Featuring Control Power

CORPORATE LAW AND ECONOMICS REVISITED

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Erasmus Universiteit Rotterdam
op gezag van de
rector magnificus

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Prof.dr. G.W.J. Hendrikse
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Prof.dr. J.A. McCahery

To my parents

Ai miei genitori

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Rotterdam, December 2007

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Introduction

Corporate Governance: What We Know and What We Don't Know

Why Corporate Governance Is Important

Corporate governance is a hot issue in the public opinion. Many people of the developed world are shareholders of a listed company: either they hold shares on their own, or they have their savings invested in financial institutions that act as shareholders. Although the vast majority of these people are unaware of the economic and legal implications of being a shareholder, they do care about their money. On the one hand, they would not dare to invest in business ventures they hardly know anything about if they did not rely on the quality of corporate governance; neither would they trust financial institutions doing that job on their behalf, in the absence of 'good' corporate governance. On the other hand, they have an easy culprit to blame should anything go wrong with their investment: once again, this is corporate governance. As a result, successes and failures of corporate governance are always on first pages of newspapers. One would hardly gather what corporate governance is all about from the news; but news will often tell, at any rate, that thousands or millions of people either made or lost a sizeable amount of money because of that.

Corporate governance is also on top of the policymakers' agenda. In a sense, this may look rather obvious in light of the growing importance of stock ownership among households. Corporate governance has just become a widespread social issue, whereas – perhaps with the exception of the United States and the United Kingdom – it was not only a few decades ago. However, while this explains the attention of politicians, and may also justify the growing interest of sociologists, it does not tell why corporate governance is a major concern for economic policy.

Here the point is, rather, that corporate governance matters for economic performance, which is in turn a key determinant of the well-being of society – albeit certainly not the only one. In this perspective, policymakers are concerned with more than investors' welfare. The goal of the latter is to get the highest possible return on their investment; that of the former is to spur economic growth. In a capitalist economy, the two matters are closely related through finance. Finance is not just what allows investors to gain or lose money on their savings, but, more importantly, what allows firms to raise the funds necessary to be established, to commit resources to production and its developments, and to grow. Thus, policymakers do worry about investors' confidence in corporate governance. On both sides of the Atlantic, the corporate scandals of the beginning of this century have been addressed as a priority of action by public authorities at any level. However, investor protection is just instrumental to a more far-reaching goal: that of promoting firms' access to finance, and thereby economic growth. Indeed, most prominent international organizations consider 'good' corporate governance as one of the key recipes against underdevelopment.[1]

Corporate finance seems to be, therefore, the fundamental reason of the importance of *corporate governance*. Both terms are relatively new in public opinion and the policy debates. Nonetheless, they have rapidly become a part of today's parlance – together with management, takeovers, CEO, and similar expressions – regardless of the language we speak. Why? The popularity of these concepts is due to a somewhat novel circumstance: globalization. The largest companies nowadays raise massive amounts of funds from an investing public spread over most remote locations of the wealthy world. Yet there is another element, which is not novel, but is crucial.

Corporate funds come in two basic kinds. One is debt, which features a maturity (i.e., it has to be repaid) and midstream interests (i.e., scheduled payments of a predetermined amount). The other is equity, which features none of the above. In their capacity as providers of equity funds, shareholders are owners, not creditors: they just sink their money in a business venture in the hope that it will be successful. When it is so, they may get conspicuous dividends or, alternatively, sell their shares for much more than they invested in the first place. However, when the company is not successful, there is little, if anything, that they may claim from its liquidation. This situation may well suit a sole proprietorship: the owner will take all the decisions on how to run the firm, and will bear all the wealth effects of these decisions

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[1] See, e.g., Organization for Economic Cooperation and Development [2004], *OECD Principles of Corporate Governance - 2004 Edition*, available at www.oecd.org; World Bank [2002], *World Development Report 2002: Building Institutions for Markets*, The World Bank (also available at www.worldbank.org); and, more recently, the "Doing Business" project of the World Bank (www.doingbusiness.org).

on the capital that he has supplied the firm with.[2] On the contrary, the combination of ownership with dispersed provision of capital is a potentially pernicious one. Not only shareholders have no guarantee of getting anything back at all, but they are also too many and too distant to be in control of how profits and losses are made on the funds they provide. The only plausible reason why they still invest in this situation is that they rely on how management decisions are taken by those in control. This is also how companies manage to raise funds from shareholders in exchange for no promise about the investment returns and its safety. Corporate governance is what makes all this possible. To this purpose, it addresses *separation of ownership and control* as the core problem.

What We Know (i.e., *Why* Corporate Law 'Matters')

Separation of ownership and control is the point where ordinary people's concerns meet the scientific debate. The problem was first studied by lawyers. In an often-quoted passage, Adam Smith – the lawyer-philosopher who founded the modern study of economics – expressed his concern about the management of "other people's money" by directors of joint-stock companies who may have conflicting interests.[3] In the eighteenth century, the proportions of separation of ownership and control were not such to be worth of further speculation. Things suddenly changed in the early twentieth century, at least in one specific location of the world: the United States of America. Once again, a lawyer (together with a journalist) denounced separation of ownership and control as a major problem of the corporate business.[4] But the problem had acquired significant proportions, and therefore it was studied much more in depth. Adolf Berle and Gardiner Means analyzed the largest American companies in the 1930s, and concluded that shareholders had simply surrendered control over the corporate enterprise to professional managers. Berle and Means did not just describe facts. They also claimed that this situation was a most serious threat to the legal underpinnings of economic order, according to which ownership and control should lie in the same hands. The modern study of corporate governance had just started.

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2 For convenience of exposition, any individual will be considered as male in gender throughout the present work. This has no bearing on shareholders, entrepreneurs, or corporate controllers being actually men or women. The reader will have no difficulty in seeing a 'she' through any 'he' that follows.

3 Smith, A. [1776], THE WEALTH OF NATIONS, Cannan Edition (Modern Library, New York, 1937), 700.

4 Berle, A.A. Jr. and Means, G.C. [1932], THE MODERN CORPORATION AND PRIVATE PROPERTY, MacMillan.

It took about 40 years for economists to join the debate significantly. Then they took it over. By the 1970s, economic theory had availed itself of a powerful tool for analyzing separation of ownership and control as a matter of delegation of tasks under asymmetric information. The analytical tool in question is the agency theory, according to which providers of services are regarded as agents of the people on whose behalf the service is performed – the principals. On the one hand, this allowed framing separation of ownership and control as a matter of division of labor: shareholders are specialized providers of capital, whereas managers are specialized providers of business administration skills. On the other hand, the problem of asymmetric information paralleled the traditional concerns of lawyers about the managers' conflict of interest with shareholders. However, by pointing to the underlying problem, the agency setting was able to address the same concerns with the force of mathematical analysis of behaviors. Michael Jensen and William Meckling famously demonstrated that separation of ownership and control was desirable (i.e., efficient) in spite of the management's ability to pursue its own interest at the shareholder's expenses, if the agent's incentives to provide the services were aptly aligned to the interest of the principals. Asymmetric information just made incentive alignment costly, and these costs – agency costs – were all that separation of ownership and control was about.[5]

Efficiency had a stronger case than vague preoccupations of lawyers about the fairness of economic order. Minimization of agency costs was not only a positive, rational explanation of why separation of ownership and control had occurred. It was also a powerful normative criterion on how to implement it in the best possible way. This approach had also an important point of tangency with the developments of methodology in the US legal thought. With the publication of Richard Posner's *Economic Analysis of Law* in 1972, Law and Economics had cleared its way from antitrust to virtually any other area of law: efficiency was imported as a paradigm also suitable for legal analysis.[6] Corporate Law and Economics was still in its infancy, but it had already managed to bring an important contribution to the economics of corporate governance. Much before the agency approach was introduced in the study of separation of ownership and control, Henry Manne – former Dean of George Mason School of Law – had already discovered one fundamental mechanism for aligning the managers' incentives with the interest of dispersed shareholders. That was the market for corporate control, where underperforming manage-

[5] Jensen, M.C. and Meckling, W.H. [1976], *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 3, 305-360.

[6] Posner, R.A. [1972], ECONOMIC ANALYSIS OF LAW, Little, Brown and Company.

ment is replaced by those who find the company's stock undervalued and may profitably take over inasmuch as they are able to improve performance.[7]

This insight was rapidly melted into the agency theory of separation of ownership and control, albeit with an important variant. In the view of financial economists, minimization of agency costs was due to takeover *threat* more than to its *actual* occurrence. In other words, takeovers need to be hostile in order to keep managers on their toes while performing their duties to shareholders.[8] During the 1980s, hostile takeovers became so popular in the US that hardly anybody could have questioned the validity of this paradigm. Managers were indeed in control of firms that they did not own; but owners had always the possibility to oust underperforming managers. The only way for managers to keep their position was to please shareholders with high stock returns; a low stock price would have easily triggered a hostile takeover. This simple market mechanism was sufficient to induce managers to behave as loyal and diligent shareholders' agents. To be sure, this relied on efficiency of stock market prices. But, apparently, a number of studies on the Efficient Capital Markets Hypothesis showed that – at least in the US – this was no reason to worry about.[9]

Meanwhile, the second generation of Law and Economics scholars brought Corporate Law and Economics to its maturity. The picture of separation of ownership and control was just too bright to think that law could do much to improve it. Quite to the contrary, chances seemed high that legal intervention would make corporate governance just worse. After a debate of about ten years, *The Economic Structure of Corporate Law* – the first comprehensive economic analysis of corporate law – was published in 1991.[10] Economic analysis was based on a straightforward agency perspective. As a result, the legal discipline of corporations was regarded as mainly a collection of default rules, aimed at saving the contracting costs between the principals (shareholders) and their agents (professional managers). The authors – Frank Easterbrook and Daniel Fischel – advocated very few exceptions worth of mandatory regulation, the most important of which being the prohibition of managers to fend off a hostile takeover. Other Law and Economics commentators had a somewhat less liberal view of corporate law, but the vast majority of them stuck to the

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[7] Manne, H.G. [1965], *Mergers and the Market for Corporate Control*, in JOURNAL OF POLITICAL ECONOMY, vol. 76, 110-120.

[8] Scharfstein, D. [1988], *The Disciplinary Role of Takeovers,* in REVIEW OF ECONOMIC STUDIES, vol. 55, 185-200.

[9] See, for a survey and interpretation of results, Gilson, R.J. and Kraakman, R.H. [1984], *The Mechanisms of Market Efficiency*, in VIRGINIA LAW REVIEW, vol. 70, 549-644.

[10] Easterbrook, F.H. and Fischel, D.R. [1991], THE ECONOMIC STRUCTURE OF CORPORATE LAW, Harvard University Press.

agency framework dominating the economic literature.[11] This framework is contractual in nature and, therefore, it allows for very limited grounds for mandatory rules, unless some problems in the contracting process are assumed. However, the mainstream view was that efficiency of the stock market and hostility in the market for corporate control were sufficient reasons to make that assumption unwarranted.

For a European student, this view was problematic. In the early 1990s, my undergraduate courses in corporate finance had little, if anything, to do with the world where I lived in. Italy featured rather dormant stock markets, very little separation of ownership and control and, above all, no such thing as hostile takeovers. Controlling shareholders, not managers, were in charge of the governance of listed companies. I discovered much later that this was just one symptom of a more serious problem with the standard theory of corporate governance. This theory simply did not fit the real world, but at most a limited part of it. In fact, it is a theory developed on the basis of the US experience.

In the same period, the theory started to be challenged on empirical grounds. It was first shown that managers were not in control of all large corporate business even in the US, where a significant proportion of listed companies had indeed a controlling shareholder.[12] Worse enough, by looking at the other side of the Atlantic, it turned out that controlling shareholders were the rule in the governance of listed companies, whereas managerial control was the exception nearly everywhere but in Britain.[13] Separation of ownership and control was not as one big issue in continental Europe, where it was limited enough to have hostile takeovers simply disallowed by concentration of ownership.

Just when this evidence was being discovered, hostile takeovers started to disappear also from Anglo-American finance. Nonetheless, Britain and the US continued to feature extensive separation of ownership and control. It was then clear that something was missing from the theoretical paradigm developed up until then. Shareholders were apparently willing to hire professional managers as their agents, even in the absence of hostile takeovers; but they would hardly dare to do so outside the US and the UK. Those countries needed to have something especially suitable to separation of ownership and control. Corporate law was considered that special feature.[14]

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11 See, illustratively, Symposium [1989], *Contractual Freedom in Corporate Law*, in COLUMBIA LAW REVIEW, vol. 89, 1395-1774 (November 1989).

12 Holderness, C.G. and Sheehan, D.P. [1988], *The Role of Majority Shareholders in Publicly Held Corporations*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 20, 317–346.

13 La Porta, R., Lopez-de-Silanes, F. and Shleifer, A. [1999], *Corporate Ownership around the World*, in JOURNAL OF FINANCE, vol. 54, 471-517.

14 Shleifer, A. and Vishny, R. [1997], *A Survey of Corporate Governance*, in JOURNAL OF FINANCE, vol. 52, 737-783.

In theory, agency problems are always the same no matter of nationality. But corporate laws vary across countries, and they affect how agency problems are dealt with. Specifically, 'good' corporate laws can create enough confidence in corporate governance that shareholders feel comfortable with entrusting their money to professional managers. Even if they do not get any enforceable promise of a return on their investment, corporate law provides sufficient guarantees that they would not be expropriated by the agents. The same proposition does not hold when the quality of legal protection of shareholders is not high enough, and then 'bad' corporate laws require that agents be more tightly monitored by the principals. This is how controlling shareholding emerges as the only possible solution of the principal-agent problem.

The above argument seemed to explain fairly well how corporate governance was dealt with differently in different countries. Four American economists – led by Andrei Shleifer at the Harvard School of Economics – apparently demonstrated that law 'matters' for separation of ownership and control depending on how well it protects non-controlling shareholders.[15] The proof was based on regression analysis. Quality of law was assessed on the basis of an index of shareholder statutory rights as opposed to the powers of directors (considered as management representatives), and this variable had a very strong explanatory power of ownership concentration. The distribution of shareholder rights exhibited another important feature: Anglo-Saxon countries scored markedly higher than the others on this account. As a result, superiority of the common law tradition in shareholder protection sprang out as a powerful corollary of the 'law matters' thesis. All of this appeared in a milestone publication of the second half of 1990s – *Law and Finance* – that inaugurated a well-known series of articles by different combinations of the same authors; the latest, but probably not also the last one, is forthcoming in 2008.[16] After more than ten years, the 'law matters' proposition still lies at the core of the debate on positive analysis of corporate governance, and on its normative implications for corporate law.

At least originally, the theoretical background of the 'law matters' thesis was not entirely clear. In a typical agency framework, the problem of asymmetric information between the principal and the agent is dealt with contractually. Unless the parties are unable to contract efficiently, law is bound to play a minimal role. Ineffi-

[15] La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R. [1998], *Law and Finance*, in JOURNAL OF POLITICAL ECONOMY, vol. 106, 1113-1155.

[16] Djankov, S., La Porta, R., Lopez-de-Silanes, F. and Shleifer, A. [2006], *The Law and Economics of Self-Dealing* (November 13, 2006), Working Paper, Harvard School of Economics, available at www.economics.harvard.edu/faculty/shleifer/papers, forthcoming in JOURNAL OF FINANCIAL ECONOMICS, 2008.

ciency of the corporate contract is difficult to argue on the basis of just asymmetric information, for the same contract is concluded between sophisticated players when companies go public. Unsophisticated shareholders only enter the play at a later stage. So how can corporate law possibly matter in this setting? The answer is that the same setting is incomplete, and so are (is) the (nexus of) contracts around which it is built.

The literature on incomplete contracts is actually grounded on this simple intuition: people cannot contract upon every possible future contingency affecting their relationships. This is not just because parties may have asymmetric information about these contingencies. More importantly, future contingencies are *uncertain*, and therefore none of the parties can costlessly foresee them at the outset.[17] One prominent consequence of uncertainty is that what is optimal today may be not optimal tomorrow. Given that future contingencies are limitedly foreseeable in contracts, the latter need to feature *flexibility*, to be managed through *organizations*, which are in their turn directed by *authority*.[18] Corporate governance actually features all these elements. Unfortunately, this also means that contracting outcomes may turn out to be inefficient. The corporate contract cannot fully protect financiers – including shareholders – unless they get some authority, at least anytime their investment is endangered. When contracts are incomplete, authority is based on institutions, for it could not be relied upon otherwise.[19] In this perspective, the economics of institutions is the ultimate explanation of *why* law matters for protecting shareholders in corporate governance.

How law matters is another question. It is often believed that the 'law matters' thesis was revolutionary from the perspective of Corporate Law and Economics, but it was not quite so. Before the publication of *Law and Finance*, no legal commentator I am aware of had ever claimed the opposite. Rather, the debate was about the right balance between enabling and mandatory provisions in corporate laws.[20] And, to be sure, Law and Economics scholars uncovered the efficiency rationale for mandatory regulation of the corporate contract much before the importance of such regulation was highlighted in the economic theory. That rationale was the risk that management abused their powers due to the structural flexibility of corporate

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17 Hart, O. and Moore, J. [1988], *Incomplete Contracts and Renegotiation*, in ECONOMETRICA, vol. 56, 755-785.

18 Williamson, O.E. [1991], *Comparative Economic Organization: The Analysis of Discrete Structural Alternatives*, in ADMINISTRATIVE SCIENCE QUARTERLY, vol. 36, 269-296.

19 Williamson, O.E. [2000], *The New Institutional Economics: Taking Stock, Looking Ahead*, in JOURNAL OF ECONOMIC LITERATURE, vol. 38, 595-613.

20 Bebchuk, L.A. [1989a], *The Debate on Contractual Freedom in Corporate Law*, in COLUMBIA LAW REVIEW, vol. 89, 1395-1415.

charters – a problem of contractual incompleteness.[21] But the literature on contractual incompleteness was still in its infancy. As a result, Law and Economics scholars were still blaming agency costs as responsible for the need of mandatory rules in corporate law, exactly when one of the founding fathers of the literature on incomplete contracts – Oliver Hart – denounced the limits of the principal-agent framework in explaining the economics of the firm.[22]

However, after *Law and Finance*, the Law and Economics debate gained a comparative dimension that it did not have before.[23] The account of comparative corporate law based on the index of shareholder rights became a standard reference for mainstream economics, but it was heavily criticized as superficial by the lawyers. Prominent scholars in Corporate Law and Economics showed that, even in the US, the celebrated index of shareholder rights had little to do with how providers of equity capital were actually protected from expropriation.[24] American shareholders had very few statutory powers to challenge directors' decisions, but could count on a highly sophisticated system of private enforcement of fiduciary duties in courts. Although this was apparently very pertinent to the common law tradition, and to be sure even more pertinent than the statutory rights considered in *Law and Finance*, the same argument was not applicable to the UK. There, directors appeared to be in a much weaker position relative to institutional investors, but this was actually due to a peculiar combination of ownership structure with statutory entitlements.[25] Shareholder litigation was simply not an issue in Britain, and this confined judge-made law to a marginal role. Given that the patterns of separation of ownership and control were similar in these two countries, also the part of the 'law matters' argument relating to legal families seemed to be misguided. More accurate inquiries in comparative Law and Economics showed that functional comparison was the

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21 See, e.g., Gordon, J.N. [1989], *The Mandatory Structure of Corporate Law*, in COLUMBIA LAW REVIEW, vol. 89, 1549-1598.

22 Hart, O. [1989], *An Economist's Perspective on the Theory of the Firm*, in COLUMBIA LAW REVIEW, vol. 89, 1757-1774. In 1989, Oliver Hart and a number of American leading scholars in Corporate Law and Economics participated in the same Symposium at the University of Columbia. However, they spoke different languages and did not understand that they were all pointing to the same problem: incompleteness of the corporate contract. See Symposium [1989], *Contractual Freedom in Corporate Law*, cit.

23 See, e.g., Hansmann, H. and Kraakman, R.H. [2001], *The End of History for Corporate Law*, in GEORGETOWN LAW JOURNAL, vol. 89, 439-468.

24 Coffee, J.C. Jr. [2001b], *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, in YALE LAW JOURNAL, vol. 111, 8; Roe, M.J. [2002], *Corporate Law's Limits*, in JOURNAL OF LEGAL STUDIES, vol. 31, 252.

25 Franks, J. and Mayer, C. [2002], *Corporate Governance in the UK – Contrasted with the US System*, in CESIFO FORUM No. 3/2002, 13-22.

real issue: the problem of investor protection may be dealt with differently by different corporate laws, and yet legal systems can deliver equivalent results.[26]

The reverse is equally true. Comparative legal analysis has also shown that in no jurisdiction of continental Europe the issue of legal protection of non-controlling shareholders is neglected. But, despite of any appearance to the contrary, these jurisdictions simply address different functional problems. The management-shareholders conflict of interest is too a parsimonious account of agency problems in corporate governance. Agency problems are as severe in the relationship between controlling and minority shareholders. Corporate law in continental Europe had traditionally focused on the second problem more than on the first one. As a result, at least some European jurisdictions created a legal environment more suitable for concentrated ownership. Alternatively, it was concentrated ownership to call for a particular attitude towards agency conflicts. In effect, the causal determinism of *Law and Finance* seems unwarranted once the statistical correlation with the tradition of legal families is dismissed as irrelevant: whether corporate law comes before separation of ownership and control, or the other way around, becomes just a chicken-egg problem. If anything, access to finance is the only issue worth discussing from a functional standpoint. Corporate law is clearly inefficient when it fails to protect outside investors from both the management and controlling shareholders, for this would impair any form of separation of ownership and control. However, that dispersed ownership is always preferable to concentrated ownership has not yet been demonstrated; neither has superiority of corporate laws that support this result.

Law and Economics also went further in exploring the theoretical underpinnings of the 'law matters' proposition. That investigation delivered two prominent results, both of which are based on integration of institutional analysis in the traditional principal-agent framework. The first result is that corporate law faces structural limits in protecting non-controlling shareholders. The most efficient laws that we could imagine may protect shareholders from outright expropriation, but not also from the management's failure to maximize profits. With a suggestive alliteration, Mark Roe has showed how corporate law can police *stealing*, but may hardly do anything about *shirking*.[27] Other institutions are responsible for that. Provided that corporate law is doing its job in constraining shareholder expropriation, extralegal institutions will determine the degree of ownership concentration compatible with

[26] Kraakman, R.H., Davies, P., Hansmann, H., Hertig, G., Hopt, K.J., Kanda, H. and Rock, E.B. [2004], THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH, Oxford University Press.

[27] Roe, M.J. [2003c], POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE, Oxford University Press.

minimization of agency costs. This view has a problem with at least one institution: the market for corporate control. In fact, takeovers *do* police shirking *and* they are affected by the law. The point is the hostility in takeovers is often short-circuited by any possible device allowed by corporate law. This may be either the ownership structure supporting controlling shareholdings or the avail of takeover defenses to directors in dispersed ownership. The final result – non-contestability of corporate control – is unchanged, but apparently, it contradicts both the goal of agency costs minimization and the irrelevance of the law in this respect. Here comes the importance of the second result of theoretical analysis.

Lucian Bebchuk has developed the first, and to date the only, comprehensive theory of how failure of corporate law to protect non-controlling shareholders results in ownership concentration.[28] The reason is not just that, as it was suggested in *Law and Finance*, shareholders are less willing to buy non-controlling stakes in the absence of such a protection. The problem is, rather, that corporate controllers are unwilling to deconcentrate ownership when they can divert a sizeable amount of resources from minority shareholders, for fear of being taken over and expropriated in their turn. This was framed as a more general problem of control rents, or *private benefits of control*, thereby including any benefit that corporate controllers may extract at the expenses of minority shareholders. Bebchuk's rent-protection theory explained not only why dispersed ownership structures were not practicable in those countries whose corporate laws allowed too much scope for private benefits of control; it also explained why hostile takeovers could be disallowed even in dispersed ownership structures, when the management was able to extract a moderate, but still substantial, amount of control rents. Given the assumption that control rents are merely redistributive of *ex post* firm value, but may induce behaviors that undermine its production *ex ante*, both these mechanisms were considered as inefficient in an incomplete contracts perspective. As such, the theory carried a very strong normative implication for corporate law: the priority of legal policy should be constraining the extraction of private benefits of control.

Since then, private benefits of control have become perhaps the most popular way to interpret comparative corporate governance and the role of the law in affecting its patterns. The rent-protection theory was tested empirically.[29] Apparently, as far as both ownership concentration and stock market performance are concerned, cross-country estimates of private benefits of control exhibited higher ex-

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[28] Bebchuk, L.A. [1999], *A Rent-Protection Theory of Corporate Ownership and Control*, NBER Working Paper No. 7203.

[29] Nenova, T. [2003], *The Value of Corporate Votes and Control Benefits: A Cross-Country Analysis*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 68, 325–351; Dyck, A. and Zingales, L. [2004], *Private Benefits of Control: An International Comparison*, in JOURNAL OF FINANCE, vol. 59, 537-600.

planatory power than the index of shareholder rights of *Law and Finance*. On the one hand, this confirmed the general merits of the 'law matters' proposition: private benefits of control are just another way to look at shareholder protection. On the other hand, it made clear also to economists that the problem of shareholder protection was addressed functionally in corporate governance: different combinations of legal and extralegal institutions could determine comparable levels of private benefits of control. Unfortunately, the techniques employed only allow for private benefits that are *transferable* in the marketplace to be measured. At least one of the empirical studies on private benefits warned that our knowledge of the phenomenon to date is too limited to draw definitive conclusions. What can only be inferred from the empirical evidence is that not all private benefits are physic, and that those who are not are likely to be affected by corporate laws and other institutional factors protecting investors. However, it cannot be excluded that other kinds of private benefits are also at play and may contribute to determining the different patterns of corporate governance that we observe around the world.[30]

What We Still Don't Know (i.e., *How* Corporate Law 'Matters')

The state of scientific knowledge about corporate governance leaves us with a number of open questions from both an empirical and a theoretical perspective. To start with, the standard account of private benefits of control, which synthesizes the predictions about how law matters in corporate governance, faces one important contradiction. There are some countries where the average size of private benefits is apparently low, and yet ownership is significantly more concentrated than in Britain and in the US.

Sweden is a case in point. Sweden features functionally good protection of noncontrolling shareholders, although this seems to be more based on powerful social norms than on tough enforcement of corporate law. Unsurprisingly, the Swedish stock market is well developed; maybe more surprisingly, the frequency of controlling shareholders in Sweden is much higher than in the US, in spite of private benefits being on average nearly as low. According to Ronald Gilson, the reason is that private benefits also come in a non-pecuniary kind, which can be neither measured nor policed by investor protection, but result anyway in ownership concentration.[31] The effect of this kind of private benefits is not necessarily inefficient. Differently

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30 Dyck, A. and Zingales, L. [2004], *op. cit.*, 590.

31 Gilson, R.J. [2006], *Controlling Shareholders and Corporate Governance: Complicating the Taxonomy*, in HARVARD LAW REVIEW, vol. 119, 1641-1679.

from the Italian case – where control benefits appear to be more pecuniary in kind, and then they must be inadequately policed by corporate law and related institutions –, the high frequency of controlling shareholders in Sweden may be interpreted as the outcome of agency costs minimization. Some businesses endogenously involve higher levels of non-pecuniary benefits, and ownership concentration is just the way to have them consumed efficiently.

While attempting to answer an important question, Gilson's analysis raises two different ones. First, if non-pecuniary private benefits of control are truly endogenous to the business, why are they so important in Sweden but not so much, for instance, in the US and in the UK? Second, even assuming that pecuniary private benefits are equally low, how can we make sure that existing controlling shareholders maintain efficient levels of extraction of non-pecuniary private benefits over time? After all, these benefits have an opportunity cost in terms of shareholder value, which would rise when more efficient controllers were willing, but unable, to take over. Both the positive and the normative question are actually considered by Gilson, but he is ultimately unable to provide a satisfactory answer to any of them. One problem is that – contrary to what is often reported in the international comparisons – controlling shareholders are not just abnormally frequent in Sweden; virtually any listed company has one, so that endogenous private benefits of control cannot be the only explanation. Another problem is that the category of private benefits not arising from outside shareholder expropriation may be under-specified: non-pecuniary private benefits may account for different kinds of control rents having different impact on the wealth of non-controlling shareholders.

If it is not even non-pecuniary benefits that explain ownership concentration, what can? Sofie Cools has suggested that the answer may be, once again, corporate law, if only we approach it from a different angle.[32] Corporate law may not only determine ownership concentration in that it fails to protect non-controlling shareholders from the consequences of abuse of control powers. Paradoxically, it may also determine an identical result in that it fails to support the exercise of these powers, when they are not being abused by extraction of pecuniary private benefits. Ongoing exercise of corporate control in dispersed ownership structures requires legal support, indeed. Management could not stay safely in charge otherwise. In certain jurisdictions, directors cannot simply do without a controlling shareholder: they would constantly risk of being voted down at the general meeting and, worse enough, to be ousted by a takeover. Only when corporate laws feature a distribution of powers favoring the board of directors relative to the general meeting,

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[32] Cools, S. [2005], *The Real Difference in Corporate Law between the United States and Continental Europe: Distribution of Powers*, in DELAWARE JOURNAL OF CORPORATE LAW, vol. 30, 697-766.

managerial control becomes feasible. Actually, besides the policing of private benefits of control, this is exactly what happens in the US. Contrariwise, in most jurisdictions of continental Europe, shareholders are just too powerful to allow for managerial control, regardless of how well they are protected from expropriation. One exception is the Netherlands, where shareholders are less powerful and, as expected, concentration of ownership is somewhat lower than in the rest of the continent.

Legal distribution of powers may be an important piece of the puzzle. It nicely tells us how separation of ownership and control may occur differently all else being equal, but still does not tell us why. Others have tried to answer this question. Edward Rock and Michael Wachter have based their analysis of distribution of powers under US (Delaware) corporate law on managerial firm-specific investments.[33] Within the Law and Economics scholarship, they are so far the only authors who have attempted a straight departure from the agency perspective and analyzed the corporation as a response to pervasive contractual incompleteness. Their results are amazingly consistent with the state of American law.

In the US, outside shareholders are particularly well protected from expropriation by corporate controllers, whether these are managers or controlling shareholder, but may expect little else from corporate law. Centralized management, as featured by the board of directors, has all of the remaining entitlements concerning decision-making. The reason is that the corporate structure copes with the limits of contracting, and therefore it features *power* as a way to deal with unforeseen contingencies. This provides managers with the incentives to specialize their skills to the corporate enterprise, as long as they can keep control over the firm's assets uncontested. Since managers are not expected to behave just like agents, shareholders are not entitled to get rid of them anytime they may find it profitable. Still, how management is induced to provide shareholders with commensurate profits is not entirely clear in this framework. According to Rock and Wachter, the answer is to be found in social norms as a fundamental guarantee of incentive-compatibility. Apparently, the state of knowledge about incomplete contracts does not allow for any better solution.

In the economics of incomplete contracts, the question of how ownership can be separated from control still awaits a final answer. Perhaps the most important achievement of this literature is that ownership should be bundled with control rights. This is the fundamental tenet of the property rights theory of the firm, which, however, is ultimately a theory of sole proprietorships. Economists have

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[33] Rock, E.B. and Wachter, M.L. [2001], *Islands of Conscious Power: Law, Norms and the Self-Governing Corporation*, in UNIVERSITY OF PENNSYLVANIA LAW REVIEW, vol. 149, 1619–1700.

tried to explain incomplete financial contracting in spite of that. Philippe Aghion and Patrick Bolton have provided a very interesting theory of debt on that basis.[34] These and other eminent economists have also tried with equity, but the results are not as satisfactory.[35] The problem is that allocation of control rights to any constituency other than shareholders is extremely difficult to reconcile with the property rights theory. One way out of this is to assume that separation of ownership and control is not for real, but is in fact a separation between *de jure* and *de facto* authority.[36] This has been framed in several different models, whose bottom line is that shareholders are formally entitled to control rights but may refrain from exercising them against the management in a number of circumstances. The threat that these rights are exercised is a fundamental device for aligning managerial incentives with shareholder interest. Conversely, a credible commitment not to exercise them is the only way to preserve managerial incentives to make firm-specific investments. Unfortunately, this framework allows no way out of a tradeoff between shareholders' security benefits (stock returns) and managers' private benefits of control.

This tradeoff is currently the most serious challenge for economic theory of separation of ownership and control. Curiously enough, this is also the conclusion that research in Corporate Law and Economics has reached. Private benefits of control are most probably the key to the solution. Luigi Zingales has nicely characterized them as evidence of an *appropriability* problem concerning the value of corporate control, which has not yet been completely understood by the theory.[37] The principal-agent framework does not even feature this problem. The incomplete contract framework does, but is in trouble when it comes to solving the appropriability and the incentive-compatibility problems simultaneously. Zingales has ultimately attempted, with Raghuram Rajan, to "search for new foundations" in a stakeholder theory of corporate governance, which allows for control rents to be appropriated through sources of power alternative to ownership.[38] These sources are considered to be extralegal, but this is quite at odds with the positive attitude of corporate laws.

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[34] Aghion, P. and Bolton, P. [1992], *An Incomplete Contracts Approach to Financial Contracting*, in REVIEW OF ECONOMIC STUDIES, vol. 59, 473-494.

[35] See, e.g., Burkart, M., Gromb, D. and Panunzi, F. [1997], *Large Shareholders, Monitoring, and the Value of the Firm*, in QUARTERLY JOURNAL OF ECONOMICS, vol. 112, 693-728; Hart, O. [2001], *Financial Contracting*, in JOURNAL OF ECONOMIC LITERATURE, vol. 39, 1079-1100.

[36] This approach is based on Aghion, P. and Tirole, J. [1997], *Formal and Real Authority in Organizations*, in JOURNAL OF POLITICAL ECONOMY, vol. 105, 1-29.

[37] Zingales, L. [2000], *In Search of New Foundations*, in JOURNAL OF FINANCE, vol. 55, 1640.

[38] Zingales, L. [2000], *op. cit.*, 1623-1654; and Rajan, R.G. and Zingales, L. [1998], *Power in a Theory of the Firm*, in QUARTERLY JOURNAL OF ECONOMICS, vol. 113, 386-432.

In reality, it seems that law worries much more than economic theory about protection of control rents: either it allows managers to fend off hostile takeovers or provides controlling shareholders with equivalent devices to that purpose. Stakeholder protection is often the alleged reason, but incumbent controllers are always those who gain from these legal arrangements. Martin Hellwig – the economist who has brilliantly made these points – is not worried, however, that non-controlling shareholders stand to lose from entrenchment of corporate control. Inefficiency of this outcome is just the received wisdom, which he finds unconvincing. Whether or not entrenchment actually results in inefficient allocation of managerial and financial resources depends on the performance of the market for corporate control.[39]

Another economist has approached the problem from a similar standpoint. Colin Mayer explains entrenchment of corporate control on the basis of a special category of private benefits of control, which have nothing to do with those (either pecuniary or non-pecuniary) that are featured by traditional agency theories.[40] He claims that these benefits, which he does not define, do not amount to reduction of wealth available to non-controlling shareholders, but simply account for entrepreneurial activities that markets are unable to reward. The same benefits are not entirely innocuous to outside shareholders, though. After some time, markets may become able to improve the allocation of corporate control, but still be prevented from doing so by the size of existing control rents. This is germane to the appropriability problem described above. None of the authors that I have mentioned has discussed how the market for corporate control may solve this problem efficiently. One of the purposes of the present dissertation is to combine this with a comprehensive theory of Corporate Law and Economics that matches empirical evidence. We do not have yet such a theory.

Purpose of Research

The central research question of this inquiry is exactly the one which both legal and economic theory has been unable to answer so far: how corporate law matters

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[39] Hellwig, M. [2000], *On the Economics and Politics of Corporate Finance and Corporate Control*, in X. Vives (ed.), CORPORATE GOVERNANCE: THEORETICAL AND EMPIRICAL PERSPECTIVES, Cambridge University Press, 95-134.

[40] Mayer, C. [1999], *Firm Control*, Inaugural Lecture at the University of Oxford (February 18, 1999), available at www.finance.ox.ac.uk, as published in J. Schwalbach (ed.) [2001], CORPORATE GOVERNANCE: ESSAYS IN HONOR OF HORST ALBACH, Springer-Verlag.

for corporate governance and its efficiency. The question is two-sided. It includes a positive account – the impact of legal rules on corporate governance; but it also has a normative dimension – what are 'good' rules for corporate governance. I am addressing the question from a comparative Law and Economics perspective. This means that diverging corporate laws of several jurisdictions are analyzed based on their consequences on economic incentives of individuals, and they are assessed on the basis of economic efficiency of resulting behaviors. The methodological implications of this approach, as applied to the study of corporate governance, will be discussed in the next section.

The research question is ambitious. It is clearly impossible to consider all factors potentially affecting its answer. We need to identify the most relevant ones. To this purpose, the question is divided in a sequence of sub-questions. The answer to each provides the basis for selection of the relevant issues.

The first sub-question is how corporate governance works: we need a framework for analyzing the phenomenon, before we can discuss the impact of its legal discipline. Based on the ongoing debate in the economic and legal analysis of corporate governance, I choose private benefits of control as such a framework.

The second sub-question is how private benefits of control affect efficiency of corporate governance, or what the consequences of private benefits of control are on social welfare. Stakeholders potentially enter the definition of social welfare, so whether they are affected by corporate governance needs to be assessed beforehand. If this is not the case, the next question is how private benefits of control affect the joint welfare of the two remaining constituencies: corporate controllers and non-controlling shareholders. The two categories are defined as broadly as to suit both managerial control and shareholder control systems. I contend that the answer to this question rests upon a qualitative distinction between three categories of private benefits having different welfare implications. In order to make discussion intuitive, I provisionally describe these three categories of private benefits as the 'good,' the 'bad,' and the 'ugly.'

The third sub-question is how corporate law affects each category of private benefits of control. This involves consideration of three major areas of regulation of corporate governance. The first is legal distribution of corporate powers, determining how 'good' private benefits can be appropriated by corporate controllers. The second is legal discipline of conflicted interest transactions, setting constraints on the extraction of 'bad' private benefits of control. The third is regulation of corporate control transactions, affecting the way in which 'ugly' benefits are minimized by the market for corporate control. With respect to each area, I formulate predictions on how different corporate laws make separation of ownership and control differ from country to country, and on whether the outcomes are efficient. The positive account of these predictions is tested through the analysis of corporate governance and its regulation in a five-country case study. When the test is successful, the theory of private benefits of control underlying the predictions may be considered as sufficiently robust to deliver normative implications for economic policy of corporate law.

This is how the present dissertation will try to answer the research question.

Two Alternative Hypotheses about Corporate Governance

In order to understand how corporate governance works one has to start from the empirical evidence. Internationally, the evidence shows two major patterns of separation of ownership and control: managerial control – where no shareholder is large enough to exert control and a professional management is in charge; and shareholder control – featuring one large shareholder, or a coalition of them, in control of firm management. Each pattern is chosen at two levels. At the firm level, the choice depends on the market conditions for the exchange of non-controlling stock. Under either pattern, control is hardly ever made contestable through deconcentration of ownership. At the country level, the choice depends on how institutions affect the market conditions. In some countries, managerial control is hardly featured; in others, shareholder control is very infrequent; few countries feature both patterns. There is apparently no set of institutions that rules contestability of control, no matter of how this is separated from ownership.

Scientific interpretation of facts is based on theoretical assumptions, which may be accepted inasmuch as the theory matches the evidence. One standard hypothesis in theoretical analyses of corporate governance is that *protecting control and its rents is unimportant*.[41] This is based on the idea that controllers perform towards non-controlling shareholders the duties of an agent. As far as private benefits of control are concerned, this hypothesis has one thesis and two corollaries. The thesis is that extraction of private benefits undermines separation of ownership and control and its efficiency. One corollary concerns the choice of the corporate governance pattern under this premise: this choice depends on the alignment of incentives of the controlling agent, which in turn depends on minimization of private benefits of control. The second corollary is about the range of feasible choices: ability to minimize private benefits of control depends on institutional and legal constraints on their extraction by the controlling agent. The first corollary is contradicted by

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41 See, authoritatively, Hart, O. [1995], FIRM, CONTRACTS, AND FINANCIAL STRUCTURE, Oxford University Press, 126.

the evidence on hostile takeovers, which would indeed align the agents' incentives, but are short-circuited in nearly every arrangement as to separation of ownership and control. The second corollary is contradicted by the fact that managerial control seems not to be an option also in those institutional environments where the average level of extraction of private benefits from shareholder wealth is low.

The thesis itself cannot be falsified, however, and I conjecture that it may just be too narrow because of the wrong hypothesis. Therefore, I advance the opposite one: *protection of control and its rents is important in corporate governance.* This is based on the idea that controllers are not just shareholder agents, but entrepreneurs who do not entirely own the firm's assets. The thesis about private benefits of control becomes now that they need to be featured in corporate governance, inasmuch as they do not undermine incentive-compatibility of equity finance. This brings about three major corollaries. First, separation of ownership and control requires willing sellers of the company's stock: controllers would stop deconcentrating ownership as soon as this involves that control and its private benefits are endangered. Second, separation also requires willing buyers: the stock demand is negatively affected by the risk that private benefits are extracted at the non-controlling shareholders' expenses. Third, the range of feasible ownership structures is affected on two prongs by institutions and the law: on the one hand, this range depends on constrains placed on shareholder expropriation: on the other hand, it depends on opportunities given for protection of control rents.

The last hypothesis seems to fit empirical evidence better. It is consistent with the lack of contestability of corporate control that we observe in the real world. It is not contradicted by ownership concentration in those countries where expropriation of minority shareholders does not seem to be an issue. As such, it provides a good basis for answering the next sub-question.

A Framework for Welfare Assessment of Private Benefits of Control

At first glance, stakeholders may appear to be a major matter of concern for welfare analysis. When the principal-agent framework is rejected as incomplete, shareholders no longer enjoy a special position among the corporation's constituencies. Exercise of control, and extraction of rents from it, may harm stakeholders as well. This concern may be unwarranted. Private benefits of control may be a problem for stakeholders if the latter are also to be compensated through rents for some specific investment of theirs. However, this hypothesis is rejected if corporate governance does not require stakeholders' investment to be firm-specific. Another problem may be that the controller-shareholders arrangements as to *their* firm-specific investments may generate externalities on stakeholders. This hypothesis is also rejected if the problem of externalities on stakeholders depends on how business is conducted, and not on how ownership is separated from control.

In the relationship between corporate controllers and non-controlling shareholders, welfare analysis of private benefits of control may be conducted on the basis of the distinction between rents and quasi-rents. This distinction has a longstanding tradition, dating back to Alfred Marshall.[42] Quasi-rents are the prospective reward to inventiveness, whereas rents are the ongoing reward to incumbency. Two important strands of literature may be brought together in this way: one is the theory of entrepreneurship; the other is the theory of the firm. Since Ronald Coase's *Nature of the Firm*, these two theories have hardly communicated with each other.[43] The loopholes of the incomplete contract theories of the firm, when it comes to separation of ownership and control, leave ample scope for integrating entrepreneurship into the analysis of corporate governance.

