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## Some of the Causes and Consequences of Corporate Ownership Concentration in Canada

Ronald J. Daniels and Edward M. Iacobucci

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The June 1997 edition of *Canadian Business* ranks the top ten Canadian corporations in terms of growth. It states of its number-one performer, the Goldfarb Corporation, "Goldfarb's expansion strategy is founded on a few basic principles: First, look to invest in global companies. . . . *Second, own more than 50% of the company in order to consolidate and control the business.* Last, use Goldfarb's own marketing expertise." It states of its number-three performer, on the other hand, "Question: What turns a \$395-million pipeline company into a \$2.5 billion powerhouse in just three years? Answer: *losing the majority shareholder.* Ever since Olympia and York Developments Ltd. sold its 65% stake in IPL Energy Inc. of Calgary in 1992, IPL has grown with a vengeance. Instead of maximizing dividend payouts to satisfy cash-hungry O&Y, it has focused on expansion" ("Performance 500, Top 10" 1997, 137, 141; emphasis added). Mere pages apart, the magazine partially credits majority ownership with driving a successful company and blames majority ownership for restraining the performance of a potentially successful company. As this paper will discuss, there may be some truth to both opinions.

At least since the time of Adam Smith, commentators have expressed concern about the effect of separating those who own a corporation from those who manage it, an effect resulting from the adoption of a widely held ownership structure (Smith 1937, 700; Berle and Means 1933). The suggested problem is that, if those who manage do not have a personal

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interest in the returns generated by the firm's assets, those assets will be utilized in a way that may be beneficial to the manager but not to the owners.

Berle and Means (1933), however, were more pessimistic, predicting not only that corporations not owned by their managers would underperform corporations owned by managers but also that these widely held corporations would eventually become the norm in developing industrial economies. The argument was simple. As an economy grows and firms strive for scale economies, entrepreneur-managers are not capable of raising money to finance the firm's growth on their own and thus are compelled to go to equity markets to finance expansion. In repeatedly going to equity markets, of course, the entrepreneur eventually loses control of the firm. Because of the unceasing demand for capital in a rapidly industrializing society, the economy will in time largely comprise widely held corporations, which, given their inadequate governance by disinterested managers, does not bode well for the efficiency of the economy.

It is apparent, however, that Berle and Means overstated the likelihood of an economy replete with widely held firms. While the widely held corporation is indeed the norm in the United States, firms controlled by very few shareholders remain predominant in other industrialized countries, such as Germany, Japan, and Canada. In Canada, for example, Morck and Stangeland (1994) report that just under 16 percent of the 550 largest corporations in Canada in 1989 were widely held in the sense that no single shareholder owned more than 20 percent of outstanding voting stock. Using the same definition, Demsetz and Lehn (1985) had found earlier that almost 50 percent of the largest 511 corporations in the United States were widely held.

We first provide a brief outline of the literature on corporate governance and ownership concentration.<sup>1</sup> Next, we examine legal issues that, as a positive matter, may have contributed to the concentrated ownership structure in Canada. We then examine the normative implications of these causal relations.

### **3.1 Concentration of Ownership and Corporate Governance**

#### **3.1.1 Problems with the Widely Held Corporation**

The fundamental concern about the widely held corporation is that, since the manager has only an attenuated interest in the profits generated by the firm, she will act not to maximize those profits but rather to maximize her own private utility. The manager may not work hard (she may "shirk"), may divert corporate resources to herself (perhaps by overcon-

1. Much of the outline draws on Daniels and Halpern (1996).

suming material perquisites), or may otherwise invest corporate resources poorly (perhaps by investing to avoid risky undertakings that, even though they may be profitable, may endanger the risk-averse manager's job).

Jensen and Meckling (1976) formally developed a theory of the firm based on Berle and Means's (1933) concern about the separation of ownership and control. Clearly, one way to reduce the conflicts of interest between the shareholders and the managers—conflicts that lead to agency costs—is to increase the proportion of shares in the firm held by the manager. As the manager's interest in the firm's performance increases because of his increased shareholding, he is less likely to manage the corporation suboptimally. Other sources of disciplinary control over managers include takeovers and the market for corporate control (Manne 1965), executive compensation, product market discipline (Hart 1983), the managerial labor market (Fama 1980), and such outside stakeholders as creditors.<sup>2</sup> Finally, by establishing disclosure obligations or fiduciary duties, the law itself may exert pressure on managers.

### 3.1.2 Problems with Concentrated Ownership

If the only agency concern relevant to corporate governance were the divergence of interest between managers and nonmanagerial shareholders, an increase in managerial ownership would be an unambiguous boon to corporate efficiency. As the divergence in interest between managers and share owners is reduced, agency costs are reduced. As more recent scholarship has suggested, however, as ownership becomes more concentrated, countervailing pressures indicate that an overall reduction of agency costs will not necessarily result.

A manager will engage in undesirable agency behavior if the private benefits exceed the private costs of doing so. Increased concentration of ownership may lower the private costs of undesirable agency behavior, thus perhaps increasing the likelihood of managerial self-indulgence. The private costs of managerial diversion include the opportunity costs to the manager resulting from the suboptimal use of corporate resources, costs that increase as managerial ownership of the firm increases. This is Jensen and Meckling's (1976) line of argument. However, private costs also comprise any disciplinary costs that result from suboptimal management. These disciplinary costs will likely decrease as ownership increases, for two principal reasons related to the entrenchment of the controlling shareholder. First, as equity control increases, the controlling shareholder exerts greater control over the board of directors, thus increasing the likelihood of translation of its wishes into action and reducing the likelihood of disci-

2. For an overview of the issues related to executive compensation, see Iacobucci and Trebilcock (1996). For an overview of the relation between corporate governance and debt, see Triantis (1996) and Triantis and Daniels (1995).

pline from the board. Second, sources of discipline other than ownership, such as the market for corporate control (Stulz 1988), may be attenuated by increased managerial ownership.<sup>3</sup> If the private costs of managerial self-indulgence fall as ownership concentration rises, increased concentration may encourage agency problems between the controlling shareholder(s) and the minority shareholders.

