# THE IMPACT OF MULTIPLE BLOCKHOLDERS IDENTITY ON EXPROPRIATION OF MINORITY SHAREHOLDERS: Evidence from Indonesia

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**Abstract**

*This paper explores the impact of multiple blockholders identity on the relation between family firms, excess control rights over cash flow rights, and expropriation of minority shareholders, in the specific case of Indonesia by using a panel of Indonesia companies over the period 2006-2008. Three research questions are investigated: 1. What is the impact of family firms on expropriation of minority shareholders; 2. What is the impact of excess control rights over cash flow rights on expropriation of minority shareholders; 3. To what extent does multiple blockholders identity moderate the relationship between family firms, excess control rights over cash flow rights, and expropriation of minority shareholders.*
*In the theory review, agency theory and stewardship theory are introduced as theoretical foundation, followed by the discussion of corporate governance in Indonesia context. While agency theory specifies the agency problems namely principal-agent conflicts and principal-principal conflicts; stewardship theory discusses that managers are considered as good stewards who will act in the best interest of the owners which ideal for explaining governance in the family business context.*
*In regards to the methodology, ten testable hypotheses are generated for empirical analysis. Multiple regression analysis of panel data applies Ordinary Least Square (OLS) regression to test the impact of multiple blockholders identity on the relation between family firms, excess control rights over cash flow rights, and expropriation of minority shareholders.*
*Finally, the research questions are answered: there is positive correlation between family firms and expropriation of minority shareholders; excess control rights over cash flow rights has positive impact on expropriation of minority shareholders; and multiple blockholders identity namely another family as the second largest blockholders as well as institutional investor generate disparate significant impact on expropriation of minority shareholders. The existence of another family as the second largest blockholders creates expropriation more severe for minority shareholders while the presence of institutional investor is notable to lessen the positive impact of family firms and excess control rights over cash flow rights on expropriation of minority shareholders.*
**Keywords:** ***Family firms, excess control rights over cash flow rights, multiple blockholders identity, and expropriation of minority shareholders***

## INTRODUCTION

Many empirical studies show evidence that many publicly traded firms outside Anglo-Saxon countries have concentrated shareholders (La Porta et al., 1999; Claessens et al., 2000; Faccio & Lang, 2002). Such ownership structures may mitigate or exacerbate agency problems. On the one hand, the presence of a larger shareholder or blockholder, defined as individual or entity that own at least 5% of a firm’s equity (Mechran, 1995; Faccio & Lang, 2002), is more efficient in mitigating the conflict between agents and principals as it reduces the free-ride problem and maximizes incentives to undertake value-enhancing interventions (Shleifer & Vishny, 1986). On the other hand, the presence of a majority shareholder may give rise to extreme conflicts between principals due to a majority shareholder is able to exercise control over the company and extract private benefits of control (Faccio et al., 2001; Shleifer & Vishny, 1997).

Claessens et al. (2000) show that with the exception of Japan, more than 50% all publicly traded firms in East Asian countries (Hong Kong, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan, and Thailand) are controlled by families and that the top 15 families control significant shares of country wealth. The researchers further discuss that East Asian firms also showed a high divergence between cash flow rights and control rights, that is, the largest shareholders was often able to control a company's operations with a relatively small direct stake in its cash flow rights.

Villalonga & Amit (2006) argue that family firms have strong incentives to monitor management's behavior thus lessen the conflict between agent and principal in the company. Moreover, family firms have salience characteristic compare to other types of ownership structure that is they wish to maintain their business with an intrinsic character which more likely to appoint a member of the family as CEO in order to strengthen the families' control (Claessens et al., 2000; Faccio & Lang, 2002; Peng & Jiang, 2010). Here, family's CEO acts as a steward for the company and his behavior will not diverge from the interest of the family business because the steward seeks to obtain the goals of the company (Davis et al., 1997). Nevertheless, family firms are often associated with the conflict between controlling and minority shareholders which raise the opportunities of expropriation of minority shareholders (Faccio et al., 2001) which defined by Johnson et al. (2000) as the transfer or diversion of company resources by the controlling shareholder to the detriment of minority.

