

## Family Firms

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### ABSTRACT

We present a model of succession in a firm owned and managed by its founder. The founder decides between hiring a professional manager or leaving management to his heir, as well as on what fraction of the company to float on the stock exchange. We assume that a professional is a better manager than the heir, and describe how the founder's decision is shaped by the legal environment. This theory of separation of ownership from management includes the Anglo-Saxon and the Continental European patterns of corporate governance as special cases, and generates additional empirical predictions consistent with cross-country evidence.

MOST FIRMS IN THE WORLD are controlled by their founders, or by the founders' families and heirs. Such family ownership is nearly universal among privately held firms, but is also dominant among publicly traded firms. In Western Europe, South and East Asia, the Middle East, Latin America, and Africa, the vast majority of publicly traded firms are family controlled (La Porta, Lopez-de-Silanes, and Shleifer (1999), Claessens, Djankov, and Lang (2000), European Corporate Governance Network (2001), Faccio and Lang (2002)). But even in the United States and the United Kingdom, some of the largest publicly traded firms, such as Wal-Mart Stores and Ford Motor, are controlled by families.

A crucial issue in the discussion of family firms from the perspective of corporate governance and finance is succession. For nearly every entrepreneurial firm that does not fail, there comes a moment when the founder no longer wishes to manage it. This can happen from the very beginning, when founders seek professional managers to run their firms, as is the case in high technology start-ups in the United States. Alternatively, a founder can retire or cut his work load later in

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life, and appoint either an heir or a professional as a successor. When control is turned over to a professional, ownership and management become separated.

The patterns of separation of ownership and management vary across countries. In the United States, founders often hire professional managers early on. By the time a founder retires, his family retains only marginal ownership. In such Berle and Means (1932) corporations, professional managers exercise nearly full control. In Western Europe, significant ownership typically stays with the family after the founder retires. His children either hire a manager, as in BMW or Fiat, or run the firm themselves, as in Peugeot. In emerging markets, both management and ownership tend to stay with the family when the founder retires. Occasionally in both developed and emerging markets, a manager marries into the family, as happened at Bombardier in Canada, Matshushita in Japan, and Worldwide Shipping in Hong Kong.

There are three broad theories of the benefits to a family of preserving control.<sup>1</sup> According to the first, there is a significant “amenity potential” of family control. The term “amenity potential,” suggested by Demsetz and Lehn (1985), refers to nonpecuniary private benefits of control, meaning utility to the founder that does not come at the expense of profits. A founder may derive pleasure from having his child run the company that bears the family name. Alternatively, in some industries, such as sports or the media, a family can participate in or even influence exciting social, political, and cultural events through ownership of firms. This reason for family control suggests that there will be a distribution of ownership patterns within a country, with companies delivering a large amenity potential of control staying in family hands. Indeed, in their study of initial public offerings of German companies, Ehrhardt and Nowak (2001) find that families nearly universally retain control, with “amenity potential” being the crucial reason.

If the amenity potential is large, we expect families to try to maintain control as long as they can. Only if a firm desperately needs capital and cannot raise it without a control change, or if the founder dies and significant inheritance taxes are due, will control be sold off. Some recent research indeed points to the importance of these considerations. In a cross section of 20 countries, Wells (1998) finds a higher incidence of widely held, as opposed to family-controlled, firms in countries with higher inheritance taxes. Bhattacharya and Ravikumar (2001, 2002) present theoretical models linking the persistence of family control to imperfect capital markets. In our model, we recognize the role of the amenity potential in keeping some firms under family control. But we use a framework that simultaneously explains capital market underdevelopment and the prevalence of family ownership based on institutional characteristics of a country.

A second reason for the preservation of family control is that the name itself may be a carrier of a reputation, in both economic and political markets. Families

<sup>1</sup> A related literature describes *how* control is maintained by a dominant shareholder, which may or may not be a family. This literature focuses on pyramids, multiple classes of stock with different voting rights, voting trusts, and so forth (see, e.g., Grossman and Hart (1988), Prowse (1995), Zingales (1994), and Nenova (2003)).

may stand for quality (as advertisements often argue) or for political connections (Faccio (2002)). Italy's Agnellis have stayed close to the government, sometimes having family members in the cabinet, and always securing public transfers to Fiat. Such "reputational benefits" would be diluted if control is surrendered to an outsider. This theory suggests, counterfactually, that *ceteris paribus* family-controlled firms would be more valuable than firms controlled by professionals. Although it deserves a closer analysis, the connection between family control and politics is not considered in this paper.

We focus on a third theory of family ownership, namely the possibility of expropriation of outside investors that comes with control. Unlike the amenity potential, such private benefits of control, as described by Jensen and Meckling (1976), do come at the expense of profits accruing to the outside investors. In our theory, the principal benefit of hiring a professional is that he is likely to be a better manager. The principal cost is that now the professional manager, rather than the founder, controls the company and so can expropriate investors. We argue that a crucial factor shaping the attractiveness of delegated management is the degree of legal protection of outside shareholders from expropriation (or tunneling) by the insiders. Earlier research shows that such protection varies sharply across countries, and that this variation predicts the differences in financial development and ownership structures (La Porta et al. (1997, 1998, 2000a, 2000b), Johnson et al. (2000)). In this paper, we examine the costs and benefits of delegating management from this perspective. This allows us, in particular, to examine the costs and benefits of keeping the succession of management inside the family.

We present a model of a founder looking for a manager to succeed him. We assume that there is no superior manager available with sufficient resources to buy the firm outright. When such a manager (or a company) is available, the firm is simply sold to them—as often happens. Absent an outright buyer, the founder chooses among three options. He can sell out completely in the stock market and create a widely held firm run by a professional manager. He can hire a professional manager but stay on as a large shareholder to monitor him. He can also keep the firm inside the family by either staying on as a less than ideal manager or by passing management to a family member, who is generally not as talented as a professional. The founder maximizes his welfare, equal to the sum of the value of the retained block, the revenues from selling shares to investors, and the amenity potential obtained only if the family keeps control.

We study the trade-off between superior management by the professional outsider and his discretion to expropriate shareholders. If the founder stays on as a large shareholder and monitors, he can control expropriation to some extent. In our framework, both the law and the monitoring reduce managerial expropriation. We show that when the family's amenity potential from managing the firm is very large, ownership and management are never separated. In contrast, management and ownership are always separated when the discrepancy between the managerial abilities of the professional and the founder (or heir) is very large and the amenity potential is small. Except for these extremes, the decision to keep control in the family depends on the quality of legal protection.

When legal protection of outside investors is very good, there is no need for monitoring in equilibrium, and the best arrangement is a widely held professionally managed firm. When legal protection of outside investors is moderate, the benefits of professional managers are still high enough for the entrepreneur to surrender control, but it pays for him or his family to stay on as large shareholders and monitor the manager. Finally, with sufficiently weak shareholder protection, the founder's ability to control expropriation is too limited, and management stays with his family even when someone else can run the firm better. In general, this analysis leads to a prediction of a negative relationship between investor protection and ownership concentration, consistent with a range of empirical evidence.

We consider two versions of the model, one in which the founder—when he detects expropriation—forces the manager to stop it and pay dividends, and another in which he and the manager just share the spoils. In the first version, as in Shleifer and Vishny (1986), the founder provides a public good to the minority shareholders by monitoring the manager. In the second version, monitoring is no longer a public good, the benefits of which are shared by all shareholders. In fact, the only effect of monitoring is to raise the founder's share of the loot. The basic results we describe hold in both specifications, but the second version also yields the empirically accurate prediction of a positive premium paid for a controlling block of shares.

At a theoretical level, the model combines in one unified framework the twin conflicts essential to understanding corporate governance: that between the manager and the outside shareholders, and that between the large shareholder and the minority shareholders. By doing so, the model sheds light on the different prevalent patterns of ownership and management among countries. It shows, for example, why Anglo-Saxon patterns of corporate governance, with widely held firms and traditional conflicts between professional managers and dispersed shareholders (Berle and Means (1932)), are likely to be a feature of countries with very good legal protection of minority shareholders. It explains why “family” firms, in which the founder's family is a significant shareholder or even the manager over several generations, are such an enduring phenomenon in countries with less effective legal protection of shareholders (La Porta et al. (1999), Claessens et al. (2000)). Indeed, it explains how, in such countries, the twin conflicts coexist between the manager and the large shareholder, and between the two of them combined and the minority shareholders. The model is moreover consistent with the evidence that family management is generally inferior to professional management (Morck, Strangeland, and Yueng (2000), Perez-Gonzales (2001)).<sup>2</sup> The basic trade-off between the benefits of delegated management and the costs of giving up control—especially when legal protection is poor—appears consistent with a great deal of data.

<sup>2</sup> For a sample of S&P 500 firms, Anderson and Reeb (2003) present evidence that Tobin's Qs are actually higher for family than for nonfamily businesses. They also find that performance measures deteriorate at high levels of family ownership, consistent with the view that entrenched family control is associated with inferior performance even in the United States.

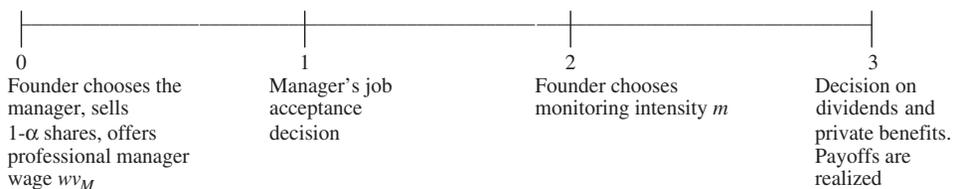
Our paper joins a growing theoretical literature on corporate governance in the regimes of poor investor protection. Bebchuk (1999) shows that poor legal protection renders dispersed ownership structure unstable, because it allows extraction of significant private benefits. Himmelberg, Hubbard, and Love (2001) and La Porta et al. (2002) study theoretically and empirically the determination of ownership structure when firms raise funds to finance investment. Burkart and Panunzi (2001) and Shleifer and Wolfenzon (2002) analyze the impact of legal shareholder protection on the optimal ownership structure. Shleifer and Wolfenzon consider owner–managers and examine the relationship between legal protection and inside equity. Burkart and Panunzi assume that the professional manager and the large shareholder are distinct parties and analyze the relationship between the law and outside ownership concentration. By making the separation of ownership and management a choice variable, the present model extends and generalizes these two papers.

The paper is organized as follows. Section I outlines the model. Section II examines the founder’s decision to hire a professional manager and to float shares when he cannot share private benefits. Section III analyzes the case with collusion between founder and professional manager and derives implications for share value, block premium, and agency costs of separating ownership and management. Section IV concludes. Mathematical proofs are in the Appendix.

## I. The Model

Figure 1 presents the model’s timeline. We consider a firm initially fully owned by its founder. At date 0, the founder decides whether to appoint a professional manager to run the firm or keep management in the family. Simultaneously, he decides what fraction  $1 - \alpha$  of the shares to sell to dispersed shareholders. The family keeps the remaining fraction  $\alpha$ . All shareholders are risk neutral. If management stays in the family, there is no separation of ownership and management. If the founder appoints a professional manager, ownership and management are separated. In this case, the founder may also offer a wage and the professional manager accepts or rejects the offer to run the company at date 1.

At date 3, the firm generates revenues that depend on the identity of the manager. If control remains inside the family, total revenues generated are  $v_F$ . In addition, the amenity potential  $B$  accrues to the founder. While  $B$  may differ across founders and industries, it does not reduce revenues  $v_F$ . If a professional manager runs the firm, total revenues are  $v_M$ . The professional manager may enjoy some



**Figure 1.** The timing of the model.

amenity potential from running the firm. He also has an outside option. To economize on notation, let  $c$  denote the professional manager's utility when pursuing his outside option net of the foregone amenity potential. For simplicity, the outside option of the founder or the family is normalized to zero.