### 3.1.3 Evidence of Ownership Concentration and Performance

While a complete survey is beyond the scope of this paper, suffice it to say that the ambiguity of the theory of the effects of increased concentration is reflected in the empirical evidence.<sup>4</sup> Some studies have shown a curvilinear relation between concentration and ownership: as ownership concentration rises from very low levels, firm performance improves, but, as ownership continues to rise, firm performance falls off.<sup>5</sup> Other studies have indicated that the effect of concentration of share ownership on firm performance is negligible.<sup>6</sup> Still others have found a significant negative correlation between performance and concentrated ownership.<sup>7</sup>

## 3.2 The Determinants of Concentrated Ownership

Commentators have offered a variety of suggestions about the determinants of ownership concentration. Some have theorized that the economic nature of the particular firm may be a significant factor in determining ownership concentration. For example, Demsetz and Lehn (1985) contend

3. In Canada, where corporate shareholding concentration is high, there is empirical support for the claim that concentrated ownership reduces the likelihood of a hostile takeover. Of the 1,148 Canadian merger-and-acquisition transactions in the Venture database in 1989, only 7 resulted in management resistance or in the making of a competitive bid (Daniels and MacIntosh 1991, 889).

4. For a more complete survey of recent empirical studies, see Daniels and Halpern (1996).

5. Morck, Shleifer, and Vishny (1988), e.g., found that, as concentration continues to rise to very high levels, firm performance (as measured by Tobin's  $Q$ ) eventually improves. An explanation for this result is that, once entrenchment is complete, increased ownership serves only to better align managerial and shareholder interests.

6. See, e.g., Jog and Tulpule (1996). Rao and Lee-Sing (1996) found that corporate concentration and performance were not correlated in Canada but that a weak, negative correlation existed in the United States. MacIntosh and Schwartz (1996) found ambiguous evidence: firms that had controlling shareholders had higher returns on assets and equity, no discernible effect on sales growth, and lower price-to-book ratios. Demsetz and Lehn (1985) found no correlation between concentrated managerial ownership and financial performance. Holderness and Sheehan (1988) found that performance as measured by Tobin's  $Q$  did not differ significantly between a sample of firms with a shareholder holding between 50 and 95 percent of equity and a matched sample of firms with diffuse holdings. They did find, however, that, if the control block was held by an individual as opposed to a corporation, performance as measured by Tobin's  $Q$  was lower than that of firms in the control group, although the difference was not significant.

7. Slovin and Sushka (1993), e.g., found that, when a CEO or founder with a significant shareholding died, there was, on average, a positive, abnormal return, a result consistent with entrenchment.

that share ownership concentration is positively related to the volatility of a firm's cash flow and the size of the firm. As cash-flow volatility rises, outside monitors cannot discern whether the managers or outside factors have determined firm performance. Inside monitoring by large shareholders attenuates this problem and reduces agency costs accordingly. As firm size increases, Demsetz and Lehn also argue, the price of a given fraction of equity rises, which reduces ownership concentration. While these and other factors may indeed be important in determining the structure of ownership, in this section we review various aspects of the Canadian legal regime that may help explain the concentrated nature of corporate ownership in that country. While we do not engage in rigorous testing of the hypotheses, we note some relevant empirical evidence.

### 3.2.1 Restrictions on Investment by Financial Intermediaries

Roe offers a political theory explaining concentration levels in the United States (Roe 1991, 1994). He suggests that political pressure from interest groups, such as small banks, combined with a general distrust of concentrated economic power, gave rise in the United States to laws designed to diminish the ability of large capital pools to invest in the equity of American corporations. Concentrated corporate ownership was correspondingly diminished: those entities controlling asset pools large enough to obtain control of corporations were legally prevented from doing so. Berle and Means's vision of an economy controlled by widely held firms emerged, not as an inevitable result of the economy's growth and economic forces, but as the result of political populism.

If Roe's theory correctly captures the American experience, then, but for the legal restrictions, American corporations would be owned by financial intermediaries controlling large pools of capital. If America's corporations would be widely held in any event, then the financial restrictions were not responsible. Thus, a prediction that one could infer from Roe's theory is that, in countries with a liberal legal attitude toward investment by financial intermediaries, ownership structure is more likely to be concentrated.

In Canada, the rules governing investment in corporate equity by banks have in fact been liberal. The first piece of general banking legislation in Canada contained no quantity restrictions on the holding of shares by banks but did provide that banks could not "either directly or indirectly . . . engage in any trade whatever . . . except in such trade generally as pertains to the business of banking."<sup>8</sup> While such a provision certainly could have been interpreted to limit the ability of banks to invest in corporate equity, courts have taken a liberal approach in interpreting the bounds

8. Bank Act, S.C., 1871, chap. 5, sec. 40. A similar limitation exists today: see S.C., chap. 46, sec. 409.

of “the business of banking.” In *White et al. v. Bank of Toronto et al.*, for example, the Ontario Court of Appeal held that there was nothing in the Bank Act

to suggest that a bank may not “deal in” the stock of its corporate debtor just as freely as it might deal in the stock of a corporation not its debtor or, for that matter in the bonds of the Dominion of Canada. . . . The conduct of modern business inevitably leads to an infinite variety of situations not the least complicated of which may occur in the carrying on in this country “of such business generally as appertains to the business of banking” and it seems to me that this has been recognized throughout the numerous decennial revisions of the Bank Act by the use of broad and general terms in describing what a bank may do.<sup>9</sup>

At the very least, banks were permitted to invest in corporations of which they were creditors, ostensibly in order to protect their investment in the debt rather than to make a profit on the security itself (Baxter 1968, 198). It was not until 1967 that quantitative restrictions on banks’ equity investments were implemented.<sup>10</sup>

Thus, Canada was a country that did not place significant limitations on the ability of its banks to invest in Canadian equity. If Roe is right that such legal limitations contributed to widely held corporate ownership structures in the United States, then perhaps the absence of such limitations in Canada would have invited bank investment and more concentrated ownership.

