

# CORPORATE GOVERNANCE AND 'PRINCIPAL-PRINCIPAL' CONFLICTS

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*Abstract: Most of the analyses for corporate governance have a company with dispersed ownership as a research object. The relevant to this type of a company classical conflict 'principal-agent' is decided by traditional mechanisms of the corporate governance and mainly by internal mechanisms.*

*A significant number of companies from developing countries have concentrated ownership. Their typical conflicts are between the controlling shareholder and minority shareholders (principal-principal), which are reduced by external and internal mechanisms.*

*For the countries of East Europe, incl. Bulgaria, the adaptation of the market principles is related to entering of foreign capitals and change of the shareholder structure. A necessity of researches for corporate governance of companies with concentrated ownership arises. The traditional issue for the corporate governance about protection of rights of minority shareholders has a new dimension – decreasing for the deviation between right of ownership and right of control.*

*Keywords: corporate governance, principal-principal*

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## INTRODUCTION

Corporate governance has traditionally been seen as the relationship between shareholders (principal) and managers (agent). According to the agent theory, the shareholders are dispersed and share a common goal - to increase their welfare. Managers are professionals and have a relative advantage of dispersed ownership, which is why they have focused on getting of their own benefit by the opportunistic behavior. The discrepancy in their interests leads to conflicts between them.

Conflicts "principal-agent" have been reduced by aligning the interests of shareholders and managers:

- internal control mechanisms (monitoring by the board and compensation packages for executives), and
- external governance mechanisms (active market for managers and threat of takeover).

Some authors define the different mechanisms as substitutable in which priority is given to internal mechanisms (Suhomlinova, 2006). Other authors recommend the

creation of an optimal combination of internal and external mechanisms in the form of a „package“ (Davis et al., 2002).

The conflicts „principal-agent“ are applicable in companies with dispersed ownership where there is separation of ownership and control. Most studies of the Anglo-Saxon type of corporate governance have been conducted for these conflicts. The elements of the external environment, such as the institutional framework, are not considered.

In some economies outside the Anglo-Saxon type, the companies are characterized by concentrated ownership. The controlling shareholder does not transfer control effectively on professional managers and reserves for himself the right to control. The managers are appointed and represent the interests of the controlling shareholder. The disciplining effect of the foreign market for managers is reduced and helps to align the interests of the controlling shareholder and managers to extract private benefits of minority shareholders. The ineffective protection of minority shareholders leads to loss of confidence in the company and they sell their shares or refuse to invest. In countries with strict investors' protection, the concentrated ownership is seen positively on the value of the company and its results (Fama et al., 1983).

The classic agency model for separation of ownership and control is inapplicable in cases of concentrated ownership (Peng et al., 2013). Corporate governance practices are determined by the institutional environment. The main conflicts are between the controlling shareholder and minority shareholders, so-called conflicts „principal-principal“. The Agent theory gives way to the institutional theory (Lin et al., 2011).

The „principal-principal“ model complements the agent theory by focusing on the conflicts „principal-agent“ according to the institutional conditions. From the perspective of institutional theory, the practices in corporate governance are defined by formal institutions. The institutions, the legislation and the regulations for investors' protection, in turn are leading forces to form a concentrated ownership (La Porta et al., 2002). The presence of concentrated ownership in combination with low investors protection are roots of conflicts „principal-principal“ (Dharwadkar et al., 2000).

In practice, the agent theory has two particular cases:

*Model „multiple principals-one agent“*

The model is applied in situations where the principals receive full information and compete with each other. The agent performs a number of management roles.

In economic literature, the model was introduced in a historical perspective (Adams, 1996). It examines the monitoring by the governments of the Netherlands and the UK over their cross-border colonial agents in East India Company. The reducing of conflicts is defined as „Hydra factor“ by creating a network of communication and accountability.

In the specialized literature, the model is analyzed and used in the trading securities (Attar et al., 2010). The principals have the same motives and time perspectives. The model is adapted to the realities - globalization of stock exchange trading (Guthrie et al.,

2007): the motives of the institutional investors vary between shareholder value and social responsibility, timeframes vary from increasing the frequency of publication of the reports prior to the public auctions.

In our view, the model is a real event in corporate governance of financial intermediaries. For example, the managers of commercial banks serving two types of capital: equity (shareholders) and quasi-equity (customers).

General between the model „principal-principal“ and model „multiple principals-one agent“ is the assumption that different groups of principals influence on decision-making and have a potential conflict of interest (Hoskisson et al., 2002).

The difference between model „principal-principal“ and model „multiple principals-common agent“ is in the situations. The „principal-principal“ model is used in the presence of ability and motives of the controlling shareholder to influence on the company when deciding and on final results (Young et al., 2008). In other situations, when the agent protects the interests of various principals or the principals are not able to effectively monitor the actions of the agent, applies the model „multiple principals-one agent“ (Arthurs et al., 2008).