ASSUMPTION 1:  $v_M - c > v_F$ .

There are two interpretations of the model. Under the first, the choice is between the founder himself, who is becoming outdated or reluctant to manage, and a professional outsider. Under the second, the founder definitely retires from management, and chooses as his successor either a professional manager or his heir. In both interpretations, retaining management inside the family reduces the profitability of the firm relative to hiring a professional.

Assumption 1 is consistent with a recent study by Morck et al. (2000) of corporate control of Canadian firms. They find that heir-controlled firms have lower returns on sales and assets than comparable firms. Furthermore, firms with founder control have earnings that are lower than those of widely held firms but higher than those in heir-controlled firms. Perez-Gonzales (2001) provides evidence on firm performance following inherited control by studying 162 family transitions in the United States. In 38 percent of these cases, family members inherit the CEO position. These family CEOs are promoted to the post an average of nine years earlier than professional managers and are detrimental to firm performance—the return on assets falls by 16 percent within two years of transition and by 25 percent compared with unrelated CEOs.

In this model, if the founder is the best manager himself, there is no reason for him ever to sell equity. He stays on as the manager, keeps 100 percent of the firm, and there are no agency problems or conflicts. This assumption distinguishes the model from the papers of La Porta et al. (2002), Shleifer and Wolfenzon (2002), and Himmelberg et al. (2001), where equity is raised to finance investment projects, and therefore the size of the firm is endogenous.

The problems arise when the founder is no longer the best manager. He must then choose between hiring a more qualified outsider to manage and staying on (or equivalently naming a mediocre son as a successor). We assume that the competent professional outsider has neither the resources nor the external funds to just buy the firm himself. As we show below, the outsider's inability to raise external funds is consistent with the assumptions of the model, since to buy the firm, he has to pay for the private benefits accruing to the founder, which he cannot pledge to investors. Unless the superior manager is himself wealthy, he has to work for the family. Hiring a professional separates ownership from management.

At date 2, shareholders can monitor the professional manager and thereby deprive him of at least some private benefits. The monitoring technology is discussed below.

At date 3, the revenues can either be paid out to all shareholders proportionally to their ownership stakes or diverted to generate private benefits  $\Phi$ . In countries with weakest shareholder protection, such private benefits take the form of outright theft. More commonly, they take the form of transactions with related

parties, expropriation of corporate opportunities, transfer pricing, excessive salaries and perquisites, and so on (see Johnson et al. (2000)).

Whoever manages the firm chooses the level of expropriation, subject to being monitored and partially impeded by the law. The noncontractible expropriation decision is modeled as the choice of  $\phi \in [0,1]$ , such that security benefits (dividends) are  $(1 - \phi)v_i$ , and private benefits are  $\Phi = \phi v_i$ ,  $i = M, F$ . Expropriation of shareholders is limited by the law. To model legal shareholder protection, we assume that the law sets an upper bound  $\bar{\phi} \in [0, 1]$  on the fraction of revenues that can be (at no cost) diverted by the party in control.<sup>3</sup> Stronger legal protection corresponds to lower values of  $\bar{\phi}$ .

The law is not the only determinant of the fraction of resources diverted for private benefits. The other is monitoring, which occurs when a professional manager is hired. Although in principle all shareholders can monitor the manager, the free-rider problem prevents small shareholders from choosing to incur the cost. In equilibrium, only the large shareholder monitors to reduce the fraction of resources appropriated by the manager.<sup>4</sup> Recall that the legal upper bound on private benefits of control is  $\bar{\phi}v_M$ . Following Pagano and Röell (1998), we assume that the large shareholder can at a cost  $k(m^2/2)$  reduce private benefit extraction by  $mv_M$ , where  $m \in [0,1]$  and  $k > 0$ .

The private benefits  $\Phi$  differ from the amenity potential  $B$  in two respects: They come at the expense of security benefits and their size depends on the legal shareholder protection and (in the absence of collusion) on the monitoring intensity.

Private monitoring and the law are alternative mechanisms for reducing expropriation of shareholders. In our model, when  $k$  is strictly positive, monitoring is costly to the founder whereas reliance on the law is free. Some legal protection, such as disclosure mandated by law, is indeed enforced by the authorities and is truly free to the founder though not to the society. Other kinds of legal protection require an investment in resources by the founder, such as litigation. What we require is not that the law be literally free to the founder, but that reducing managerial extraction by a given amount through a combination of stricter rules and less monitoring be cheaper for the founder and the shareholders than achieving the same protection through a combination of weaker laws (higher  $\bar{\phi}$ ) and more monitoring (higher  $m$ ).

Alternatively, one can think of legal protection as reducing the cost of monitoring. Our framework can accommodate this interpretation. The cost parameter  $k$  would then be a measure of shareholder protection: The law protects shareholders by increasing the effectiveness of monitoring.<sup>5</sup> Under this formulation,

<sup>3</sup>The amount  $\bar{\phi}v_i$  is the legal upper bound that can be extracted as private benefits of control, irrespective of the form in which those benefits are enjoyed. In particular, wages in excess of market value are already incorporated in  $\bar{\phi}v_i$ .

<sup>4</sup>We assume that there is no reason for the founder to sell his shares to another large shareholder who would monitor, since, if anything, the founder has a comparative advantage at monitoring because of his knowledge. In addition, the founder may want to retain his stake because of some residual amenity potential.

<sup>5</sup>Modeling the differences in legal shareholder protection by varying the efficiency of the monitoring technology or by changing the upper bound on diversion is equivalent when the

private monitoring and the law are complements rather than substitutes. The crucial feature of our model is that better legal protection mitigates the agency problem between the management and the shareholders either by directly reducing the scope of expropriation or by making the founder's intervention more effective.

We assume that corporate and other law governing investor protection matters, and that firms cannot opt into more protective legal regimes via a contract, such as cross-listing or a better corporate charter. This assumption is consistent with the evidence that legal rules governing investor protection in different countries have significant consequences for financial development (La Porta et al. (1997, 1998, 2000b)). This assumption is also consistent with recent theory and evidence pointing to the limited usefulness of such contractual solutions (Siegel (2002), Nenova (2003)). If a founder could opt into a more protective legal regime before selling any shares, he would do so, since in equilibrium he bears the monitoring cost of reducing managerial expropriation.

If a professional manager is hired, the question arises whether a monitoring founder can enjoy a part of the private benefits. We consider both the cases of collusion and no collusion between the professional manager and the founder. Excluding the founder from the spoils of extraction is tantamount to assuming that his interests and those of the small shareholders are perfectly congruent. This case is most appropriate when the legal duties of the large shareholder, perhaps as a board member, bar him from complicity with the manager in expropriating shareholders. In contrast, when the founder and the professional manager can share the private benefits, they may collude at the expense of minority shareholders. This assumption might be more suitable for weaker legal regimes. The second assumption complicates the model, in that rent-seeking monitoring, intended to capture some of the private benefits rather than serve all shareholders, becomes attractive. We solve the model under the first assumption in the next section, and under the second in Section III.

## II. Owner-Manager or Professional Manager

We analyze the founder's decision whether to hire a professional manager in steps. We begin by considering the founder's maximization problem for the cases of nonseparation and separation of ownership and management. In each case, we solve the model by backward induction, going from the date 3 expropriation decision, to the founder's date 2 monitoring intensity, to the manager's date 1 job acceptance choice. We then can determine the optimal number of shares that the founder retains in cases of separation and nonseparation. Having done that, we can compare the founder's welfare in different legal environments, that is, different values of  $\bar{\phi}$ . This enables us to infer under what circumstances the founder chooses to separate ownership from management.

founder and the small shareholders have congruent interests. With collusion between the founder and the professional manager (Section III), this equivalence breaks down because monitoring protects the founder but not the shareholders from managerial expropriation.

### A. No Separation of Ownership and Management

Due to the simplicity of the model, the case of no separation does not yield precise predictions, notably for the ownership structure. At date 3, the founder decides how to allocate the revenues. While the law does not influence the amenity potential  $B$ , it constrains the founder to divert no more than  $\bar{\phi}v$  of the revenues as private benefits  $\Phi$ . Unless he owns all the shares, in which case he is indifferent between any  $\phi \in [0, \bar{\phi}]$ , he extracts the legal upper bound  $\bar{\phi}$ . Absent a professional manager, there is neither date 2 monitoring nor a date 1 job acceptance decision. Hence, we move directly to the founder's date 0 decision as to which fraction of shares to sell to outside investors. The founder maximizes his welfare  $V^{NS} = \alpha(1 - \bar{\phi})v_F + \bar{\phi}v_F + (1 - \alpha)(1 - \bar{\phi})v_F + B$ . The first term,  $\alpha(1 - \bar{\phi})v_F + \bar{\phi}v_F$ , is the value of his date 3 block; the second term,  $(1 - \alpha)(1 - \bar{\phi})v_F$ , is the proceeds from selling  $1 - \alpha$  shares at date 0; the final term is the amenity potential. Since diversion is efficient and since the founder is by assumption neither financially constrained nor risk averse, the optimal ownership structure is indeterminate when ownership and management are separated.

LEMMA 1: For any  $\bar{\phi} \in [0, 1]$ ,  $V^{NS}(\alpha^*) = v_F + B$  and  $\alpha^* \in [0, 1]$ .

The founder's welfare is equal to  $v_F + B$ —total revenues under his management plus the amenity potential of managing the company. Even though private benefit extraction decreases with the quality of the law, the founder's welfare is independent of the legal environment. Since the extraction of private benefits is efficient, each diverted dollar reduces the security benefits by a dollar. Diversion reduces the price at which the founder can sell shares to investors, but increases the value of his block by an identical amount. The sum of security and private benefits (including both the amenity potential  $B$  and private benefits  $\Phi$ ) is constant.

### B. Separation of Ownership and Management

What happens when ownership and management are separated? The founder gives up the amenity potential  $B$  and also transfers to the professional manager the opportunity to divert corporate revenues as private benefits rather than pay them out as dividends to the shareholders. While the law constrains diversion, the founder can further limit private benefit extraction through monitoring. Monitoring may also induce opportunistic behavior by the founder even when he does not share in the private benefits. Once the professional manager has signed on to run the firm and revenues are realized, the founder has an incentive to reduce the professional manager's private benefits by monitoring more. Anticipating high levels of monitoring, the professional manager may reject the offer to run the firm. That is, the founder may overmonitor in the sense that the ex post optimal monitoring level exceeds the ex ante optimal amount (Pagano and Röell (1998)). To induce the manager to agree to run the firm, the founder has to commit himself not to monitor excessively. He can do so by dispersing some of the shares to small investors because the actual monitoring intensity is determined by the size of the founder's equity stake (Burkart, Gromb, and Panunzi (1997)). In addi-

tion (or instead), the founder may offer the professional manager monetary incentives to convince him to run the firm.

We solve the game by backward induction, beginning with the date 3 resource allocation decision. Total revenues under the professional manager are  $v_M$ . The law stipulates that  $(1 - \bar{\phi})v_M$  must be paid out either to shareholders as dividends or to the professional manager as salary. What fraction of the remaining  $\bar{\phi}v_M$  is actually diverted depends on monitoring. The founder who monitors with intensity  $m$  can control the use of an additional fraction  $m$  (or at most  $\bar{\phi}$ ) of  $v_M$ . Being excluded from sharing private benefits, the founder forces the professional manager to pay out all of them as dividends. The professional manager then has discretion over  $\max\{0, (\bar{\phi} - m)v_M\}$  in resources. He strictly prefers to extract them as private benefits, unless he is the sole shareholder.