Canada certainly does have more concentrated ownership, but, historically, banks’ equity investments have not been significant. The level of securities held by Canadian banks as a percentage of total assets was around 7 percent in 1926, 7 percent in 1935, 5 percent in 1955, 5 percent in 1965, and 6.0 percent in 1980 (Daniels and Halpern 1996, 34).<sup>11</sup> In the 1990s, this level has not exceeded 1.5 percent (MacIntosh 1996, 181). Various explanations have been offered for this low level of investment by banks. Neufeld (1972, 113) claims that the disinterest in equity arose because of the need for large-scale government financing during the wars and the depression and because of losses suffered by the banks from financing railways. Jamieson (1953, 134–37) concludes that concern for stability and liquidity led banks to invest in government debt rather than corporate equity. Niosi (1982, chap. 1) claims that the inculcation of British financial practices in Canadian bankers led Canadian banks to place a premium on traditional debt financing rather than equity investment.

9. *White et al. v. Bank of Toronto et al.*, [1953] 3 D.L.R. 118 (Ont. C.A.), 125.

10. A change that followed the recommendations of the Royal Commission on Banking and Finance (1964).

11. As indicators of banks’ investment in corporate equity, these figures are biased upward, given that they do not discriminate between corporate equities and other types of securities, such as municipal securities and corporate bonds and debentures.

For whatever reason, Canadian banks did not invest significantly in corporate equity. This observation may cast doubt on Roe's explanation of the American experience: in Canada, in any event, the absence of legal restrictions in the United States may not have had the binding effect that Roe ascribes to them. More germane to the present analysis, the legal differences between the United States and Canada with respect to rules governing banks' investments do not appear to have contributed to the concentration of ownership in Canada since banks were not the source of capital that allowed firms to grow while maintaining concentrated ownership structures.

A similar conclusion applies with respect to equity investment by insurance companies. In 1868, federal law treated investment by insurance companies as a matter to be set out in the companies' corporate charters,<sup>12</sup> and, in 1899, the statute was amended to permit all life insurance companies to invest in securities. In 1910, the Insurance Act limited equity investment to a maximum of 30 percent of any single firm—and then only if the firm met a seven-year dividend test of at least 4 percent.<sup>13</sup> Following the market crash of 1929, restrictions were tightened, limiting equity investment to 15 percent of total investments (Royal Commission on Banking and Finance 1964, 249). In 1965, the restrictions were relaxed again, and the limit became 25 percent of total investments.<sup>14</sup>

While the legal restrictions have varied over time, observers suggest that they were rarely binding, at least during the postwar period. Insurance companies had suffered significant losses during the depression and were also concerned about meeting regulatory liquidity standards (Hood and Main 1956, 478). Total industry investment in equity stood at about 3 percent of the value of the portfolio in 1964, and this did not change significantly with the introduction of the 25 percent rule in 1965, investment rising only to 5 percent by 1968. In more recent times, this percentage has remained well below the legal limit, at around 10 percent in the 1980s and up to 1991, although jumping to 19.7 percent in 1992 (MacIntosh 1996, 182).

While the experience with insurance investment has been more ambiguous than that with bank investment, it supports the conclusion that, over the years, "the traditional picture of Canadian finance, one of abstention [by Canadian financial intermediaries] from the founding, reorganization and control of non-financial corporations, has remained unchanged" (Niosi 1982, 63). The cause of concentrated ownership in Canada is unlikely to be found in the legal regime governing the investment portfolios of financial intermediaries.

12. An Act Respecting Insurance Companies, S.C. 1868, chap. 48.

13. Insurance Act, 1910, R.S.C., chap. 32, sec. 59.

14. An Act to Amend Certain Acts Administered in the Department of Insurance, S.C. 1964–65, chap. 40, sec. 5(9).

### 3.2.2 Banking Regulations

Canadian banks faced regulations that differed from those faced by American banks in other ways that may have contributed to a lower cost of debt for Canadian corporations and therefore allowed firm growth to rely more on debt than equity financing. There are at least two relevant differences in Canadian banking regulations. First, entry into banking in Canada is difficult. Under the Bank Act, only eight "Schedule I" banks are presently permitted to carry on business as full-service banks.<sup>15</sup> Second, Canadian banks are permitted to carry on business throughout Canada, without regard to provincial boundaries.<sup>16</sup> These rules imply that Canadian banks are large relative to the economy. In 1984, for example, there were 7,547 bank branches in Canada, with the 5 largest banks having over 1,000 branches each (Shearer, Chant, and Bond 1984, 225). In contrast, in the United States, there were 15,000 separate banks with a total of 39,000 branches, or an average of 2.6 branches per bank (Shearer, Chant, and Bond 1984, 225).

It may be that the structure of Canadian banking that resulted from these rules led to efficiencies in providing debt financing (Daniels and Halpern 1996). Canadian banks faced economies in monitoring that American banks, fettered by such restrictions on growth as limitations on interstate banking, did not realize. The large absolute size of Canadian banks permitted the spreading of the fixed costs of monitoring over a larger number of transactions. Moreover, the small number of banks in Canada enhanced the information supply among banks there, lowering screening and monitoring costs. On top of these economies relative to American banking, the law in Canada permitted greater bank input in the affairs of a borrower in financial distress. For example, Canadian courts have yet to embrace the doctrine of equitable subordination,<sup>17</sup> which allows courts to subordinate a lender's claims if the lender uses its control over the borrower to obtain an advantage at the expense of other creditors.<sup>18</sup> Given the lower costs to Canadian banks resulting from these differences, it may be that firm growth in the Canadian economy was permitted through debt financing to a greater extent than it was in the United States, a consequence of which was the maintenance of high-equity ownership concentration.

