THE EFFECT OF SEPARATING OWNERSHIP FROM CONTROL ON CORPORATE LEVERAGE

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ABSTRACT

This paper aims to examine how corporate leverage is affected by the separation of ownership from control .Using data from a sample of 643 listed UK firms, the results show supportive evidence of a statistically significant positive relationship between the largest shareholder's ownership concentration and debt ratio. More importantly, the results of the paper show a statistically significant and positive relationship between control-wedge (deviation between control rights and cash flow rights) and the debt ratio confirming that control attracts controlling shareholders to extract private benefits. This finding offers directly evidence for the debt-increasing effect of the hypothesis formulated in this paper: the non-dilution entrenchment effect and signaling effects of debt finance contribute to a higher corporate debt level when the control-rights and cash-flow rights of the largest controlling shareholder are highly separated.

***KEY WORDS**; Controlling shareholders, expropriation, debt ratio, control- rights, cash flow- rights*

INTRODUCTION

The objective of this paper is to explore the impact of separating ownership from control corporate leverage. In a modern corporation, ownership is separated from control because owners may lack the time, skills and experience required to manage the corporation. In this case professional managers are employed to control corporations on behalf of the owners. However, the challenge is that, managers can have their own personal interests which deviate from the objective of the firm (Berle and Means, 1932).

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Management's unfavourable behavioural patterns, which affect firm value, may be limited by several approaches such as take-over bids, market for corporate control measures, incentive packages and monitoring by external shareholders. The approach which currently has attracted researchers' attention is monitoring by large external shareholders. The literature highlights the impact of institutional shareholders' voting power in corporate decision making, as seen in such areas as choice of value-maximizing capital structure. Shleifer and Vishny (1986) contend that, the external larger shareholders are vital agents in monitoring managerial selfish behaviours and hence in reducing direct agency costs.

In an attempt to choose the value-maximizing capital structure level of debt should be watched carefully. Debt may play a very crucial role in limiting the misappropriation of corporate excess cash flows as previously suggested by Jensen and Meckling,(1976) and further developed by Jensen, (1986). However, this role depends on the structure of corporate ownership and control. The conflict between minority and majority shareholders becomes serious if the controlling shareholders accumulate more control by applying control-enhancing mechanisms such as pyramidal structures and dual-class structures.

Because debt may be used by controlling shareholders in pyramid firms to enhance expropriation by forcing their subsidiaries to raise more external debt (reorganizing this via intercompany transactions)it is very crucial to mind the level of debt in companies whose ownership and control are as highlighted by Atanasov *et al.*(2009). Following this argument, it may be suggested that, in pyramid firms debt is used to facilitate expropriation of minority shareholders rather than using it to enhance control as expected in stand-alone companies.

According to Faccio *et al. (2003)*, when the company fails to honour its debt obligations, the net worth of professional managers might not be affected although their reputations and careers may be at risk. Therefore, debt may be considered to play two roles here: first, to limit expropriation of dispersed shareholders by professional managers, as in the US, and yet to facilitate the expropriation of minority shareholders and bank depositors by the business dominants, controlling block holders, of the corporate groups. Due to the fact that debt may be used as a double edge sword, it is the motivation of this study to know why separating ownership from control matters crucially on corporate leverage.

In the UK, using the data employed in this paper, about 25% of ultimate controlling shareholders are financial institutions such as banks. This suggests that these block holders may have control over the provision of loans in their institutions and can,

therefore, easily facilitate offering huge loans to companies in which they have financial interests. Thus, debt may not be used as a monitoring device but rather as an expropriation device.

This paper is aware of few UK published studies on the impact of corporate ownership and control on leverage. The paper presents new evidence of the impact of separating ownership from control on leverage. To the best of my knowledge, few (if any) studies of this kind have been conducted in the UK.