Since private benefit extraction is efficient, there are no gains to shareholders from using monetary incentives to resolve the conflict over resource allocation. To induce the manager to abstain from extracting an additional dollar, shareholders have to offer him this dollar as a transfer. Monetary incentives (henceforth called the wage) can, however, play a role in inducing the manager to accept the job of running the firm. Let  $wv_M$  denote the wage paid to the professional manager when he accepts the job offer from the founder.<sup>6</sup>

At date 2, the founder chooses the monitoring intensity. For a given block  $\alpha$  and for a given wage rate  $w$ , the founder maximizes  $\alpha(1 - w - \bar{\phi} + m)v_M - k(m^2/2)$ .<sup>7</sup> He receives a fraction  $\alpha$  of the security benefits net of the wage bill less his monitoring costs. Since the law already shields  $(1 - \bar{\phi})v_M$  of the revenues from private benefit extraction, the founder never monitors more than  $\bar{\phi}$ . Hence,  $m = \min\{\bar{\phi}, \alpha(v_M/k)\}$  and weakly increases with the block size.

At date 1, the manager agrees to run the firm if the sum of the wage and the private benefits exceeds his outside utility  $c$ .<sup>8</sup> The condition  $(w + \bar{\phi} - m)v_M \geq c$  can be rewritten as

$$m \leq \bar{m} = w + \bar{\phi} - \frac{c}{v_M}. \quad (1)$$

High levels of monitoring and strict legal rules reduce the professional manager's private benefits and may thus discourage him from running the firm. Offering him a higher wage can sway him to accept the job. Higher ownership concentration and better legal protection make it more difficult to satisfy the professional manager's participation constraint, whereas higher wages make it easier. This is the basic trade-off when ownership and management are separated.

At date 0, the founder chooses the ownership structure and the wage to maximize his welfare  $V^s = [1 - w - \bar{\phi} + m]v_M - k(m^2/2)$  subject to the manager's participation constraint.

If the founder were to choose an ownership structure such that  $\bar{\phi} < \alpha(v_M/k)$ , the professional manager would be left with zero private benefits. Consequently,

<sup>6</sup> The subsequent analysis implicitly assumes that  $\bar{\phi} + w < 1$ , which holds in equilibrium.

<sup>7</sup> The range  $m \in [0, 1]$  implies that  $k \geq v_M$ .

<sup>8</sup> An alternative interpretation of the model is one where the manager has to exert an effort to generate revenues  $v_M$  and where  $c$  is the disutility of the effort.

the founder would have to offer a wage  $w = c$  to induce the professional manager to accept the job. Leaving some private benefits to the professional manager in exchange for a lower wage saves on monitoring costs. Hence, the founder always chooses an ownership structure such that  $\bar{\phi} > \alpha(v_M/k)$  and  $m = \alpha(v_M/k)$ .

Inserting the monitoring level  $m = \alpha(v_M/k)$  into the founder's welfare yields  $V^S = [1 - w - \bar{\phi} + (\alpha v_M/k)] v_M - [(\alpha v_M)^2/2k]$  with  $dV^S/d\alpha = (1 - \alpha)v_M^2/k \geq 0$  and  $dV^S/dw = -v_M < 0$ . The founder's welfare increases with ownership concentration and decreases with the wage, provided that the professional manager's participation constraint is satisfied.

A binding participation constraint is obviously in the interest of the founder as any managerial rent comes at his expense. Sometimes, however, the founder cannot avoid leaving some rents to the professional manager. More precisely, there are parameter values for which the participation constraint  $(w + \bar{\phi} - m)v_M \geq c$  does not bind despite a fully concentrated ownership structure and a zero wage. This occurs when  $\bar{\phi} > v_M/k + c/v_M$ . We want to allow for the possibility of legal regimes in which the professional manager can extract a rent.

ASSUMPTION 2:  $\frac{v_M}{k} + \frac{c}{v_M} < 1$ .

Since  $\bar{\phi} \leq 1$ , Assumption 2 is a necessary condition for  $\bar{\phi} > v_M/k + c/v_M$  to hold.

LEMMA 2:

- (i) For  $\bar{\phi} \leq c/v_M$ ,  $\alpha^* = 0$ ,  $w^* = c/v_M - \bar{\phi}$ ,  $m^* = 0$ , and  $V^S(\alpha^*, w^*, \bar{\phi}) = v_M - c$ .
- (ii) For

$$\frac{c}{v_M} < \bar{\phi} \leq \frac{c}{v_M} + \frac{v_M}{k}, \quad \alpha^* = \frac{k}{v_M} \left( \bar{\phi} - \frac{c}{v_M} \right), \quad w^* = 0, \quad m^* = \bar{\phi} - \frac{c}{v_M},$$

$$V^S(\alpha^*, w^*, \bar{\phi}) = v_M - c - \frac{k}{2} \left( \bar{\phi} - \frac{c}{v_M} \right)^2.$$

- (iii) For

$$\bar{\phi} > \frac{c}{v_M} + \frac{v_M}{k}, \quad \alpha^* = 1, \quad w^* = 0, \quad m^* = \frac{v_M}{k},$$

$$\text{and } V^S(\alpha^*, w^*, \bar{\phi}) = v_M(1 - \bar{\phi}) + \frac{v_M^2}{2k}$$

When legal protection is strong (case (i)), then even in the absence of monitoring, private benefits are insufficient to induce the professional manager to run the firm. Ownership is then completely dispersed and the professional manager is offered a wage equal to the difference between his outside utility and the private benefits. The founder's welfare  $V^S(\alpha^*, w^*, \bar{\phi})$  is at its highest possible level under separation ( $v_M - c$ ) and does not depend on legal rules.

When legal protection is moderate (case (ii)), expected private benefits exceed the outside utility  $c$ . As a result, the founder has to monitor the professional

manager to limit the size of his rent. Setting the wage equal to zero minimizes the monitoring intensity that keeps the professional manager's participation constraint binding. Since monitoring is costly, this dominates all other combinations of positive wage and monitoring level that also leave no rent to the professional manager. A positive wage and concentrated ownership do not coexist in equilibrium. Due to the monitoring costs, the founder's welfare  $V^S(\alpha^*, w^*, \bar{\phi})$  is below its highest possible level. Moreover,  $V^S(\alpha^*, w^*, \bar{\phi})$  decreases in both  $\bar{\phi}$  and  $k$ : Less legal protection entails a higher optimal level of monitoring, and a higher  $k$  makes monitoring more expensive.

When legal protection is poor (case (iii)), the founder cannot avoid leaving a rent to the professional manager. Offering a zero wage and retaining all shares to implement a monitoring level  $m = v_M/k$  is all that the founder can do. The resulting rent to the professional manager is equal to  $R = [\bar{\phi} - (v_M/k)]v_M - c$ . The founder's welfare  $V^S(\alpha^*, w^*, \bar{\phi})$  is equal to the highest possible level  $(v_M - c)$  less monitoring costs and managerial rent. As in the range with moderate legal protection,  $V^S(\alpha^*, w^*, \bar{\phi})$  decreases in both  $\bar{\phi}$  and  $k$ .<sup>9</sup>

We now turn to the final step of determining the conditions under which the founder chooses to hire a professional manager. The answer follows from comparing the founder's welfare under no separation  $V^{NS}$  (Lemma 1) to that under separation  $V^S$  (Lemma 2). The next propositions describe the overall equilibrium outcomes.

**PROPOSITION 1.** (i) *If  $v_F + B \geq v_M - c$ , ownership and management are never separated.*  
(ii) *If  $v_M^2/2k \geq v_F + B$ , ownership and management are always separated.*

When the family's amenity potential  $B$  exceeds the professional manager's superior ability net of his outside option ( $B \geq v_M - c - v_F$ ), separation of ownership and management is never optimal, irrespective of the quality of legal protection. A necessary condition for separation is that  $B < v_M - c - v_F$ . At the other extreme, if the discrepancy between the managerial abilities of the professional and the founder (or his heir) is very large, keeping management in the family is always a bad choice. The founder or the family retains an ownership stake of a size depending on the quality of the legal protection as described in Lemma 2, but gives up control. The condition  $v_M^2/2k \geq v_F + B$  is intuitive if we consider the founder's welfare under separation at its minimum when the law provides no protection ( $\bar{\phi} = 1$ ). In this case, all dividend payments are exclusively due to monitoring, a fully concentrated ownership structure is optimal, and  $V^S = v_M^2/2k$ , which is still better than keeping control in the family.

Proposition 1 sheds light on some of the reasons for observing a variation in ownership structures *within* a country, so the legal protection of investors is held

<sup>9</sup>The conclusions of Lemma 2 also obtain if we use the efficiency of monitoring (cost parameter  $k$ ) rather than the upper bound on diversion as the measure of legal shareholder protection, with one difference. Since the founder and the small shareholders have congruent interests, legal protection and monitoring are substitutes when  $\bar{\phi}$  is the measure of legal protection, but are complements when  $k$  is the measure of legal protection.

roughly constant. Even with very strong protection of investors, a founder might want to keep control in the family if the amenity potential is very large or if the heir is relatively competent. Consistent with this prediction, Demsetz and Lehn (1985) document the pervasiveness of family control in the media and professional sports companies in the United States. Conversely, even with very weak investor protection, family control is likely to be surrendered when the heir is at a particularly strong disadvantage in management. Thus, in Western Europe, one often sees professionally managed firms in relatively “technical” areas, such as utilities and telecommunications.

Consider now the parameter range of “moderate” amenity potential and relative competency of the heir:  $v_M^2/2k < v_F + B < v_M - c$ . In this range, the law shapes the attractiveness of hiring a professional manager. Denote by  $\bar{\phi}^* \in (c/v_M, 1)$  the unique value of  $\bar{\phi}$  such that  $V^S(\alpha^*, w^*, \bar{\phi}) = V^{NS}$ . This value exists because  $v_M^2/2k < v_F + B$ .

PROPOSITION 2. *If  $v_M^2/2k < v_F + B < v_M - c$  there are three regimes:*

- (i) *When legal shareholder protection is strong ( $\bar{\phi} \leq c/v_M$ ), ownership and management are separated, and ownership is fully dispersed.*
- (ii) *When legal protection is moderate ( $\bar{\phi} \in (c/v_M, \bar{\phi}^*]$ ), ownership and management are separated, and the founder retains a block.*
- (iii) *When legal protection is poor ( $\bar{\phi} > \bar{\phi}^*$ ), there is no separation of ownership and management.*

When legal rules are very protective, that is, with  $\bar{\phi} \leq c/v_M$ , the separation of ownership and management allows the founder to capitalize on the superior ability of the professional manager and only give up the amenity potential  $B$ . Strong legal protection also solves at no cost to the founder the agency conflict over the allocation of revenues. More precisely, the law restricts private benefit extraction below the professional manager’s outside utility. Letting this manager divert corporate resources is part of his compensation package, which needs to be supplemented by a wage. In this case, selling all the equity and hiring a professional manager is the optimal choice for the founder.

In this model, a legal system with strong protection of outside shareholders is socially desirable. The best manager is hired to run the firm, and no resources are wasted on monitoring. This conclusion is driven by the assumption that law enforcement is free—at least from the viewpoint of the founder. If better legal protection imposes higher enforcement costs on the society, we would have to compare these costs with the social costs of private monitoring.<sup>10</sup>

Once investor protection falls below the threshold  $c/v_M$ , the separation of ownership and management involves a trade-off. On the one hand, the firm is run by a more qualified manager. On the other hand, the founder has to incur monitoring

<sup>10</sup>The private and social calculations are further complicated when there are private costs of compliance with legal rules. For example, the costs of complying with better accounting and disclosure standards might be higher.

costs (and possibly leave a rent to the professional manager) as well as give up the amenity potential  $B$ .

