

THE ROLE OF MINORITY SHAREHOLDERS IN PRIVATE COMPANIES

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ABSTRACT

We study the monitoring behavior of minority shareholders in private companies. We draw on Ritchie v. Rupe, a landmark judgment by Supreme Court of Texas in June 2014 that significantly curtailed minority shareholders' monitoring ability in private firms. The judgment provides a natural experiment to examine how the reduced monitoring ability impacted firm performance and to infer the monitoring behavior of minority shareholders. Using hand-collected data, we document evidence consistent with inefficient monitoring by minority shareholders. Further, we document investments and leverage as potential channels of monitoring. We contribute to existing literature by providing evidence on the monitoring behavior of minority shareholders in private firms. Importantly, our evidence also highlights the importance of market feedback mechanism; without a continuous feedback loop from the stock markets, minority shareholders seem to act in a manner that unknowingly hurts the firms they are invested in.

Keywords: Minority Shareholders, Private Companies, Corporate Governance, Closely Held Corporations

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I. INTRODUCTION

This paper studies the monitoring behavior of minority shareholders in private companies. While vast literature suggests that minority shareholders do not actively monitor management, that evidence is based almost exclusively on publicly traded firms, (e.g., Ang, Cole and Lin; Edmans and Manso; McCahery, Sautner and Starks). However, minority shareholders in public companies (hereafter “public minority”) do not face certain constraints that are unique to minority shareholders in private companies (hereafter “private minority”).¹

These unique constraints arise because of the following three characteristics of private companies. First, shares in private companies are not traded on equity markets, which significantly reduces liquidity and limits minority shareholders’ ability to exit the firm.² In addition, absence of traded shares removes the stock market feedback mechanism that the public minority enjoy.³ This can trigger a need to actively monitor the

¹ See app. 3 for a detailed explanation of key differences between the private minority and the public minority.

² See generally *What is Offering Shares in a Private Company?*, UPCOUNSEL, <https://www.upcounsel.com/offering-shares-in-a-private-company#:~:text=Selling%20Private%20Company%20Stock,-Sometimes%2C%20public%20and&text=In%20the%20case%20of%20publicly,hard%20to%20find%20a%20buyer> (last visited Oct. 30, 2020); Amar Bhidé, *The Hidden Cost of Stock Market Liquidity*, 34 J. FIN. ECON. 31 (1993); John C. Coffee Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991); Joseph A. McCahery et al., *Behind the Scenes: The Corporate Governance Preferences of Institutional Investors*, 71 J. FIN. 2905 (2016).

³ See generally Yao-Min Chiang et al., *Do Investors Learn from Experience? Evidence from Frequent IPO Investors*, 24 REV. FIN. STUD. 1560 (2011) (studying IPO trades and showing how investors learn from and use prior market changes). Manager reputation, based on prior capital market measures, can influence how investors react to financial restatements by managers; that is, prior capital market events can influence investors’ reputation assessment of the manager. See generally Anna M. Cianci et al., *How Do Investors Respond to Restatements? Repairing Trust Through Managerial Reputation and the Announcement of Corrective Actions*, 158 J. BUS. ETHICS 297 (2019). Investors learn from the past; when companies issue follow-on equity, investors use previous equity issues as one way to predict the success of the current equity issue. Additionally, existing literature also shows how investors (shareholders) learn from the market. See generally Eric Duca, *Do Investors Learn from the Past? Evidence from Follow-On Equity Issues*, 39 J. CORP. FIN. 36 (2016); W. Bruce Johnson et al., *Managerial Reputation and the Informativeness of Accounting and Market Measures of Performance*, 10 CONTEMP. ACCT. RSCH. 305 (1993) (providing evidence on the investor learning hypothesis using the gold market); Bibo Liu & Xuan Tian, *Do Venture Capital Investors Learn From Public Markets?*, SSRN, <https://deliverypdf.ssrn.com/delivery.php?ID=982097066117090109097004127120127066099037085046045000109117082099091106102103000090025030031007112048112096072099079098031083006085002001036073001127095090100011010060086098075091106070087067113079003011009076029069068087069127092001019015083027020&EXT=pdf&INDEX=TRUE> (last visited Oct. 10, 2020) (showing that Venture Capital investors (shareholders) learn from public stock markets). Company insiders also learn from the market. Stock returns to a merger announcement help company insiders learn how investors perceive the

majority shareholders.⁴ Second, majority shareholders in private firms are typically also the managers, which facilitates extraction of private benefits at the expense of the minority shareholders. Third, the average minority stake in private companies is usually much larger than in public companies, which can induce risk aversion and increase the need to monitor majority shareholders.⁵ All these factors can prompt active monitoring by the private minority.⁶ Since monitoring can influence firm performance, as well as allocation of capital, the monitoring behavior of minority shareholders in private companies warrants a closer examination. To the best of our knowledge, this is the first study to document evidence on this topic.

We draw on *Ritchie v. Rupe*,⁷ a landmark judgment passed in June 2014 by the Supreme Court of Texas that significantly reduced the monitoring ability of minority shareholders.⁸ Prior to *Ritchie*, a “buy-out remedy” provided minority shareholders in closely held corporations the

upcoming M&A and use this information in deciding whether to go ahead with the M&A. See generally Yuanzhi Lou, *Do Insiders Learn from Outsiders? Evidence from Mergers and Acquisitions*, 60 J. FIN. 1951 (2005); Grant McQueen & Steven Thorley, *Do Investors Learn? Evidence from a Gold Market Anomaly*, 32 FIN. REV. 501 (1997).

⁴ We use the terms “majority shareholders” and “managers” in the context of private companies interchangeably.

⁵ See generally Bill Payne, *Limiting the Number of Shareholders in Private Companies*, GUST BLOG (Jan. 5, 2012), <https://gust.com/blog/limiting-the-number-of-shareholders-in-private-companies/#:~:text=The%20US%20Securities%20Exchange%20Act,to%20fewer%20than%20500%20shareholders>. As this article documents, the number of shareholders in private companies is usually less than 500. *Id.* On the contrary, public companies can have shareholders in the millions. *Id.* As a result, the average stake held by a shareholder will be higher in private firms (100 % divided by maximum 500, as opposed to 100% divided by millions). *Id.*

⁶ See UPCOUNSEL, *supra* note 2 (explaining why minority shareholders in private firms are motivated to closely monitor management).

⁷ *Ritchie v. Rupe*, 443 S.W.3d 856 (Tex. 2014).

⁸ As explained above, sale of shares in private firms is very difficult. As a result, minority shareholders in private firms would usually engage in active monitoring/intervention of firm decisions a lot more than would minority shareholders in public firms. However, in close corporations in Texas, prior to 2014, an earlier ruling had established precedent allowing minority shareholders to claim “minority oppression” and force/require majority shareholders to buy out the minority shareholding. Buying out the minority shareholding is not always easy since it can involve millions of dollars, which the majority shareholders may not have in idle cash. Thus, it is inferred that majority shareholders had a reason to bow down to pressure from minority shareholders in order to avoid an expensive buyout.

This gave more teeth to the minority shareholders as they could pressure majority shareholders to reverse certain decisions. In *Ritchie*, this buyout remedy was taken away, thereby reducing the influence minority shareholders had in the firm. Minority shareholders could not use buyout remedy to intervene with the decisions of the majority shareholders. Exit via sale of shares was difficult, as it is. Removal of the buyout remedy made it difficult to exercise active monitoring/intervention, since the majority shareholders did not have to worry about costly buyout of the minority shareholders. This reduced the ability of minority shareholders to monitor majority shareholders. That is, *Ritchie* reduced their monitoring ability. *Id.*

option to force a buy-out of their shareholding by other shareholders in the event of shareholder oppression.⁹ This buy-out remedy thereby provided a fair degree of influence to minority shareholders, who could use oppression as an excuse to exit the firm.¹⁰ However, *Ritchie* invalidated the buy-out remedy,¹¹ which significantly reduced the influence and monitoring ability of minority shareholders in the firms and tilted the balance back in favor of the majority shareholders. *Ritchie* thereby provides a natural experiment to examine how the reduced monitoring ability of minority shareholders impacted firm performance and to infer the monitoring behavior of minority shareholders in private.

We assess the impact of *Ritchie* on the profitability of closely held private firms because any change or reduction in monitoring ability is bound to manifest in firm profitability. Plus, existing literature in corporate governance has used stock market reactions to infer the governance role of large shareholders.¹² Since we study private firms, we use operating performance (return on assets or “ROA”) to infer the monitoring role of minority shareholders. To control for the effect of common factors affecting all companies in Texas, we use private corporations in Texas which are not-closely held as our control sample. We employ a difference-in-difference specification and analyze how the performance of closely held private corporations changed relative to that of non-closely held private corporations after *Ritchie*.

Using hand-collected data, we document evidence consistent with inefficient (active) monitoring by minority shareholders in private firms.

⁹ Closely held private firms are a type of private firms recognized in the Texas Business Organizations Code and characterized by a limited number of shareholders and absence of a board of directors. These characteristics can make the constraints faced by the private minority especially severe in such closely held private firms. Further details of the judgment are provided in Section II. See *infra* Section II.

¹⁰ See Pornsit Jiraporn & Kimberly C. Gleason, *Capital Structure, Shareholder Rights, and Corporate Governance*, 30 J. FIN. RSCH. 21 (2007); see generally McCahery, *supra* note 2; UPCOUNSEL, *supra* note 2.

¹¹ *Ritchie* was highly unexpected and considered a landmark development for two reasons: 1) *Ritchie* ended the long-standing practice of buy-out remedy, which had granted a certain degree of influence to minority shareholders; and 2) *Ritchie* also reversed a 2011 Dallas Court of Appeals decision of providing a \$7.3 million buy-out remedy to the minority shareholders. See, e.g., James Dawson, *Ritchie v. Rupe and the Future of Shareholder Oppression*, 124 YALE L. J. 89 (2014) (pointing to the impact of *Ritchie*); Eric Fryar, *Filling in the Gaps: Shareholder Oppression after Ritchie v. Rupe*, TEX. J. BUS. L. 47 (2017)(same); see *infra* Section II (detailing *Ritchie*).

¹² See generally Anup Agrawal & Gershon N. Mandelker, *Large Shareholders and the Monitoring of Managers: The Case of Antitakeover Charter Amendments*, 25 J. FIN. & QUANT. ANALYSIS 143 (1990); Kenneth A. Borokhovich et al., *Variation in the Monitoring Incentives of Outside Stockholders*, 49 J. L. & ECON. 651 (2006).

Specifically, we find that after *Ritchie*, closely held firms witnessed a significant increase in operating performance. This evidence suggests that prior to *Ritchie*, the presence of the buy-out remedy afforded a certain extent of bargaining power to minority shareholders, which might have led to the inefficient monitoring by the private minority (in the form of blocking of investments, taking on debt, etc.). Removal of the buy-out remedy helped reduce their influence and allowed managers more flexibility and thereby improved firm performance.

One concern could be small sample size due to limited data availability. To address this, we follow Santa-Clara & Valkanov and Bertrand, Duflo & Mullainathan,¹³ and conduct a bootstrap regression and find qualitatively similar results. Another concern might be that our results capture a trend in the performance of closely held corporations, rather than as a consequence of *Ritchie*. To alleviate that issue, we also run a pseudo-year test (in which we use a year other than the year *Ritchie* was decided and rerun our test)¹⁴ and find that there is no performance improvement in that year. We also conduct several other robustness tests including alternative performance measures, dummy dependent variables to reduce effect of outliers, as well as matched sample analysis. The results are qualitatively similar in all the robustness tests.

To further corroborate our evidence on inefficient monitoring, we conduct two additional tests. For the first test, we follow prior evidence which shows that managers in firms with poor performance face stricter disciplining.¹⁵ Consistent with the inefficient monitoring hypothesis, we find that poorly performing firms experience a much larger improvement in firm performance as compared to other firms.¹⁶ For the second test, we partition our sample based on median firm size.¹⁷ Smaller firms generally

¹³ See generally Pedro Santa-Clara & Rossen Valkanov, *The Presidential Puzzle: Political Cycles and the Stock Market*, 58 J. FIN. 1841 (2003); Marianne Bertrand, et al., *How Much Should We Trust Differences-in-Differences Estimates?*, 119 Q. J. ECON. 249 (2004).

¹⁴ See details *infra* Table 4.

¹⁵ See generally Jun-Koo Kang & Anil Shivdasani, *Firm Performance, Corporate Governance, and Top Executive Turnover in Japan*, 38 J. FIN. ECON. 28, 29–58 (1995) (finding a negative relation between firm performance and the probability of turnover); Steven R. Matsunaga & Chul W. Park, *The Effect of Missing a Quarterly Earnings Benchmark on the CEO's Annual Bonus*, 3 ACCT. REV. 313, 313–32 (2001) (documenting an adverse effect on a CEO's annual cash bonus when the firm's quarterly earnings fall short of a benchmark (consensus analyst forecast or prior performance)).

¹⁶ We define firms with a consistent drop in sales for the past two years as poor performers. We do not use ROA as the partitioning variable because ROA is our performance measure in our main test.

¹⁷ This partition is based on findings documented in existing research. Existing literature shows that larger firms have better corporate governance practices. See, e.g., Bernard S. Black et al., *Predicting Firms' Corporate Governance Choices: Evidence from Korea*, 12 J. CORP.

face a higher degree of uncertainty.¹⁸ They are also less likely to have independent directors or voluntarily have their financial statements audited.¹⁹ These factors could increase the monitoring incentives of the private minority in smaller private firms. Consistent with inefficient monitoring, we find that the improvement in performance is predominant in smaller firms than in larger firms. These tests corroborate our conclusion regarding inefficient monitoring by the private minority.

In the second test, we attempt to identify a channel/mechanism of inefficient monitoring. Burkart, Gromb & Panunzi²⁰ shows that inefficient monitoring by non-controlling shareholders reduces managers' initiatives to undertake new investments.²¹ In line with Burkart, Gromb & Panunzi, the removal of the buy-out remedy should provide more freedom for managers to undertake new investments.²² We test if closely held corporations experienced an increase in investments after *Ritchie*. We use a dummy variable, equal to 1 if net Property, Plant & Equipment (PPE)

FIN. 660, 660–91 (2006) (showing that larger firms have better corporate governance practices). This is usually the case because large firms have better qualified directors. The higher qualification/diversity of directors can improve governance and reduce the need for minority intervention, as better qualified directors will exercise better monitoring of the majority shareholders. See Martin Arnegger, et al., *Firm Size and Board Diversity*, 18 J. MGMT. & GOVERN. 1109, 1109–35 (2014) (finding that firm size is positively correlated with the occupational and international background diversity of the directors). Additionally, literature in finance shows that firm size is a determinant of firm risk. See Eugene F. Fama, & Kenneth R. French, *Common Risk Factors in the Returns on Stocks and Bonds*, 33 J. FIN. ECON. 3, 3–6 (1993) (showing that larger firms have lower risk). This shows that firm size will be an important determinant of corporate governance as well as of the frequency of minority intervention.

Based on the above relation between firm size and governance quality, we split our sample into two sub-samples—smaller firms and larger firms. To show that our results are not muddled by firm size, we split our sample into two sub-samples based on median size. Based on existing research, larger firms will exhibit better governance and have lower risk, which will reduce the need for minority shareholders to intervene. This suggests that the frequency of use of buy-out remedy will be lower in larger firms since the higher governance quality and lower risk will reduce the need for minority shareholders to intervene. This implies that after the Texas ruling, the improvement in performance will be lower for larger firms than for smaller firms.

¹⁸ See generally Gabriel Perez-Quiros & Allan Timmermann, *Firm Size and Cyclical Variations in Stock Returns*, 55 J. FIN. 1229, 1229–62 (2000) (documenting that smaller firms display a higher degree of asymmetry in their risk and are also more sensitive to variables of credit market conditions); Mario Sítum, *The Age and the Size of the Firm as Relevant Predictors for Bankruptcy*, 2 J. APPLIED ECON. & BUS. 5 (2014) (using univariate differences to show that smaller firms are more likely to be bankrupt).

¹⁹ See generally Michael Minnis, *The Value of Financial Statement Verification in Debt Financing: Evidence from Private US Firms*, 49 J. ACCT. RES. 457 (2011).

²⁰ See generally Mike Burkart, et al., *Large Shareholders, Monitoring, and the Value of the Firm*, 112 Q. J. ECON. 693 (1997).

²¹ This is consistent with an anecdote obtained from a CEO in our sample.

²² See generally Burkart et al., *supra* note 20.

increased and 0 otherwise.²³ We document a higher likelihood of increase in net PPE for closely held firms after *Ritchie*. This finding suggests that prior to *Ritchie*, the monitoring ability facilitated restriction on firm investments, which relaxed after *Ritchie* and allowed managers to undertake more investments.