In contract theory, quasi-rents are non-contractible rewards to investments in relationship-specific assets. According to transaction costs economics, asset specificity depends on the identity of the investing party: firm-specific investments by any constituency are therefore characterized as 'idiosyncratic.'[44] According to the property rights theory, rewards on idiosyncrasy are instead appropriated just by the owners of the physical assets being specialized.[45] Both approaches try to explain why firms exist. However, they do not entirely explain entrepreneurship, which involves the highly peculiar idiosyncrasy of inventiveness in management, but "for which ownership is never a condition."[46] Corporate governance may indeed feature entrepreneurship. This requires that quasi-rents be allocated as a reward of managerial talent, independently of ownership of the underlying assets. I define these quasi-rents as *idiosyncratic* private benefits of control; and I maintain as an assumption that they must be featured by separation of ownership and control in order for corporate governance to work.

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[42] Marshall, A. [1893], *On Rents*, in ECONOMIC JOURNAL, vol. 3, 74-90. In contemporary economics, the concept of quasi-rents has been popularized by Klein, B., Crawford, R.G. and Alchian, A.A. [1978], *Vertical Integration, Appropriable Rents and the Competitive Contracting Process*, in JOURNAL OF LAW AND ECONOMICS, vol. 21, 297–326.

[43] Coase, R.H. [1937], *The Nature of the Firm*, in ECONOMICA, vol. 4 (New Series), 386-405. After Coase's criticism of Knight, F.H. [1921], RISK, UNCERTAINTY, AND PROFIT, Houghton Mifflin, the theory of the firm has been separated from the theory of entrepreneurship.

[44] Williamson, O.E. [1979], *Transaction-Cost Economics: The Governance of Contractual Relations*, in JOURNAL OF LAW AND ECONOMICS, vol. 22, 233-261.

[45] Grossman, S.J. and Hart, O. [1986], *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, in JOURNAL OF POLITICAL ECONOMY, vol. 94, 691-719.

[46] Kirzner, I.M. [1979], PERCEPTION, OPPORTUNITY, AND PROFIT, University of Chicago Press, 94.

At the outset, idiosyncratic private benefits are harmless to non-controlling shareholders. These quasi-rents are of no value to anybody but the entrepreneur. What makes entrepreneurs important in the economy is exactly that they are able to foresee profit opportunities that markets are unable to price. In corporate governance, this means that the value of corporate control to the entrepreneur is higher than to anybody else. This situation is allocatively efficient. The private benefits at issue may be thus characterized as the 'good' ones. However, things may change over time. Eventually, another entrepreneur may qualify as a better manager; but protection of idiosyncratic private benefits may still be a sufficient reason for the incumbent to prevent the insurgent from taking over. Whether and to what extent idiosyncratic private benefits effectively undermine the efficient dynamics of control allocation is a fundamental question of this inquiry.

Other kinds of private benefits of control may deserve a more severe judgment. To start with, they have no quasi-rent feature. This is exhausted by idiosyncratic private benefits, and so any other kind of such benefits qualifies as just rents. Separation of ownership and control allows for these rents to be extracted in two different fashions. One is outright diversion of firm's assets and profits from non-controlling shareholders. The other is distortion of management decisions aimed at maximizing consumption of control perquisites rather than the firm's profits. I define the rents arising from the first kind of behavior as *diversionary* private benefits of control, and those arising from the second kind as *distortionary* private benefits of control.[47]

Diversionary private benefits account for 'stealing' in its broadest characterization. Welfare assessment of stealing is not a novel subject in Law and Economics. *Ex post*, stealing may look like a mere redistribution of resources, which already exist, so that – paradoxically – it may seem neutral to overall social welfare. However, it is not for at least two reasons. The first is that, in general, any effort taken to implement or to prevent stealing is a waste of resources. In corporate governance, there is a second and even more important reason for inefficiency: the risk that stealing is operated *ex post* reduces investors' willingness to pay for non-controlling stock *ex ante*, thereby raising the cost of equity capital all else being equal. A rational corporate controller would be willing to commit to a no-stealing policy at the outset, in order to maximize the proceeds from the sale of non-controlling stock. However, to the extent that this commitment is not credible, diversion is always implemented *ex post* and less separation of ownership and control than would be optimal occurs *ex ante*. In this perspective, diversionary private benefits are certainly the 'bad' ones.

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[47] I am borrowing this terminology from Mayer, C. [1999], *op. cit.*, 7.

Distortionary private benefits of control crudely account for bad management of the firm's resources. This is intuitively illustrated by a broad notion of 'shirking:' a non-owner manager will always put a lower effort than he could in the management of the resources under control, and consume some of them in the form of perquisites. In economics, this is understood as an opportunity cost – that is, the value of the next best use of the same resources. Under separation of ownership and control, extraction of perquisites will continue until it is worth far less to the controller than it costs to the owners as a whole. Therefore, distortionary private benefits are always extracted in an inefficient amount, whether they are considered in an *ex ante* or in an *ex post* perspective. Unfortunately, there is not much we can do about it. Separation of ownership and control can only generate second best outcomes. This is perhaps the most important result of the agency theory of corporate governance. Distortionary private benefits of control are nothing but an illustration of agency costs. In spite of their adverse effects on efficiency, they can only be characterized as 'ugly.'

The matter is more complicated in a dynamic perspective. Conditions for second best are subject to change. The market for corporate control is the place where these changes are handled. The prevailing interpretation of this dynamics is that diversionary and distortionary private benefits of control stand in a tradeoff relationship: the latter may be minimized by hostile takeovers on condition that prospective acquirers are entitled to appropriate the former to some extent. However, hostile takeovers are more in law and finance textbooks than in the real world. Having disallowed them by protection of idiosyncratic control rents, I wonder whether the market for corporate control could also be efficiently operated via friendly takeovers. I shall therefore discuss a scenario where idiosyncratic private benefits set a constraint on dynamic minimization of distortionary private benefits, and efficient allocation of corporate control may be achieved through side payments on condition that diversionary private benefits do not interfere with the process. As I will show, both the static and the dynamic conditions of this scenario require support by corporate law.

Three Predictions about Corporate Law's Impact on Corporate Governance

How the three categories of private benefits of control are dealt with in corporate governance depends on institutions, which determine the range of feasible contractual arrangements as to separation of ownership and control and the degree of efficiency that may be reached thereby. In order to assess the role of legal rules in this context, I posit that corporate law affects separation of ownership and control via its impact on each category of private benefits of control described above. This implies that how corporate law 'matters' for corporate governance can be summarized in the following three predictions.

Prediction 1: Law and Investor Protection

Law matters as a device supporting protection of non-controlling shareholders against *diversionary private benefits* that may be extracted by the corporate controller. Effective protection makes separation of ownership and control a workable way to finance business, whereas ineffective protection hampers it.

The prediction is not novel: it lies at the core of the standard 'law matters' argument.

Prediction 2: Law and Support of Corporate Control

Law also matters for separation of ownership and control in that it protects the corporate controller's *idiosyncratic private benefits*. Corporate law is a source of entitlements to firm control independent of corporate ownership, affecting the distribution of powers between the corporate controller and non-controlling owners. Once shareholders have been protected from expropriation of their investment, distribution of corporate powers determines the degree of separation of ownership and control that can be afforded by entrepreneurs concerned with their control rents.

The prediction is partly novel: although the importance of distribution of legal powers for separation of ownership and control has been recently highlighted by the literature, no connection with the role of control rents in corporate governance has yet been made.

Prediction 3: Law and the Market for Corporate Control

Law does not only matter statically, in that it supports the exercise of power by the corporate controller and constrains its abuse. It also matters dynamically, in the same two respects, in that it promotes the allocation of corporate control to the best managers while preventing non-controlling owners from being exploited through unfair control transactions. *Insufficient protection* of non-controlling shareholders leads to concentrated ownership structures where the efficiency of the market for corporate control is impaired by value diversion. However, *excessive shareholder protection* may prevent insurgents from compensating the incumbents' control rents through the proceeds of efficient control transactions. Eventually, this leads to excessive consumption of *distortionary private benefits* under too dispersed or too concentrated ownership structures.

The prediction is basically novel: both the consequences of managerial control rents on the takeover mechanism and the effects of minority shareholder protection on the acquirer's incentives have been dealt with in previous literature, but they have always been considered separately.

Depending on how we look at private benefits of control, these predictions are both positive and normative in character. They might be questioned on either account. In order to verify whether they provide a satisfactory answer to the research question, I am testing their positive contents against the empirical evidence. This requires that corporate laws be compared between countries whose prevailing patterns of separation of ownership and control differ. For the reasons that I shall clarify momentarily, I do not perform a quantitative analysis, but a qualitative one. I am checking the effects that *any* regulatory factor having a bearing on each prediction produces on the corporate governance of a restricted sample of countries. These factors pertain to three different *functional* areas of corporate law, namely: i) conflicted interest transactions; ii) distribution of powers; iii) corporate control transactions.

According to the mainstream view, only the first one really matters in that it counters the extraction of diversionary private benefits of control. Therefore, selection of the countries of the sample is based on a falsification criterion. I pick five countries that, for different reasons, cast some doubts on the validity of the standard account of how law matters. These countries are Italy, the US, the UK, Sweden, and the Netherlands. If legal analysis based on the three above-mentioned predictions matches corporate governance patterns in this five-country case study, the theory I am advocating has higher explanatory power than the mainstream view about Corporate Law and Economics. At least in the restricted domain of the countries sample, I feel therefore comfortable enough to extend the discussion to how corporate law should be, based on welfare analysis of private benefits of control.

Methodology

This research is carried out with a straightforward Law and Economics approach. In spite of the long-standing tradition of economic analysis of law, legitimacy of this approach is still questioned in some fields of legal analysis. Not in corporate law. This should be already clear from the foregoing illustration of the state of the art, and therefore issues of legitimacy of Corporate Law and Economics are not worth discussing any further. Nevertheless, the approach being taken here has a number of specificities that deserve a brief illustration.

To start with, a prominent implication of the comparative feature is that the analysis of corporate laws is purely functional. Legal rules are considered regardless of their *nomen juris*, and are selected on the basis of their ability to influence behaviors which are relevant to the subject-matter of this study: that is, those behaviors affecting separation of ownership and control via the extraction of control benefits of three kinds. It follows that the strength of legal analysis depends more on the quality of selection than on its inclusiveness.

The comparative approach has also important implications on the economic side. As I am not taking any *a priori* as regards 'most important' rules in corporate law, but consider any of them as potentially suitable for addressing the problem of private benefits of control, I am also considering any pattern of separation of ownership and control as a potentially efficient way to combine rewards to entrepreneurship with equity finance. This means that I am not making the assumption that an optimal model of corporate governance exists across the board. Likewise, I do not expect corporate law to be optimal in that it supports a single pattern of separation of ownership and control. Whether corporate law is efficient or not should rather depend on its ability to promote the choice of the optimal governance and ownership structure at the firm level. Empirical analyses have been unable so far to reject the hypothesis – famously advanced by Harold Demsetz – that corporate governance is endogenous to the business.[48] Others have approached comparative Law and Economics of corporate governance under this assumption;[49] but the results are heavily biased by reliance on the agency paradigm, which may be ultimately irreconcilable with it.

The functional approach to both the analysis of legal rules and the interpretation of economic evidence also explains why the theoretical predictions concerning the role of private benefits of control, and the impact of corporate laws thereon, are not tested with a quantitative methodology. In spite of the popularity of "numerical comparative law" inaugurated by *Law and Finance*, this approach has currently a number of practical shortcomings and perhaps a structural one.[50] So far, the econometrics of legal rules has been quite sophisticated as to the statistical methodology, but not as much as regards collection of data for legal comparison and, to

[48] Demsetz, H. [1983], *The Structure of Ownership and the Theory of the Firm*, in JOURNAL OF LAW AND ECONOMICS, vol. 26, 375-390.
[49] Gilson, R.J. [2006], *op. cit.*
[50] The expression "numerical comparative law" has been coined by Siems, M. [2005], *Numerical Comparative Law - Do We Need Statistical Evidence in Order to Reduce Complexity?*, in CARDOZO JOURNAL OF INTERNATIONAL AND COMPARATIVE LAW, vol. 13, 521-540.

be sure, not even as far as descriptive statistics about ownership and control patterns are concerned. While I believe that the latter problem may be, at least partially, cured (and this is the reason why one entire chapter of the present dissertation is devoted to descriptive statistics of comparative corporate governance), I seriously doubt that separation of ownership and control can be explained on the basis of a single scale, or index, of measurement of corporate law's quality.

In order for legal comparison to be functional, all rules potentially affecting the explanatory variables of corporate governance should be considered. Having identified such variables in a tripartite account of private benefits of control surely helps in reducing the scales of measurement to a finite number. However, every jurisdiction is likely to affect each category of private benefits in a different fashion, and the number of jurisdictions to be considered must be sufficiently large in order for statistical inference to make any sense. The consequence on the definition of the indexes of comparison is twofold. On the one hand, we would need an algorithm to transform in quantitative ranking the qualitative impact of national rules on private benefits of control. On the other hand, if we want the sample of jurisdiction to be suitable to statistical inference, the amount of legal information to process for both qualitative analysis and its consistent reduction to numbers would be huge. Unfortunately, neither we have one such algorithm, nor does any single researcher (or group of them) have sufficient knowledge of corporate laws around the world to allow for its construction. For this reason, the legal and economic comparison of the present work is undertaken for just five jurisdictions. In this domain, predictions of the theory are tested on a qualitative basis, depending on *how* – and not also on *how much* – each functional area of corporate law affects extraction of private benefits of control and, in turn, separation of ownership from control and its efficiency.

One last methodological *caveat* is about the interdisciplinary of the analysis. This may seem straightforward, given the choice of a Law and Economics approach. However, making sense of interdisciplinarity requires that the discussion be equally intelligible and interesting to economists and lawyers. Many papers in today's Corporate Law and Economics do not have this feature. Either legal or economic analysis is overly technical. Some legal inquiries are so deeply embedded in the technicalities of the jurisdiction being analyzed (which is, most often, federal and/or state law in the US) that economists are hardly able to recognize what is relevant for the economics of corporate governance. The majority of economic analyses of corporate governance are based on highly formalized models featuring a very stylized account of legal rules. Lawyers seldom read more than introduction and conclusion of those papers, and they would stop reading even earlier when they do not recognize the actual contents of corporate law in the stylized description.

Yet these two worlds have much to learn from each other, if only interdisciplinary communication managed to be put through.

The intuition of the thesis being defended in the present dissertation comes from years of study of comparative corporate law: it is remarkable how, in so many jurisdictions, featuring corporate control is at least as important as protecting shareholders from its abuse. However, economic rationales and implications of that are understood on the basis of the highly sophisticated treatment of contracting and institutions in formalized models. Over the past decades, economic theory of corporate governance have addressed most issues of incentive alignment and allocation of bargaining power under uncertainty, and how institutions, including corporate law, shape the range of feasible contracts in these respects. Besides its thesis, one major novelty of this work is the attempt to bring together comprehensively these two areas of knowledge. While I am taking stock of both in-depth legal analysis and formal economic models, I am just presenting the results of this investigation as a combination of *functional* legal disciplines and *informal* economic mechanisms. I refrain as much from dogmatic illustration of legal institutions as from the use of mathematics in explaining individuals' behavior. In spite of what I had to go through to retrieve the underlying information, I believe that this style of presentation is the best way to interpret the interdisciplinary character of the research.

As anything in economics, and most probably also in life, this approach comes with a price to pay. Elements of novelty in the interpretation of Corporate Law and Economics that I am advocating are discussed by arguments of consistency between positive law and existing economic theory, but not also with the force of legal theory or mathematics. Legal categorization and economic formalization of the framework that is going to be presented are very interesting topics for future research in either law or economics.

Research Outline: Structure and a Roadmap

Both interdisciplinarity and the far-reaching character of this research have required the adoption of a very articulated structure. The book is therefore divided in three parts. The first deals with the massive amount of knowledge about corporate governance and its regulation that has been reached over the past few decades, and highlights what both theoretical and empirical analyses have been unable to explain so far. The second part introduces an alternative framework of analysis, based on three categories of private benefits of control and on how corporate law provides opportunities for and constraints to their extraction. The three predictions on how corporate law affects separation of ownership and control through regulation of private benefits are formulated on this basis. The third part is where these predictions are confronted with the five-country case study. I will attempt to demonstrate the explanatory power of this theoretical framework through the analysis of three major areas of corporate law in these countries, and of their bearing on the prevailing patterns of separation of ownership and control. The normative implications of the same framework for legal policy will then be discussed within each area of corporate governance regulation, and tailored to corporate laws of the five countries of the case study.

Scientific relevance of research is as easy to claim as difficult to demonstrate. The ambition of this research project as to both its purpose and its methodology has made inclusion of a large number of contents necessary. Research papers in corporate governance are often concluded with suggestive implications for the big picture. In spite of how much they add to our knowledge, they provide us with at best just one piece of the puzzle. Some of them match, whereas others apparently do not. The crucial point is that we do not have yet a clear view of the big picture, and this makes partial solutions of the puzzle as precious as not completely reliable. These solutions will be therefore discussed in a critical perspective in the first part of the dissertation, in order to take stock of them in the following attempt to reconstruct the big picture. The interdisciplinary approach makes discussion of the three basic accounts from where existing knowledge is retrieved (empirical, theoretical, and legal) particularly lengthy. However, it also allows for shortcuts to be highlighted depending on the cultural background of the reader. The following illustration of the structure of research is accompanied by a roadmap for Corporate Law and Economics scholars, empirical researchers in corporate governance, and economic theorist in the same field.

That being said, contents of the research may still look somewhat over-inclusive. However, they are not. The careful reader will easily recognize that the many topics in corporate governance considered in this book all pertain to the core problem being analyzed (separation of ownership and control) just from the specific perspective being taken for its interpretation (private benefits of control). This criterion is sufficiently broad to allow for reconstruction of the big picture, but also sufficiently narrow to operate a selection of the relevant empirical, theoretical, and legal issues. The list of neglected subjects in corporate governance would be just too long to be reviewed here, so I make just one example concerning each of the above-mentioned strands of literature. In the empirical field, the identity of both controlling and non-controlling owners is not considered, thereby excluding the specificities of involvement of banks and other financial intermediaries. This matches the limited consideration for the role of institutional investors in the theoretical analysis, in spite of the increasing attention being paid to hedge funds by the literature. Finally, a prominent exclusion from Law and Economics analysis is the matter of regulatory competition – not to speak about all the regulations that are not pertinent to the relationship between controllers and non-controlling shareholders. Inasmuch neither one of the above-mentioned exclusions nor any other factor being neglected significantly affect private benefits of control, results of the analysis should be unchanged.

Part I – Theory and Evidence on Corporate Law and Economics

Chapter One is a presentation of corporate governance from both an economic and a legal perspective. It is a very special introduction to the subject-matter, for it is based on a non-technical discussion of players and problems. Separation of ownership and control is identified as the core issue, and this is analyzed as a problem of entrepreneur's access to finance. The corporate structure addresses this problem through a number of features customarily identified by economic analysis of corporate law. The major claim of this chapter is that those features fail to account for at least one player and one problem of real-world corporate governance: the player is the entrepreneur in his capacity as corporate controller; the problem is disenfranchisement of non-controlling shareholders. Consideration for the two could be integrated in Corporate Law and Economics if entrenchment of corporate control was considered as one additional feature of corporate governance, and not just as a distortion. The theory of entrepreneurship provides the scientific background of this hypothesis. Those who are familiar with both this theory and the standard framework of Corporate Law and Economics may proceed directly to other parts of the work.

Chapter Two deals with the empirical evidence about comparative corporate governance. This is necessary to assess the relevance of the research hypothesis – entrenchment of corporate control and disenfranchisement of outside shareholders – across different countries featuring different patterns of separation of ownership and control. Unfortunately, the empirical research available in this field is contradictory. On the one hand, this depends on our inability to ascertain how corporate control is exerted, and with how much ownership, with a single methodology suitable for all countries. On the other hand, this has also to do with limited availability of data and narrow assumptions for making them comparable across different countries. I address just the second problem by reconciling international comparisons with more precise studies at the national level. Also, I only consider the US and most economically developed countries in Europe. This chapter attempts to show that some countries feature more concentration of ownership (like, e.g., the

US) or just more controlling shareholders (like, e.g., Sweden) than they are normally credited for. In other countries (most notably in the Netherlands), controlling shareholders may account for much less than reported in the international comparisons. Regardless of diversity in the prevailing ownership structures, entrenchment of corporate control is what all systems of corporate governance seem to have in common. Empirical economists who are already aware of these results may not need to go through this chapter.

Does the existing theory of corporate governance match the evidence? *Chapter Three* attempts to answer this question. Here mainstream economic theories of the firm and of separation of ownership and control are critically reviewed. The traditional principal-agent framework apparently cannot explain how different patterns of corporate governance are featured in different countries, and how corporate law may influence the choice. Consideration for contractual incompleteness may possibly explain both things. Unfortunately, incomplete contracts theories of the firm have problems in featuring control as separated from ownership. On the one hand, the existing models seem to allow just for control rights to be delegated from shareholders to the management, under the threat of delegation being withdrawn in case of underperformance. On the other hand, contractual incompleteness opens the door not just to division of control rights between owners and managers, but also to legal protection of non-shareholder constituencies. While existing arguments against stakeholder involvement in corporate governance seem quite convincing regardless of the allocation of control between managers and shareholders, the upgrade of the agency framework based on delegation of control rights still does not entirely explain why we observe much less convergence in corporate governance, corporate laws, and contestability of corporate control than the theory would predict. These are quite well known problems for economists, but much less so for lawyers, who may therefore find the discussion of current limitations of economic theory interesting.

A relatively autonomous line of inquiry is based on institutional analysis. As far as corporate governance is concerned, institutions may explain not only why patterns of separation of ownership and control differ between countries, but also why contestability of corporate control fails to occur. *Chapter Four* deals with this approach, which currently provides the most popular explanation of comparative corporate governance: the famous 'law matters' thesis. An often-neglected circumstance is that this is the domain where *two* different schools of thought meet each other. On the one hand, economists stand with the strength of econometric analysis and the weakness of legal knowledge; on the other hand, Law and Economics scholars respond with a subtler account of mandatory and enabling rules in corporate law, but have often a weak case against a much too coarse statistical inference that ultimately works. I endeavor the difficult task of discussing together these two conflicting strands of literature and the limits that they both have in arguing why, how, and in which respects law matters for corporate governance. With very few exceptions, neither account considers the possibility that law may matter not only in that it restricts extraction of private benefits of control out of shareholder wealth, but also in that it allows protection of control rents that outside shareholders are unable to price (and yet they may wish to appropriate at a later stage). In this narrow configuration, even corporate law – either alone or in combination with other institutions – does not entirely explain international diversity in prevailing ownership structures and regularities in entrenchment of corporate control. Those who are already familiar with the limits of the standard 'law matters' story may wish to proceed further. Nevertheless, contributions of the Law and Economics scholarship to this debate should be of particular interest to the economists.

Part II – Rethinking 'Law Matters' in a Theory of Private Benefits of Control.

Chapter Five introduces the interpretation of corporate governance on the basis of a more comprehensive classification of private benefits of control. Most recent advances in Corporate Law and Economics have already suggested that the presence of private benefits of control not arising from shareholder expropriation may explain different outcomes in corporate governance, in spite of functional equivalence of corporate laws and of other institutional factors as to the protection of non-controlling shareholders. The problem with this approach is that principal-agent models, upon which it is based, do not really allow private benefits to enter corporate governance efficiently, for they are "at best diversionary and at worst distortionary."[51] However, the conclusion may be different once the agency paradigm is departed from and consideration for a third category of private benefits – the idiosyncratic ones – is added to the framework. I explore the hypothesis that how corporate governance is implemented at both the firm and the country level depends on interaction between all of these three kinds of private benefits, and not between just two of them. Characterization of control rents also as a prospective reward to idiosyncratic investments may allow for a more even welfare assessment of private benefits of control. It may be argued on this basis that, while diversionary private benefits undermine efficiency of corporate governance in the absence of adequate institutional constraints, idiosyncratic private benefits can justify entrenchment of corporate control. In this framework, distortionary private benefits

[51] Mayer, C. [1999], *op. cit.*, 7.

would be ultimately policed by a market for corporate control where takeovers are friendly, and not hostile. This explanation is consistent with the empirical evidence.

This suggests that entrenchment of corporate control may be not just a distortion of separation of ownership and control, as it is commonly understood, but rather one of its distinctive features. *Chapter Six* deals with how this feature is implemented in the corporate structure and with the conditions under which such an arrangement may be an efficient way to conduct and finance business. Implementation may require a legal distribution of powers whereby control rights are definitively *allocated* to the corporate controller, and not just *delegated* from shareholders. Unfortunately, this solution raises severe concerns of incentive-compatibility in the management of the corporate enterprise. Consistent with the traditional 'law matter' thesis, corporate law should also make sure that control powers are not abused through extraction of diversionary private benefits. This is necessary, but may be not sufficient. Corporate controllers should also be induced to part with control when a more efficient manager is available – i.e., when distortionary private benefits are not minimized. This problem may be handled through side payments compensating for the incumbent's idiosyncratic rents. The market for corporate control would be thus interpreted as an application of the Coase Theorem, and corporate law should accordingly cope with its frictions depending on transaction costs.[52] From the framework developed in this chapter, three predictions are derived on how as many key areas of corporate law affect corporate governance through the effects on private benefits of control.

Part III – Corporate Law and Economics Revisited

Chapter Seven discusses the second prediction (law and protection of idiosyncratic private benefits) through the analysis of distributions of corporate powers in the five jurisdictions of the case study.[53] The matter is addressed directly at its functional core: the distribution of decision rights between the board of directors and the general meeting of shareholders. Issues of board structure and stakeholder involvement in the appointment of board members are also considered. However, the focus is on whether directors may avail themselves of sufficient powers to exercise ongoing control and to resist ouster. The hypothesis is that these are crucial

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[52] See Coase, R.H. [1960], *The Problem of Social Costs*, in JOURNAL OF LAW AND ECONOMICS, vol. 3, 1-44. Those who are not familiar with Law and Economics should not expect to find any theorem enunciated in this or in any other publication by Ronald Coase.

[53] Sequence of predictions 1 and 2 is inverted for logical reasons: although distribution of powers is not considered in the standard 'law matters' framework, regulatory constraints on the abuse of control powers are better understood after the discussion of how these powers are featured by corporate law in the first place.

underpinnings of managerial control. Discipline of director's appointment and removal, regulation of the shareholder meeting's agenda and proxy voting, and legal devices for takeover resistance are analyzed in this perspective. The analysis is also extended to derogations to the one share–one vote principle, supporting dispersed ownership where controlling shareholders are the only option. Standard arguments in favor of empowerment of non-controlling shareholder are possibly reversed in this framework, and so are the traditional beliefs that: i) Dutch law empowers shareholders too little; ii) American law empowers directors too much; iii) the liberal attitude of Swedish law towards disproportional voting power is problematic. The opposite result may hold for the celebrated, but often little understood, shareholder friendliness of British company law.

Discussion of the first prediction (how corporate law protects non-controlling shareholders from extraction of diversionary private benefits) is divided in two chapters. *Chapter Eight* illustrates the discipline of conflicted interest transactions in functional terms. This is somewhat less immediate than in the case of distribution of powers. For instance, director's fiduciary duties and the discipline of corporate groups may seem to have little in common, but they are just two different approaches to regulation of related-party transactions. As shown in the Law and Economics literature, this regulation deals with just one kind of potential misbehavior by the corporate controller: that depending on *stealing* (diversionary private benefits), and not also that depending on *shirking* (distortionary private benefits). Legal interference with the second kind of behavior would involve second-guessing of management decisions, which courts are normally unwilling to undertake. Judicial abstention from reviewing business judgment is considered to be efficient by economic analysis. However, interference with business judgment is almost unavoidable in the scrutiny of related-party transactions. Their discipline is therefore analyzed as a tradeoff between discretion and accountability, or between false positives and false negatives in policing diversion of shareholder value. Efficiency of the three functional features of this regulation – disclosure, standards, and enforcement – will be assessed upon this criterion.

In *Chapter Nine* the functional framework is applied to the analysis of the five jurisdictions. The aim is to demonstrate that, contrary to the standard 'law matters' thesis, shareholder protection from self-dealing only partly explains dispersion of ownership. In addition, the discipline of related-party transactions is more accurately assessed in a functional framework than by the popular index methodology of international comparisons. It will be shown that Sweden features a limited degree of separation of ownership and control in spite of the high quality of investor protection due to *both* legal rules and social norms. Dutch corporate law – which otherwise supports dispersed ownership – will be analyzed with greater precision than in the international comparisons, showing that good quality of shareholder protection obtains from case-law elaboration on the general clauses of the civil code, from a specialized judiciary, and from a powerful procedure for private enforcement. American and British law also feature an overall strong shareholder protection, but their disciplines of related-party transactions seem to have much less in common than is told by received wisdom. Italian corporate law actually features weak protection of minority shareholders, but this may be not the sole responsible of ownership concentration. In addition, Italy may be not the only country where the balance between false positives and false negatives in policing diversionary private benefits could be improved. It will be suggested that reforms of independent directorships might fare pretty well in this regard, but also that it would be a mistake to address the matter at the EU level.

Discussion of the third prediction (how corporate law affects the market for corporate control) is also divided in two chapters. *Chapter Ten* sets the framework for analyzing friendly takeovers, on the assumption that hostility is ruled out of takeovers by the presence of idiosyncratic private benefits of control. How transaction costs undermine efficiency of the takeover process is analyzed in order to identify the role of corporate law. This may result in a relatively narrow set of conditions for value-*decreasing* takeovers, depending on extraction of diversionary private benefits, which need to be disallowed by regulation. However, in order for distortionary private benefits to be policed by the market for corporate control, regulation should encourage value-*increasing* takeovers too. This chapter will attempt to demonstrate that, contrary to the mainstream approach to takeovers, this problem is not necessarily solved as a tradeoff between shareholder protection and efficient allocation of corporate control – which typically provides the rationale for mandatory bid regulation. Takeover regulation may be more efficient when it provides for an optimal discipline of squeeze-out coupled with a ban on takeovers having looting purposes. This can make the case for mandatory bid very weak, regardless of whether ownership is dispersed or concentrated.

Chapter Eleven tests the third prediction based on the functional results of the previous chapter. Shareholder protection in takeovers may compromise the operation of the market for corporate control not merely because there is too much or too little of it, but more importantly because it is implemented in the wrong fashion. This point is first discussed through the comparison of the two leading models of takeover regulation, the American and the British one. They have just opposite attitudes towards the key aspects of the discipline: shareholder protection is either implemented by fiduciary duties or by a mandatory bid; regulation of control premia and managerial severance payments is either very permissive or very restrictive; takeover resistance is either allowed or prohibited. Contrary to what is often argued, hostile takeovers are extremely rare events not only in the US, but also in the UK. Nevertheless, insistence of British law on equal treatment of shareholders seems to result in a somewhat lower frequency and performance of friendly takeovers. The drawbacks of the mandatory bid may be much more severe in continental Europe, due to higher ownership concentration than in Britain. Emulation of the British model by the EC Takeover Directive might have been therefore most unfortunate. Not only harmonization has failed in a number of key respects, but the ability of European jurisdictions to support an efficient market for corporate control may depend on circumvention of the few items that have been ultimately harmonized – most notably, the mandatory bid. An analysis of national policies towards implementation of the Directive will be conducted on this basis.

The major results of this dissertation are summarized in a final chapter of *Conclusions*. Taking inspiration from the tradition of doctoral defenses at the Universities of the Netherlands, they will be articulated and briefly discussed in the form of propositions. A number of avenues for future research will also be highlighted.

PART I

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THEORY AND EVIDENCE ON CORPORATE LAW AND ECONOMICS

CHAPTER ONE – Corporate Governance: Players and Problems

1.1. The Core Problem of Corporate Governance

1.1.1. The Problem to Be Analyzed

Defining a very popular expression, such as 'corporate governance', is always a daunting task. Different people attach different meanings to the same words. There is obviously little question about the literal meaning of corporate governance: it is simply the way in which firms established in the legal form of a corporation are governed.[1] Disagreement arises on the implications of a more elaborated semantics. Surveying the terms of this debate is not the purpose of the present inquiry.[2] It is for this reason that – perhaps unconventionally – I do not start by providing a definition of corporate governance, and I shall discuss existing definitions only at a later stage.[3] What this work attempts to investigate is why there is a problem of corporate governance, what lies at its core, and what economic and legal mechanisms are in place, or can be devised, to solve this problem.

Why governing a corporation should be a problem at all? Perhaps the most intuitive answer is because a corporation has a special kind of financiers, who share in the ownership of the firm but are not necessarily entitled to participate in the deci-

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1 For an interesting discussion of the origin of the idiom "corporate governance", and of why it has become so important today, see Becht, M., Bolton, P. and Röell, A. [2002], *Corporate Governance and Control*, ECGI Finance Working Paper No. 02/2002, available at www.ssrn.com and www.ecgi.org, as published in G. Constantinides, M. Harris, and R. Stulz (eds.) [2003], HANDBOOK OF ECONOMICS AND FINANCE, North-Holland.

2 For two excellent surveys, see Shleifer, A. and Vishny, R. [1997], *A Survey of Corporate Governance*, in JOURNAL OF FINANCE, vol. 52, 737-783; and Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*

3 See *infra*, Chapter Six, section 6.1.

sions on how the firm is to be managed.[4] These financiers are the *shareholders*. Shareholders have a very special (and difficult) position among financiers. They provide funds to the firm, but what they receive in exchange is nothing but the promise to share in a future and uncertain stream of profit. The realization of this profit, however, is not entrusted to shareholders, or at least not to all of them. It is entrusted to somebody who may, or may not, be a shareholder himself. I shall henceforth refer to this individual as to the firm (or the corporate) *controller*.[5]

The nature of shareholder claim on the firm's assets has a very special feature compared to a typical ownership claim. Normally, property rights over an asset confer the entitlement to both the asset management (*control rights*) and its profit stream (*cash flow rights*).[6] The ownership of a corporate enterprise works quite differently. On the one hand, shareholders are entitled to all the revenues from the firm activity which have not been assigned to any other provider of inputs. Having the status of owners of the enterprise, shareholders are *residual claimants*, so they are those ones with the strongest interest in the maximization of the firm's profits and the firm value.[7] On the other hand, they are not necessarily in control of the assets they own. Differently from the typical owner, shareholders who are not also the corporate controllers (non-controlling shareholders) do not have *residual rights of control*: that is, the rights to discretionally manage the firm's assets in circumstances not disciplined by any contract entered into by the firm.[8] For the reasons and in the ways that will be analyzed throughout this work, residual rights of control are held just by the firm controller.

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4 Hellwig, M. [2000], *On the Economics and Politics of Corporate Finance and Corporate Control*, in X. Vives (ed.), CORPORATE GOVERNANCE: THEORETICAL AND EMPIRICAL PERSPECTIVES, Cambridge University Press, 95-134.

5 To be sure, the corporate controller need not be a single individual. The corporate practice shows many instances of plurality of corporate controllers. However, when there are two or more people exerting ultimate control over a publicly held corporation, they typically do it as a *coalition*. See, in this regard, the discussion of alternative models of corporate governance in Chapter Two. Throughout this work, I shall not deal with how these people manage to co-ordinate. Unless otherwise indicated, I shall always assume that a coalition of corporate controllers acts in fact as a single person.

6 For a non-technical discussion of the economic rationales underlying such an arrangement, see Hart, O. [1995], FIRM, CONTRACTS, AND FINANCIAL STRUCTURE, Oxford University Press, 63-66.

7 For discussion and implications of residual claimancy in corporate governance (hereinafter CG), see Fama, E.F. and Jensen, M.C. [1983b], *Agency Problems and Residual Claims*, in JOURNAL OF LAW AND ECONOMICS, vol. 26, 327-349.

8 Such an account of ownership rights was developed by Grossman, S.J. and Hart, O. [1986], *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, in JOURNAL OF POLITICAL ECONOMY, vol. 94, 691-719; and by Hart, O. and Moore, J. [1990], *Property Rights and the Nature of the Firm*, in JOURNAL OF POLITICAL ECONOMY, vol. 98, 1119-1158.

1.1.2. Separation of Ownership and Control

Separation of residual control rights from the residual claim on the firm's assets is what is customarily referred to as *separation of ownership and control*.[9] More precisely, the controller of a typical corporate enterprise does not bear all the wealth effects of his decisions, and often not even a substantial share of them.[10] The farther from 100% is the corporate controller's ownership stake, the more his behavior might diverge from the pursuit of the interest of non-controlling shareholders and be aimed at maximizing something else than the firm's profits.[11] This, at least apparently, makes the position of non-controlling shareholders not very attractive.

Separation of ownership from control is therefore the source of the corporate governance problem.[12] However, it should be emphasized that this separation is not

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9 Shleifer, A. and Vishny, R. [1997], *op. cit.*, 740-741.

10 Fama, E.F. and Jensen, M.C. [1983a], *Separation of Ownership and Control* in JOURNAL OF LAW AND ECONOMICS, vol. 26, 301-325.

11 This basic intuition underlies the so-called 'agency theory' of the corporation. See Jensen, M.C. and Meckling, W.H. [1976], *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 3, 305-360.

12 Jensen, M.C. and Meckling, W.H. [1976], *op. cit.*, were the first to formalize separation of ownership and control as a matter of conflict of interest between an owner-manager and his financiers (i.e., as an agency problem – see *infra*, Chapter Three). But they were definitively not the first to make such a point. In 1776, Adam Smith – a lawyer-philosopher universally considered as the founder of modern economic theory – was well-aware of the problem underlying the management of "other's people money" in joint-stock companies (what we refer today as to separation of ownership and control):

> "The directors of [joint stock companies], being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. *Negligence* and *profusion*, therefore, must always prevail, more or less, in the management of the affairs of such a company. It is upon this account that joint stock companies for foreign trade have *seldom* been able to *maintain* the *competition* against private adventurers." (Emphases added).

Smith, A. [1776], THE WEALTH OF NATIONS, Cannan Edition (Modern Library, New York, 1937), 700.

Adam Smith's skepticism towards the ancestors of modern corporations was paralleled 157 years later by another lawyer, Adolf Berle, along with a journalist, Gardiner Means. Their book, published in 1932, is considered a cornerstone in modern CG scholarship: Berle, A.A. Jr. and Means, G.C. [1932], THE MODERN CORPORATION AND PRIVATE PROPERTY, MacMillan. They warned against the unaccountability of corporate managers to the firm's owners (the shareholders), due to dispersion of large firm's ownership. While the expansion of the optimal firm's size after the Industrial Revolution made impossible (or financially unwise) to collect enough funds to own a controlling interest in large corporations (on this account, see also Chandler, A.D. Jr. [1977], THE VISIBLE such a bad thing. Separation of ownership and control is a necessary condition for *equity finance* – i.e., external funds being raised by the firm with an unlimited time horizon. Equity capital is the firm's own capital, so it needs not be repaid until the firm, or some of its assets, are liquidated. Thanks to separation of ownership and control, equity capital need not be provided entirely by the firm insiders (i.e., those in charge of the firm management – the corporate controllers), but can be raised from outside investors with no management responsibilities. Providers of external equity finance are ultimately *non-controlling* shareholders. Equity finance is one of the most distinctive features of the corporate firm as opposed to the entrepreneurial firm. More importantly, the vast majority of large firms in the world do resort to equity finance.[13]

What are then the advantages of equity finance? A comprehensive answer to that question would fall outside the scope of the present work.[14] Nonetheless, I shall at least explain why firms do bother of equity finance at all. To begin with, equity finance supplies the advantages of financing. By raising funds from outside investors, the entrepreneur can finance projects beyond his wealth constraint. He can also avoid putting his entire wealth at stake, enjoying the benefits of liquidity and financial risk diversification. However, corporate finance is not just equity. The second reason for equity finance lies in its comparative advantages over debt.

HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS, Harvard University Press), this gave rise to a serious economic problem:

> "On the one hand, the owners of passive property, by surrendering control and responsibility over the active property, have *surrendered* the right that the corporation should be operated in their *sole* interest. [...] At the same time, the controlling groups, by means of the extension of corporate powers, have in their own interest broken the bars of tradition which require that the corporation be operated solely *for the benefit of the owners* of passive property." (Emphases added).

Berle, A.A. Jr. and Means, G.C. [1932], *op. cit.*, 355.

Apparently, both Smith's and Berle and Means' concern about the efficiency of the corporate structure was unwarranted. In "most advanced economies", separation of ownership and control "has assured the flow of enormous amounts of capital to firms, and actual repatriation of profits to the providers of finance" (Shleifer, A. and Vishny, R. [1997], *op .cit.*, 737).

13 Shleifer, A. and Vishny, R. [1997], *op. cit.*, 737.

14 For a comprehensive introduction to the theory of debt and equity, see Brealey, R.A. and Myers, S.C. [2003], PRINCIPLES OF CORPORATE FINANCE, 7th edn., McGraw-Hill.

1.2. Corporate Governance and Corporate Finance

1.2.1. Does the Firm's Financial Structure Matter?

One amazing feature of economics is that many of its achievements are based on theoretical arguments that, at first sight, bear little resemblance to the real world. Typical instances in this regard are the so-called 'irrelevance' propositions. Curiously enough, economic analysis of law is largely based on one such proposition, the 'Coase Theorem', holding that – under certain assumptions – the way in which the legal system allocates entitlements does not matter for economic efficiency.[15] Provided that whether and how this allocation *does* matter in corporate governance is the ultimate focus of Corporate Law and Economics, I shall come back to the Coase Theorem and its implications for corporate governance in the next Chapters. What is now worth noting is that the modern study of corporate finance is also based on another irrelevance proposition: the 'Modigliani and Miller Theorem.' In the late 1950s, Franco Modigliani and Merton Miller demonstrated that, in the absence of capital market imperfections and taxation, the firm value is independent of the financial structure. That is, the choice between *debt* and *equity* finance *does not matter* for the efficiency of the firm.[16]

If the Modigliani and Miller Theorem really held, it would be pointless to discuss separation of ownership and control as well as related problems of corporate governance.[17] In fact, the reason why separation of ownership and control is an issue for the efficient management of the firm is that the choice between debt and equity finance *does matter*. This is due, in turn, to the capital market imperfections that are assumed away in the derivation of the Modigliani and Miller Theorem. Modern corporate finance basically deals with how the firm's financial structure performs in coping with all these imperfections.[18] Our purpose here is much more modest. We

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[15] Coase, R.H. [1960], *The Problem of Social Costs*, in JOURNAL OF LAW AND ECONOMICS, vol. 3, 1-44. To be sure, Ronald Coase has never formulated any such theorem. See *infra*, the discussion of the Coase Theorem in Chapter Five, section 5.5.1.

[16] The Modigliani and Miller Theorem holds under a number of assumptions that make financial arbitrage always possible. See Modigliani, F. and Miller, M.H. [1958], *The Cost of Capital, Corporation Finance, and the Theory of Investment*, in AMERICAN ECONOMIC REVIEW, vol. 48, 261–297.

[17] For a broader discussion of this problem, see Zingales, L. [2000], *In search of new foundations*, in JOURNAL OF FINANCE, vol. 55, 1629-1632.