Cutting against the banking efficiency explanation of ownership con-

15. Bank Act (n. 3 above), sec. 14.

16. *Ibid.*, sec. 15.

17. In *Canada Deposit Insurance Corp. v. Canadian Commercial Bank*, [1992] 3 S.C.R. 558, the Supreme Court of Canada expressly declined to consider whether the doctrine of equitable subordination exists in Canada.

18. For example, *In re American Lumber Co. v. Bergquist*, 5 Bankr. 470 (D. Minn. 1980) (equitable subordination applied to creditor who received new security interests in inventory and equipment from distressed borrower).

centration in Canada is the possibility that the same regulations that led to large banks in absolute and relative terms, and thus lower costs, may also have led to market power. With such high barriers to entry and so few significant Canadian banks, it may have been that, even if debt was less costly to the banks, an absence of competition prevented prices on debt to firms from being below those prevailing in the United States.

If it is true that efficiencies in Canadian banking relative to banking in the United States led to a lower cost of debt to firms and thus contributed to the concentration of ownership there, then Canadian firms would historically have had a higher debt-to-equity ratio than their American counterparts. We do not have any definitive empirical evidence that would allow us to answer this question.<sup>19</sup>

### 3.2.3 Protectionism

Historically, Canada has erected barriers to the free movement of goods and capital across its borders. Both these types of barriers may have contributed to the concentration of Canadian ownership.

A particularly relevant capital restriction penalized Canadian investment portfolios that had over 10 percent of their value in foreign assets.<sup>20</sup> Such a restriction may have given Canadian issuers market power<sup>21</sup> that allowed them to finance growth without relinquishing control (Daniels and Halpern 1996). For example, in the absence of market power, it may be that the sale of minority equity under a concentrated ownership structure that allows significant transfers of wealth from minority shareholders to the controller will fail to raise sufficient capital for a liquidity-constrained entrepreneur to finance a particular investment. On the other hand, in the presence of market power, investors may accept the lower returns associated with entrenchment, and sufficient funds will be available despite the risk of transfers. While we cannot explain why firms would prefer to take a discount on the shares from adopting an inefficient ownership structure, if the firms chose to do so, some degree of market power may have allowed liquidity-constrained firms to raise sufficient capital for a particular project despite an inefficient structure. Perhaps as evidence of this phenomenon, firms in Canada have often adopted dual class share structures, which, by concentrating control in a small minority of shares, are known to have significant potential for agency problems between the controlling shareholders and the noncontrolling shareholders.<sup>22</sup>

19. Preliminary work in comparative international capital structures does not reveal significant differences in firm leverage across the G7 (Rajan and Zingales 1994).

20. There were tax consequences with respect to retirement savings if a portfolio had over 10 percent of its assets in foreign investments (An Act to Amend the Income Tax Act, S.C. 1970-71-72, chap. 63, sec. 206). Since 1991, the threshold is 20 percent.

21. That is, the ability to earn supracompetitive returns when issuing equity.

22. As of December 1987, companies listing restricted shares constituted 15 percent of the total number of companies listed on the Toronto Stock Exchange (TSE) (Amoako-Adu, Smith, and Schnabel 1990, 39).

Canada has also historically imposed significant trade barriers. These may have had several effects on industry conducive to concentrated ownership. First, tariffs may have helped keep firms small given the relatively small size of the Canadian economy and the restriction of international trade (Harris 1984; Eastman and Stykolt 1967). As Demsetz and Lehn (1985) point out, the smaller a firm is, the lower the cost of a control block and thus the greater the likelihood of concentrated ownership. Thus, by fostering small firms, tariffs may have contributed to concentrated ownership.

Second, to circumvent the high tariffs on trade with Canada, foreign firms often established partially owned subsidiaries in Canada. Rather than owning these firms outright, which would have led to private companies, not to concentrated ownership structures in the sense of controlling and minority shareholders, the foreign firms had tax incentives to sell part of their equity to Canadians. For example, in the 1963 budget, withholding taxes on dividends were lower if Canadians owned at least 25 percent of the voting shares of a company (Daniels and Halpern 1996, 42). These incentives, along with the tariff barriers, may have contributed to the concentrated nature of Canadian corporate ownership.

A third reason why trade barriers may have led to increased concentration relates to market power. By limiting foreign competition, tariff barriers discouraged the development of competitive markets in Canada (Harris 1984; Eastman and Stykolt 1967). We argue in more detail in the next section that market power may contribute to concentrated ownership.

### 3.2.4 Market Power

There are two significant ways in which Canadian law has fostered the growth of market power<sup>23</sup> in its economy. First, Canada has historically been protectionist. The National Policy of 1879 established high tariffs and thus significant barriers to entry into the Canadian market for foreign producers, and tariffs since then have continued to protect Canadian firms from foreign competition (Harris 1984; Eastman and Stykolt 1967). Obviously, the 1989 Free Trade Agreement with the United States and successor agreements considerably opened trade and the likelihood of competition. Second, while a competition policy regime has been in place since 1889, the regime was virtually ineffective until the Competition Act of 1986.