One might argue that, in order to avoid the potential costs of inefficient monitoring, it would be easier for firm managers to use debt financing instead of equity; but this argument cannot hold because it assumes perfect foresight on the part of the managers. When a manager seeks financing through minority equity, she cannot predict the potential inefficient monitoring unknowingly undertaken by the minority shareholders.²⁴ It is similar to a marriage; the couple does not go into the marriage knowing they will get divorced later.

An alternate channel of monitoring could be firm leverage. Faccio, Marchica & Mura state that when shareholders' wealth is concentrated in the firms they own, they try to avoid risk more than they would have if they had a diversified portfolio.²⁵ In addition, Bodenhorn provides evidence that undiversified shareholders prefer lower risk as manifested in lower leverage.²⁶ The private minority faces a unique set of constraints and generally holds an undiversified portfolio that could induce a strong preference for lowering firm risk, or lower leverage.²⁷ Our test confirms

²³ We use a dummy variable because using a continuous variable could bias the results (due to depreciation).

²⁴ There is no research supporting the idea that a manager seeking financing through minority equity can predict inefficient monitoring.

²⁵ See generally Mara Faccio, et al., *Large Shareholder Diversification and Corporate Risk-Taking*, 24 REV. FIN. STUD. 3601 (2011).

²⁶ See generally Howard Bodenhorn, *Voting Rights, Shareholdings, and Leverage at Nineteenth-Century U.S. Banks*, 57 J.L. & ECON. 431 (2014). Although the author uses bank data from the early 19th century, the findings are still applicable to our setting.

²⁷ See discussion *infra* app. 3; see also Michael Minnis & Nemit Shroff, *Why Regulate Private Firm Disclosure and Auditing?*, 47 ACCT. & BUS. RES. 473 (2017). These are the constraints that the minority shareholders in private firms' faces, as explained in the paper. These constraints arise due to the following reasons:

1. Shares in private firms are not listed on stock exchanges. As researchers have pointed out, minority shareholders have two options to respond to firm decisions: intervene in the decisions, or sell their shareholding and exit the firm. Since shares in private firms are more difficult to sell, the only realistic way in which minority shareholders can respond to firm decisions is by intervening. However, if their shareholding is not large enough to matter in a simple majority vote, this is a constraint they face. Minority shareholders in public companies can sell their shares on stock exchanges and exit;

2. Average minority stake. On average, the number of shareholders in a private firm is much lower than the number of shareholders in public firms. Given this, average stake for a given shareholder would be higher than the average stake held in a public firm. Ang et al. (2000) state that the average minority stake and number of shareholders in a firm can influence the extent of monitoring undertaken by each shareholder;

this hypothesis. We find an increase in firm leverage after *Ritchie*. This finding suggests that leverage could be another possible channel of monitoring used by the private minority, which increased after *Ritchie*, reduced the minority monitoring ability. While investments and leverage are two possible channels of monitoring, there could be other alternative channels, including cash distributions or employment.²⁸ However, data on dividends or executive employment is not available, and hence we cannot test for these outcomes in our paper.

We contribute to existing research in three ways. First, our result highlights the crucial role played by stock markets for minority shareholders of public companies. Stock market feedback provides minority shareholders with important information on managers' decisions.²⁹ Also, stock liquidity allows minority shareholders in public firms an easy exit option, which further reduces the need to actively monitor the managers.³⁰ In the absence of the beneficial role of stock

3. Availability of quality information about the firm—private firms are not required to publish their financial statements on the SEC website. See Evan Tarver, *Are Private Companies Required to Publish Financial Statements?*, INVESTOPEDIA (Oct. 30, 2022), <https://www.investopedia.com/ask/answers/062415/private-company-required-disclose-financial-information-public.asp#:~:text=In%20short%2C%20not%20in%20the,financial%20information%20to%20the%20public>. As a result, minority shareholders in private firms are dependent on the majority shareholders/managers for this information. If the manager refuses to provide the same, the minority shareholders may not have any quality information to assess the performance of the firm they are invested in. In addition, private firms are not required to be audited as per the SEC rules. Auditors act as an external source of governance. Potential lack/absence of this important governance mechanism reduces the reliability of the firm's financial statements. Lack of audits implies that the financial statements are not verified/vetted by an external source. This can thereby make the financial statements of private firms less reliable for the minority shareholders.

These key points present constraints to minority shareholders in private firms; constraints that are not faced by minority shareholders in public firms. See also discussion *infra* app. 3.

²⁸ For example, potentially occupying board seats or executive positions even when not well qualified for the position. After *Ritchie*, the manager might be able to hire well-qualified people for the job, which could also improve firm performance.

²⁹ Manager reputation (based on prior capital market measures) can influence how investors react to financial restatements by the managers; that is, prior capital market events can influence investors' reputation assessment of the manager. See, e.g., Cianci et al., *supra* note 3; Chiang et al., *supra* note 3 (studying the IPO trades, and showing how investors learn from prior market changes and use that learning in the future); Duca, *supra* note 3 (using follow-on equity issues (SEOs) to show that investors use the previous SEO returns, to assess current SEOs); Johnson, *supra* note 3 (showing that stock market performance influences CEO reputation); Liu & Tian, *supra* note 3 (showing that Venture Capital investors (shareholders) learn from public stock markets); Luo, *supra* note 3 (showing that company insiders also learn from the market); McQueen, *supra* note 3 (providing evidence on the investor learning hypothesis using the gold market).

³⁰ See Bhide, *supra* note 2 (arguing that stock liquidity can reduce the intervention likelihood since higher stock liquidity makes it easier for shareholders to 'cut and run'); see also

markets, minority shareholders in private corporations engage in more active monitoring of their firm managers.³¹ Further, without a feedback loop provided by stock markets, the private minority tend to act in a manner that (unknowingly) hurts the firm.³² Second, we document evidence of inefficient monitoring by private minority. Existing literature on minority shareholders has focused on public corporations and has found a generally passive role for minority shareholders in public corporations.³³ However, private minority face unique constraints, and as such experience higher motives to monitor.³⁴ Our paper is the first study to provide empirical evidence on the monitoring behavior of minority shareholders in private corporations. While we use two types of private firms, our results generalize to private firms, as non-closely held private firms, still continue to enjoy the buy-out remedy, which can induce active/inefficient monitoring. Since non-closely held firms are a large proportion of private

Coffee Jr., *supra* note 2 (same); McCahery et al., *supra* note 2 (stating that existing literature shows that stock liquidity is an important factor for whether shareholders intervene in manager decisions).

³¹ See sources cited *supra* note 2.

³² As shown elsewhere in this paper, shares of private firms are not listed on stock exchange. As a result, minority shareholders in private firms do not enjoy the benefits of ‘learning’ from the stock market participants—traders, investors, analysts, etc. For instance, how a firm’s stock reacts to certain news, or how analysts change their forecasts and predictions about a firm based on certain news provides information to investors and stockholders about the value-impact of a particular firm decision(s). Without this feedback loop, minority shareholders in private firms have no mechanism to inform them of good or bad choices. Prior to the ruling, minority shareholders could have used the buyout remedy to force certain decisions (or reversal of certain decisions). However, without a feedback mechanism, there was no way for them to see if this decision (or reversal thereof) was actually beneficial to the firm, or harmful to the firm. This implies that the frequency of bad decisions (for instance, stopping a large positive NPV project just because it looks very risky), would be higher in private firms, since shareholders in private firms do not have access to general wisdom as exhibited by more informed participants in the stock market.

³³ Existing research in corporate governance uses public companies’ data, and has discussed the generally passive role of minority shareholders. Some of the research is quoted here. See, e.g., Henrik Cronqvist & Mattias Nilsson, *Agency Costs of Controlling Minority Shareholders*, 38 J. FIN. & QUANT. ANALYSIS 695 (2003); Amedeo De Cesari, *Expropriation of Minority Shareholders and Payout Policy*, 44 BRIT. ACCT. REV. 207 (2012); see generally Luca Enriques et al., *The Basic Governance Structure: Minority Shareholders and Non-Shareholder Constituencies*, in THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 79, 94–96 (2d ed. 2009); Maria Gutiérrez & Maribel Sáez, *Strong Shareholders, Weak Outside Investors*, 18 J. CORP. L. STUD. 277 (2018); Assaf Hamdani & Yishay Yafeh, *Institutional Investors as Minority Shareholders*, 17 R. FIN. 691 (2013); F. Hodge O’Neal, *Oppression of Minority Shareholders: Protecting Minority Rights*, 35 CLEV. ST. L. REV. 121 (1987); William A. Reese Jr. & Michael S. Weisbach, *Protection of Minority Shareholder Interests, Cross-Listings in the United States, and Subsequent Equity Offerings*, 66 J. FIN. ECON. 65 (2002); Jayanth Rama Varma, *Corporate Governance in India: Disciplining the Dominant Shareholder*, J. INDIAN INST. MGMT., BANGALORE (1997).

³⁴ See Minnis & Shroff, *supra* note 27; see also discussion *infra* app. 3.

firms on average,³⁵ our results generalize to all private firms. Third, we document evidence of real effects of minority monitoring on investments and leverage. The literature so far, has identified real effects of firms' financial reporting decisions on firm investments and leverage.³⁶ Our paper shows that firm investments and leverage can be affected by inefficient monitoring too.³⁷

One question may arise in this study. Can shareholders become aware of the *Ritchie* ruling quickly enough to influence their behavior in the first year itself? While shareholders may or may not become aware of this ruling on their own, they would find out from their lawyers, especially given the significance of this ruling. Once the shareholders are apprised of this by the lawyers, it is adequate to influence their behavior. In the interviews we conducted with some of the CEOs in our sample, this view was corroborated.

Our paper proceeds as follows: Section II discusses the literature review and the hypothesis development, Section III talks about data collection and research design, Section IV presents the results, and Section V concludes.

³⁵ This is based on our sample of about 20 firms. 25% of our sample are closely held firms, which implies that about 75% of the observations are non-closely held firms. See Descriptive Statistics *infra* Table 1.

³⁶ See, e.g., Richard Lambert et al., *Accounting Information, Disclosure, and the Cost of Capital*, 45 J. ACCT. RSCH. 385 (2007); see generally Feng Chen et al., *Financial Reporting Quality and Investment Efficiency of Private Firms in Emerging Markets*, 86 ACCT. REV. 1255 (2011); Art Durnev & Claudine Mangen, *The Real Effects Of Disclosure Tone: Evidence From Restatements*, SSRN (Sept. 12, 2011), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1650003; Nemit Shroff, *Real Effects of Financial Reporting Quality and Credibility: Evidence from the PCAOB Regulatory Regime*, SSRN (Oct. 10, 2015), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2667969.

³⁷ Our evidence on investments is consistent with Burkart, Gromb & Panunzi, who state that over interference by minority shareholders can reduce managers' initiatives to undertake new investments. See generally Burkart et al., *supra* note 20.

II. LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

A minority shareholder holds a unique position in a firm. While she provides capital to the firm, she usually has no significant voice in deciding how the capital will be utilized or invested.³⁸ If minority shareholders have no rights and no role to play, they will refuse to provide the requisite capital to the firm, and many firms would suffer.³⁹ As a result, it becomes important to understand the role of minority shareholders, their rights and limitations, and how their rights interplay with firm outcomes.

Existing literature studying minority shareholders has mostly focused on public companies. That literature has found that minority shareholders in public companies, on average, do not engage in active monitoring of the manager.⁴⁰ There are several reasons for such behavior.

³⁸ Referring to our discussion in other places, minority shareholders do not have a large stake in the firm (that is why they are called minority shareholders). Given a non-majority stake (less than 50%), they are not in a position to influence firm decisions directly. This implies that their stake by itself is not enough to influence firm decisions (no significant voice in deciding how the capital will be utilized). They by themselves cannot decide whether their firm can make an investment or not. Minority shareholders also are not usually part of firm management, which implies no executive authority to influence firm decisions either. As a result, minority shareholders are in a unique position. Given this, the existence of an exit option is important for minority shareholders.

³⁹ This is an anecdotal observation. It was pointed out by researchers, reviewers, and editors present at the conferences where this paper was presented.

⁴⁰ This list shows that the existing evidence on minority shareholders focuses mainly on public firms. (Several other papers study minority/small or larger shareholding but with respect to public firms). See generally Christian Andres, *Large Shareholders And Firm Performance — An Empirical Examination of Founding-Family Ownership*, 14 J. CORP. FIN. 431 (2008) (using founding family ownership as a measure of magnitude and concentration of shareholding to show the impact between founding family ownership and firm performance, by using publicly listed firms in Germany); Dušan Isakov & Jean-Philippe Weiskopf, *Are Founding Families Special Blockholders? An Investigation of Controlling Shareholder Influence on Firm Performance*, 41 J. BANKING & FIN. 1 (2014) (showing similar results using publicly listed Swiss firms); Stijn Claessens et al., *Disentangling the Incentive and Entrenchment Effects of Large Shareholdings*, 57 J. FIN. 2741 (2002) (investigating the entrenchment effects of large shareholding using data from publicly listed firms in eight East Asian countries, to better incorporate and control for differences in country-level governance practices); Stuart L. Gillan & Laura T. Starks, *Corporate Governance Proposals and Shareholder Activism: The Role of Institutional Investors*, 57 J. FIN. ECON. 275 (2000) (using activist shareholders as a unique type of shareholders, and investigating how different types of activist shareholders behave and how they interact with other type of shareholders; based on publicly traded data); Paul Gompers et al., *Corporate Governance and Equity Prices*, 118 Q. J. ECON. 107 (2003) (deriving a measure of corporate governance quality (shareholder rights) for firms, using data on 1500 publicly traded firms in the US); Rafael La Porta et al., *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3 (2000) (investigating the differences in ownership concentrations across countries); David F. Larcker et al., *Corporate Governance, Accounting Outcomes, and Organizational Performance*, 82 ACCT. REV. 963, 963–1008 (2007) (investigating the impact of various measures of corporate governance on accounting and reporting outcomes—accrual quality, restatements, etc., using data on publicly traded firms); see, e.g., Randall Morck et al.,

First, due to their small stake in the firm, the minority shareholders' benefits from monitoring are not large enough to justify the costs of monitoring.⁴¹ Edmans & Manso find that a structure with numerous small blockholders can be suboptimal for governance, as splitting of equity between numerous shareholders leads to a free-rider problem.⁴² Second, as documented in prior research, even a larger stake may not necessarily incentivize the shareholder to engage in active monitoring.⁴³ For instance, Kahn & Winton shows that a blockholder may instead “cut and run”; i.e. sell shares instead of trying to monitor the managers.⁴⁴ Third, legal constraints can restrict institutional investors from taking a large enough stake which can justify the costs of monitoring.⁴⁵ Even if some institutional investors own a large enough stake to justify monitoring effort (cost), they

Management Ownership and Market Valuation: An Empirical Analysis, 20 J. FIN. ECON. 293, 293–315 (1998) (investigating the impact of management ownership of shares on firm performance using data on publicly traded firms in the US).

⁴¹ Even if some institutional investors own a large enough stake to justify monitoring effort (cost), they may not actively monitor managers, due to conflicts of interest, legal barriers and investment management industry structure. See, e.g., James A. Brickley et al., *Ownership Structure and Voting on Antitakeover Amendments*, 20 J. FIN. ECON. 267, 267–91 (1988); see generally Ying Duan et al., *Business Ties and Information Advantage: Evidence from Mutual Funding Trading*, 35 CONTEMP. ACCT. RSCH. 866, 866–97 (2018); McCahery et al., *supra* note 2.

⁴² See, e.g., Alex Edmans & Gustavo Manso, *Governance Through Trading and Intervention: A Theory of Multiple Blockholders*, 24 REV. FIN. STUD. 2395, 2395–2428 (2011).

⁴³ There is no official definition of a “large” stake. Papers use blockholders (those with stakes of 5% or more) and institutional investors as proxies for “large” stakes. See generally Henrik Cronqvist & Rüdiger Fahlenbrach, *Large Shareholders and Corporate Policies*, 22 REV. OF FIN. STUD. 3941, 3941–76 (2008) (using blockholders with a 5% or more shareholding as a large shareholder because such shareholders can be referred to as ‘Principal Shareholders’ and have to be reported in proxy statements); María Gutiérrez & Josep A. Tribó, *Multiple Large Shareholders in Corporate Control: Evidence for Spain* (Universidad Carlos III de Madrid, Working Paper, Paper No. 28903, 2003) (“Traditionally the corporate finance literature dealing with the problem of the concentration of ownership has compared a dispersed ownership structure where no shareholder has a significant stake with a concentrated ownership structure where a large shareholder effectively controls the firm (Berle and Means, 1932; Jensen and Meckling, 1976; Grossman and Hart, 1980; Sheleifer and Vishny, 1986; Burkart et al. 1997)”; Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, *Corporate Ownership Around the World*, 54 J. FIN. 471, 471–517 (1999) (defining a firm as having concentrated ownership if the largest shareholder has more than 20% shareholding); Yongjia Rebecca Lin & Xiaoqing Maggie Fu, *Does Institutional Ownership Influence Firm Performance? Evidence from China*, 49 INT’L REV. OF ECON. & FIN. 17, 17–57 (2017) (using institutional investors as a measure/proxy for large shareholders); Andrei Shleifer & Robert W. Vishny, *Large Shareholders and Corporate Control*, 94 J. POL. ECON. 461, 461–88 (1986).