When ownership and management are separated, the founder's welfare  $V^S$  decreases with  $\bar{\phi}$ , because weaker legal protection entails higher monitoring costs and (possibly) an increasing managerial rent. In contrast, when ownership and management are not separated, the founder's welfare is  $v_F + B$  and independent of the quality of legal protection. Hence, there exists a unique threshold value  $\bar{\phi}^*$  below which the cost of separating ownership and management (monitoring costs, managerial rent, and  $B$ ) is less than the gain in managerial efficiency ( $v_M - c - v_F$ ). In this case, the founder or family simply retains an ownership stake whose size depends on legal protection (Lemma 2). Conversely, for  $\phi > \bar{\phi}^*$ , the forgone efficiency loss associated with keeping control in the family is smaller than the agency costs of separating ownership and management. This holds when the sum of  $B$  and revenues under family control exceeds the net dividends under separation.

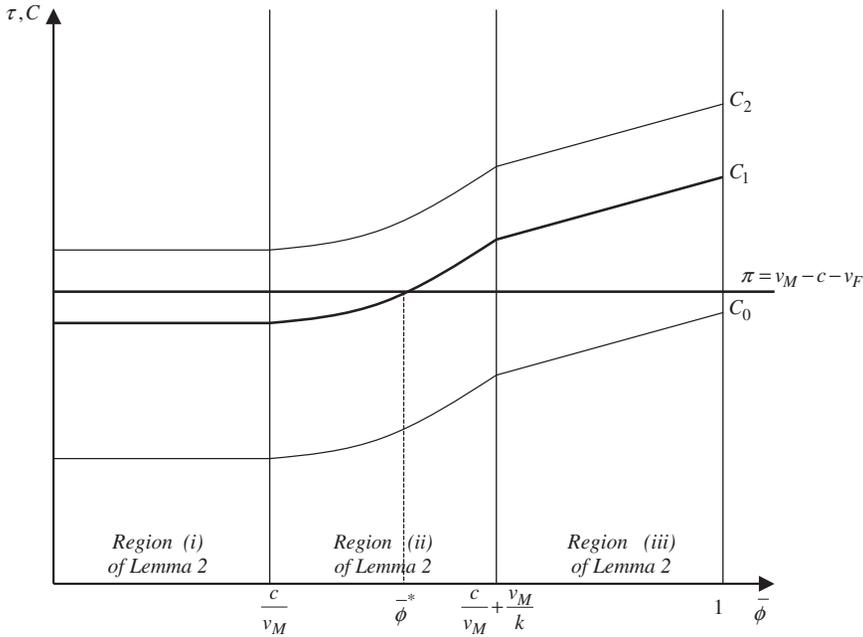
Propositions 1 and 2 can be described in a simple diagram, which shows the gains and costs of appointing a professional manager as a function of the degree of legal protection  $\bar{\phi}$  (Figure 2). The gain is independent of  $\bar{\phi}$  and is reflected by the horizontal line  $v_M - c - v_F$ . The cost includes the monitoring cost, managerial rent, and the forgone amenity potential  $B$ . As Proposition 1 and Figure 2 show,  $B$  could be very high, in which case there is no separation regardless of the legal regime, or very low, in which case there is separation for any legal regime. In the intermediate range, it follows from Lemma 2 that below  $\bar{\phi} \leq c/v_M$  the cost is constant and equal to  $B$ ; in the range  $c/v_M < \bar{\phi} \leq c/v_M + v_M/k$  the cost increases at an increasing rate; and above  $\bar{\phi} > c/v_M + v_M/k$  the cost increases linearly in  $\bar{\phi}$ . The parameter restrictions  $v_M^2/2k < v_F + B < v_M - c$  ensure that the two lines cross at  $c/v_M < \bar{\phi}^* < 1$ , that is, we are in the parameter range where Proposition 2 applies.

The model has a clear implication for how the law shapes ownership structure.

**PROPOSITION 3.** *When ownership and management are separated and  $\alpha^* \in (0,1)$ , more concentrated ownership structures go together with weaker legal protection, that is,  $dx/d\bar{\phi} \geq 0$ .*

The founder's objective when ownership and management are separated is to pay the professional manager no more than his outside utility. Both legal protection and monitoring restrict the manager's extraction of private benefits. Since the law does this at no cost, the founder resorts to monitoring only to the extent that the law leaves the manager a payoff in excess of his outside utility. To keep the manager's participation constraint binding, the founder has to monitor more as legal protection deteriorates. Thus, for  $\bar{\phi} \in (c/v_M, c/v_M + v_M/k]$ , legal protection and ownership concentration are inversely related when ownership and management are separated.<sup>11</sup>

<sup>11</sup>The (inverse) relationship between ownership concentration and legal protection depends crucially on the absence of wealth constraints for the founder and the assumed monitoring



$C$  = monitoring cost + managerial rent + amenity potential = cost of delegation

$\pi = v_M - c - v_F$  = benefit of delegation

$C_1$  obtains for  $\frac{v_M^2}{2k} < v_F + B < v_M - c$  } Law Matters: Proposition 2

$C_0$  obtains for  $\frac{v_M^2}{2k} > v_F + B$  Law does not matter: delegation

$C_2$  obtains for  $v_F + B > v_M - c$  Law does not matter: family management

} Proposition 1

**Figure 2.** Illustration of Lemma 2, Proposition 1, and Proposition 2.

Propositions 2 and 3 make strong empirical predictions, namely that family ownership should be common around the world, and relatively more common in countries with poor investor protection. Recent empirical work is consistent with these predictions. Family control is the dominant form of corporate ownership around the world. Looking at the 20 largest firms in 27 wealthy economies, La Porta et al. (1999) find that families or individuals control 30 percent in number and 25 percent in value of the top 20 firms in each country. These numbers are higher for smaller firms. Family transitions are a frequent and important occurrence: Only about one-third of family-controlled firms are run by their founders;

technology. In particular, the positive relationship between optimal monitoring intensity and ownership concentration relies on the assumption that the incentive to monitor depends on the ownership stake but is independent of legal protection. In contrast, when legal protection has a direct impact on the (marginal) return from monitoring, changes in investor protection have an ambiguous effect on ownership concentration (Burkart and Panunzi (2001)).

the rest are run by descendants or by families that came to own them later. In addition, La Porta et al. show that widely held firms are more common in countries with good shareholder protection: 34 percent versus 16 percent in the countries with a low level of protection. Moreover, ownership patterns tend to be relatively stable. In short, when expropriation is a concern, firms remain family controlled.

Claessens et al. (2000) find that, with the exception of Japan, more than 50 percent of all publicly traded firms in nine East Asian countries are controlled by families and that the top 15 families control significant shares of country wealth.<sup>12</sup> East Asian countries outside Japan are indeed known for particularly poor protection of outside investors. Faccio and Lang (2002) find higher incidence of family firms in countries with inferior shareholder protection in a large sample of West European corporations. The European Corporate Governance Network (2001) documents the prevalence of concentrated corporate ownership in OECD countries.

Propositions 1 and 2 together predict both the general tendencies in ownership patterns across countries and the existence of possibly large variation within each country. In our model, the sources of within-country variation are the amenity potential of control and the differences in skill between heirs and professionals. Of course, there are other potential sources of within-country variation. If firms require outside finance for expansion, or to pay inheritance taxes, ownership is likely to become dispersed. Such dispersion is compatible with the preservation of family control if shares with inferior voting rights are sold in the market. This external finance effect is likely to reinforce our finding: Since valuations in countries with weaker investor protection are lower, using markets to raise funds is less attractive, raising the attractiveness of family control (Shleifer and Wolfenzon (2002)). Another force toward ownership dispersion—diversification—is also less powerful in markets with lower valuations.

Propositions 1 and 2 analyze the institutional conditions under which professional managers are hired. Alternatively, one can consider the managerial efficiency gain necessary to have separation of ownership and management in a regime with weak legal protection.

*COROLLARY 1: The separation of ownership and management requires higher managerial skills in regimes with poorer legal shareholder protection.*

The founder's welfare under separation  $V^S$  increases with both the professional manager's ability (higher  $v_M - c$  values) and the quality of the law (lower  $\bar{\phi}$  values). In contrast, the founder's welfare under no separation  $V^{NS}$  is independent of  $\bar{\phi}$ . Ceteris paribus, the switch from keeping family control to hiring a professional manager requires a more able professional manager when legal protection is less effective: Such legal regimes are associated with higher agency costs of

<sup>12</sup>In Taiwan, the top 15 families control 20.1 percent of listed corporate assets; in Hong Kong, Indonesia, Korea, Malaysia, the Philippines, Singapore, and Thailand, the top 15 families control more than 25 percent of listed corporate assets.

separation of ownership and management. To make hiring a professional manager nonetheless worthwhile, the efficiency gain must be larger.

This section has analyzed how legal rules affect the trade-off between the benefits and costs of separating ownership and management. The model makes accurate predictions about the patterns of such separation in different countries. Some implications of our basic model do, however, clash with the empirical evidence. In particular, the model implies that the founder's block trades at a discount when ownership and management are separated. There is some evidence of negative block premia, but they are the exception rather than the rule. In a study of 63 large block sales in the United States that are not necessarily made by founders, Barclay and Holderness (1989) report that about 20 percent were priced at a discount from the postannouncement exchange price. On average, however, block premia are both positive and higher in countries with weaker protection of outside shareholders (Zingales (1994), Dyck and Zingales (2003), Nenova (2003)). The reason for the negative block premia in our model is that all shareholders benefit in proportion to their stakes from monitoring, but only the founder bears the cost. The negative block premium follows from the assumption that the founder cannot extract any private benefits, thereby ensuring that monitoring is a public good. In the next section, we allow the founder to benefit privately from his monitoring activity.

A final theoretical point concerns our assumption that ownership structure remains stable once the manager has agreed to run the company. If the founder had the opportunity and incentive to retrade *ex post*, he may want to increase his stake and extract a higher fraction of private benefits from the manager. This, in turn, would affect the decision of the manager to accept the offer to run the company. For the model in this section, we can prove that, so long as trade is not anonymous, the purchase of an additional fraction of shares is not profitable for the founder. Because shareholders free ride on the entire value improvement implied by the founder's final holding,<sup>13</sup> the founder does not make a profit on the additional shares acquired in the retrading stage. Moreover, the increase in the monitoring costs due to the larger final holding exceeds the increase in the value of the shares owned initially by the founder. Matters are more complicated when trade is anonymous (DeMarzo and Urošević (2000)), or when the founder shares some of the private benefits of control with the manager, as happens in the next section. In these instances, we need to make the assumption that there is no retrading, or alternatively that the manager's wage can be conditioned on the founder's final equity stake.

### III. Transferable Private Benefits of Control

In Section II, the founder cannot by assumption extract any private benefits  $\Phi$  unless he manages the firm himself. The founder's interest and that of the minority shareholders are perfectly congruent when a professional manager runs the

<sup>13</sup> A proof of a similar result is contained in Burkart et al. (1997) and Pagano and Röell (1998).

firm. In this section, we consider the other extreme, where the private benefits are perfectly transferable, thereby aligning the founder's interest in expropriation with that of the professional manager. For example, the founder and the manager can jointly create a private company that does business with the public firm, and divert cash flows to their private company through related transactions at nonmarket prices, such as asset sales, transfer pricing, or loan guarantees.

The possibility of sharing the spoils with the professional provides a new rationale for monitoring, namely to secure for the founder a larger share of the private benefits. Monitoring becomes a rent-seeking activity. Below we repeat the analytical steps of the previous section for this case of transferable private benefits, and establish that the existence of the three patterns of separation of ownership and management holds as before. We then explore the implications of the model for the relationship between legal protection, share value, block premium, and the agency costs of separating ownership and management. Transferable private benefits only matter in the presence of a professional manager, leaving unchanged the founder's welfare in the case of no separation (Lemma 1). We therefore move directly to the case of separation of ownership and management.