[18] Describing the evolution of the theory of corporate finance, Colin Mayer and Oren Sussman summarize this point very clearly:

> "In the absence of capital-market imperfections and taxation, arbitrage between the prices of different financial instruments makes choices of financial structure *irrelevant* to the value

just need to find out whether the availability of outside equity can provide any advantage in this regard, thereby improving the entrepreneur's ability to raise funds from the capital market: that is, whether, and to what extent, equity finance may reduce the overall cost of capital.

1.2.2. Capital Market Imperfections

The majority of capital market imperfections fall into two broad categories: asymmetric information and contractual incompleteness. In the Third Chapter, I shall extensively discuss both kinds of market failure, and their implications for corporate governance. In the meantime, let me put it very simply. *Asymmetric information* makes financiers only imperfectly able to *screen* the quality of the borrower and to *monitor* his performance (the borrower knows more about his own capabilities and behavior than his counterparties do). This gives rise to two problems, which are respectively known as *adverse selection* and *moral hazard*.[19] Because of them financiers cannot make sure they get the expected return on their investment. This negatively affects the pricing of corporate securities and, therefore, the cost of capital to the firm.

A similar consequence (higher cost of capital) is brought about by *contractual incompleteness*, although because of a different reason. Here is not an information imbalance at issue, but rather the uncertainty about future states of the world that makes most of the related events contractually incomputable. This affects *both* parties' transacting capabilities (they both do not know), thereby leading to *technological breakdowns* in financial as well as in any other long-term contracting.[20] For instance,

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> of companies. [This was basically the Modigliani and Miller's Theorem.] But there were two problems. First, the Modigliani and Miller Theorem did not work – taxation did not explain what firms or investors actually did. Second, the *assumption* required to derive the Modigliani and Miller Theorem were *unrealistic*. […] The assumption that caused most problems was the one that required everyone to have access to the *same* information. Perfect information is not required of the theory, but it cannot cope with different people having access to different information – what is referred to as *'asymmetries' of information*." (Emphases added).

Mayer, C. and Sussman, O. [2001], *The Assessment: Finance, Law, and Growth*, in OXFORD REVIEW OF ECONOMIC POLICY, vol. 17, 458. For a general account on the Modigliani and Miller Theorem and its shortcomings, see Brealey, R.A. and Myers, S.C. [2003], *op. cit.*, chapters 17 (*'Does Debt Policy Matter?'*) and 18 (*'How Much Should a Firm Borrow?'*).

[19] Arrow, K.J. [1985], *The Economics of Agency*, in J. Pratt and R. Zeckhauser (eds.), PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS, Harvard University Press, 37-51.

[20] See, e.g., Bratton, W.B. and McCahery, J.A. [2001a], *Incomplete Contracts Theories of the Firm and Comparative Corporate Governance*, in THEORETICAL INQUIRIES IN LAW, vol. 2, n. 2, *Protecting Investors in a Global Economy*, 13-16. Both the economic and the legal literature on incomplete contracts are

"while, in principle, contracts might have foretold that 'the world would change' on 11 September 2001, in practice they did not. Many events are simply too unlikely to be worth contemplating, let alone contracting."[21] As a result, corporate securities – which are contracts at their core – are not simply mispriced relative to the prospective cash flow that they are capable of generating. The same cash flow is also contractually under-specified, given that securities cannot account *ex ante* for all possible future contingencies affecting their value *ex post* (i.e., after they have been issued).

1.2.3. Debt and Equity Compared

Debt and equity cope differently with both asymmetric information and contractual incompleteness. That is because the nature of the financial claims respectively associated to debt and equity is very different. I have already defined the equity claim as a *residual* claim on the firm's assets. Shareholders are entitled to what is left of the firm's income, after all the other providers of inputs (including lenders) have been compensated.[22] This difference is the firm's profit and it is open-ended by definition: clearly, profit has no upper bound. In addition, shareholder entitlement to the firm's profit is established over an indefinite time horizon, paralleling the firm's lifetime. Midstream distributions of profits (dividends) are optional, and they are provided just at the entrepreneur's discretion. Failure to pay dividends to shareholders *does not mean* that the entrepreneur is defaulting on his obligations.[23]

Debt works differently. In principle, it provides creditors with a *fixed* claim on the firm's assets: loans are to be repaid with the interests agreed upon. As a result, the creditor's interest is narrower compared to the shareholder's. While the latter cares of both the *upside potential* (gains from profit) and the *downside risk* (liability for

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highly sophisticated and related issues are far from settled. For a non-technical presentation, see – in economics – Hart, O. [1998], *Residual Rights of Control*, in P. Newman (ed.), THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW, vol. 3, Macmillan, 330-335; in the legal literature, Schwartz, A. [1998], *Incomplete Contracts*, in P. Newman (ed.), THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW, Macmillan, 277-283. For a more technical discussion of the problem of unforeseen contingencies in the economic theory of contracts, compare Tirole, J. [1999], *Incomplete contracts: Where Do We Stand?*, in ECONOMETRICA, vol. 67, 741-781, with Hart, O. and Moore, J. [1999] *Foundations of Incomplete Contracts*, in REVIEW OF ECONOMIC STUDIES, vol. 66, 115-138. For discussion of contractual incompleteness in the theory of the firm, and of its implications for CG, see *infra*, Chapter Three.

21 Mayer, C. and Sussman, O. [2001], *op. cit.*, 459.

22 This is a quite settled point in Corporate Law and Economics. See Easterbrook, F.H. and Fischel, D.R. [1991], THE ECONOMIC STRUCTURE OF CORPORATE LAW, Harvard University Press, 67.

23 Hart, O. [1995], *op. cit.*, 9.

losses) of his investment, the former just cares of the downside. The corporate form features not only debt, but also equity holders with *limited liability*: investors of both kinds cannot lose more than they invested in the first place.[24] The crucial difference is that debt-holders *also cannot gain more* than the return that they contracted for. In addition, payments on debt are normally due on a tight schedule. Default on scheduled payments finally triggers a shift of control from the entrepreneur to the creditors. *Bankruptcy* involves that creditors get ultimate authority over either managing the corporation or liquidating its assets.[25]

1.2.4. Asymmetric Information: Ease of Monitoring vs. Incentive Alignment

The differences that have been just outlined provide debt with both advantages and disadvantages over equity in dealing with asymmetric information and contractual incompleteness.

As far as asymmetric information is concerned, the advantages of debt can be summarized as follows:[26]

a) Monitoring performance of *well-specified obligations* (paying out borrowed capital and interests) is easier compared to the monitoring of a residual claim (whose fulfillment involves maximization of an open-ended stream of profits);
b) Provided they are not open-ended, debtor's obligations can be (and quite often are) backed by the creditor's entitlement to seize some identifiable *collateral* (monitoring can be thus limited to just one or a few of the firm's assets);

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[24] Luigi Zingales very nicely summarizes how limited liability underlies most part of modern economic theory of the firm's capital structure, developed after the Modigliani and Miller Irrelevance Theorem. As Zingales puts it:

> "The most distinguishing feature of the legal entity called the corporation is limited liability: investors are not personally responsible for corporate liability. As Black and Scholes (1973) pointed out in their seminal article, this feature assimilates a firm's equity to a call option on the firm, having a strike price equal to the face value of the outstanding debt. This option-like nature of equity is behind the asset-substitution effect of Jensen and Meckling (1976) and the underinvestment problem of Myers (1977). These two effects represent the workhorse of the capital structure literature for the last 20 years. Especially before the advent of the literature on control (e.g., Aghion and Bolton (1992)), most papers on capital structure that were not using signaling or taxes were based on some variation of the asset substitution effect or the underinvestment problem (or both)."

Zingales, L. [2000], *op. cit.*, 1627 (and references cited therein).

[25] For a comprehensive discussion of debt contracts on these terms, see Hart, O. [1995], *op. cit.*, 95-120.

[26] See, in general, Shleifer, A. and Vishny, R. [1997], *op. cit.*, 761-764 (and references cited therein).

c) Debt normally has a *maturity*: a definite time horizon provides the entrepreneur with a commitment to pay back investors on a regular basis, instead of wastefully playing with cash flow that has no deadline (so-called 'free cash flow').[27]

While the above reasons explain why monitoring debt claims may prove cheaper, *incentives misalignment* provides the basic advantage of equity finance over debt under asymmetric information. High leverage (i.e., high debt/equity ratio) provides the borrowing firm with the incentive to undertake overly risky investment projects. If they are successful, the entrepreneur and his shareholders will reap all the gains from this strategy (debt does not participate in the upside potential); if they are not, most of the losses will be borne by the creditors (due to limited liability).[28] True, this tendency could be constrained by contractual safeguards (so-called debt covenants), limiting the ability of the entrepreneur to externalize risks to the creditors. However, this involves that debt finance alone will get eventually too burdensome to support some high-risk investment projects. Therefore, either they are, at least partly, financed through equity or they will have to be foregone. Every firm has in fact a *limited* indebtedness capacity.[29] The ultimate reason of this outcome is that precisely instructing the entrepreneur about how to invest the financial resources under his management is not an option for financiers, due to *contractual incompleteness*.[30]

1.2.5. Contractual Incompleteness and the Problem of Underinvestment

Intuitively, when contracts are incomplete, a crucial issue is determining who has the right to decide what to do with the firm's assets, in the event that any unforeseen contingency materializes. This is what is ultimately meant for by allocation of *control rights*.[31] As I mentioned in the previous section, they are *residual* with respect to the rights and obligations provided for by any contract entered into by the firm. Normally, they are held by who is in charge of 'running' the firm – the *entrepreneur*.

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27 On this very last point, see Jensen, M.C. [1986], *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, in AMERICAN ECONOMIC REVIEW, vol. 76, 323-329.

28 Myers, S.C. [1977], *Determinants of Corporate Borrowing*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 5, 147-175.

29 Jensen, M.C. and Meckling, W.H. [1976], *op. cit.*, 333-343.

30 On the debt vs. equity choice, see the excellent and concise survey of the literature provided for by Shleifer, A. and Vishny, R. [1997], *op. cit.*, 761-766.

31 Zingales, L. [1998], *Corporate Governance*, in P. Newman (ed.), THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW, Macmillan, 497-503.

A nice feature of (incomplete) debt contracts is that they provide for a state-contingent allocation of control rights. The entrepreneur is not instructed about what to do with the money he borrowed, but creditors are entitled to take from him control of the firm should anything go wrong (in the jargon of economic contract theory, 'in bad states of the world'). In fact, creditors gain control over the firm's assets upon the entrepreneur's failing to repay loans on scheduled dates.[32]

The advantage of such an arrangement is that fear of losing firm control will induce the entrepreneur to exert his managerial discretion in such a way to be always able to pay back lenders. The disadvantage is that when debt gets large relative to the firm's own capital, it will impose too tough a constraint on managerial discretion. Good, but too risky projects might be foregone.[33] On the one hand, lenders are just interested in having their loans repaid, but not also in the firm's profits. On the other hand, the entrepreneur has to make lenders happy in order to avoid bankruptcy.

The underinvestment problem of highly leveraged firms is ultimately due to the *cost of financial distress*: some of the firm value is always lost in bankruptcy procedures.[34] Provided that perfectly state-contingent contracts are impossible to draft, forced liquidation of the firm's assets is often inefficient.[35] Risk of bankruptcy is higher when short-term revenues are highly uncertain and might easily turn out to be insufficient to service debt payments. Forced liquidation is particularly inefficient when the assets combined into the firm have limited alternative use. The two situations very often come together. This typically happens when the firm value comes out of future and uncertain growth opportunities, its assets are mostly intangible or anyway highly specific to that combination and, therefore, they are not very appealing as collateral. It is exactly in such situations that equity financing provides most of its advantages over debt. In fact, *equity can be issued to outside investors without the entrepreneur having necessarily to surrender firm control either now or in the future.*

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32 This is the prevailing theory of debt, based on Aghion, P. and Bolton, P. [1992], *An Incomplete Contracts Approach to Financial Contracting*, in REVIEW OF ECONOMIC STUDIES, vol. 59, 473-494.

33 Shleifer, A. and Vishny, R. [1997], *op. cit.*, 763.

34 On this key point, see – in very general terms – Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 16-21.

35 It is quite ironic that this issue was raised well before the development of the literature on incomplete contracts. See, e.g., Jensen, M.C. and Meckling, W.H. [1976], *op. cit.*, 340. However, Luigi Zingales has recently pointed out that the complete contracting approach "does not seem to provide a very rich and convincing theory of the costs of financial distress" (Zingales, L. [2000], *op. cit.*, 1631). Financial distress is in fact more properly understood as a problem of contractual incompleteness. See, e.g., Hart, O. [1995], *op. cit.*, 95-120 and 156-185.

1.3. Equity Finance and Firm Control

Equity finance allows the entrepreneur to raise funds without having to give up residual control rights upon failure to pay back financiers. This is the ultimate reason why equity capital matters and, consequently, separation of ownership and control is an issue worth discussing. What is puzzling about equity finance is the weakness of its providers: namely, individual, non-controlling shareholders. In their authoritative survey of corporate governance, Andrei Shleifer and Robert Vishny illustrate this point quite clearly:

> "Unlike creditors, *individual* shareholders are not promised any payment in return for their financial investment in the firm, although often they receive dividends at the discretion of the board of directors. Unlike creditors, individual shareholders have no claim to specific assets of the firm, and have no right to pull collateral. […] Unlike creditors, shareholders do not have a final date at which the firm is liquidated and the proceeds are distributed. In principle, they may never get anything back at all."[36]

The flip side of the coin is that this situation confers an enormous discretion to the entrepreneur, provided that he is no longer the (sole) owner of the firm, but still holds residual control rights over its assets. This discretion is particularly useful when the business undertaken is surrounded by a deep uncertainty. Unforeseen contingencies might too quickly drive the firm into bankruptcy, when it is highly indebted. Quite to the contrary, equity holders are bound to wait. In this perspective, equity can loosen the budget constraint on the entrepreneur's behavior that would arise from alternative sources of finance.[37] In the same vein, external equity finance ultimately enhances the entrepreneur's decision-making power over the hierarchical organization of the firm. An important achievement of economic theory is that centralized control over a hierarchical organization is the most distinguished feature of the firm, and the ultimate reason why it exists.[38]

One issue that is often overlooked in the mainstream literature on corporate governance is that, when ownership is separated from control, hierarchical powers

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[36] Shleifer, A. and Vishny, R. [1997], *op. cit.*, 764 (emphasis in the original).

[37] Here one is basically turning upside down Oliver Hart's argument about debt's hardening the entrepreneur's budget constraint. See Hart, O. [1995], *op. cit.,* 6, 115-117 (based on Hart, O. and Moore, J. [1989], *Default and Renegotiation: A Dynamic Model of Debt*, Working paper, MIT Department of Economics, subsequently published in QUARTERLY JOURNAL OF ECONOMICS, vol. 113, 1-41, 1998).

[38] See *infra*, the discussion of the theory of the firm in Chapter Three, sections 3.2 and 3.3.

of the firm controller (i.e., residual control rights) are no longer established through the property rights system and need therefore be supported by *alternative legal entitlements*.[39] Every corporate law system allows for such a kind of entitlements, although by means of very different arrangements. The quality of those arrangements determines the degree of separation of ownership and control that can be afforded by an entrepreneur wishing to maintain firm control.

In the presence of significant uncertainty, the entrepreneur may attach to firm control a value higher than what can be obtained by selling control to the market. I shall refer to this excess value as *private benefits of control* – a topic that will be extensively discussed in the Fifth Chapter, for it is a central issue of the present inquiry.[40] How much separation of ownership and control is compatible with the entrepreneur's goal of preserving his private benefits depends on availability of legal entitlements to control power independent of corporate ownership. Such a degree may, or may not, correspond to the optimal amount of equity funds to be raised for financing the corporate business. *A first way in which law matters for the efficiency of corporate governance is therefore the provision of legal entitlements supporting the corporate controller's power* over a firm that he does not – or, at least, not completely – own.

Of course, unconstrained power risks being abused, and then non-controlling shareholders might never get any return on their investment. Obtaining funds 'no strings attached' would be probably the best of all worlds for the entrepreneur. But, clearly, this would not be feasible in the absence of a meaningful guarantee of the investors' interest.[41] Appropriate sharing of equity holding between the controlling entrepreneur and non-controlling shareholders can provide such guarantee. To the extent that the corporate controller retains some equity interest in the firm (either in the form of share ownership, or through a compensation scheme contingent on the realization of profits), it would be *also* his own interest to provide outside equity holders with a return on their investment.

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39 To be sure, Luigi Zingales also raises this issue, although he apparently disagrees that the solution is to be provided by means of *legal* entitlements. See Zingales, L. [2000], *op. cit.*, 1638; and, more in detail, the discussion of corporate law's double mission in Chapter Six.

40 The general notion of private benefits of control (hereinafter PBC) being adopted throughout this work is quite neutral as to their implications for social welfare. In other words, they might be efficient, inefficient, or not affecting social welfare at all. For such a definition of PBC, see, e.g., Coates, J.C. IV [2003], *Ownership, Takeovers and EU Law: How Contestable Should EU Corporations Be?*, ECGI Law Working Paper No. 11/2003, available at www.ssrn.com and www.ecgi.org, reprinted in E. Wymeersch and G. Ferrarini (eds.) [2004], COMPANY AND TAKEOVER LAW IN EUROPE, Oxford University Press, 13: "PBC are any benefits that a control person derives from [her] control of a firm that are not shared proportionally with non-controlling shareholders."

41 Aghion, P. and Bolton, P. [1992], *op. cit.*, 474.

However, for this to hold, two additional conditions must be satisfied. The first is that the only way for the corporate controller to get out of the firm his share of the realized surplus is to have profits distributed pro-rata, either through midstream dividends or, ultimately, upon dissolution of the company.[42] This would avoid *diversion* of the firm's cash flow. The second condition is that extra benefits arising from the exercise of corporate control do not come at the shareholders' expenses. This would limit *distortion* of management choices, sacrificing the firm's profits to the pursuit of the manager's goals (e.g., extravagant perquisites, power-enhancing investments, etc.).[43]

Both diversion of the firm's profits and its distorted underproduction are additional sources of *private benefits of control* and, to be sure, they are the two sources mostly referred to by the literature.[44] However, albeit important, these are not the only instances of private benefits that matter in corporate governance.[45] As I mentioned, this crucial point will be extensively discussed in Chapter Five. In the meantime, it is important to bear in mind that ability of the corporate controller to extract private benefits *at the shareholder's expenses* undermines the basic incentive-compatibility of corporate governance. This ability also depends on the legal system, which might fail either to set sufficient constraints on the corporate controller's misbehavior or to allow private ordering to feature appropriate mechanisms to the same purpose. Therefore, *law also matters for the efficiency of corporate governance in that it prevents the corporate controller from abusing his power.*

When opportunities for abusing control power are adequately policed, the corporate controller can only make money out of his position by increasing either actual or prospective shareholder wealth (the so-called 'shareholder value'). "So long as non-pro-rata distributions are prohibited, the only way the [corporate controller] can benefit is by increasing the value of the firm as a whole, thereby also benefiting [non-controlling] shareholders."[46] So long as private benefits of control do not re-

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42 Rock, E.B. and Wachter, M.L. [2001], *Islands of Conscious Power: Law, Norms and the Self-Governing Corporation*, in UNIVERSITY OF PENNSYLVANIA LAW REVIEW, vol. 149, 1659-1660.

43 In order to describe the two basic instances of the corporate controller's misbehavior, I am borrowing the "diversion/distortion" terminology from Colin Mayer. Mayer, C. [1999], *Firm Control*, Inaugural Lecture at the University of Oxford (February 18, 1999), available at www.finance.ox.ac.uk, as published in J. Schwalbach (ed.) [2001], CORPORATE GOVERNANCE: ESSAYS IN HONOR OF HORST ALBACH, Springer-Verlag, 7.

44 See, e.g., Bebchuk, L.A. [1999], *A Rent-Protection Theory of Corporate Ownership and Control*, NBER Working Paper No. 7203.

45 "It must be cautioned […] that private benefits need not reduce the wealth of minority shareholders. This is an assumption of some analyses, but it is wrong." Holderness, C.G. [2003], *A Survey of Blockholders and Corporate Control*, in FEDERAL RESERVE BANK NY – ECONOMIC POLICY REVIEW, April 2003, 55.

46 Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1659-1660.

duce shareholder wealth, they can only increase firm value prospectively by motivating the corporate controller's investment of managerial skills for the firm's success.[47] Provided that the corporate controller retains – even without full ownership – residual rights of control over the firm's assets, those benefits could be eventually cashed in through a future control sale to anybody who attaches a higher value to that combination of assets.[48] This would benefit not only the incumbent controller, but also non-controlling shareholders by enhancing the value of the assets they own. Intuitively, when such a sale takes place, they will be able to get a higher price in return for their shares.[49]

1.4. The Basic Structure of the Corporation in Law and Economics

1.4.1. Supporting the Entrepreneur's Access to Equity Finance

The corporation does not exist in nature. It is in fact a legal creation. However, its features serve some basic economic functions. The positive structure of the corporation as a legal device provides support for all the above-mentioned characteristics, which make separation of ownership and control both appealing for the entrepreneur and an interesting deal for non-controlling shareholders.[50] Let me sketch them out as follows:

a) Hierarchical authority over the firm management vested in a corporate controller.
b) Pro-rata sharing of the firm's profits between the corporate controller and non-controlling shareholders.

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47 See, on this specific point, Holderness, C.G. [2003], *op. cit.*, 55; Mayer, C. [1999], *op. cit.*, 8-10.

48 See *infra*, Chapters Five and Six, for the development of this intuition.

49 This is indeed one of the few settled results of the empirical analysis of the market for corporate control. Whether takeovers are friendly or hostile, target shareholders are always those who stand to gain. See Burkart, M. and Panunzi, F. [2006b], *Takeovers*, ECGI Finance Working Paper No. 118/2006, available at www.ssrn.com and www.ecgi.org. To be sure, the theoretical underpinnings of this outcome are still controversial. But see *infra*, the theoretical discussion of changes in control in Chapters Five (section 5.5) and Six (section 6.3), and its regulatory implications in Chapter Ten.

50 For such an approach to the corporate structure, see Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1654-1660. A more traditional approach to Corporate Law and Economics is contained in the influential book by Frank H. Easterbrook and Daniel R. Fischel [1991], *op. cit.*, 1-39.

c) Corporate controller's entitlement to secure his position as a reward for the investment of managerial skills.

1.4.2. The Standard View

To be sure, the basic structure of the business corporation is usually depicted in a quite different manner. In standard Law and Economics, the corporate structure consists of at least *five* core features.[51]

The first one is *legal personality*: corporations can hold property and conclude contracts in their own names. Although corporate personality is often labeled as a legal fiction, it is certainly a very useful one. Provided that the firm activity is implemented through corporate transactions, legal personality allows framing the question of who has got the ultimate right to decide what assets to bring into the firm, how to combine them, and how to manage their operation as a unique problem: that of allocation of corporate control.[52]

The second characteristic is *limited liability*. Provided that the corporate enterprise cannot lose more than the assets it owns, the entrepreneur and its financiers participating in a corporate venture can limit their risk exposure: their personal wealth is not placed at hazard, unless they want it. As we have just seen, this makes – among other things – the choice between equity and debt a meaningful issue for corporate finance.[53]

The third feature of the corporate structure is *free transferability of shares* of equity capital. This allows equity finance to be provided by a large number of outside investors, who can hold small stakes in each firm's capital and exchange them in financial markets (normally referred to as 'secondary' markets) where already issued

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51 For the most up-to-date description of these features, in a comparative perspective, see Kraakman, R.H., Davies, P., Hansmann, H., Hertig, G., Hopt, K.J., Kanda, H. and Rock, E.B. [2004], THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH, Oxford University Press (hereinafter Kraakman *et al.* [2004], *The Anatomy*), 5-15.

52 Zingales, L. [1998], *op. cit.*, 500. How this problem can be possibly solved will be discussed in Chapter Six. For the more traditional view that the corporation is just a legal fiction, see Jensen, M.C. and Meckling, W.H. [1976], *op. cit.*, 311 (emphases in the original):

> "The private corporation or firm is just a *legal fiction which serves as a nexus for contracting relationship and which is also characterized by the existence of divisible claims on the assets and cash flows of the organization which can generally be sold without permission of the other contracting individuals*."

On the usefulness of legal personality from both a legal and an economic perspective see, however, Blair, M.M. and Stout, L.A. [2006], *Specific Investment: Explaining Anomalies in Corporate Law*, in JOURNAL OF CORPORATION LAW, vol. 31, 719-744 (citing Clark, R.C. [1986], CORPORATE LAW, Little, Brown and Company).

53 See *supra,* note 24.

securities are traded for cash. Transferability of shares enables shareholders to enjoy the benefits of liquidity and risk diversification of their investments.[54] The resulting dispersion of non-controlling shareholders has important implications for corporate governance, which will be addressed at the end of this Chapter.

The fourth and fifth features of the corporate structure in the standard picture are those most closely related to separation of ownership and control. They are *centralized management* and *shareholder ownership*. As we are going to see, while the former provides the basis for the exercise of authority over the firm decision-making, the latter does not imply (as it is often believed) that shareholders as a group should ultimately have residual control rights.[55] I should then add a *sixth feature* to the standard outline of the basic corporate structure: *entrenchment of corporate control* – that is, tenure of control rights over the assets belonging to the corporate enterprise.[56]

1.4.3. Centralized Management: The Board of Directors

Centralized management is the tool that allows the controller of a corporate enterprise to exercise ultimate authority over the firm's decision-making. In a corporation, centralized management is normally implemented by means of a board structure. The *board of directors* is the institution vested with the authority over corporate management.[57] Directors select the firm managers who are in charge of day-to-day business, and they decide most significant corporate transactions. Residual rights of control over the firm's assets are therefore exercised *through* the board of directors. Whoever controls the board (i.e., determines the appointment of its members) is, in

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54 Easterbrook, F.H. and Fischel, D.R. [1991], *op. cit.*, 10-11.

55 For quite a similar approach, see Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1657-1660.

56 There are not many advocates of entrenchment of corporate control among legal scholars. To be sure, most legal scholars consider entrenchment as something to fight against. Two prominent exceptions in this regard are Kahan, M. and Rock, E.B. [2002], *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, in UNIVERSITY OF CHICAGO LAW REVIEW, vol. 69, 871-915; and Bainbridge, S.M. [2002b], *Director Primacy: The Means and Ends of Corporate Governance,* in NORTHWESTERN UNIVERSITY LAW REVIEW, vol. 97, 547-606. And yet, the majority of corporate laws feature entrenchment at least as an option – and it seems that the vast majority of publicly held corporations are willing to opt this in (see *infra*, Chapter Two, section 2.4).
In theoretical economics, there are at least a few studies arguing that, in certain situations, managerial entrenchment may be efficient. See, e.g., Almazan, A. and Suarez, J. [2003], *Entrenchment and Severance Pay in Optimal Governance Structures,* in JOURNAL OF FINANCE, vol. 58, 519-547; Schnitzer, M. [1995], *'Breach of Trust' in Takeovers and the Optimal Corporate Charter*, in JOURNAL OF INDUSTRIAL ECONOMICS, vol. 43, 229-259. Both Hart, O. [1995], *op. cit.*, 188 and 206-208, and Mayer, C. [1999], *op. cit.*, 10-15, recognize that entrenchment of corporate controllers must have some virtue, for otherwise we would not observe so many family firms and entrenched managers in real-world CG.

57 Kraakman *et al.* [2004], *The Anatomy*, cit., 11-12.

turn, the ultimate holder of these control rights. I have already defined this individual as the corporate controller.

Here comes, however, a crucial point. Formally, most corporate law systems require that board members be ultimately selected by another institution: the *general meeting of shareholders*.[58] Apparently, it should follow that shareholders are the ultimate holders of residual rights of control. These rights are allegedly *delegated* to the board of directors by the owners of the firm – the shareholders – who elect its members and may remove them anytime, whenever they are dissatisfied with how they deal with the firm management.[59] Separation of ownership and control would not be then an accurate description of the corporate phenomenon. One should rather speak about "separation of ownership and *effective* control, or management;"[60] or alternatively, separation of *formal* control rights from *real*, or *de facto*, control of the corporate enterprise.[61]

Based on this view, directors (and – more in general – whoever gets to 'run' the company) are typically regarded as shareholder *agents* in Corporate Law and Economics.[62] I shall extensively discuss the agency theory of the corporation, from both an economic and a legal perspective, in the next Chapters. In the meantime, let me just point out that this view is at odds with what we observe in the corporate practice worldwide. One British economist – John Kay – made this point very effectively:

> "If we asked a visitor from another planet to guess who were the owners of a firm by observing behaviour rather than by reading text books in law or eco-

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58 Id., at 12-14.

59 Shleifer, A. and Vishny, R. [1997], *op. cit.*, 740-745.

60 Hart, O. [1995], *op. cit.*, 127.

61 Tirole, J. [2001], *Corporate Governance*, in ECONOMETRICA, vol. 69, 17-19. This view is based on the more general framework developed by Aghion, P. and Tirole, J. [1997], *Formal and Real Authority in Organizations*, in JOURNAL OF POLITICAL ECONOMY, vol. 105, 1-29.

62 See, e.g., Easterbrook, F.H. and Fischel, D.R. [1991], *op. cit.,* 8-15; Kraakman *et al.* [2004], *The Anatomy*, cit., 21-31. The agency approach to Corporate Law and Economics is indeed the prevailing one among lawyers, but this is far from uncontroversial. In the US, the most authoritative contrarian view is provided by former Dean of Harvard Law School, Robert Clark. See Clark, R.C. [1986], *op. cit.,* 22: "The relationship between shareholders and directors is *not* well described as being between principals and agents" (emphasis added). For a summary of the arguments, Clark, R.C. [1985], *Agency Costs versus Fiduciary Duties*, in J. Pratt and R. Zeckhauser (eds.), PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS, Harvard University Press, 55-79. More recently, see the criticism of the agency approach provided on both legal and economic grounds by Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1627 and 1654-1660.

nomics, there can be little doubt that he would point to the company's senior managers."[63]

One might wonder then why the corporate phenomenon looks that way. After all, when ownership is significantly separated from control, senior managers are not necessarily among the firm owners (they might not even be shareholders) and, in any case, they are not the only ones. The reason why they behave *as if* they were the sole owners of the corporation is that they *control* it.[64] And the corporate structure supports their behavior.

Senior, or 'chief' managers (like the CEO – Chief Executive Officer) are actually playing the role of the corporate controller or, at least, they are alter egos (if not puppets) of the latter. The corporate controller usually sits in the board and, even if he does not, he has anyway the last word about the decisions that are taken there. This might seem counterintuitive if we take the view that powers of board members are *delegated* by the general meeting of shareholders who appoint them as agents. In the following Chapters, we will see that this is just theory, and it is most likely to be incorrect.

In practice, *the corporate controller selects the board members*, by determining the outcome of elections at the shareholder meetings. This may, and in fact does, happen in different ways. To put it very simply, the corporate controller may directly or indirectly hold enough shares to have any resolution he wishes passed by the shareholder meeting (i.e., he can be a *controlling shareholder*). Alternatively, he may control the agenda of the shareholder meeting and enjoy considerable advantages in having favored resolutions passed, even without any sizeable share ownership (i.e., he can be a *powerful CEO* dominating the board and facing no significant opposition from outside shareholders). How the corporate controller manages to exert his authority depends on both the *economic* and *legal* distribution of corporate powers. I shall come to this shortly. What is worth noting meanwhile is that, whatever this distribution, the corporate structure supports anyway the hierarchical authority of a corporate controller over the firm management; and this has little, if anything, to do with a principal-agent relationship.[65]

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63 This passage is reported by Zingales, L. [2000], *op. cit.*, 1638 – quoting Kay, J. [1996], THE BUSINESS OF ECONOMICS, Oxford University Press, 111.

64 Luigi Zingales is also skeptical about the mainstream approach to CG, based on ultimate "identification of control with ownership." As he claims, "this line of research has found it extremely difficult to deal with the separation between ownership and control" (Zingales, L. [2000], *op. cit.*, 1638). His ideas about sources of control power alternative to ownership are, however, very different from the view which is being presented in this work. See *infra*, Chapters Five and Six.

65 I am not aware of many economists (or lawyers) who dared to describe in such a way CG in the real world. One notable exception is the path-breaking essay by Hellwig, M. [2000], *op. cit.*, 95-100.

1.4.4. Shareholder Ownership: The Corporate Controller's Fiduciary Duties

The fifth feature of the corporate structure – *shareholder ownership* – is intended to guarantee that the firm is efficiently managed under the corporate controller's responsibility; that is, that the corporate controller exerts his managerial discretion in such a way as to maximize the value of the firm.[66] This does not necessarily require that shareholders as a group retain residual rights of control, and thereby ultimate authority over the appointment and removal of the board members.[67] However, it is necessary that the position of non-controlling shareholders as residual claimants on the firm's assets is adequately protected by means of both an incentive-compatible contract with the corporate controller and legal entitlements against expropriation.[68] Contracting upon incentives is needed to align the corporate controller's interest with that of outside shareholders. Legal protection of outside shareholders is required to prevent the corporate controller from diverting profits at their expenses. To the same purposes, however, the corporate controller does not also need to be deprived of residual control rights.

Why do we need legal entitlements to protect shareholders' residual claim? Could not such a protection be accomplished by the equity contract – that is, the corporate charter?[69] *Ex ante*, when the company's stock is sold to the investing public, the alignment of corporate controller's incentives can be obtained by having him participating in the shareholders' residual claim. Whether or not the controlling

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66 Kraakman *et al.* [2004], *The Anatomy*, cit., 13-15. Still, the most convincing explanation of why the governance of business corporations should feature shareholder ownership is contained in Easterbrook, F.H. and Fischel, D.R. [1991], *op. cit.*, 67-70 ("shareholders are the residual claimants to the firm's income"). For a broader perspective on this matter, see Hansmann, H. [1996], THE OWNERSHIP OF ENTERPRISE, Harvard University Press. Criticism of the view that shareholders be considered as the only residual claimants in business corporations underlies the so-called "stakeholders approach" to CG (whereupon *infra*, Chapter Three, section 3.5). In Law and Economics, this position has been recently summarized by two of its prominent advocates: see Blair, M.M. and Stout, L.A. [2006], *op. cit.*

67 Most economists and lawyers would disagree on this statement. See, e.g., on both sides, Shleifer, A. and Vishny, R. [1997], *op. cit.*, 750-753; and Easterbrook, F.H. and Fischel, D.R. [1991], *op. cit.*, 63-89 and 162-211. But see also note 64 above.

68 Shleifer, A. and Vishny, R. [1997], *op. cit.*, 740-745 and 750-753. The problem with the mainstream approach to CG is that issues of legal protection of the shareholders' residual claim are bundled with those of allocation of control rights. As it will become clearer throughout the following analysis, this confusion underlies most misunderstandings in the analysis of CG. See *infra*, Chapter Three, section 3.4.2, and Chapter Five, section 5.6.2.

69 This question underlies the long-lived debate on contractual freedom in corporate law. At least as far as the Law and Economics debate is concerned, the standard references are contained in Symposium [1989], *Contractual Freedom in Corporate Law*, in COLUMBIA LAW REVIEW, vol. 89, 1395-1774 (November 1989). See *infra*, Chapter Four, section 4.5., for discussion.

entrepreneur keeps any significant shareholding, his reward should be anyway contingent on the realization of the firm's surplus: this would clearly enhance the incentives to its production. However, provided that contracts are incomplete, the outcome *ex post* may significantly differ from the arrangement devised *ex ante*. In particular, shareholders worry that "the managers will utilize their day-to-day control of the assets to augment the managers' return by reducing the residual available to the shareholders."[70]

This explains why shareholder ownership needs to be supported by a meaningful ban on non-pro-rata distributions of the firm's profits.[71] Should the corporate controller have no opportunity to divert profits from shareholders to his own pockets, he would have no choice but attempting to *increase* the aggregate value of residual claims (shareholder value), thereby enhancing his share of it.[72] Of course, legal rules simply providing for mandatory pro-rata distribution of the firm's profits would not be sufficient to achieve this result. In fact, "there are a million and one ways to evade such a rule."[73] The corporate structure provides a more meaningful support of shareholder entitlement to residual surplus by setting a rigorous discipline of conflicted interest transactions.[74]

Conflicted interest transactions provide the corporate controller with the opportunity of siphoning off some of the firm's assets, thereby eluding the prohibition of non-pro-rata distributions. The most obvious instance of conflicted interest transaction is self-dealing – i.e., the corporate controller dealing with himself in the company's name. But, of course, there are much more sophisticated ways of diverting resources from the company (and its residual claimants) to the corporate controller's pockets. All of these ways are ideally dealt with by a discipline of conflicted interest transactions in corporate law. As we will see in the next Chapters, some legal systems are more effective than others in this regard, and this has very important consequences for both the shape and the efficiency of corporate governance in

70 Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1654.

71 Id., at 1657.

72 The fulfillment of the condition in the text is not sufficient to have shareholder value also *maximized* by the corporate controller, since the potential for moral hazard (in the form of lower effort than contracted for – i.e., 'shirking') may vary over time and can only be policed by *dynamic* incentives. See the discussion of this point in the following section. For a more detailed analysis, see Chapters Three and Five.

73 Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1661.

74 See *infra*, Chapters Six and Eight.

different countries.[75] However, in no system of corporate law this issue is foregone.[76]

Typically, in Corporate Law and Economics, the system of legal rules aimed at preventing expropriation of outside shareholders by the corporate controller is referred to as *fiduciary duties*. Although this terminology is based on the tradition of common law systems, it captures the basic idea that the corporate controller must refrain from cheating on outside shareholders.[77] Fiduciary duties do not actually go much further. In particular, they do not challenge the corporate controller's discretion in managing the firm's assets. Whoever plays the role of the corporate controller – either directors dominating the board or a controlling shareholder – gets authority over the firm decision-making under the corporate structure. In the exercise of such an authority, both directors and controlling shareholders (depending on who is actually in control of the firm management) owe a strict *duty of loyalty* to non-controlling shareholders.[78] To be sure, fiduciary duties also include a *duty of care*, which may seem to allow for some interference with managerial discretion based on the enforcement of a diligence standard. Yet, upon a more careful investigation, this impression turns out to be a misinterpretation of fiduciary duties in corporate law.[79]

It would be a mistake to conclude that the controller's authority is constrained more than necessary by fiduciary duties (as well as by corporate law in general).[80]

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75 See *infra*, Chapters Two and Four.

76 In this regard, see Kraakman *et al.* [2004], *The Anatomy*, cit., 101-129. More recently, in the comparative Law and Economics debate, see Djankov, S., La Porta, R., Lopez-de-Silanes, F. and Shleifer, A. [2006], *The Law and Economics of Self-Dealing*, Working Paper, Harvard School of Economics, available at http://www.economics.harvard.edu/faculty/shleifer/papers, forthcoming in JOURNAL OF FINANCIAL ECONOMICS, 2008.

77 More precisely, one is referring to just one of the two basic components of fiduciary duties in corporate law, the duty of loyalty. Economists typically disregard the second component, the duty of care. See Shleifer, A. and Vishny, R. [1997], *op. cit.*, 743-744. For a "Positive Theory of Fiduciary Duties" see Clark, R.C. [1985], *op. cit.*, 71-79. To understand why economists dismiss the duty of care from their analysis of corporate law, see the summary presentation of the duties of directors under US corporate law provided by Hamilton, R.W. [2000], THE LAW OF CORPORATIONS, West Group, 444-467 (describing the 'business judgment rule' – a norm of judicial abstention from second-guessing business judgment – as "the operative test for determining whether directors are liable for damages for failing to exercise reasonable care"). The distinction between the duty of loyalty and the duty of care will be discussed in more detail throughout this work. See especially Chapters Eight and Nine below.

78 Bainbridge, S.M. [2002a], CORPORATION LAW AND ECONOMICS, Foundation Press, 305-360.

79 See *infra*, Chapter Eight, section 8.4. With reference to US corporate law, see the discussion of the duty of care and the so-called 'business judgment rule' by Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1663-1694. See also, with a similar view, Bainbridge, S.M. [2002a], *op. cit.*, 241-304.

80 This is one major result of Mark Roe's legal and economic analysis over the past few years. See, e.g., Roe, M.J. [2003c], POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE, Oxford Univer-

These duties are just aimed at preserving the incentive-compatibility of the corporate structure, by ruling out *'stealing'* of corporate assets by the individual(s) who control(s) their management.[81] In most corporate law jurisdictions judges exhibit deference to management choices, which they are unwilling to review in the absence of potential conflicts of interest. These choices might prove mistaken or unfaithful to outside shareholders; they might show laziness, incompetence, or dishonesty of the corporate controller. When enforcing the corporate controller's fiduciary duties, judges' efforts are directed to preventing fraud and punishing dishonesty – i.e., breaches of the duty of loyalty. However, courts normally abstain from any attempt to correct business mistakes on the basis of the duty of care, and very seldom (if ever) they challenge managerial *'shirking'* and incompetence not involving clear instances of waste.[82] The very core of the corporate controller's authority over the firm management is preserved by a rule of *judicial abstention* from second-guessing business choices.[83] At least in the US, this is referred to as *business judgment rule*.[84] Fiduciary duties do protect outside shareholders from expropriation of their residual claim, but they do not also challenge residual rights of control over the firm's assets.

1.4.5. Entrenchment of Corporate Control: Entrepreneurship and Its Reward

The above discussion tells us *how* shareholder ownership can work without residual rights of control, but does not also explain *why* it should be so. Apparently, assigning residual rights of control to shareholders as a group would provide the best guarantee that the firm is managed in their interest. In an ideal scenario, underperforming managers would be quickly replaced by disgruntled shareholders and the threat of ouster would constantly keep corporate managers on their toes.[85] Not

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sity Press, esp. 159-196. For a brief outline of how managerial motivation cannot be fully explained by the actual set of legal rules disciplining CG in the US, see also Klausner, M. [2004], *The limits of Corporate Law in Promoting Good Corporate Governance*, Working Paper No. 300, Stanford Law School, available at www.ssrn.com, as published in J.W. Lorsch, L. Berlowitz, and A. Zelleke (eds.) [2005], RESTORING TRUST IN AMERICAN BUSINESS, MIT Press.

[81] This point is now quite well settled in Corporate Law and Economics. See Roe, M.J. [2004b], *The Institutions of Corporate Governance*, Harvard Law and Economics Discussion Paper No. 488, available at www.ssrn.com; Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1661-1663.

[82] Roe, M.J. [2002], *Corporate Law's Limits*, in JOURNAL OF LEGAL STUDIES, vol. 31, 233-271.

[83] Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1647-1653 and 1663-1670.

[84] See, e.g., Hamilton, R.W. [2000], *op. cit.*, 453-467.

[85] See, illustratively, Shleifer, A. and Vishny, R. [1997], *op. cit.*, 741 and 753-757. For a number of reasons that I will later elaborate upon in more detail (see *infra*, Chapter Three, section 3.4.4.), this is supposed to take place by means of (the threat of) hostile takeovers. See, e.g., Scharfstein, D.

simply enhancing, but *maximizing* shareholder value would be then the only way for the corporate controller to make money out of his position, for he would lose it otherwise.