Strong legal institutions and regulatory regimes may act as external mechanism to shield minority shareholders from expropriation (La Porta et al., 1998). However, Young et al. (2008) argue that such mechanism is likely to be less effective in the emerging countries due to their uncertain institutional environment, ineffective or non-existent takeover markets, and poor organized managerial labor market. Peng et al. (2009) suggest that in this kind of environment internal mechanisms of corporate governance may play a larger role in protecting benefit of minority shareholders.

The presence of multiple blockholders as internal mechanism is crucial for enhance governance mechanism (Faccio et al., 2001; Attig et al., 2009). Supporting this argument, Lemmon & Lins (2003) and Jiang & Peng (2011b) provide the evidence based on their study of family firms in several East Asian countries that the existence of multiple blockholders may prevent family firms gain private benefits at the expense of minority shareholder.

One dimension of multiple blockholders structure is multiple blockholders identity which appears to be important (Holderness & Shehan, 1988). The identity of multiple blockholders may matter due to shareholders have heterogeneous incentives, preferences, and capabilities when they invest in a firm (Becth et al., 2002; Thomsen & Pederson, 2000). Furthermore, Attig et al. (2009) discuss that the monitoring role of the second largest blockholders is seemed to depend on its identity.

As one of emerging economies, Indonesia offers an interesting setting for examining linkages between family firms and expropriation of minority shareholders. Capulong et al. (2000) provide evidence that the highly concentrated structure of ownership in the country, which is family-based ownership, enables controlling shareholders to obtain control unequal to their share of ownership and extract private benefits from minority shareholders and company's resources.

Based on the discussion above, it seems to be consensus that having multiple blockholders is pivotal for increase protection of minority shareholders toward expropriation practices conducted by majority shareholder. Nonetheless, the conceptual and measurement of multiple blockholders identity especially on the relation of family firms and expropriation of minority shareholders remains under-examined.

This research will evaluate the effect of multiple blockholders identity in family firms in the context of emerging economy. From a resource-based view standpoint, multiple blockholders represent valuable, rare, and inimitable resources, which may limit a family firms' ability to obtain certain control structures likely to expropriate minority shareholders (Jiang & Peng, 2011b). However, whether the identity of the multiple blockholders is crucial in the term of their impact on expropriation of minority shareholders is yet to be examined.

## LITERATURE REVIEW

Since the early study of Berle and Means (1932), corporate governance has focused upon the separation of ownership and control as a central characteristic of the modern corporation. The authors emphasize the potential of divergence between owners' and managers' objectives arguing that this separation will create opportunity for managers to expropriate company resources for their own private benefits. This issue is formalized by Jensen & Meckling (1976) who introduced the shareholder model which also be known as agency theory. It based on the premise that managers, as agents of principals (shareholders), can engage in decision making and behaviors that may be inconsistent with the maximization of shareholder wealth (Jensen & Meckling, 1976; Fama & Jensen, 1983).

The principal-agent model which has been addressed by Jensen & Meckling (1976) was based on the basic rationale that if both parties – principal and agent – to the relationship are utility maximizers there is a good reason to believe that the agent will not always act in the best interests of the principal. The authors believe that divergence of interests between owner and manager leads agents to fail to maximize the welfare of the principal. They continue by explaining that the agent's actions in running the business using the principal's resources may deviate with the owner's main objective of maximizing their investment. The actions employed by managers who are the core of decision making process in the corporation will sometimes result in negative impacts to the principal. Agents are assumed to be self-interested and likely to pursue goals for their own interests thus could damage principal wealth (Jensen & Meckling, 1976).

Prior academic findings suggest that large shareholders are important in reducing the traditional agency problem between managers and owners (Jensen & Meckling, 1976; Shleifer & Vishny, 1986). The presence of large shareholders may decrease the conflict between principal and agent because their large equity holdings give them higher incentive to collect information and monitor management (Shleifer & Vishny, 1986) and also their voting power gives them the ability to force management to act in the interest of the shareholders (La Porta et al., 1999). However, these large shareholders may give rise to the conflict among principals because a majority shareholder is able to employ control over the corporation and extract private benefits of control from minority shareholders (Shleifer & Vishny, 1997; Faccio et al., 2001).