The possible connections between market power and concentrated ownership are complex. Rather than viewing market power as a cause of concentrated ownership, a possibility that we discuss shortly, Morck has suggested that concentrated corporate ownership may lead to market power because of political rent seeking (Morck 1996). If the benefits exceed the

23. That is, the ability of firms to earn supracompetitive returns in their product markets.

costs, firms will lobby politicians to erect barriers to entry and other impediments to competition in order to increase their market power. Morck provides two reasons why firms with concentrated ownership are lower-cost rent seekers and, therefore, why they are more likely to have market power. First, more narrowly held firms may be able to operate in greater secrecy than their widely held counterparts. Second, the managers of narrowly held firms may be less likely to be terminated and therefore better able to repay politicians or bureaucrats in exchange for the erection of impediments to competition.

We are skeptical of Morck's claims.<sup>24</sup> Secrecy may or may not be important to rent seeking. For example, a corporation may wish to establish a reputation of reliably returning favors. On the other hand, a politician may want secrecy in order to preserve a reputation of integrity, but this will not always be true. For instance, a politician may wish to take public credit if the corporation promises to build a factory in her jurisdiction in exchange for an entry barrier. Even if secrecy is important, however, it is unclear how significant an advantage concentrated public firms have in this regard. Disclosure rules, such as in the case of campaign contributions, will publicize both a concentrated and a widely held firm's rent-seeking efforts equally. To the extent that public disclosure is not required, there may be a secrecy benefit for *privately* held firms that do not have to hold public meetings or issue annual reports, but it may not be significantly easier to keep secrets as ownership concentration increases in public corporations.

With respect to Morck's second point, it is not clear that managers of more narrowly held firms are more secure in their positions. Where the controlling shareholder and managers are different people, it may be that management has less security of tenure than at a widely held firm. Rational apathy on the part of shareholders may protect managers at a widely held firm from termination, while managers subject to intense monitoring by a controlling shareholder do not have such protection.

In any event, even if the threat of termination shortens significantly the widely held firm's horizons for rent seeking, it is unclear whether politicians and bureaucrats, who are subject to the whims of the political process, have particularly long horizons themselves. It strikes us as plausible to assume that rent-seeking deals are struck with a view to forthright consummation.

In our view, there may be a difference with respect to the *benefits* of rent seeking that establish ownership concentration as a potential cause of market power. As outlined above, control blocks of equity may give

24. We do, however, accept Morck's premise that rent seeking is an important determinant of market outcomes. For a thoughtful expression of reservations about the importance of rent seeking in practice in recent years, see Trebilcock (1999).

their owners the opportunity to realize a disproportionate share of the firm's profits. The controller will undertake an investment if the private benefits to it exceed the total costs, costs that are shared by both the controller and the minority shareholders. If the controller has an interest in activities outside the firm (such as ownership stakes in other firms) that could benefit from a particular form of rent seeking, it may use the firm's resources to invest in this rent seeking even if the total private benefits of the rent seeking are less than the total costs. The controller's interests outside the firm imply that it realizes a disproportionate share of the private benefits of rent seeking, while the costs are shared with the firm's shareholders.

Thus, as compared to a shareholder who has significant holdings but who is not entrenched, an entrenched controlling shareholder may invest more in rent seeking; rent seeking itself is an agency problem between the minority and the controller. Because of this agency behavior by the controlling shareholder, concentrated ownership may give rise to market power.

While ownership concentration may have an effect on market power, there is also a possibility that market power may have an effect on ownership concentration. The simple reason for this is that, as market power and the future profits from an enterprise rise, a lower degree of outside financing is required. In what follows, we assume, following Myers and Majluf (1984), that there is asymmetric information between a firm's insiders and outside investors. There is some information that is difficult to convey to the market, such as the ability of management, and there is an adverse selection problem about unobservable information: outsiders discount the likely prospects of the firm.

With market power and higher profits, firms may be able to finance future investment out of retained earnings. Because of asymmetric information between insiders and outside investors, such retained earnings may entail a lower cost of capital and thus may be the capital source of choice (Myers and Majluf 1984). Profitable firms—firms with market power—are better able to finance investment without selling equity. Hence, firms with market power are more likely to retain a concentrated ownership structure than competitive firms given that the former do not have to use outside financing to the same extent. Another reason why firms with market power may have more concentrated ownership is that a firm with prospects for significant profits is able to raise a given amount of capital selling a relatively low percentage of its total shares when it does go to equity markets. If an asymmetric information problem exists, therefore, market power and higher profits are likely to be correlated with a greater degree of ownership concentration.<sup>25</sup>

25. In his comment on our paper, George Triantis rightly points out that, by treating the cash available to the corporation as a function of market power, we do not account for the

To summarize, market power, ownership concentration, and the law are related in the following ways. Ownership concentration may encourage rent seeking, which may result in laws encouraging market power, such as tariffs. Laws that encourage market power by definition give rise to market power, which in turn may give rise to ownership concentration by allowing firms to minimize outside financing. These effects are reinforcing, solidifying the relation between ownership concentration, market power, and the law.<sup>26</sup>

### 3.2.5 Rigidity in Ownership Structure and the Equal Opportunity Rule

There may be rigidity in a concentrated ownership structure that heightens concern about inefficiently concentrated ownership structures. Even if it is efficient to evolve to a less concentrated ownership structure and the parties know that it is efficient to do so, once in place, an inefficiently concentrated ownership structure may be difficult to change. The law in Canada may exacerbate the problem by adherence to an “equal opportunity rule.” We first explain the rigidity phenomenon and then review the legal problem.

By definition, there would be gains from lowering the concentration of an inefficiently concentrated firm: agency costs would be lower. However, even assuming now that there is no asymmetric information between the firm and outsiders (as in the previous section), the following factors may conspire to prevent the realization of those gains. First, the controlling shareholder realizes a disproportionate return to its shares as a result of agency behavior.<sup>27</sup> Second, minority shareholders and the controlling shareholder could collectively benefit from deconcentration and need each other to accomplish those gains; thus, the surplus from lowering agency costs will likely be shared between the controlling shareholder and the minority shareholders. Given these two factors, the controlling shareholder will require compensation for the private losses to it from forgone control benefits and will also likely require a share of the surplus created

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prospect that cash flow itself may cause agency problems and lower profits. This is analytically similar to the problem we do address: concentrated ownership may itself cause agency problems. While reducing concentrated ownership through equity sales and reducing free cash flow through debt issuance may both reduce agency problems, asymmetric information may deter such sales in either case—the information discount may dominate the losses from agency costs.