THEORETICAL PERSPECTIVE OF THE STUDY

Agency Theory

Among the many theories which are used in literature to explain the conflict of interest between managers and shareholders, minority shareholders and majority shareholders such as property right theory, stewardship theory and transaction cost theory, according to Jensen and Meckling (1976), agency theory is the most popular one and provides a powerful theoretical basis to reduce the agency problem. The theory is based on several assumptions. The first is that managers or controlling shareholders may maximize their utility at the expense of shareholders' wealth (Jensen and Meckling, 1976). The second is that there is an information asymmetry between managers and shareholders or between majority shareholders and minority shareholders and the third is that there are costly contracts to be written and enforced between principals and agents (Fama and Jensen, 1983).

In their seminal paper on the agency problem, Jensen and Meckling refer to agency relationship as the contractual agreements between one or more person(s) known as the principal(s) and the other person(s) known as agent(s), whereby an agent is engaged by the principal to perform some activity or service on his behalf. This involves delegating some decision-making authority. The best example is in corporations with diffused ownership structure where there is an agency relationship between the shareholders and managers of a corporation. Jensen and Meckling suggest that there is no agency problem at all when the manager holds 100% of the company's equity. In this case, the two parties, owners and manager, are unified and no separation of ownership and control exists.

On the other hand, when the ownership of a firm's equity are spread among different outside investors, as in the case of public companies, the separation of ownership and control results in a divergence of interest between managers and owners.

RELATED LITERATURE AND HYPOTHESES DEVELOPMENT

In a growing business, external financing is an unavoidable practice. The source of this finance is commonly either equity finance or debt finance. According to Harris and Raviv (1988), when deciding on which source to employ, controlling shareholders are more drawn to debt finance because of the non-dilution motives. This is the motive whereby controlling shareholders prevent their control diminishing by blocking out other equity block holders' efforts to bring in capital and dilute their control.

According to Jensen and Meckling (1976), shareholders of a company with more concentrated ownership may prefer less debt as long as it facilitates monitoring. Rajan and Zingales (1995) also supports this effect of ownership concentration on capital structure.

However, companies may prefer debt over equity if issuing equity means diluting or losing their control. Therefore, shareholders of firms with highly concentrated ownership will not prefer issuing equity instead of debt so as to maintain their control over corporate assets if they have confidence about the future growth potential of the company.

It therefore, follows from this discussion that the more concentrated the firm's ownership is, the more likely existing shareholders are to issue debt instead of equity when the company requires funds. This results into the first testable implication:

The ownership concentration of the largest shareholder is positively related to corporate leverage.

There exists substantial literature such as Berger *et al.* (1997), Firth, (1995) and Lang *et al.* (2004), which examines the disciplinary role of debt in firms with dispersed share ownership. The results from these studies are consistent with Jensen (1986) who considers debt as an obstacle to managers who intend to divert corporate recourses for their own benefit. Limited studies are available on the role of debt on companies with complex control structures where controlling shareholders own shares in companies directly or indirectly. However, debt is believed to lose its disciplinary ability in companies with ultimate equity ownership. The reason for this is that there is a complex control structure which may be used by controlling shareholders to expropriate minority shareholders.

According to Bertrand *et al*. (2004), the discrepancy between control-rights and cash-flow rights in firms with ultimate ownership widens the possibility for minority shareholders' expropriation.

Controlling shareholders may use debt to enhance expropriation by forcing their subsidiaries to raise more external debt, reorganizing this via intercompany transactions and finally facilitating deployment of corporate resources for their own preferred projects (Atanasov *et al.* 2009). However, the expected bankruptcy which is considered as the disciplinary mechanism for over-usage of debt is avoided because controlling shareholders in structures such as a pyramid have limited liabilities for the insolvency of their subsidiaries and the loss of reputation is minimal because it is difficult to hold them responsible due to the complexity of the control web.