Principal-principal conflicts highlight the relationship between owners, focusing in particular on problems between majority and minority shareholders. Young et al. (2008) argue that the principal-principal conflicts are likely to be especially severe when firms' ownership and control rights are concentrated in the hands of one large shareholder or blockholder who is individual or entity that own at least 5% of company's equity (Mechran, 1995; Faccio & Lang, 2002). Dharwadkar et al. (2000) and Morck et al. (2005) state that most contribution under this principal-principal perspective refers to emerging countries, where the diffuse patterns of concentrate ownership, combined with weak external governance mechanism, result in frequent conflicts between controlling and non-controlling shareholders.

Stewardship theory contrasts directly with agency theory. Donaldson & Davis (1991) introduce that the theory presents a different model of management, where managers are considered as good stewards who will act in the best interest of the principals. Davis et al. (1997) discuss that stewardship theory takes a broader view of human behavior, proposing that agent's behavior is pro-organizational and collectivistic and has higher utility than individualistic self-serving behavior. Further, the authors state that the steward's behavior will not diverge from the interest of the organization because the steward seeks to obtain the goals of the organization. Donaldson (1990) argues that steward searches for higher level needs, such as self-actualization, through the fulfillment of personal values and aspirations.

Bubolz (2001) argues that stewardship theory is ideal for explaining governance in the family business context due to family business principals' deep emotional investment as well as their personal satisfaction, motivation, and reputation which are tied to the family enterprise (Ward, 2004). Within this context, the family business owners adopt the role of the steward in serving their organization rather than themselves and also they have high motivation to serve their business interests, and as a result they receive intrinsic satisfaction when the business advances and succeeds (Corbetta & Salvato, 2004). Family members are concerned about the business because it is part of their collective legacy and is often the primary assets of the family (Arrègle et al., 2007). Therefore, the control mechanisms and agency costs associated to agency theory as being necessary to control opportunistic and self-serving managers are not necessary (Davis et al., 1997).

The theoretical framework presented in the previous section will be used to develop the testable hypotheses for the study. The basis of the hypotheses is that the multiple blockholders identity which focuses on the second largest blockholders will moderate the relationship between family firms, excess control, and expropriation of minority shareholders in Indonesia publicly listed companies. In this paper, family firms (H1) and excess control (H2) indicate the possible effect of certain ownership and control structure on expropriation of minority shareholders. Further, the identity of the multiple blockholders which categorized into 4 identities namely, another family, government, financial institution, and other company (H2a, H2b, H3a, H3b, H4a, H4b, H5a, H5b, H6a, and H6b) are represented to investigate the moderating effect of multiple blockholders identity on the relation between family firms, excess control, and expropriation of minority shareholders.

The proposed hypotheses of this study as follows:

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| Hypothesis 1 | : | There is positive correlation between family firms and expropriation of minority shareholders. |
| Hypothesis 2 | : | There is positive correlation between excess control rights over cash flow rights and expropriation of minority shareholders. |
| Hypothesis 3a | : | The positive correlation between family firms and expropriation of minority shareholders is stronger when the second largest blockholder is another family. |
| Hypothesis 3b | : | The positive correlation between excess control rights over cash flow rights and expropriation of minority shareholders is stronger when the second largest blockholder is another family. |
| Hypothesis 4a | : | The positive correlation between family firms and expropriation of minority shareholders is stronger when the second largest blockholder is government. |
| Hypothesis 4b | : | The positive correlation between excess control rights over cash flow rights and expropriation of minority shareholders |

is stronger when the second largest blockholder is government.