⁴⁴ See generally Charles Kahn & Andrew Winton, *Ownership Structure, Speculation, and Shareholder Intervention*, 53 J. FIN. 99, 108, 121 (1998).

⁴⁵ This refers to constraints that require institutional investors to diversify their portfolio, preventing them from taking a significant stake in the company that can justify monitoring efforts. See McCahery et al., *supra* note 3.

may not actively monitor managers, due to conflicts of interest, legal barriers, and investment management industry structure.⁴⁶

The aforementioned literature, however, does not consider minority shareholders in private firms (collectively the “private minority”).⁴⁷ The private minority can exhibit a very different monitoring behavior since they face a unique set of constraints not applicable to the public minority.⁴⁸ These constraints can arise because of a few key reasons. First, shares in private companies are not traded on equity markets, which significantly reduces liquidity and limits the private minority’s ability to exit the firm.⁴⁹ Stock illiquidity can influence active monitoring by minority shareholders.⁵⁰ Edmans has documented that stock illiquidity reduces the profitability of selling, and thus encourages intervention by blockholders.⁵¹ Coffee and Bhide have argued that higher liquidity reduces active monitoring of managers as it facilitates quicker exit by shareholders.⁵² Therefore, the lack of liquidity of shares in private companies is thereby bound to influence monitoring behavior of the private minority.⁵³ Not all these interventions are efficient.⁵⁴ Second, unlike public companies, private companies are not required to get their financial statements audited.⁵⁵ Absence of this important oversight mechanism can enhance the likelihood of motivation for monitoring by the private minority.⁵⁶ Third, majority owners are also usually the managers in these private firms.⁵⁷ This owner-manager duality can facilitate easy extraction of private benefits by

⁴⁶ See Brickley et al., *supra* note 41; Duan et al., *supra* note 41; McCahery et al., *supra* note 3.

⁴⁷ See discussion and sources cited *supra* note 40.

⁴⁸ We have provided reasons for why minority shareholders in private firms are different from minority shareholders in public firms. See discussion *infra* app. 3.

⁴⁹ Here, equity markets refer to the stock exchanges such as NYSE or NASDAQ. See UPCOUNSEL, *supra* note 2.

⁵⁰ See *id.*

⁵¹ See generally Alex Edmans, *Blockholders and Corporate Governance*, 6 ANN. REV. FIN. ECON. 23, 27 (2014).

⁵² There are many other papers which have shown how liquidity influences governance of a firm. The papers mentioned here are just a few, to make the point. See e.g., Coffee, *supra* note 2; Bhide, *supra* note 2.

⁵³ See UPCOUNSEL, *supra* note 2.

⁵⁴ This is an anecdotal observation supported by the informal interviews conducted with the owners of the close-corp. firms in Texas.

⁵⁵ See, e.g., Reciprocity, *Are Public Companies Required to be Audited?*, RECIPROCITY (Jul. 21, 2020), <https://reciprocity.com/resources/are-public-companies-required-to-be-audited/#:~:text=The%20SEC%20requires%20publicly%20traded,t%20issue%20audited%20financial%20statements> (highlighting the fact that private companies are not required to be audited as per the SEC rules).

⁵⁶ See UPCOUNSEL, *supra* note 2.

⁵⁷ This is an anecdotal observation supported by the informal interviews conducted with the owners of the close-corp. firms in Texas.

these managers at the expense of minority shareholders (or at least the perception of extraction of private benefits, in the minds of the private minority).⁵⁸ Hence, minority shareholders might exert higher monitoring effort and/or more inefficient monitoring effort.⁵⁹ All these differences are significant enough and can create substantial incentives for the private minority to exert higher monitoring efforts than do public minority.⁶⁰ However, it is difficult to predict how efficient/inefficient the higher monitoring would be and whether the higher monitoring would be beneficial or detrimental to the firm. Consequently, the monitoring behavior of minority shareholders in private companies warrants a closer examination; and whether the higher monitoring efforts are beneficial or not can be determined using empirical evidence.

⁵⁸ Morck et al., *supra* note 40 (stating that when a shareholder has control rights (through management position) and ownership (through a large shareholding), the opportunity increases to extract personal gains at the expense of minority shareholders (increase opportunity to engage in non-value-maximizing activities)); *see generally* Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 759 (1997) (stating once “large owners gain nearly full control of the company, they prefer to generate private benefits of control that are not shared by minority shareholders”). This suggests that when a shareholder has a large enough stake to influence firm decisions (through voting) and has the executive authority to pass those decisions (through the C-suite and executive authority granted), there is a much higher likelihood of such shareholder using his/her position to derive personal benefits at the expense of the minority shareholders.

⁵⁹ *See generally* Jiraporn & Gleason, *supra* note 10; *see also* Shleifer & Vishny, *supra* parenthetical text accompanying note 58. This suggests that when a shareholder has a large enough stake to influence firm decisions (through voting) and has the executive authority to pass those decisions (through the C-suite and executive authority granted), there is a much higher likelihood of such shareholder using his/her position to derive personal benefits at the expense of the minority shareholders. Morck et al., *supra* note 40 (stating that when a shareholder has control rights (through management position) and ownership (through a large shareholding), the opportunity increases to extract personal gains at the expense of minority shareholders (increase opportunity to engage in non-value-maximizing activities)). Minority shareholders in private firms hold shares that are extremely illiquid. Building up on existing research, this leaves the minority shareholders in private firms with one main channel to stop/reverse firm decisions that they are unhappy with—active intervention. They can actively intervene in the firm management to try and stop/reverse the decisions they think are not good for the firm. However, since their shareholding does not exceed 50% (minority shareholding), they can’t just use their shareholding to force a stoppage/reversal of their decision. The ability to force a buyout of their shares gave them a fair degree of bargaining power, as such buyouts could end up being expensive. Thereby, we infer that such buyout remedy was a way for minority shareholders to exercise some degree of influence on firm decisions. *See generally* McCahery et al., *supra* note 2; UPCOUNSEL, *supra* note 2.

⁶⁰ *See* discussion *supra* note 59; *see also* Jiraporn & Gleason, *supra* note 10; McCahery et al., *supra* note 2; Morck et al., *supra* note 40; Shleifer & Vishny, *supra* note 58; UPCOUNSEL, *supra* note 2; Reciprocity, *supra* note 55 (highlighting the fact that private companies are not required to be audited per the SEC rules).

Our paper uses a Supreme Court of Texas ruling,⁶¹ which provides us a natural experiment to study the monitoring behavior of minority shareholders in private firms. Private firms in Texas can be split into closely held and non-closely held firms.⁶² We draw on a landmark ruling passed in June 2014 by the Supreme Court of Texas, which significantly curtailed the monitoring ability of minority shareholders in closely held private firms.⁶³ *Ritchie* was specific to closely held private firms, and did not impact the rights and liabilities of non-closely held private firms.⁶⁴ Consequently, it provides an optimal setting to examine how the reduced monitoring ability, brought on by *Ritchie*, impacted performance of closely held private firms relative to that of non-closely held private firms, and thereby draw inferences on the role of minority shareholders in private firms in general.⁶⁵

It is not clear what effect the *Ritchie* would have on the performance of closely held private firms. On one hand, the buy-out remedy could have facilitated effective monitoring by the private minority that could have been beneficial for the firm. In line with this argument, the reduction in monitoring ability would negatively impact firm productivity and profits; we call this the “efficient monitoring hypothesis.” On the other hand, given the constraints they face (as listed above), the private minority might become too conservative and extremely risk averse. This might cause them to increase their monitoring efforts to a point where it becomes inefficient and is detrimental to the firms. In such a case, a substantial reduction in the monitoring ability of minority shareholders could positively impact firm performance as it could provide higher flexibility to the managers to run the firm more efficiently; we call this the “inefficient monitoring hypothesis.” Due to these contrasting forces, it is not clear *ex ante* how the reduced monitoring ability would impact firm performance. As a result, we state our hypothesis in the null form as follows:

⁶¹ See *Ritchie v. Rupe*, 443 S.W.3d 856 (Tex. 2014).

⁶² This idea is recognized in the Texas Business Organizations Code and characterized by a limited number of shareholders and absence of a board of directors. These characteristics can make the constraints faced by the private minority especially severe in closely held private firms. Articles of incorporation which state whether the corporation is closely held are recorded by the Secretary of State. See generally TEXAS SECRETARY OF STATE, <https://www.sos.state.tx.us/> (last visited Oct. 2, 2022); see, e.g., examples of articles of association *infra* app. 2; see also discussion *infra* Section III.A ¶ 1 (containing a detailed description of collecting the closely held status).

⁶³ For more information on *Ritchie*, see discussion *infra* app. 4.

⁶⁴ See generally *Ritchie*, 443 S.W.3d 856.

⁶⁵ Use of non-closely held private firms as a control group also allows the control of factors that could have affected all firms in Texas.

H₀: Performance of closely held private corporations will remain unchanged after the Supreme Court of Texas ruling (consistent with passive monitoring by the private minority).

Since the direction of the performance change cannot be predicted *ex ante*, due to the contrasting nature of the two hypotheses, our alternate hypothesis is given in a two-pronged manner as below:

H_{1a}: Performance of closely held private corporations will decline after the Supreme Court of Texas ruling (consistent with the efficient monitoring hypothesis).

H_{1b}: Performance of closely held private corporations will improve after the Supreme Court of Texas ruling (consistent with the inefficient monitoring hypothesis).

III. DATA COLLECTION AND RESEARCH METHODOLOGY

A. Data Collection

Data on private corporations, especially closely held private corporations, is not easily available. We hand-collect our data from various sources. We use the Capital IQ database to collect financial data (although the private companies' data is limited).⁶⁶ Capital IQ also provides nonfinancial data including firms' address, SIC code, and (in some cases), year of founding.⁶⁷ We start with the universe of private corporations registered within Texas, which are available in the Capital IQ database for the period 2012 to 2016.⁶⁸ We require firms to have data on sales, net profit, and assets for the entire sample period.⁶⁹ We then exclude firms belonging to the one-digit SIC code 6 (financial institutions),⁷⁰ as well as firms belonging to the one-digit SIC code 8 (service oriented firms).⁷¹ The service-oriented firms include law firms, hospitals, and consulting firms where the firms are either owned by managing partners or operated by a trust. These firms do not have the typical shareholding structure to help draw inferences on the role of minority shareholders. We also exclude nonprofit firms, for the same reason (nonprofit firms are those belonging to SIC code 7997);⁷² we confirm their nonprofit status by reviewing their articles of incorporation filed with the Texas Secretary of State.⁷³ To identify the closely held status of each firm, we manually review the firm's articles of incorporation.⁷⁴ A firm's closely held private corporation status would usually either be mentioned as a separate clause,

⁶⁶ This includes data on sales, net income, total assets, total equity, current assets, current liabilities and net Property, Plant & Equipment (PPE). See generally CAPITALIQ, <https://www.capitaliq.com/> (membership required to view databases) (last visited Oct. 2, 2022).

⁶⁷ *Id.*

⁶⁸ Data in Capital IQ was not in a form directly readable in SAS or STATA. Financial data was in Excel sheets—one for each firm. *Id.* Even for each firm, Income Statement and Balance Sheet were on separate tabs. *Id.* So, the first task was to combine all the financial information in one place, in machine-readable form. CAPITALIQ, *supra* note 66. Nonfinancial information, such as firm address and SIC code, was available in separate Word documents. *Id.*

⁶⁹ This potentially removes firms with data for the pre-period but not for the post period, and vice versa. Including firms with information for only the pre- or post-period could bias our results.

⁷⁰ See CAPITALIQ, *supra* note 66.

⁷¹ *Id.*

⁷² *Id.*

⁷³ TEXAS SECRETARY OF STATE, *supra* note 62.

⁷⁴ See flowchart *infra* Figure 2 (showing steps involved in identifying closely-held corporation status of a firm).

or be embedded in its name.⁷⁵ If the information cannot be identified from the articles of incorporation, we look for another document, “Statement to Operate as a Close Corporation.”⁷⁶ If that statement is available, we classify that firm as a closely held private corporation. We only classify a firm as closely held if the firm has either of the two aforementioned documents. All other firms are classified as non-closely held private corporations.⁷⁷ No firm in our sample changed its closely held/non-closely held status.

Our final sample consists of 421 observations, with 82 observations for closely held private firms. This sample reduces to 361 observations for the full regression model, which we explain below. The difference is due to missing data on PPE Growth. One way to resolve this issue could be to replace the missing values by the median PPE growth for the industry-year combination. Doing that actually improves our results in terms of economic magnitude and statistical significance. We chose not to replace these missing values with the median values to alleviate any concerns that the replacement could drive our results.⁷⁸ In order to confirm the hypothesized impact of *Ritchie*, we also reached out to about 30% of the CEOs from our sample. Our discussion with the CEOs corroborates our main finding of inefficient monitoring by the private minority. In addition, they also confirmed their lawyers as a source of immediate information for such landmark rulings.

B. Research Methodology

Because we compare the change in performance of closely held and non-closely held private corporations from the pre-ruling to the post-ruling era, we use a difference-in-difference (DID) specification to study our

⁷⁵ See examples of how information on closely held private corporation status was displayed *infra* app. 1.

⁷⁶ See *Form 812—General Information (Statement of Operation as a Close Corporation)*, TEXAS SECRETARY OF STATE (revised May 2011), https://www.sos.texas.gov/corp/forms/812_boc.pdf.

⁷⁷ To make sure that there was no error in classifying the firms, we audited a few firms from our sample again, a few days after our data collection was over. A colleague also randomly reviewed the data entry; no errors were found.

⁷⁸ The results using the industry-year median values of PPE growth are available to the interested reader on request. We understand that the sample size is rather limited, arising from data collection difficulties. One possible solution is to increase the length of the pre and post periods to two years. However, that can result in other confounding factors impacting firm performance and can make it more difficult to associate the change in firm performance to *Ritchie*; see generally *Ritchie*, 443 S.W.3d. 856.

research question.⁷⁹ *Ritchie* specifically impacted the rights of the private minority in closely held firms, while keeping the rights of the private minority in non-closely held firms unchanged.⁸⁰ Hence, it provides a natural setting for a DID methodology. We use the following model:

Equation 1:

$$\begin{aligned}
 \text{Firm Performance}_{it} &= \alpha_0 + \beta_1 \text{Post} + \beta_2 \text{Close} + \beta_3 \text{Post} * \text{Close} \\
 &+ \beta_4 \text{Size}_{it} + \beta_5 \text{Change in PPE}_{it} + \beta_6 \text{Firm Age} \\
 &+ \beta_7 \text{Leverage}_{it} + \beta_8 \text{Performance}_{it-1} \\
 &+ \beta_9 \text{Ind Avg Profit Margin} + \beta_{10} \Delta \text{US GDP}_t \\
 &+ \beta_{11} \Delta \text{TX GDP}_t + \Sigma \text{Industry FE} + \varepsilon_{it}
 \end{aligned}$$

Although all variables are described in Appendix 1, we provide a short explanation of the variables here, to facilitate the reader's understanding of the model. In the above model (equation 1), *Firm Performance* is measured as return on assets.⁸¹ We also use return on equity and profit margin as alternate measures of firm performance; profit margin is calculated by dividing net income by sales. *Close* is a dummy variable equal to 1 if the firm is a closely held private corporation, and 0 otherwise. *Post* is a dummy variable equal to 1 if the observation falls in the post-ruling period, and 0 for the pre-ruling period. The pre-ruling and post-ruling periods are one-year long each. By restricting the pre and post periods to one year long each, we are able to associate any change in firm performance to the mentioned Texas ruling. Extending the length of the pre and post periods can result in other confounding events impacting firm performance and thereby make it difficult to associate the change in performance to *Ritchie*. The interaction term *Close * Post* is our main variable of interest. It identifies the incremental impact on the performance of closely held private corporations after the judgment. Following Minnis (2011), we control for *Size*, which is calculated as natural logarithm of assets.⁸² Minnis (2011) finds a significant positive association between

⁷⁹ DID is an econometric technique used to estimate impact of an event by comparing before-and-after study. The following sources contain additional information. See Michael Lechner, *The Estimation of Causal Effects by Difference-in-Difference Methods*, 4 FOUNDATIONS AND TRENDS IN ECONOMETRICS 165, 167 (2010) (explaining and defining DID); see generally *Difference-in-Difference Estimation*, COLUMBIA PUBLIC HEALTH, <https://www.publichealth.columbia.edu/research/population-health-methods/difference-difference-estimation> (last visited Oct. 9, 2022).