Following this argument, it may be suggested that for companies with controlling shareholders having more control-rights than cash-flow rights, debt is used to facilitate the expropriation of minority shareholders rather than being used to enhance control. According to Johnson (2000), in affiliates located at the bottom of the pyramid structure, controlling shareholders have high voting rights but low cash-flow rights.
The deviation between the two rights creates incentives to transfer resources from the bottom to the top where controlling shareholders have larger cash-flow rights. Johnson (2000) refers to this transfer of resources as "tunneling". According to Johnson, tunneling includes, among others, "*a wealth transfer among affiliate firms through transfer pricing, using assets of one group member as collateral for another, inflated payments for intangibles such as patents, brand names and insurance."* According to Faccio *et al.* (2003), controlling shareholders may expropriate the interests of minority shareholders by instituting a higher level of debt in firms where they have lower cash-flow rights, and transfer that to affiliates where they can explore their own preferred projects without being detected by minority shareholders due to the complex control web in pyramids. This argument is consistent with the expropriation hypothesis which postulates the theory as follows:

The deviation of control rights from cash flow rights (measured by control-ownership wedge) of the largest controlling block holder negatively relates to corporate debt ratio.

METHODOLOGY

Data Collection and Sample Selection

The sample used in this paper comprises UK public companies listed on the London Stock Exchange. The raw data is adapted from Faccio and Lang (2002) which comprises 5,232 firms in 13 Western European countries after excluding all companies with no ownership data, companies which use nominee accounts and foreign affiliate companies whose ownership chain could not be traced. In this paper 1,953 UK

companies are selected from the raw data and screened. After eliminating financial companies we are left with 1,511 non-financial companies. 442 financial companies are eliminated following the tradition in literature of excluding financial companies. When financial data was matched with ownership data only 643 companies remained.

The source of raw ownership data used in this paper is similar to that used in assessing the complex ownership and firm valuation in Laeven and Levine (2008) focusing on Western Europe and Attig et al. (2008) in examining the relationship between multiple large shareholders, control contest and implied cost of equity. This paper focuses on the UK for several reasons: First, the UK is a relatively developed market compared to other Western Europe countries included in the raw sample and previous literature such as Frank et al. (2009) and La Porta et al. (1998) consider the UK to have better investor protection levels than most European countries. Therefore, assessing the level of expropriation, while mixing UK with other countries may not actually provide a real picture of expropriation levels in UK, hence dealing with the UK separately is an ideal option.

Second, disclosure level for UK companies is higher relative to other Western Europe countries; hence the quality of UK data is also expected to be better. This is supported by Faccio and Lang (2002) when tracing the ultimate ownership of unlisted companies of the companies in Western Europe, as they put it: "*Where the ultimate owner of a corporation is an unlisted firm, owners were traced using all available data sources. It was not easy to have complete success because most of the sample countries do not require unlisted firms to disclose their owners. One exception is the UK, where the 3% disclosure rule also applies to unlisted firms. If we failed to identify the owners of unlisted firm, then we classified them as a family"*

Variable Constructions and Definitions

Financial leverage

Previous studies related to debt financing claim that the effectiveness of monitoring by debt holders depends on the level of debt. Debt holders become effective monitors if debt level reaches a critical threshold. The paper uses Debt to Asset ratio to measure financial leverage similar to several previous studies such as Maury and Pajuste (2005) and Laeven and Levine (2008).

Ownership and Control Characteristics

In this paper the largest fraction of voting rights is used to measure the impact of the decision making power of investors as adapted from Faccio et al. (2011). This measure is also used by Thomsen and Pedersen (2000) when dealing with the ownership identity. In this paper, a controlling owner of the company is defined as the owner who

has over 10% of company's votes like in Laeven and Levine (2008) as adapted from La Porta et al. (1999).According to the authors controlling over 10% of company's shares provides a sufficient power to influence firm's decisions and more control is achieved by increasing their stakes in the company. If more than one category each owns above 10% of firm's shares, each of them are considered as large shareholders and the one with higher votes is considered as the controlling shareholder. In the case where the firm has no owner with above 10% of shares, such a firm is considered as widely held firm. Other cut-off such as 20% (Faccio and Lang, 2002) and 25% (Cronqvist and Nilsson, 2003) are also employed.

Faccio and Lang (2002) define cash flow right as the right of the corporate owner to share the net cash of the company and influence the decision of the company directly while the control right as the right the owner has to influence the decision of the company indirectly through another company which he owns directly.