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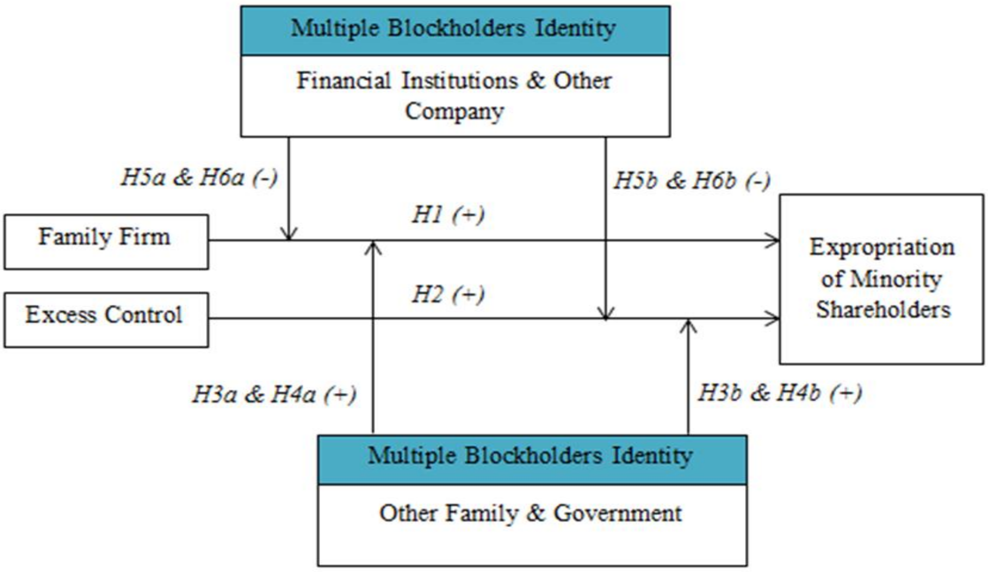
| Hypothesis 5a | : | The positive correlation between family firms and expropriation of minority shareholders is weaker when the second largest blockholder is institutional investor. |
| Hypothesis 5b | : | The positive correlation between excess control rights over cash flow rights and expropriation of minority shareholders is weaker when the second largest blockholder is financial institutions. |
| Hypothesis 6a | : | The positive correlation between family firms and expropriation of minority shareholders is weaker when the second largest blockholder is other company. |
| Hypothesis 6b | : | The positive correlation between excess control rights over cash flow rights and expropriation of minority shareholders is weaker when the second largest blockholder is other company. |

The research model in figure 1 shows the presumed relationship between family firms, excess control rights over cash flow rights, multiple blockholders identity, and expropriation of minority shareholders as stated in the hypotheses.




This study will use a panel data of publicly listed firms in Indonesia during the period of 2006 to 2008. The main resources regarding data of ownership structure and financial indicators for this project are Orbis, Datastream, and Worldscope data sources.

This paper at hand will apply family firm and excess control as independent variables to test expropriation of minority shareholders as dependent variable. It follows former studies on this correlation (La Porta et al., 1999; Claessens et al., 2000; Attig et al., 2008) to set up multiple blockholders identity namely another family, government, financial institution, and other company to test moderating effects of this identity factor on the relationship between family firms, excess control, and expropriation of minority shareholders. In line with prior empirical studies (Faccio et al., 2005; Peng & Jiang, 2010; Jiang & Peng, 2011b), this project will apply financial leverage, and firm risk to control for company characteristics. Firm age and firm size (Villalonga & Amit, 2006; Berkman et al., 2009; Jiang & Peng, 2011b) also will be used as control variable. Finally, accounting transparency will be included to examine whether increasing accounting transparency leads to better stock performance (Peng & Jiang, 2010; Jiang & Peng, 2011b).

Multiple regression analysis to panel data will be used in this project to gain insight into the relation between family firms, excess control, multiple blockholders identity and expropriation of minority shareholders. Two statistical models will be employed to test the hypotheses of this study. In the model 1, the estimation of moderating effect of multiple blockholders identity on expropriation of minority shareholders will be tested by family firm as independent variable and all of control variables while in the model 2, the moderating effect of multiple blockholders identity on expropriation of minority shareholders will be examined by excess control rights over cash flow rights as the predictor variable.