⁸⁰ See generally *Ritchie*, 443 S.W.3d 856.

⁸¹ See definitions of variables *infra* app. 1.

⁸² Minnis, *supra* note 19.

firm size and audit propensity.⁸³ He finds that private firms that undertake audits are about three times larger than private firms that do not.⁸⁴ He also documents firm size as a proxy for the extent of internal accounting sophistication.⁸⁵ As a result, firm size is an important control variable.⁸⁶ In addition, we include *lagged firm performance* to control for persistence in earnings. We also control for *firm age*. Firm age has been documented to influence the quality of corporate governance.⁸⁷ We calculate *firm age* as the current year less the registration year. Registration year of the firm (with the Texas Secretary of State),⁸⁸ is found on the firm's articles of incorporation. We control for *leverage*, which is calculated as total liabilities divided by total assets.⁸⁹ Controlling for leverage is important because higher leverage could imply higher financial risk faced by a company. As a company becomes riskier, monitoring by shareholders would increase.⁹⁰ We further control for industry profit margin (*Ind. Profit Margin*), as a proxy for product market competition.⁹¹ Shleifer & Vishny) suggest that product market competition is an effective external governance mechanism.⁹² They state that companies making bad decisions would be ousted and would not get the desired financial capital, due to the fear that the money would not be returned.⁹³ To calculate the industry profit margin, we use the Fama-French 12-industry classification.⁹⁴ In order to control for any macroeconomic factors, we control for the change in the Gross Domestic Product (GDP) of both, US and Texas. In an additional test, to further control for any macroeconomic impact, we also

⁸³ *Id.*

⁸⁴ *Id.*

⁸⁵ *Id.*

⁸⁶ Minnis, *supra* note 19.

⁸⁷ See generally Shaker A. Zahra, *Public and Corporate Governance and Young Global Entrepreneurial Firm*, 22 CORP. GOV'T. INT'L REV. 77, 77–83 (2014); Tammy K. Berry et al., *The Interaction Among Multiple Governance Mechanisms in Young Newly Public Firms* 12 J. CORP. FIN. 449, 449–66 (2006); Viral V. Acharya et al., *The Internal Governance of Firms* 66 J. FIN. 689, 689–720 (2011).

⁸⁸ TEXAS SECRETARY OF STATE, *supra* note 62.

⁸⁹ Since total debt is not available for all firms, we could not use total debt to calculate leverage.

⁹⁰ Bodenhorn *supra* note 26.

⁹¹ Higher industry profit margin would imply lower competition, because higher competition would reduce profit margins.

⁹² See generally Shleifer & Vishny, *supra* note 43.

⁹³ *Id.* (suggesting that product market competition is an effective external governance mechanism).

⁹⁴ See Eugene F. Fama & Kenneth R. French, *Common Risk Factors in the Returns on Stocks and Bonds*, 33 U. CHI. J. FIN. ECON. 3 (1993) (discussion of five common risk factors in the returns on stocks and bonds); see also Kenneth R. French, *Details for 12 Industry Portfolios*, DARTMOUTH: FACULTY PAGES, https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/Data_Library/det_12_ind_port.html (last visited Oct. 9, 2022).

include the change in the GDP of the Metropolitan Statistical Area (MSA) in which the firm is located. To obtain information on firms' MSA, we map each firm to an MSA using its zip code. For this test, we only include firms with an MSA mapping. The mapping of zip codes to MSAs was obtained from the website of the U.S. Department of Labor.⁹⁵ For all our tests, we include industry fixed effects, using the Fama-French 12-industry classification.⁹⁶ We winsorize all our variables at the 2% and 98% levels, and cluster standard errors on firm level.

IV. RESULTS

A. Descriptive Statistics

Table 1 presents descriptive statistics for the key variables used in the study. Closely held private corporations are usually smaller in size than non-closely held private corporations.⁹⁷ An average closely held private corporation has about \$3.8 million in assets, whereas an average non-closely held private corporation has about \$4.2 million in assets.⁹⁸ However, the difference in size between closely held and non-closely held private corporations is not statistically significant (in both, pre-ruling and post-ruling periods).⁹⁹ Closely held private corporations also exhibit lower sales revenues in general.¹⁰⁰ An average closely held private corporation has about \$12 million in sales in the pre-ruling period, whereas an average non-closely held private firm has about \$20 million in sales in the pre-ruling period.¹⁰¹ The sales figures are not statistically significantly different between closely held and non-closely held private corporations for both the pre- and the post periods.¹⁰² Closely held private corporations are slightly less profitable than non-closely held private corporations in the pre-ruling period, as measured using ROA.¹⁰³ However, this difference in ROA is not statistically significant.¹⁰⁴ In the post-ruling period, the ROA

⁹⁵ *OWCP MEDICAL FEE SCHEDULE – July 10, 2011* (spreadsheet), U.S. DEP'T OF LABOR (July, 10 2011), https://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=&ved=2ahUKewjU-unW_r_4AhU-BjQIHclWDoMQFnoECAkQAQ&url=https%3A%2F%2Fwww.dol.gov%2Fowcp%2Fregs%2Ffeeschedule%2Ffee%2Ffee11%2Ffs11_gpci_by_msa-zip.xls&usg=AOvVaw1QvFBlca8HgrIkEpY3qnUE

⁹⁶ See sources cited *supra* note 94.

⁹⁷ See Descriptive Statistics *infra* Table 1.

⁹⁸ See Descriptive Statistics *infra* Table 1.

⁹⁹ See Descriptive Statistics *infra* Table 1.

¹⁰⁰ See Descriptive Statistics *infra* Table 1.

¹⁰¹ See Descriptive Statistics *infra* Table 1.

¹⁰² See Descriptive Statistics *infra* Table 1.

¹⁰³ See Descriptive Statistics *infra* Table 1.

¹⁰⁴ See Descriptive Statistics *infra* Table 1.

for closely held private corporations is about 11.4%, whereas that for non-closely held private corporations fell to 6.4%.¹⁰⁵ ROA for closely held private firms is statistically different than that for non-closely held private firms in the post-*Ritchie* period.¹⁰⁶ In addition, all profitability measures – ROA, ROE and profit margin – are statistically indistinguishable between pre- and post-ruling periods for non-closely held private corporations.¹⁰⁷ For the sample overall, the ROA for closely- and non-closely held private corporations is not significantly different. Leverage does not show any statistical difference between closely- and non-closely held private corporations or between the pre-period and the post period. Closely held private corporations are also slightly younger than non-closely held private corporations, although the difference is not statistically significant.¹⁰⁸ Average PPE growth is positive for both closely- and non-closely held private corporations in both the pre- and post-ruling periods. This implies that closely held and non-closely held private firms were quite similar prior to *Ritchie*.

In Table 2, we present the Pearson correlation within all variables.¹⁰⁹ Size is positively correlated with total revenues as well as with firm age. We also find a positive correlation of size with ROA, PPE growth, and leverage. As can be seen¹¹⁰, the *Close* dummy is not statistically significantly correlated with any of the variables for the entire sample, implying that closely held private corporations are very similar to non-closely held private corporations in general.

B. Main results, robustness tests

In this section, we present the empirical results for our main test (equation 1). The results are provided in Table 3, Panel A. Our variable of interest is the interaction term *Post * Close*, which shows the impact of the Texas ruling on firm performance. This variable is positive and significant, implying that the performance of closely held private firms improved significantly after the judgment, relative to the performance of non-closely held private firms. The effect is statistically and economically significant. The result implies that the presence of buy-out remedy facilitated inefficient monitoring of the managers that negatively impacted

¹⁰⁵ See Descriptive Statistics *infra* Table 1.

¹⁰⁶ See Descriptive Statistics *infra* Table 1.

¹⁰⁷ See Descriptive Statistics *infra* Table 1.

¹⁰⁸ See Descriptive Statistics *infra* Table 1.

¹⁰⁹ Phillip Good, *Robustness of Pearson Correlation*, 15 INFO. RSCH. 1, 1–6 (2009).

¹¹⁰ See Correlations *infra* Table 2.

the firm. The removal of the buy-out remedy significantly reduced minority influence and provided more freedom to the majority shareholders to run the firm efficiently.

To provide credibility to our results, we employ several robustness tests. First, we use two alternate performance measures: return on equity and profit margin. The results are provided in Panel B of Table 3.¹¹¹ As shown, even with alternate performance measures, the results are qualitatively similar to those in Panel A.¹¹² The use of profit margin also helps allay any concern of real earnings management. In the presence of real earnings management, companies could potentially deflate prices to boost sales. If that happens, profits might increase but profit margin will usually decline (holding all other factors constant). We find an increase in profit margin, which contradicts a possibility of real earnings management.

In the second test, we use a dummy variable for increase in each of the three performance measures.¹¹³ As seen from Table 1, the three performance measures—ROA, ROE, and profit margin—are a bit skewed. To alleviate any concern of outliers driving the results, we use the dummy variable equal to 1 if firm performance based on the respective measure increases, and 0 otherwise. The results are shown in Panel C of Table 3. The results are qualitatively similar to those in Panel A of Table 3.

Next, we use 2016 as a pseudo-*Ritchie*-ruling year, instead of the actual *Ritchie*-ruling year of 2014.¹¹⁴ This helps show that the increase in firm performance is due to *Ritchie*, and not due to a persistent differential trend between the closely held and non-closely held private corporations. We re-run our main test (equation 1) using the pseudo-*Ritchie*-ruling year and find no significant difference in profitability between closely held and non-closely held private firms. This suggests that the increase in profitability in 2014, was indeed due to *Ritchie*,¹¹⁵ and not due to closely held private firms having improved performance due to a simultaneous event.

Next, we re-run our main test using a matched sample. We match closely held private corporations with non-closely held private corporations on size and year. Although a DID specification should be able to tease out the effect of *Ritchie* on firm performance,¹¹⁶ using a matched sample provides further credibility. The results are presented in Table 5,

¹¹¹ See Panel B *infra* Table 3.

¹¹² See Panel A *infra* Table 3.

¹¹³ The regression specification for this is logit and not OLS.

¹¹⁴ See *generally* *Ritchie*, 443 S.W.3d 856.

¹¹⁵ *Id.*

¹¹⁶ See explanation and sources cited *supra* note 79.

Panel A.¹¹⁷ The results are qualitatively similar even when using a matched sample. One concern arising from the results could be the small sample size, due to limited data availability. To resolve this issue, we follow Santa-Clara & Valkanov and Bertrand, Duflo & Mullainathan and conduct a bootstrap regression (1000 replications) as additional robustness test.¹¹⁸ The result is presented in Table 5, Panel B.¹¹⁹ The bootstrap regression provides qualitatively similar results as those presented in Table 3, Panel A.¹²⁰

All our evidence so far suggests inefficient monitoring by the private minority. *Ritchie* removed the buy-out remedy to minority shareholders and thereby curtailed their monitoring ability.¹²¹ Loss of the buy-out remedy and the consequent monitoring ability helped improve firm performance.¹²² We do not differentiate between monitoring effort and monitoring effectiveness. It is possible that the monitoring efforts remained the same or even increased after *Ritchie*, but the effectiveness of the monitoring significantly reduced. As a result, we refer to monitoring effectiveness throughout our paper.

C. Additional (cross-sectional) tests

To further corroborate our evidence on inefficient monitoring, we conduct two additional tests. For the first test, we follow prior evidence

¹¹⁷ See Panel A *infra* Table 5.

¹¹⁸ See generally Santa-Clara, *supra* note 13; Bertrand, *supra* note 13; M. Laurentius Marias et al., *The Experimental Design Of Classification Models: An Application of Recursive Partitioning and Bootstrapping to Commercial Bank Loan Classifications* J. ACCT. RSCH. 87, 87–114 (1984) (explaining and defining a bootstrap regression).

¹¹⁹ See Panel B *infra* Table 5.

¹²⁰ See Panel A *infra* Table 3.

¹²¹ See *Ritchie v. Rupe*, 443 S.W.3d 856 (Tex. 2014).

¹²² McCahery et al., *supra* note 2. As mentioned elsewhere, presence of the buy-out remedy could have provided minority shareholders some degree of influence/bargaining power in their firm. However, due to some constraints explained elsewhere in this paper, this influence could have been misused. For instance, minority shareholders cannot easily exit the firm, if they are unhappy about some firm decisions. This implies that (in line with McCahery et al. 2016), minority shareholders would adopt the other channel of monitoring—active intervention. However, this buyout remedy could get misused/abused if the minority shareholders start using it for every risky investment the firm proposes. As Markowitz clearly states, risk-return tradeoff implies that if an investment is risky, it will also have higher expected returns. So, some investments (even if risky) are required to be undertaken to keep the firm growing. However, active intervention on each such proposed investment could prove costly for the firm's growth opportunities. So, if the buyout remedy provided the minority shareholders this ability to interfere with every risky decision, the removal of buy-out remedy would be beneficial for the firm. This is what we find in the paper. After the buyout remedy was removed, firm performance improved, especially for firms which would be expected to have the highest active monitoring/intervention by minority shareholders.

which shows that managers in firms with poor performance face stricter disciplining.¹²³ If the inefficient monitoring hypothesis is true, the severity of inefficient monitoring (and the consequent improvement in performance) would be higher in poorly performing firms as compared to other firms.¹²⁴ Consistent with the inefficient monitoring hypothesis, we find that poorly performing firms experience a much larger improvement in firm performance as compared to other firms.

For the second test, we partition our sample based on firm size. Smaller firms generally face a higher degree of uncertainty.¹²⁵ They are also less likely to have independent directors or voluntarily have their financial statements audited.¹²⁶ These factors could increase the monitoring incentives of the private minority, specifically in smaller firms. If the inefficient monitoring hypothesis is true, the severity of inefficient monitoring (and the consequent improvement in performance) would be higher in smaller firms than in larger firms.¹²⁷ Consistent with the inefficient monitoring hypothesis, we find that the improvement in performance is centered within smaller firms than in larger firms. These two tests corroborate our conclusion regarding inefficient monitoring by the private minority.

Further, to corroborate the evidence on inefficient monitoring by minority shareholders, we conduct two additional tests. In the first test, we follow prior evidence, which shows that managers in firms with poor performance face stricter disciplining.¹²⁸ For instance, Kang & Shivdasani document that the probability of CEO/president turnover significantly increases following a decline in firm performance.¹²⁹ In addition, Matsunaga & Park documents that missing a quarterly earnings benchmark has an adverse impact on the CEO's annual cash bonus.¹³⁰ These studies provide evidence on stricter disciplining of managers when firm performance is below a certain threshold.¹³¹ In line with these studies, if the inefficient monitoring hypothesis is true, the severity of inefficient

¹²³ See sources cited and parenthetical discussions *supra* note 16.

¹²⁴ We define firms with a consistent drop in sales for the past two years as poor performers.

¹²⁵ See Fama & French, *supra* note 94; see also sources cited and parenthetical discussions *supra* note 18.

¹²⁶ Auditors are an external governance mechanism. Absence of auditors could create a higher incentive for monitoring. See Minnis, *supra* note 19 (finding a significantly positive association between size and audit propensity).

¹²⁷ Firms smaller in size than the median sized firm are small firm, and the remaining are large firms.

¹²⁸ See sources and parenthetical discussions *supra* note 15.

¹²⁹ See Kang & Shivdasani, *supra* note 15.

¹³⁰ See Matsunaga & Park, *supra* note 15.

¹³¹ See sources cited and parenthetical discussions *supra* note 15.

monitoring (and the consequent improvement in performance) would be higher in poorly performing firms as compared to other firms. We use change (drop) in firm sales in the past two years to identify poor performers and run our main test (equation 1) separately for the poor performers and other firms.¹³² The results are presented in Table 6, Panel A.¹³³ Consistent with the inefficient monitoring hypothesis, poor performers experience a much larger improvement in performance as compared to that of other firms.

In the second test, we partition our sample into two subsamples based on firm size. Generally, larger firms have more resources at the disposal of the shareholders.¹³⁴ Larger firms also have more standard practices and stable businesses.¹³⁵ In addition, as Minnis points out, larger

¹³² See Equation 1 *supra* Section III.B.

¹³³ See Panel A *infra* Table 6.