The paper differentiates control-rights with cash flows rights as defined by Leaven and Levine (2008) as follows;
Control-Largest equals the control-rights of the largest shareholder with control of 10% or more of the voting rights.
Cash flow-Largest equals the cash-flow rights of the largest shareholder with control of 10% or more of the voting rights.
Control-Ownership wedge equals the ratio of cash flow-rights to control rights
Control Variables

The following table summarises control variables in this paper as suggested from literatures

Table 1 Summary table for control variables

VARIABLE	DEFINITION	ADAPTED FROM
Growth Opportunities	Three years Sales growth rate	Laeven and Levine (2008)
Free Cash Flows	Free cash flows scaled by total assets	Boone *et al.* (2007).
Leverage	Book value of all long-term liabilities divided by total assets	Maury and Pajuste (2005), Laeven and Levine (2008) Gugler and Yurtoglu (2003).
Firm size	The natural logarithm of total assets	Rajan and Zingales (1995) Maury and Pajuste (2005), Laeven and Levine (2008) and Yurtoglu (2003) and Farinha (2003)
Investment ratio	Ratio of capital expenditure to fixed assets	Bhattacharya and Grahams (2009) as in Short (1994)
Profitability	Measured as Return on Assets (ROA)	Jensen *et al.* (1992) and Fama and French (2001)
Volatility	Standard Deviation of Share prices	Jensen *et al.* (1992) and Fama and French (2001)

Empirical Method

To analyses the data cross-sectional regression is carried out. Because our argument is, in essence, cross-sectional, this methodology is the most suitable one. The use of panel regression is also common in capital structure studies, but one potential problem we face when applying panel regression is the relative time-invariance of ownership variables, which is a problem in our case, as the ownership variables of this paper are taken at one point in time. Consistent with Faccio and Lang (2002), La Porta *et al.* (1999) and Laeven and Levine, (2008) we observe that, ownership does not change significantly over time.

Some previous studies such as Rajan and Zingale (1995) and Bevan and Danbolt (2002) employed Tobin regressions in works similar to this, due to the presence of some observations on debt ratio with zero values. Hence, censored regression was necessary in this case. However, their results are consistent with the results generated from the clustering correction method. In fact about 13% of debt ratio observations in our paper have zero value and therefore, the paper uses Tobit regression for testing the robustness and consistency of the reported results. Our model is a pooled OLS regression specified as follows:

$$DT_{i,t} = \alpha + \beta_1 * OWN_{i,t} + \beta_2 * PROF_{i,t} + \beta_3 * FSZ_{i,t} + \beta_4 * VOLAT_{i,t} + \beta_5 * SGR_{i,t} + \beta_6 * FCF_{i,t} + e_{it} \quad ..(1)$$

Where;

$DT_{i,t}$ = Leverage at time t

$OWN_{i,t}$= Cash-flow rights of the largest shareholder, Control-rights of the largest shareholder or

Control-ownership wedge (Cash-flow rights/Control-rights)

$FSZ_{i,t}$ = Firm Size

$VOLAT_{i,t}$ = Volatility (Variations of corporate returns)

$SGR_{i,t}$ = Sales growth rate

$PROF_{i,t}$= Returns on Assets

$FCF_{i,t}$= Free Cash Flows

However;

$$\left\{ \begin{array}{ll} DT_{i,t} = DT^{*}_{i,t} & \text{If } DT^{*}_{i,t} > 0 \\ 0 & \text{If } DT^{*}_{i,t} \leq 0 \end{array} \right\} \quad \text{---------- (2)}$$

Empirical Results

Using the sub-sample of companies whose ownership and control are separated, the analysis starts by testing the statistical mean differences between companies with higher voting rights (above-mean) lower voting rights (below-mean) values of voting rights. The test shows that companies with higher voting rights have greater mean debt ratios compared to companies with lower values of voting rights. The debt ratio mean difference is tested to be statistically significant at 5% significant level as presented in table 2.

