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The risks of having minority controlling shareholders in firms

Such stakeholders can exploit their control at the expense of the company and other minority shareholders without being caught by interested person transaction and other rules. BY MAK YUEN TEEN

IN conversations on corporate governance with practitioners here, some still hold the view that independent directors need only to be independent from management (sometimes referred to as independent from management and business relationships) but need not be independent from significant shareholders because the interests of these shareholders and those of the company are generally aligned. They believe that in cases where there is misalignment, interested person or related party transaction rules can provide adequate safeguards.

When the first Code of Corporate Governance was introduced in Singapore in 2001, independence was defined as independence from management only. At that time, the Corporate Governance Code in the United Kingdom similarly defined independence as independence from management only. Ownership of UK companies tended to be dispersed, with few companies having large shareholders, while in Singapore, ownership is concentrated among one or a few large shareholders in most companies.

By the time the Singapore Code was revised in 2005, UK had embraced the broader concept of independence from both management and significant shareholders because more companies, particularly overseas companies, that are listed on the London Stock Exchange have significant shareholders. More recently, the rules for UK companies with a Premium Listing have introduced stricter requirements for companies with controlling shareholders, including on the election of independent directors. The Council on Corporate Disclosure and Governance here had proposed moving to the broader definition of independence in 2005, but it was rejected. Finally, in 2012, the Singapore Code was revised to include independence from 10 per cent shareholders.

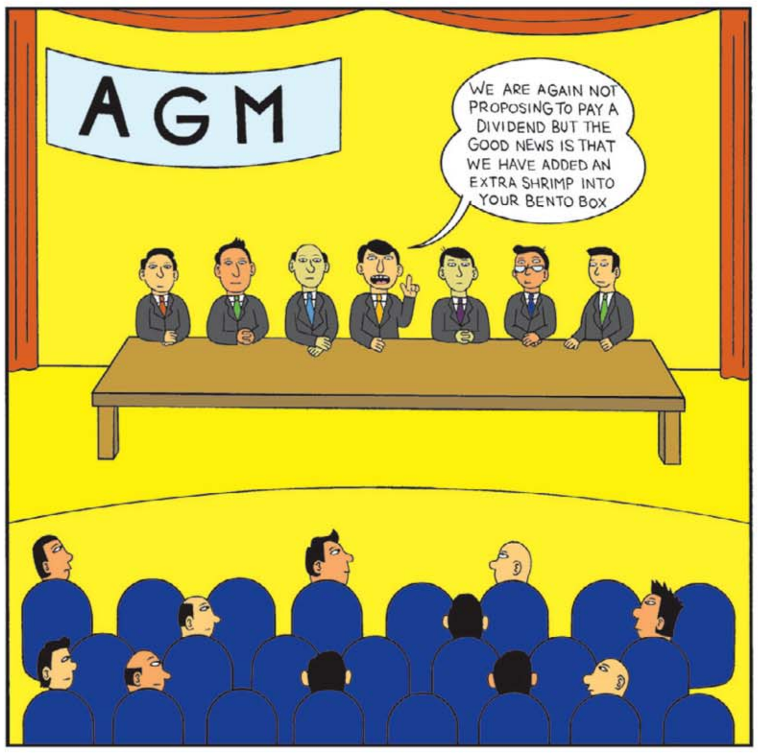
In the United States, independent directors are only required to be independent from management. This is despite an increase in companies with controlling shareholders in the US. Often, control is obtained with relatively low ownership, using two or more classes of shares with different voting rights. This has led some here to point to the US approach to support their position that independent directors need only be independent from management.

The US system of corporate governance is very different from Singapore's. Up till the early 2000s, US regulators imposed requirements on companies to disclose certain key corporate governance practices but there were only very minimal prescriptions to adopt "best practices". This changed in the early 2000s after corporate scandals involving companies such as Enron and WorldCom, which resulted in the enactment of the Sarbanes-Oxley Act, Securities and Exchange Commission rules, and detailed corporate governance standards in listing rules. Therefore, the US had moved from non-prescriptive to prescriptive when it comes to corporate governance, with exceptions allowed for "controlled companies". In fact, it is one of the few countries that does not give companies the flexibility of being able to "comply or explain" against a corporate governance code.