In this view, the corporate controller's position is equated to that of a shareholder agent. This would work perfectly on condition that the manager's skills are a sort of market commodity: that is, on condition that managerial skills are not firm-specific and, therefore, the manager's preferences are 'unimportant' for the maximization of firm value. In other words, managers should not be supposed to undertake any investment in tailoring their skills to the firm that could not be replicated on the managerial labor market. Neither should they be required "to be innovative or inventive, given that many of the actions of the managers of a large company are relatively routine."[86] This is most often assumed in explaining separation of ownership from (effective) control.

The above assumptions do not always hold. What is missing from that approach is consideration for the role of *entrepreneurship* in the corporate business.[87] There-

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[1988], *The Disciplinary Role of Takeovers,* in REVIEW OF ECONOMIC STUDIES, vol. 55, 185-200. For still one of the most appealing descriptions of the takeover mechanism, see Manne, H.G. [1965], *Mergers and the Market for Corporate Control*, in JOURNAL OF POLITICAL ECONOMY, vol. 76, 110-120. Jensen, M.C. [1986], *op. cit.*, subsequently showed how the takeover mechanism might fail to entirely discipline managerial behavior. For an up-to-date review of the existing literature on takeovers, see Burkart, M. and Panunzi, F. [2006b], *op. cit.*

86 Hart, O. [1995], *op. cit.*, 126.

87 For an introduction to the problem, see Ricketts, M. [2002], THE ECONOMICS OF BUSINESS ENTERPRISE, Elgar, 122-128 and 265-267 (and references cited therein). The main difficulty of integrating entrepreneurship in CG arises from lack of coordination between theories of entrepreneurship and theories of the firm. Both emerged as a response to the inadequate assumptions of neoclassical economics, and to the firm being regarded as a 'black box' in a world of perfect information. However, the way in which these two strands of literature have attempted to look inside the firm is significantly different. Coase, R.H. [1937], *The nature of the firm*, in ECONOMICA, vol. 4 (New Series), 386-405, regarded uncertainty as a source of (transaction) costs of using the price mechanism and, therefore, of the comparative advantage of authority-based institutions (firms) over consensus-based exchange (markets). According to Knight, F.H. [1921], RISK, UNCERTAINTY, AND PROFIT, Houghton Mifflin, uncertainty was nothing that markets could possibly handle. Then he advocated the decision-making role of a person, rather than of an organization: that of the entrepreneur, who receives profits in return for (successfully) bearing uncertainty. After Coase – who criticized Knight for failing "to give a *reason* why the price mechanism should be superseded" (Coase, R.H. [1937], *op. cit.*, 401 – emphasis added) – mainstream nexus of contracts theory of the firm was developed with a clear neoclassical flavor (albeit allowing for imperfect information). See the discussion of the agency theory of the corporation in Chapter Three. After Knight other theories of entrepreneurship followed, bearing almost no relationship with the neoclassical paradigm (the so-called 'Neo-Austrian approach'). Kirzner's entrepreneur is especially alert to exploiting profit opportunities which are available, but still unknown to others (Kirzner, I.M. [1979], PERCEPTION, OPPORTUNITY, AND PROFIT, University of Chicago Press). Schumpeter's is a revolutionary innovator who pushes knowledge beyond what is available to society (Schumpeter, J.A. [1943], CAPITALISM, SOCIALISM,

fore, the same approach does not account for any reward of firm-specific entrepreneurial talent that would not arise from a standardized maximization of shareholder value. However, in many (if not most) business ventures, shareholder investment is definitely not the most important for the firm's success.[88] Whenever innovation and inventiveness are at stake, what the entrepreneur commits to the firm is really crucial: the firm's success will depend much more on his own managerial talent than on the money involved. Now, suppose that this entrepreneur decides to raise equity funds from the market. Differently from outside shareholders, the entrepreneur would not have (only) his money invested in the firm. Differently from outside shareholders, then, a share of the residual claim on the firm's assets might be not enough to reward his investment.[89]

The entrepreneur's investment requires *human capital* being irreversibly committed to the firm. Typically, the investment of entrepreneurial human capital is highly specific to the particular combination of assets that constitutes the firm.[90] *Asset*

AND DEMOCRACY, Unwin University Books). Shackle's is ultimately a visionary featured with a particularly creative imagination (Shackle, G.L.S. [1970], EXPECTATION, ENTERPRISE AND PROFIT: THE THEORY OF THE FIRM, Allen and Unwin). Casson's is – more broadly – a specialized judgment-maker about coordination of scarce resources whereupon individuals with the same preferences, and under identical circumstances, would make different decisions (Casson, M.C. [1982], THE ENTREPRENEUR: AN ECONOMIC THEORY, Martin Robertson).

Two major conclusions arise from this discussion. First, entrepreneurship cannot be investigated with the aid of price theory; for whatever underlies entrepreneurship, this is exactly what markets are unable to price at the outset. Second, failing to account for entrepreneurship makes any inquiry on the theory of the firm inherently incomplete. As Ricketts, M. [2002], *op. cit.*, 81, puts it: "If the firm is a vehicle for the exercise of entrepreneurship we have to get used to the idea that a significant proportion of the income received by those who work in the firm is *entrepreneurial profit*. […] The important thing is that entrepreneurs have the means of transferring their *insights* into *personal gain*." (emphases added) The matter – as we are about to see – has a special bearing on the theory and practice of CG.

88 See Rajan, R.G. and Zingales, L. [2000], *The Governance of the New Enterprise*, in X. Vives (ed.), CORPORATE GOVERNANCE: THEORETICAL AND EMPIRICAL PERSPECTIVES, Cambridge University Press, 201-232.

89 The intuition is borrowed from the theory of entrepreneurship. In this regard, Kirzner eminently claimed that entrepreneurial profits are captured by those "who exercise pure entrepreneurship, for which ownership is never a condition" (Kirzner, I.M. [1979], *op. cit.*, 94). "By this statement, Kirzner is emphasizing the point that entrepreneurial gains are a distinct category and [have] nothing to do with the conventional return to capital." (Ricketts, M. [2002], *op. cit.*, 124). In mainstream theory of CG, issues of entrepreneurship and the Neo-Austrian critique to the neoclassical paradigm of microeconomics are almost completely disregarded. If such a perspective was adopted – as I am going to do throughout this work – separation of ownership and control would appear merely as the "division of capitalist from the entrepreneur" (Ricketts, M. [2002], *op. cit.*, 266).

90 Rajan, R.G. and Zingales, L. [2000], *op. cit.*, 214-220 (referring to the general provision of human capital within the firm). For a similar account of the problem and its implications for CG, see – on the legal side – Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1631-1636. A more technical discussion of how this relates to the allocation of control power within the firm can be found in Rajan,

specificity is a key feature of the modern theory of the firm, which I shall return to for more detailed discussion in Chapter Three. For the moment, let me just point at the major consequences of asset specificity for the relation of entrepreneurs with outside shareholders. To the extent that entrepreneurial investments are *too specific* to be redeployed outside the firm, they are *sunk costs* – they have no resale value on the market. Shareholder investments are firm-specific too and, to the extent that there is a difference between the current value of the firm's assets and their liquidation value on the market, they are sunk costs. However, unless the firm goes bankrupt, such a difference will be ultimately rewarded by the firm's profits. An adequate reward of the entrepreneur's investments cannot instead be secured through profit sharing; it also requires *tenure* – that is, holding on firm control.[91]

It might take quite a long time before firm-specific investments are rewarded through the firm's actual or prospective profitability. However, sharing the profits with the entrepreneur and a prohibition of non-pro-rata distributions make sure that outside shareholders ultimately get a return on their investment. No matter how late they come, realized profits are bound to be distributed among residual claimants according to the sharing rule originally contracted for.[92]

This arrangement has two shortcomings. First, it does not guarantee that firm's profits are as high as possible. Secondly, it does not entirely protect the investment of who is ultimately responsible of maximizing those profits – the entrepreneur. Without tenure, the entrepreneur would get his share of the profits until he is in charge of the firm's management. But, as soon as he is no longer in control of the firm's assets, he would get nothing more.[93] Why then should he bother of maximizing the firm's profits in the long run (which would be the ultimate interest of shareholders)? All the profits that have been neither realized nor yet anticipated by forward-looking stock markets are appropriated by who is entitled to decide a change in control, by selling the firm's assets at a premium above market price. That is, the part of the firm's surplus that has not yet been priced by the stock market is not shared among residual claimants; it is just appropriated by the holder of residual control rights.[94]

R.G. and Zingales, L. [1998], *Power in a Theory of the Firm*, in QUARTERLY JOURNAL OF ECONOMICS, vol. 113, 386-432.

91 This is quite clearly illustrated by Hart, O. [1995], *op. cit.*, 9 and 95-125. Most legal scholars simply refuse to follow this line of inquiry. But there are exceptions. See, most notably, Coates, J.C. IV [2000], *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, in TEXAS LAW REVIEW, vol. 79, 316-317.

92 Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1653-1660.

93 Hart, O. [1995], *op. cit.*, 9 and 206-209.

94 See, in the economic theory, Zingales, L. [1998], *op. cit.*, 499-500; on the legal side, Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1653-1660.

Let me refer to that part of the surplus as to *idiosyncratic control rents*.[95] Idiosyncratic means that they are specific to any combination of managerial skills with the firm's assets.[96] They are consequently *non-verifiable* (they have no contractible market

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95 This is definitely not standard terminology. To be sure, most recent literature on CG does account for control rents in the form of *private benefits of control*. However, the mainstream approach is quite negative about them. See, e.g., Bebchuk, L.A. [1999], *A Rent-Protection Theory of Corporate Ownership and Control*, NBER Working Paper No. 7203. Some economists at least acknowledge that they may possibly play a beneficial role in CG (Dyck, A. and Zingales, L. [2004], *Private Benefits of Control: An International Comparison*, in JOURNAL OF FINANCE, vol. 59, 540–541; Mayer, C. [1999], *op. cit.*, 5-10. Corporate Law and Economics is just beginning to consider control rents as a potentially important motivation for entrepreneurship in business corporations. See, very supportively, Coates, J.C. IV [2001], *Explaining Variation in Takeover Defenses: Blame the Lawyers*, in CALIFORNIA LAW REVIEW, vol. 89, 1326-1333, and Coates, J.C. IV [2003], *op. cit.*; much more cautiously, Bebchuk, L.A. [2003a], *Why Firms Adopt Antitakeover Arrangements*, in UNIVERSITY OF PENNSYLVANIA LAW REVIEW, vol. 152, 730-734. Nobody, however, at least to my knowledge, has ever explicitly characterized these 'motivational' rents as idiosyncratic.

96 Oliver Williamson introduced the term 'idiosyncrasy' into the jargon of economics and, not much later, of Law and Economics – idiosyncratic being any exchange where "the *specific identity* of the parties has important cost-bearing consequences." Williamson, O.E. [1979], *Transaction-Cost Economics: The Governance of Contractual Relations*, in JOURNAL OF LAW AND ECONOMICS, vol. 22, 240 (and, more in general, 238-245 – "The Economics of Idiosyncrasy"). Idiosyncrasy is a rather suggestive way to describe the non-marketable value of tangible and intangible assets, once they have been brought within a particular relationship (in our case, within a firm).
According to the theoretical approach closest to the one being followed here, CG ultimately deals with the allocation of non-contractible firm surplus over what could be obtained in the marketplace (Zingales, L. [1998], *op. cit.*, 497) – so, basically, it just deals with idiosyncrasy. In economics, the definition for the above surplus is 'quasi-rent' (Klein, B., Crawford, R.G. and Alchian, A.A. [1978], *Vertical integration, appropriable rents and the competitive contracting process*, in JOURNAL OF LAW AND ECONOMICS, vol. 21, 297–326). Quasi-rents cannot be contracted for *ex ante* (before relationship-specific investments are made) and must be divided *ex post* (after those investments have been exploited and the surplus has been realized). Meanwhile, in a firm relationship, quasi-rents describe the specificity of the investments committed to their production – their excess value within the relationship. *Ex ante*, both the rents and the investments they are intended to reward are therefore *idiosyncratic* to the ongoing relationship.
Rewarding the entrepreneur's investment of managerial talent is one way to look at the function of quasi-rents that is normally neglected by the literature on CG. To the extent it is not priced by the stock market, this investment is idiosyncratic and can only generate *quasi*-rents. However, as long as quasi-rents can be secured by the entrepreneur *before* he invests (*i.e.*, as long as they can be separated from the financial returns to shareholders), *ex post* they may also be considered as purely entrepreneurial *rents* (Ricketts, M. [2002], *op. cit.*, 265-267). The intuition is far from novel. In introducing quasi-rents into economic theory, Alfred Marshall based their distinction from "true rents" just on the latter's being "independent of man's efforts" while the former being like "the gains of a settler in a new country" – that is, "the returns to new capital applied to the land", where "land in a *new* country, *but only there*, resembles a manufacturing plant from this point of view." (Marshall, A. [1893], *On Rents*, in ECONOMIC JOURNAL, vol. 3, 76-78 – emphases added).
The idiosyncratic character of the (quasi) rents in question implies that they do not affect shareholder value until they are realized; in the meantime, they may continue to motivate entrepreneurship notwithstanding separation of ownership and control; the next entrepreneur will have to both

value) and *non-transferable* (they can only be enjoyed by who is actually in charge of the firm's management). As I mentioned earlier, these control rents are one particular instance of *private benefits of control*.[97] I shall extensively discuss private benefits of control at a later stage of this inquiry. However, it should be noticed at the outset that non-verifiability (non-marketability) of *this kind* of private benefits implies that they do no actual harm to shareholders, who should only care about the verifiable surplus they are entitled to – i.e., profits.[98] Nonetheless, those benefits could be eventually appropriated by outside shareholders. When shareholders have residual rights of control, "managers worry that the shareholders will threaten to force a sale

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compensate the rents of the former and to set up for his own (see Chapter Six in this regard). Idiosyncratic control rents retained by the firm's management can thus help reconciling theory of the firm and theory of entrepreneurship, which have proven unable to communicate with each other so far. See, e.g., Foss, N.J. and Klein, P.G. [2005], *Entrepreneurship and the Economic Theory of the Firm: Any Gains from Trade?*, in R. Agarwal, S.A. Alvarez, and O. Sorenson (eds.), HANDBOOK OF ENTREPRENEURSHIP: DISCIPLINARY PERSPECTIVES, Kluwer, 55-80.

97 This is very precisely illustrated by Aghion, P. and Bolton, P. [1992], *op. cit.*, 476:

> "The investor is only interested in the monetary returns of the project. The entrepreneur, who thought about the project and took the initiative of setting it up, cares not only about the monetary returns but also about other less tangible things such as reputation, specific human capital, effort, etc. […] We shall refer to [these non-monetary elements in his payoff] as the *private benefits* of the entrepreneur since they are not observable or verifiable by third parties."

A quite extensive literature is developing on the role of private benefits of control in CG. As I mentioned, they are mostly understood as control rents arising from diversion of shareholder value (La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R. [2000a], *Investor protection and corporate governance*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 59, 3–27). As a result, they negatively affect not only the value of individual firms but also the social welfare as a whole (Bebchuk, L.A. [1999], *op. cit.*). However, PBC can be analyzed along many dimensions, having different implications on both firm value and social welfare. A few economists and lawyers have started to consider also a non-diversionary dimension of PBC and its role in CG. See, e.g., among the economists: Zingales, L. [1995], *Insider ownership and the decision to go public*, in REVIEW OF ECONOMIC STUDIES, vol. 62, 425–448; Holderness, C.G. [2003], *op. cit.*; Mayer, C. [1999], *op. cit.*; among legal scholars: Gilson, R.J. [2006], *Controlling Shareholders and corporate Governance: Complicating the Taxonomy*, in HARVARD LAW REVIEW, vol. 119, 1641-1679; Coates, J.C. IV [2003], *op. cit.*

98 One important implication of control rents – or private benefits of control – being idiosyncratic is that they do not involve any monetary loss for non-controlling shareholders. As long as control rents are idiosyncratic, they are non-transferable. In other words, they depend on the identity of the corporate controller, who is the only one who can enjoy them. Specific synergies in the control of group companies are a case in point (Zingales, L. [1995], *op. cit.*, 428; Holderness, C.G. [2003], *op. cit.*, 55). More in general, entrepreneurs and managers may (and apparently often do – Brau, J.C. and Fawcett, S.E. [2006], *Initial Public Offerings: An Analysis of Theory and Practice*, in JOURNAL OF FINANCE, vol. 61, 399-436) attach a highly idiosyncratic value to being the ultimate boss in a hierarchy. See Boot, A., Gopalan, R. and Thakor, A. [2006], *The Entrepreneur's Choice between Private and Public Ownership*, in JOURNAL OF FINANCE, vol. 61, 803-836 (whose framework, however, abstracts from PBC); and Coates, J.C. IV [2003], *op. cit.*, 15-16 (explicitly considering this value as an instance of PBC).

to a third party as a way of forcing a redistribution of the [non-verifiable] surplus created by the [specific] investments."[99]

Auctioning firm control to the highest bidder for the company shares would be in fact a profitable strategy for shareholders to appropriate the entrepreneur's control rents from operating the assets.[100] On the one hand, this would undermine the entrepreneur's incentive to invest in the production of any non-promptly verifiable surplus.[101] On the other hand, production of verifiable surplus would be suboptimal, for realized profits are bound to be shared pro-rata with outside shareholders, and then the entrepreneur would better maximize his own benefits while he is in charge.[102] Conversely, if the entrepreneur retains residual control rights, his efforts will be directed to the production of both verifiable and unverifiable surplus.[103] *The former (profits) might be then enhanced dynamically, by cashing in the latter (idiosyncratic control rents) through control sales.*

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99 Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1654. Of course, idiosyncratic control rents are lost with firm control – unless the corporate controller is entitled to bargain for their compensation. If shareholders are entitled to sell firm control to the highest bidder anytime they find it profitable to do so, no compensation for control rents can be bargained for (*ex post*) by the corporate controller. The discussion that follows is about how this affects the corporate controller's incentives to invest (*ex ante*) his unverifiable talent in the company management.

100 See Laffont, J.-J. and Tirole, J. [1988], *Repeated Auctions of Incentive Contracts, Investments, and Bidding Parity with an Application to Takeovers*, in RAND JOURNAL OF ECONOMICS, vol. 19, 516-537. More broadly, on *ex post* appropriation of firm-specific investments undertaken by the firm's 'stakeholders' (whereupon see Chapter Three, section 3.5), Shleifer, A. and Summers, L.H. [1988], *Breach of Trust in Hostile Takeovers*, in A.J. Auerbach (ed.), CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES, University of Chicago Press.

101 Laffont, J.-J. and Tirole, J. [1988], *op. cit.*, 530, characterize such an investment as "not observable" while transferable – in the form of a positive externality – from the incumbent to the insurgent management; in fact, they assume complete contracting. For an incomplete contracting perspective, see Schnitzer, M. [1995], *op. cit.* See also Canoya, M., Riyanto, Y.E. and Van Cayseele, P. [2000], *Corporate Takeovers, Bargaining and Managers' Incentives to Invest*, in MANAGERIAL AND DECISION ECONOMICS, vol. 21, 1-18.

102 This outcome could be avoided by means of a simple incentive scheme, if only entrepreneurs were to derive no private benefits from firm control – i.e., if his managerial investments were fully contractible *ex ante* (Hart, O. [1995], *op. cit.*, 126-155). When firm-specific investments by the management are involved, an incentive-compatible remuneration would become simply too costly to implement in the absence of control rents (Bratton, W.B. and McCahery, J.A. [2001a], *op. cit.*, 14 – fn. 34). In theory, the manager could be made residual claimant on *all* returns generated by his investment. "But this cannot be optimal for shareholders since the manager's limited wealth makes it impossible to extract these returns from the manager *ex ante* via a lump sum payment. In order to reduce the manager's rent the optimal contract from shareholders' point of view would give the manager only a fraction of the returns of his investment and there would still be underinvestment." (Schnitzer, M. [1995], *op. cit.*, 235).

103 For the intuition, see Holderness, C.G. [2003], *op. cit.*, 55.

For the moment, let me just hint at how this may work.[104] Suppose a more efficient manager eventually shows up, bringing about a prospective increase in the firm's profitability large enough to more than offset the incumbent entrepreneur's private benefits from operating the assets. Our entrepreneur would of course agree to a control sale – he would finally have his firm-specific investments entirely rewarded in cash. To the extent some further surplus is brought about by the change in control, this would ultimately accrue to the firm value, thereby benefiting also other (actual or prospective) residual claimants.

The above mechanism requires *tenure* of control rights. That is, control over the firm's assets cannot be taken away from the entrepreneur against his will. This is actually the only way in which non-verifiable and non-transferable (i.e., idiosyncratic) control rents can be secured by the entrepreneur and thus motivate his firm-specific investments. When equity finance is involved, this implies that the corporate controller keep his position unchallenged, even though the firm's ownership mostly belongs to non-controlling shareholders.[105]

In their capacity as owners of the firm, actual or would-be outside shareholders may at some point attempt to oust the corporate controller and have him replaced with some other manager. As a result, corporate control may be taken over against the will of the incumbent management. This is the so-called *hostile takeover*.[106] Another conventional way to put it is corporate control being 'contestable' on a very special market where firms are bought and sold: the market for corporate control.[107] Firm control is said to be *contestable* anytime shareholders can force a change

[104] For a detailed discussion of the mechanism, see *infra*, Chapter Six, section 6.2.

[105] John Coates IV provides perhaps one of the most suggestive illustrations of why this should be the case. Coates, J.C. IV [2003], *op. cit.,* 12-16.

[106] Manne, H.G. [1965], *op. cit.*, 115-119, originally distinguished (friendly) mergers – which do require management's approval – from (hostile) takeovers – which do not. However, takeovers are customarily followed by a merger. For this reason, the standard divide is nowadays between friendly and hostile Takeovers. See Morck, R., Shleifer, A. and Vishny, R. [1987], *Characteristics of Hostile and Friendly Takeover Targets*, NBER Working Paper No. 2295.

[107] This expression was famously introduced by Manne, H.G. [1965], *op. cit.* See Carney, W.J. [1999], *The Legacy of "The Market for Corporate Control" and the Origins of the Theory of the Firm*, in WESTERN RESERVE LAW REVIEW, vol. 50, 215-244, for a comprehensive discussion of Manne's contribution not just to Corporate Law and Economics, but to the very economic foundations of corporate governance. Henry Manne was the first to argue that corporate control must be analyzed as a market commodity. However, he has never argued in favor of contestability of this market – neither has he ever mentioned contestability. See *infra*, Chapter Five, section 5.5. Professor Manne just distinguished between takeovers (hostile) and mergers (friendly) as two alternative ways to have the market for corporate control operated. The notion of contestability was borrowed later from the theory of industrial organization. As the threat of entry by a more efficient competitor makes product markets 'contestable,' so the threat of hostile takeover makes the (typically monopolistic) market

in control notwithstanding the incumbent management's opposition. A 'contestable' market for corporate control is operated by means of (the threat of) hostile takeover.[108]

Ability of the corporate controller to successfully resist a hostile takeover is called *entrenchment*.[109] Entrenchment of corporate control is just the opposite of contestability: it implies that hostile takeovers are ruled out. Entrenchment of corporate control is, in turn, the ultimate feature of residual rights of control being granted to an entrepreneur seeking for equity finance, while unwilling to give up his private benefits from operating the firm's assets. Entrenchment essentially entails the right to decide upon a change in control over those assets.

The corporate structure also provides support for that feature. In fact, the legal entitlements available to the corporate controller extend beyond the current authority over centralized management. They also allow for the possibility of making such an authority – and its private benefits – *unchallenged* by any insurgent shareholder. Corporate law systems provide for a menu of alternatives when it comes to entrenchment devices.[110] In some jurisdictions (like Delaware in the US), the board of directors basically can 'just say no' to hostile takeovers – unless it is prevented from doing so by the corporate charter – by setting up so-called 'takeover defenses' that make any unfriendly acquisition unprofitable.[111] Since the overwhelming majority of corporate charters are very permissive in this regard, whoever controls the board of such a corporation is normally entitled to entrench himself.[112] Alternatively, where

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for corporate control likewise 'contestable.' See Baumol, W.J., Panzar, J.C. and Willig, R.D. [1982], CONTESTABLE MARKETS AND THE THEORY OF INDUSTRY STRUCTURE, Harcourt Brace Jovanovich.

108 In standard CG terminology, contestability is just synonymous of hostile takeovers being possible. I shall stick to this very basic notion throughout the present work.

109 See, conceptually, Stulz, R. [1988], *Managerial Control of Voting Rights: Financing Policies and the Market for Corporate Control*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 20, 25-54. Entrenchment has been first described as a strategic behavior of the managers by Shleifer, A. and Vishny, R. [1989a], *Management Entrenchment: The Case of Manager-Specific Investments*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 25, 123–139. For the emerging, contrarian view on the potential benefits of entrenchment, see the references cited *supra,* note 56. For a broad overview of the causes and consequences of entrenchment, see Morck, R., Wolfenzon, D. and Yeung, B. [2005], *Corporate Governance, Economic Entrenchment and Growth*, in JOURNAL OF ECONOMIC LITERATURE, vol. 43, 657–722.

110 See, illustratively, Georgakopoulos, N.L. [2001], *Corporate Defense Law for Dispersed Ownership,* HOFSTRA LAW REVIEW, vol. 30, 11-120.

111 This holds most prominently in the US, where the leading corporate law jurisdiction (the state of Delaware – see *infra*, Chapter Seven, note 7) is quite liberal when it comes to takeover resistance by the board of directors. For a non-technical overview, see Ricketts, M. [2002], *op. cit.*, 313-316. In the legal literature, see Bainbridge, S.M. [2002a], *op. cit.*, 677-693. A similar, but much less known case is Dutch corporate law. See *infra*, Chapter Seven, section 7.3.3.

112 Bebchuk, L.A., Coates, J.C. IV and Subramanian, G. [2002a], *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence & Policy*, in STANFORD LAW REVIEW, vol. 54, 887-951.

takeover defenses are subject to shareholder approval (like in many European countries), corporate controllers can still entrench themselves by owning enough shares to make unfriendly acquisitions unprofitable or impossible.[113] While the entrenchment potential of inside ownership requires some qualifications in those situations where the management is ultimately in charge, it should be noted that a controlling shareholder is entrenched almost by definition. But in order to understand why this is more than a tautology, a few elements should be added to the picture of corporate governance.

1.5. Shareholder Voting: Theory and Practice

1.5.1. Who Is in Charge for Real?

An essential issue is missing from the picture of corporate governance that has been presented so far. I have depicted non-controlling shareholders as entirely powerless financiers. There are both an important lie and an important truth in this description. The lie is that shareholders have *formally* no right to influence the way in which their money are managed. In fact, *shareholders do not only get a residual claim* on the firm's assets in return for their investment; normally (albeit not always) *they also get voting rights* proportional to their share of company ownership.[114] On that basis, shareholders are entitled to participate in the general meeting and to vote for both appointing the managers and approving most significant corporate transactions. The truth in the 'powerless financiers' picture is that this formal entitlement does not confer any *actual* power to non-controlling shareholders.[115] In practice, the outcome of the voting process is generally determined by the corporate controller.[116] Actually, there is no such thing as a 'shareholder democracy' in corporate governance.

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[113] See Becht, M. and Mayer, C. [2001], *Introduction*, in F. Barca and M. Becht (eds.), THE CONTROL OF CORPORATE EUROPE, Oxford University Press, (hereinafter Becht, M. and Mayer, C. [2001], *Introduction*), 11-15. For an interesting discussion on how the US do not look any different from continental Europe as far as non-contestability of corporate control is concerned, see Coates, J.C. IV [2003], *op. cit.*, 20-24.

[114] Shleifer, A. and Vishny, R. [1997], *op. cit.*, 750-751.

[115] Hellwig, M. [2000], *op. cit.*, 96-100.

[116] There are not many empirical studies on corporate voting. The only two I am aware of definitely support the conclusion in the text. See De Jong, A., Mertens, G. and Roosenboom, P. [2005], *Shareholders' Voting at General Meetings: Evidence from the Netherlands*, Working Paper, Erasmus Univer-

However, in both law and economics, shareholder voting is deemed a central feature of corporate governance.[117] Thus, I have to explain why the above description of the basic structure of the corporation does not account for it. The reason is that, in the corporate organization, who is entitled to vote might seem *ipso facto* the ultimate holder of residual rights of control. In theory, any matter that is not explicitly dealt with in the equity contract has to be decided – directly or indirectly – upon a vote by the general meeting of shareholders. Indirectly means that shareholders are in charge of electing and revoking the members of the board of directors who, in turn, select the managers for day-to-day decision-making. In addition, shareholders have to consent to those transactions (so-called 'fundamental transactions') that do not fall within the board's or the management's discretion; they must approve the amendments to the corporate charter; in some jurisdictions, they need to endorse conflicted interest transactions either by a straight vote or indirectly, by having them sanctioned by independent directors acting on their behalf.[118]

Therefore, in standard Corporate Law and Economics, voting is the basic tool for allocating residual rights of control to shareholders.[119] True, the standard view recognizes that large companies have thousands of small, dispersed shareholders who would never exercise their voting rights individually.[120] However, dispersed

sity (ERIN series), available at www.ssrn.com; Maug, E. and Rydqvist, K. [2001], *What is the Function of the General Meeting? Evidence from the U.S. Proxy Voting Process*, Working paper, Humboldt University and Norwegian School of Management, available at www.ssrn.com.

117 Easterbrook, F.H. and Fischel, D.R. [1991], *op. cit.*, 63-89.

118 Indeed, corporate laws are functionally structured in this way. See Kraakman *et al.* [2004], *The Anatomy*, cit., 33-70.

119 Easterbrook, F.H. and Fischel, D.R. [1991], *op. cit.*, 67-70; Hart, O. [1995], *op. cit.*, 126-129 and 186-209. All of them contend that shareholding should be featured with an identical proportion of voting rights and cash flow rights (so-called 'one share–one vote' principle, whereupon *infra*, section 1.6.2.). However, Hart's view differs from Easterbrook and Fishel's on the *reasons* why residual control rights should be linked to income rights. In a former article, Easterbrook, F.H. and Fischel, D.R. [1983], *Voting in Corporate Law,* in JOURNAL OF LAW AND ECONOMICS, vol. 26, 403, argued that "as residual claimants, the shareholders are the group with the appropriate incentives (collective choice problems to one side) to make discretionary decisions." This has become a standard reference in Corporate Law and Economics. Hart's view is based on a different set of arguments, developed in Grossman, S.J. and Hart, O. [1988], *One Share–One Vote and The Market for Corporate Control*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 20, 175-202, and Harris, M. and Raviv, A. [1989], *The Design of Securities*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 24, 255-287, which he later summarized as follows: "One share–one vote is optimal not so much because it gives shareholders the right incentives to take decisions, but rather because it forces someone who wants to obtain control of the company to acquire a share of the company's dividend stream commensurate with this control." Hart, O. [1995], *op. cit.*, 189. See *infra*, in the text, and Chapter Three, section 3.4.4., for a more detailed discussion.

120 "Voting rights are of limited value unless they are concentrated." Shleifer, A. and Vishny, R. [1997], *op. cit.*, 764.

votes of a corporation can coalesce. "When votes are concentrated – either in a large share holding or through a takeover – they become extremely valuable, since the party that controls the concentrated votes can make virtually *all* corporate decisions."[121] As a result, corporate control needs ultimately to be supported by *actual* or *potential* shareholder voting, depending on whether votes are already concentrated or may quickly get so through a takeover.

While the above description works very nicely in theory, the empirical evidence shows us quite a different picture. In the worldwide corporate practice, non-controlling shareholders very seldom vote, whether or not they are dispersed.[122] Whenever casting their vote is needed by the corporate controller to have a nominee (possibly, himself) appointed to the board or a resolution passed, outside shareholders normally endorse the controller's proposals. Should insurgent shareholders have the intention and coalesce the voting power either to oust the incumbent controller or to challenge his plans, the latter would be often (if not always) able to hold on both his position and propositions by entrenching himself.[123] The reason why I have omitted the issue of shareholder voting so far is then that this issue, at least in the way it is typically presented, is misleading.

1.5.2. Voting and Residual Control Rights

Nevertheless, shareholder voting matters in corporate governance. It is true that voting is the core legal instrument for allocating residual rights of control. However, formal entitlement to vote does not suffice to conclude that residual rights of control are allocated to all shareholders indistinctively. Both legal and economic

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121 Id., at 764.

122 The standard debate is centered on institutional investor's passivity, in the face of the desirability of their activism. Compare Black, B.S. [1992], *Agents Watching Agents: The Promise of Institutional Investor Voice*, in UCLA LAW REVIEW, vol. 39, 811-893, with the evidence provided by Mallin, C. [2001], *Institutional Investors and Voting Practices: An International Comparison*, in CORPORATE GOVERNANCE: AN INTERNATIONAL REVIEW, vol. 9, 118-126. Most studies on shareholder passivity refer to the US. See, e.g., Black, B.S. [1990a], *Shareholder Passivity Reexamined*, in MICHIGAN LAW REVIEW, vol. 89, 529-591; Black, B.S. [1998], *Shareholder Activism and Corporate Governance in the United States*, in Newman P. (ed.), THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW, vol. 3, Macmillan, 459-465. For a comparative overview of the role of institutional investors in CG, see Baums, T., Buxbaum, R.M. and Hopt, K.J. (eds.) [1994], INSTITUTIONAL INVESTORS AND CORPORATE GOVERNANCE, de Gruyter.

123 On the legal implications of shareholder passivity ("The limits of shareholder consent"), see Eisenberg, M.A. [1989a], *The Structure of Corporation Law*, in COLUMBIA LAW REVIEW, vol. 89, 1474-1480. Id., at 1488-1584, criticizes the view that shareholder primacy would be anyway guaranteed by means of market mechanisms and "other forms of private ordering."

theory has to be reconciled with what we observe in the corporate practice, wherein non-controlling shareholders are granted voting rights that are extensive in theory, but almost useless in fact. It is consequently hard to believe that those shareholders could actually exert any residual right of control, as the standard theory would predict.[124] Albeit counterintuitive at first glance, *voting is in fact the instrument whereby the corporate controller, and not shareholders as a group, exerts (residual rights of) control over the firm management.*

Large firms around the world are characterized by two major patterns of corporate control.[125] One is *managerial control* of a company where no shareholder has enough voting power to influence corporate decision-making systematically. This is the so-called 'public company', a model of corporate governance prevailing in Anglo-Saxon countries and practically unknown in the rest of the world.[126] Managers govern a public company without any significant share ownership (and related voting rights), since they enjoy considerable advantages in controlling how votes are cast by dispersed outside shareholders. The second and much more widespread model of corporate governance is *shareholder control*. It is based on a controlling shareholder (or more of them, acting as a coalition) exerting direct voting power through share ownership. The vast majority of corporate enterprises around the world are governed by a controlling shareholder.[127] Even in the US and the UK, the public company model applies just to some of the largest firms (like, for instance, the General Motors Corporation) but, to be sure, not to all of them (see, e.g., the Ford or the Microsoft Corporations).

In both cases, non-controlling shareholders are almost powerless. Under shareholder control, the majority shareholder has himself enough voting power to do without the support of minority shareholders, whether or not they are dispersed.[128] Since the voting rights of the latter are practically useless, only the former really has residual rights of control. Under managerial control, incumbent managers are in a privileged position to get support from outside shareholders.[129] Provided that they

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[124] For a similar view, Hellwig, M. [2000], *op. cit.*, 98.

[125] See *infra*, Chapter Two, section 2.2.1, for discussion of main classifications in the literature on comparative CG.

[126] Shleifer, A. and Vishny, R. [1997], *op. cit.*, 754-755.

[127] La Porta, R., Lopez-de-Silanes, F. and Shleifer, A. [1999], *Corporate Ownership around the World*, in JOURNAL OF FINANCE, vol. 54, 471-517.

[128] Becht, M. and Mayer, C. [2001], *Introduction*, cit., 18-26.

[129] Blair, M.M. and Stout, L.A. [2006], *op. cit.* (citing Clark, R.C. [1986], *op. cit.*). See also Bebchuk, L.A. and Kahan, M. [1990], *A Framework for Analyzing Legal Policy towards Proxy Contests*, in CALIFORNIA LAW REVIEW, vol. 78, 1073-1135; and, more recently, Bebchuk, L.A. [2005a], *The Case for Increasing Shareholder Power*, in HARVARD LAW REVIEW, vol. 118, 833-914

are dispersed, they will normally rubberstamp any management proposal brought to their attention.[130]

What if, in the last scenario, dispersed ownership concentrates eventually? In theory, an insurgent shareholder might anytime acquire enough voting power to challenge the incumbent managers' position and/or decisions. In practice, most often such a threat would not be credible. Collecting voting power against the corporate controller would be a very costly strategy to be pursued outside a takeover context.[131] Incumbent managers normally have the opportunity to make it even more expensive (or less profitable) by resisting a hostile takeover. Management entrenchment is then a serious obstacle to shareholder coalescence.[132] No insurgent shareholder would ever embark on a control contest knowing *ex ante* that he has very little chances of breaking through rapidly (and cheaply) the incumbent's barricades. Therefore, also in a public company the exercise of residual rights of control by non-controlling shareholders is ultimately a myth. Whatever the model of corporate ownership and control is, the corporate controller(s) is (are) always the one(s) who hold(s) residual rights of control.[133]

Apparently, then, lack of outside shareholder interference with the firm management obtains anyway in corporate governance. To show how this result is achieved, I am now going to introduce one last topic: the distribution of corporate powers. Traditionally, this distribution has been analyzed just as a matter of economic incentives. It has been only recently emphasized that legal rules also play a role in this respect, and indeed a fundamental one.[134] Legal regulation of corporate powers differs across jurisdictions. Therefore, the way in which the economic and legal distributions of corporate powers *jointly* affect the allocation of residual control rights can help us to interpret the real patterns of ownership and control characterizing the corporate business around the world.

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[130] Eisenberg, M.A. [1989a], *op. cit.*, 1477-1480. See also Black, B.S. [1990a], *op. cit.*, 566-608, for discussion of the proposition in the text with special reference to the US.

[131] Easterbrook, F.H. and Fischel, D.R. [1991], *op. cit.*, 66-67 and 70-72.

[132] Shleifer, A. and Vishny, R. [1997], *op. cit.*, 756-757.

[133] Hellwig, M. [2000], *op. cit.*, 107-112.

[134] Cools, S. [2005], *The Real Difference in Corporate Law between the United States and Continental Europe: Distribution of Powers*, in DELAWARE JOURNAL OF CORPORATE LAW, vol. 30, 697-766.

1.6. Distribution of Corporate Powers

1.6.1. Concentrated vs. Dispersed Ownership: Shareholders' Rational Apathy

How the corporate controller gains power against non-controlling shareholders depends on *both* economics and the law. Economics shapes the incentives of outside shareholders to exert their voting rights. The law tilts the balance of powers between the two parties by determining the degree of shareholder involvement necessary to control the corporate enterprise. That is: i) when the vote of outside shareholders is required to uphold managerial decision-making; ii) how the voting process can be directed by the corporate controller; iii) and whether its desired outcome can be obtained without involving outside shareholders in the actual decision-making. Legal and economic distribution of powers explains, in turn, both how firms are governed and the degree of separation of ownership and control that can be afforded by an entrepreneur wishing to maintain effective control of the firm.[135]

As regards shareholder willingness to be involved in the firm management, not all corporations are the same. They can be divided in two broad categories: *closely held companies* (close corporations) and *publicly held ones* (open corporations).[136] Close corporations do not typically raise equity finance from the investing public. Therefore, separation of ownership and control is limited and serves not only financial purposes. Close corporations have a few shareholders that are normally involved, to various extents, in the firm management. Hierarchy matters also in closely held firms, and therefore one or more shareholders must play the role of the corporate controller. However, in close corporations, consensus of counterparties (i.e., non-controlling shareholders) is important too. Whether or not they are merely financiers, their investment in kind, money, or human capital is anyway substantial, so they will ask for a say in most important corporate decisions, thereby limiting the latitude of the entrepreneur's residual rights of control. Minority shareholder voting is consequently decisive for many issues in the governance of close corporations. The typical drawback of this situation is the risk of deadlock, when the parties disagree over renegotiation of the corporate charter. In this respect, close corporations nearly resemble the governance structure of a (multilateral) long-term contract (ba-

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[135] The same intuition underlies the work by Cools, S. [2005], *op. cit.*, 736-739 and 755-765.

[136] For historical reasons, this distinction is borrowed from Anglo-American corporate law. See Hamilton, R.W. [2000], *op. cit.*, 343-348 and 376-384; Davies, P. [2002a], INTRODUCTION TO COMPANY LAW, Oxford University Press, 17-18 and 24-30.

sically, a combination of supply, distribution, labor and financial contracts). This is actually the way in which they are typically analyzed in Law and Economics.[137]

The focus of the present inquiry is on publicly held companies, though. They are very different from closely held ones. In open corporations, separation of ownership and control is always significant, for it is aimed at raising equity funds from the investing public. What investors put in the firm is just money. They only strive for the highest possible financial return on their investment. A fundamental tenet of financial investment is risk diversification: 'Never put all your eggs in the same basket.' Therefore, the rational investor's stake in one single firm is typically negligible relative to his wealth. In turn, this explains why outside shareholders do not want to interfere with the firm management. Being involved would require the acquisition of both information and expertise. This would cost the individual shareholder a lot of time and money, while providing him with very tiny benefits: he would bear all the costs, but the benefits would be shared with the other shareholders, free riding on his efforts.[138]

Theoretically, the free riding problem could be overcome by coordinating with the other shareholders. Yet, apart from the additional costs that this would involve, why should one bother so much about a negligible share of his financial assets? Non-controlling shareholders of a publicly held corporation have in fact a better option: when they are dissatisfied with the return on their investment, they can simply sell their shares and buy some other company's stock. This option is clearly not available to non-controlling shareholders of a close corporation, who lack by definition a secondary market for their shares.[139] This is the ultimate reason why non-controlling shareholders of a close corporation are a few; they have concentrated ownership and are consequently interested in the firm's management. On the contrary, non-controlling shareholders of an open corporation are a lot; they have dispersed ownership and do not care much about how the firm is managed, provided that such a management is profitable.

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[137] See, e.g., Easterbrook, F.H. and Fischel, D.R. [1986], *Close Corporations and Agency Costs*, in STANFORD LAW REVIEW, vol. 38, 271-301; Rock, E.B. and Wachter, M.L. [1999], *Waiting for the Omelet to Set: Match-Specific Assets and Minority Oppression in Close Corporations*, in JOURNAL OF CORPORATION LAW, vol. 24, 913-948. For a broader overview, see McCahery, J.A., Raaijmakers, T. and Vermeulen, E.P. (eds.) [2004], THE GOVERNANCE OF CLOSE CORPORATIONS AND PARTNERSHIPS: US AND EUROPEAN PERSPECTIVES, Oxford University Press.

[138] See, e.g., Marks, S.G. [2000], The *Separation of Ownership and Control*, in B. Bouckaert and G. De Geest (eds.), ENCYCLOPEDIA OF LAW AND ECONOMICS, vol. V, No. 5630, 693-694. In publicly held corporations, the free rider problem affects takeovers the most severely. This problem has been famously investigated by Grossman, S.J. and Hart, O. [1980b], *Takeover Bids, the Free Rider Problem, and the Theory of the Corporation*, in BELL JOURNAL OF ECONOMICS, vol. 11, 42–69. For a detailed illustration, see *infra*, Chapter Ten, sections 10.2 and 10.3.