#### *Model „principal-stakeholder“*

The model focuses on the conflicting interests of shareholders and other persons interested in the activities of the company. The traditional concept of corporate governance limits the range of stakeholders to creditors and employees of the company. The modern concept considers the effects of the behavior of the company and its results on a wide part of society and other companies.

The conflicts "principal-interested person" are concluded in breach of good practices to competitors. Reducing these tensions is done by finding common interests between the company and its stakeholders, as opposed to resolve conflicting interests inside the company at „principal-principal“.

The effectiveness of the corporate governance is determined by a combination comprising external and internal mechanisms (Gedajlovic et al., 1998). Conflicts „principal-principal“ occur when a combination of concentrated ownership/control and weak institutional protection of the minority shareholders.

### **EXTERNAL GOVERNANCE MECHANISMS**

The external environment defines governance mechanisms to reduce the conflicts in the company.

– The external environment affects the company through legal institutions. The legal and regulatory regimes of different countries differ in terms of the security of the minority shareholders (Dyck et al., 2004). The size and scope of protection of property rights determine the structure of ownership and control (La Porta et al., 1998).

- The effective market of corporate control stimulates the monitoring over the management. In the event of poor results, the company is bought or acquired.
- The level of organisation of the managers market determines the degree of protection of property. The impact on the conflicts „principal-principal“ gives appointment of managers by the controlling shareholder of non-market principles. The reduced numbers of managers due to the requirement for their approval by the competent authority also contributes to such conflicts.
- The number of publicly traded companies reflects the level of investor protection and access to external finance (La Porta et al., 1997).

External mechanisms are leading in the reduction of conflicts, but they often have to be accompanied by internal mechanisms. Internal mechanisms replace external mechanisms (Walsh et al., 1990).

### **INTERNAL CONTROL MECHANISMS**

The institutional environment is conducive to effective internal conditions by placing regulations (La Porta et al., 1998). In situations of weak institutional environment, the internal mechanisms play a significant role in reducing conflicts in corporate governance (Peng et al., 2009).

– The presence of multiple blocking persons, instead of controlling shareholder, is appropriate internal mechanism for resolving conflicts „principal-principal“. The advantages are forming a coalition for more effective control over managers than individual controlling shareholder.

– The most effective internal mechanism for the protection of shareholder rights is the low divergence of the voting rights from payment entitlements. This argument is directly connected with the reasons for the controlling shareholder to expropriate minority shareholders.

– One of the most frequently cited reason is the entrenchment by managers. It relates to organizational commitments that effectively protect the insiders of the company from the market for corporate control or interference by shareholders.

– In systems, characterized by weak external, but strict internal conditions (i.e. low divergence between control and rights to payment), the controlling shareholder has a strong motive to increase the value of the company because „nobody steals his own money“ (Peng et al., 2010). In this context, companies with a controlling shareholder must build a reputation for respecting the rights of minority shareholders.

– Effective protection of the rights of minority shareholders. By applying the „one share-one vote“ rule is aligned the right of property and the right of control, incl. receiving information. One of the basic rights of shareholders, the voting rights for dividend, incl. liquidation and other forms of profit-sharing, is ensured by the implementation of the „one share-one vote-one dividend“ rule.

## CONCLUSION

The conflicts „principal-principal“ are reduced by external governance mechanisms (i.e. effective laws and regulations), combined with the internal control mechanisms (i.e. low divergence of control and rights to payment). The combination creates a situation of low private benefits of control and protection of the rights of minority shareholders.

The differences in the institutional environment of individual countries did not permit implementation of a common agency model (Lubatkin et al., 2005). In countries with concentrated ownership and legal mechanisms for protection of minority shareholders is applied model „principal-agent“. In economies with weak institutional framework adds to the cost of agent contracts and prevails concentrated ownership (Wright et al., 2005).

The conflicts „principal-principal“ are common in the countries of Eastern Europe due to the processes of privatization and listing on the stock exchange of previous public companies (Carmichael et al., 2001). For example, the conflict „principal-principal“ is associated with the desire of some majority shareholders to control strategic industries for their own benefit by delisting, i.e. to limiting the minority shareholders.

The conflicts „principal-principal“ may exist in developed economies. For example, a partial overlapping of interests between managers and those of other stakeholders, such as bondholders (Hart et al., 1995).

The current economic situation is forcing companies to change the shareholding structure by attracting foreign capital, most often through the stock exchange. The change in the shareholding structure leads to new conflicts between controlling and minority shareholders. To reduce conflicts „principal-principal“ is recommended to use a combination of internal and external mechanisms.

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