Notwithstanding the move to a more prescriptive approach to corporate governance in the US, the disclosure-based philosophy remains fundamental. One manifestation is in the "controlled company" concept used by the US stock exchanges, whereby companies in which more than 50 per cent of the voting power for the election of their directors is held by a single person, entity or group, can avail themselves to exemptions from certain key corporate governance requirements. These include requirements for a majority of independent directors on the board and independent governance/nominating and compensation committees. A company that chooses to do so must disclose that it is relying on the controlled company exemption, the basis for the exemption and the corporate governance standards with which the company does not comply. Investors are therefore forewarned – that is, caveat emptor.

However, the disclosure-based/caveat emptor approach in the US is backed by strong regulatory enforcement, a very developed commercial court system and the availability of contingency-fee class actions for shareholders. Controlling shareholders in the US also have fiduciary duties to the company and other shareholders, unlike most other countries, including Singapore.

Some years ago, my wife and I went to our doctor for our blood test results. The doctor looked at my wife's results and jokingly said that I should follow what she eats. I said that if I do, I will probably die very quickly. Similarly, when it comes to corporate governance – whether it is dual-class shares, quarterly reporting or other market rules and practices – just following what others do without assessing risk factors in our own environment can undermine the integrity of our market.



It is important to have independent directors who are independent from management and controlling shareholders, and who cannot be appointed or removed just by controlling shareholders. Companies with minority controlling shareholders warrant closer attention. BT ILLUSTRATION: MAK YUEN TEEN, CHRIS BENNETT

VESTED INTERESTS

Another important difference between the US and Singapore is that, in the US, the percentage of shares voted at AGMs is often in the 90-plus range. In Singapore, studies I have done with Chew Yi Hong show that only about 58 per cent of all shares on average are voted at AGMs here. For 2016 AGMs in Singapore, only 13 issuers had more than 90 per cent of shares voted. This means that, on average, a shareholder only needs to hold about 29 per cent of the shares to control 50 per cent of the votes at the AGM. Ordinary resolutions, including resolutions to appoint and remove directors, only require a majority of votes. It is therefore easier to gain control of a company here than in the US.

At Datapulse Technology, for example, only 30 per cent of all shares were voted at the last AGM. The new controlling shareholder now holds 29 per cent of the shares so will be able to pass all resolutions, even special resolutions, unless many of the 9,000-plus minority shareholders exercise their voting rights. In fact, Datapulse's shareholders who hold one million shares or less collectively own 43 per cent of the shares. The controlling shareholder is really a minority shareholder but the larger stake is held by a fragmented group.

There are many ways that controlling shareholders can exploit their control at the expense of the company and other minority shareholders without being caught by interested person transaction and other rules. Examples include appointing less qualified family members as management and paying themselves excessive remuneration as directors and management. These risks are even greater where there are minority controlling shareholders.

Let's consider a simplified example. A family owns 30 per cent of the company, controls the board and has various family members as executive directors, key management and employees. There is a choice between paying themselves an extra S$10 million in remuneration or distributing that S$10 million as dividends. Dividends are tax-exempt but remuneration is taxed. Let's assume the top marginal personal tax rate of 22 per cent. What will the family prefer? Clearly, the S$10 million extra remuneration. They will get to keep S$7.8 million after tax. If it is distributed as dividends, they will get their 30 per cent share, or S$3 million, on a tax-exempt basis. In fact, the family stake in the company must be exceptionally high before the family is indifferent between remuneration and dividend. How high? This happens when the stake is 78 per cent, assuming any additional remuneration for the family members is taxed at the highest tax rate of 22 per cent.

Therefore, not surprisingly, it can be observed that even in family companies that are relatively small, executive directors and key management can be paid millions. For example, in one Singapore family company with a market capitalisation of around S$350 million, the three executive directors who are siblings own about a third of the shares. Together, they were paid as much as S$12 million in 2016 (based on the band disclosures), although there was a significant decline in 2017 due to lower bonuses/profit-shares with a substantial decline in profits.

As the stake becomes larger, the interest of a controlling shareholder will become more aligned with that of the company. However, the larger the stake, the more easily the shareholder can entrench itself – which is the other (negative) effect of increased ownership.

To be fair, some companies with controlling shareholders, including family companies, are more conscious of the interests of other minority shareholders and what constitutes fair remuneration. In a coming report on executive and director remuneration, we will look more closely at this issue.

It is critically important to have independent directors who are independent from management and controlling shareholders, and who cannot be appointed or removed just by controlling shareholders. In particular, companies with minority controlling shareholders warrant more attention. We should put our minds to addressing the risks in such companies.

The writer is associate professor of accounting at the NUS Business School where he specialises in corporate governance