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Do foreign minority shareholders matter? A theoretical framework

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ABSTRACT

The identity of minority shareholders is assumed to be irrelevant in most applications. Yet, firms in practice do care about the presence of foreign investors, and empirical studies have shown that firms cater to such investors. We fill this gap by proposing a simple theoretical framework to test whether shareholder identity matters. We show that catering to foreign minority shareholders is rational if their presence increases firm value. More broadly, we offer a general framework for using investor-specific shocks in empirical research.

1. Introduction

The identity of shareholders is often assumed to be irrelevant in most applications of corporate finance, a principle rooted in the design of public corporations where shares are freely transferable. This feature allows traders to value a firm based on its business fundamentals without needing to consider the personal financial affairs of its owners, a separation facilitated by legal innovations such as limited liability (Woodward, 1985) and entity shielding (Hansmann, 2012). However, some investors, such as those providing better corporate governance or enhancing firm value through other channels (e.g., innovation or visibility), may indeed matter.

Testing empirically whether minority shareholders matter is challenging. Ownership structure is an equilibrium outcome and detailed, high-frequency data on the ownership of a given class of minority investors are usually unavailable, making it difficult to link shifts in their holdings to firm-level outcomes. As a result, empirical research on this critical question remains scarce, and the assumption of shareholder identity irrelevance persists[1]; this gap leaves unexplored whether certain foreign investors, potentially more value-enhancing than others, should be weighted differently in capital flow data and in policy discussions on financial liberalization and corporate governance.

In a recent study, Lai et al. (2025) take a different route and infer whether minority shareholders matter from how firms respond to an exogenous investor-side shock. They exploit the U.S. Jobs and Growth Tax Relief Reconciliation Act of 2003, JGTRRA, which changes U.S. investors' tax incentives for dividends paid by a subset of non-U.S. firms, creating treated and otherwise comparable control firms.[2] Comparing the evolution of dividend payments between treated and control firms before and after the shock, they argue that absent any effect of the targeted minority shareholders, payouts should not diverge across the two groups. However, if we observe that treated firms significantly increase their dividend payments relative to control firms precisely after the shock, this pattern is consistent with firms adjusting payout policy to attract that investor clientele. This design infers investor relevance from policy-induced changes in incentives rather than from direct ownership measurement.

This paper proposes a simple theoretical framework to explain the patterns documented by Lai et al. (2025). We develop a simple model that clarifies when investor-side shocks should affect firm policy in the context of Lai et al. (2025). The model formalizes three elements: (i) when the identity of minority shareholders does or does not affect firm value, (ii) how a controlling shareholder trades off private benefits

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[1] Kandel et al. (2011), Merton (1987), and La Porta et al. (2000) are some important studies that show minority shareholders' identities do matter.

[2] This shock only affects the investor side and is not driven by changes in the firms' own fundamentals or preferences. Conceptually, it is akin to an instrument that shifts investors' incentives without directly shifting firm fundamentals.

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against attracting valuable investors, and (iii) how an investor-side policy shock can be used as a test of whether a given investor group matters. We show that a controlling shareholder caters to foreign minority investors if their presence increases firm value; observing such catering behavior provides direct evidence that identity is relevant. Our simple framework can also be extended in other contexts to assess the often-assumed-away, yet seldom-measured, value of minority shareholders.

2. The model

To set the stage, let us consider two countries, A and B. In country A, there is a firm with a controlling shareholder owning $k \in (0.5, 1)$ fraction of the shares; the controlling shareholder can choose a strategy to maximize her own utility. In country B, some investors form a minority group collectively owning $s \in (0, 0.5)$ fraction of the shares of the firm in country A[3]; their incentives to invest in the country-A firm can be affected by policies implemented in country B.[4]