## RESULT

Using panel data for 187 firms during 2006-2008, this study finds that family firms (b = -0.202; p value = 0.041) and excess control rights over cash flow rights (b = -0.086; p value = 0.039) decrease the company stock performance, representing more expropriation of minority shareholders. The presence of another family as the second largest blockholders creates expropriation of minority shareholders more severe, signifying principal-principal conflicts (b = -0.239 and p value = 0.000 for model 1 and b = -0.317 and p value = 0.000 for model 2). Meanwhile, institutional investor as the second largest blockholders delivers positive impact on company stock performance (b = 0.204 and p value = 0.006 for model 1 and b = 0.094 and p value = 0.045 for model 2), indicating that institutional investor have the capability to dampen principal-principal conflicts between majority and minority shareholders. However, the impact of government (b = -0.001 and p value = 0.990 for model 1 and b = -0.071 and p value = 0.168 for model 2) and other company (b = 0.099 and p value = 0.262 for model 1 and b = -0.040 and p value = 0.381 for model 2) as the second largest blockholder on the correlation between family firms, excess control rights over cash flow rights, and expropriation of minority shareholders are not significant.

## DISCUSSION

Regarding family firms and expropriation of minority shareholders, this study finds evidence to support previous finding that family firms often associated with potential expropriation of minority shareholders (Faccio et al., 2001; Lemmon & Lins, 2003; Kim & Lee, 2003; Jiang & Peng, 2011b). Expropriation of minority shareholders is made easier where rules and regulation fail to protect investor rights and systems are more prone to corruption (Young et al., 2008). Better formal legal protection of investor rights in developed countries, may decrease the amount of expropriation of minority shareholders (La Porta et al., 2000). On the contrary, emerging countries typically do not have an effective and predictable rule of law which in turn, creates a weak governance environment (Dharwadkar et al., 2000). Empirical study by Carney & Gedajlovic (2002a) find that ownership of public listed companies in Indonesia is highly concentrated in the hands of family, which may control and manage them as sources of personal and family wealth enhancement. The evidence of this entrenchment was also supported by non-transparent accounting practices, non-market based transactions, strong controlling shareholder groups, and weak minority shareholder rights (Young et al., 2008).

Turning to the excess control rights over cash flow rights on expropriation of minority shareholders, the result of this study shows a positive correlation between excess control rights over cash flow rights and expropriation of minority shareholders. This paper supports empirical finding by Shleifer & Vishny (1997) who argue that when discrepancy of a large shareholder’s control rights and cash flow rights is large, the greater his abilities to expropriate minority shareholders. Peng & Jiang (2010) argue that family firms choose certain control structures such as excess control rights over cash flow rights in response to the formal institutions that often do not promote mutually beneficial impersonal exchange between economic actors. Consequently, this increases the principal-principal conflicts between majority and minority shareholders.

Hofstede (2001) categorized Indonesia as a country with high score in power distance and characterized by collectivism. The collectivism dimension identifies that people are belong to ‘in group’ that take care of them in exchange for loyalty. There are several cultural attributes that derives from these dimensions, such as respect for age and social position, group orientation, and importance of relationships within a community (Hofstede, 2001). Many businesses in Indonesia are established by joint work of different families due to they have ethnic similarity or friendship ties. For instance, Salim family is well-known for their closeness with the family of former Indonesia president, Soeharto. Bank Central Asia, one of the biggest banks in Indonesia and Indofood Sukses Makmur, the largest food processing company in Indonesia and the world’s biggest producer of instant noodles, are examples of those family partnerships. The collectivist culture in the country seems to advocate coalition form amongst different families in business. However, in most cases of emerging economies, formal institutions such as laws and regulations regarding accounting requirements, information disclosure, securities trading, and their enforcement are either absent, inefficient, or do not operate as intended (Young et al., 2008). This results in relational ties, family connection and coalition which in turn lead to potentially expropriate of minority shareholders (Peng & Heath, 1996).