¹³⁴ This is based on existing evidence as well as on discussions with existing managers and researchers. See, e.g., Victoria Dickinson, *Cash Flow Patterns as a Proxy for Firm Life Cycle*, 86 ACCT. REV. 1969, 1969–94 (2011) (showing that mature firms (usually larger firms) have higher earnings per share, higher return on assets and higher profit margin than do introduction or growth (smaller) firms); Palani-Rajan Kadapakkam et al., *The Impact of Cash Flows and Firm Size on Investment: The International Evidence*, 22 J. BANKING & FIN 293, 293–320 (1998) (documenting that larger firms have greater flexibility to time their investments (that is more flexibility in deciding when/where to invest available resources)); Jimmy D. Moss & Bert Stine Cash, *Conversion Cycle and Firm Size: a Study of Retail Firms*, 19 MANAGERIAL FIN. 25, 25–34 (1993) (stating that smaller firms have fewer sources of both short and long term financing); Ernest W. Walker, & J. William Petty, II, *Financial Differences Between Large and Small Firms*, FIN. MGMT. 61-68 (1978) (pointing out the restrictions applicable to smaller firms than can reduce the financial options available to the smaller firms); Vijay Govindarajan et al., *The Gap Between Large and Small Companies is Growing. Why?*, HARVARD BUSINESS REVIEW: FINANCE AND INVESTING (Aug. 16, 2019), <https://hbr.org/2019/08/the-gap-between-large-and-small-companies-is-growing-why> (showing that smaller companies report losses more frequently, which further reduces the resources they have at their disposal); Beth Braccio Hering, *Pros and Cons: Working for Large Companies vs Small Businesses*, FLEXJOBS, <https://www.flexjobs.com/blog/post/pros-cons-working-large-companies-v2/> (last visited Aug. 20, 2022) (noting that small companies have fewer resources than large ones).

¹³⁵ For both points, we have cited existing literature which we base our discussion on. However, this statement was also confirmed with industry practitioners and other researchers. See, e.g., David J. Denis & Igor Osobov, *Why do Firms Pay Dividends? International Evidence on the Determinants of Dividend Policy*, 89 J. FIN. ECON. 62–82 (2008) (showing that larger firms exhibit a higher likelihood of repeated dividend payments—that is, larger firms have a more predictable dividend policy); see generally Hollis Ashbaugh, *Non-US Firms' Accounting Standard Choices*, 20 J. ACCT. & PUB. POL'Y 129 (2001) (stating that existing evidence shows that larger firms provide more voluntary disclosure and therefore a more predictable voluntary disclosure practice); see also T. E. Cooke, *The Impact of Size, Stock Market Listing and Industry Type on Disclosure in the Annual Reports of Japanese Listed Corporations*, 22 ACCT. & BUS. RSCH. 229 (1992); see also Sidney J. Gray, et al., *International Capital Market Pressures and Voluntary Annual Report Disclosures by US and UK Multinationals*, 6 J. INT'L FIN. MGMT. & ACCT. 43-68 (1995); Dickinson, *supra* note 134. Size and age should be maximized during the mature life cycle stage of a firm. That is, a life cycle stage when business is usually stable, and has reached consistent cash flows and revenues as well as working capital.

private firms exhibit a higher propensity to undertake a voluntary external audit.¹³⁶ Presence of auditors can improve the quality of governance in these firms, reducing the need for minority shareholders to closely monitor the managers.¹³⁷ Smaller firms, on the other hand, generally are more volatile and face higher uncertainty of operations.¹³⁸ Thereby, minority shareholders in smaller firms would face higher incentives to over monitor the majority shareholders.¹³⁹ In line with the above arguments, if the inefficient monitoring hypothesis is true, we expect that the severity of inefficient monitoring and the consequent improvement in firm performance would be much higher in smaller firms than in larger firms. We split our sample in two based on the median firm size and re-run our main test (equation 1) separately for two sub-samples.¹⁴⁰ The results are presented in Table 6, Panel B.¹⁴¹ Consistent with the inefficient monitoring hypothesis, the effect is concentrated in smaller firms than for larger firms. All in all, these two tests provide strong evidence of inefficient monitoring by minority shareholders.

¹³⁶ See Minnis, *supra* note 19.

¹³⁷ Ross L. Watts & Jerold L. Zimmerman, *Positive Accounting Theory* (1986) (stating that external auditing has become an important corporate governance mechanism); Xianjie He et al., *Do Social Ties Between External Auditors and Audit Committee Members Affect Audit Quality?*, 92 ACCT. REV. 61, 61–87 (2017) (referring to the beneficial role of auditors in the monitoring of financial reporting by documenting how social ties of external auditors with firm managers can impact this role); Jerry W. Lin & Mark I. Hwang, *Audit Quality, Corporate Governance and Earnings Management: A Meta-Analysis*, 14 INT'L J. REV. 57, 57–77 (2010) (documenting the negative association between auditor quality and instances of earnings management, thereby showing that auditors act as an external governance mechanism); A. S. Evisi & C. N. Ezuwore, *The Impact of Forensic Auditors in Corporate Governance*, 5 RSCH. J. FIN & ACCT. 31, 31–9 (2014) (showing that forensic auditors have a positive impact on the firm's corporate governance quality); see generally Mark Schelker, *Auditors and Corporate Governance: Evidence from the Public Sector*, 66 KYKLOS 275–300 (2013) (showing a positive impact of auditor expertise on a firm's state credit rating, thereby documenting further evidence of the monitoring role played by auditors).

¹³⁸ Firm size is a systematic risk factor, and documents lower returns for larger firms. This indicates that larger firms have lower risk, and thereby larger firms exhibit lower returns (due to the lower risk). See Fama & French, *supra* note 94; see, e.g., Perez-Quiros & Timmermann, *supra* parenthetical text accompanying note 18; Situm, *supra* parenthetical text accompanying note 18.

¹³⁹ Dickinson, *supra* parenthetical text accompanying note 134; see Fama & French, *supra* parenthetical text accompanying note 94; Kadapakkam et al., *supra* parenthetical text accompanying note 134; Moss & Stine, *supra* parenthetical text accompanying note 134; Perez-Quiros & Timmermann, *supra* parenthetical text accompanying note 18; Situm, *supra* parenthetical text accompanying note 18; Walker & Petty, *supra* parenthetical text accompanying note 134; Govindarajan et al., *supra* parenthetical text accompanying note 134; Hering, *supra* parenthetical text accompanying note 134.

¹⁴⁰ See Equation 1 *supra* Section III.B.

¹⁴¹ See Panel B *infra* Table 6.

D. Analysis of the monitoring channel

We now attempt to identify potential channels of inefficient monitoring. One possible channel could be firm investments. Burkart, Gromb & Panunzi have provided theoretical arguments that inefficient monitoring by minority shareholders hinders managerial initiative to undertake investments.¹⁴² Following Burkart, Gromb & Panunzi, if minority shareholder monitoring prior to *Ritchie* was excessive, it would have negatively impacted firm investments.¹⁴³ Consequently, the removal of the buy-out remedy should also allow improvement in firm investments.¹⁴⁴ To measure change in investments, we use a dummy variable equal to 1, if net PPE increased and 0 otherwise. Use of the dummy is appropriate, because as we can see in Table 1, the PPE growth variable is highly skewed. Moreover, since we do not have data on gross PPE and accumulated depreciation, use of the continuous variable can bias our results due to the depreciation effect. The results are presented in Table 7, Column 1. Using a logit model,¹⁴⁵ we find a higher likelihood of increase in net PPE after *Ritchie*. This finding suggests that inefficient monitoring facilitated by the presence of the buy-out remedy restricted firms' investments. The evidence also points to possible risk aversion in minority shareholders, who preferred "status quo" too risky but potentially value-enhancing investments.

¹⁴² See generally Burkart et al., *supra* note 20.

¹⁴³ *Id.*

¹⁴⁴ This is an inference drawn from the analysis. As explained in other parts of the document, minority shareholders in private firms do not have an easy exit option, since the shares are not listed on public stock exchanges. Investments can be risky. For instance, installation of a new machinery can significantly increase supply, but if it is not met with demand, the capacity can stay idle. New research can be risky, if it does not help the company come up with new products, new patents, etc. As shown in this document, if minority shareholders in public companies do not agree with the investments of the public firm, they can just sell their shares on a public stock exchange and exit the firm. Thereby, they won't have to deal with the potential negative outcomes from the investments. However, minority shareholders in private firms do not have that option. As a result, the likelihood of intervention will significantly increase for them. Investments is one potential channel through which they can perform the monitoring/intervention. Since investments are risky, and exit from private firms is difficult, minority shareholders will be expected to try and block risky investments as much as possible (higher intervention). Prior to the ruling, they could potentially stop/delay the investment by using the minority oppression clause and forcing the majority shareholder to buy out the minority shareholders. After the court removed that remedy, minority shareholders could not use that clause to try and intervene in the firm's investment policy. This potentially provide the manager more room to make (risky) investments to foster growth in the firm. This is what we see in the analysis results. Investments is a potential channel of minority monitoring, and the results suggest that too.

¹⁴⁵ See generally Joseph Berkson, *Application to the Logistic Function to Bio-assay*, 39 J. AM. STAT. ASS'N 357 (1944).

Another possible channel of monitoring could be firm leverage. Faccio, Marchica & Mura find a significant impact of shareholders' personal wealth diversification (over private and public firms) on the risk-taking propensity of the firm they control.¹⁴⁶ The authors find higher risk taking in firms owned by diversified shareholders but find a much more conservative approach in firms owned by non-diversified shareholders.¹⁴⁷ The private minority in our sample face a unique set of constraints and exhibit limited diversification that could induce risk aversion and preference for lower firm risk. Bodenhorn shows that undiversified shareholders tend to prefer lower risk which can manifest itself in lower leverage ratios.¹⁴⁸ This suggests that risk-averse private minority would exhibit a preference for lower leverage.¹⁴⁹ A reduction in their monitoring ability would therefore also lead to an increase in firm leverage.¹⁵⁰ The results are presented in Table 7, Column 2.¹⁵¹ Consistent with our expectation, we find an increase in the leverage of closely held private corporations after *Ritchie*. This finding suggests that leverage could be another channel of monitoring used by the private minority.

While investments and leverage are two possible channels of monitoring, there could be other alternate channels, including distributions or employment. However, data on dividends or executive employment is not available, because of which we are unable to test for these mechanisms.

E. Possible alternative explanations

An alternative explanation for our results could be related to earnings management. This line of reasoning suggests that the monitoring ability of minority shareholders was beneficial, as it helped curtail majority shareholders' propensity to manipulate earnings.¹⁵² After *Ritchie* reduced the monitoring ability, majority shareholders were more easily

¹⁴⁶ See Faccio et al., *supra* note 25.

¹⁴⁷ See Faccio et al., *supra* note 25.

¹⁴⁸ See Bodenhorn, *supra* note 26.

¹⁴⁹ See Bodenhorn, *supra* note 26.

¹⁵⁰ See Bodenhorn, *supra* note 26.

¹⁵¹ See *infra* Table 7.

¹⁵² The results show that after the buyout remedy was removed, firm performance improved for close corporations. The improvement was stronger for those close corporations, where the active monitoring by minority shareholders was expected to be high. This suggests that prior to the ruling, the buyout remedy provided enough bargaining power for minority shareholders to intervene in decisions that would have been beneficial for the firm. The active monitoring part was confirmed in informal discussions with two CEOs in our sample.

able to manipulate earnings.¹⁵³ This explanation would be consistent with Leuz, Nanda & Wysocki (2003), who find a higher likelihood of earnings management in firms from countries with poor investor protection.¹⁵⁴ Since *Ritchie* reduced minority rights,¹⁵⁵ the improvement in firm performance could be a manifestation of earnings management. We resolve this issue first, by showing no significant increase in accruals-based earnings management for closely held private corporations after *Ritchie*. We calculate discretionary accruals using three methods. First, we use the Jones model and extract residuals from the following regression:¹⁵⁶

$$Accruals_{it} = \alpha_0 + \beta_1 \left(\frac{1}{Assets_{it}} \right) + \beta_2 \Delta Revenue_{it} + \beta_3 \left(\frac{PPE}{Assets_{it}} \right) + \varepsilon_{it}$$

Second, we use the Modified-Jones model from Dechow, Sloan & Sweeney (1995).¹⁵⁷ Accordingly, we adjust the change in revenues for the change in receivables and extract the residuals from the following regression:

$$Accruals_{it} = \alpha_0 + \beta_1 \left(\frac{1}{Assets_{it}} \right) + \beta_2 (\Delta Revenue_{it} - \Delta Receivables_{it}) + \beta_3 \left(\frac{PPE}{Assets_{it}} \right) + \varepsilon_{it}$$

¹⁵³ This sentence refers to one of the alternative explanations that we disprove in our paper. It follows Leventis and Dimitropoulos who find that in firms with weak corporate governance, managers can more easily/more frequently manage earnings. As mentioned earlier, the subject ruling took away the buy-out remedy that was available to minority shareholders. This buy-out remedy, as discussed earlier, gave a fair bit of influence to minority shareholders. Minority shareholders who were unhappy with some decision could use “shareholder oppression” to potentially force the majority shareholders to buy out the minority shareholding. This is because a buyout could be potentially expensive, and majority shareholders may not have the money or want to spend the money on the buyout. However, after the ruling took away the buyout remedy, it could have potentially weakened the governance of the firm. An alternative explanation for our results could be that managers now manage earnings more due to the weakened governance. We argue in our paper that this explanation cannot hold. *But see*, Stergios Leventis & Panagiotis Dimitropoulos, *The Role of Corporate Governance in Earnings Management: Experience from US Banks*, 13 J. APPLIED ACCT. RSCH. 161 (2012).

¹⁵⁴ *See generally*, Christian Leuz et al., *Earnings Management and Investor Protection: An International Comparison*, 69 J. FIN. ECON. 505 (2003).

¹⁵⁵ *See generally* Ritchie, 443 S.W.3d 856.

¹⁵⁶ *See generally* Jennifer J. Jones, *Earnings Management During Import Relief Investigations*, 29 J. ACCT. RSCH. 193 (1991).

¹⁵⁷ *See generally* Patricia M. Dechow et al., *Detecting Earnings Management*, 70 ACCT. REV. 193 (1995).

Third, we use the Performance-Matched Modified-Jones model from Kothari, Leone & Wasley,¹⁵⁸ and include lagged ROA in the above equation to calculate performance-matched discretionary accruals.

For all the tests, we follow Srinidhi & Gul (2006) to define accruals as follows:¹⁵⁹

$$\text{Accruals} = \frac{(\Delta CA - \Delta \text{Cash}) - (\Delta CL - \Delta \text{STDebt})}{\text{Average Assets}}$$

The results of the earnings management test are provided in Table 8.¹⁶⁰ Column 1 provides results on the Jones model, Column 2 presents results on the Modified-Jones model, and Column 3 presents results on the performance-matched discretionary accruals as per Kothari, Leone & Wasley (2005)¹⁶¹. Panel A presents results based on absolute (unsigned) discretionary accruals, whereas Panel B presents results based on signed discretionary accruals.¹⁶² As we can see, in either of the three Columns or in the two Panels, there is no significant increase in discretionary accruals for closely held private corporations relative to non-closely held private corporations after *Ritchie*.¹⁶³ This evidence disproves higher earnings management as a possible explanation for the results. In addition, as alluded to earlier, we do not find any robust evidence of real earnings management either. Based on the evidence in Roychowdhury, one channel of real earnings management is to deflate sales prices to push more sales.¹⁶⁴ If this were the case, profit margin would have declined, holding all other expenses constant. Instead, we find an increase in profit margin for closely held private corporations after *Ritchie*.¹⁶⁵ The above evidence proves that our results are not driven by an increase in earnings management. One thing to note is that our results only test for incremental earnings management. This does not state anything about the extent of earnings management in private firms in general.

¹⁵⁸ See generally S.P. Kothari, et al., *Performance Matched Discretionary Accrual Measures*, 39 J. ACCT. ECON. 163, 163–197 (2005).

¹⁵⁹ See generally Bin N. Srinidhi & Ferdinand A. Gul., *The Differential Effects of Auditors' Non-audit and Audit Fees on Accrual Quality*, 24 CONTEMP. ACCT. RES. 595, 595–629 (forthcoming 2006).

¹⁶⁰ See *infra* Table 8.

¹⁶¹ See *infra* Table 8; see also Kothari et al., *supra* note 158.

¹⁶² See Panel A & Panel B *infra* Table 8.

¹⁶³ See Panel A & Panel B *infra* Table 8.

¹⁶⁴ Sugata Roychowdhury, *Earnings management through real activities manipulation*, 42 J. ACCT. & ECON. 335, (2006).

¹⁶⁵ We do not have data on COGS or on discretionary spending to test for those channels of real earnings management.

Another alternative explanation could be related to unobserved macroeconomic events. One might argue that an unobserved macroeconomic event could have impacted closely held private corporations differently than non-closely held private corporations.¹⁶⁶ Although that is highly unlikely, we still disprove this hypothesis. First, we control for the growth in U.S. and Texas GDP. Results are unaffected by these two variables. Second, we searched for any major policy changes, investment proposals, or budget allocations in Texas that happened around June 2014. We did not find any evidence of a policy at exactly the same time as *Ritchie* that could have impacted closely held private corporations more or less than non-closely held private corporations. Third, using firms' zip codes, we plotted each firm on a map of Texas. The map is presented in Figure 1.¹⁶⁷ As we can see from the map, closely held private corporations are clustered very similarly to non-closely held private firms. As a result, if there was a significant macroeconomic development in any part of Texas, there is no reason why closely held private corporations could be affected differently than non-closely held private corporations. Fourth, using firms' zip code, we map them to their MSAs and include the growth in the GDP of the MSA to which the firm belongs, as an additional control variable. Since we could not map all firms in our sample to an MSA, we did not include this variable as a control variable in our main test. The result from including change in MSA GDP as an additional control is presented in Table 9.¹⁶⁸ The results remain qualitatively similar even after including growth in MSA GDP as an additional control. All of the above evidence refutes the possibility of an unobserved macroeconomic event driving our results.