In the context of Lai et al. (2025)'s empirical analysis, country A is a non-U.S. foreign country and country B is the U.S. The controlling shareholder of the country-A firm decides the fraction of cash to pay as dividends (denoted by $d \in [0, 1]$). The country-B policy concerns the tax rate (denoted by $t \in [0, 1]$) applicable to the dividends paid by the country-A firm to the country-B investors. We assume that:

1. $s_d > 0$: Minority shareholding from the country-B investors in the country-A firm increases with the dividends paid by the country-A firm.
2. $s_t < 0$: Minority shareholding from the country-B investors in the country-A firm decreases with the dividend tax rate in country B (Desai et al., 2001).
3. $s_{dt} < 0$: A higher (lower) dividend tax rate in country B reduces (enhances) the country-B investors' sensitivity to the dividends paid by the country-A firm.

What is the controlling shareholder's optimal decision (denoted by d^*)? How does it change with the dividend tax rate (i.e., $\frac{\mathrm{d}d^*}{\mathrm{d}t}$)?[5] To ensure tractability, we assume that the controlling shareholder solves the following optimization problem of the controlling shareholder (similar to Doidge et al. 2004):

$$\max_d \; U = k\underbrace{\left[dC - \frac{1}{2}b(1-d)^2pC\right]}_{\text{Firm value}} + \underbrace{(1-d)C}_{\substack{\text{Private}\\ \text{benefits}}} \equiv g(d)C, \tag{1}$$

where $g(d) \equiv k\left[d - \frac{1}{2}b(1-d)^2p\right] + (1-d)$, C is the firm's cash flow which could potentially depend on s, $\frac{1}{2}b(1-d)^2pC$ represents the deadweight loss of diversion (where $b > 0$ is a constant and $p > 0$ reflects investor protection strength).

The first order condition for an optimal dividend policy d^* is:

$$U_d = g'C + gC's_d = 0. \tag{2}$$

We then totally differentiate (2) with respect to t to obtain $\frac{\mathrm{d}d^*}{\mathrm{d}t} = -\frac{U_{dt}}{U_{dd}}$. By the second order condition, $U_{dd} < 0$. Thus, the sign of $\frac{\mathrm{d}d^*}{\mathrm{d}t}$ is determined by the sign of U_{dt}. Note that $U_{dt} = g'C's_t + gC''s_ts_d + gC's_{dt}$ and $g' = -\frac{gC's_d}{C}$ (from (2)). Therefore:

$$U_{dt} = \left(-\frac{gC's_d}{C}\right)C's_t + gC''s_ts_d + gC's_{dt} = gC'\left[\left(\frac{C''}{C'} - \frac{C'}{C}\right)s_ds_t + s_{dt}\right]. \tag{3}$$

So far we have not made any assumptions about how the country-A firm's cash flow (C) depends on minority shareholders from country B (s). Let us compare the following two cases:

- **Benchmark case:** Minority shareholders from country B do not create value to the firm in country A, such that $C' = 0$.
- **Alternative case:** Minority shareholders from country B create value to the firm in country A ($C' > 0$) with diminishing returns ($C'' < 0$).

Proposition 1. *Under the benchmark case ($C' = 0$), a change in the dividend tax rate in country B has no effect on the dividend policy of the firm in country A: $\frac{\mathrm{d}d^*}{\mathrm{d}t} = 0$.*

Proof. (3) suggests that when $C' = 0$, $U_{dt} = 0$, so that $\frac{\mathrm{d}d^*}{\mathrm{d}t} = 0$. ■

Intuition: If minority shareholders are irrelevant to firm value, the controlling shareholder ignores their tax situation. The trade-off is purely internal: balancing deadweight loss against private benefits, without external value feedback from the minority base.