[139] Easterbrook, F.H. and Fischel, D.R. [1991], *op. cit.*, 228-232.

Dispersed shareholders of a publicly held company are thus said to be 'rationally apathetic.'[140] Although they are entitled to voice their disagreement by voting, they almost never do it. Rather, they keep silent and, if necessary, they 'vote with their feet' – that is, they sell their shares.[141] Dispersed shareholders prefer 'exit' to 'voice'.[142] However, outside shareholders are not apathetic only because they are dispersed. Wealthy individuals or financial institutions can (and often do) hold a significant portion of large firm's equity capital without giving up the advantages of financial risk diversification. Ownership concentration is itself not sufficient to get over rational apathy, unless it is associated to the maintenance or the acquisition of corporate control.[143] In a publicly held company, control matters more than ownership: only the corporate controller(s) and a rider in a control contest always cast their votes. They do it whatever their ownership stake is. How large this stake must be to exert, maintain, or acquire control over a company depends, in turn, on how voting is disciplined by corporate law.

1.6.2. Legal Distributions of Corporate Powers

Corporate law's discipline of shareholder voting determines the way in which the corporate controller makes sure that he keeps his residual rights of control undisputed. Of course, such a discipline must be intended in a very broad meaning. It is not just formal entitlement to voting rights that matters, but also the corporate controller's influence on the voting process and, above all, its outcome. This influence explains how power is exercised, maintained, and lost in a publicly held com-

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140 The notion of 'rational apathy' is borrowed from the theory of electoral participation to politics. Downs, A. [1957], AN ECONOMIC THEORY OF DEMOCRACY, Harper and Row. Corporate Law and Economics acknowledges this as core feature in the governance of publicly held enterprises. See, e.g., Roe, M.J. [1994], STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE, Princeton University Press.

141 Also the idea that shareholders 'vote with their feet' is borrowed from the economic analysis of politics. According to Charles Tiebout, people "vote with their feet" to choose the local government that provides them with the right number of services at preferred levels and costs. See Tiebout, C.M. [1956], *A Pure Theory of Local Expenditures*, in JOURNAL OF POLITICAL ECONOMY, vol. 64, 416-424.

142 This terminology is based on Hirschman, A.O. [1970], EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES, Harvard University Press.

143 This is the basic intuition underlying the analysis of ownership concentration as a tradeoff between liquidity of financial investments and stability of corporate control. See, in this regard, two companion papers: Bolton, P. and von Thadden, E.-L. [1998a], *Blocks, Liquidity, and Corporate Control*, in JOURNAL OF FINANCE, vol. 53, 1-25; Bolton, P. and von Thadden, E.-L. [1998b], *Liquidity and Control: A Dynamic Theory of Corporate Ownership Structure*, in JOURNAL OF INSTITUTIONAL AND THEORETICAL ECONOMICS, vol. 154, 177-211.

pany. As a result, *the legal discipline of corporate voting is ultimately a discipline of distribution of powers.*

Non-controlling shareholders normally do not vote. However, the corporate controller might need their votes to support the exercise and the maintenance of his decision-making power. First, he needs to appoint himself and/or the people he trusts on the board of directors. This is extremely important, but far from sufficient. Once he has gained control of the board, the controller also needs to have some corporate transactions (like, for instance, a merger) approved by the general meeting of shareholders. In addition, he might need to get shareholder support for amending the corporate charter. Finally, the corporate controller needs to secure his position, and therefore to avoid being voted out by an insurgent shareholder who wishes to take over.[144]

Corporate law may provide the controller with the legal instruments necessary to exploit rational apathy of shareholders to his own advantage. Regulation of corporate elections may favor reappointment of incumbent directors by the corporate controller.[145] Shareholders with no board representation might be prevented from taking any initiative concerning corporate decision-making, when they lack control over the agenda of the shareholder meeting.[146] Whenever approval by shareholders is required, voting procedures might be disciplined in such a way as to facilitate collection of their suffrages by the incumbent board.[147] This advantage might be coupled with takeover defenses available to the board, thereby shielding the corporate controller from shareholder insurgency.[148] More in general, all legal devices that allow for *separation of control rights from voting rights* (supporting a powerful board of directors) make residual rights of control available without a significant share ownership.[149] Such devices are therefore a legal precondition for the emergence of a model of corporate governance based on *managerial control*.[150]

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144 On the limits of (formal) shareholder consent, obtained by the corporate controllers to any of the above purposes, see Eisenberg, M.A. [1989a], *op. cit.*, 1474-1480.

145 Bebchuk, L.A. [2003b], *The Case for Shareholder Access to the Ballot*, in THE BUSINESS LAWYER, vol. 59, 43-66; and – more recently – Bebchuk, L.A. [2005b], *The Myth of the Shareholder Franchise*, Working Paper, Harvard University, available at www.ssrn.com, forthcoming in VIRGINIA LAW REVIEW, 2007.

146 Bebchuk L. [2005a], *op. cit.*, 843-850. See also, in a comparative perspective, Cools, S. [2005], *op. cit.,* 126, 738-750.

147 Black, B.S. [1990a], *op. cit.*, 530-566.

148 Bebchuk, L.A., Coates, J.C. IV and Subramanian, G. [2002a], *op. cit.*, 887-951.

149 This is indeed a key point. For its original formulation, see Becht, M. and Mayer, C. [2001], *Introduction*, cit., 11-15.

150 On the costs of this arrangement, see Bebchuk, L.A. and Cohen, A. [2005], *The Cost of Entrenched Boards*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 78, 409–433. Their assessment, however, is limited to the inefficient extraction of PBC. Lucian Bebchuk contemplates elsewhere efficiency-

Alternatively, in the absence of autonomous control rights vested in the board of directors, residual rights of control can only be attained through share ownership.[151] The corporate controller needs to count on enough voting power to maintain support of the shareholder meeting. He must be then a *controlling shareholder*.[152] In most countries, resolutions of the shareholder meeting are generally regulated by a relative majority rule – although some issues require a super-majority.[153] Thus, the simplest way to control shareholder resolutions is to hold the majority of the company's stock. Simple majority may be not enough, however. Corporate laws (or corporate charters) normally also require quorums (i.e., a minimum percentage of voting shares to be represented at the meeting) for a resolution to be passed by shareholders.[154] Majority ownership held by the controlling shareholder then needs not to be lower that the highest quorum required by the law or the charter.

Under the above conditions, relative majority would make corporate control practicable, but still unsafe. Indeed, outside shareholders would not challenge the controlling shareholder's majority until they are dispersed, but a raider could always oust the incumbent by buying out a larger ownership stake. Consequently, in the absence of takeover defenses, the *safest* way for a controlling shareholder to shield himself from a hostile takeover is to maintain at least 50% (absolute majority) of the company shares.[155] Of course, given the controlling shareholder's wealth constraints and risk aversion, this solution would involve a limited capacity to raise equity finance from the capital market.[156] Legal distribution of powers favoring shareholders over the board of directors thus leads not only to a model of corporate governance based on a controlling shareholder, but may also hinder separation of ownership from control.

At least to some extent, further separation of ownership and control can be achieved even in models of corporate governance based on the presence of a controlling shareholder. In the above discussion, I have implicitly assumed shareholder voting is regulated by a 'one share–one vote' principle: this means that voting rights

based explanations of managerial entrenchment, as either "inducement to deconcentrate ownership" or "efficient rent protection" (Bebchuk, L.A. [2003a], *op. cit.*, 730-734). See also *infra*, note 159.

[151] The first, and – to my knowledge – the only one to have set forth this interpretation is Cools, S. [2005], *op. cit.*, 755-762 (where, however, no explicit reference is made to the economics of corporate control).

[152] For a positive analysis of how models of shareholder control are implemented in various jurisdictions, see Kraakman *et al.* [2004], *The Anatomy*, cit., 54-61 and 67-70.

[153] Id., at 131-155.

[154] See, illustratively, Hamilton, R.W. [2000], *op. cit.*, 254-257.

[155] See, e.g., Coates, J.C. IV [2000], *op. cit.,* 316-317.

[156] Hart, O. [1995], *op. cit.,* 6, 188.

are strictly proportional to share ownership. If this were always the rule, one could only get 50% of voting power by holding 50% of share ownership – i.e., by investing 50% of equity capital. However, most legal systems provide some way to get around such a principle. In fact, there are many techniques to *separate voting rights from ownership claims* (so-called 'cash flow rights').[157] The more common in the corporate practice are:

a) *Dual class shares* – whereby the corporate controller gains the majority of voting rights by holding a minority of the company's shares, albeit the most powerful ones.
b) *Pyramidal group structures* – that allow control over the companies at the bottom of the pyramid with just the equity held in a shell company positioned at its top.
c) *Cross-ownership* – that mutually reinforces the corporate controller's voting power in two or more companies, with no additional inflow of equity capital.

When corporate law allows for one or more of those techniques to be implemented for corporate control purposes, powers are partly rebalanced in favor of the corporate controller. Similarly to separation of control rights from voting rights, separation of voting rights from cash flow rights provides both a governance tool and an entrenchment device.[158] By allowing residual rights of control to be exercised (and maintained) with a limited stake in the company ownership, the above techniques enhance the degree of separation of ownership and control that can be achieved in governance models based on the presence of one (or more) controlling shareholder(s).[159]

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[157] This is just another way to achieve separation of ownership and control, and, to be sure, the prevailing one outside the US and the UK. See Becht, M. and Mayer, C. [2001], *Introduction*, cit., 7-18, and the country chapters in the same F. Barca and M. Becht (eds.) [2001], THE CONTROL OF CORPORATE EUROPE, Oxford University Press.

[158] Becht, M. and Mayer, C. [2001], *Introduction*, cit., 36-38.

[159] This does not come without costs. And, indeed, the mainstream view is quite skeptical about the desirability of departures from the 'one share–one vote' principle. See, most notably, Bebchuk, L.A., Kraakman, R.H. and Triantis, G. [2000], *Stock Pyramids, Cross-Ownership, and Dual Class Equity: the Mechanisms and Agency Costs of Separating Control from Cash-flow Rights*, in R. Morck (ed.), CONCENTRATED CORPORATE OWNERSHIP, NBER Conference Volume, University of Chicago Press, 295-315. However, such a view is based on consideration of PBC as inefficient for the social welfare. This is definitely not the only way PBC can enter the CG framework. See, e.g., Aghion, P. and Bolton, P. [1992], *op. cit.*, 475-486. See also the discussion of PBC and their taxonomy in Chapter Five.

1.7. Rethinking Corporate Governance

1.7.1. Positive and Normative Analysis

The foregoing description of corporate governance is perhaps unconventional, but is realistic. Faced with it, at least two questions might arise. First, one might wonder *how* disenfranchising outside shareholders is actually possible, given that they are ultimately the owners of the corporate enterprise. Secondly, one might doubt *whether* this outcome is *efficient*, provided that shareholder franchise is intended to make sure that the firm is managed in such a way as to maximize its profits (i.e., shareholder value). These are two crucial research questions of the present dissertation. The first one is a matter of *positive* analysis: *how* corporations around the world are actually governed by corporate controllers without the support of outside shareholders. The second one is a *normative* issue: what are the conditions under which the exercise of corporate control without the support of outside shareholders can be deemed efficient.

The second question is more difficult to answer, and this clearly requires a preliminary investigation of both facts and theory underlying the positive account. The following discussion of the next Chapters will show that facts do not really match the prevailing theory of corporate governance. Only after delivering a more realistic positive theory of corporate governance, I shall be able to draw normative conclusions. As we will see, both the positive and the normative account are based on a more comprehensive analysis of private benefits of control in corporate governance and how they are regulated by corporate law.

Therefore, I shall start from positive analysis. This entails a comparative dimension, which illustrates how corporate governance is far from a standard phenomenon.

1.7.2. The Dual Role of Legal Rules in Corporate Governance

Patterns of corporate governance around the world exhibit significant variation as to modes and intensity of separation of ownership and control. Yet, apparently, they are always characterized by a corporate controller holding on his residual control rights against any possible insurgency by non-controlling shareholders. The legal distribution of corporate powers seems to play an important role in this respect, by determining the degree of separation of ownership and control that can be afforded by the corporate controller without endangering his position. But, of course, this is just the corporate controller's point of view.

What about that of non-controlling shareholders? Would they ever accept the weakness of their position in the absence of guarantees that they will not be duped? Of course, they would not. Legal entitlements supporting corporate control regardless of the underlying ownership stake are in fact necessary, but not sufficient to achieve separation of ownership and control. As I mentioned, law needs also to prevent the corporate controller from abusing his power. In the absence of adequate legal protection against expropriation of their residual claim, outside shareholder would be unwilling to place their money under the management of the corporate controller. This would obviously undermine the provision of equity finance, and thereby separation of ownership and control, no matter of how powers are distributed between the corporate controller and outside shareholders.[160]

Maybe for this reason *investor protection* is normally considered *the* legal precondition for separation of ownership and control and, consequently, the *only* way in which law 'matters' in corporate governance.[161] If anything, the foregoing discussion suggests that the question is more complicated. Apparently, the legal distribution of corporate powers at least contributes to determining the actual patterns of separation of ownership and control.[162] This separation does not only require effective protection of non-controlling shareholders' residual claim, but also legal entitlements supporting the exercise of residual control rights by the corporate controller, in the form of either managerial control or shareholder control.

How these two basic patterns of corporate control are actually implemented around the world is an empirical question. The next Chapter will try to answer this question, given the state of our knowledge about corporate governance patterns in Europe and the US. The available empirical evidence on comparative corporate governance, which is contradictory and even misleading in many respects, is going to be reconciled. This will be mostly descriptive, but will provide us with the necessary basis for assessing the role of law, and especially of corporate law, in determining the choice of ownership and control structure of the corporate business.

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160 Shleifer, A. and Vishny, R. [1997], *op. cit.*, 750-753.

161 Over the last decade, 'law matters' has been probably the most popular slogan in the literature on corporate governance. The standard references inaugurating this extremely lucky strand of research are: La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R. [1997], *Legal Determinants of External Finance*, in JOURNAL OF FINANCE, vol. 52, 1131-1150; and La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R. [1998], *Law and Finance*, in JOURNAL OF POLITICAL ECONOMY, vol. 106, 1113-1155.

162 Cools, S. [2005], *op. cit.,* 126.

CHAPTER TWO – Comparative Corporate Governance: Facts

2.1. Comparative Law and Economics of Corporate Governance

One empirical investigation about how corporate law affects corporate governance requires two basic steps to be taken. The first one is *economic comparison* of patterns of corporate governance prevailing in different countries. The reason why the investigation has to be carried out in this way is that variation of corporate governance *within a country* can hardly depend on corporate law, which is practically the same even in those countries – like the US – allowing for different jurisdictions.[1] On the contrary, regardless of the within-country variation, pronounced *cross-country* differences in national corporate laws might possibly be responsible of the systematic prevalence of a model of corporate governance over another.[2]

The second step to be taken is *legal comparison*, which is also an empirical work. Rules that most significantly affect corporate governance in each country have to be selected and then compared with the possibly – and, most often, typically – different kind of corporate law arrangements that address the *same* problems in other countries.[3] No matter of whether those key problems of corporate governance are

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1 US corporate law is basically Delaware law. See *infra*, Chapter Seven, note 7.

2 This hypothesis has been famously tested by four American economists – Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny (hereinafter La Porta *et al.*). La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R. [1998], *Law and Finance*, in JOURNAL OF POLITICAL ECONOMY, vol. 106, 1113-1155. But, to be sure, the same methodology may be applied to every institutional variable, and not just to the legal ones. For extension of empirical analysis to non-legal institutions, see, e.g., Dyck, A. and Zingales, L. [2004], *Private Benefits of Control: An International Comparison*, in JOURNAL OF FINANCE, vol. 59, 537-600, and Roe, M.J. [2003c], POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE, Oxford University Press.

3 This is the realm of *functional* comparison – the standard methodology of comparative legal analysis. See, in general terms, Zweigert, K. and Kötz, H. [1998], INTRODUCTION TO COMPARATIVE LAW, 3rd

dealt with by identical or just opposite legal rules, their different solution with similar rules may indeed explain discrepancies in national patterns of corporate governance, whereas similar solutions – albeit with different rules – may provide the basis for understanding resemblances. In other words, legal comparison has to be performed *functionally* rather than *nominally*.[4]

Over the last ten years Law and Economics has embarked on both tasks. *Comparative analysis of corporate governance* has rapidly shown the weakness of the prevailing account of separation of ownership and control, based on a framework where managers just act in their capacity as shareholder agents. This is the standard principal-agent framework.[5] The corporate governance paradigm typically arising out of that framework – the public company, governed by managers and not by controlling shareholders – has proven almost inexistent outside most developed Anglo-Saxon countries and, to be sure, featured with some puzzling differences even in that restricted sample.[6] *Comparative corporate law* has tried to restore that account, claiming that 'law matters' for shareholders to be willing to delegate control to corporate managers.[7] Delegation of management responsibilities to an agent can only arise in the presence of a strong legal protection of the principals (the shareholders), and apparently Anglo-Saxon countries perform much better than the rest of the world

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edn. (translated from German by T. Weir), Oxford University Press. See also *infra*, Chapter Four, section 4.3.2.

4 For illustration and implementation of this approach as applied to comparative corporate law, see most prominently Kraakman, R.H., Davies, P., Hansmann, H., Hertig, G., Hopt, K.J., Kanda, H. and Rock, E.B. [2004], THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH, Oxford University Press.

5 See *supra*, Chapter One, section 1.4.3. For a detailed discussion of the agency theory of corporate governance, see Chapter Three below.

6 See La Porta, R., Lopez-de-Silanes, F. and Shleifer, A. [1999], *Corporate Ownership around the World*, in JOURNAL OF FINANCE, vol. 54, 471-517. For illustration (and possible explanation) of the main differences between American and British corporate governance (hereinafter CG), see instead Franks, J. and Mayer, C. [2002], *Corporate Governance in the UK – Contrasted with the US System*, in CESifo Forum 3/2002, 13-22.

7 This is the mainstream explanation of why controlling shareholders and concentrated ownership dominates the CG picture around the world, investor protection being significantly stronger in Anglo-Saxon countries than in the rest of the world. According to this view, it is law that makes the difference ('law matters'), depending on how well it protects non-controlling shareholders from expropriation of their investment. See La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R. [2000a], *Investor Protection and Corporate Governance*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 59, 3–27, for illustration of theoretical arguments and empirical methodology; and La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R. [1998], *op. cit.*, for introduction and discussion of the indexes of legal protection of outside shareholders. But see also Roe, M.J. [2003c], *op. cit.*, for a different explanation based on political, rather than legal, institutions being ultimately responsible of making managers (the agents) accountable to the shareholders (the principals). See *infra,* Chapter Four, for a thorough discussion.

in that respect. To date, however, these two kinds of comparison have only been performed quite poorly. Even more importantly, they have been very unsatisfactorily related to each other. The reason is threefold.

To begin with, the underlying theoretical background is highly incomplete. As it will be shown in the next Chapter, the agency paradigm alone leaves too many theoretical questions unanswered,[8] as well as most facts of corporate governance in the real world unexplained.[9] Both economic and legal comparison cannot but suffer from this problem, by showing inconsistencies, leading to inconclusiveness, or wondering about apparently inexplicable puzzles. The comparative picture shows that separation of ownership and control is featured more by disenfranchisement of outside shareholders than by their empowerment.[10] Contrary to conventional wisdom,[11] this result equally holds under managerial control and shareholder control systems.[12] As I am going to show by a detailed empirical analysis of corporate governance in Europe and the US, whether managers or controlling shareholders are in charge, non-controlling shareholders are normally entitled to *no interference* with the firm management, let alone to eventually taking over firm control. As a matter of fact, control is insulated from the threat of hostile takeover nearly everywhere in the world.[13] We will see very soon that this picture has little to do with the standard characterization of corporate governance as a principal-agent relationship, which would involve – among other features – contestability of corporate control.

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8 Zingales, L. [1998], *Corporate Governance*, in P. Newman (ed.), THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW, Macmillan, 501.

9 See Rajan, R.G. and Zingales, L. [2000], *The Governance of the New Enterprise*, in X. Vives (ed.), CORPORATE GOVERNANCE: THEORETICAL AND EMPIRICAL PERSPECTIVES, Cambridge University Press, 201-232, for inconsistencies in the economic picture; Rock, E.B. and Wachter, M.L. [2001], *Islands of Conscious Power: Law, Norms and the Self-Governing Corporation*, in UNIVERSITY OF PENNSYLVANIA LAW REVIEW, vol. 149, 1619–1700, for how the agency paradigm fails to deliver a positive theory of corporate law.

10 Hellwig, M. [2000], *On the Economics and Politics of Corporate Finance and Corporate Control*, in X. Vives (ed.), CORPORATE GOVERNANCE: THEORETICAL AND EMPIRICAL PERSPECTIVES, Cambridge University Press, 98.

11 The standard account of comparative CG is very well summarized by Shleifer, A. and Vishny, R. [1997], *A Survey of Corporate Governance*, in JOURNAL OF FINANCE, vol. 52, 737-783.

12 Hellwig, M. [2000], *op. cit.*, 108-112.

13 See *infra*, section 2.4. But see, contrariwise, La Porta, R., Lopez-de-Silanes, F. and Shleifer, A. [1999], *op. cit.*, arguing that in countries with good legal protection of minority shareholders, "controlling shareholders have less fear of being expropriated themselves in the event that they ever lose control through a takeover or a market accumulation of shares by a raider, and so might be willing to cut their ownership of voting rights by selling shares to raise funds or to diversify." This parallels the standard account of comparative CG according to which in Anglo-Saxon countries both ownership of publicly held companies is more dispersed and control is more contestable. As we are going to see, the latter contention is incorrect, whereas the former (dispersion of ownership) is not restricted to Anglo-Saxon countries.

Secondly, while comparative corporate governance has provided us with a significantly improved understanding of how separation of ownership and control can mean different things in different countries, it has been unable so far to deliver a clear-cut description of how firms are actually governed around the world, as well as of their typical ownership structure.[14] This issue will be addressed in the following pages just with the purpose to avoid a misleading depiction of separation of ownership and control in different countries, given our knowledge of the matter to date. However, a more precise picture of corporate governance around the world will probably require a few more years of empirical research.[15]

Thirdly, comparative legal research in the field of corporate governance appears to have been carried out with either too much superficiality by the economists or with too much meticulousness by the lawyers. None of the two approaches is consistent with our goal of ascertaining the role of corporate law in comparative corporate governance. The first one does not comply with the *functional* criterion that makes comparison of legal rules meaningful.[16] The second one does not meet the *relevance* requirement that makes the same comparison useful for understanding rather than just describing differences and similarities. Coping with these two problems would be much premature at this stage of the inquiry. I shall address the issue in the Fourth Chapter, while discussing the shortcomings of the current debate over whether, and how, law matters in determining corporate governance patterns and their efficiency across different jurisdictions.[17] Yet, only after developing a more comprehensive framework for functional analysis, I shall be able to undertake legal comparison with a more refined methodology. So let us set aside, for the moment, both the theory and the rules of corporate governance. What we are now going to consider are just the *facts* of comparative corporate governance.

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14 See Becht, M. and Mayer, C. [2001], *Introduction*, in F. Barca and M. Becht (eds.), THE CONTROL OF CORPORATE EUROPE, Oxford University Press, (hereinafter Becht, M. and Mayer, C. [2001], *Introduction*), 15-18, for a similar conclusion.

15 To date, perhaps the most sophisticated analysis of control patterns in a comparative perspective is that undertaken in Barca, F. and Becht, M. (eds.) [2001], THE CONTROL OF CORPORATE EUROPE, Oxford University Press, with reference to 9 European countries and the US. That work acknowledges, however, a number of limitations in available knowledge about ownership and control of both European and American listed companies (not to speak about the unlisted ones). See Becht, M. and Mayer, C. [2001], *Introduction*, cit., esp. at 38-40 (*Appendix*), where different methodologies of comparison are discussed together with their shortcomings.

16 For illustration of the basic problem with the analyses by La Porta *et al.*, from a comparative law perspective, see Siems, M. [2005], *Numerical Comparative Law - Do We Need Statistical Evidence in Order to Reduce Complexity?*, in CARDOZO JOURNAL OF INTERNATIONAL AND COMPARATIVE LAW, vol. 13, 521-540.

17 See *infra*, Chapter Four, sections 4.3 and 4.4.

2.2. Separation of Ownership and Control: The Empirical Evidence

2.2.1. A Brief History of Comparative Corporate Governance

Comparative corporate governance is a very young discipline. Most of the empirical research on corporate governance was originally based on the study of the ownership and control structure of listed companies in the US. The modern study of corporate governance started with a famous empirical work by Berle and Means in the early 30s. Their celebrated book – *The Modern Corporation and Private Property* – is the first comprehensive analysis of how ownership had been separated from control by means of the corporate structure in the US.[18] It is also where the conceptual paradigm of the so-called 'public company' was first developed, as accounting for a corporation in which neither a single shareholder nor a group of them acting together own sufficient stock to control the firm, thereby empowering the management.[19] This has become the 'Berle and Means paradigm' of separation of ownership and control. According to Berle and Means, dispersed ownership and managerial control were *inherent* to the corporate system. In the 30s, separation of owner-

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[18] Berle, A.A. Jr. and Means, G.C. [1932], THE MODERN CORPORATION AND PRIVATE PROPERTY, MacMillan.

[19] See the discussion in chapter 5 of their classic: Berle, A.A. Jr. and Means, G.C. [1932], *op. cit.*, 69-118. Berle and Means identified 5 categories of corporate control: i) almost complete ownership; ii) majority ownership and control (both above 50%); iii) majority control through a legal device (e.g., a pyramidal structure) without majority ownership; iv) minority control (voting power between 20% and 50%); v) managerial control (voting power concentration below 20%). "Of these, the first three are forms of control resting on a legal base and revolve about the right to vote a majority of the voting stock. The last two, minority and management control are extra-legal, resting on a *factual* rather than a *legal* base." Id., at 70 (emphases added). It was however the fifth category – managerial control – which attracted their attention the most, so much as to be characterized as *the* 'Berle and Means paradigm' of separation of ownership and control in the corporate enterprise. It was defined as a "type of control […] in which ownership is so widely distributed that no individual or small group has even a minority interest large enough to dominate the affairs of the company." Id., at 84. Later, that became the definition of the so-called 'public company.' Berle and Means also explained how this translates into 'managerial control:'

> "As his personal vote will count for little or nothing at the meeting unless he has a very large block of stock, the stockholder is practically reduced to the alternative of not voting at all or else of *handing over his vote to individuals over whom he has no control and in whose selection he did not participate.* [These are the members of the proxy committee] by whom […] the election of directors for the ensuing period may be made. Since the proxy committee is appointed by the existing management, the latter can virtually dictate their own successors. [T]he management can thus become a self-perpetuating body even though its share in the ownership is negligible."

Id., at 86-88.

ship from management had "already proceeded far", was "rapidly increasing," and appeared "to be an inevitable development."[20]

In a sense, that was worrisome. Berle and Means claimed that separation of ownership and control would "destroy the very foundation on which the economic order of the past three centuries has rested."[21] Both their positive and normative contentions have been subsequently criticized.[22] Undoubtedly, Berle and Means solicited the attention of both researchers and the public opinion on the problem of separation of ownership and control. But they also generated a long-lived misunderstanding. "For at least two generations, their book has fixed the image of the modern corporation as one run by professional managers unaccountable to shareholders."[23]

One had to wait at least until the 70s before that image started to be challenged.[24] At the beginning, that was confined to the US debate. Melvin Eisenberg – a legal scholar – showed in his handbook that even among the largest American firms there was some non-negligible concentration of ownership.[25] He was rapidly followed by economists.[26] In the late 80s, Clifford Holderness and Dennis Sheehan found out that 13% of US publicly traded firms had a single shareholder accounting

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20 Id., at 47. However, both methodology and results of the analysis by Berle and Means have been seriously questioned in more recent times. Specifically, the frequency of American listed firms characterized by significant separation of ownership and control in the 30s appears to have been significantly overestimated (according to Berle and Means, 65% of the '200 largest' listed companies in the US were "controlled either by management [44%] or by a legal device involving a small proportion of ownership [21%]" – Id., at 94). See Gadhoum, Y., Lang, L.H.P. and Young, L. [2005], *Who Controls US?*, in EUROPEAN FINANCIAL MANAGEMENT, vol. 11, 342-343.

21 Berle, A.A. Jr. and Means, G.C. [1932], *op. cit.*, 7-8.

22 See, most recently, Holderness, C.G. [2006], *A Contrarian View of Ownership Concentration in the United States and around the World*, AFA 2006 Boston Meetings Paper, available at www.ssrn.com, 26-29.

23 La Porta, R., Lopez-de-Silanes, F. and Shleifer, A. [1999], *op. cit.*, 471.

24 This is somewhat imprecise. Shortly after the publication of Berle and Means' classic, a few empirical studies materialized to challenge the validity of their results. See Gadhoum, Y., Lang, L.H.P. and Young, L. [2005], *op. cit.*, 342-343, for a summary review. However, as the authors conclude, "[d]espite these early challenges, later generations accepted the picture of separation of ownership and control drawn by Berle and Means, touched up by Galbraith's best-seller, *The New Industrial State*." Id., at 343, citing Galbraith, J.K. [1968], THE NEW INDUSTRIAL STATE, Houghton-Mifflin.

25 Eisenberg, M.A. [1976], THE STRUCTURE OF THE CORPORATION, Little, Brown and Company, 37-63.

26 See, e.g., Demsetz H. and Lehn, K. [1985], *The Structure of Corporate Ownership: Causes and Consequences*, in JOURNAL OF POLITICAL ECONOMY, vol. 93, 1155-1177; Shleifer, A. and Vishny, R. [1986a], *Large Shareholders and Corporate Control*, in JOURNAL OF POLITICAL ECONOMY, vol. 94, 461-488; Morck, R., Shleifer, A. and Vishny, R. [1988], *Management Ownership and Market Valuation: An Empirical Analysis*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 20, 293-315. All of these studies show a modest concentration of ownership even among the largest American publicly held companies.

for more than 50% of share ownership.[27] At that time, still very little was known about ownership and control of firms listed outside the US.[28] However, some stylized facts suddenly became very popular in the international comparisons of the early 90s. [29]

Firms listed in the US or the UK were supposed to be governed under a *'market-monitoring'* model, with managers raising funds from dispersed shareholders and constantly obsessed with stock market performance because of the threat of being taken over.[30] Such an 'optimistic' view of the Berle and Means corporation was apparently not applicable outside the US and the UK, where a different paradigm was supposed to hold. Firms listed in the rest of the developed world (and most notably

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27 Holderness, C.G. and Sheehan, D.P. [1988], *The Role of Majority Shareholders in Publicly Held Corporations*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 20, 317–346. More recently, based on sample data for 1994-1995, Holderness, C.G. [2006], *op. cit.*, 7, estimated that about 10% of US listed firms have an absolute majority shareholder. According to Berle, A.A. Jr. and Means, G.C. [1932], *op. cit.*, 94, just 5% of the '200 largest companies' in the US had an absolute majority shareholder as of 1930.

28 As noticed by Becht, M. and Mayer, C. [2001], *Introduction*, cit., 1, "Such has been the influence of Berle and Means that the textbook description of dispersed ownership and separation of ownership and control has been presumed to be universally applicable." I experienced myself those textbooks during my undergraduate studies, and was puzzled since then by their striking contrast with the evidence (just anecdotal, at that time) on Italian and European CG.

29 The first theoretical distinction that appeared in comparative CG is 'market-oriented' vs. 'bank-oriented' systems. Berglöf, E. [1990], *Capital Structure as a Mechanism of Control: A Comparison of Financial Systems*, in M. Aoki, B. Gustavsson, and O.E. Williamson (eds.), THE FIRM AS A NEXUS OF TREATIES, European Sage, 237-262. See, for a critical review, Becht, M., Bolton, P. and Röell, A. [2002], *Corporate Governance and Control*, ECGI Finance Working Paper No. 02/2002, available at www.ssrn.com and www.ecgi.org, as published in G. Constantinides, M. Harris, and R. Stulz (eds.) [2003], HANDBOOK OF ECONOMICS AND FINANCE, North-Holland, 59-62; and Becht, M. and Mayer, C. [2001], *Introduction*, cit., 1-4.

30 The idea of 'market monitoring' was based on managerial discipline being obtained by means of takeover threat, as opposed to the risk of shareholder disenfranchisement by self-perpetuating management. In this way, the major concern of the analysis by Berle and Means was overcome. But contrarian views have always abounded. Simply put, takeover threat might be either ineffective in disciplining management or may lead, alternatively, to management being too much concerned with short-term performance in order to make myopic stock markets happy. See, e.g., for the first view, Jensen, M.C. [1989], *The Eclipse of the Public Corporation*, in HARVARD BUSINESS REVIEW, vol. 67, 60-70; for the second, Shleifer, A. and Vishny, R. [1989b], *Equilibrium Short Horizons of Investors and Firms*, in AMERICAN ECONOMIC REVIEW, vol. 80, 148-153; and, for a recent overview, Burkart, M. and Panunzi, F. [2006b], *Takeovers*, ECGI Finance Working Paper No. 118/2006, available at www.ssrn.com and www.ecgi.org. The argument that markets are myopic is partly related to the concern for idiosyncratic entrepreneurial values that stock exchanges are unable to price, which is being explored in the present dissertation (see *supra*, Chapter One, section 1.4.5). See Laffont, J.-J. and Tirole, J. [1988], *Repeated Auctions of Incentive Contracts, Investments, and Bidding Parity with an Application to Takeovers*, in RAND JOURNAL OF ECONOMICS, vol. 19, 529-532, for discussion of the advantages of takeover resistance when it comes to promoting the investment of managerial talent which is unobservable by (myopic) stock markets.

in Germany and in Japan) were classified under a *'bank-monitoring'* model, where large banks were supposed to directly police the firm management and have it replaced in case of underperformance. The market vs. bank monitoring juxtaposition was the prevailing account of comparative corporate governance, and apparently, there was no need (or possibility) to investigate separation of ownership and control outside that framework. Earlier criticism about the fitness of the Berle and Means model of corporate enterprise even to the reality of US listed companies was practically muted.[31]

However, the theoretical fragility of the market vs. bank monitoring distinction was soon discovered.[32] Many countries of continental Europe (like for instance France, Belgium, Italy and the Netherlands) did not fit the distinction, having neither banks involved in the governance of non-financial companies nor a market for corporate control based on hostile takeovers.[33] More importantly, it seems that German banks were and are not actually involved in monitoring and controlling corporations as received wisdom most often says;[34] and that the celebrated bank-firm ties in Japan (the so-called 'keiretzu') may have increased the availability of capital to non-financial firms, but at the end of the day they were not concerned with firm performance.[35]

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31 Implications of the above reasoning are worth mentioning, since they may seem bizarre nowadays but certainly they were not only a few years ago. By many commentators, bank monitoring was held superior to market monitoring provided that the former is focused on performance in the long run, whereas the latter is negatively affected by the short-slightness of stock markets. See, e.g., Porter, M.E. [1992], *Capital Disadvantage: America's Failing Capital Investment System*, in HARVARD BUSINESS REVIEW, vol. 70, 65-82. The very good performance of Western German and Japanese economies across the 80s-90s seemed to support that view, until Germany had to face the costs of re-unification and Japan had to deal with the Asian financial crisis. See La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R. [2000a], o*p. cit.*, 17-18. Now that the primacy of the Anglo-American model of corporate finance and governance seems to be out of question, reminding how different the picture looked like slightly more than a decade ago may serve as a warning against too hasty inferences. See Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 59-65; and Bianco, M. [2004], *Book Review ("Rassegna bibliografica") on M. Roe's 'Political Determinants of Corporate Governance'*, in RIVISTA DI POLITICA ECONOMICA, March-April 2004, 357-373.

32 Becht, M. and Mayer, C. [2001], *Introduction*, cit., 3.

33 Bergstrom, C., Högfeldt, P., Macey, J.R. and Samuelsson, P. [1995], *The Regulation of Corporate Acquisitions: A Law and Economic Analysis of European Proposals for Reform*, in COLUMBIA BUSINESS LAW REVIEW, vol. 1995, 495-524.

34 Edwards, J. and Fischer, K. [1994], BANKS, FINANCE AND INVESTMENT IN GERMANY, Cambridge University Press.

35 Weinstein, D.E. and Yafeh, Y [1998], *On the Costs of a Bank-Centered Financial System: Evidence from the Changing Main Bank Relations in Japan*, in JOURNAL OF FINANCE, vol. 53, 635-672. For a general survey of the 'revisionist' literature on the primacy of Japanese and German models of CG, see Becht, M. and Mayer, C. [2001], *Introduction*, cit., 3-4; and Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 59-65.

The distinction was then rapidly supplanted by a broader one. In the mid-90s, comparative corporate governance was more often described as a tale of two systems: *outsider* systems – typical of Anglo-Saxon countries – and *insider* systems – prevailing in continental Europe.[36] This distinction was based on concentration of ownership rather than on different providers of finance. In outsider systems, no single shareholder is large enough to exert control over corporations. A plethora of dispersed owners yields *de facto* firm control to the corporate management, so that the Berle and Means paradigm holds. In insider systems, the picture is somehow reversed. A single shareholder holds a fraction of the equity capital large enough to control the corporation: either he chooses the firm management or he manages the firm himself. Concentrated ownership involves that at least one owner is in charge, whereas all the others – whether or not they are dispersed – are not. The presence of a controlling shareholder is clearly incompatible with the Berle and Means paradigm, which postulates that control by *any* large owner be displaced.

The distinction between outsider and insider systems comes very close to the characterization of corporate governance models being adopted here, as alternatively based on *managerial control* or *shareholder control*.[37] The basic difference lies in the emphasis on corporate control and its entrenchment in both categories, and espe-

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[36] Franks, J. and Mayer, C. [1995], *Ownership and Control*, in H. Siebert (ed.), TRENDS IN BUSINESS ORGANIZATION: DO PARTICIPATION AND COOPERATION INCREASE COMPETITIVENESS?, Mohr (Siebeck).

[37] See *supra*, Chapter One, section 1.5.1. It is worth noting that, nowadays, models of CG are distinguished in none of the ways illustrated in the text. After *Law and Finance* (La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R. [1998], *op. cit.*), another classification has become more fashionable, based on the quality ('high' or 'low') of investor protection provided by the legal system. Categorization of CG systems on that basis has rapidly supplanted the more traditional 'banks vs. markets' and 'insider vs. outsider systems' classifications. See La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R. [2000a], *op. cit.*
However, corporate control around the world features a more immediate dichotomy: in fact, publicly held companies are characterized either by *managerial control* or by the presence of a *controlling shareholder*. Throughout the present inquiry, it will be shown that – contrary to what La Porta *et al.* have claimed since about ten years – this distinction does not always correspond with the quality of investor protection. The classification that I am advocating may appear as overly simplistic, and it is to some extent. For instance, it does not distinguish between different typologies of controlling shareholders – most notably, whether or not they are financial intermediaries. However, it captures one important feature of corporate control: whether or not it is exercised through stable control or voting power. In this respect, it is quite similar to the insider vs. outsider classification, save that outsiders are never considered as being – not even indirectly – in control. More importantly, our simple classification has potentially more to say about the role of legal institutions in CG than a narrow focus on investor protection as the *exclusive* determinant of patterns of ownership and control.

cially in the first one.[38] Outside shareholders may be not involved in day-to-day management but might possibly rise against incumbent managers; under certain conditions, also an insider might be ousted by more powerful insurgent shareholders. However, to the extent hostile insurgency is not an option – and I will show that most often it is not – distinctions of corporate governance based on the typology of corporate controllers (shareholders vs. managers) seem to be preferable to those based on the involvement of the owners (insiders vs. outsiders).

A more general point is that any such distinction requires some greater precision. As we are about to see, shareholder control and managerial control systems are not identical within each categorization. Once qualifications are added to the basic framework, in some managerial control systems inside ownership appears to be more important than one would expect;[39] whereas some shareholder control systems allow for outside ownership being extraordinarily larger than inside ownership.[40]

2.2.2. Corporate Ownership around the World: The First Results

A more detailed investigation of different ownership and control patterns around the world required switching from stylized facts to a systematic analysis of data.[41] Andrei Shleifer and two of his most famous co-authors (Rafael La Porta and Florencio Lopez-de-Silanes) had 27 relatively wealthy countries analyzed in such a

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[38] See *infra,* section 2.4. An alternative way to put it is that only *insider* systems exist in nature. That being said, either a controlling shareholder or the management, to the extent that it is able to insulate itself from excessive interference from the outsiders, may qualify as insiders. That *outsiders* may be ultimately in charge of CG is largely a myth. For a similar view, see Hellwig, M. [2000], *op. cit.*

[39] In the UK, for instance, the aggregate ownership of board members accounts for an average 11% in established companies and 22% in recent Initial Public Offerings (IPOs). See Goergen, M. and Renneboog, L. [2001], *Strong Managers and Passive Institutional Investors in the UK*, in F. Barca and M. Becht (eds.), THE CONTROL OF CORPORATE EUROPE, Oxford University Press, 259-284.

[40] In Sweden, outside ownership is on average three times larger than inside ownership; and the figure rises up to 23 for the largest firms representing more than a half of the national stock market capitalization! See Holmén, M. and Högfeldt, P. [2005], *Pyramidal Discounts: Tunneling or Agency Costs?*, ECGI Finance Working Paper No. 73/2005, available at www.ssrn.com and www.ecgi.org.

[41] That was first attempted to support the insider vs. outsider distinction. See Franks, J. and Mayer, C. [1997], *Corporate Ownership and Control in the UK, Germany and France*, in JOURNAL OF APPLIED CORPORATE FINANCE, vol. 9, 30-45. Julian Franks and Colin Mayer reported that in 1990 more than 50% of French and German listed companies had a single shareholder owning the absolute majority of the equity capital, and more than 80% had a single shareholder owning not less than one quarter of the company's stock; the corresponding figures for the UK were significantly smaller (6% and 16%, respectively). However, they only managed to compare the 170 largest listed companies in those three countries.

way, but they had to limit themselves to the 20 largest listed firms at the end of 1995.[42] Although the quality of the results clearly suffers from the very small number of companies in each country sample, this is nonetheless the first comprehensive cross-country study of ownership and control structures. Some of its findings are worth reporting since, on the one hand, they have improved our understanding of comparative corporate governance and, on the other hand, the resulting overall picture has proven robust to subsequent and more refined inquiries.