At date 3, the law imposes that  $(1 - \bar{\phi})v_M$  be paid out either as dividends to all shareholders or as the wage to the professional manager. The founder and the professional manager bargain over how to share the remaining  $\bar{\phi}v_M$ . For simplicity, we assume Nash bargaining with equal bargaining power. That is, both the founder and the manager receive their outside options plus half the surplus. The payoff that each party obtains if bargaining were to break down, that is, the outside option, depends on monitoring. If the founder monitors with intensity  $m$ , his outside option is  $\alpha mv_M$ , which corresponds to his share of security benefits salvaged from managerial expropriation. Due to the constraint  $m \leq \bar{\phi}$ , the outside option is equal to  $\min\{\alpha mv_M, \alpha \bar{\phi}v_M\}$ . The outside option of the professional manager is the fraction of revenues that he does not have to pay out to shareholders. For the same reason, ( $m \leq \bar{\phi}$ ), this is equal to  $\max\{0, (\bar{\phi} - m)v_M\}$ . The surplus to be shared in the bargaining between the founder and the manager is the difference between  $\bar{\phi}v_M$  and the sum of the two outside options, and is equal to  $\min\{(1 - \alpha)mv_M, (1 - \alpha)\bar{\phi}v_M\}$ . Under the assumption of equal bargaining power, the founder receives in the bargaining a payment equal his outside option plus half the surplus, or  $\min\{[(1 + \alpha)/2]\bar{\phi}v_M, m[(1 + \alpha)/2]v_M\}$ , and the manager likewise gets  $\max\{\bar{\phi}[(-1 - \alpha)/2]v_M, (\bar{\phi} - m[(1 + \alpha)/2])v_M\}$ . Since these payoffs exceed their outside options, the founder and the manager always agree to set  $\phi = \bar{\phi}$ . They expropriate minority shareholders to the maximum, and share the spoils.<sup>14</sup>

<sup>14</sup>The question arises again whether there are any gains from using monetary incentives to induce the manager to abstain from extracting private benefits. At first glance, this seems possible, since the manager receives only half of the surplus. While the use of such a compensation scheme is in the minority shareholders' interest, the founder prefers ex post to extract private benefits. Since such extraction is efficient, the founder is ex ante indifferent. All that matters is to keep the manager's participation constraint binding, that is, to leave him no rents.

At date 2, the founder chooses the monitoring intensity to maximize  $\{\alpha(1 - w - \bar{\phi}) + [(1 + \alpha)/2]m\}v_M - k(m^2/2)$ . Since the law already protects  $(1 - \bar{\phi})v_M$  of the revenues from extraction, there is no gain from monitoring more than  $\bar{\phi}$ . The founder therefore chooses  $m = \min\{\bar{\phi}, [(1 + \alpha)/2k]v_M\}$ . If  $\bar{\phi} < (1 + \alpha)v_M/2k$  holds, monitoring does not depend on the block size and is purely driven by the prospect of extracting a part of the private benefits. Otherwise ( $\bar{\phi} \geq (1 + \alpha)v_M/2k$ ), monitoring is a function of both private benefits and the ownership stake.

Indeed, decomposing the first-order condition into  $\alpha(v_M/k) + [(1 - \alpha)/2](v_M/k)$  reveals the two motives for monitoring. The first term reflects monitoring in the absence of collusion aimed at preventing managerial expropriation of the founder's stake  $\alpha$ . The second term captures the additional monitoring that the founder undertakes to appropriate some of the private benefits. While monitoring increases as before with the block size  $\alpha$ , the second term implies that monitoring is positive even when the founder retains no shares, that is,  $m(0) > 0$ . This implies that the founder cannot withdraw from the firm. To remove this purely mechanical feature of the model, we impose the following assumption.

*ASSUMPTION 3: If the founder retains less than  $\underline{\alpha} > 0$ , he abstains from monitoring.*

Assumption 3 simply means that, to monitor effectively, the founder must have some power over the manager, and for that he needs a minimum ownership stake. This stake may enable him to sit on the board, to have enough shares to convene an extraordinary shareholder meeting, to have standing in litigation, or to exercise power in other ways. When the stake of the founder is below the threshold  $\underline{\alpha}$ , he has no power vis-à-vis the manager. Put differently, owning a stake below  $\underline{\alpha}$  and dispersing the shares among small investors enables the founder to commit not to interfere through monitoring in the running of the firm.<sup>15</sup>

When  $\alpha \geq \underline{\alpha}$ , the founder monitors in part to avoid expropriation by the professional manager, but he does so only to help himself. Indeed, from the minority shareholders' perspective, monitoring is a pure rent-seeking activity. The founder and the professional manager agree to set  $\phi = \bar{\phi}$  irrespective of the monitoring intensity  $m$ .<sup>16</sup> This result illustrates an important difference between legal shareholder protection and monitoring: While the law protects all the shareholders, monitoring in this model is a form of self-protection by the founder, which has either positive or negative externalities for other investors.

At date 1, the professional manager agrees to run the firm if  $(w + \bar{\phi} - m(1 + \alpha)/2)v_M \geq c$ . The condition that the wage and the manager's share of the

<sup>15</sup>In the absence of collusion, fully dispersed ownership ( $\alpha=0$ ) ensures no monitoring ( $m(0)=0$ ). Introducing a threshold  $\underline{\alpha}$  in Section II would have complicated the analysis without adding any insight.

<sup>16</sup>If one introduces a dead-weight loss associated with private benefit extraction, monitoring also benefits minority shareholders because the founder internalizes part of the inefficiency and hence reduces the level of diversion (Burkart and Panunzi (2001)).

private benefits exceed the outside utility can be rewritten as

$$m \leq \bar{m} \equiv \min \left\{ \bar{\phi}, \frac{(\bar{\phi} + w)v_M - c}{\frac{1+\alpha}{2}v_M} \right\}. \quad (2)$$

The maximum level of monitoring compatible with the professional manager's participation constraint weakly decreases with the founder's stake. A larger block increases the founder's outside option in the bargaining, thereby reducing the share of private benefits that the professional manager obtains. Nonetheless, as  $(1 + \alpha)/2 \leq 1$  the threshold  $\bar{m}$  is higher for a given wage  $w$  and legal protection  $\bar{\phi}$  when the founder and professional manager collude than in the absence of collusion. Withholding  $(1 - \alpha)mv_M$  from the minority shareholders makes it more likely that the professional manager's participation constraint is satisfied.

At date 0, the founder chooses ownership  $\alpha$  and wage  $w$  to maximize his welfare

$$V^S = (1 - \bar{\phi} - w)v_M + \frac{1 + \alpha}{2}mv_M - k\frac{m^2}{2} \quad (3)$$

The founder's welfare is composed of three terms: The first,  $(1 - \bar{\phi} - w)v_M$ , is the dividends accruing to all shareholders if there were no monitoring (again, the founder obtains this amount as the value of the block and as the proceeds from selling shares at date 0); the second,  $[(1 + \alpha)/2]mv_M$ , is the share of private benefits that the founder extracts due to monitoring in the bargaining with the manager; the third,  $km^2/2$ , is the monitoring cost.

ASSUMPTION 4:  $\underline{\alpha} \leq (2kc/v_M^2) - 1$ .

Assumption 4 is purely technical, made to restrict the number of cases. The threshold  $\underline{\alpha} > 0$  (Assumption 3)<sup>17</sup> and Assumption 4 imply that the equilibrium monitoring intensity  $m^*$  is either zero or given by the first order condition  $m = (1 + \alpha^*)v_M/2k$ .<sup>18</sup> In the absence of Assumption 4, monitoring intensity for small  $\bar{\phi}$  values would be determined by the legal threshold ( $m^* = \bar{\phi}$ ), leaving the ownership structure indeterminate in that range of  $\bar{\phi}$  values. Nonetheless, all our results on founder welfare, share value, and separation of ownership and management are robust with respect to relaxing Assumptions 3 and 4.

LEMMA 3:

(i) For  $\bar{\phi} \leq c/v_M$ ,  $\alpha < \underline{\alpha}$ ,  $w^* = (c/v_M) - \bar{\phi}$ ,  $m^* = 0$ , and  $V^S(\alpha^*, w^*, \bar{\phi}) = v_M - c$ .

<sup>17</sup> As  $\underline{\alpha} > 0$ , Assumption 4 implies that  $v_M/2k \leq c/v_M$ .

<sup>18</sup> Rearranging Assumption 4 to  $(1 + \underline{\alpha})v_M/2k \leq c/v_M$  shows that for all  $\bar{\phi} \leq c/v_M$  the first order condition and not the constraint  $m \leq \bar{\phi}$  determines the monitoring intensity. Since monitoring is zero in equilibrium for  $\bar{\phi} \leq c/v_M$ , the constraint  $m \leq \bar{\phi}$  never binds in equilibrium.

(ii) For

$$\frac{c}{v_M} < \bar{\phi} \leq \frac{c}{v_M} + \frac{(1 + \underline{\alpha})^2}{8k} v_M, \quad \alpha < \underline{\alpha}, \quad w^* = 0, \quad m^* = 0, \quad \text{and}$$

$$V^S = (1 - \bar{\phi})v_M.$$

(iii) For

$$\frac{c}{v_M} + \frac{(1 + \underline{\alpha})^2}{8k} v_M < \bar{\phi} \leq \frac{c}{v_M} + \frac{(1 + \underline{\alpha})^2}{4k} v_M, \quad \alpha^* = \underline{\alpha},$$

$$w^* = \frac{c}{v_M} - \bar{\phi} + \frac{(1 + \underline{\alpha})^2}{4k} v_M,$$

$$m^* = \frac{1 + \underline{\alpha}}{2k} v_M, \quad \text{and} \quad V^S = v_M - c - \frac{(1 + \underline{\alpha})^2}{8k} (v_M)^2.$$

(iv) For

$$\frac{c}{v_M} + \frac{(1 + \underline{\alpha})^2}{4k} v_M < \bar{\phi} \leq \frac{c}{v_M} + \frac{v_M}{k}, \quad \alpha^* = \frac{2}{v_M} \sqrt{k(\bar{\phi}v_M - c)} - 1, \quad w^* = 0,$$

$$m^* = \sqrt{\frac{\bar{\phi}v_M - c}{k}}, \quad \text{and} \quad V^S(\alpha^*, w^*, \bar{\phi}) = v_M - c - \frac{\bar{\phi}v_M - c}{2}.$$

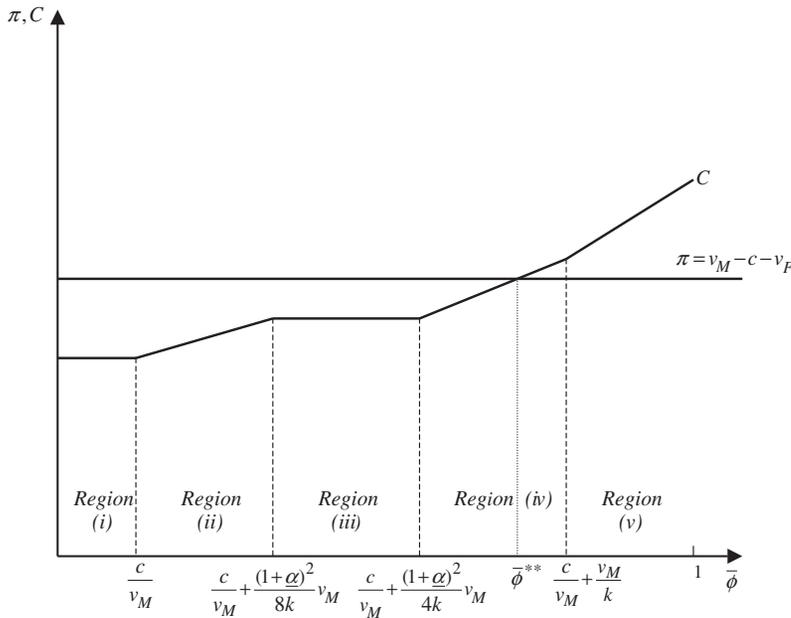
(v) For

$$\bar{\phi} > \frac{c}{v_M} + \frac{v_M}{k}, \quad \alpha^* = 1, \quad w^* = 0, \quad m^* = \frac{v_M}{k}, \quad \text{and}$$

$$V^S(\alpha^*, w^*, \bar{\phi}) = v_M(1 - \bar{\phi}) + \frac{v_M^2}{2k}.$$

LEMMA 3—illustrated in Figure 3—replicates Lemma 2 with an added twist due to collusion and a discontinuity in the feasible monitoring level.<sup>19</sup> In particular, region (i) coincides with region (i) in Lemma 2 and region (v) coincides with region (iii) of Lemma 2. The differences between transferable and nontransferable

<sup>19</sup>There is another difference between Lemma 2 and 3. When legal protection is measured by the upper bound on diversion, the founder's welfare under separation  $V^S$  decreases with  $\bar{\phi}$  both in the case of transferable and in the case of nontransferable private benefits. When legal protection is measured by monitoring efficiency,  $V^S$  does not always decrease with  $k$  in the case of transferable private benefits (region (iii) of Lemma 3). Since monitoring in this setting is also a rent-seeking activity, lower  $k$  values lead to more monitoring in equilibrium—a cost ultimately paid by the founder.