Table 2 Univariate Tests on the Debt Ratio

In this table, the mean DEBT RATIOS are compared using standard t-tests on means. Information from World scope and firms' annual reports is used to build the values of debt ratios. For a particular firm DEBT RATIO is the ratio between the total debt and total assets. The mean values of the debt ratios for observations related to firms with controlling shareholders holding higher voting rights are compared to the mean values of the same variable for observations of firms with controlling shareholders possessing lower voting rights (HVR VS. LVR).*, ** and *** stand for statistically significant at 10%, 5% and 1% respectively.

VARIABLES	***HIGHER VOTING RIGHTS (HVR) VS. LOWER VOTING RIGHTS***
DEBT RATIO	2.24**

Using a sub-sample of companies whose ownership and control are not separated, a regression between ownership concentration of the largest shareholder and debt ratio is run. Model1 in table 3 reports the regression results which show supportive evidence of a statistically significant positive relationship between the largest shareholder's ownership concentration and debt ratio at 5% significant level

In line with the size-effect argument, the firm size in this regression is positively related to debt ratio with a statistically significant relationship at 1% significant level as reported in Table 3, model 1.

Table 3 OLS models: Ownership &Control and Debt ratio

This table reports the estimates for OLS regression of the dependent variable DEBT RATIO (Total debt over total assets) on several independent variables. The regressions are run on sample firms with controlling shareholders. The sample period is 1996-1999. The regressions include the cash-flow rights (CF-RIGHTS) Model 1; control-ownership wedge of the largest shareholders (CFCR); MODEL 2. The data necessary to build the variables is extracted from Thomson DataStream and Wold Scope. The ownership variables are constructed from Faccio and Lang (2002) ownership database. For a particular firm, the variables *SIZE*, *FCF*, *GRTH*, *VOLAT and PROF are* computed using information as of the end of the fiscal year one year after the year in which ownership variable is extracted. *SIZE is* the natural logarithm of book value of total assets, FCF is the free cash flows scaled to total assets, GRTH is the three years average of sales growth rates, VOLAT is standard deviation of share price measuring firm risk and PROF is the EBIT scaled to total assets. For each independent variable, the table shows the coefficient estimate, the t-statistic robust to heteroscedasticity and within-firm correlation accompanied with *, **, or **** to represent the statistical significance at 10%, 5% and 1% significant level respectively, and t-statistics in bracket. The table also reports the number of observations and the value of the log-likelihood function for every regression. Industry dummies are included in the models and reported as INDUMMY.

Indep: Variable	MODEL 1	MODEL 2
CF- RIGHTS	**0.009**(2.11)**	
CFCR		**-0.629*(-1.76)**
SIZE	0.892***(3.23)	0.001***(4.33)
FCF	-0.004(-1.20)	0.004(0.43)
GRTH	-0.006**(-2.30)	-0.005*(-1.66)
VOLAT	-0.016**(2.48)	-0.002(-0.16)
PROF	-0.036**(2.09)	0.014**(2.38)
CONSTANT	-1.975***(-9.52)	3.203***(9.99)
R^2 /Pseudo R^2	0.269	0.158
F-stat	4.52***	7.78***
INDUMMY	Yes	Yes
Observations	313	534

Table 3, model 1 also reports a negative and statistically significant relationship between debt ratio and volatility at 5% significant level, suggesting that companies whose earnings have higher volatility, hence their borrowing capacity is impaired since variability of earnings of the company is a measure of safety of lenders' money; the more volatile the company's earnings, the less is a company's borrowing ability, and vice versa.

Furthermore, the table reports a negative coefficient and statistically significant between profit ability and debt which is consistent with Myers (1977)'s pecking order theory. The results also report a positive and statistically significant at 5% significant level coefficient of growth opportunities.

Table 3, model 1 further shows a negative insignificant relationship between free cash flow and debt ratio. These results were not anticipated and the reason for this may be due to the fact that other independent variables in the model overlap and display multiple effects.