Their major results are summarized in Table 1 below. The authors (hereinafter, La Porta *et al.*) have attempted to infer shareholder control at two alternative thresholds of voting power: 20% and 10%. Although their paper broadly refers to ownership, they perfectly understand that what matters for corporate control is voting power and that the two figures very often differ from each other. In addition, disclosure of voting power is normally mandatory under national or supernational regulations, whereas disclosure of the corresponding ownership figure is very seldom compulsory.[43] The matter only gets worse when complex control structures – which are customary outside the US and the UK – require that *ultimate voting power* (most often referred to as 'ultimate ownership') be calculated by adding up voting rights exerted by different entities and individuals all referring (or, at least, deferring) to the same controller.[44] Then the *integrated ownership* of the latter (how much he actually invested in the controlled firm, both directly and indirectly) becomes extremely difficult to ascertain with a standardized methodology.[45]

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42 La Porta, R., Lopez-de-Silanes, F. and Shleifer, A. [1999], *op. cit.* Data are mostly based on *Worldscope*, which has a limited coverage as far as firms listed outside the US are concerned. However, La Porta *et al.* also gathered information from country-specific books, proxy statements and the Internet. To be sure, the authors collected two samples of firms, one ("large firms") consisting of the top 20 listed firms ranked by market capitalization, the other ("medium firms") considering – "whenever possible" – the smallest 10 firms with market capitalization of common stock of at least $500 million. For a number of reasons – e.g., the two samples intersecting for countries with small stock markets, or the market capitalization of listed firms being always lower than $500 million in some countries – cross-country comparisons in the second sample are no more significant than those in the first one; nor do they convey additional information in the analysis by La Porta *et al.* Therefore, I shall neither report nor discuss statistics for the second sample.

43 See Becht, M. and Mayer, C. [2001], *Introduction*, cit. (highlighting this point at 18 and 40).

44 Faccio, M. and Lang, L.H.P. [2002], *The Ultimate Ownership of Western European Corporations*, in JOURNAL OF FINANCIAL INTERMEDIATION, vol. 65, 365-395.

45 La Porta *et al.* attempt to cope with these complexities in their dichotomy between firms that have, or do not have, "ultimate owners" – the latter being characterized as "widely held." La Porta, R., Lopez-de-Silanes, F. and Shleifer, A. [1999], *op. cit.*, 476-480. However, their methodology of accounting for dual class shares, cross-ownership, and pyramids leads to quite a rudimentary assessment of voting power concentration. In addition, they do not even try to calculate the share of cash-flow rights held by the ultimate controllers.

For accurate definition of 'ultimate' voting power (or 'ultimate control') see Becht, M. and Mayer, C. [2001], *Introduction*, cit., 15-18. The authors acknowledge, however, that available data do not al-

La Porta *et al.* were among the firsts to document all these complexities by clear examples from the corporate practice worldwide.[46] Then they had no choice but abstracting from the same complexities in order to provide some general results about how listed companies are governed in different countries. They attempted to trace voting power back up to its ultimate 'owner', conditional on availability of information in this regard, and proceeding by assumptions otherwise. The strongest of those assumptions is that the company is *controlled* by a shareholder anytime his ultimate 'ownership' exceeds either 20% or 10% of voting rights, and widely held (i.e., subject to managerial control) otherwise. As we will see from the discussion of subsequent analyses, improved availability of data about corporate ownership has not yet brought about a better methodology of assessing shareholder control in different countries. In fact, we are still unable to determine precisely, on a standardized basis, how many firms are governed by controlling shareholders and how many are instead under managerial control.[47]

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ways allow observing cash-flow rights held by the ultimate controllers of publicly held corporations. Indeed, the country chapters in *The Control of Corporate Europe* sometimes provide this information. But, typically, only direct stakes are computed (see, e.g., Agnblad, J., Berglöf, E., Högfeldt, P. and Svancar, H. [2001], *Ownership and Control in Sweden: Strong Owners, Weak Minorities, and Social Control*, in F. Barca and M. Becht (eds.), THE CONTROL OF CORPORATE EUROPE, Oxford University Press, 228-258). One exception is Bianchi, M., Bianco, M. and Enriques, L. [2001], *Pyramidal Group and the Separation between Ownership and Control in Italy*, in F. Barca and M. Becht (eds.), THE CONTROL OF CORPORATE EUROPE, Oxford University Press, 154-187, where integrated ownership – direct plus indirect stakes, taking dilution by every layer of the pyramidal structure into account – is calculated for all listed firms. For illustration of the algorithm for calculating integrated ownership, see Bianchi, M., Bianco, M., Giacomelli, S., Pacces, A.M., Trento, S. [2005], PROPRIETÀ E CONTROLLO DELLE IMPRESE IN ITALIA*,* Il Mulino.

46 Franks, J. and Mayer, C. [1997], *op. cit.*, 37-39, also present and discuss the ownership and control structure of some representative individual firms. However, they just managed to report four examples (three from Germany and one from France). The coverage of the examples provided by La Porta *et al.* is much larger. See La Porta, R., Lopez-de-Silanes, F. and Shleifer, A. [1999], *op cit.*, 480-491.

47 For a very interesting attempt to cope with this methodological problem, at least at the national level, see Bianchi, M. and Bianco, M. [2006], *Italian corporate governance in the last 15 years: from pyramids to coalitions?*, ECGI Finance Working Paper No. 144/2006, available at www.ssrn.com and www.ecgi.org.

Table 1
Basic Patterns of Corporate Control around the World

PANEL A: 20% cut-off	WIDELY HELD	SHL CTRL > 20%	FAMILY CTRL > 20%	STATE CTRL > 20%
World Wide avg.	36.48%	63.52%	30.00%	18.33%
'Good' Law avg.	47.92%	52.08%	24.58%	13.55%
'Bad' Law avg.	27.33%	72.67%	34.33%	22.00%
Anglo-Saxon avg.	58.57%	41.43%	22.14%	5.00%
Non Anglo-Saxon avg. (excl. JPN)	25.53%	74.47%	34.21%	23.95%
US/UK avg.	90.00%	10.00%	10.00%	0.00%
Continental Europe avg.	29.29%	70.71%	27.50%	24.29%
PANEL B: 10% cut-off	WIDELY HELD	SHL CTRL > 10%	FAMILY CTRL > 10%	STATE CTRL > 10%
World Wide avg.	24.07%	75.93%	34.81%	20.19%
'Good' Law avg.	34.17%	65.83%	30.42%	15.83%
'Bad' Law avg.	16.00%	84.00%	38.33%	23.67%
Anglo-Saxon avg.	47.86%	52.14%	27.86%	5.00%
Non Anglo-Saxon avg. (excl. JPN)	13.95%	86.05%	38.68%	26.58%
US/UK avg.	85.00%	15.00%	12.50%	0.00%
Cont. Europe avg.	15.36%	84.64%	31.43%	27.50%

Note: Descriptive statistics on the frequency of listed firms governed by a controlling shareholder (SHL ctrl) – and, among them, those controlled by families or the state – vs. widely held companies where no controlling shareholder exists. Shareholder control is inferred when the ultimate owner of the largest voting block holds more than, alternatively, 20% or 10% of voting power. Family and state control are assumed when such an owner is respectively one or more individuals with the same family name, or the state. Data are for 1995 and refer to the 20 largest listed companies in each of the 27 sample countries. Those countries are divided into different sub-groups: 'good law' (GL) vs. 'bad law' (BL); and Anglo-Saxon (AS) vs. non Anglo-Saxon (NAS). The countries under consideration are: Argentina (GL; NAS), Australia (GL; AS), Austria (BL; NAS), Belgium (BL; NAS), Canada (GL; AS), Denmark (BL; NAS), Finland (BL; NAS), France (BL; NAS), Germany (BL; NAS), Greece (BL; NAS), Hong Kong (GL; AS), Ireland (GL; AS), Israel (BL; NAS), Italy (BL; NAS), Japan (GL; N/D), Mexico (BL; NAS), Netherlands (BL; NAS), New Zealand (GL; AS), Norway (GL; NAS), Portugal (BL; NAS), Singapore (GL; NAS), South Korea (BL; NAS), Spain (GL; NAS), Sweden (BL; NAS), Switzerland (BL; NAS), United Kingdom (GL; AS), United States (GL; AS).

Source: Elaborations on La Porta, R., Lopez-de-Silanes, F. and Shleifer, A. [1999], *Corporate Ownership around the World*, in JOURNAL OF FINANCE, vol. 54, 471-517.

As Table 1 shows, La Porta *et al.* demonstrated that the Berle and Means corporation was definitely not the prevailing model of corporate governance around the world. On a worldwide basis, managerial control is far less frequent than shareholder control. More precisely, nearly one half of the sample firms is controlled by either a family (30%) or the state (18%) holding more than 20% of voting rights, whereas slightly more than one third are widely held. Both families and the state get a few more points when shareholder control is inferred at 10%, while the percentage of widely held firms falls to less than one fourth.[48]

Even more interesting are the differences between groups of countries. Building on their earlier work with Robert Vishny – that inaugurated the 'law matters' strand of literature –, La Porta *et al.* found a both large and statistically significant difference in the proportion of widely held firms between countries with respectively below-average and above-average legal protection of minority shareholders.[49] At the 20% cut-off, the latter group displays nearly one half of the sample firms as widely held (one fourth as family controlled), while three fourths of the firms belonging to the former group are under shareholder control (one third under family control). Differences are, however, no less striking if we compare the Anglo-Saxon countries (where legal protection of shareholders is always 'high') with non-Anglo-Saxon countries (where the same protection is 'low' more often than not), excluding Japan whose corporate governance is too peculiar to fit into the shareholder control vs. managerial control dichotomy.[50] This at least casts some doubt on whether dispersion of ownership simply depends on investor protection or, rather, on some other factor concealed behind 'Anglo-Saxoneity.'[51]

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48 However, it is worth noting that the 10% cut-off also captures large shareholdings by financial institutions that do not necessarily have to do with the exercise of corporate control. While institutional monitoring would be apparently highly beneficial for CG, the behavior of financial institutions still looks much more passive than one would expect or simply auspicate. See Mallin, C. [2001], *Institutional Investors and Voting Practices: An International Comparison*, in CORPORATE GOVERNANCE: AN INTERNATIONAL REVIEW, vol. 9, 118-126. More importantly, however, the distinction between *monitoring* and the exercise of corporate *control* is too often overlooked by both theoretical and empirical literature. See *infra,* Box 1. See also Chapter Three, section 3.4.2, for theoretical discussion, and Chapter Five, section 5.6.1, for some key implications of this distinction.

49 Based on La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R. [1998], *op. cit.*, protection of minority shareholders is measured upon the score on a synthetic index of legal rules, named 'Anti-director Rights Index.' See *infra*, Chapter Four, section 4.3, for discussion.

50 At the 20% cut-off, nearly 60% of Anglo-Saxon firms are widely held and family control accounts just for 22%; in the second sub-sample, about one fourth of the firms are widely held and families account for 34% of corporate control. Differences are of course more pronounced at the 10% cut-off.

51 This might also suggest there is a bias in the interpretation of the data by La Porta *et al.*, which is quite recurrent in literature that followed the first formulation of the 'law matters' thesis (La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R. [1996], *Law and Finance*, NBER Working Paper No. 5661). 'Good law' appears to be strongly correlated to English legal origin, but it is in fact unclear what makes Anglo-Saxon countries score better on ownership dispersion. The usual claim that, for historical reasons, they perform better than any other country on investor protection is not supported by a more in-depth legal comparison. As we will see, something else seems to be at play too. Compare, e.g., La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R. [2000a], *op. cit.*, with Paredes, T.A. [2004], *A Systems Approach to Corporate Governance Reform: Why Importing U.S. Corporate Law Isn't The Answer*, in WILLIAM AND MARY LAW REVIEW, vol. 45, 1055-1157 (for the

Table 1 also displays a comparison between the US and the UK, on the one hand, and continental Europe, on the other hand. The Berle and Means corporation appears to be the rule in the Anglo-American world, but it is quite exceptional in the Old Continent. Differences in the incidence of family control are less pronounced (albeit still substantial), but this is due to the selection of sample firms (the 20 largest in each country), which underestimates the importance of families in corporate governance especially where – like in continental Europe – family control is more frequent. Similarly – as more comprehensive studies have subsequently revealed –, the sample of La Porta *et al.* *overestimates* the prevalence of widely held companies in the US and the UK.[52] Yet, the overall picture is unaffected by these biases.[53]

Given the overwhelming importance of shareholder control structures around the world, La Porta *et al.* also focused on a more in-depth analysis of their characteristics. Following that path, not only had they found that families overly dominate the controlling shareholders category, but also that controlling shareholders are "typically *unchallenged* by other equity holders:" on the one hand, "banks do not often exercise much control over firms as shareholders;" on the other hand, "other large shareholders are usually not there to monitor the controlling shareholder."[54]

In addition, controlling shareholders "often have control rights [more precisely, voting rights] in excess of their cash flow rights," and this is especially true for families.[55] However, separation of voting rights from ownership claims *is not* a standard phenomenon. Both its incidence and relevance within shareholder control structures vary from country to country, being for instance the highest in Sweden, most significant in Scandinavian countries, in Switzerland and in the Netherlands, almost negligible – but still positive – in the US, and apparently nil in the UK and in nearly a half of the countries sample. Also the devices which are used to achieve that separation (dual class shares, pyramids, cross shareholdings) vary among coun-

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US), and with Cheffins, B.R. [2001], *Does Law Matter?: The Separation of Ownership and Control in the United Kingdom*, in JOURNAL OF LEGAL STUDIES, vol. 30, 459-484 (for the UK). See *infra*, Chapter Four, section 4.4, for a more detailed discussion.

52 See, e.g., Gadhoum, Y., Lang, L.H.P. and Young, L. [2005], *op. cit.*, for the US; and Faccio, M. and Lang, L.H.P. [2002], *op. cit.*, for continental Europe and the UK.

53 The overall results of the comparison between continental Europe and the US/UK can be summarized as follows:

- The US and the UK have the far highest rate of listed firm not subject to shareholder control, which are supposedly governed by their *management* ('widely held' or 'public' companies).
- In continental Europe (more in general, outside Anglo-Saxon countries and Japan, with its typical bank-firm ties), listed firms are normally governed not by managers but by *controlling shareholders*, and these are *families* more often than not.

54 La Porta, R., Lopez-de-Silanes, F. and Shleifer, A. [1999], *op. cit.*, 498-505.

55 Id., at 505.

tries. The variation seems to be only partly due to regulation. Apparently, the potential for separation of voting rights from ownership claims allowed by the law is never fully exploited.[56] This suggests that a minimum ownership stake has always to be maintained by the controlling shareholder as a commitment that he will manage the firm also in the interest of non-controlling owners.[57]

While the latter observation is apparently consistent with a principal-agent framework, it is worth noting that separation of voting rights from ownership claims may allow a controlling shareholder to be in charge with ownership stakes nearly as small as those of the managers of the most diffusely held of US corporations.[58] Provided that either position is typically insulated from outside shareholder interference, the agency paradigm cannot ultimately explain why devices like pyramids or dual class shares are chosen instead of a plainer managerial control structure. This point will be further elaborated upon at a later stage of the present inquiry.[59]

2.2.3. Restricting the Analysis to the Most Developed Economies

Subsequent analyses have provided us with more precise figures, without significantly altering the general picture summarized above. Over the 90s, public availability of data on ownership and control structures of listed firms around the world

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[56] Id., at 498-500. Incidentally, it is worth noting that this separation is not assessed very accurately by La Porta *et al.* For instance, as far as dual class shares are concerned, La Porta *et al.* do not report the average percentage of cash-flow rights actually held by the corporate controllers but, rather, the average *minimum* proportion of cash flow rights which is *theoretically* required to purchase 20% of voting rights under each sample company's security-voting structure. See La Porta, R., Lopez-de-Silanes, F. and Shleifer, A. [1999], *op. cit.*, 477; and Becht, M. and Mayer, C. [2001], *Introduction*, cit., 38-40, for criticism.

[57] That minimum stake rises steeply in the presence of opportunities for expropriation of non-controlling shareholders. This makes perfect sense: outside shareholders are less willing to invest when they risk being subsequently expropriated. According to La Porta, R., Lopez-de-Silanes, F. and Shleifer, A. [1999], *op. cit.*, 500, the risk of cash flow diversion is the *only* reason why the legal potential for separation of voting rights from ownership claims cannot be fully exploited by controlling shareholders. However, this contention can only explain why exploitation of the same potential is the highest in Sweden – where expropriation of minority shareholders appears not to be an issue –, but not also why, also there, separation of voting rights from ownership claims is more limited than regulation would allow. This apparently puzzling circumstance calls for a different explanation, which can only be found outside the standard 'law matters' framework. See *infra*, Chapter Four, section 4.4.

[58] Morck, R., Wolfenzon, D. and Yeung, B. [2005], *Corporate Governance, Economic Entrenchment and Growth*, in JOURNAL OF ECONOMIC LITERATURE, vol. 43, 678.

[59] See *infra*, Chapter Three, section 3.4.2., and Chapter Four, section 4.1.2.

improved very much. This is particularly true for Western European countries.[60] To be sure, the empirical analysis has been extended also to a few other countries, most notably from East Asia.[61] However, I deliberately choose not to deal with countries that do not belong to Western Europe, with the only exception of the US. The reason is twofold. The first is that the selected area includes all but one (Japan) of the most developed countries in the world. The second is that extension of the analysis to non top-developed countries would make the comparison far more complicated than it is already, and therefore is left out of the scope of the present research.

As I mentioned before, Japan is excluded because of the high peculiarity of corporate governance, whose integration within the relatively simple categorization of corporate control being employed here (shareholder control vs. managerial control) would deserve a special investigation – a good topic for future research. A few other countries of East Asia have levels of per-capita income comparable to those of the Wealthy West: there, it seems that the typical ownership structure can be either dispersed or concentrated, depending on the country.[62] Practically all of the remaining countries for which data are available are either developing or emerging economies.[63] Widely held companies are highly exceptional there.[64] This is likely to

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60 Becht, M. and Mayer, C. [2001], *Introduction*, cit., 16-17.

61 See, most prominently, Claessens, S., Djankov, S., Fan, J.P.H. and Lang, L.H.P. [2000], *The Separation of Ownership and Control in East Asian Corporations*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 58, 81–112 (for description); and Claessens, S., Djankov, S., Fan, J.P.H. and Lang, L.H.P. [2002], *Disentangling the Incentive and Entrenchment Effects of Large Shareholdings*, in JOURNAL OF FINANCE, vol. 57, 2741–2771 (for analytical interpretation). The East Asian countries at issue are nine. Some of them (Japan, Singapore, Hong Kong, and South Korea) were also included by La Porta *et al.*

62 See the summary statistics reported by Claessens, S., Djankov, S., Fan, J.P.H. and Lang, L.H.P.. [2002], *op. cit.*, 2750 (table II), and compare them with levels of per-capita income across 74 developed and developing countries reported for 2003 by Djankov, S., La Porta, R., Lopez-de-Silanes, F. and Shleifer, A. [2006], *The Law and Economics of Self-Dealing*, Working Paper, Harvard School of Economics, available at http://www.economics.harvard.edu/faculty/shleifer/papers, forthcoming in JOURNAL OF FINANCIAL ECONOMICS, 2008 (table V – *Regulation of self-dealing and GDP per capita*), on the basis of the *World Development Indicators* issued by The World Bank (www.worldbank.org).

63 I am not considering Canada, for which comparable data are indeed available (see, e.g., Attig, N., Gadhoum, Y., and Lang, L. [2003], *Bid–Ask Spread, Asymmetric Information and Ultimate Ownership*, Working Paper, available at www.ssrn.com), nor other relatively developed countries (like, for instance, Australia and New Zealand) for which data on ownership and control structures certainly exist but – at least to my knowledge – they have not yet been brought to any international comparison. For emerging countries there is an important study paralleling the analysis by Claessens, S., Djankov, S., Fan, J.P.H. and Lang, L.H.P. [2002], *op. cit.*, for East Asia: see Lins, K.V. [2003], *Equity Ownership and Firm Value in Emerging Markets*, in JOURNAL OF FINANCIAL AND QUANTITATIVE ANALYSIS, vol. 38, 159-184.

64 International research on ownership and control patterns in the world has been recently surveyed by Morck, R., Wolfenzon, D. and Yeung, B. [2005], *op. cit.*, 663-664. As they put it, "these various

support the standard 'law matters' argument (*i.e.*, ownership cannot separate from control when legal protection of non-controlling shareholders is weak), since expropriation of minority shareholders seems to be the major concern of corporate governance in those countries.[65] However, the general weakness of legal institutions in developing and emerging economies makes the analysis of causes and consequences extremely more complicated.[66] On the one hand, it provides little scope for verifying whether or not law may also matter in some other way for corporate governance. On the other hand, drawing any policy implication about how corporate law could be improved becomes an extremely difficult and highly context-specific task where overall legality itself – the so called 'rule of law' – is in question.[67] Bringing developing and emerging countries into a comprehensive comparative inquiry about the role of law in corporate governance would need, therefore, a separate work.

2.3. 'Ultimate Ownership:' A Systematic Assessment

Focusing on Western Europe, Mara Faccio and Larry Lang provided the most inclusive analysis of ownership and control of European listed companies available to date.[68] Their database covers more than 94% of the firms listed in 13 Western European countries at some point between 1996 and 1999, with only the Netherlands being most notably excluded. A later study by Larry Lang and his co-authors provides comparable information about firms listed in the US, based on a similar methodology albeit with a much lower coverage (only about 40% of listed firms in 1996).[69] Therefore, these data are reported together. Both papers attempt to trace control back up to the ultimate 'owners' (i.e., to those who ultimately exercise the voting power), although – as we will see – it is quite doubtful that this attempt was

studies […] clearly display the rarity of widely held firms and the ubiquity of family control." Id., at 663.

65 Claessens, S., Djankov, S., Fan, J.P.H. and Lang, L.H.P. [2002], *op. cit.*, 2770, also suggest this explanation. For extension of the argument to the emerging countries (the so-called 'transition economies'), see Pistor, K., Raiser, M. and Gelfer, S. [2000], *Law and Finance in Transition Economies*, in ECONOMICS OF TRANSITION, vol. 8, 325-368.

66 See, e.g., Paredes, T.A. [2004], *op. cit.*, 1112-1154, for a similar view. The role played by institutions, and especially by corporate law, in explaining different CG patterns will be introduced in Chapter Four, section 4.1.

67 For further speculation on this point, see, e.g., Berkowitz, D., Pistor, K. and Richard, J.-F. [2003], *The Transplant Effect*, in AMERICAN JOURNAL OF COMPARATIVE LAW, vol. 51, 163-204.

68 Faccio, M. and Lang, L.H.P. [2002], *op. cit.*

69 Gadhoum, Y., Lang, L.H.P. and Young, L. [2005], *op. cit.*

completely successful, at least as far as countries of the Old Continent are concerned.

Table 2
Major Differences in the Corporate Governance of the Wealthy West

	WIDELY HELD	SHL CTRL > 20%	FAMILY CTRL > 20%	STATE CTRL > 20%
Continental Europe	22.63%	77.37%	53.82%	8.21%
Ireland	62.32%	37.68%	24.63%	1.45%
United Kingdom	63.08%	36.92%	23.68%	0.08%
United States	71.89%	28.11%	19.82%	0.00%

Note: Descriptive statistics on the frequency of listed firms governed by a controlling shareholder (SHL ctrl) – and, among them, those controlled by families or the state – vs. widely held companies where no controlling shareholder exists. Shareholder control is inferred when the ultimate owner of the largest voting block holds more than 20% of voting power. Family control is assumed when such an owner is an individual or a group of individuals with the same family name, or an unlisted non-financial company; state control is deduced when such an owner is the state. Data are for different years within the range 1996-1999, depending on the country. Overall, they account for about 94% of firms listed in Western Europe and about 40% of those listed in the US. Continental Europe includes 11 Western European countries (see Figure 1).

Sources: Faccio, M. and Lang, L.H.P. [2002], *The Ultimate Ownership of Western European Corporations*, in JOURNAL OF FINANCIAL INTERMEDIATION, vol. 65, 365-395; Gadhoum, Y., Lang, L.H.P. and Young, L. [2005], *Who Controls US?*, in EUROPEAN FINANCIAL MANAGEMENT, vol. 11, 339-363.

2.3.1. Ownership Patterns in Europe and the US

Increased significance of the sample compared to the study by La Porta *et al.* provides us with a more refined picture where still managerial control prevails in Anglo-Saxon countries and shareholder control characterizes firms listed in continental Europe. But, to begin with, *differences are less marked.* Secondly, family control appears to be even more important than illustrated by La Porta *et al.* in *both* Anglo-Saxon countries *and* in continental Europe, accounting on average for more than 50% of corporate control in the latter region, but anyway for no less than about 20% within Anglo-Saxon countries. Thirdly, the incidence of controlling ownership by the state seems to be very much reduced compared to La Porta *et al.* for firms listed in continental Europe (while remaining negligible, when not nil, in Anglo-

Saxon countries).[70] This is partly due to the higher inclusiveness of the sample, but it may also account for a *real* reduction of state ownership through the European privatization campaigns undertaken between 1995 and the years considered by Faccio and Lang.

Data are summarized in Table 2 above, where control is only inferred at a 20% voting power threshold. The 10% cut-off loses much of its significance as regards control inference once the analysis is no longer restricted to the largest firms. When middle-sized firms are included, a 10% stake (or even less, should cash flow rights be separated from voting rights) may be not always enough of a financial commitment to challenge managerial control – thereby overestimating shareholder control in dispersed ownership structures. Conversely, forming a dominating shareholder coalition (that may escape disclosure and then fail to be reported as a single controlling entity) is still possible with a few stakes below 10% – thereby continuing to underestimate shareholder control in concentrated ownership structures. Biases are almost unavoidable when international comparisons are only possible with a rather rudimentary 'threshold-methodology.' Since the state of the art leaves us with no better alternative, I prefer at least having biases going in the same direction. As a result, bearing in mind that a threshold of 20% or higher *systematically underestimates* shareholder control, control inferences at the 10% threshold will no longer be reported.[71]

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70 There are only four countries that exhibit a figure over 10%, and anyway below 16% (reference years are reported in parenthesis): Finland and Austria (1999), Norway (1998), and Italy (1996). For more information, see Figure 1 below.

71 Both the data and the evolution in the tastes of researchers indirectly support the argument in the text. As regards the latter, Faccio and Lang in the end chose – with no apparent reason – not to report country statistics on corporate control at the 10% cut-off; they are only available in an earlier and unpublished version of their paper, where a smaller sample of (five) countries was considered. Faccio, M. and Lang, L.H.P. [2000], *The Separation of Ownership and Control: An Analysis of Ultimate Ownership in Western European Corporations*, Working Paper, available at www.ssrn.com. As far as data are concerned, switching from the 20% to the 10% cut-off, the percentage of firms that appear to be under shareholder control basically doubles in the US (see Gadhoum, Y., Lang, L.H.P. and Young, L. [2005], *op. cit.*) and the UK, whereas the increase ranges from 9% to 20% for France, Germany, Italy and Spain (data for other countries are not available in Faccio, M. and Lang, L.H.P. [2000], *op. cit.*). As a result, when the 10% threshold is adopted, *differences* between Anglo-American CG and the Old Continent are seriously *understated*, and this insinuates the suspicion that there might be something different going on. Box 1 that follows in the text is for those who are intrigued by suspicions. Somebody may be instead just content with knowing that the incidence of largest shareholders at the 10% threshold in both the US and the UK is still lower than that of largest shareholders at the 20% threshold in each of the other countries. However, this information adds as much to our understanding of CG as knowing that mushrooms are smaller and less numerous than potatoes contributes to the farmer's choice of what to eat – the two taste in fact very differently and, more importantly, not all mushrooms are edible!

BOX 1.
Why 20% is better than 10% for inferring control (and what else can be said about that)

With regard to the US – where corporate ownership is typically dispersed – Lang and his co-authors exhibit a clear preference for the 10% threshold. As a consequence, they argue that nearly 60% of firms listed in the US have a controlling shareholder and more than one third is controlled by a family. Apparently, even in the US, just a minority (albeit substantial) of listed companies is under managerial control. The Berle and Means corporation seems to be then a very misleading depiction of today's American corporate governance (as it has probably always been, at least according to the authors).[72] In the same vein, Clifford Holderness has recently reported that 93% of a randomly selected sample of US listed firms have at least one blockholder accounting for 5% of voting rights, and that the average largest block of at least that size is about 24%. Whether voting blocks of at least 5% are considered individually or aggregated firm by firm, ownership appears to be more concentrated in the US than in non-US countries overall and in many single countries of Western Europe (not only Ireland and the UK, but also Spain, Norway and, in at least one respect, even Italy, Germany, and France).[73] Once again, the Berle and Means account of corporate governance in the US is under fire.

They might be right. To be sure, the above picture would be supportive of a view of corporate governance giving more credit to control concerns than to outside shareholder empowerment. In the absence of regulatory constraints on exercise, maintenance and transfer of corporate control (that – as we will see – appear to be very low in the US), how much control is separated from ownership is ultimately *a matter of choice* between entrepreneurs and investors willing to provide equity capital. However, I do not believe that the evidence reported by the two above studies is compelling enough to reject the standard view that the degree of separation of ownership and control in the US is among the highest in the world (even though, as we will see, controlling shareholders and family control are very important in the US too).

As regards the study by Holderness, its methodology has little to do with the evidence I am looking for here. He considers all blocks carrying at least 5% of voting rights, but they are *not necessarily* controlling blocks. The author is aware of this problem. He claims – as I also will do – that mainstream literature fails to distinguish owners that just *monitor* managers from those who *control* them outright.[74] However, even though he argues that large owners control *far more often* than they monitor, he is able to provide just one figure about *how often* they actually control US listed corporations: 10% of them have an absolute majority shareholder. Controlling shareholders in the US stock market most probably account for more than that, but – to my knowledge – the exact percentage is still unknown (as it is for the rest of the world, by the way).

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72 Gadhoum, Y., Lang, L.H.P. and Young, L. [2005], *op. cit.*

73 Holderness, C.G. [2006], *op. cit.*

74 Id., at 24-26. Indeed, the theoretical difference between large and controlling shareholders is very often overlooked by mainstream literature (see *infra*, Chapter Three, section 3.4.2). For how this distinction can be possibly dealt with within an alternative framework, see *infra*, Chapter Five, section 5.6.1.

Arguably, Lang and his co-authors also overestimate the importance of shareholder control in the US by applying a 10% threshold. Apparently, the frequency of controlling shareholders increases by about 30 percentage points when control is inferred at 10% instead of 20%. However, widely held financial institutions account for more than one third of that increase. For both historical and regulatory reasons, financial institutions in the US are not banks, but pension funds, mutual funds and insurance companies.[75] With a less than 20% stake, they may possibly monitor (although there is apparently no evidence that they ever do) but it is very unlikely that they control (i.e., appoint and replace) the management. Family 'control' account for more than a half of that increase: however, only about 9 additional percentage points correspond to a further involvement of family members in the management. This is the only figure from which, in my opinion, shareholder control can be reliably inferred at a 10% threshold. That would leave *managerial control still accounting for the vast majority of firms listed in the US* (about 63% instead of approx. 72%), families being the second largest category of corporate controllers (nearly 30% instead of about 20%).

If we apply the same reasoning to the data for the UK resulting from an earlier version of the paper by Faccio and Lang, the picture there changes even more slightly.[76] Apparently, shareholder control increases by about 37 percentage points when a 10% threshold is applied (leaving managerial control as accounting for just a quarter of the firms listed at the London Stock Exchange - LSE); but now more than two thirds of that increase is represented by large stakes held by widely held financial institutions (that are non-banks like in the US, albeit just for historical reasons).[77] Considering only controlling families that become involved in management at the 10% cut-off as additional controlling shareholders, *managerial control goes down to about 57%* (from 63%) and family control rises up to about 30% (from nearly 24%).

In conclusion, a careful examination of available empirical evidence does not provide grounds for rejecting the widespread belief that the Berle and Means corporation is still the prevailing (albeit far from exclusive) corporate governance pattern in both the US and the UK. In the same vein, a 20% threshold seems to be a quite better predictor of shareholder control than a 10% threshold. While the former seems to lead to a moderate downwards bias, the latter definitively involves a much higher upwards bias. A 20% threshold also makes more meaningful the comparison with continental Europe, where biases in the estimate of shareholder control are most often downwards *whatever the threshold*. In fact, shareholder coalitions are very often at play in the Old Continent and they are still very difficult to trace (disclosure obligations, when present, are often circumvented). On the contrary, in the UK, coalitions are disfavored by the Listing Rules of the Financial Services Authority (and anyway they cannot escape disclosure, unless they are informal), whereas in the US they take the form

75 See, most prominently, Roe, M.J. [1994], STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE, Princeton University Press.

76 Faccio, M. and Lang, L.H.P. [2000], *op. cit.*

77 On institutional ownership (and regulation) in the UK, as opposed to the US, see Black, B.S. and Coffee, J.C. Jr. [1994], *Hail Britannia: Institutional Investor Behavior under Limited Regulation*, in MICHIGAN LAW REVIEW, vol. 92, 1997-2087.

of voting trusts (which are also subject to mandatory disclosure).[78]

That being said, the elaboration of data at the 10% threshold uncovers some important differences between corporate governance in the US and the UK that are hidden (to be sure, contradicted) by a straight 20% threshold. From a crude comparison of US and UK data at the 10% cut-off, ownership still appears to be *more* dispersed in the US than in the UK, where families and institutional investors (always dominating the residual category) respectively account for a lesser and for a greater percentage of corporate control. But, in the end, the incidence of managerial control is lower. Once we have control inferences corrected according to the above discussion, the comparative picture is no longer as clear about whether the US or, rather, the UK have the highest percentage of firms under managerial control. Overall, it seems that family control is at least *as important* in the UK as in the US (and not less than that); whereas British institutional investors are far (and not just slightly) more involved in corporate governance than American ones (although in both cases it is doubtful whether they in practice exert any firm control even with stakes above 20%).

One has to be extremely careful with these results, since they are based on data for the UK at the 10% cut-off that are no longer reported in the published version of the paper by Faccio and Lang – even though many authors keep on using them.[79] Anyway, Lang and his co-authors – by re-arranging the UK sample as to make it comparable to the US one – showed later that in the UK family control is by 30% less frequent and institutional involvement in corporate governance by 50% more frequent than in the US, *at both the 20% and the 10% cut-off*.[80] These are of course scant evidences, which as such must be taken with caution, but they all suggest that *ownership may be indeed more dispersed in the UK than in the US*, where families as controlling shareholders are relatively *more* and *not less* important.[81] Not only the above-mentioned work by Holderness, but also some other independent inquiries that will be discussed shortly provide indirect support for this conclusion. As we will see in the following Chapters, corporate law provides a good explanation of this often overlooked (and almost never understood) difference between the US and the UK, based on regulatory biases disfavoring shareholder control patterns over managerial control.

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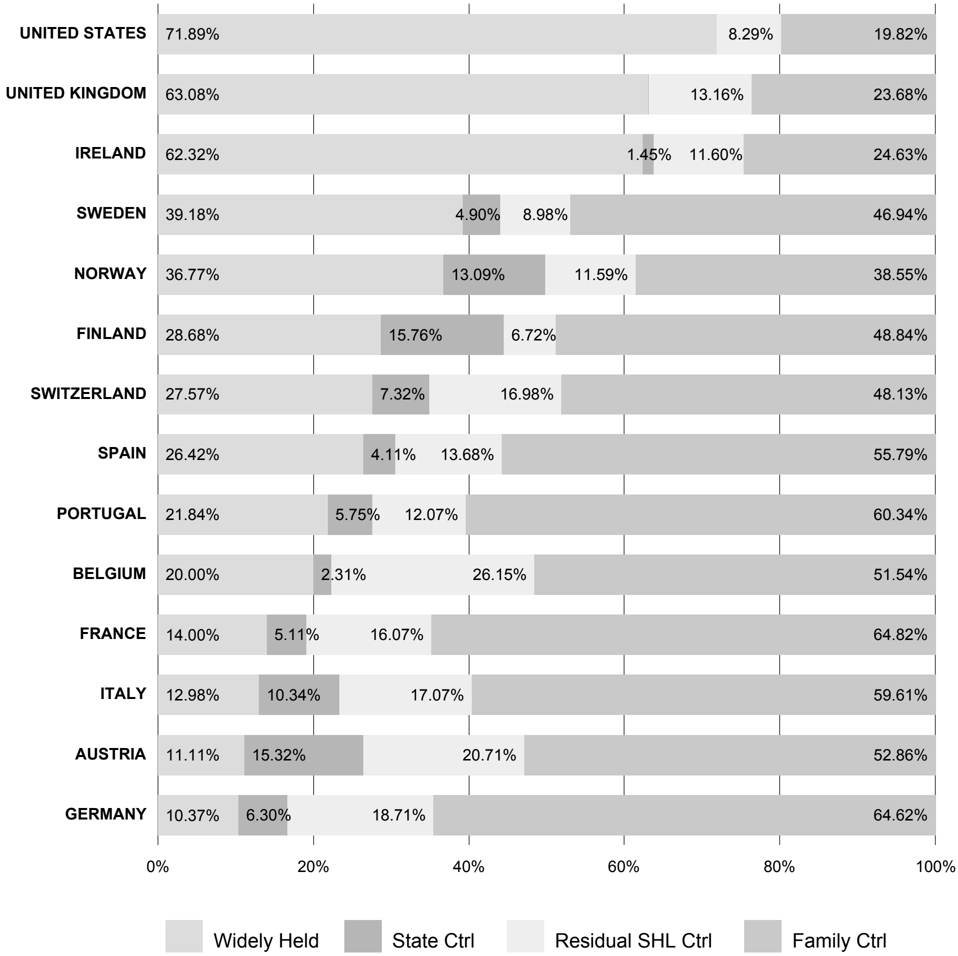
78 See, for Europe, Becht, M. and Mayer, C. [2001], *Introduction*, cit., 11-15; and, for the US, Gadhoum, Y., Lang, L.H.P. and Young, L. [2005], *op. cit.*, 348-349.

79 See, e.g., Morck, R., Wolfenzon, D. and Yeung, B. [2005], *op. cit.*, 664.

80 Gadhoum, Y., Lang, L.H.P. and Young, L. [2005], *op. cit.*, 352.

81 It should be noted that, upon identical empirical evidence, Gadhoum, Y., Lang, L.H.P. and Young, L. [2005], *op. cit.*, 360, reach just the opposite conclusion (ownership being *more* concentrated in the UK than in the US). Their conclusion, however, is just based on the relative frequency of widely held firms in the US and the UK at both the 10% and 20% threshold. On this basis, the frequency of large shareholders appears to be actually higher in the UK than in the US. The identity of large shareholders in the two countries is quite different, though. In Britain, ownership concentration is mostly due to *institutional* ownership; whereas, in the US, it owes more to *family* ownership. It would be a mistake to consider non-bank financial institutions (like mutual funds and pension funds) as controlling shareholders, provided that their role in CG is substantially different. Once we consider *only* family ownership – that is most likely to account for 'controlling,' and not just 'large,' shareholding – the conclusion in the text holds.

Figure 1
Corporate Control in Western Europe and the US



Note: See Table 2.
Sources: Faccio, M. and Lang, L.H.P. [2002], *The Ultimate Ownership of Western European Corporations*, in JOURNAL OF FINANCIAL INTERMEDIATION, vol. 65, 365-395; Gadhoum, Y., Lang, L.H.P. and Young, L. [2005], *Who Controls US?*, in EUROPEAN FINANCIAL MANAGEMENT, vol. 11, 339-363.

The higher inclusiveness of the sample relative to the study by La Porta *et al.* makes more detailed comparisons worth reporting. Major patterns of corporate control are then displayed in Figure 1 above, on a country-by-country basis. Anybody can see the discontinuity between Anglo-Saxon countries and continental

Europe. In the former group, *less than a quarter* of listed firms appear to be family controlled; in the latter, families are always the largest category of corporate controller and very often they control far *more than a half* of listed companies. Widely held corporations pass from an overwhelming majority in the US/UK to a minority whose weight on the number of listed firms ranges from about 30-40% in Scandinavian countries to the tiny 10% of Germanic ones. Scandinavian countries appear then to be somewhere in between the rest of the Old Continent and Anglo-Saxon countries. However, it would be a mistake to draw any conclusion upon this appearance, for it is most likely to be incorrect.[82]

We know that shareholder control is being underestimated by the choice of a relatively high voting power threshold. This problem is worsened by intrinsic limitations of the analysis by Faccio and Lang. They could not take publicly undisclosed shareholder coalitions into account, and their sources (publicly accessible, but not always official databases) did not always allow them to bring *all* stakes referring to the same interest sphere together.[83] As a result, while a more precise investigation

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[82] More reliable information about CG in Scandinavian countries is provided by national studies. Specifically, "[o]wnership and control data is of unusually high quality in Sweden, both in terms of detail provided and timeliness". Agnblad, J., Berglöf, E., Högfeldt, P. and Svancar, H. [2001], *op. cit.*, 231. Data on ownership and control of Swedish listed companies are made public twice a year in the *Public Shareholder and Nominee Shareholder Registries* (VPC). They include reliable information about both corporate controllers and their integrated ownership (by aggregating both direct and indirect stakes). On that basis, it is possible to draw a very precise picture of ownership and control in Sweden. However, this has been done so far just by Swedish economists. Apparently, they have access to the historical collection of data reported in the Public Registries, published annually by Sundin, A.-M. and Sundqvist, S.-I. [1985-2002], OWNERS AND POWER IN SWEDEN'S LISTED COMPANIES, Dagens Nyheter, Stockholm. All the national studies on Swedish CG report an incredibly high concentration of voting power in the hands of controlling shareholders, but also quite a high dispersion of ownership. More importantly, all of these studies report the absence of a controlling shareholder in Swedish listed companies as highly exceptional, and suggests that widely held companies in the Anglo-Saxon style may not exist at all in Sweden. This plainly contradicts the results of the analysis by Faccio and Lang. See, e.g., Cronqvist, H. and Nilsson, M. [2003], *Agency Costs of Controlling Minority Shareholders*, in JOURNAL OF FINANCIAL AND QUANTITATIVE ANALYSIS, vol. 38, 695-719.

[83] Faccio and Lang had their data cross-checked with official sources (the national securities authority or the national stock exchange) only for Austria, Belgium, France, Italy, Portugal, Spain, and the UK. It should be noticed that *none* of the Scandinavian countries is included. For the US the matter is more complicated, since recent empirical literature have shown that data collected from non-official sources most often resorted to are highly biased. Apparently, the only reliable source of information about voting power (but not also about corporate ownership) are proxy statements filed with the Securities and Exchange Commission (SEC) under Regulation 14A following the Securities Exchange Act of 1934. See Holderness, C.G. [2006], *op. cit.*, 3-7; and, for a more detailed analysis, Dlugosz, J., Fahlenbrach, R., Gompers, P. and Metrick, A. [2006], *Large Blocks of Stock: Prevalence, Size, and Measurement*, in JOURNAL OF CORPORATE FINANCE, vol. 12, 594-618. However, this should not be a serious problem for the paper by Lang and his co-authors, provided that they

would apparently leave unchanged the substance of the picture for the US and the UK (see Box 1 above), for the other countries we simply do not know how much shareholder control is actually hidden under multiple stakes below 20% all referring to a unique controlling authority.[84]

For the reasons that will become clearer through the legal analysis of the Seventh Chapter, I conjecture that in most countries of continental Europe this figure may be actually as large as to make managerial control highly exceptional, if not inexistent. Scandinavian countries are no exception. In particular, Sweden seems to have one of the highest occurrences of controlling shareholders in the developed world. In that respect, a more in-depth national study shows that nearly 85% of firms listed in Sweden in 1998 had an ultimate controlling shareholder belonging to a definite non-financial category (62% were controlled by families), just 8% of them had the largest shareholder represented by (presumably passive) financial institutions, and in the remaining 7% the largest ultimate owner belonged to an indefinite category (like, for instance, unlisted companies that both Faccio and Lang and Lang with his co-authors would have classified as family control).[85] Both Figure 1 and Table 2 must thus be regarded as a *very conservative* estimate of shareholder control in the Old Continent, especially as far as Scandinavian countries are concerned.