26. There is evidence from Canada that is at least not inconsistent with the conjecture that competition-promoting policies will lower the concentration of ownership. While competition policy has existed in Canada for over a century, it was largely ineffective until the passage of the Competition Act in 1986. Moreover, in 1989, Canada entered into the Free Trade Agreement with the United States. Defining widely held firms as those with a float percentage above 90 percent, we find that the number of widely held firms on the TSE 300 has indeed risen since these competition-promoting developments. In December 1988, 29.0 percent of firms on the TSE 300 were widely held; in December 1997, 65.7 percent of firms were widely held.

27. Since the agency behavior is inefficient, however, the control benefits to the majority are smaller than the costs of these benefits to the minority.

by the deconcentration (the surplus being the recovered deadweight losses). If they could act as a collective unit, the minority shareholders could compensate the controller and still profit since the gains from deconcentration exceed the losses. However, there will likely be a significant collective action problem.

If concentration is excessive, deconcentration is a public good: all minority shareholders benefit from lower agency costs. Given this factor and the controlling shareholder's demand for a share of the surplus as well as compensation for lost control benefits, a minority shareholder is best off when it does not buy any of the controller's shares but the other minority shareholders collectively act to purchase some of the controller's shares. Since each minority shareholder is best off when the others act to purchase the shares, the purchase may not occur even though it is efficient. Once established, a concentrated ownership structure may be difficult to change even though it is efficient to do so and the parties know that it is efficient to do so.<sup>28</sup>

The law in Canada, exemplified by the law in Ontario, may compound the rigidity problem in the following respects. Section 1 of the Ontario Securities Act provides that the sale of any shares by a shareholder with sufficient holdings materially to affect control of the corporation, or, in any event, holding 20 percent or more of the voting securities of the corporation, is defined to be a "distribution." Under part 15 of the Ontario Securities Act, any trade that is a distribution must be accompanied by a prospectus. The sale of part of a control block in order to bring about lower concentration of ownership may be in part discouraged by the transactions costs that are particular only to control-block transactions.

Another potential legal impediment to efficient deconcentration is that Ontario courts and statutes have frowned on the payment of a premium to controlling shareholders when they sell part of their control blocks. In *Re CTC Dealer Holdings Ltd. and Ontario Securities Commission*, a corporation had a dual class share structure: there were about 3.5 million common shares with voting rights and about 80 million outstanding "class A" shares that did not have voting rights.<sup>29</sup> There was a "coattail" provision

28. The collective action problem described here is similar to that described by Grossman and Hart (1980) in the takeover context: shareholders subject to a takeover bid are best off if other shareholders tender into the bid. The problem of compensation for control benefits impeding efficient deconcentration is similar to Bebchuk's (1994) analysis of inefficiencies in the sale of corporate control. Bebchuk points out that an efficient sale of control may not take place if the potential buyer is unable to compensate the target's current owner for the lost benefits of private control; even a buyer that could increase the value of the firm may not buy it. The problem that we point out assumes that the buyer of part of control, the minority shareholders, could, acting collectively, compensate the controller for the lost benefits of private control and still profit from the increased value of the firm, but a collective action problem prevents them from doing so.

29. *Re CTC Dealer Holdings Ltd. and Ontario Securities Commission*, [1987] 37 D.L.R. (4th) 94 (Ont. H. Ct.).

in the corporation's articles that provided that, if a majority of the common shares were tendered into a takeover bid, the class A shares would convert to voting shares. A prospective buyer of control offered to buy 49 percent of the common shares from three members of the Billes family at a considerable premium relative to the stock market price, thus gaining effective control without triggering the coattail provision. The Ontario Securities Commission set aside the transaction on the grounds of public policy, holding that the deliberate attempt to sidestep the coattail was "grossly abusive" of the class A securityholders and of the equity market in general.

While this case clearly involved matters beyond the question of the legitimacy of a control premium, the commission and, in approving the commission's decision, the Ontario Court of Justice both viewed negatively the incumbent controlling shareholders' desire to realize the control premium themselves without sharing it with the class A shareholders. Justice Reid referred to the Billes family's clear wish to horde the control premium for itself as evidence supporting the commission's finding of an abuse.<sup>30</sup> In that case, the court clearly viewed a premium to controlling shareholders alone as unfair.

By adhering to the equal opportunity rule, Ontario statutes also discourage the payment of premia to controlling shareholders. If a purchaser will own 20 percent of the shares of a particular class after the transaction is completed, the transaction is a takeover bid under section 89 of Ontario Securities Act. Pursuant to section 97, a takeover bid must offer the same consideration to all shareholders in the same class. A large shareholder contemplating the purchase of shares from the majority cannot single out the majority for its offer but rather must extend it to all shareholders in the relevant class. Obviously, the payment of a premium to the controlling

30. Justice Reid stated for the court (*ibid.*, 109):

The Commission made it clear that the abuse it perceived was of two kinds: abuse of the Class A shareholders and of the marketplace itself. There was much evidence before it to support its conclusion that the offer was an abuse of the Class A shareholders. . . . The Commission was concerned that the Billeses had participated in the offer in order to serve their sole object, i.e., to get the maximum amount possible for their control position, and wholly ignored the interests of the Class A shareholders. . . .