The paper further presents the effect of separating corporate ownership from control on debt ratio. Regression results reported in model 2, table 3 show that there is a negatively significant relationship between corporate control-ownership wedge and debt ratio. The relationship is statistically significant at 10% significant level.

Turning to control variables, it is reported that have statistically significant coefficients except free cash flows and volatility. Contrary to pecking order theory that profitable firms use internal funds to explore potential investment opportunities before borrowing, profitability is reported to be positively related to debt ratio and the relationship is statistically significant at 5% significant level.

The results in table 3 further show that firm size is positively related to debt ratio as predicted. The coefficient of size is statistically significant at 1% significant level. It is also reported that growth is negative and statistically significant at 10% significant level.

As in previous studies such as Rajan and Zingale, (1995) and Bevan and Danbolt, (2002) Tobin regressions are employed in this paper to check for the robustness of our results. Tobit regression is considered necessary in this paper due to the presence of some observations on debt ratio with zero values representing 13% of the whole sample observations. However, their results are consistent with the results generated from the clustering correction OLS method.

In table 3 and table 4 the relationship between the voting rights of the largest controlling shareholder and debt ratio is tested and the relationship for both methods is reported to be positive and statistically significant at 1% significant level. The relationship between debt ratio and control contestability for both Tobit and OLS regressions as reported in table 3 and table 2 respectively show that both methods report positive and statistically significant coefficients of control contestability measure although the relationship is more statistically significant using OLS (1% significant level) compared to Tobit regression (5% significant level). Finally, table 4 also reports the results of the relationship between the control-ownership wedge of the largest shareholder and debt ratio using both techniques and it is confirmed that in both methods the relationship is negative and statistically significant at 5% significant level. Generally, it is confirmed that, the results for OLS are reported to be consistent throughout with those of Tobit regression

Table 4 Tobit Models: Ownership &Control and Debt ratio

This table reports the estimates for Tobit regressions of the dependent variable DEBT

Indep: Variable	MODEL1	MODEL 2
CF-RIGHTS	0.011***(2.85)	
CFCR		-0.762*(1.76)
GRTH	-0.010***(-3.59)	-0.008*(1.67)
VOLAT	-0.020**(-2.15)	-0.004(-0.02)
PROF	-0.041**(2.13)	-0.018**(2.2)
CONSTANT	-3.373***(2.79)	3.143***(7.03)
R^2/*Pseudo* R^2	0.076	0.158
F-stat	8.42***	4.14***
INDUMMY	Yes	Yes
Log Likelihood	-462.3243	-1128.2375
Observations	313	198

RATIO (Total debt over total assets) on several independent variables. The regressions are run on sample firms with controlling shareholders. The regressions include the cash-flow rights (CF-RIGHTS); MODEL 1, control-ownership wedge of the largest shareholders (CFCR); MODEL 2, the data necessary to build the variables is extracted

from Thomson DataStream and World Scope. The ownership variables are constructed from Faccio and Lang (2002) ownership database. For a particular firm, the variables *SIZE, FCF, GRTH, VOLAT and PROF are* computed using information as of the end of the fiscal year one year after the year in which ownership variable is extracted. *SIZE is* the natural logarithm of book value of total assets, FCF is the free cash flows scaled to total assets, GRTH is the three years average of sales growth rates, VOLAT is standard deviation of share price measuring firm risk and PROF is the EBIT scaled to total assets. For each independent variable, the table shows the coefficient estimate, the t-statistic robust to heteroscedasticity and within-firm correlation accompanied with *, **, or **** to represent the statistical significance at 10%, 5% and 1% significant level respectively, and t-statistics in bracket. The table also reports the number of observations and the value of the log-likelihood function for every regression. Industry dummies are included in the models and reported as INDUMMY

DISCUSSION OF THE RESULTS

The mean difference test between companies with higher voting rights (above-mean) lower voting rights (below-mean) values of voting rights test confirms that companies with higher voting rights of the largest shareholder have more potential to expropriate the interests of minority shareholders by issuing more debt and using that debt for their private deals, while those companies with lower voting rights will avoid higher debt, as the potential for bankruptcy jeopardizes their substantial investments in the company in which they have higher cash-flow rights.