$C$  = monitoring cost + managerial rent + amenity potential = cost of delegation.  
 $B = v_M - c - v_F$  = benefit of delegation.

In region (i), ownership is dispersed  $\alpha^* < \underline{\alpha}$ , wage rate is  $w^* = c/v_M - \bar{\phi}$  and managerial rent is  $R = 0$ .

In region (ii),  $\alpha^* < \underline{\alpha}$ ,  $w^* = 0$  but  $R = \bar{\phi}v_M - c > 0$  (due to undermonitoring).

In region (iii),  $\alpha^* = \underline{\alpha}$ ,  $w^* = c/v_M - \bar{\phi} + (1 + \underline{\alpha})^2 v_M / 4k > 0$  but  $R = 0$  (due to overmonitoring)

In region (iv),  $\alpha^* = (2/v_M) \sqrt{k(\bar{\phi} - c/v_M)} - 1 \in (\underline{\alpha}, 1)$ ,  $w^* = 0$  and  $R = 0$ .

In region (v),  $\alpha^* = 1$ ,  $w^* = 0$  and  $R = \bar{\phi}v_M - c > 0$ .

**Figure 3.** Illustration of Lemma 3.

private benefits appear in the intermediate range of legal protection.<sup>20</sup> In region (iv), weak legal protection permits private benefits to an extent that sharing them between the founder and the professional manager is compatible with the participation constraint and a zero wage. Indeed, to avoid leaving a rent to the manager, the founder has to retain  $\alpha > \underline{\alpha}$  and monitor accordingly. In contrast, in regions (ii) and (iii), where the law is more protective, a zero wage, sharing of private benefits, and satisfying the professional manager's participation constraint are not compatible with each other. Because of the discontinuity in

<sup>20</sup> Irrespective of Assumptions 3 and 4, the equilibrium outcome with collusion is more complicated than Lemma 2. In the absence of Assumptions 3 and 4, the complication is due to the fact that monitoring may be determined by the law ( $m^* = \bar{\phi}$ ) rather than by the first order condition.

monitoring, the founder faces a trade-off between under- and overmonitoring. More precisely, the founder has the option to either not monitor or to monitor at least  $m = (1 + \underline{\alpha})v_M/2k$ . While abstaining from monitoring concedes a rent to the professional manager, monitoring with intensity  $m = (1 + \underline{\alpha})v_M/2k$  requires a positive wage to satisfy the participation constraint. In region (ii), the sum of the wage and the monitoring cost when  $m = (1 + \underline{\alpha})v_M/2k$  exceeds the rent that the professional manager can extract. Hence, it is optimal to fully disperse ownership and to leave the manager with a rent of  $R = \bar{\phi}v_M - c$ . The reverse holds in region (iii): Overmonitoring and compensating the professional manager with a wage to satisfy the participation constraint is less costly to the founder. Consequently, the optimal ownership concentration jumps to  $\alpha^* = \underline{\alpha}$ .

Another implication of Lemma 3 is that the founder cannot gain from selling the entire company to a penniless professional manager who would raise funds in the capital market. From the discussion of the no separation case, it follows that the professional manager could raise at most  $(1 - \bar{\phi})v_M$  in the market. Moreover, he will never pay more than  $v_M - c$ . Simple inspection shows that the founder's welfare  $V^S$  is always at least as large as the minimum of  $(1 - \bar{\phi})v_M$  and  $v_M - c$ . Hence selling the entire company to a penniless manager is weakly dominated by selling some stock in the market and hiring a professional manager.

The feature of Lemma 3 that is both crucial for the subsequent results and robust to relaxing Assumptions 3 and 4 is that the agency cost of separation of ownership and management rises as investor protections become weaker. When  $\bar{\phi}$  increases, the professional manager can appropriate a larger fraction of the revenues. This in turn implies either more monitoring or a larger rent. Since the founder ultimately bears the agency cost, his welfare weakly decreases with  $\bar{\phi}$ .

The final step in analyzing the founder's decision to hire a professional manager and to float part of the equity is the comparison of Lemma 1 with Lemma 3. Since Lemmas 2 and 3 coincide for  $\bar{\phi} \leq c/v_M$  and  $\bar{\phi} > c/v_M + v_M/k$ , Proposition 1 continues to hold. When the amenity potential is very high ( $B > v_M - c - v_F$ ), it is never optimal for the founder to separate ownership and management. As before, a necessary condition to have separation is  $B \leq v_M - c - v_F$ . Also, if the discrepancy between the competence of the professional manager and that of the founder is very large ( $v_M^2/2k \geq v_F + B$ ), separation is always superior.

In the remaining case ( $v_M^2/2k < v_F + B < v_M - c$ ), the decision to separate or not depends on legal protection. When legal protection is good ( $\bar{\phi} \leq c/v_M$ ), ownership and management are separated, and ownership is fully dispersed. When legal protection is less strong ( $\bar{\phi} > c/v_M$ ), the founder's welfare  $V^S$  under separation and collusion (weakly) decreases with  $\bar{\phi}$ . Hence, Proposition 2 also continues to hold: There exists a unique threshold  $\bar{\phi}^{**} \in (c/v_M, 1]$  above which the sum of agency cost and forgone amenity potential  $B$  exceeds the loss in managerial efficiency, and keeping management in the family is optimal. The threshold  $\bar{\phi}^{**}$  again denotes the  $\bar{\phi}$  value where  $V^S(\alpha^*, w^*, \bar{\phi}) = V^{NS}$ . As we show below,  $\bar{\phi}^{**}$  is smaller than the threshold  $\bar{\phi}^*$  derived in the previous section. The only qualitative difference from the case with nontransferable private benefits is that separation and concentrated ownership may or may not be an equilibrium outcome. That is, the threshold value  $\bar{\phi}^{**}$  at which the founder switches to no separa-

tion may entail either a concentrated or a dispersed ownership structure under separation: Both  $\alpha^*(\bar{\phi}^{**}) > \underline{\alpha}$  and  $\alpha^*(\bar{\phi}^{**}) = 0$  are possible.

From the founder's perspective, legal protection and monitoring are substitutes: Both restrict the professional manager's ability to extract private benefits. While monitoring is costly, better legal protection comes at no cost to the founder. This has two implications. First, as legal protection improves, the level of monitoring falls, which in turn entails a less concentrated ownership structure. Proposition 3 thus also holds with transferable private benefits: Legal protection and ownership concentration are inversely related under separation of ownership and management. Second, weaker legal protection raises the agency cost of separation. Hence, hiring a professional manager in regimes with weaker legal rules requires higher managerial skills (Corollary 1).

The quality of the law also affects share value, defined as the total amount of dividends paid out to all shareholders at the final date.

**PROPOSITION 4.** *Share value increases as legal shareholder protection improves.*

From the minority shareholders' perspective, monitoring is not a substitute for legal protection when private benefits are transferable. Ex post, both the founder and the manager prefer to extract private benefits. As a rent-seeking activity, monitoring merely determines how the two split these private benefits. In contrast, the law prescribes that no less than  $(1 - \bar{\phi})v_M$  is used for dividends and wage payments. Hence, the expected share value is equal to  $S = (1 - \phi - w)v_M$ . For  $\bar{\phi} \leq c/v_M$ , better legal protection unambiguously increases share value because the reduction in private benefits exceeds the wage increase.<sup>21</sup> Nonetheless, the minority shareholders are indifferent to the quality of the legal rules because they always get what they pay for. Because the minority shareholders anticipate at date 0 that the founder and the manager will divert the fraction  $\bar{\phi}$  of revenues, the founder's proceeds from selling  $(1 - \alpha)$  shares are equal to  $(1 - \alpha)S$ .

Proposition 4 also holds when the founder or his family keeps control over the firm. Since the founder sets  $\phi = \bar{\phi}$  at date 3 (unless  $\alpha = 1$ ), better laws boost share value because a larger fraction of the proceeds has to be paid out as dividends.

La Porta et al. (2002) examine the valuation of companies (relative to their assets) in different countries, with different levels of shareholder protection. They find that companies in countries with above the world median measures of shareholder protection have Tobin's  $Q$ s about 20 percent higher than do comparable companies in countries with below world median shareholder protection. The positive association between investor protection and the valuation of corporate assets survives a variety of controls for industry, ownership structure, and growth opportunities. Claessens et al. (2002) find similar evidence of higher valuation of companies in more protective legal regimes using data from East Asia.

<sup>21</sup>In contrast, variations in  $k$  have no impact on share value because a more efficient monitoring technology does not benefit the minority shareholders when the founder and the manager collude. This independence suggests that modeling legal (minority) shareholder protection in terms of efficient monitoring technology may not be appropriate.

The positive relationship between share value and legal protection also has implications for the value of the controlling block.

**COROLLARY 2:** *Total block premium  $V^S - S$  increases as legal shareholder protection falls.*

When  $\alpha^* \in (\underline{\alpha}, 1)$ , the founder responds to lower investor protection by monitoring more. Hence, his welfare is reduced by these extra monitoring costs (and possibly by the rent paid to the manager). In contrast, monitoring has no positive impact on share value, and the law is the only safeguard of dividends. As a result, changes in the quality of the law have a larger impact on share value than on the founder's welfare. Corollary 2 also holds when management and ownership are not separated. Since the founder does not monitor in this case, his welfare is independent of the law, while share value decreases with the quality of the law.

A number of recent empirical studies examine the valuation of block premia in different jurisdictions. For example, Zingales (1994) presents evidence of a very significant premium on the high voting rights shares trading on the Milan stock exchange. Nenova (2003) explicitly compares the value of a corporate voting right across legal jurisdictions in a sample of 661 dual-class firms from 18 countries. She presents striking evidence that control is more highly valued in countries with inferior protection of minority shareholders, consistent with Corollary 2. Using a different methodology for computing block premia, Dyck and Zingales (2003) extend and confirm Nenova's findings.

In contrast to minority shareholders whose wealth is independent of the law, the founder's welfare  $V^S$  increases with the quality of the law when ownership and management are separated. The possibility of colluding with the manager also affects the founder's welfare.