2.3.2. How Controlling Shareholders Enhance Their Power

Similarly to La Porta *et al.*, Faccio and Lang have also investigated *how* shareholder control is exerted. Since their results are more representative of the 'universe' of listed firms, they are detailed in Table 3 below.

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cross-checked their data with information available from the SEC website. Cf. Gadhoum, Y., Lang, L.H.P. and Young, L. [2005], *op. cit.*, 343-344. See also Faccio, M. and Lang, L.H.P. [2002], *op. cit.*, 367-373, for discussion of sources and methodology of their analysis.

84 To present, the only comparative empirical study that attempts to systematically account for the effect of shareholder coalitions is *The Control of Corporate Europe* (Barca, F. and Becht, M. (eds.) [2001], *op. cit.*). That study is based on compliance with the EC Directive on Large Holdings (88/627/EEC), which also mandates disclosure of *formal* coalitions among shareholders. Unfortunately, this regulation has been not implemented in the same way by all the Member States. More importantly, *informal* coalitions may always escape disclosure depending on how strict is the national regulation in this regard. *Coalitional control* may be thus not precisely assessed in some European countries, and then the frequency of widely held companies therein would continue to be overestimated therein. However, albeit imperfect, the study at issue provides the only cross-national estimate of the effect of coalitions on control patterns that we have to date. As we are about to see, it provides us with more reliable information on voting power concentration in Europe than Faccio, M. and Lang, L.H.P. [2002], *op. cit.*

85 See Agnblad, J., Berglöf, E., Högfeldt, P. and Svancar, H. [2001], *op. cit.*, 231-234.

Table 3
Enhancement of shareholder control

	PANEL A: TECHNIQUES OF CONTROL ENHANCEMENT				PANEL B: VOTING LEVERAGE (DUAL CLASS SHARES)				PANEL C: VOTING BLOCKS	
	CTRL SHL IS ALONE	DUAL CLASS SHARES	PYRAMIDS	OTHER	FAMILY	STATE	WIDELY HELD FINANC.	AVG	AVG LARGEST BLOCK	AVG VOTING LVG
Austria	82.89%	23.69%	18.42%	7.89%	1.06	1.02	1.09	1.05	53.52%	1.18
Belgium	68.60%	0.00%	8.14%	3.49%	1.00	1.00	1.00	1.00	40.09%	1.28
Finland	39.28%	38.46%	5.95%	1.19%	1.35	1.19	N/A	1.31	37.43%	1.19
France	63.97%	1.41%	14.98%	2.84%	1.00	1.00	1.00	1.00	48.32%	1.08
Germany	59.54%	17.67%	21.21%	7.42%	1.07	1.01	1.06	1.06	54.50%	1.19
Italy	55.29%	40.93%	22.70%	7.74%	1.09	1.08	1.09	1.09	48.26%	1.35
Norway	38.20%	14.35%	37.08%	20.22%	1.09	1.00	1.00	1.06	31.47%	1.29
Portugal	59.68%	0.00%	14.52%	3.22%	1.00	1.00	1.00	1.00	41.00%	1.08
Spain	44.13%	0.00%	15.97%	5.98%	1.00	1.00	1.00	1.00	44.24%	1.06
Sweden	48.15%	66.39%	17.77%	2.22%	2.14	1.83	1.46	2.07	30.96%	1.27
Switzerland	67.37%	58.64%	8.51%	1.42%	1.48	1.11	1.29	1.40	46.68%	1.35
Continental Europe	57.01%	23.78%	16.84%	5.79%	1.21	1.11	1.10	1.19	43.32%	1.21
Ireland	47.62%	13.49%	9.52%	4.76%	1.02	1.00	1.00	1.02	21.55%	1.23
United Kingdom	43.40%	22.17%	17.45%	6.60%	1.04	1.00	1.07	1.05	25.13%	1.13
United States	93.12%	8.19%	3.38%	0.66%	N/A	N/A	N/A	N/A	17.73%	1.06

Note: Descriptive statistics about devices for enhancing the power of controlling shareholders. Panel A reports the percentage of listed firms employing each device when a controlling shareholder is present (i.e., he holds at least 20% of voting rights). A controlling shareholder is 'alone' if no other owner controls at least 10% of voting rights. Panel B shows the average voting power accruing to each category of controlling shareholders for one unit of share ownership (voting leverage), when control is inferred at the 20% threshold of voting power and only the effect of dual class shares is accounted for. Panel C displays the average largest voting block considering only firms having at least one blockholder with 5% of voting rights, whether or not a controlling shareholder would be also present at the 20% threshold. Voting leverage is calculated as the ratio of the largest blockholder's voting power to his integrated (direct plus indirect) ownership stake.

Sources: Elaborations on: Faccio, M. and Lang, L.H.P. [2002], *The Ultimate Ownership of Western European Corporations*, in JOURNAL OF FINANCIAL INTERMEDIATION, vol. 65, 365-395; Gadhoum, Y., Lang, L.H.P. and Young, L. [2005], *Who Controls US?*, in EUROPEAN FINANCIAL MANAGEMENT, vol. 11, 339-363; Dlugosz, J., Fahlenbrach, R., Gompers, P. and Metrick, A. [2006], *Large Blocks of Stock: Prevalence, Size, and Measurement*, in JOURNAL OF CORPORATE FINANCE, vol. 12, 594-618.

Panel A displays the frequency of various 'techniques' of enhancing shareholder control within each country.[86] The first row shows how often the largest share-

[86] Of course, data refer only to firms having a controlling shareholder at the 20% threshold and, to be sure, not even to all of them. For sake of precision, figures about Europe have been recalculated

holder is 'alone'; that is, there is no other shareholder holding more than 10% of voting rights. With some qualifications mainly regarding takeover defenses (an issue that *is not* considered by Faccio and Lang), it may be argued that being alone means being practically the 'corporation's king.' But being in company does not necessarily imply that control is challengeable. Under a number of conditions collusion is more likely to emerge than competition, leading to *formal* coalitions – where penalties for cheating are set contractually, but which may nonetheless get around disclosure obligations – or to *informal* ones based on spontaneous convergence of interests over time – that would never be disclosed. Bearing this in mind, data show some important results:

a) As also La Porta *et al.* illustrated, on average controlling shareholders are alone more often than not. This is specifically true for all *but* Scandinavian countries (where, however, aggregation of ultimate ownership stakes seems to be particularly unreliable),[87] Spain, Ireland, and the UK.
b) Surprising as it may appear, controlling shareholders in the US are usually like kings: 93% of them have no other large shareholder around (and, on top of this, takeover defenses are plainly available to American controlling shareholders, should they ever need them).[88] None of the other countries considered here exhibit a similar figure. If anything, the opposite result holds for Britain: there, kingdoms appear to be just for the Royal Family.[89]
c) Lacking information about coalitions, we cannot say what is exactly going on in the numerous situations where the controlling shareholder *is not alone* in all the other countries. However, it should be noted that, apart from Scandinavian countries (where the usual proviso about reliability of control inferences ap-

considering only firms controlled by families, the state or widely held financial institutions, based on table 8 of Faccio, M. and Lang, L.H.P. [2002], *op. cit.*, 390-391. This leaves out about 9% of European firms under shareholder control for which data on dual class shares are not available, and explains why; i) data in the 2nd row of Panel A differ from those reported by Faccio and Lang in table 6 of their article (absolute percentage of listed firms having multiple classes of shares outstanding); ii) figures about other control enhancement mechanisms are slightly different from those reported in table 7 of Faccio and Lang. Data for the US include instead all firms controlled by a shareholder at the 20% cut-off, based on table 2 of Gadhoum, Y., Lang, L.H.P. and Young, L. [2005], *op. cit.*, 348.

87 Data for all of Scandinavian countries come just from one unofficial source (*Hugin*) and are most likely to underestimate shareholder control by failing to trace some control stakes back up to their ultimate owners. See *supra,* note 83.

88 See *infra*, Chapter Seven, section 7.3.1.

89 Curiously enough, this is also true for all the other kingdoms considered here, where always controlling shareholders are alone *less* often than not. That is just curiosity. Figures for Scandinavian countries are most likely to be underestimated; and other below-average results deserve further investigation just as far as the UK is concerned (fewer information is available for Ireland and Spain, which are also below average – by the way, Ireland does no longer belong to a kingdom!).

plies), this happens the most frequently in the UK. This is partly because, in the UK, institutional investors are more involved in corporate governance than in the rest of the world. But, more importantly, it depends on the prominent role of *informal coalitions* among insiders in British corporate governance – formal ones are treated as a single shareholder in any respect.[90]

The next three rows of Panel A show, for each country, the *incidence* of typical devices for having voting rights separated from ownership claims (dual class shares, pyramids, and a residual category).[91] Notice that they can be used either jointly or alternatively by each firm, and – more importantly – that the figures do not tell *how much* voting power is obtained in excess of cash flow rights either when those devices are considered separately or when their overall contribution to control enhancement is in question.[92] The *magnitude* of the individual effect is only assessed

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[90] On the role of shareholder coalitions in British CG, see most prominently Crespi-Cladera R., Renneboog L. [2003], *Corporate Monitoring by Shareholder Coalitions in the UK*, ECGI Finance Working Paper No. 12/2003, available at www.ssrn.com and www.ecgi.org. For a number of regulatory reasons that will be explored in more detail in the Seventh Chapter, corporate control in the UK can only be *secured* from takeovers through share ownership, while it basically needs to be *exerted* by coordinating separate stakes that individually do not exceed 10% of voting power. Being takeover defenses unavailable there and extensive resort to other control-enhancing devices being otherwise restricted, forming *informal* shareholder coalitions within the board of directors is much preferable to the burdensome and most often minority position of a lonely controlling shareholder. There is apparently no more convenient alternative: absolute majority shareholders seem to account for just 2.4% of firms listed at the London Stock Exchange. See Goergen, M. and Renneboog, L. [2001], *op. cit.*, for data and illustration.

[91] The residual category in the analysis by Faccio and Lang is "multiple control chains." This imply that control be exerted by means of *both* direct and indirect holdings, or through a number of indirect holdings. Indirect holdings may, or may not, involve pyramiding. Only in case they do, we observe a significant separation of voting power from ultimate (or 'integrated') ownership stakes. See Faccio, M. and Lang, L.H.P. [2002], *op. cit.*, 372-373.

[92] The reader should be warned that the state of the empirical knowledge of cross-country patterns of ownership and control does not yet provide us with a comprehensive answer to this question. As Becht, M. and Mayer, C. [2001], *Introduction*, cit., 18, recognize, "It is a fundamental question of corporate governance whether cash-flow rights are sold proportionally to voting rights." Barca, F. and Becht, M. (eds.) [2001], *op. cit.*, does not even try to answer this question, provided that information on cash-flow rights held by corporate controllers must not be provided under the disclosure regulation of the European Union (see Becht, M. and Mayer, C. [2001], *Introduction*, cit., 40 – *Appendix*). Information of that kind is sometimes collected by national studies, relying on their country's databases. For instance, country chapters in Barca, F. and Becht, M. (eds.) [2001], *op. cit.*, for Italy, Sweden, and the Netherlands also include information about concentration of cash-flow rights. See Bianchi, M., Bianco, M. and Enriques, L. [2001], *op. cit.*; Agnblad, J., Berglöf, E., Högfeldt, P. and Svancar, H. [2001], *op. cit.*; and de Jong, A., Kabir, R., Marra, T. and Röell, A. [2001], *Ownership and Control in the Netherlands*, in F. Barca and M. Becht (eds.), THE CONTROL OF CORPORATE EUROPE, Oxford University Press, 188–206. See also Holmén, M. and Högfeldt, P. [2005], *op. cit.*, and Bianchi, M., Bianco, M., Giacomelli, S., Pacces, A.M., Trento, S. [2005], *op. cit.*, for more up-to-date information. The results are not always comparable, though, since data elaboration is

for dual class shares in Panel B.[93] Panel C displays an attempt to estimate the joint effect, which however needs to be supplemented by some major qualifications.[94]

All that can be said from the last three rows of Panel A is that separation of voting rights from ownership claims appears to be the *least* frequent in the US and the *most* frequent in Sweden. More in general, it seems that having voting rights separated from cash flow rights is customary in all Scandinavian countries (even in

not based on a standard methodology. Given the variation of CG patterns in Europe and around the world, it is fair to say that such methodology does not yet exist. In conclusion, how concentration of voting rights does, or does not, involve also concentration of cash-flow rights remains an open question.

93 It should be noted that the elaborations by Faccio and Lang share the same weakness of the analysis by La Porta *et al.* (see *supra,* note 56). Both studies report the (average) minimum share of cash-flow rights necessary to control 20% of votes, based on each firm's security-voting structure. That figure is therefore purely *theoretical*, and does not correspond to the *actual* voting leverage that corporate controllers obtain by virtue of dual class shares. However, this analysis by Faccio and Lang is restricted to the firms having voting power concentration of at least 20%. The theoretical figure they provide can thus be considered as a relatively good proxy of the average 'voting leverage' (defined below in the text) really obtained by controlling shareholders through dual class security voting structures. Panel B of Table 3 presents it in that fashion, abstracting from the original reference to the exercise of 20% of voting rights.

94 Panel C is based on table 9 of Faccio, M. and Lang, L.H.P. [2002], *op. cit.*, 392. To present, this is the only comprehensive cross-country estimate of *both* voting rights and cash-flow rights ultimately held by controlling shareholders in Europe. The authors made the effort to calculate these figures for *each* firm in their database where the largest controlling owners had at least 5% of voting rights. However, the major problem with their analysis is that the estimates of both ultimate voting power and integrated ownership held by controlling shareholders are not completely reliable. In many cases, those estimates are contradicted by other studies which are based on official sources, whereas – as we know – Faccio and Lang did not manage to have their information cross-checked with official databases for all of the countries included in their investigation.

The problem is particularly severe for Scandinavian countries. For instance, national studies for Sweden – which are based on a very high quality of data (see *supra,* note 82) – report quite a higher concentration of voting power and, in relative terms, a lower integrated ownership for the average controlling shareholder. According to Agnblad, J., Berglöf, E., Högfeldt, P. and Svancar, H. [2001], *op. cit.*, when only the effect of dual class shares is accounted for, the average largest voting block in Sweden is 37.7%, the average voting leverage being equal to 1.47 (on the definition of 'voting leverage', see *infra* in the text). Once the effect of pyramids is also accounted for, the average concentration of voting power in Sweden is about 50% and the combined voting leverage rises up to about 2 on average. See both Holmén, M. and Högfeldt, P. [2005], *op. cit.*, and Cronqvist, H. and Nilsson, M. [2003], *op. cit.*, as well as their discussion *infra,* section 2.4.3. Notice that the figures reported by Faccio and Lang for Sweden are 30.96% and 1.27, respectively.

Cross-checking for other countries – whenever possible – exhibits similar problems, although the differences are less marked. For instance, according to Bianchi, M., Bianco, M. and Enriques, L. [2001], *op. cit.*, the average voting power of Italian controlling shareholders was 51.9% in 1996, the average voting leverage being not higher than 1.2. Faccio and Lang report instead 48.26% and 1.35 (higher than in Sweden!), respectively. This is quite puzzling, indeed, provided not only that sources and reference years should be identical for the two studies, but also that each of them was performed by at least an Italian researcher!

Norway, where issuing dual class shares requires government approval), in Italy (where restrictions also apply to both the kind and the amount of dual class shares that can be issued) and in Switzerland.[95] In addition, separation devices are on average far more frequent in European countries than in the US. Perhaps more surprisingly, this holds also for the UK where the frequency of each separation device is in line with the European average.

2.3.3. Separation of Voting Rights from Cash Flow Rights

a) *Methodology*

The overall picture does not change dramatically when the magnitude of the effects is considered. However, this still enables us to gather some important, additional information. The separation effect is measured by the ratio of voting rights to cash flow rights held by the controlling shareholder, defined as 'voting leverage' in Panel B and C of Table 3. Unfortunately, having this figure calculated as an accurate proxy of control enhancement is very difficult.

To begin with, dual class shares are not always used for control purposes. Their effect on control enhancement may be then *overestimated*. Secondly, assessing the effect of pyramiding and similar control enhancement devices requires a precise aggregation of *all* voting rights that are exerted under the authority of the controlling shareholder and calculation of his *integrated* ownership. When coalitions are not always accounted for and control chains are not traced back up to the very ultimate owner (e.g., because unlisted companies are involved), the magnitude of the effect can be seriously *underestimated*. Finally, the combined effects may be underestimated by averaging. Not only the within-country distributions of voting leverage are very skewed (there are much fewer high-leveraged firms than low-leveraged ones).[96]

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[95] See Faccio, M. and Lang, L.H.P. [2002], *op. cit.*, table 6 (summarizing regulatory restrictions for each country). To be sure national regulations of dual class shares *are not* always accurately reported. With special reference to the UK, see *infra,* section 2.3.3. I have double-checked information for Italy and Norway, though. See, e.g., Deminor-rating [2005], *Application of the one share–one vote principle in Europe*, a study commissioned by the Association of British Insurers, available at www.abi.org.uk.

[96] Faccio, M. and Lang, L.H.P. [2002], *op. cit.*, 392, also provide some information about *skewedness* in table 9 of their article, based on percentile analysis (see *infra*, section 2.4.3, for explanation). It should be noted that:

i) In every country but Italy and Switzerland the ratio of cash-flow rights to voting rights (the inverse of voting leverage) is 1 for at least a half of the firms considered (i.e., voting leverage is present in less than one half of listed firms);

ii) Mean values are always lower than median values;

iii) For a few countries (France, Portugal, Spain, and the UK), this also holds for the first quartile.

More importantly, whenever indirect stakes fail to be added to the corporate controller's voting power (with his integrated ownership also rising, but by a lower amount), this brings down the average of both the largest voting block and of the related voting leverage.

Notwithstanding all the above problems, data displayed in Panel B may represent a fairly good assessment of voting leverage due *exclusively* to dual class shares. Since only blocks accounting for at least 20% of voting power are being considered,[97] it is fair to assume that dual class shares mainly serve control purposes.[98] It seems then that Sweden has not only the highest rate of firms employing dual class shares, but also the highest average voting leverage due to that device. Correspondence between the *incidence* of dual class shares and the average *magnitude* of their control enhancement effect is also observed for the other Scandinavian countries (again, with the exception of Norway) and for Switzerland. As La Porta *et al.* also noted, leveraging voting power is more extensive there when families are in charge rather than when control is exerted by the state or widely held financial institutions.

Dual class shares seem not to matter much outside Sweden, Finland, and Switzerland. In all of the other countries, the average enhancement of voting power depending on dual class shares is ridiculously low. This is also true for Italy, and even more so for the UK.[99] It might be that dual class shares are still relatively popular there, although there is evidence to the contrary for both Italy and the

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As a result, firms with high voting leverage are always a minority (and sometimes even less than a quarter) of listed firms. Also in Italy and Switzerland – that apparently have more than a half of publicly held companies controlled through voting leverage – firms with above-average voting leverage are much fewer than those below the average. Both countries exhibit a mean ratio of cash-flow to voting rights of about 0.74, whereas the median values are as high as 0.97 and 0.83 respectively.

[97] Like in Panel A, only firms controlled by families, widely held financial firms, or the state are considered. Comparable data are, in this case, not available for the US.

[98] Basically, it is fair to believe that we are not overestimating too much the control enhancement effect of dual class security-voting structures, provided that only firms having *actually* a blockholder with at least 20% of voting rights are being considered in Panel B. Once again, however, the reader should be warned that these figures *do not* report the actual voting leverage, but only the *theoretical* enhancement of voting power that could be obtained by the controlling shareholder by fully exploiting the security-voting structure of the company. See *supra,* note 93.

[99] Coverage of the statistics is different, though. For Italy, we are considering 171 out of 208 listed firms having one shareholder with at least 20% of voting rights. In the UK, just 636 out of 1,953 firms are included in the analysis by Faccio and Lang for having such a shareholder (see Faccio, M. and Lang, L.H.P. [2002], *op. cit.*, table 8, 390-391). Even in that restricted sample, the maximum voting leverage that is obtained, on average, by means of dual class shares is absolutely negligible in the UK.

UK.[100] However, their effect on voting leverage by the corporate controller is certainly negligible.[101]

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[100] The empirical analysis of both the frequency of dual class security-voting structures among listed firms and their effect on voting leverage still provides us with mixed evidence. Once again, several national studies apparently contradict the results documented by Faccio and Lang. Bianchi, M., Bianco, M., Giacomelli, S., Pacces, A.M., Trento, S. [2005], *op. cit.*, 143-144 show that dual class shares have enjoyed some popularity in the Italian stock market during the 80s, but they have almost disappeared in recent times. In 1990, 40% of Italian listed firms still employed limited-voting or non-voting shares (multiple voting shares are prohibited under Italian corporate law), and accounted for 14.4% of the national stock market capitalization. However, the corresponding figures for 2003 are 15% and 3.6%. In that study we document, as a result, that "pyramidal groups are the main instrument for separating ownership from control in Italy," and that dual class shares may just serve the purpose of "enhancing the leverage effect that can be obtained through pyramidal groups" (Id., at 143 – my own translation). We collected and elaborated our data directly from the database of the national securities authority (the *Consob*). Therefore, they can be considered as more reliable, and are anyway more up-to-date, than those provided in Faccio, M. and Lang, L.H.P. [2002], *op. cit.*, 386-387.

The situation for the UK is more complicated, but still national studies unambiguously contradict the results presented by Faccio and Lang. Several academic authorities in Britain present the view that dual class security-voting structures are nowadays *very* unusual among the firms listed at the London Stock Exchange. According to Goergen and Renneboog:

> "Although non-voting shares are in principle admitted by the London Stock Exchange, issues of non-voting shares have been actively discouraged (Brennan and Franks, 1997). Goergen and Renneboog (2001) report that the few listed UK companies that had issued non-voting shares converted them into voting shares under the pressure of the London Stock Exchange and institutional investors during the early 1990s."

Goergen, M. and Renneboog, L. [2003], *Why are the levels of control (so) different in German and UK companies? Evidence from initial public offerings*, in JOURNAL OF LAW, ECONOMICS AND ORGANIZATION, vol. 19, 149 (citing Goergen, M. and Renneboog, L. [2001], *op. cit.*; and Brennan, M. and Franks, J. [1997], *Underpricing, Ownership and Control in Initial Public Offerings of Equity Securities in the UK*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 45, 391-413). Franks, J., Mayer, C. and Rossi, S. [2005b], *Ownership: Evolution and Regulation* (March 25, 2005), Working Paper, available at www.ssrn.com (earlier versions: ECGI Finance Working Paper No. 09/2003; EFA 2004 Maastricht Meetings Paper No. 3205; AFA 2003 Washington, DC Meetings), also provide a very interesting historical account of how dual class shares (and pyramidal structures) have been used in Britain, and why. They document that both instruments for separating control rights from ownership appeared for a very brief period during the 50s and the 60s, as a response to the emergence of an unregulated takeover market. But then, on the one hand, the Takeover Panel was established in 1968 for regulating takeovers. On the other hand, under the pressure of institutional investors, the London Stock Exchange "made it known that it disapproved of the use of dual class shares and would not permit their use in new equity issues" (Id., at 22). What happened next is that, following the merger and acquisition process, dual class security voting structures gradually disappeared from the British stock market. "By the late 1980s there were only a handful of companies with dual class shares left among listed companies in the U.K." (Id., at 23). See the data they present in table 8 with reference to listed firms in three different industrial sectors.

[101] One important study has recently confirmed this result (which is also implicit in the analysis by Faccio and Lang). See Bennedsen, M. and Nielsen, K.M. [2005], *The Principle of Proportionality: Separating the Impact of Dual Class Shares, Pyramids and Cross-ownership on Firm Value across Legal Regimes in*

b) Voting Leverage in the US and the UK

The above picture is, of course, incomplete. Consideration for pyramiding and similar ways to separate voting rights from ultimate ownership must be added. To this purpose, Panel C displays both the average largest voting block (supposedly held by the ultimate controller) and the average *combined* voting leverage on a country-by-country basis. European data have been calculated by Faccio and Lang including *all* largest stakes carrying at least 5% of voting power. Here, all the abovementioned problems of computation are at play, although both their kind and severity vary from country to country.

Data for the US come from two different sources. The combined voting leverage is taken from Lang and his co-authors and refers *only* to the *largest* shareholders at either the 20% or the 10% cut-off.[102] Since they do not also provide information about the average largest voting stake in their database, I have calculated it myself from a different, but comparable database by aggregating both direct and indirect voting power and considering the largest of such stakes of at least 5%.[103]

Western Europe, Working Paper, University of Copenhagen, Centre for Industrial Economics, available at www.econ.ku.dk/cie/Discussion%20Papers/2005/. Specifically, the authors document that "surprisingly" dual class shares are "widely used" even in the UK. For us this is not as surprising, given that data for the UK are taken from the same databases as in Faccio, M. and Lang, L.H.P. [2002], *op. cit.* However, they are not confirmed by the empirical analyses at the national level, documenting a much lower frequency of dual class security-voting structures in Britain (see the previous note). And yet, this is not the crucial point. Bennedsen and Nielsen illustrate that "ownership structures in […] Anglo-Saxon countries generally are *more proportional* than in Continental Europe. In Continental Europe, disproportionality instruments are used to concentrate control in the hands of the largest owners, whereas in the UK and Ireland, the typical ownership structure has a more even distribution of ownership and control *even* in the presence of these instruments." Bennedsen, M. and Nielsen, K.M. [2005], *op. cit.*, 13 (emphases added). If one just looks at figure 1 of their paper, the average voting leverage obtained by means of "disproportionality instruments" is negligible in the UK and in Ireland, even if only firms departing from one share–one vote security-voting structures are considered. More importantly, disproportionality results in only very few firms having a controlling shareholder with 50% or more of voting rights. This confirms my conjecture that, whatever the actual frequency of deviations from one share–one vote in the UK, those deviations may not always serve control purposes. Incidentally, it should be noted that this does not hold also for the rest of European countries. In continental Europe, the control enhancement effect of voting rights being separated from ownership is always significant, even though the both the frequency and the intensity of voting leverage varies from region to region. See *infra* in the text.

102 The average voting leverage in the US is 1.06 (ratio of cash-flow rights to voting rights equal to 0.94) whatever the threshold employed for inferring shareholder control. See Gadhoum, Y., Lang, L.H.P. and Young, L. [2005], *op. cit.*, 348.

103 The average largest voting stake in the US is also reported, for the year 1996, by Becht, M. [2001], *Beneficial Ownership in the United States*, in F. Barca and M. Becht (eds.), THE CONTROL OF CORPORATE EUROPE, Oxford University Press, 285-299. See *infra*, section 2.4. However, the database from which this measure is derived – *Disclosure CD*, now owned by Thomas Financial – is not completely reliable. It has been shown that it systematically underestimates both size and frequency of block-

Data for the US then provide a reasonable assessment of both the overall voting leverage by 'real' controllers and the average largest voting block (where also blocks that do not necessarily confer control are included). As expected, both figures (1.06 and 17.7%, respectively) are lower than in every European country.[104] Controlling shareholders do not only hold smaller blocks than their European colleagues (and they are fewer, surely in comparison with the Old Continent), but they also make comparatively littler use of devices for separating voting rights from ownership claims. The latter circumstance does not depend on a restrictive regulation, or at least not only.[105] Dual class shares are allowed without limitations in the US, but

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holdings. This is documented by Holderness, C.G. [2006], *op. cit.*, 3-4, and detailed by Dlugosz, J., Fahlenbrach, R., Gompers, P. and Metrick, A. [2006], *op. cit.*, 599-608. Both papers address this problem by analyzing hand-collected data from the proxy statements filed yearly with the SEC. The paper by Dlugosz *et al.*, however, has an online appendix reporting 'cleaned' blockholder data by firm in the period 1996-2001. See Professor Metrick's homepage at the University of Pennsylvania, Wharton School, section on data (http://finance.wharton.upenn.edu/~metrick/data.htm).

I have extracted the data for 1996 (the reference year of most of the studies for the other countries), and aggregated the direct and indirect holdings pertaining to the same blockholder through either a trust or a company (this information is flagged in the database). Next, I have isolated the three largest blockholders for each firm (the average and median size of voting blocks by rank is reported *infra*, in Table 4). Finally, I have calculated the frequency distribution of firms for different classes of top blockholders exceeding a 5% stake (i.e., >50%, 50%<>25%, and <25% – see *infra*, Figure 2). The database covers 1130 sample firms listed in the US in 1996, and explicitly *excludes* companies with a dual class security-voting structure. Dual class firms are also excluded from the statistics reported by Becht, M. [2001], *op. cit.* In order to take these companies into account, I have integrated the calculations with independent information about the distribution of blockholders's voting power in dual class firms, as reported in table 4 of Gompers, P.A., Ishii, J. and Metrick, A. [2004], *Incentives vs. Control: An Analysis of U.S. Dual-Class Companies*, NBER Working Paper No. 10240. Since the percentage of dual class listed companies in the American stock market is not reported in that paper, I have used the proportion of dual class firms reported by Gadhoum, Y., Lang, L.H.P. and Young, L. [2005], *op. cit.*, 347 (8.19%) as a correction factor for the descriptive statistics of the single class firms database.

104 Spain may seem to be the only exception, the average voting leverage being as low as in the US. However, shareholder coalitions – which are an alternative way to enhance control power, working also in the absence of voting leverage – appear to play an important role in Spanish CG, and they are not accounted for in the statistics calculated by Faccio and Lang. Neither are they considered in other studies, provided that Spanish law does not require their disclosure. Yet their importance is Spanish CG is generally acknowledged. See Crespi-Cladera, R. and Garcia-Cestona, M.A. [2001], *Ownership and Control of Spanish Listed Firms*, in F. Barca and M. Becht (eds.), THE CONTROL OF CORPORATE EUROPE, Oxford University Press, 207-227, and the following discussion in section 2.4.

105 Historically, in the US, pyramidal structures have been discouraged by regulation since the 30s. The policy of Roosevelt administration was clearly aimed at dismantling large American business group. This was achieved through a combination of measures, among which a prominent role has been played by double taxation of inter-corporate dividends. See Morck, R. [2005], *How to Eliminate Pyramidal Business Groups The Double Taxation of Inter-corporate Dividends and Other Incisive Uses of Tax Policy*, in J. Poterba (ed.), NATIONAL BUREAU OF ECONOMIC RESEARCH TAX POLICY ANNUAL, University of Chicago Press. In 2003 a tax reform slightly changed the status quo, by reducing, without

they seem to be employed by no more than 8% of sample firms.[106] In fact, American corporate controllers have a better alternative available: once they control the board of directors, they may count on a wide array of takeover defenses.

Data for European countries must be taken with more caution. Let us start with the UK, whose data seem to be more reliable than anywhere else in Europe.[107]

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eliminating individual dividend income taxes. See Morck, R. and Yeung, B. [2005], *Dividend Taxation and Corporate Governance*, in JOURNAL OF ECONOMIC PERSPECTIVES, vol. 19, 163-180, for a broad discussion of the policy implications. But see also *infra*, Chapter Seven, section 7.6.2, for the view that demand for pyramidal structures in American CG might be little, or even inexistent, even if this arrangement were not penalized by tax policies.

106 The percentage of dual class firms in the US reported by Gadhoum, Y., Lang, L.H.P. and Young, L. [2005], *op. cit.*, is 8.16. However, this figure ultimately proved *overestimating* the real incidence of dual class listed firms in the US.
It should be recalled that this analysis is based on a *sample* accounting for less than a half of listed firms in the US as of 1996 and that their data are simply retrieved from *Worldscope Global 1996 Discloser* and the SEC website. Very recently, the problems with the analysis of corporate ownership in the US based on raw data have been highlighted and possibly corrected for. Dlugosz, J., Fahlenbrach, R., Gompers, P. and Metrick, A. [2006], *op. cit.* Apparently, they are particularly severe when firms having multiple classes of shares are considered. See Anderson, R.C. Lee, D.S. [1997], *Ownership Studies: The Data Source Does Matter*, in JOURNAL OF FINANCIAL AND QUANTITATIVE ANALYSIS, vol. 32, 311-329. For this reason, Dlugosz, J., Fahlenbrach, R., Gompers, P. and Metrick, A. [2006], *op. cit.*, *excluded* dual class firms from their analysis of blockholders in the US, reporting just that they account for "less than 10% in all years." The 'cleaned' database that they made publicly available (and that I also used for integrating the information provided by Gadhoum, Y., Lang, L.H.P. and Young, L. [2005], *op. cit.* – see *supra,* note 103) does not include them too. The authors analyzed American dual class listed companies in a companion paper, based on a separate database: Gompers, P.A., Ishii, J. and Metrick, A. [2004], *op. cit.* That paper did not provide any information about the percentage of dual class firms in the American stock market. Other inquiries based on sample data confirmed that dual class firms approximately account for less than 10% of American listed companies (Holderness, C.G. [2006], *op. cit.*), but in the end the most precise figure was still that provided by Gadhoum, Y., Lang, L.H.P. and Young, L. [2005], *op. cit.*
While the present dissertation was being revised, Gompers, Ishii and Metrick finally updated their paper, and its current version now provide precise and reliable information about the universe of dual class firms relative to the universe of single class ones. See Gompers, P.A., Ishii, J. and Metrick, A. [2006], *Extreme Governance: An Analysis of Dual-Class Companies in the United States*, American Finance Association 2005 Philadelphia Meetings Paper, available at www.ssrn.com. According to this study, the average percentage of listed companies having dual or multiple classes security voting structure in the US over the 1995-2002 period is about 6%. It should be noted that this work provides us with the first *comprehensive* analysis of dual class companies in the US. As the authors notice, "There are no papers analyzing a panel of all dual-class firms – perhaps because the identification of these firms is highly labor intensive and has only become feasible with the recent availability of electronic documents from the SEC." Id., at 2.

107 In Faccio, M. and Lang, L.H.P. [2002], *op. cit.*, data for the UK are cross-checked with official sources, and therefore formal coalitions among shareholders are less likely to escape the analysis. Data are collected from official sources also for some other countries of continental Europe (see *supra,* note 83). However, control chains in Britain are relatively simpler than in the Old Continent (Goergen, M. and Renneboog, L. [2003], *op. cit.*), so that both ultimate voting power and integrated

Here the problem is that figures might be *overestimated*. Indeed, it is unclear whether the higher combined voting leverage (1.13) compared to the figure in Panel B (1.05) is due to the effect of pyramids or, rather, to the fact that also dual class shares that do not necessarily serve control purposes are accounted for. For at least two reasons I conjecture that the latter interpretation is correct.[108] On the one hand, contrary to what Faccio and Lang reported, leveraging voting power through pyramidal group structures seems to be a very uncommon practice in the UK.[109] On the other hand, the only deviations from 'one share–one vote' security-voting structures that we observe among British listed companies possibly involve just *preference shares* carrying *no voting rights* (if not under certain conditions). British public companies virtually never issue *multiple voting shares* of the kind customary – for instance – in Scandinavian countries.[110] Contrary to what is often believed, this is not due to restric-

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ownership of the controlling shareholder are more likely to be accurately calculated (and they should differ little from each other).

[108] The validity of this conclusion is also confirmed by the findings of a recent comparative study on deviations from one share–one vote in Europe. See Bennedsen, M. and Nielsen, K.M. [2005], *op. cit.*, and its discussion *supra,* note 101.

[109] This is another point where the analysis by Faccio, M. and Lang, L.H.P. [2002], *op. cit.*, is contradicted by more 'UK-based' empirical studies. Goergen, M. and Renneboog, L. [2003], *op. cit.*, 148-149, report the following:

> "While pyramids are not explicitly forbidden in UK corporate law, it is surprising that this control leverage technique *is not used at all*. The main reason is that ownership disclosure regulation in the UK does not only apply to individuals or companies but also to individuals and companies with voting agreements. Such voting agreements consist in obligations or restrictions between shareholders with respect to the use, retention or disposal of their stakes. A coalition of shareholders with a voting-agreement will be considered by the regulatory authorities as one single shareholder. This implies, for instance, that if the combined direct and indirect shareholdings of a coalition amount to at least 3%, disclosure is compulsory. Furthermore, a coalition controlling directly and indirectly 30% or more of the equity will be obliged to make a tender offer for all shares outstanding"

The authors confirm their contention in Goergen, M. and Renneboog, L. [2001], *op. cit.* Other British scholars also authoritatively report that the UK "does not have pyramid structures" in CG. Similarly to dual class security-voting structures, pyramids experienced some success in the UK during the 50s and the 60s. However, by the 80s they were dismantled together with other control-protective measures. "The elimination of dual class shares and pyramids in the UK was […] due to the dominance of institutional investors." Other regulatory factors – basically, the non-discriminatory treatment of shareholders in takeovers imposed by the British *City Code on Take-overs and Mergers* – contributed to making this elimination quite a natural outcome. Franks, J., Mayer, C. and Rossi, S. [2005a], *Spending Less Time with the Family: The Decline of Family Ownership in the UK*, in R. Morck (ed.), A HISTORY OF CORPORATE GOVERNANCE AROUND THE WORLD: FAMILY BUSINESS GROUPS TO PROFESSIONAL MANAGERS, NBER Conference Volume, University of Chicago Press, 581-607 (also available as NBER Working Paper No. 10628).

[110] The implication is that voting power enhancement through dual class shares is typically *indirect* where just non-voting shares are employed: such enhancement depends on how many of those shares are placed with the investing public. Contrariwise, multiple voting shares *directly* increase the

tive regulations, but is just a matter of *choice* by market participants. British Company Law places no restriction on either the number of classes in which stock capital may be divided or on the voting rights that may be attached to each class.[111]

The bottom line is that deviations from 'one share–one vote' are *de facto* only implemented *downwards* at the London Stock Exchange. As a result, these deviations may end up enhancing the voting power of the largest shareholders even when they are not large enough to exert any actual control. This is very often the case in the UK, and it may explain why the estimate of voting leverage is significantly higher when all largest stakes above 5% are considered, and not just those above 20%.[112] If one sticks just to the figure reported in Panel B, it should be noticed that the average voting leverage in the UK would be almost as low as in the US, if not lower.

Also the average size of the largest voting block (25.13%) seems to be overestimated in the UK, albeit for a different reason. The 5% cut-off leaves out nearly 17% of the sample firms in the UK, whereas the inclusiveness of the analysis is much higher (to be sure, almost full) for the other countries. As we will see, another inquiry shows that in 1992 the average largest voting block was only about 14%

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corporate controller's voting power, inasmuch as he holds them. With possibly one single exception, British listed companies have no multiple voting shares outstanding. See Deminor-rating [2005], *op. cit.* The typical dual class security-voting structure in the UK allows, rather, for shares with limited or just no voting rights to be placed with the investing public. These are normally preference shares, carrying preferential cash-flow rights but no voting rights unless the company fails to pay dividends for a while and in other specific circumstances provided for by the law or the charter. Davies, P. [2002a], INTRODUCTION TO COMPANY LAW, Oxford University Press, 259-270. As I am going to argue, preference shares are more likely to be issued in order to meet investors' preferences than for control enhancement purposes, especially when no shareholder accounts for more than 20% of voting rights.

111 There is some confusion among economists on this point, and precise information is provided just by British scholars on both the economic and the legal side. Faccio and Lang report that non-voting shares have been outlawed in Britain since 1968, and that multiple voting shares were likewise prohibited as of 1998. Neither piece of information is correct. Other studies (Goergen, M., Martynova, M. and Renneboog, L. [2005], *Corporate Governance Convergence: Evidence from Takeover Regulation Reforms in Europe*, in OXFORD REVIEW OF ECONOMIC POLICY, vol. 21, 1-27) report that multiple voting shares (but not also non-voting shares) are prohibited in the UK, and this is also incorrect. The *typical* arrangement under which just preference shares are issued, whose voting rights are restored when dividends are in arrears, emerged in Britain as a market outcome, not as a matter of regulation. See Franks, J., Mayer, C. and Rossi, S. [2005b], *op. cit.*; see also Farrar, J.H. and Hannigan, B (with contributions by Furey, N.E. and Wylie, P.) [1998], FARRAR'S COMPANY LAW, Butterworths, 226-235 (chapter 18 – Classes of shares and share rights).

112 That is to say, the higher voting leverage resulting from Panel C may be just due to the voting power of largest stakes within the 5-20% range. Differently from those above 20% being considered in Panel B, these holdings are unlikely to be controlling stakes. Nonetheless, their voting power may still be enhanced by the typical dual class security-voting structure of British listed companies. It just suffices that a significant number of preference shares is outstanding to obtain that result.

when all stakes above the mandatory disclosure threshold (3%) are considered.[113] Unless things changed dramatically between 1992 and 1996 (the reference year for the UK in the study by Faccio and Lang), this might indirectly confirm my previous conjecture that ownership concentration be actually higher in the US than in the UK (see Box 1).

c) *Voting Leverage in Continental Europe*

Quite to the contrary, results for many countries of continental Europe seem to be significantly *underestimated*. There is no apparent reason why the *combined* effect of both dual class shares and other voting power enhancement devices should ever be *lower* than the voting leverage *only* attributable to dual class shares.[114] However, this is exactly what we observe for Finland, Switzerland and, most significantly, for Sweden. This incongruence is easily explained by inaccurate tracing of indirect stakes back up to their ultimate owners. It seems that the effect of pyramids on dual class security-voting structures disappears through averaging, but it is in fact there to *increase* (and not to *decrease*) the combined voting leverage.[115] A further consequence of the above inaccuracy is that the average largest voting block may be also underestimated in those countries. At least for Sweden, independent and more accurate inquiries have shown that both the average largest voting block and the average combined voting leverage are in fact *much higher* than reported by Faccio and Lang.[116] Swedish corporate governance shows then not a similar, but quite the opposite pattern compared to the US and the UK. Controlling shareholders have

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[113] Goergen, M. and Renneboog, L. [2001], *op. cit.* See *infra,* section 2.4.

[114] To be sure, this may just depend on how the two measures are constructed in Faccio, M. and Lang, L.H.P. [2002], *op. cit.* The control enhancement effect generated by dual class shares is in fact theoretical, for it is based on the *maximum* voting leverage attainable under each company's security-voting structure. Contrariwise, the combined voting leverage is based on the *actual* voting and cash-flow rights held by the largest shareholder in each company. Then one possibility is that the first result is overestimated, whereas the second one should be correct.
However, I do not think that this is the right explanation. Albeit theoretical, the voting leverage depending on dual class shares is estimated with *exclusive* reference to companies having at least one blockholder accounting fro 20% or more of voting rights. Such a blockholder is quite likely to *effectively* enhance his voting power through dual class shares, when they are issued. The combined voting leverage is instead calculated for *any* stake above the 5% threshold, provided it is the largest one in each company. As a result, the voting leverage is underestimated anytime indirect stakes are not accurately traced back up to their ultimate holders.