A third explanation for our results could be that minority shareholders did not engage in any active monitoring prior to *Ritchie*. When *Ritchie* removed the buy-out remedy,¹⁶⁹ they increased their monitoring efforts to compensate for the reduced monitoring ability; in other words, the increased monitoring could have caused the improvement in firm performance. We can make three arguments to refute this possibility. First, what incentive did managers have to suddenly respond to minority shareholders' concerns, especially when the minority influence in firms reduced? Second, it is not clear what channel or mechanism they could have used to effectively monitor the managers after

¹⁶⁶ For example, say Austin had big investments, and closely held private corporations are clustered around Austin.

¹⁶⁷ See *infra* Figure 1.

¹⁶⁸ See *infra* Table 9.

¹⁶⁹ See generally *Ritchie*, 443 S.W.3d 856.

Ritchie. *Ritchie* did not change any other rights or provisions applicable to minority shareholders.¹⁷⁰ If there was a right or a mechanism that was used after *Ritchie*, a question arises as to why the private minority didn't elect to use that channel prior to *Ritchie*. Third, as we show in our cross-sectional tests, we find a larger improvement in firm performance when the likelihood of inefficient monitoring is high—for example, in poorly performing firms and small firms. If the improvement in firm performance was in fact driven by an increase in monitoring, then there was no reason to expect a more pronounced effect for firms with a higher likelihood of inefficient monitoring. This refutes the possibility that the improved firm performance was a result of increased minority monitoring after *Ritchie*.

V. CONCLUSION

In this paper, we study the monitoring behavior of minority shareholders in private companies. Empirical literature has examined this question mostly from the perspective of public companies.¹⁷¹ The findings from these studies suggest that minority shareholders, on average, do not engage in active monitoring of the managers.¹⁷² However, it is not clear whether this finding will generalize to private companies. Minority shareholders in private companies differ significantly from those in public companies.¹⁷³ They do not have easy access to capital markets.¹⁷⁴ They exhibit very limited diversification, which can result in risk-aversion.¹⁷⁵ Moreover, owner-manager duality in private firms makes it easier to

¹⁷⁰ *Id.*

¹⁷¹ See sources and accompanying text *supra* note 40.

¹⁷² This is based on our discussion with researchers in this field. This is a general understanding among researchers in corporate governance, that minority shareholders generally do not engage in active monitoring.

¹⁷³ Minority shareholders in private firms are different from minority shareholders in public firms. See discussion *infra* app. 3.

¹⁷⁴ This is another way of saying that minority shareholders in private firms cannot easily sell their shares, since their shares are not listed on a public stock exchange. See UPCOUNSEL, *supra* note 2.

¹⁷⁵ Minority shareholders in public companies usually do not invest a big chunk of their wealth in the public companies. However, the minority stake in private companies could form a much larger proportion of shareholders' personal wealth. See generally Tobias J. Moskowitz & Annette Vissing-Jorgensen, *The Returns to Entrepreneurial Investment: A Private Equity Premium Puzzle?*, 92 AM. ECON. REV. 745, 745–778 (2002). Investors have particularly strong incentives to monitor a stock that occupies a large part of their overall portfolio. This difference could further enhance the extent of monitoring by the private minority. See generally Anders Ekholm & Benjamin Maury, *Portfolio Concentration and Firm Performance*, 49 J. FIN. QUANT. ANALYSIS 903, 903–31 (2014) (supporting this proposition).

extract private benefits at the expense of minority shareholders.¹⁷⁶ These differences are significant enough to induce active monitoring by minority shareholders in private companies.¹⁷⁷ Understanding the monitoring behavior of minority shareholders in private companies is important because private companies make up a large chunk of total registered businesses in the United States; they account for more than twenty-five percent of aggregate pre-tax profits and account for more than two-thirds of the total employment in the private sector.¹⁷⁸ Compared to their importance to the U.S. economy, relatively little is known about these companies in academic literature.

We draw on the landmark *Ritchie* judgment passed in June 2014, by the Supreme Court of Texas that significantly reduced minority shareholders' monitoring ability in closely held private firms in Texas.¹⁷⁹ We use this ruling as an exogenous shock and assess how the performance of closely held private corporations changed relative to non-closely held private corporations in Texas, from the pre-*Ritchie* to the post-*Ritchie* periods. We find that the performance for closely held private corporations improved significantly after *Ritchie*. This suggests inefficient monitoring by the private minority prior to *Ritchie*. Our results are robust to alternate

¹⁷⁶ See Shleifer & Vishny, *supra* parenthetical text accompanying note 58; Morck et al., *supra* parenthetical text accompanying note 58; see generally Venky Nagar et al., *Governance Problems in Closely-Held Corporations*, 46 J. FIN. & QUANT. ANALYSIS, 943–66 (2009) (stating that a major issue in closely held corporations is expropriation of minority shareholders by majority shareholders); Janis Berzins et al., *Dividends and Taxes: The Moderating Role of Agency Conflicts*, 58 J. CORP. FIN. 583, 583–604 (2019) (identifying the issue of conflict between controlling and minority shareholders (called horizontal agency problem) which gives majority shareholders sufficient power both to single-handedly make the dividend decision and to extract private benefits at the expense of minority shareholders). In addition, this problem can get exacerbated in private firms, since shares in private firms are not listed on a stock exchange. This makes it difficult for shareholders to exit the firm. In a public firm, if the owner-manager is suspected of extracting personal gains at the expense of the minority shareholders, the minority shareholders can exit the firm before they suffer a lot of value damage. This block sale can also lead to a substantial drop in the stock price of the firm thereby hurting the owner-manager's wealth as well. However, shares in private firms are not listed on a stock exchange. Further, since it is so difficult to sell the shares in private firms, the "sale mechanism" is not available to minority shareholders in private firms, thereby exacerbating the owner-manager's likelihood of extracting personal gains at the expense of minority shareholders.

¹⁷⁷ See Minnis, *supra* note 19; discussion *supra* note 27; discussion *supra* app. 3.

¹⁷⁸ "Private firms make up a significant portion of the economic activity in the US." In the US, there are about 8 million private employers representing about one half of the nation's GDP. Ole-Kristian Hope, et al., *Stakeholder Demand for Accounting Quality and Economic Usefulness of Accounting in US Private Firms*, 36 J. ACCT. & PUB. POL'Y, 1, 1–13 (2016); Janis Berzins et al., *Corporate Finance and Governance in Firms With Limited Liability: Basic Characteristics*, SSRN (Sept. 1, 2008), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2294269 (showing that private firms have about four times more employees than public firms, three times higher revenues and twice the amount of assets).

¹⁷⁹ *Ritchie*, 443 S.W.3d 856.

performance measures, matched sample, bootstrap regression, or potential confounding macroeconomic events.

We further find that the impact of *Ritchie* is much larger for poorly performing firms and in smaller firms. These firms experience a higher likelihood of inefficient monitoring, and thereby the evidence corroborates our conclusion about the inefficient monitoring by the private minority. We also document firm investments and leverage as potential channels for inefficient monitoring. We find an increase in firm investments and leverage after *Ritchie*. This evidence hints at potential risk-aversion by the private minority, who preferred status quo to risky but potentially value-increasing activities. The increase in firm investments is in line with existing theoretical arguments that any inefficient monitoring by non-controlling shareholders impacts managerial initiative, especially in undertaking new investments.

To the best of our knowledge, this is the first paper to study the role of minority shareholders in private companies. Our findings provide insights into the role of minority shareholders in private companies. Our results are consistent with existing theoretical literature that has suggested inefficient monitoring by minority shareholders,¹⁸⁰ as well as theoretical literature that has suggested the negative investment impact of inefficient monitoring.¹⁸¹ Our findings also shed light on the possibility that findings from public companies need not always generalize to private companies. Our study shows that there are inherent differences between minority shareholders in private and public companies, which can incentivize minority shareholders in private companies to behave differently than the minority shareholders in public companies. Our results also provide insights on the real effects of monitoring by minority shareholders. We use available hand-collected data to provide one of the first insights into the role of minority shareholders in private firms. Future research can focus on identifying new ways of obtaining data and using that to provide new insights into this question.

¹⁸⁰ Due to their small stake in the firm, the minority shareholders' benefits from monitoring are not large enough to justify the costs of monitoring. See Edmans & Manso, *supra* note 43 (finding that a structure with numerous small blockholders can be suboptimal for governance, as splitting of equity between numerous shareholders leads to a free-rider problem).

¹⁸¹ See Burkart et al., *supra* note 20 (showing that inefficient monitoring by non-controlling shareholders reduces managers' initiatives to undertake new investments). This is consistent with an anecdote obtained from a CEO in our sample. In line with Burkart, the removal of the buy-out remedy should provide more freedom for managers to undertake new investments.

VI. APPENDICES

APPENDIX 1: VARIABLE DEFINITIONS

Variable	Definition
Close	Dummy variable equal to 1 if the firm in the sample is a closely held private corporation, and 0 otherwise
Delta Texas GDP	Change in annual GDP of Texas, obtained from the St. Louis' Federal Reserve Economic Database
Delta US GDP	Change in annual U.S. GDP, obtained from the St. Louis' Federal Reserve Economic Database
Firm Age	Number of years from the founding year until the current year
Ind Avg Profit Margin	Average profit margin for the industry as per Fama-French 12-industry classification
Leverage	Total debt divided by total assets
MSA	Metropolitan statistical area to which each firm belongs to
Post	The period of one year after <i>Ritchie</i> by the Supreme Court of Texas
Change in PPE	Change in the net PPE of a firm in % terms
Profit Margin	Net income divided by sales
Return on Assets (ROA)	Net income divided by average assets
Return on Equity (ROE)	Net income divided by equity
Size	Natural logarithm of total assets

Figure 1: Geographical locations of sample firms

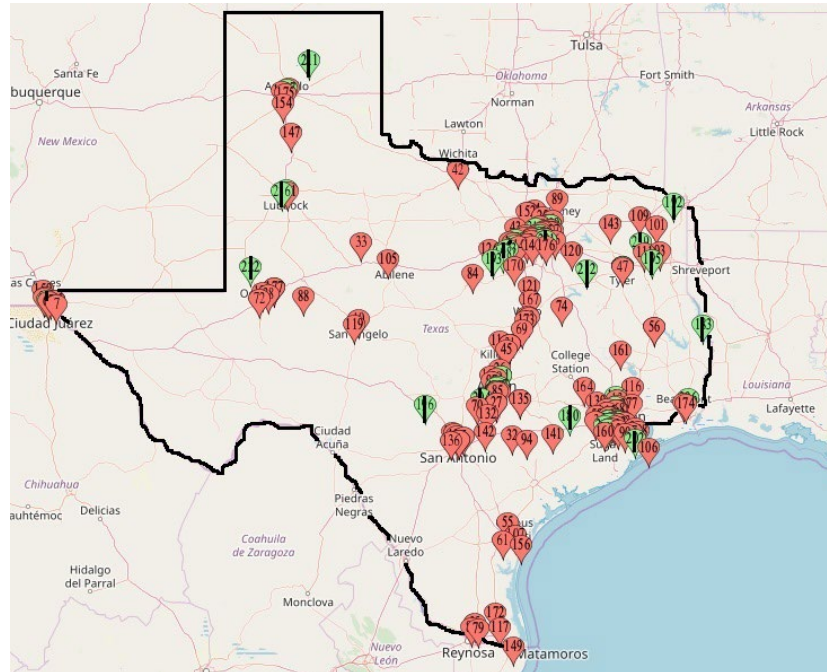


Figure 1 provides a geographical mapping of the sample firms. We plot all our sample firms on a map of Texas. The bold black line shows the Texas boundary. We use the zip code from the firm's registered address available from either the Articles of Incorporation or Capital IQ database. The green dot (with a vertical line) represents closely held private firms, whereas the red dot (no lines) represents non-closely held private firms.

Figure 2: A flowchart of steps to identify closely held private corporations

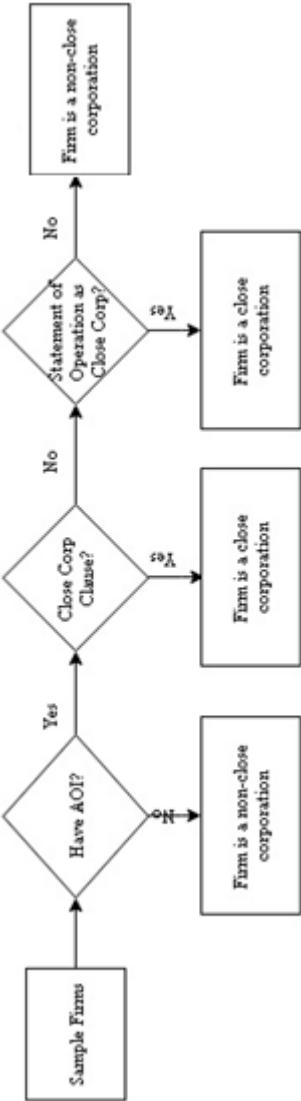


Figure 2 shows the steps involved in identifying firms, from our sample, as closely held private corporations or not. *AOI* stands for Articles of Incorporation. *Close corp* clause refers to a clause/article in the AOI specifying the company's closely held corporation status. *Statement of operation as a close corp* is a statement filed by a company in lieu of the clause in the AOI.

Table 1: Descriptive Statistics

Variable	Closely held private corporations					Non-closely held private corporations					Diff	T-stat
	N	Mean	Med	Q1	Q3	N	Mean	Med	Q1	Q3		
Pre-Period												
Size	41	1.355	1.328	0.777	1.896	169	1.443	1.306	0.396	2.030	-0.088	-0.450
Revenues	41	12.073	5.367	0.957	13.772	169	20.588	3.641	0.585	18.156	-8.515	1.134
ROA	41	0.066	0.045	0.016	0.102	169	0.087	0.045	0.005	0.159	-0.021	0.786
ROE	41	0.134	0.075	0.029	0.220	169	0.162	0.064	0.010	0.289	-0.029	0.538
Profit Margin	41	0.036	0.027	0.010	0.084	169	0.040	0.033	0.004	0.081	-0.004	0.159
Leverage	41	0.286	0.236	0.058	0.444	169	0.294	0.197	0.047	0.495	-0.008	0.161
Change in PPE	36	0.210	-0.056	-0.327	-0.010	152	1.228	-0.047	-0.319	0.214	-1.019	-1.188
Post Period												
Size	42	1.291	1.222	0.757	1.896	169	1.432	1.277	0.365	2.083	-0.141	0.722
Revenues	42	12.226	5.005	1.080	15.224	169	17.827	3.345	0.358	15.760	-5.601	0.871
ROA	42	0.114	0.058	0.022	0.239	169	0.064	0.039	-0.021	0.141	0.050	1.692*
ROE	42	0.202	0.103	0.039	0.286	169	0.116	0.062	-0.029	0.191	0.087	1.605
Profit Margin	42	0.079	0.046	0.012	0.107	169	0.021	0.024	-0.017	0.073	0.058	2.112**
Leverage	42	0.321	0.240	0.040	0.612	169	0.273	0.160	0.034	0.450	0.047	0.934
Change in PPE	33	0.113	-0.003	-0.126	0.098	140	0.446	-0.037	-0.117	0.113	-0.332	-0.567

Table 1 presents descriptive statistics of the key variables used in this study. Size is calculated as natural logarithm of total assets. Revenues are in US\$ million. ROA is calculated as net income divided by average assets. ROE is calculated as net income divided by average book value of equity. Profit Margin is calculated as net income divided by sales. Leverage is calculated as total liabilities divided by total assets. Change in PPE is the percentage change in the balance of net Property, Plant & Equipment.