**PROPOSITION 5:** *Collusion between the founder and the manager increases the agency costs of separating ownership and management.*

In equilibrium, the agency cost of separating ownership from management is the sum of the monitoring cost and the managerial rent. Compared to the case with nontransferable private benefits, the equilibrium level of monitoring is higher when private benefits are transferable. This is so for two reasons. First, the rent-seeking motive induces the founder to monitor more for a given  $\alpha$  and  $\bar{\phi}$ . Higher levels of monitoring allow the founder to appropriate a larger share of the private benefits. From an ex ante perspective, however, the founder bears the cost of such wasteful monitoring himself. Second, the professional manager receives a larger payoff for a given monitoring intensity  $m$ . Rather than increasing the dividends for all shareholders by  $mv_M$ , the founder and the professional manager withhold the minority shareholders' share  $(1 - \alpha)mv_M$  and split it among themselves. Consequently, collusion requires higher monitoring levels in order to avoid leaving a rent to the professional manager. When private benefits are transferable, the impossibility of fine-tuning monitoring (undermonitoring) also allows the manager to obtain a positive rent in the range  $\bar{\phi} \in [c/v_M, c/v_M + (1 + \underline{\alpha})^2 v_M/8k]$ . The rent

in very poor legal regimes ( $\bar{\phi} > c/v_M + v_M/k$ ) is identical with nontransferable and transferable private benefits, as the two cases coincide once ownership is fully concentrated ( $\alpha = 1$ ).

The present model formalizes legal shareholder protection as a limit on the share of corporate resources that the party in control can divert as private benefits. The law can protect shareholders in other ways as well. One possibility suggested by Proposition 5 is that legal rules can hinder or prevent collusion between the founder and the manager. Examples of such legal rules are equal treatment provisions and fiduciary duties. In fact, Proposition 5 provides a rationale for such rules. They reduce the agency costs of separation of ownership from management, thereby increasing the founder's welfare.<sup>22</sup>

Collusion influences the founder's welfare when ownership and management are separated as well as his decision whether to hire a professional manager.

**COROLLARY 3:** *Collusion between the founder and the manager is detrimental to the hiring of a professional manager, that is  $\bar{\phi}^{**} \leq \bar{\phi}^*$ .*

When ownership and control are separated, the founder's welfare is lower with transferable than with nontransferable private benefits. In contrast, collusion has no impact on his welfare when control is kept in the family. Hiring a professional manager is therefore comparatively less attractive when private benefits are transferable.

#### IV. Conclusion: The Separation of Ownership from Management

It is often claimed that there are two paradigms of corporate governance: the Anglo-Saxon paradigm centered on the conflict between the shareholders and the manager, and the rest of the world's paradigm where the conflict is between large and small shareholders. We show that the two paradigms are special cases of a single model of managerial succession, in which the founder must simultaneously decide whether to hire an outside professional manager (as opposed to keeping management in the family) and how much of the shares to float. We argue that this decision is to some extent shaped by the degree of legal protection of minority shareholders, and derive implications for optimal succession and ownership structures from this premise.

We show that in the regimes with the strongest legal protection of minority shareholders, the optimal solution for the founder is to hire the best professional manager and sell off the entire firm in the stock market—unless his amenity potential of keeping control in the family is huge. This gives rise to the Anglo-Saxon model, in which the law is the principal constraint on managerial discretion and the agency conflict is between the manager and small minority shareholders. With intermediate protection of minority shareholders, the founder still hires a professional manager, but the law is not strong enough to control managerial

<sup>22</sup>In contrast, minority shareholder wealth is affected neither by the quality of the law nor by collusion. When purchasing shares at date 0, they pay no more than the date 3 share value.

discretion, and the founder or his children must stay on as large shareholders to monitor the manager. This gives rise to the twin problems of a conflict between the manager and the controlling shareholders, but also between the two of them and minority outside investors. When the protection of minority shareholders is the weakest, the agency problems are too severe to allow for separation of ownership and management. The founding family must stay on and run the firm; they can only afford to cede control to a professional manager if they make him a member of the family. The separation of ownership and management is thus an indication of a superior corporate governance environment. The lack of such separation, and the prevalence of family firms, is evidence of financial underdevelopment.

Our analysis raises the question of why entrepreneurs do not lobby the government for better investor protection. In the model, if a country improves investor protection ex ante, before the entrepreneur has sold off any shares in the market, he would be strictly better off. On the other hand, for a founder who has already sold a substantial fraction of his company, an improvement in investor protection entails a reduction of the private benefits of control, while the gains in the valuation of publicly traded shares accrue not to him but to the public shareholders. Many of these founders are therefore worse off from the improvement in the corporate governance environment, and indeed, in developing countries the established families generally oppose such reforms (La Porta et al. (2000b)). The new entrepreneurs, as well as firms with significant needs for outside financing, would benefit from legal reform, but their voices are rarely as influential as those of publicly traded family firms in the political debate.

### Appendix

*Proof of Lemma 2:* For  $\bar{\phi} > (c/v_M) + (v_M/k)$ , the professional manager's participation constraint  $(w + \bar{\phi} - \alpha v_M/k)v_M \geq c$  is slack for any admissible pair  $(\alpha, w)$ . Since  $dV^S/d\alpha > 0$  and  $dV^S/dw < 0$ ,  $\alpha^* = 1$  and  $w^* = 0$  is the solution. Thus, for  $\bar{\phi} > (c/v_M) + (v_M/k)$ ,  $m(\alpha = 1) = v_M/k$ ,  $V^S(\alpha^*, w^*, \bar{\phi}) = (1 - \bar{\phi})v_M + (v_M^2/2k)$ , and the professional manager receives a rent  $R = [\bar{\phi} - (v_M/k)]v_M - c$  (part iii).

For  $\bar{\phi} \leq (c/v_M) + (v_M/k)$  the professional manager's participation constraint binds. Rearranging this binding constraint to  $\alpha = [w + \bar{\phi} - (c/v_M)](k/v_M)$  and substituting  $\alpha$  into the objective function yields

$$V^S = v_M - c - \frac{k}{2} \left( w + \bar{\phi} - \frac{c}{v_M} \right)^2,$$

which decreases with  $w$ . Consequently, the founder sets  $w$  at the lowest value compatible with  $w \geq 0$  and  $\alpha \geq 0$ . Hence,  $w = \max\{0, (c/v_M) - \bar{\phi}\}$ , and there are two cases: For

$$\begin{aligned} \bar{\phi} \leq c/v_M, \quad \alpha^* = 0, \quad w^* = (c/v_M) - \bar{\phi}, \\ m^* = 0, \quad \text{and} \quad V^S(\alpha^*, w^*, \bar{\phi}) = v_M - c \end{aligned} \quad (\text{part i}).$$

For

$$\frac{c}{v_M} + \frac{v_M}{k} \geq \bar{\phi} > \frac{c}{v_M}, \quad \alpha^* = k \left( \frac{\bar{\phi}}{v_M} - \frac{c}{(v_M)^2} \right), \quad w^* = 0, \quad m^* = \bar{\phi} - \frac{c}{v_M}, \quad \text{and}$$

$$V^S(\alpha^*, w^*, \bar{\phi}) = v_M - c - \frac{k}{2} \left( \bar{\phi} - \frac{c}{v_M} \right)^2 \quad (\text{part ii}). \quad \text{Q.E.D.}$$

*Proof of Proposition 1:* By Lemma 1,  $V^{NS} = v_F + B$ , and by Lemma 2,  $V^S \leq v_M - c$ . Thus, if  $B > v_M - c - v_F$ ,  $V^{NS} > V^S$  for  $\bar{\phi} \in [0, 1]$ . Since  $V^S$  decreases with  $\bar{\phi}$ ,  $V^S$  reaches its minimum,  $v_M^2/2k$ , at  $\bar{\phi} = 1$ . Therefore, if  $v_F + B < v_M^2/2k$ , then  $V^S > V^{NS}$  for  $\bar{\phi} \in [0, 1]$ . Q.E.D.

*Proof of Proposition 2:* For  $\bar{\phi} \leq c/v_M$ ,  $V^S = v_M - c$  and  $V^{NS} = v_F + B$ . If  $B < v_M - c - v_F$ , then separation and fully dispersed ownership are optimal. For

$$\frac{c}{v_M} + \frac{v_M}{k} \geq \bar{\phi} > \frac{c}{v_M}, \quad V^S(\alpha^*, w^*, \bar{\phi}) = v_M - c - \frac{k}{2} \left( \bar{\phi} - \frac{c}{v_M} \right)^2,$$

and

$$dV^S/d\bar{\phi} = -k(\bar{\phi} - c/v_M) < 0,$$

while for

$$\bar{\phi} > \frac{c}{v_M} + \frac{v_M}{k},$$

$V^S(\alpha^*, w^*, \bar{\phi}) = (1 - \bar{\phi})v_M + (v_M^2/2k)$  and  $dV^S/d\bar{\phi} = -v_M < 0$ . Moreover, the two expressions for  $V^S$  coincide when  $\bar{\phi} = (c/v_M) + (v_M/k)$ . Hence,  $V^S$  decreases with  $\bar{\phi}$  and is continuous in  $\bar{\phi}$  for  $\bar{\phi} > c/v_M$ . Since  $V^{NS}$  is independent of  $\bar{\phi}$  (Lemma 1), there exists a unique  $\bar{\phi}^* \in (c/v_M, 1)$  where  $V^{NS} = V^S$  provided that  $V^{NS} > V^S(\bar{\phi} = 1)$ , that is,  $v_F + B > v_M^2/2k$ . Hence, separation dominates no separation for  $\bar{\phi} \leq \bar{\phi}^*$ , and the reverse holds for  $\bar{\phi} > \bar{\phi}^*$ . Q.E.D.

*Proof of Corollary 1:* As  $V^{NS}$  is independent of  $\bar{\phi}$ , it suffices to show that  $dV^S/dv_M > 0$  and  $dV^S/d\bar{\phi} < 0$  for  $\bar{\phi} > c/v_M$ . Since the latter is proved above, we only need to show that  $dV^S/dv_M > 0$ . In region (iii)  $dV^S/dv_M = (1 - \bar{\phi}) + v_M/k > 0$ , and in region (ii)

$$dV^S/dv_M = 1 - k(\bar{\phi} - \frac{c}{v_M}) \frac{c}{(v_M)^2} \geq 1 - k \left[ \frac{c}{v_M} + \frac{v_M}{k} - \frac{c}{v_M} \right] \frac{c}{v_M^2} = 1 - \frac{c}{v_M} > 0$$

as  $\bar{\phi} \leq \frac{c}{v_M} + \frac{v_M}{k}$ .

Q.E.D.

*Proof of Lemma 3:* For  $\bar{\phi} > (c/v_M) + (v_M/k)$ , the monitoring intensity is given by

$$m = \frac{1 + \alpha}{2k} v_M \leq \frac{v_M}{k} < \bar{\phi},$$

and the professional manager's participation constraint

$$(w + \bar{\phi} - \frac{1 + \alpha}{2} m) v_M \geq c$$

is slack for any admissible pair  $(\alpha, w)$ . Hence, as in Lemma 2,  $\alpha^* = 1$ ,  $w^* = 0$ ,  $m^* = v_M/k$ , and  $V^S(\alpha^*, w^*, \bar{\phi}) = (1 - \bar{\phi})v_M + (v_M^2/2k)$  (part v).

Consider now the range  $\bar{\phi} \leq (c/v_M) + (v_M/k)$ . Suppose that the monitoring intensity is given by the FOC  $m = [(1 + \alpha)/2k]v_M$ . That is, abstract from the discontinuity in monitoring and from the possibility that  $[(1 + \alpha)/2k]v_M > \bar{\phi}$ . Then the participation constraint must be binding. Rearranging the constraint to  $w = (c/v_M) - \bar{\phi} + \{[m(1 + \alpha)]/2\}$  and substituting  $w$  in the founder's objective function yields  $V^S = v_M - c - k(m^2/2)$  which decreases with  $m$ . Thus, the founder chooses the lowest monitoring intensity compatible with  $m \geq 0$  and  $w \geq 0$ . For  $\bar{\phi} \leq c/v_M$ ,  $m = 0$ , that is,  $\alpha < \underline{\alpha}$ , and  $w = (c/v_M) - \bar{\phi}$ . Otherwise,  $w = 0$  is optimal. Substituting the FOC  $m = [(1 + \alpha)/2k]v_M$  into the professional manager's participation constraint yields the corresponding optimal ownership concentration  $\alpha = (2/v_M)\sqrt{k(\bar{\phi}v_M - c)} - 1$  and monitoring intensity  $m = \sqrt{(\bar{\phi}v_M - c)/k}$ .