Proposition 2. *Under the alternative case ($C' > 0$), the firm in country A increases dividends in response to a dividend tax cut in country B if the dividend sensitivity of the investors in country B is sufficiently enhanced by the tax cut (i.e., if s_{dt} is sufficiently negative): $\frac{\mathrm{d}d^*}{\mathrm{d}t} < 0$.*

Proof. We note that $g > 0$, $C' > 0$, $\left(\frac{C''}{C'} - \frac{C'}{C}\right)s_ds_t > 0$, and $s_{dt} < 0$. Thus, the terms inside the square brackets of (3) can be positive or negative. However, if s_{dt} is sufficiently negative $\left(\text{specifically if } s_{dt} < -\left(\frac{C''}{C'} - \frac{C'}{C}\right)s_ds_t\right)$, the terms in the square brackets of (3) will be negative, so that $U_{dt} < 0$ and $\frac{\mathrm{d}d^*}{\mathrm{d}t} < 0$. ■

Intuition: When minority shareholders from country B create value to a firm in country A, dividends become a tool to attract them. A tax cut in country B makes this tool more potent by making after-tax returns increase by more to a fixed increase of a dividend payout. If the tax cut sufficiently amplifies investors' responsiveness to dividends, the controlling shareholder finds it optimal to increase payouts, sacrificing some private benefits of tunneling to capture gains from expanding the value-relevant investor base. Equivalently, when $C'(s) > 0$, a tax cut that sufficiently increases dividend sensitivity implies higher optimal dividends (d^* rises as t falls).

3. Possible extensions and concluding remarks

This paper provides a theoretical framework for the empirical test conducted by Lai et al. (2025), which finds that qualifying non-U.S. firms – those whose dividends benefited from the 2003–2012 U.S. tax cut (U.S. Jobs and Growth Tax Relief Reconciliation Act of 2003, JGTRRA) – increased their payouts relative to non-qualifying firms. This result aligns with our Proposition 2, suggesting that for a subset of these non-U.S. firms, American minority shareholders create value ($C' > 0$), prompting controlling shareholders to cater to them through higher dividends.

Our framework can be extended to study other investor-specific shocks by (a) identifying "country A" and "country B", (b) the country-B policies affecting investors' incentives to invest in country-A firms, and (c) analyzing how these policies affect the optimal choices of the country-A firm (or its controlling shareholders). The analysis can thus go beyond dividend policy to study investment, innovation, or disclosure. "Country B" may represent other investor countries or blocs, while "country A" may be the U.S. instead of non-U.S. firms. More generally, the same logic applies whenever an investor-side policy changes the marginal value of a firm policy.

As an alternative example, changes in cross-border dividend taxation can generate clean shocks to the dividend tax wedge faced by a

[3] Throughout the analysis, we assume that $k + s < 1$.

[4] Importantly, these country-B policies do not affect the country-A firm directly. Besides, it is also possible that the country-B policy can affect some but not all firms in country A. In this case, we can have treated and control country-A firms.

[5] Doidge et al. (2004), on the other hand, focus on the cross-listing decision of the controlling shareholder of a firm in a non-U.S. foreign country (country A) in the U.S. (country B).

minority investor clientele. For instance, the Canada–U.K. tax treaty (as amended by the 2014 protocol) exempts dividends paid by Canadian firms to U.K. "recognized pension plans" from Canadian withholding tax, subject to a 10% ownership threshold. This reduces the dividend tax wedge for an identifiable minority investor group without changing firm fundamentals. Our model predicts a payout increase only when this clientele is value-relevant ($C'(s) > 0$).

Our framework also has direct policy implications for financial liberalization. Since not all foreign capital is equal, attracting investor groups that enhance firm value through monitoring, expertise, or visibility ($C' > 0$) generates efficiency gains beyond aggregate capital inflows. This implies that policymakers should consider the composition, not just the volume, of foreign investment. Moreover, liberalization is most valuable where domestic institutional quality is weak and foreign investors can provide governance improvements. Finally, firm responses to investor-side shocks offer regulators a diagnostic tool for identifying value-enhancing versus speculative foreign capital.

From a research design perspective, the framework highlights the usefulness of investor-specific policy variation, especially when ownership data are limited.

Data availability

No data was used for the research described in the article.

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