Table 2: Correlation Matrix

	Close	Size	Revenues	ROA	ROE	Profit Margin	Leverage	PPE Growth
Close	1.000							
Size	-0.041	1.000						
Revenues	-0.070	0.693	1.000					
ROA	0.037	0.100	0.106	1.000				
ROE	0.038	0.225	0.239	0.695	1.000			
Profit								
Margin	0.072	0.179	0.066	0.660	0.437	1.000		
Leverage	0.027	0.304	0.364	-0.011	0.211	-0.135	1.000	
PPE								
Growth	-0.069	0.093	0.059	0.058	0.060	0.028	0.029	1.000

Table 2 presents the pairwise correlations between closely held private corporations and key variables. Close is a dummy variable equal to 1 if the firm in the sample is a closely held private corporation, and 0 otherwise. Size is calculated as natural logarithm of total assets. Revenues are in US\$ million. ROA is calculated as net income divided by average assets. ROE is calculated as net income divided by average book value of equity. Profit Margin is calculated as net income divided by sales. Leverage is calculated as total liabilities divided by total assets. Change in PPE is the percentage change in the balance of net Property, Plant & Equipment. Bolded figures indicate that the correlation between the two variables is significant at the 10% level. All continuous variables are winsorized at the 2% and 98% levels. Variables are defined in Appendix 1.

Table 3: Impact of *Ritchie* on Firm Performance**Panel A: Use of ROA as the performance measure**

$$\begin{aligned}
 \text{Firm Performance}_{it} &= \alpha_0 + \beta_1 \text{Post} + \beta_2 \text{Close} + \beta_3 \text{Post} * \text{Close} \\
 &+ \beta_4 \text{Size}_{it} + \beta_5 \text{Change in PPE}_{it} + \beta_6 \text{Firm Age} \\
 &+ \beta_7 \text{Leverage}_{it} + \beta_8 \text{Performance}_{it-1} \\
 &+ \beta_9 \text{Ind Avg Profit Margin} + \beta_{10} \Delta \text{US GDP}_t \\
 &+ \beta_{11} \Delta \text{TX GDP}_t + \Sigma \text{Industry FE} + \varepsilon_{it}
 \end{aligned}$$

	ROA	ROA
Post	-0.021 (0.014)	-0.018 (0.020)
Close	-0.014 (0.021)	-0.002 (0.019)
Post * Close	0.067*** (0.024)	0.078*** (0.028)
Size		0.018** (0.009)
Change in PPE		0.003 (0.002)
Firm Age		-0.000 (0.001)
Leverage		0.007 (0.032)
Lag Performance		0.413*** (0.092)
Ind Avg Profit Margin		0.890 (0.609)
Delta U.S. GDP		1.080 (2.499)
Delta Texas GDP		0.839*** (0.383)
Obs.	421	361
Industry Fixed Effects	Yes	Yes
R ²	0.056	0.279

Panel B: Use of ROE and profit margin as alternate performance measures

	Profit Margin	ROE
Post	-0.039** (0.020)	0.028 (0.039)
Close	-0.006 (0.019)	-0.005 (0.046)
Post * Close	0.063*** (0.020)	0.129*** (0.058)
Other Control Variables	Included	Included
Obs.	361	361
Industry Fixed Effects	Yes	Yes
R ²	0.224	0.210

Panel C: Dummy variable for increase in performance

	ROA	Profit Margin	ROE
Post	-0.354 (0.444)	-0.354 (0.444)	-0.400 (0.423)
Close	0.136 (0.495)	0.135 (0.496)	0.124 (0.484)
Post * Close	2.687*** (0.862)	2.687** (0.862)	2.954*** (0.960)
Other Control Variables	Included	Included	Included
Obs.	350	350	355
Industry Fixed Effects	Yes	Yes	Yes
Pseudo-R ²	0.234	0.234	0.181

Table 3 presents results of the DID test of the effect of the Texas ruling on performance. Panel A shows results using ROA as the main performance measure. Panel B uses alternate performance measures—ROE and profit margin. Panel C uses a dummy variable for increase in the performance measures—ROA, ROE and profit margin. Panels A, B and C do not report constants and Panels B and C do not report control variables for brevity. In all Panels, *Post* is a dummy variable equal to 1 for the period after *Ritchie*, and 0 otherwise. *Close* is a dummy variable equal to 1 for closely held private corporations and 0 otherwise. *Post * Close* captures the impact on performance of closely held private corporations after *Ritchie*. *Size* is calculated as natural logarithm of total assets. *Change in PPE* is the percentage change in the balance of net Property, Plant &

Equipment. *Firm Age* is number of years from the founding year until the current year. *Leverage* is calculated as total liabilities divided by total assets. *Lag Performance* is defined as the previous year's firm performance. *Industry Profit Margin* is calculated as average profit margin for the industry as per Fama-French 12-industry classification. *Delta US GDP* is defined as change in annual U.S. GDP, obtained from the St. Louis' Federal Reserve Economic Database. *Delta Texas GDP* is defined as change in annual GDP of Texas, obtained from the St. Louis' Federal Reserve Economic Database. All variables are as defined in Appendix 1. Variables are winsorized at 2% and 98% levels. ***, **, and * denote significance at the 0.01, 0.05, and 0.10 levels for the two-tailed test of coefficients, respectively. Standard errors are presented in parentheses.

Table 4: Placebo Test: Using 2016 as a Pseudo-shock year, instead of 2014

$$\begin{aligned}
& Firm Performance_{it} \\
& = \alpha_0 + \beta_1 Post + \beta_2 Close + \beta_3 Post * Close \\
& + \beta_4 Size_{it} + \beta_5 Change\ in\ PPE_{it} + \beta_6 Firm\ Age \\
& + \beta_7 Leverage_{it} + \beta_8 Performance_{it-1} \\
& + \beta_9 Ind\ Avg\ Profit\ Margin + \beta_{10} \Delta US\ GDP_t \\
& + \beta_{11} \Delta TX\ GDP_t + \Sigma Industry\ FE + \varepsilon_{it}
\end{aligned}$$

	ROA	Profit Margin	ROE
Post	-0.016 (0.022)	-0.006 (0.023)	0.019 (0.041)
Close	0.002 (0.029)	-0.003 (0.020)	0.010 (0.065)
Post * Close	0.036 (0.059)	-0.000 (0.051)	-0.038 (0.121)
Size	0.013 (0.009)	0.029*** (0.010)	0.041* (0.024)
Change in PPE	-0.005** (0.002)	-0.003 (0.002)	-0.014** (0.005)
Firm Age	-0.001** (0.001)	-0.000 (0.001)	-0.004*** (0.001)
Leverage	0.019 (0.035)	-0.075** (0.031)	0.288** (0.118)
Lag Performance	0.450*** (0.102)	0.288*** (0.067)	0.646*** (0.226)
Ind Avg Profit Margin	1.464 (1.432)	0.754 (0.892)	1.408 (1.767)
Delta U.S. GDP	3.202* (1.912)	0.051 (1.900)	6.715** (3.151)
Delta TX GDP	-0.954 (0.875)	-0.185 (0.686)	-3.250** (1.470)
Obs.	203	200	203
Industry Fixed Effects	Yes	Yes	Yes
R ²	0.401	0.268	0.349

Table 4 presents results of the DID test of the effect of using 2016 as a pseudo-ruling year, instead of 2014. *Post* is a dummy variable equal to 1 for the period after 2016, and 0 otherwise. *Close* is a dummy

variable equal to 1 for closely held private corporations and 0 otherwise. *Post * Close* captures the impact on performance of closely held private corporations after 2016. *Size* is calculated as natural logarithm of total assets. *Change in PPE* is the percentage change in the balance of net Property, Plant & Equipment. *Firm Age* is number of years from the founding year until the current year. *Leverage* is calculated as total liabilities divided by total assets. *Lag Performance* is defined as the previous year's firm performance. *Ind Avg Profit Margin* is calculated as average profit margin for the industry as per Fama-French 12-industry classification. *Delta US GDP* is defined as change in annual U.S. GDP, obtained from the St. Louis' Federal Reserve Economic Database. *Delta Texas GDP* is defined as change in annual GDP of Texas, obtained from the St. Louis' Federal Reserve Economic Database. All variables are defined in Appendix 1. All variables are winsorized at 2% and 98% levels. ***, **, and * denote significance at the 0.01, 0.05, and 0.10 levels for the two-tailed test of coefficients, respectively. Standard errors are presented in parentheses.

Table 5: Robustness using Matched sample and Bootstrap Regression

$$\begin{aligned}
 \text{Firm Performance}_{it} &= \alpha_0 + \beta_1 \text{Post} + \beta_2 \text{Close} + \beta_3 \text{Post} * \text{Close} \\
 &+ \beta_4 \text{Size}_{it} + \beta_5 \text{Change in PPE}_{it} + \beta_6 \text{Firm Age} \\
 &+ \beta_7 \text{Leverage}_{it} + \beta_8 \text{Performance}_{it-1} \\
 &+ \beta_9 \text{Ind Avg Profit Margin} + \beta_{10} \Delta \text{US GDP}_t \\
 &+ \beta_{11} \Delta \text{TX GDP}_t + \Sigma \text{Industry FE} + \varepsilon_{it}
 \end{aligned}$$

Panel A: Using Matched sample

Variables	ROA	Profit Margin	ROE
Post	-0.058 (0.041)	-0.040 (0.042)	-0.001 (0.074)
Close	-0.039 (0.033)	-0.047 (0.032)	-0.004 (0.067)
Post * Close	0.124*** (0.044)	0.098** (0.044)	0.165** (0.078)
Other Control Variables	Included	Included	Included
Obs.	122	122	122
Industry Fixed Effects	Yes	Yes	Yes
R ²	0.407	0.200	0.349

Panel B: Using Bootstrap Regression

Variables	ROA	Profit Margin	ROE
Post	-0.018 (0.021)	-0.039* (0.020)	0.028 (0.035)
Close	-0.002 (0.021)	-0.006 (0.019)	-0.005 (0.051)
Post * Close	0.078** (0.031)	0.063*** (0.019)	0.129** (0.059)
Other Control Variables	Included	Included	Included
Obs.	361	361	361
Industry Fixed Effects	Yes	Yes	Yes
Adjusted R ²	0.257	0.176	0.161

Table 5 presents two robustness tests to provide further credibility to the main test. Panel A uses a matched sample, matched on the basis of size and year. Panel B uses bootstrap regression method, with 1000 replications. Panels A and B do not report constants and control variables for brevity. *Post* is a dummy variable equal to 1 for the period after *Ritchie*, and 0 otherwise. *Close* is a dummy variable equal to 1 for closely held private corporations and 0 otherwise. *Post*Close* captures the impact on performance of closely held private corporations after *Ritchie*. *Size* is calculated as natural logarithm of total assets. *Change in PPE* is the percentage change in the balance of net Property, Plant & Equipment. *Firm Age* is number of years from the founding year until the current year. *Leverage* is calculated as total liabilities divided by total assets. *Lag Performance* is defined as the previous year's firm performance. *Ind Avg Profit Margin* is calculated as average profit margin for the industry as per Fama-French 12-industry classification. *Delta US GDP* is defined as change in annual U.S. GDP, obtained from the St. Louis' Federal Reserve Economic Database. *Delta Texas GDP* is defined as change in annual GDP of Texas, obtained from the St. Louis' Federal Reserve Economic Database. All variables are defined in Appendix 1. The constant and control variables are not reported for brevity. All variables are winsorized at 2% and 98% levels. ***, **, and * denote significance at the 0.01, 0.05, and 0.10 levels for the two-tailed test of coefficients, respectively. Standard errors are presented in parentheses.

Table 6: Cross sectional test, on the basis of past performance and size

$$\begin{aligned}
 \text{Firm Performance}_{it} &= \alpha_0 + \beta_1 \text{Post} + \beta_2 \text{Close} + \beta_3 \text{Post} * \text{Close} \\
 &+ \beta_4 \text{Size}_{it} + \beta_5 \text{Change in PPE}_{it} + \beta_6 \text{Firm Age} \\
 &+ \beta_7 \text{Leverage}_{it} + \beta_8 \text{Performance}_{it-1} \\
 &+ \beta_9 \text{Ind Avg Profit Margin} + \beta_{10} \Delta \text{US GDP}_t \\
 &+ \beta_{11} \Delta \text{TX GDP}_t + \Sigma \text{Industry FE} + \varepsilon_{it}
 \end{aligned}$$

Panel A: Cross sectional test, splitting on the basis of past performance

	Poor Performance	Strong Performance
Post	-0.092 (0.069)	-0.001 (0.022)
Close	-0.132 (0.072)	0.017 (0.020)
Post * Close	0.164* (0.096)	0.072** (0.032)
Other Control Variables	Included	Included
Obs.	59	302
Industry Fixed Effects	Yes	Yes
R ²	0.303	0.321

Panel B: Cross sectional test, splitting on the basis of firm size

	Smaller Firms	Larger Firms
Post	-0.071 (0.047)	0.020 (0.018)
Close	-0.018 (0.030)	0.008 (0.029)
Post * Close	0.105** (0.052)	0.041 (0.039)
Other Control Variables	Included	Included
Obs.	160	201
Industry Fixed Effects	Yes	Yes
R ²	0.236	0.526

Table 6 presents the results of the two cross-sectional tests. In Panel A, we split the sample in two subsamples, on the basis of past two years' performance. We measure performance by the change in sales. Dropping sales for two consecutive years is termed as poor performance. In Panel B, we split the sample in two subsamples, on the basis of median size. Panels A and B do not report constants and control variables for brevity. *Post* is a dummy variable equal to 1 for the period after *Ritchie*, and 0 otherwise. *Close* is a dummy variable equal to 1 for closely held private corporations and 0 otherwise. *Post*Close* captures the impact on performance of closely held private corporations after *Ritchie*. *Size* is calculated as natural logarithm of total assets. *Change in PPE* is the percentage change in the balance of net Property, Plant & Equipment. *Firm Age* is number of years from the founding year until the current year. *Leverage* is calculated as total liabilities divided by total assets. *Lag Performance* is defined as the previous year's firm performance. *Ind Avg Profit Margin* is calculated as average profit margin for the industry as per Fama-French 12-industry classification. *Delta US GDP* is defined as change in annual U.S. GDP, obtained from the St. Louis' Federal Reserve Economic Database. *Delta Texas GDP* is defined as change in annual GDP of Texas, obtained from the St. Louis' Federal Reserve Economic Database. All variables are defined in Appendix 1. All variables are winsorized at 2% and 98% levels. ***, **, and * denote significance at the 0.01, 0.05, and 0.10 levels for the two-tailed test of coefficients, respectively. Standard errors are presented in parentheses.

Table 7: Tests on Channel of Monitoring

$$\begin{aligned}
 \text{Positive } PPE_{it} = & \alpha_0 + \beta_1 \text{Post} + \beta_2 \text{Close} + \beta_3 \text{Post} * \text{Close} \\
 & + \beta_4 \text{Size}_{it} + \beta_5 \text{Change in } PPE_{it} + \beta_6 \text{Firm Age} \\
 & + \beta_7 \text{Leverage}_{it} + \beta_8 \text{Performance}_{it-1} \\
 & + \beta_9 \text{Ind Avg Profit Margin} + \beta_{10} \Delta US \text{ GDP}_t \\
 & + \beta_{11} \Delta TX \text{ GDP}_t + \Sigma \text{ Industry FE} + \varepsilon_{it}
 \end{aligned}$$

$$\begin{aligned}
 \text{Leverage}_{it} = & \alpha_0 + \beta_1 \text{Post} + \beta_2 \text{Close} + \beta_3 \text{Post} * \text{Close} + \beta_4 \text{Size}_{it} \\
 & + \beta_5 \text{Change in } PPE_{it} + \beta_6 \text{Firm Age} + \beta_7 \text{Leverage}_{it} \\
 & + \beta_8 \text{Performance}_{it-1} + \beta_9 \text{Ind Avg Profit Margin} \\
 & + \beta_{10} \Delta US \text{ GDP}_t + \beta_{11} \Delta TX \text{ GDP}_t + \Sigma \text{ Industry FE} \\
 & + \varepsilon_{it}
 \end{aligned}$$

	PPE Increase Dummy	Leverage
Post	0.189 (0.316)	0.035 (0.044)
Close	-0.603 (0.387)	-0.014 (0.047)
Post * Close	1.174** (0.497)	0.086** (0.043)
Size	0.143 (0.108)	0.071*** (0.019)
Change in PPE		-0.001 (0.004)
Firm Age	-0.002 (0.008)	-0.002** (0.001)
Leverage	-0.694* (0.386)	
Lag Performance	0.885 (0.667)	-0.363*** (0.125)
Ind Avg Profit Margin	-0.818 (0.980)	-0.172 (0.119)
Delta U.S. GDP	0.610* (0.345)	2.324 (3.716)
Delta TX GDP	0.122* (0.066)	1.537 (1.020)
Obs.	414	361
Industry Fixed Effects	Yes	Yes
Pseudo-R ² / R ²	0.048	0.190

Table 7 presents the results of tests on the channels of monitoring. Column 1 shows results for PPE increase dummy. The variable is defined as 1 if net PPE increased over the previous year, and 0 otherwise. Column 2 presents the results of change in leverage, calculated as total liabilities divided by total assets. *Post* is a dummy variable equal to 1 for the period after *Ritchie*, and 0 otherwise. *Close* is a dummy variable equal to 1 for closely held private corporations and 0 otherwise. *Post*Close* captures the impact on performance of closely held private corporations after *Ritchie*. *Size* is calculated as natural logarithm of total assets. *Change in PPE* is the percentage change in the balance of net Property, Plant & Equipment. *Firm Age* is number of years from the founding year until the current year. *Leverage* is calculated as total liabilities divided by total assets. *Lag Performance* is defined as the previous year's firm performance. *Ind Avg Profit Margin* is calculated as average profit margin for the industry as per Fama-French 12-industry classification. *Delta US GDP* is defined as change in annual U.S. GDP, obtained from the St. Louis' Federal Reserve Economic Database. *Delta Texas GDP* is defined as change in annual GDP of Texas, obtained from the St. Louis' Federal Reserve Economic Database. All variables are as defined in Appendix 1. All variables are winsorized at 2% and 98% levels. US GDP and TX GDP variables have been scaled to avoid large coefficients. ***, **, and * denote significance at the 0.01, 0.05, and 0.10 levels for the two-tailed test of coefficients, respectively. Standard errors are presented in parentheses.