[T]he Commission heard evidence from Fred, the son of one of the founders, that neither he nor his brother or sister were concerned over the Class As being left out of the enormous premium they were to receive under the offer. The following evidence was considered important enough for the Commission to repeat it in its reasons at p. 82 . . . :

- Q. Am I correct in assuming that you, David and Martha wanted to maximize the control proceeds which you realized, if you were going to sell your shares of Canadian Tire.
- A. I believe that is correct.
- Q. Your concern for the well-being of the holders of the A shares did not extend to permitting them to participate in the control premium?
- A. That's correct.

shareholder alone is deterred by such a rule. Such deterrence under the takeover rules may be particularly problematic given that a shareholder most likely to be willing to pay a premium and compensate the controlling shareholder for lost control benefits is one with significant shareholdings. Only with significant shareholdings are the benefits of lower agency costs sufficiently realized by an individual purchaser such that it may be privately profitable to purchase part of the control block in order to reduce agency costs.<sup>31</sup> The equal opportunity rule may prevent payment of a premium by those shareholders most likely to overcome the free-rider problem in moving to a more efficient, less concentrated ownership structure.

The equal opportunity rule also applies to corporate buybacks where the firm purchases some of its own outstanding equity. Such a buyback could address the rigidity problem. If the firm itself purchases some of the controlling shareholders' equity, the collective action problem may be overcome. The firm acts as a representative of all shareholders, and the costs and benefits of the share purchase are thus shared on a pro rata basis. It will, however, remain the case that the controlling shareholder will demand a premium for its shares in order both to be compensated for lost control benefits and to share in the surplus from efficient deconcentration. The law in Ontario prevents such a premium.

According to section 89 of the Ontario Securities Act, any offer by an issuer of securities to redeem or acquire any or all of the outstanding shares of that issuer is an "issuer bid." An issuer bid is subject to many of the same rules as takeover bids, including the equal opportunity rule. Under section 97, the same consideration must be offered to all members of a class in an issuer bid. This effectively eliminates the possibility of reliance on a buyback to overcome the rigidity problem. The controller will demand a premium, yet the equal opportunity rule prevents an idiosyncratic premium. Given that the premium cannot be offered profitably to the class as a whole, the equal opportunity rule may deter efficient deconcentration through a buyback.

There are two circumstances in which the free-rider problem inherent in paying the controlling shareholder a premium may be overcome and therefore efficient deconcentration may occur: where there is a large minority shareholder and where there is a buyback. The equal opportunity rule prevents the payment of a premium to the controlling shareholder in precisely these circumstances. Thus, the rule may deter deconcentration even if it is efficient to move to a less concentrated ownership structure. The existence of this rule in Canada, but not in the United States, may perhaps contribute to the concentrated ownership structures in Canada,

31. Just as toehold stakes held by the raider in the takeover context may overcome the Grossman and Hart (1980) free-rider problem.

although we have no specific empirical evidence supporting or rejecting this hypothesis.<sup>32</sup>

### 3.3 Normative Implications

The various possible causal links between the law and ownership concentration have different normative implications. As discussed, there is no theoretically optimal corporate ownership structure. Widely held firms may face agency costs because of rogue managers, while more narrowly held firms may face agency costs because of rogue controlling shareholders. The following discussion remains neutral on the question of the optimal structure but does assess other normative implications of the relations between various laws and ownership structure.

Whether the rules governing financial intermediaries have affected ownership concentration levels in Canada is, as discussed, unclear. Financial intermediaries appear not to have invested in Canadian equity despite permissive regulations. In any event, even supposing that the legal regulation had an effect on ownership structure by permitting significant investment by financial intermediaries, this cause itself does not add anything to the question of the social desirability of the regulations. The question is simply whether concentrated ownership is desirable relative to widely held firms: if so, then the regulations were desirable in this respect; if not, then they were not desirable in this respect. We have no opinion on this matter.

The second causal factor discussed above argues in favor of the regulations in question. If a regulatory environment fostering large banks helped reduce the cost of debt to both banks and corporations in Canada, which led in turn to greater ownership concentration, then ownership concentration could perhaps be viewed as evidence of the efficiency of the Canadian banking system, at least relative to that in the United States. Whether ownership concentration was a desirable result in itself is a separate question; as a causal explanation of ownership concentration, however, the regulations may demonstrate their efficiency-enhancing properties.<sup>33</sup>

To the extent that they were a cause of ownership concentration, protectionist policies with respect to trade and capital flows may have served to distort the form of Canadian corporations away from the optimum. For example, tax incentives may have induced foreign corporations to estab-

32. Our analysis is based on rigidity of concentrated ownership structures once established. Bebchuk and Zingales (chap. 2 in this volume) show that the equal opportunity rule may encourage the establishment of a concentrated ownership structure as opposed to a private firm.

33. We do not have an opinion, however, about one aspect of the regulatory regime discussed: the doctrine of equitable subordination. While it contributes to a lower cost of debt, it may raise the cost of equity to an inefficient level.

lish potentially inefficient concentrated ownership structures for their Canadian subsidiaries rather than wholly owned subsidiaries. Moreover, the subsidiaries themselves may have been established only to circumvent tariffs. Such distortions argue against the protectionist regulatory regime that spawned them.

We argued that a lax regulatory attitude with respect to competition may have contributed to concentrated ownership in Canada and that concentrated ownership in Canada may have contributed to a lax regulatory attitude with respect to competition. The latter possibility perhaps suggests an additional reason for concern about concentrated ownership. The welfare effects of the former possibility are as follows. In the absence of asymmetric information, in establishing an ownership structure an entrepreneur would choose a level of ownership concentration that maximizes the value of the firm in order to maximize her private returns from the sum of future profits and the proceeds from the sale of equity. That is, she would choose a level of ownership that minimizes agency costs. If, however, there is asymmetric information such that outside investors discount the value of the equity, she may avoid equity financing in order to avoid her private losses associated with outsiders' discounting the equity. Asymmetric information combined with product market power, which allows the firm to raise a given amount of capital selling a smaller fraction of equity, may give rise to a concentrated ownership structure that does not minimize agency costs.