Furthermore, a negative relationship between control-ownership wedge and debt ration shows that, as the difference between control-rights and cash-flow rights decreases, the value of control-ownership wedge increases. As a result the debt ratio decreases and when the difference increases the control-ownership wedge decreases resulting in an increase in debt ratio. The literature suggests that those shareholders whose control-rights are higher than their corresponding cash-flow rights may force their subsidiaries to raise more external debt, reorganizing this via intercompany transactions and finally, facilitating deployment of corporate resources for their private self-interest (Atanasov*et al.* (2009).

This finding supports directly the expropriation hypothesis brought forward earlier. The results offer evidence for the debt-increasing effect of the hypothesis formulated in this research, *i.e.*, the non-dilution entrenchment effect and signaling effects of debt finance contribute to a higher corporate debt level when control-rights and cash-flow rights of the largest controlling shareholder are effectively separated.

Following the size effect, the positive relationship between the firm size and debt shows that larger firms are highly levered because the size of the company is proportional to its profitability, hence borrowing capacity increases. This finding is consistent with the theoretical works of Scott and Martin, (1975) and Ferri and Jones (1979) and empirically supported by Agrawal and Nagarajan (1990).

Regarding the negative relationship between debt ratio and profitability as insisted in pecking order theory the study suggests that profitable companies use available internal funds to explore available investment opportunities before they use debt as their preferred source of finance. This is empirically proved by Titman and Wessels (1988) and Friend and Lang (1988). The relationship between profitability and debt ratio is statistically significant at 5% significant level.

Finally, as expected the positive relationship reported between debt ratio and growth opportunities is consistent with previous results by Bradley *et al.* (1984) and Titman and Wessels (1988). This reflects that, as growth opportunities increase, according to pecking order theory, internal funds may not be sufficient to explore potential investments and therefore, the company needs to utilize more of its debt capacity.

CONCLUSIONS

After testing the relationship between the largest block holder's ownership concentration and corporate leverage, the results conclude the evidence of a statistically significant positive relationship between the largest shareholder's ownership concentration and debt ratio.

The paper also concludes that as the deviation between control-rights and cash-flow rights of the largest shareholder decreases, the debt ratio decreases and when the deviation between control-rights and cash-flow rights increases there is an increase in debt ratio.

Therefore, companies with higher voting rights of the largest shareholder have more potential to expropriate the interests of minority shareholders by issuing more debt and using that debt for their private deals, while those companies with lower voting rights will avoid higher debt, as the potential for bankruptcy jeopardizes their substantial investments in the company in which they have higher cash-flow rights.

This finding offers directly evidence for the debt-increasing effect of the hypothesis formulated in this paper: the non-dilution entrenchment effect and signaling effects of

debt finance contribute to a higher corporate debt level when the control-rights and cash-flow rights of the largest controlling shareholder are highly separated.

The results of this paper are relevant in Tanzanian environment because Tanzania is one of the African countries which had formulated its laws and institutions based on already advanced corporate models like the OECD, Delaware and the European Union in which UK is part of the Union. Among the benefits derived from these models include the corporate shareholders protection clauses which create the favourable environment for investment in companies operating in Tanzania economy.

As the paper reflects the effect of controlling shareholders on corporate leverage it is paramount to believe that if corporate minority shareholders' wealth is well protected from expropriation by controlling shareholders, more investors will be attracted to invest in Tanzania Capital market.

Like in the UK, according to Melyoki (2005), Tanzanian listed companies (limited to his sample) all have controlling shareholders holding over 50% of the shares which provide them with control rights and incentives to exercise control. The question which immediately arises is "*Does the existing legal and regulatory framework in Tanzania based on the adopted models provides sufficient protection to shareholders' interests"?* This paper was confined to UK companies only, which might limit its comparability with data from other countries like Tanzania. The comparative study, however, is necessary to uncover whether the adopted models provide sufficient protection to shareholders' interests in listed Companies in the Dar es Salaam Stock Exchange (DSE)

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