This is the solution to the founder's maximization problem only if it satisfies the conditions that the monitoring intensity is both given by the FOC, that is,  $m^* \leq \bar{\phi}$ , and feasible, that is,

$$m^* \notin \left(0, \frac{1 + \underline{\alpha}}{2k} v_M\right).$$

Zero monitoring trivially satisfies both conditions and  $\alpha^* < \underline{\alpha}$  and  $w^* = (c/v_M) - \bar{\phi}$  is indeed the solution for  $\bar{\phi} \leq c/v_M$ . The founder's welfare is  $V^S(\alpha^*, w^*, \bar{\phi}) = v_M - c$  (part i).

For

$$\frac{c}{v_M} < \bar{\phi} \leq \frac{c}{v_M} + \frac{v_M}{k},$$

the first condition ( $m^* \leq \bar{\phi}$ ) is equivalent to  $\sqrt{(\bar{\phi}v_M - c)/k} \leq \bar{\phi}$ , which is always satisfied because of Assumption 4. Given  $m = \sqrt{(\bar{\phi}v_M - c)/k}$ , the second condition ( $m^* \geq [(1 + \underline{\alpha})/2k]v_M$ ) is equivalent to

$$\bar{\phi} \geq \frac{c}{v_M} + \frac{(1 + \underline{\alpha})^2}{4k} v_M.$$

Therefore,  $w^* = 0$ ,  $\alpha^* = (2/v_M)\sqrt{k(\bar{\phi}v_M - c)} - 1$ , and  $m^* = \sqrt{(\bar{\phi}v_M - c)/k}$  is the solution only for

$$\frac{c}{v_M} + \frac{(1 + \underline{\alpha})^2}{4k} v_M < \bar{\phi} \leq \frac{c}{v_M} + \frac{v_M}{k}.$$

The founder's resulting welfare is

$$V^S(\alpha^*, w^*, \bar{\phi}) = v_M - c - \frac{\bar{\phi}v_M - c}{2} \quad (\text{part iv}).$$

For

$$\frac{c}{v_M} < \bar{\phi} \leq \frac{c}{v_M} + \frac{(1 + \underline{\alpha})^2}{4k} v_M,$$

the only two possible optimal levels of monitoring are  $m = 0$  and  $m = [(1 + \underline{\alpha})/2k]v_M$ . If  $m = 0$  (that is,  $\alpha < \underline{\alpha}$ ),  $w = 0$  and  $V^S = (1 - \bar{\phi})v_M$ . If  $m = [(1 + \underline{\alpha})/2k]v_M$  (i.e.,  $\alpha = \underline{\alpha}$ ), the participation constraint implies

$$w = \frac{c}{v_M} - \bar{\phi} + \frac{(1 + \underline{\alpha})^2}{4k} v_M,$$

and  $V^S = v_M - c - [(1 + \underline{\alpha})/8k]v_M^2$ . Simple calculations show that  $v_M - c - [(1 + \underline{\alpha})^2/8k]v_M^2 > (1 - \bar{\phi})v_M$  holds for

$$\bar{\phi} > \frac{c}{v_M} + \frac{(1 + \underline{\alpha})^2}{8k} v_M.$$

Thus, for

$$\frac{c}{v_M} < \bar{\phi} \leq \frac{c}{v_M} + \frac{(1 + \underline{\alpha})^2}{8k} v_M,$$

$\alpha^* < \underline{\alpha}$ ,  $w^* = 0$ ,  $m^* = 0$ , and  $V^S(\alpha^*, w^*, \bar{\phi}) = (1 - \bar{\phi})v_M$  (part ii), while for

$$\begin{aligned} \frac{c}{v_M} + \frac{(1 + \underline{\alpha})^2}{8k} v_M < \bar{\phi} \leq \frac{c}{v_M} + \frac{(1 + \underline{\alpha})^2}{4k} v_M, \quad \alpha^* = \underline{\alpha}, \quad w^* = \frac{c}{v_M} - \bar{\phi} + \frac{(1 + \underline{\alpha})^2}{4k} v_M, \\ m^* = \frac{1 + \underline{\alpha}}{2k} v_M, \quad \text{and} \quad V^S(\alpha^*, w^*, \bar{\phi}) = v_M - c - \frac{(1 + \underline{\alpha})^2}{8k} v_M^2. \quad (\text{part iii}). \end{aligned}$$

Q.E.D.

*Proof of Proposition 4:* We need to show that over the five regions of Lemma 3 share value  $S = (1 - \bar{\phi} - w^*)v_M$  (weakly) decreases with  $\bar{\phi}$ . To this end, we substitute the optimal wage  $w^*$  from Lemma 3 into  $S = (1 - \bar{\phi} - w^*)v_M$ . To establish that share value does not increase from one region to the next, we also explicitly derive (when necessary) the share value at the lower and/or upper bound of the regions.

In region (i)  $w^* = c/v_M - \bar{\phi}$  making the share value constant and equal to  $S = v_M - c$ .

In region (ii)  $w^* = 0$  and  $S = (1 - \bar{\phi})v_M$ , which decreases with  $\bar{\phi}$ . At the lower bound of region (ii) ( $\bar{\phi} = c/v_M$ ) share value is equal to  $S = v_M - c$ , and at the upper bound

$$\left( \bar{\phi} = \frac{c}{v_M} + \frac{(1 + \underline{\alpha})^2}{8k} v_M \right), \quad S = v_M - c - \frac{(1 + \underline{\alpha})^2}{8k} v_M^2.$$

In region (iii),

$$w^* = \frac{c}{v_M} - \bar{\phi} + \frac{(1 + \underline{\alpha})^2}{4k} v_M$$

making the share value constant and equal to

$$S = v_M - c - \frac{(1 + \underline{\alpha})^2}{4k} v_M^2.$$

At the transition from region (ii) to region (iii)

$$\left( \bar{\phi} = \frac{c}{v_M} + \frac{(1 + \underline{\alpha})^2}{8k} v_M \right)$$

the share value is discontinuous jumping from

$$v_M - c - \frac{(1 + \underline{\alpha})^2}{8k} v_M^2 \quad \text{to} \quad v_M - c - \frac{(1 + \underline{\alpha})^2}{4k} v_M^2.$$

In regions (iv) and (v),  $w^* = 0$  and  $S = (1 - \bar{\phi})v_M$ , which decreases with  $\bar{\phi}$ . At the lower bound of region (iv)

$$\left( \bar{\phi} = \frac{c}{v_M} + \frac{(1 + \underline{\alpha})^2}{4k} v_M \right),$$

share value is equal to

$$S = v_M - c - \frac{(1 + \underline{\alpha})^2}{4k} v_M^2$$

and decreases thereafter at a constant rate  $v_M$ . Q.E.D.

*Proof of Corollary 2:* The block premium is meaningful only in the range where  $1 > \alpha^* > 0$ , that is, in regions (iii) and (iv) of Lemma 3. In region (iii),  $\alpha^* = \underline{\alpha}$  and

$$V^S(\alpha^*, w^*, \bar{\phi}) - S = \frac{(1 + \underline{\alpha})^2}{8k} v_M^2,$$

which is independent of  $\bar{\phi}$ . In region (iv),

$$\alpha^* = \frac{2}{v_M} \sqrt{k(\bar{\phi}v_M - c)} - 1 \quad \text{and} \quad V^S(\alpha^*, w^*, \bar{\phi}) - S = \frac{\bar{\phi}v_M - c}{2}$$

which increases with  $\bar{\phi}$  and is equal to

$$V^S(\alpha^*, w^*, \bar{\phi}) - S = \frac{(1 + \underline{\alpha})^2}{8k} v_M^2$$

at the lower bound

$$\left( \bar{\phi} = \frac{c}{v_M} + \frac{(1 + \underline{\alpha})^2}{4k} v_M \right).$$

Q.E.D.

*Proof of Proposition 5:* Denote by  $V^{S_{NC}}$  the founder's welfare in the absence of collusion (Lemma 2) and by  $V^{S_C}$  his welfare with collusion (Lemma 3). As the subsequent comparison shows,  $V^{S_{NC}} \geq V^{S_C}$  in the interval

$$\frac{c}{v_M} < \bar{\phi} \leq \frac{c}{v_M} + \frac{v_M}{k},$$

while  $V^{S_{NC}}$  and  $V^{S_C}$  coincide for  $\bar{\phi} \leq c/v_M$  and for  $\bar{\phi} > (c/v_M) + (v_M/k)$ , that is, in regions (i) and (v) of Lemma 3.

For

$$\frac{c}{v_M} < \bar{\phi} \leq \frac{c}{v_M} + \frac{(1 + \underline{\alpha})^2 v_M}{8k},$$

$V^{S_{NC}} \geq V^{S_C}$  is equivalent to

$$c + \frac{k}{2} \left( \bar{\phi} - \frac{c}{v_M} \right)^2 \leq \bar{\phi} v_M.$$

Rearranging this inequality, we obtain

$$\frac{k}{2v_M} \left( \bar{\phi} - \frac{c}{v_M} \right)^2 \leq \left( \bar{\phi} - \frac{c}{v_M} \right),$$

which can be rewritten as

$$\bar{\phi} \leq \frac{c}{v_M} + 2 \frac{v_M}{k}.$$

This condition is always satisfied for

$$\bar{\phi} \leq \frac{c}{v_M} + \frac{(1 + \underline{\alpha})^2 v_M}{8k}.$$

For

$$\frac{c}{v_M} + \frac{(1 + \underline{\alpha})^2 v_M}{8k} < \bar{\phi} \leq \frac{c}{v_M} + \frac{(1 + \underline{\alpha})^2 v_M}{4k},$$

$V^{S_{Nc}} \geq V^{S_c}$  is equivalent to

$$\frac{k}{2} \left( \bar{\phi} - \frac{c}{v_M} \right)^2 \leq \frac{(1 + \underline{\alpha})^2}{8k} v_M^2.$$

Since the LHS increases with  $\bar{\phi}$ , it is sufficient to check that the inequality is satisfied at the upper bound of the interval. Substituting

$$\bar{\phi} = \frac{c}{v_M} + \frac{(1 + \underline{\alpha})^2 v_M}{4k}$$

into the inequality and rearranging yields  $(1 + \underline{\alpha})/2 \leq 1$  which always holds.

For

$$\frac{c}{v_M} + \frac{(1 + \underline{\alpha})^2 v_M}{4k} < \bar{\phi} \leq \frac{c}{v_M} + \frac{v_M}{k},$$

$V^{S_{Nc}} \geq V^{S_c}$  is equivalent to

$$\frac{k}{2} \left( \bar{\phi} - \frac{c}{v_M} \right)^2 \leq \frac{\bar{\phi} v_M - c}{2}.$$

Rearranging this inequality, we obtain

$$k \left( \bar{\phi} - \frac{c}{v_M} \right)^2 \leq v_M \left( \bar{\phi} - \frac{c}{v_M} \right),$$

which can be rewritten as

$$\bar{\phi} - \frac{c}{v_M} \leq \frac{v_M}{k}.$$

This condition is always satisfied for  $\bar{\phi} \leq \frac{c}{v_M} + \frac{v_M}{k}$ . Q.E.D.

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