legal framework for corporate governance should thus generate interesting predictions.

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