Shleifer & Vishny (1986) and Kochkar & David (1996) suggest that institutional investors have the potential to force companies to adopt governance reforms by leveraging their voting power and media influence. By leveraging their ownership power to enforce managers and controlling shareholder into adopting governance reforms, institutional investors have the capability to minimize the principal-agent conflicts and principal-principal conflicts that arise when executives or majority shareholders pursue policies that benefit them-selves at the expense of minority shareholders (Wahal, 1996).

Even though insignificant, the negative standardized coefficient of the second largest blockholder government (both in model 1 and 2) signs that expropriation of minority shareholders is more likely when government holds large portion of stake in firm. The result may confirm finding by Nguyen (2008) who find a negative influence of government as the second largest blockholder on the firm value. On the other side of coin, although statistically insignificant, the positive standardized coefficient of the second largest blockholder other company in model 1 indicates that company shareholding in family firms generates positive impact on cumulative stock return, thus delivering lower expropriation of minority shareholders. It might confirm the empirical study of Gedajlovic & Shapiro (2002) who find the evidence of positive relationship between corporate shareholdings and company performance in Japanese publicly listed companies.

With regard to the impact of other company as the second largest blockholders on the correlation between excess control rights over cash flow rights and expropriation of minority shareholders (model 2), interestingly, this study finds that the presence of other company as the second largest blockholders delivers negative correlation on company stock performance. Indeed, the result is statistically insignificant. Nevertheless, it denotes that other company as the second largest blockholder might intensify the level of excess control rights over cash flow rights, indicating more potential expropriation of minority shareholders. An answer for this finding can be related to the other feature of corporate in emerging economies namely business groups.

Large family businesses often are organized around business groups, with different affiliated companies being run by various family members or branches (Wilkinson, 1996). On the one side, business groups in emerging economies may provide advantages because they can substitute for weak institutional environments in capital, labor, and product markets (Khanna & Palepu, 2000b; Li et al., 2006). On the other side, they tend to be large cumbersome organizations that carry coordination and administration costs (Claessens et al., 2002). More importantly, for corporate governance reasons, law transparency in coordinating and allocating resources between the affiliated members make difficult for minority shareholders to identify and challenge unfair intra-group transactions (Chang, 2003) since the networks provide significant opportunity for collusion or other unethical transactions (Hoskisson et al., 2000). Khanna & Rivkin (2001) and Claessens et al. (2002) argue that business group affiliation provides a means by which controlling shareholders can expand their control rights over cash flow rights and thus increases the likelihood of expropriation of minority shareholders, which causes principal-principal conflicts.

## CONCLUSION AND RECOMENDATION

As emerging economies have their own characteristics compare to developed economies, resolving principal-principal conflicts in these countries requires creative solutions which may beyond standard approaches. In emerging economies, ownership concentration such as family firms became an important factor to potentially expropriate minority shareholders (Jiang & Peng, 2011b). Yet, eliminating concentrated ownership is not a realistic solution due to the lack of supporting institutions such as laws and enforcement regimes in the countries (La Porta et al, 1998). This study aims to examine whether multiple blockholders identity has competency to limit the likelihood of expropriation of minority shareholders. Further, this study will serve fruitful insight regarding relation of multiple blockholders identity and expropriation of minority shareholders especially in Indonesia context as one of emerging economies countries.

This study is subject to several limitations. A first limitation of the study is that the results may not generalize to other companies and countries. This study investigates principal-principal conflicts in one country as the institutional setting, making future research using other settings promising. A second limitation of this study concerns the proxy for the expropriation of minority shareholders. This study employs only cumulative stock return to measure expropriation of minority shareholders. Future research should use other indicators to denote principal-principal conflicts such as related party transactions or excessive compensation. Finally, in the terms of institutional investor, this study does not distinguish different categories of institutional investors, such as bank, pension fund, and mutual fund. Such distinctions are important because various types of institutional investors may exhibit differing preferences and objectives (Grinstein & Michaely, 2005). Therefore, future study may explore the impact of different types of institutional investors on expropriation of minority shareholders.

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