From a policy perspective, it is important to isolate the respective roles played by market power and information asymmetry in excessive ownership concentration. It is the asymmetry of information that leads the entrepreneur to minimize equity sales despite agency costs, while market power simply accommodates concentrated ownership. While minimizing asymmetric information problems, perhaps by establishing penalties for false disclosure, is clearly desirable from a policy perspective, there is no a priori reason to conclude that reducing market power will have a beneficial effect on the choice of corporate ownership since it will focus the entrepreneur's choice on choosing the ownership structure that maximizes the value of the firm.<sup>34</sup> Again, it depends on the unanswered question of the overall desirability of concentrated as opposed to atomistic ownership. As a positive matter, however, we would predict that tougher competition rules and liberalized trade would lead to a lower level of ownership concentration.<sup>35</sup>

The final aspect of Canadian law that we considered that may contrib-

34. In Ontario, see the Ontario Securities Act, pt. 23.

35. As noted above, there is evidence from Canada that is at least not inconsistent with the conjecture that competition-promoting policies will lower the concentration of ownership (see n. 26 above).

ute to concentrated ownership was the equal opportunity rule. By perhaps preventing efficient deconcentration of ownership, the rule may have harmful effects. There are competing considerations,<sup>36</sup> but our analysis here suggests a reason for repeal.

If the rule were to be abolished, it is important to recognize its sources. An equal opportunity rule is clearly established by the Ontario Securities Act, but, apparently, it also has independent support in the courts, as evidenced by *CTC Dealer Holdings*. By finding that a control premium was an abuse of noncontrolling shareholders, in *CTC Dealer Holdings* the court established a precedent that may hurt minority shareholders by deterring efficient deconcentration.

### 3.4 Conclusion

The law may have contributed to Canada's corporate ownership structure in a variety of ways. Our theoretical analysis, which would require empirical confirmation before any firm conclusions could be reached, suggests that some of these contributions were likely socially beneficial (e.g., relatively liberal banking regulations), some were likely neutral with respect to corporate ownership (e.g., liberal investment rules for financial intermediaries), and others were undesirable (e.g., protectionism). While there may be implications for specific laws to be culled from our analysis, we do not offer any answers to the basic question of whether there is too much concentrated ownership in Canada. For example, as a positive matter, we predict that, as market power in Canada declines because of international competition and competition law, so, too, will ownership concentration. Whether, as a normative matter, this would be a desirable development we cannot say.

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36. For example, Bebchuk (1994) describes how the equal opportunity rule may in some circumstances discourage inefficient sales of control, although it may also deter efficient sales of control in other circumstances.

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## Comment      George G. Triantis

Ronald Daniels and Edward Iacobucci describe various ways in which the concentrated ownership structures in Canada may be due to the organization of Canadian industry. The focus of my comments is on two of their claims: (1) Market concentration in many industries has produced higher profits, thereby allowing firms to finance their activities with retained earnings rather than external capital. (2) Concentration in the banking sector has produced efficiencies in lending, thereby reducing the cost of debt financing and enabling firms to finance by borrowing rather than diluting equity interests.

These two claims relate to the means by which a firm can finance its activities without issuing new stock: internal capital or debt finance. With respect to the former, Daniels and Iacobucci suggest that many Canadian firms enjoy market power that increases their retained earnings and hence

their pool of internal capital. In a world of imperfect information, the abundance of internal funds is a mixed blessing. It is efficient when the ability of a firm to tap equity markets is impeded by information asymmetry between its managers and investors (Myers and Majluf 1984). However, internal capital also insulates managers from the scrutiny and discipline of capital markets and enables them to appropriate free cash for self-interested activities (e.g., Easterbrook 1984; Jensen 1986). The determination of the optimal amount of internal capital depends on the firm's opportunity set, and it can be implemented to some degree by manipulating capital structure (e.g., Triantis 2000).

Daniels and Iacobucci treat the availability of retained earnings as exogenous: the cash available to the firm is determined by its profitability, which is a function of its market power. However, it ought to be viewed as an endogenous variable in the choice of capital structure. The analysis should consider that capital markets might entice or compel firms to commit to paying out earnings by taking on debt or paying dividends and to returning to capital markets for the funding of new projects. The issue then becomes the conditions under which the entrepreneur or controlling shareholder can internalize the efficiency gains from making such commitments.

Daniels and Iacobucci suggest that Canadian banks have achieved economies of scale and scope in screening, monitoring, and intervening in the affairs of their borrowers. As a result, the cost of bank loans may be lower in Canada than in the United States, encouraging firms to borrow rather than issue new equity. The more leveraged a firm is, the more concentrated will be its ownership. The argument is sound, but it may miss a more relevant point by focusing on concentration of stockholding rather than of control. While stockholders enjoy voting rights and the ability to enforce fiduciary duties, debtholders hold rights embedded in the covenant, default, acceleration, and enforcement provisions of their contracts with the firm. A breach of a covenant enables the debtholder to accelerate the maturity of the debt and, if it is not paid in full, to remove assets from the firm. Thus, the control rights of equity and debt vary in relative significance with the prevailing financial condition of the firm. Specifically, the managers of a financially distressed firm tend to be more responsive to the voice of their lenders than shareholders are. As a firm becomes more leveraged, the likelihood of financial distress increases, as does, consequently, the effective control of its lenders. Therefore, if it is true that Canadian firms have more concentrated ownership structures because they are more highly leveraged, this fact simply means that control rights are more likely to be held by lenders rather than shareholders. Indeed, the authors imply that, beyond the majority shareholders, control over Canadian firms is exercised aggressively by a concentrated group of highly skilled banks.

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