Table 8: Earnings Management Tests**Panel A: Using unsigned accruals**

$$\begin{aligned}
 ABSDA_{it} = & \alpha_0 + \beta_1 Post + \beta_2 Close + \beta_3 Post * Close + \beta_4 Size_{it} \\
 & + \beta_5 Change\ in\ PPE_{it} + \beta_6 Firm\ Age + \beta_7 Leverage_{it} \\
 & + \beta_8 Performance_{it-1} + \beta_9 Ind\ Avg\ Profit\ Margin \\
 & + \beta_{10} \Delta US\ GDP_t + \beta_{11} \Delta TX\ GDP_t + \Sigma Industry\ FE \\
 & + \varepsilon_{it}
 \end{aligned}$$

	Discretionary Accruals calculated using		
	Jones model	Modified-Jones model	Performance Matching
Post	-0.022 (0.021)	-0.016 (0.021)	-0.021 (0.021)
Close	0.019 (0.030)	0.018 (0.030)	0.015 (0.030)
Post * Close	-0.018 (0.036)	-0.025 (0.035)	-0.022 (0.034)
Other Control Variables	Included	Included	Included
Obs.	359	359	359
Industry Fixed Effects	Yes	Yes	Yes
R ²	0.220	0.222	0.237

Panel B: Using signed accruals

$$\begin{aligned}
DA_{it} = & \alpha_0 + \beta_1 Post + \beta_2 Close + \beta_3 Post * Close + \beta_4 Size_{it} \\
& + \beta_5 Change\ in\ PPE_{it} + \beta_6 Firm\ Age + \beta_7 Leverage_{it} \\
& + \beta_8 Performance_{it-1} + \beta_9 Ind\ Avg\ Profit\ Margin \\
& + \beta_{10} \Delta US\ GDP_t + \beta_{11} \Delta TX\ GDP_t + \Sigma Industry\ FE \\
& + \varepsilon_{it}
\end{aligned}$$

	<u>Discretionary Accruals calculated using</u>		
	Jones model	Modified-Jones model	Performance Matching
Post	0.008 (0.025)	-0.001 (0.025)	-0.003 (0.022)
Close	-0.013 (0.046)	-0.014 (0.045)	-0.015 (0.046)
Post * Close	0.030 (0.057)	0.042 (0.056)	0.047 (0.055)
Other Control Variables	Included	Included	Included
Obs.	359	359	359
Industry Fixed Effects	Yes	Yes	Yes
R ²	0.073	0.078	0.068

Table 8 presents results of earnings management tests. Panels A and B present absolute (unsigned) and signed discretionary accruals respectively. In both Panels, Columns 1, 2 and 3 present discretionary accruals using Jones model, Modified-Jones model and Performance Matched Modified-Jones model respectively. Panels A and B do not report constants and control variables for brevity. *Post* is a dummy variable equal to 1 for the period after *Ritchie*, and 0 otherwise. *Close* is a dummy variable equal to 1 for closely held private corporations and 0 otherwise. *Post*Close* captures the impact on performance of closely held private firms after *Ritchie*. *Size* is calculated as natural logarithm of total assets. *Change in PPE* is the percentage change in the balance of net Property, Plant & Equipment. *Firm Age* is number of years from the founding year until the current year. *Leverage* is calculated as total liabilities divided by total assets. *Lag Performance* is defined as the previous year's firm performance. *Ind Avg Profit Margin* is calculated as average profit margin for the industry as per Fama-French 12-industry classification. *Delta US GDP* is defined as change in annual U.S. GDP, obtained from the St. Louis' Federal Reserve Economic Database. *Delta Texas GDP* is defined as change in annual GDP of Texas, obtained from the St. Louis' Federal Reserve Economic Database. All variables are as defined in Appendix 1.

Variables are winsorized at 2% and 98% levels. ***, **, and * denote significance at the 0.01, 0.05, and 0.10 levels for the two-tailed test of coefficients, respectively. Standard errors are presented in parentheses.

Table 9: Considering impact of macroeconomic factors: Using MSA GDP as an additional control variable

Firm Performance_{it}

$$\begin{aligned}
 &= \alpha_0 + \beta_1 Post + \beta_2 Close + \beta_3 Post * Close + \beta_4 Size_{it} \\
 &+ \beta_5 Change\ in\ PPE_{it} + \beta_6 Firm\ Age + \beta_7 Leverage_{it} \\
 &+ \beta_8 Performance_{it-1} + \beta_9 Ind\ Avg\ Profit\ Margin \\
 &+ \beta_{10} \Delta US\ GDP_t + \beta_{11} \Delta TX\ GDP_t + \beta_{12} \Delta MSA\ GDP_t \\
 &+ \Sigma Industry\ FE + \varepsilon_{it}
 \end{aligned}$$

	ROA	Profit Margin	ROE
Post	-0.015 (0.021)	-0.036* (0.021)	0.036 (0.042)
Close	-0.012 (0.020)	-0.011 (0.019)	-0.021 (0.051)
Post * Close	0.087*** (0.031)	0.066*** (0.020)	0.155** (0.064)
Size	0.019** (0.008)	0.028*** (0.009)	0.047** (0.018)
Delta PPE	-0.000 (0.001)	-0.002 (0.001)	-0.002 (0.003)
Firm Age	-0.001** (0.000)	-0.000 (0.001)	-0.003*** (0.001)
Leverage	0.021 (0.033)	-0.092*** (0.033)	0.225** (0.113)
Lag Performance	0.392*** (0.104)	0.238*** (0.086)	0.474** (0.203)
Ind Avg Profit Margin	0.778 (0.586)	0.315 (0.383)	-1.483 (2.265)
Delta U.S. GDP	0.301 (2.684)	1.193 (2.077)	-2.826 (5.903)
Delta TX GDP	1.199*** (0.414)	0.171 (0.597)	3.042*** (0.882)
Delta MSA GDP	-0.001* (0.001)	-0.001 (0.001)	-0.001 (0.002)
Obs.	317	317	317
Industry Fixed Effects	Yes	Yes	Yes
R ²	0.291	0.202	0.216

Table 9 presents the results of the DID test of the effect of the Supreme Court of Texas ruling on firm performance. We include *Change MSA GDP* as an additional control variable to control for macroeconomic factors causing the change in firm performance. *Post* is a dummy variable equal to 1 for the period after *Ritchie*, and 0 otherwise. *Close* is a dummy variable equal to 1 for closely held private corporations and 0 otherwise. *Post*Close* captures the impact on performance of closely held private corporations after *Ritchie*. *Size* is calculated as natural logarithm of total assets. *Change in PPE* is the percentage change in the balance of net Property, Plant & Equipment. *Firm Age* is number of years from the founding year until the current year. *Leverage* is calculated as total liabilities divided by total assets. *Lag Performance* is defined as the previous year's firm performance. *Ind Avg Profit Margin* is calculated as average profit margin for the industry as per Fama-French 12-industry classification. *Delta US GDP* is defined as change in annual U.S. GDP, obtained from the St. Louis' Federal Reserve Economic Database. *Delta Texas GDP* is defined as change in annual GDP of Texas, obtained from the St. Louis' Federal Reserve Economic Database. All variables are defined in Appendix 1. All variables are winsorized at 2% and 98% levels. ***, **, and * denote significance at the 0.01, 0.05, and 0.10 levels for the two-tailed test of coefficients, respectively. Standard errors are presented in parentheses.

APPENDIX 2: SAMPLES OF ARTICLES OF INCORPORATION WITH INFORMATION ON CLOSELY HELD CORPORATION STATUS

Company names and shareholder names have been redacted for legal reasons.

Example 1: Information is provided as a separate article

ARTICLE FIVE

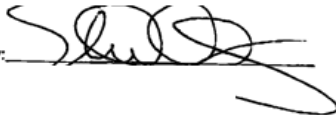
Close Corporation

This corporation is a close corporation.

Example 2: Information is provided in the statement of operation as closely held private corporation

STATEMENT OF OPERATION AS CLOSE CORPORATION Corporations Section

As of July 1, 2004, Fire Protection, Inc. is being operated as a close corporation. The Corporation is being operated and its business and affairs are being conducted under the terms of a shareholders' agreement made pursuant to the Texas Close Corporation Law.

By: 

SHAREHOLDERS:



Example 3: Information is embedded in the name of the company

ARTICLES OF INCORPORATION

OF

HENDERSON'S FLYING "H" TRUCKING, INC.

(A Close Corporation)

FILED
In the Office of the
Secretary of State of Te.

FEB 26 2001

Corporations Section

Example 4: A company that has expressly elected not to be a closely held private corporation

ARTICLE IV

ELECTION NOT TO BECOME A CLOSE CORPORATION

The Corporation does not elect to become a close corporation under provisions of the Texas Business Corporation Act specifically governing close corporations.

APPENDIX 3: DIFFERENCES BETWEEN MINORITY SHAREHOLDERS IN PRIVATE AND PUBLIC COMPANIES

Ease of sale of the shares: While minority shareholders in public companies can buy and sell shares in a competitive market, minority shareholders in private companies do not have that option.¹⁸² Existing literature has documented a significant relation between liquidity and active shareholder monitoring.¹⁸³ Consistent with this evidence, a lack of liquidity difference in liquidity is bound to alter monitoring by minority shareholders in private companies.

Average minority stake: Private companies have much fewer shareholders than do public companies. Average minority stake in private companies, therefore, is usually higher than in public companies. Ang, Cole and Lin (2000) find that monitoring by non-managing shareholders is decreasing in their individual ownership and in the number of non-managing shareholders.¹⁸⁴ Since private firms have fewer shareholders and higher shareholding on average, we expect higher monitoring efforts by minority shareholders in private companies.

Proportion of wealth invested in the minority stake: Minority shareholders in public companies usually do not invest a big chunk of their wealth in the public companies. However, the minority stake in private companies could form a much larger proportion of shareholders' personal wealth.¹⁸⁵ Ekholm and Maury find that investors have particularly strong incentives to monitor a stock that occupies a large part of their overall portfolio.¹⁸⁶ This difference could further enhance the extent of monitoring by the private minority.

¹⁸² Sale of minority shares in private companies usually starts with offering the shares to other shareholders and, if required, scout for an outside buyer. This process would take much longer than selling shares in the open market.

¹⁸³ Literature has identified two forms of shareholder oversight: voice and exit. Voice implies active monitoring (voting, proxy battles, etc.). Exit is sale of shares or threat thereof. See Edmans, *supra* note 51, and Alex Edmans & Clifford G. Holderness, *Blockholders: A Survey of Theory and Evidence*, 1 HANDBOOK ECON. CORP. GOVERNANCE 541 (2017), which both provide excellent reviews.

¹⁸⁴ Ang, James S., Rebel A. Cole, and James Wuh Lin, *Agency costs and ownership structure*, 55 J. Fin. 81 (2000).

¹⁸⁵ Tobias J. Moskowitz & Annette Vissing-Jorgensen, *The Returns to Entrepreneurial Investment: A Private Equity Premium Puzzle?*, 92 AM. ECON. REV. 745 (2002).

¹⁸⁶ See Ekholm & Maury *supra* note 175.

Financial Statement Audits: Public companies are required to get their financial statements audited by independent auditors—a requirement not applicable to private firms. Given that audits can be an important oversight mechanism, absence of the same in private corporations is bound to influence the behavior of private minority.

**APPENDIX 4: THE SUPREME COURT OF TEXAS RULING IN JUNE 2014:
RITCHIE V. RUPE**

The judicial landscape for minority shareholder oppression in Texas has been shaped by a seminal judgment dating back to 1988. In that judgment, referred to as “*Davis v. Sheerin*,” two tests were laid down to prove minority shareholder oppression: (1) the reasonable expectations test or (2) the fair dealing test.¹⁸⁷ According to the reasonable expectations test, an act of a majority shareholder can be considered oppressive if it defeats the reasonable expectations that were central to the shareholder’s decision to join the venture. This includes, among other things, majority shareholders’ cooperation in selling the minority shares. The fair dealing test refers to actions of the majority shareholders or directors that exhibit visual departure from the standards of fair dealing and probity, and a violation of fair play. The court, in its 1988 judgment, stated that minority shareholders can be considered oppressed if the actions of the managers or directors failed to uphold either of the two tests mentioned above. In *Davis v. Sheerin*, the court, under their power of equity, ordered the majority shareholders to buy out the minority stake, which came to be called the buy-out remedy. No Texas court had previously forced a shareholder buyout in the absence of a buy-out clause in the shareholders’ agreement. Since *Davis v. Sheerin*, courts in Texas continued this practice in minority shareholder oppression lawsuits. This buy-out remedy was an important exit mechanism for minority shareholders to escape a potential squeeze out scenario. The buy-out remedy had thus dramatically shaped the landscape of minority shareholder oppression in Texas.

In the case *Ritchie v. Rupe*, Anne Rupe, an 18% minority shareholder in Ritchie Investment Corp. (RIC), wanted to sell her shares. Without any cooperation from the majority shareholders (either to buy her shares at a fair price or cooperate with selling the shares to an outsider), she was left with no choice, and was unable to sell her shares. With no other choice, and feeling squeezed out, she sued the majority shareholders for minority shareholder oppression. The Dallas Court of Appeals granted a buy-out remedy, directing the majority shareholders to buy her stake for \$7.3 million. This ruling was in line with the prevailing approach.

However, the Supreme Court of Texas later overturned the decision and drastically redefined the minority shareholder oppression landscape in two ways. First, the court removed the buy-out remedy, calling it unconstitutional. The Supreme Court of Texas stated that the buy-out remedy cannot be mandated by Texas courts, even under the general

¹⁸⁷ See Dawson *supra* note 11.

power of equity. Second, the court narrowed the scope of minority shareholder oppression. It removed both the tests laid down earlier and stated that “actions of managers or directors could be considered oppressive only if they abused their authority over the corporation with the intent to harm the interests of one or more of the shareholders, in a manner that does not comport with the honest exercise of their business judgment, and by doing so create a serious risk of harm to the corporation”. This change was also important, because proving oppression now mandatorily required proving harm to the corporation, which was difficult. Courts in Texas usually rely on the “business judgment rule”—that is without any obvious signs of harm to the corporation, the courts would trust the actions of the manager or directors to be beneficial to the corporation.

The 2014 ruling was a highly unexpected decision and has been considered a landmark development because it redefined the scope of minority shareholder oppression; it effectively removed court-ordered buy-out remedy and made it substantially difficult to prove minority shareholder oppression. The timeline of the original judgement is provided below.

The following timeline provides a quick overview of what events transpired up to the June 2014 ruling.

Year 2002	Original shareholder dies; leaves his 18% stake for his wife and son
Year 2004	Widow wants to sell her shares; offers shares to other shareholders
January 2005	Other shareholders offer \$1 million for the shares; widow refuses
February 2005	Other shareholders revise offer to \$1.7 million; widow refuses again on the grounds that the sum is not commensurate with the assets and revenues
March 2005	Widow appoints financial advisor to find outside buyer
January–June 2006	Outside buyers try to meet the managing shareholders, but they refuse to meet any of the potential buyers; financial advisor finds it almost impossible to sell without managing shareholders’ meeting
July 2006	Widow sues the managing shareholders for minority shareholder oppression
March–April 2011	Dallas Court of Appeals rules in favor of minority shareholder; allows for a buyout of her shares for \$7.3 million

April 2011– February 2012	Managing shareholders appeal to Supreme Court of Texas for hearing petition
March 2012	The Supreme Court of Texas grants their motion for rehearing/review
February 2013	Oral arguments are heard in the Supreme Court of Texas; nine amicus curiae briefs also filed (amicus curiae briefs refer to expert information from parties not directly involved in the case, but who could be affected by the case)
June 2014	The Supreme Court of Texas passes judgment, overturning the earlier decision of Dallas Court of Appeals (removing the buy-out remedy and making the scope of minority shareholder oppression very narrow).