[115] For a technical analysis of the combined effect of pyramidal groups and multiple voting shares on voting power enhancement, see Holmén, M. and Högfeldt, P. [2005], *Pyramidal Discounts: Tunneling or Agency Costs?*, ECGI Finance Working Paper No. 73/2005, available at www.ssrn.com and www.ecgi.org.

[116] See, most notably, Cronqvist, H. and Nilsson, M. [2003], *op. cit.*; and Holmén, M. and Högfeldt, P. [2005], *op. cit.* See also *infra,* section 2.4.3., for discussion.

indeed *very large* voting stakes in Sweden, mostly in excess of their ultimate ownership, and voting power is enhanced through *both* pyramiding and dual class shares. Similar results should hold also for Finland and Switzerland.

Downwards biases on the average largest block or the average voting leverage (and, most often, on both) may also affect the results for other countries, especially where pyramidal groups and/or voting agreements among shareholders are customary and unlisted companies (whose ownership and control structure is most difficult to trace) are involved in the control enhancement.[117] Nevertheless, the strong effect of pyramiding on the average voting leverage is still quite noticeable – for instance – in Norway, Italy and Belgium. This might depend on regulation of dual class shares, which have been always substantial in these countries.[118] However, the effect of pyramidal group structures is not negligible also in other countries, like Austria and Germany, where regulation of dual class shares is traditionally more liberal.[119]

[117] As I mentioned, our empirical knowledge of separation between ownership and control in continental Europe is still limited. A more recent study based on nearly the same data as those collected by Faccio and Lang provides some additional information about control enhancement by disproportional security-voting structures. Bennedsen, M. and Nielsen, K.M. [2005], *op. cit.*, report that disproportionality is the most frequent in Northern Europe and in German-speaking countries, and the least frequent in Southern Europe (one should recall from note 101 above that disproportionality is even less frequent in Ireland and the UK). The degree of disproportionality follows different trends across the above mentioned regions. In Southern Europe, the rate of disproportionality is very low on average (even though it is significant for the few firms that depart from one share–one vote), but corporate controllers hold larger ownership stake than in the other regions. In Northern Europe the picture is somewhat reversed: disproportionality is higher on average and apparently not much more intense at the margin (this last conclusion is contradicted by the Swedish empirical studies, though – see section 2.4.3. below). However, corporate controllers manage to stay in charge with a smaller ownership stake. German-speaking countries are somewhat in between: disproportionality is on average slightly lower than in Scandinavian countries; however, largest ownership stakes are not as small as in Northern Europe and they are nearly as large as in the Southern part of the continent. Finally, in Ireland and in the UK disproportionality has little, if any, control enhancement effect, given the limited size of largest ownership stakes (see *supra,* note 101).

[118] In all of these countries a general 'one share–one vote' principle is established. However, derogations are allowed. In Norway, an authorization must be granted by the government – even though it seems not difficult to get it (Bennedsen, M. and Nielsen, K.M. [2005], *op. cit.*). In Italy, limited voting and non-voting shares are allowed up to a maximum of 50% of share capital, whereas multiple voting shares are prohibited (Bianchi, M., Bianco, M., Giacomelli, S., Pacces, A.M., Trento, S. [2005], *op. cit.*). A similar regulation is established in Belgium (multiple voting shares are prohibited, non-voting shares are allowed), but most listed companies apparently stick to the 'one share–one vote' rule at least "within one ownership tier" – pyramiding is the typical technique for leveraging voting power in Belgium (Deminor-rating [2005], *op. cit.*, and Becht, M., Chapelle, A. and Renneboog, L. [2001], *Shareholding Cascades: The Separation of Ownership and Control in Belgium*, in F. Barca and M. Becht (eds.), THE CONTROL OF CORPORATE EUROPE, Oxford University Press, 71-105).

[119] In Austria there is basically no restriction on classes of shares that may be issued, save that multiple voting shares are not allowed. Multiple voting shares used to be allowed in Germany, but due to

When the above results are supplemented with the picture having just been discussed for Sweden and the UK, we can draw an important conclusion. *Differently from their Anglo-American colleagues, controlling shareholders in continental Europe are accustomed to holding voting power in excess of their cash flow rights*. However, how and to what extent they accomplish that result *may indeed be influenced by regulation, but does not completely depend on it.*[120] One possible interpretation is that corporate controllers are inclined to dilute non-controlling shareholders' voting power as much as they can, provided that it is both legal and profitable to do so. Where managerial control is not an option, corporate controllers might have to resort to dual class shares or to pyramidal structures (depending on the law), in order to raise equity funds while securing control from hostile takeover. However, how much voting power corporate controllers can actually leverage in excess of their ownership stake also depends on outside shareholders' willingness to accept dilution – that is, how large is the discount they will require for buying inferior-voting stock. The discount will eventually get large enough to make further dilution unprofitable for the corporate controller. In this perspective, separation of voting rights from ownership claims is driven by both financial economics and corporate law. We will carefully investigate these two aspects, and their interaction, in the following Chapters.[121]

How actually large are, on average, controlling shareholders in the countries of the Old Continent is another question.[122] More accurate investigations into the matter have been performed for some, but not all of them.[123] As we are about to see, they report higher figures for Austria, France, Italy, Belgium, and Sweden, but also lower ones for Germany and Spain. It seems that, in the latter two cases, this aspect of ownership concentration have been estimated even more conservatively than by Faccio and Lang.[124]

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the *KonTraG* (*Gesetz zur Kontrolle und Transparenz im Unternehmensbereich* – Corporate Control and Transparency Act) of 1998 they have disappeared as of 2003 (with the only exception of Volkswagen – Deminor-rating [2005], *op. cit.*). Limitation or exclusion of voting rights is basically not regulated. See Becht, M. and Boehmer, E. [2001], *Ownership and Voting Power in Germany*, in F. Barca and M. Becht (eds.), THE CONTROL OF CORPORATE EUROPE, Oxford University Press, 128-153.

120 Both Faccio, M. and Lang, L.H.P. [2002], *op. cit.,* 384-388 and Becht, M. and Mayer, C. [2001], *Introduction*, cit., reach a similar conclusion.

121 See, respectively, Chapter Six, section 6.4, and Chapter Seven, 7.6.

122 As in Sweden, one might conjecture that also in other Scandinavian countries the average largest voting block is actually bigger than reported by Faccio and Lang. Data for Scandinavian countries are all retrieved from the same, unofficial source (*Hugin*), and this casts some doubt on how precisely control stakes are traced back up to the ultimate owners. However, one could not say whether, and to what extent, the same kind of problem affect the data for each of the other countries.

123 See Barca, F. and Becht, M. (eds.) [2001], *op. cit.*

124 However, it should be noticed that the figures for the average largest voting block are still very high in Germany and Spain (nearly 50% and more than 40%, respectively). See Becht, M. and Boehmer, E. [2001], *op. cit.*, and Crespi-Cladera, R. and Garcia-Cestona, M.A. [2001], *op. cit.*

2.4. Corporate Control and Its Entrenchment: Europe and the US

2.4.1. Information from the EC Directive on Large Holdings

We have already learned a lot about the comparative picture of corporate governance in Europe and the US. However, our knowledge of how listed firms are controlled is still approximate. Some fundamental information is still lacking, not completely reliable, or imprecise. More specifically, how would our inferences about the frequency of controlling shareholders change when *formal* voting coalitions and complex control chains are more accurately accounted for? And how *concentrated* voting power would appear then? In addition, what happens in the numerous situations in which the largest shareholder is not 'alone' and *informal* coalitions might be formed between large owners either to *support* or to *challenge* the corporate controller's power?

There is not yet a clear-cut answer to these questions. However, more precise information has become available thanks to regulatory improvements within the EU. What definitively improved our understanding of ownership and control structures in Europe was the adoption of the so-called 'Large Holdings Directive', requiring disclosure of voting power of at least 10% exerted directly or *indirectly* (e.g., through a subsidiaries chain), individually or *in concert* (e.g., by means of voting pacts or trusts).[125] Implementation of the Large Holdings Directive' was completed by Member States by the mid-90s, and the disclosure threshold was most often lowered to 5%.[126] The latter threshold is the current regulatory standard set by the new 'Transparency Directive,' adopted at the end of 2004.[127] Based on compliance with the old EC directive, the European Corporate Governance Network (now the European Corporate Governance Institute) sponsored a few studies by several country experts that were eventually collected into a book, edited by Fabrizio Barca

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[125] Council Directive 88/627/EEC of 12 December 1988 – On the information to be published when a major holding in a listed company is acquired or disposed of. See the illustration in Becht, M. and Mayer, C. [2001], *Introduction*, cit., 15-18.

[126] Id., at 16.

[127] Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 – On the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC Directive 109/2004/EC. Implementing measures have been ultimately adopted by the Commission Directive 2007/14/EC (laying down detailed rules for the implementation of certain provisions of Directive 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market).

and Marco Becht: *The Control of Corporate Europe* (hereinafter, Barca-Becht).[128]

That book has a few disadvantages. Only nine European countries (and the US) are considered, thus leaving out five of the thirteen countries included by Faccio and Lang. Data and methodologies for their interpretation are not always comparable. Information is no more up-to-date than in Faccio and Lang: both studies refer to more than ten years ago. However, the study by the European Corporate Governance Network has a number of important advantages.

To begin with, data are only collected from *official* sources, so that compliance with at least the basic requirements of the Large Holdings Directive is out of question. As a result, ultimate voting stakes generally account for indirect holdings and formal shareholder coalitions, at least to the extent that they cannot escape filing with the national authorities. Unfortunately, this does not hold for all of the countries surveyed in Barca-Becht. Data for Spain, for instance, do not account for coalitional control, since Spanish law did not require disclosure of voting agreements.[129] Those reported for Sweden do not consider the effect of pyramids on both voting power concentration and separation of ownership and control – even though this information is available from other sources.[130] More in general, data on integrated ownership – and, therefore, about *actual* separation of voting rights from cash flow rights – are not available for all countries, since the Large Holdings Directive does not require disclosure of ultimate ownership.[131]

Secondly, an entire chapter is devoted to the in-depth analysis of each country's corporate governance, where data are interpreted, commented, and further elaborated upon by national experts. Those chapters are an extraordinary source of country-specific information that would be missed in a straight numerical comparison, but that of course improves the comparison qualitatively.

Thirdly, even though the scope of the comparison is reduced by five countries (Finland, Norway, Portugal, Ireland, and Switzerland are no longer included), finally we are able to add *the Netherlands* to the European picture. The reader will soon discover how precious this addition is.

Fourthly, the study by the European Corporate Governance Network contains a rather precise assessment (and, anyway, the most precise assessment available to date) of exactly the *comparative information* we need. That is to say:

i) What fraction of listed firms is governed by a controlling shareholder in each

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[128] Barca, F. and Becht, M. (eds.) [2001], *op. cit.*

[129] Crespi-Cladera, R. and Garcia-Cestona, M.A. [2001], *op. cit.*

[130] Compare Agnblad, J., Berglöf, E., Högfeldt, P. and Svancar, H. [2001], *op. cit.*, with two other national studies on Swedish CG: Cronqvist, H. and Nilsson, M. [2003], *op. cit.*, and Holmén, M. and Högfeldt, P. [2005], *op. cit.*

[131] Becht, M. and Mayer, C. [2001], *Introduction*, cit., 18.

country (or at least a consistent lower bound on the effective figures);

ii) How much voting power these shareholders control on average (when both indirect and coalitional holdings are traced as accurately as possible);

iii) How likely informal coalitions are to be formed between large shareholders or owners-managers in order to *entrench* corporate control.

2.4.2. A More Precise Assessment of Shareholder Control

The answers to the above questions can be derived from Figure 2 and Table 4 that follow. Figure 2 shows, for each country, the percentage of firms under shareholder control. Since in Barca-Becht data for the US are the only ones not entirely based on official sources, they have been supplemented with my own calculations on a more reliable database: the latter are displayed as USA (2), whereas the original results are reported as USA (1).[132] Control is inferred at two thresholds. The first (50% of voting rights) provides the most conservative – but also the most reliable – estimate of shareholder control; there is almost no doubt that whoever controls 50% or more of voting rights is in charge of the company management. The second (25% of voting rights) is still more conservative than the 20% threshold chosen by Faccio and Lang, and nonetheless ownership concentration appears to be higher in Belgium and Sweden – probably due to more accurate estimation.[133] That being said, Figure 2 confirms some of the previous understandings, but also tells us a few things we did not know yet.

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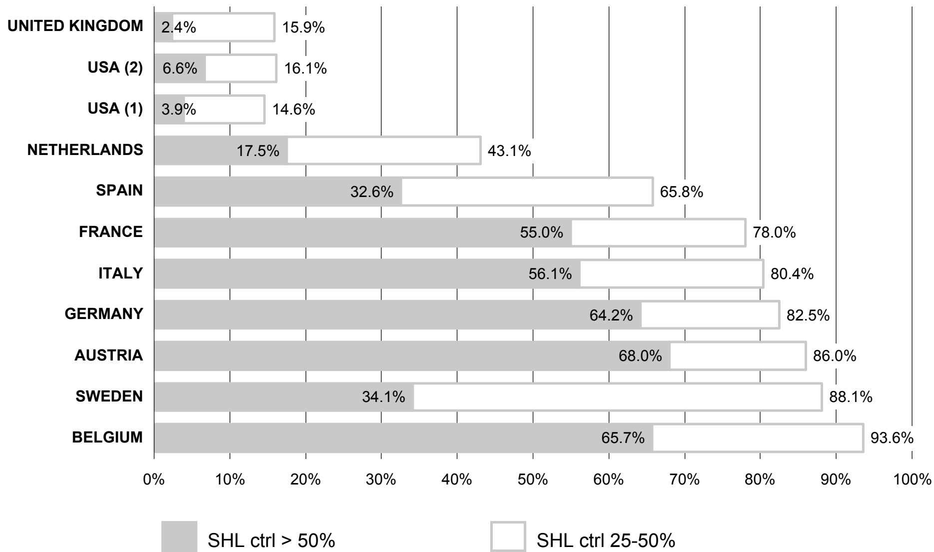
[132] Data for USA (1) are retrieved from Becht, M. [2001], *op. cit.* Calculations for USA (2) are based on the database provided as an online appendix of Dlugosz, J., Fahlenbrach, R., Gompers, P. and Metrick, A. [2006], *op. cit.* (a 'cleaned' database of ownership and control of US listed firms). See *supra*, note 103, for illustration of the methodology.

[133] It should be noted that the statistics reported in Figure 4 are taken individually from each country chapter of *The Control of Corporate Europe*. For some reason they differ sometimes from those provided by the summary tables at the end of the volume (see, especially, table AIII.2. in Barca, F. and Becht, M. (eds.) [2001], *op. cit.*, Appendix III – Comparative Tables). Even though those summary tables have become a standard reference in the European CG debate (see, e.g., McCahery, J.A., Renneboog, L. (with P. Ritter and S. Haller) [2003], *The Economics of the Proposed European Takeover Directive*, CEPS Research Report in Finance and Banking No. 32, available at www.ceps.be), I prefer sticking to the original data reported in the country expert's essays. One case in which the difference is most substantial is Sweden. Data reported in the summary tables do not match those of the country chapter. In fact, the frequency of shareholder control reported by Agnblad, J., Berglöf, E., Högfeldt, P. and Svancar, H. [2001], *op. cit.*, is based on another study: Cronqvist, H. and Nilsson, M. [1999], *Agency Costs of Controlling Minority Shareholders*, Working Paper, Department of Finance, Stockholm School of Economics (the published version – Cronqvist, H. and Nilsson, M. [2003], *op. cit.* – does no longer report all the data on voting power concentration).

Figure 2
Incidence of shareholder control in Europe and in the US



Note: Fraction of listed firms governed by a controlling shareholder or by a formal coalition of shareholders (voting pacts). A firm has a controlling shareholder when at least one shareholder or a coalition of them holds more than 25% of voting power (the grey area refers to the percentage of firms with an absolute majority shareholder). Data for Europe come from the country chapters in Barca-Becht [2001] and may differ from the summary tables at the end of the volume. They refer to the 'ultimate' (i.e., direct plus indirect) holders of voting power, unless otherwise indicated. Statistics about France are only based on direct holdings. Data for Spain consider both direct and indirect voting power, but do not account for voting pacts. Direct and indirect holdings are considered separately for Sweden. Data for The Netherlands refer to ownership instead of voting power, in order to exclude voting power concentration *de facto* in the hands of the incumbent management (see Box 2 and Figure 3 below). Data for the United States come from two separate sources. USA (1) reports data based on the country chapter of Barca-Becht [2001], aggregating information about the two major national exchanges, the NYSE and the NASDAQ. Statistics for USA (2) are calculated from a 'cleaned' database provided by Dlugosz *et al.* [2006] with hand-picked information about ultimate holders of voting power, corrected with information about firms with a dual class security-voting structure taken from Gompers *et al.* [2004]; the correction factor is 8.19% and it is based on the frequency of firms with dual class shares reported by Lang *et al.* [2005]. See *supra*, note 103, for illustration of the methodology. Reference years and the number of companies in each country sample are reported in Table 4 below.

Sources: Country chapters in Barca, F. and Becht, M. (eds.) [2001], THE CONTROL OF CORPORATE EUROPE, Oxford University Press. Elaborations on: Gadhoum, Y., Lang, L.H.P. and Young, L. [2005], *Who Controls US?*, in EUROPEAN FINANCIAL MANAGEMENT, vol. 11, 339-363; Dlugosz, J., Fahlenbrach, R., Gompers, P. and Metrick, A. [2006], *Large Blocks of Stock: Prevalence, Size, and Measurement*, in JOURNAL OF CORPORATE FINANCE, vol. 12, 594-618; Gompers, P.A., Ishii, J. and Metrick, A. [2004], *Incentives vs. Control: An Analysis of U.S. Dual-Class Companies*, NBER Working Paper No. 10240.

Controlling shareholders dominate the corporate governance arena in the Old Continent, by a typical rate of about 80% of listed firm when shareholder control is inferred at the 25% threshold. Contrary to what Faccio and Lang reported, this is no less true (and, if anything, even truer) in Sweden. The frequency of controlling shareholders appears to be somewhat lower in Spain, where however shareholder control is underestimated due to the effect of undisclosed coalitions. Nonetheless, shareholder control still accounts for about two thirds of Spanish listed firms at the 25% threshold. The opposite result holds for the US and the UK where shareholder control is very uncommon: it accounts for just about 15% of listed firms at the same 25% cut-off. By three out of four measures available for the US, controlling shareholders are slightly more frequent in the US than in Britain; yet their occurrence is still incomparable with the figures for continental Europe. There is only one significant exception to the dichotomy between continental Europe and Anglo-American countries. This is the Netherlands, which geographically belongs to the European continent, but where only about 43% of listed firms appear to be managed under the authority of a controlling shareholder (see *infra*, Box 2).

Trends of ownership (voting power) concentration remain relatively stable whether we consider a 50% or a 25% threshold. Countries that have more shareholders with at least 25% of voting rights have also a higher proportion of absolute majority shareholders. Very noticeably, in most countries of continental Europe, the latter and far more expensive governance structure prevails:[134] the majority of listed firms are governed by a shareholder featured with at least one half of voting rights.

There are two exceptions, both relating to otherwise very concentrated ownership structures, where only about one third of the firms appear to be governed by an absolute majority shareholder, and at least as many firms have one shareholder whose voting power is between a half and a quarter of voting rights. One is Spain, where according to the country experts this is due to takeover regulation (mandatory bid obligations arguably make the acquisition of a 50% stake particularly expensive).[135] In addition, voting power concentration would be higher in Spain, should also formal coalitions between shareholders be taken into account. The other is Sweden, where unfortunately the combined effect of dual class shares and

[134] Even though we are just considering voting power, and it often exceeds the underlying ownership stakes in shareholder control models, voting rights never come for free. More voting power always requires a higher, albeit possibly less than proportional, financial commitment. As a result, exerting control with a relative majority of the votes is always cheaper than holding an absolute majority position.

[135] Crespi-Cladera, R. and Garcia-Cestona, M.A. [2001], *op. cit.* See *infra*, Chapter Ten, for a broader discussion of this point in Law and Economics perspective.

pyramids on the largest shareholder's voting power is still being underestimated.[136] More precise estimates of voting power concentration in Sweden actually show that in *about one half* of listed firms the largest shareholder controls the absolute majority of voting rights, when the effect of complex control chains is fully accounted for.[137]

When we switch to the countries where ownership is more typically dispersed, shareholder control with a relative majority of the votes is instead *always* more popular than absolute shareholder control. This holds for the Netherlands, the US, and the UK; and it is particularly true for the latter. Indeed, the position of an absolute majority shareholder is not very convenient under British regulation of listed companies. To be sure – as it will be better illustrated in the Seventh Chapter – the regulatory disfavor extends to all significant shareholders, and it used to be particularly severe when they controlled more than 30% of voting rights. Indeed, if one relies on less underestimated measures of American ownership concentration than in Barca-Becht (i.e., those labeled as USA (2) in Figure 2), ownership appears to be the least concentrated in the UK also with respect to the frequency of large stakes ranging between 25% and 50% of voting rights.[138]

[136] In Agnblad, J., Berglöf, E., Högfeldt, P. and Svancar, H. [2001], *op. cit.*, only *direct* holdings are considered. Given that pyramidal groups are a very important feature of Swedish CG this clearly leads to underestimation of voting power concentration.

[137] This result is obtained by taking full account of both *direct* and *indirect* voting power – that is, of both dual class security-voting structures and pyramidal groups. According to one study, over 50% of non-financial listed firms have an absolute majority shareholder. See Holmén, M. and Högfeldt, P. [2005], *op. cit.* The frequency is somewhat lower when the universe of *all* listed firms is considered. According to the data reported by Cronqvist, H. and Nilsson, M. [2003], *op. cit.*, the frequency of listed firms under majority control in Sweden should be between 40% and 45%. See also note 146 below.

[138] Goergen, M. and Renneboog, L. [2001], *op. cit.*, 268, report that: "Of 200 [British] sample companies in 1992, 18 had one shareholder controlling more than 30% of the equity." These stakes were usually held by "family or individuals, who are the founders or their heirs." A remarkable frequency is observed for shareholdings just below the 30% threshold. This may be due not only to the threshold triggering the mandatory bid obligation, but also to the burdensome restrictions on shareholder control that used to be placed by the Listing Rules when 30% of the voting rights was held by the same person (or coalition of shareholders). See Crespi-Cladera R., Renneboog L. [2003], *op. cit.*, and – for a more detailed discussion – *infra*, Chapter Seven, section 7.3.2.

BOX 2
Corporate control in the Netherlands

The data reported for the Netherlands in Figure 2 are significantly different from the description of Dutch corporate governance prevailing in the comparative literature.[139] This requires a bit of explanation. Voting power concentration is in fact much higher in the Netherlands: in about two thirds of listed firms the largest voting block accounts for no less than 25% of voting rights (and for at least 50% in nearly 40% of the firms). Apparently, this situation does not look very different from the rest of continental Europe. However, these figures are not always evidence of shareholder control.

In more than one third of listed firms, concentrated voting power (i.e., the largest shareholder accounting for 25% or less of voting rights) is in fact held by a typical Dutch institution, the *administratiekantoor* (an 'administrative' or, more precisely, a trust office).[140] This is a voting trust foundation, which exerts voting rights pertaining to shareholders, but upon which shareholders may end up having no influence. Once the shares are placed with an *administratiekantoor*, shareholders only get in exchange depository receipts that carry no voting rights (see Chapter Seven for more details). In most cases, the *administratiekantoor* is friendly to the incumbent management and therefore exerts its voting rights in such a way as to support managerial control. Less frequently, the *administratiekantoor* is set up by a controlling shareholder for his own convenience. When the shares held through an *administratiekantoor* are referred to their ultimate owners, only about 43% of Dutch firms exhibit a controlling shareholder at the 25% threshold (17.5% have an absolute majority shareholder).[141] Data on ownership are particularly significant in the Netherlands, since *formal* deviations from 'one share–one vote' are hardly allowed and pyramids are very uncommon.[142] Situations where

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139 The standard reference for Dutch ownership and control structure is that provided for by the summary table AIII.2. in Barca, F. and Becht, M. (eds.) [2001], *op. cit.*, Appendix III – Comparative Tables. These data correspond to the statistics calculated by de Jong, A., Kabir, R., Marra, T. and Röell, A. [2001], *op. cit.*, as far as voting power concentration is concerned. If one just sticks to this information, controlling shareholders would seem to dominate also the governance of Dutch listed firms. But this is definitely *not* what de Jong and his co-authors report in their essay (Id., at 193-204). In the Netherlands, a substantial part of voting power is held by *administratiekantoor*. When the beneficial ownership of the underlying stock is dispersed, it is reasonable to credit the same voting power to the management instead of to a controlling shareholder that does not exist. In fact, in the absence of such a shareholder, the board of an *administratiekantoor* is typically friendly to the management. See *infra* in the text of the Box.

140 About 39% of Dutch listed firms had shares placed with such a trust office in 1996. In nearly 37% of listed companies voting power of the *administratiekantoor* exceeded 25% of voting rights, and it accounted for no less than 50% of voting rights in about 26% of the firms. See de Jong, A., Kabir, R., Marra, T. and Röell, A. [2001], *op. cit.*, 202 (table 7.8).

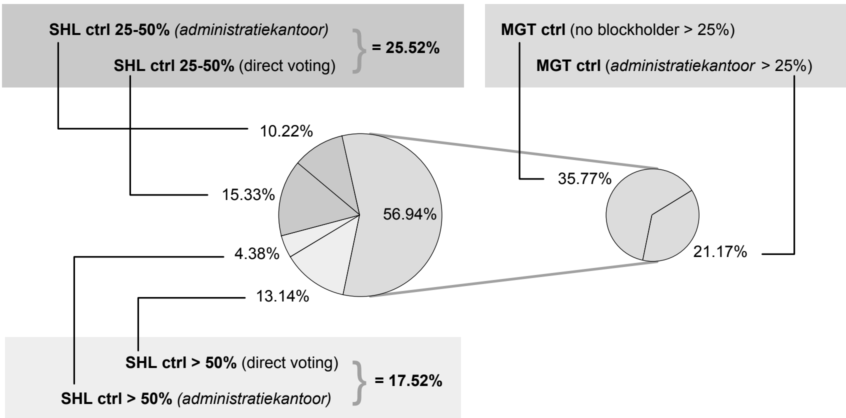
141 Id., at 196 (table 7.3).

142 Non-voting shares are plainly prohibited by Dutch corporate law. See Schuit, S.R., Bier, B., Verburg, L.G. and Ter Wisch, J.A. [2002], CORPORATE LAW AND PRACTICE OF THE NETHERLANDS : LEGAL AND TAXATION, 2nd edn., Kluwer Law Int'l, 73. Multiple voting shares are theoretically allowed, but voting rights must be anyway proportional to the share capital. Different classes of shares may have different voting rights, but then they must have also different par values. As a re-

voting power concentration exceeds ownership concentration (about 21% of listed firms at the 25% threshold) derive from the *administratiekantoor* collecting voting rights from dispersed shareholders; and this is perhaps the most compelling evidence we have of managerial control.

By combining information about ownership and voting power concentration with data referring to the stakes held by voting trust foundations, we are able to get a more precise picture of both direct and indirect exercise of voting power in the Netherlands, as well as of its impact on corporate governance. The results are summarized in Figure 3 below.

Figure 3
Controlling Shareholders and Managerial Control in the Netherlands



Note: Fraction of firms listed in the Netherlands in 1996 by type of corporate controller. Shareholder control is inferred at the 25% and 50% threshold of ownership concentration. Voting power held by trust offices in excess of the same thresholds is credited to controlling shareholders to the extent ownership concentration is higher than direct voting power concentration. The remaining voting power exerted through *administratiekantoor* is credited to the management. The latter is also supposed to be in charge when no shareholder owns at least 25% of share capital.

Source: Elaborations on de Jong, A., Kabir, R., Marra, T. and Röell, A. [2001], *Ownership and Control in the Netherlands*, in F. Barca and M. Becht (eds.), THE CONTROL OF CORPORATE EUROPE, Oxford University Press, 188-206.

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sult, a 'one share–one vote' principle formally holds in Dutch corporate law. In practice, however, this principle is short-circuited by means of more sophisticated techniques. See Deminor-rating [2005], *op. cit*. Placing shares in an *administratiekantoor* is indeed one of these techniques See, in general, Chirinko, R., van Ees, H., Garretsen, H. and Sterken E. [2004], *Investor Protections and Concentrated Ownership: Assessing Corporate Control Mechanisms in the Netherlands*, in GERMAN ECONOMIC REVIEW, vol. 5, 119–138. See *infra*, Chapter Seven, section 7.3.3, for a more detailed legal analysis. Overall, these techniques for separating control rights from ownership are so powerful that virtually no Dutch company resorts to pyramidal group structures in order to leverage voting power. See de Jong, A., Kabir, R., Marra, T. and Röell, A. [2001], *op. cit.*, 193.

2.4.3. Controlling Shareholders in Continental Europe

Table 4 is intended to answer the next questions. That is, firstly, how strong *the largest shareholder* is on average (i.e., how likely he is to be powerful enough to exert uncontestable control over the company management). Secondly, how strong *other large shareholders* are on average relative to the largest one (i.e., what the likelihood is that informal coalitions are formed to govern the company and to shield it from hostile takeovers). In Table 4, the three largest shareholders are considered. This time we complement information about country averages with median values. The median is the value that splits the sample in two parts each accounting for 50% of the firms. By comparing this value with the average (sample mean) we are able to get an idea about how *skewed* are the country distributions of largest shareholders. The farther is the sample mean from the median value, the more skewed is the distribution. In addition, when the median is lower than the mean, there are more below-average than above-average firms; and the reverse is true in the opposite case. This tells us about the direction of skewedness.

It seems that the distributions of the largest voting blocks in continental Europe are *not* very skewed. Median values confirm that, apart from Spain, Sweden, and the Netherlands, *the majority of firms* listed in any country of the Old Continent have a controlling shareholder with more than 50% of voting rights. In the same countries, also the average size of the largest voting block is above (or just below) 50%, and there are more firms with above-average than below-average controlling shareholders.

Apparently, the typical controlling shareholder does not need much help in Austria, Belgium, France, Germany, and Italy – his position is normally *uncontestable*. Neither would other shareholders be large enough to help. In fact, the average figures for the second and the third largest shareholders are very much lower than those of the largest one, and if we also look at median values, the vast majority of the firms have second and third largest shareholders below the average. Even though such shareholders have non-negligible stakes in the company, their relative weakness compared to the largest shareholder gives them little chance to be actually involved in corporate control. In these countries, shareholder coalitions not featuring a disclosed voting pact seem to have just a *residual* importance, limited to those instances where the largest shareholder's voting power would not alone be sufficient to guarantee stability (i.e., non-contestability) of corporate control.[143] This might hold, for instance, for that fraction of listed firms where each single sharehol-

[143] See Becht, M. and Mayer, C. [2001], *Introduction*, cit., for a similar conclusion.

Table 4
Size of voting blocks by rank

	YEAR	NO. OF COMPANIES	LARGEST VOTING BLOCK MEAN	LARGEST VOTING BLOCK MEDIAN	2ND LARGEST VOTING BLOCK MEAN	2ND LARGEST VOTING BLOCK MEDIAN	3RD LARGEST VOTING BLOCK MEAN	3RD LARGEST VOTING BLOCK MEDIAN
Belgium	1995	135	56.1%	55.8%	6.6%	10.2%	4.5%	4.7%
Austria	1996	50	54.1%	52.0%	7.8%	2.5%	2.6%	0
France [(a)]	1996	674	52.0%	N/A	N/A	N/A	N/A	N/A
Italy	1996	214	51.9%	54.5%	7.7%	5.0%	3.5%	2.7%
Germany	1996	372	49.6%	57.0%	2.9%	0	0.6%	0
Netherlands [(b)]	1996	137	42.8%	43.5%	11.4%	7.7%	4.0%	0
Spain [(c)]	1995	193	40.1%	34.5%	10.5%	8.9%	3.5%	1.8%
Sweden [(d)]	1998	304	37.7%	35.0%	11.2%	8.7%	5.6%	4.8%
USA (1)								
NYSE	1996	1,309	8.5%	5.4%	3.7%	0	1.8%	0
NASDAQ	1996	2,831	13.0%	8.6%	5.7%	0	3.0%	0
USA (2)	1996	1,130	15.8%[(e)]	10.0%	5.1%	5.8%	2.4%	0
United Kingdom	1992	207	14.4%	9.9%	7.3%	6.6%	6.0%	5.2%

Notes: Descriptive statistics about the average (mean) and median size of voting blocks held by the three largest shareholders in each country. Zero values are not excluded and are assigned when no voting block above the disclosure threshold (5% for all countries except the UK – 3% – and Italy – 2%) is observed. Data for Europe come from the country chapters in Barca-Becht [2001] and may differ from the summary tables at the end of the volume. They account for 'ultimate' (i.e., direct plus indirect) voting stakes, unless otherwise indicated. Data for the United States come from two separate sources. See note for Figure 2. Data for USA (1) are split between the two major national exchanges, the NYSE and the NASDAQ.

(a) More detailed information is only available for the 40 largest firms by market capitalization (CAC 40). Data reported in the Table only account for direct voting stakes.
(b) Data include the voting stakes concentrated in trust offices (*administratiekantoor*).
(c) Direct and indirect holdings are added to each other, but voting agreements between shareholders are not considered.
(d) Direct and indirect holdings are considered separately. Data account for the effect of dual class shares, but not also for that of pyramidal structures.
(e) Companies with dual class shares are only considered in calculating the average largest voting block. Other statistics for dual class shares companies are either unavailable or impossible to calculate. However, dual-class shares are employed by too few companies to affect median values considerably, and they are likely to have quite a negligible (downwards) impact on voting power of the second and third largest shareholder.

Sources: Country chapters in Barca, F. and Becht, M. (eds.) [2001], THE CONTROL OF CORPORATE EUROPE, Oxford University Press. Elaborations on: Gadhoum, Y., Lang, L.H.P. and Young, L. [2005], *Who Controls US?*, in EUROPEAN FINANCIAL MANAGEMENT, vol. 11, 339-363; Dlugosz, J., Fahlenbrach, R., Gompers, P. and Metrick, A. [2006], *Large Blocks of Stock: Prevalence, Size, and Measurement*, in JOURNAL OF CORPORATE FINANCE, vol. 12, 594-618; Gompers, P.A., Ishii, J. and Metrick, A. [2004], *Incentives vs. Control: An Analysis of U.S. Dual-Class Companies*, NBER Working Paper No. 10240.

der accounts for less than 25% of voting rights, and therefore the three largest shareholders are likely to be closer to each other.[144] But one should not forget that this fraction of listed companies is lower than 20% in all of the countries under consideration. Whatever is the actual, and still unexplored, role of shareholder coalitions in these countries, the near totality of listed firms exhibits very little contestability of corporate control, if any at all.

The picture looks somewhat different in a few other countries of continental Europe, namely in Spain, Sweden, and the Netherlands. However, in all but the last case, the differences may be more apparent than real.

In Spain, the average size of the largest voting block is about 40%, and the median is five percentage points lower (i.e., most listed firms have below-average voting power concentration). This is consistent with previous observation about the relatively low frequency of absolute majority shareholders in Spain. However, one should not forget that shareholder control is being underestimated by failing to account for voting pacts between shareholders. In fact, the relatively short distance between top-ranking voting blocks (as displayed in Table 4) suggests that shareholder coalitions may be actually an important feature of Spanish corporate governance – even though it is ultimately unclear whether they are formal or informal. Consistently, country experts report that little contestability is observed among Spanish listed firms.[145]

In Sweden, the average size of the largest voting block seems to be even lower than 40% and, again, the majority of listed firms appear to be (slightly) below average. However, these figures only account for the effect of dual class shares for enhancing voting power. Once indirect holdings through intermediate companies (typically organized in a pyramidal structure) are also accounted for, the picture of Swedish corporate governance becomes not much different from the rest of continental Europe. Two separate inquiries about concentration of both ownership and voting power in Sweden either show or suggest that the average largest block is about 50% and it is basically equal to the median value (i.e., about one half of listed

[144] In all of the countries under consideration, shareholder (informal) coalitions are more likely to emerge than managerial control where no single shareholder (or a formal coalition of them) accounts for at least 25% of voting power. This is basically due to the legal distribution of powers between shareholders and the board of directors, as it will be explained in the Seventh Chapter. As far as empirical evidence is concerned, one might just mention the following circumstance characterizing the countries at issue: listed firms where the sum of *all* voting blocks above the disclosure threshold account for less than 25% of voting rights are highly exceptional (See table AIII.2. in Barca, F. and Becht, M. (eds.) [2001], *op. cit.*, Appendix III – Comparative Tables). With special reference to shareholder coalitions in Italian CG, see most recently Bianchi, M. and Bianco, M. [2006], *op. cit.*

[145] Garcia-Cestona, M.A. [2001], *op. cit.*

firms has an absolute majority shareholder).[146] This is achieved by extensive separation of voting rights from ownership claims whose leverage effect is on average about 2 votes for each unit of share capital.[147] The average voting leverage is already 1.47 votes for each unit of share capital when the effects of indirect holdings and pyramiding are *not* accounted for.[148] Then it may be argued that dual class shares – employed by 63% of listed firms – are relatively more important than pyramids for separation of ownership and control in Sweden, but pyramids have anyway a considerable impact on both the average voting leverage and the actual size of the average voting block.

It should also be noticed that, in Sweden, voting leverage at the margin is much higher than on average. About one half of market capitalization at the Stockholm Stock Exchange is under the control of two major closed-end funds: *Investor* – controlled by the Wallenberg family – and *Industrivärden* – controlled by the *Svenska Handelsbanken* (SHB).[149] The integrated ownership of the two major corporate controllers in Sweden is 23 times lower than the stock market capitalization of the firms under control.[150] If there was one single firm accounting for such a stock market capitalization, this would involve that the ultimate ownership of the controlling shareholder would be as low as 4.4%, and nonetheless sufficient to exert corporate control.[151] This should give an idea of the corporate governance pattern having the highest relevance in the Swedish stock market.[152]

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[146] These are the figures reported for a sample of 156 large non-financial firms listed at the Stockholm Stock Exchange at some point between 1984 and 2000, accounting for about 70% of each year's market capitalization Holmén, M. and Högfeldt, P. [2005], *op. cit.* Data for the universe of Swedish listed firms within the 1991-1997 period are also available (Cronqvist, H. and Nilsson, M. [2003], *op. cit.*), but the mean and median size of the largest voting block are only reported for single categories of controlling shareholders at the 25% threshold (jointly accounting for about 88% of listed firms). It should be noted that the average size of the largest voting block for that portion of listed firms is about 52%, and that should not decrease dramatically once the remaining 12% of listed firm with allegedly dispersed ownership is included. See also note 141 above.

[147] Holmén, M. and Högfeldt, P. [2005], *op. cit.*

[148] Agnblad, J., Berglöf, E., Högfeldt, P. and Svancar, H. [2001], *op. cit.*

[149] Agnblad, J., Berglöf, E., Högfeldt, P. and Svancar, H. [2001], *op. cit.*; Holmén, M. and Högfeldt, P. [2005], *op. cit.*

[150] Holmén, M. and Högfeldt, P. [2005], *op. cit.*

[151] In reality, in 1998 the Wallenbergs controlled 14 large listed firms accounting for 42% of stock market capitalization; and the SHB controlled 11 large firms accounting for 12% of stock market capitalization. See Agnblad, J., Berglöf, E., Högfeldt, P. and Svancar, H. [2001], *op. cit.* The value of integrated ownership reported in the text should be regarded as the *average* ratio of ultimate ownership to the market value of corporate assets under control. The reciprocal of this ratio is customary referred to as 'control leverage' and it is of course always higher than the voting leverage. See Holmén, M. and Högfeldt, P. [2005], *op. cit.*

[152] For the historical roots of the Swedish model of CG, see Högfeldt, P. [2005], *The History and Politics of Corporate Ownership in Sweden*, in R. Morck (ed.), A HISTORY OF CORPORATE GOVERNANCE

Of course, in such a scenario, voting power held by the second and the third largest shareholder is basically unimportant. All the more so as the data in this regard (Table 4) are likely to be significantly *overestimated* relative to those concerning the largest voting block, provided that direct and indirect holdings of 'ultimate' controlling shareholders are considered separately. Overall, the typical controlling shareholder of a Swedish listed company enjoys so much voting power in excess of ownership to be already insulated from takeover threat. As a result, contestability of corporate control and shareholder coalitions appear to be both very exceptional in Sweden.[153]

2.4.3. Dispersed Ownership in the Netherlands

The situation in the Netherlands is instead much more different from continental Europe than it appears from the figures. The average size of the largest voting block is indeed quite high (about 43%) and roughly equal to the median value. But this is mostly due to the blocks held through trust offices (*administratiekantoor*) – the typical way in which voting rights are separated from ownership in the Netherlands.[154] Since the shares deposited in a trust office are mostly *controlled* by inside management while *belonging* to dispersed investors, ownership in the Netherlands seems to be much more concentrated than it actually is. Once we look at *beneficial ownership* of shares held by trust offices, the average largest stake gets just *as low as about 27%* and the median is almost one third lower: that is to say, a half of Dutch listed firms have the largest owner accounting for no more than 18% of share capital. Only about *a quarter* of listed firms have a blockholder accounting for over 40% of share capital.[155] Shares held through trust offices explain why *voting power* concentration is much higher (more than *a half* of listed firms have a voting block larger than 40%). The difference should be credited to managerial control.[156]

In this perspective, information about the second and the third largest voting block adds little to our knowledge. For the reasons that will be clarified by the analysis of corporate law in the Netherlands, the management of a Dutch publicly

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AROUND THE WORLD: FAMILY BUSINESS GROUPS TO PROFESSIONAL MANAGERS, NBER Conference Volume, University of Chicago Press, 517-579 (also available as NBER Working Paper No. 10641).

153 This conclusion is reported by all of the Swedish commentators. See, e.g., Agnblad, J., Berglöf, E., Högfeldt, P. and Svancar, H. [2001], *op. cit.*

154 See Chapter Seven, section 7.3.3, for a broad discussion of the pertinent legal rules.

155 de Jong, A., Kabir, R., Marra, T. and Röell, A. [2001], *op. cit.*

156 For a more precise assessment of the incidence of voting trust foundations (*administratiekantoor*) on managerial control in the Netherlands, see Box 2 and Figure 3 above.

held company does not have much either to expect or to fear from shareholders, provided that they do not get too large; and Dutch corporate law allows for a number of techniques to prevent this from happening.[157] Coalitions might be instead of some help to support shareholder control, whenever the largest shareholder is not large enough to hold the management accountable. In theory, this might be an option for some of the firms where neither the managers nor any shareholder control at least 25% of voting rights (about one third of Dutch listed firms – see Figure 3). However, how many of those firms are actually controlled by a coalition of shareholders instead of by their management is ultimately an empirical question that can hardly be answered on the basis of aggregated data. The overall result would be unchanged anyway: contestability of corporate control is definitely *not* a feature of Dutch corporate governance. According to some national commentators, this comes with both costs and benefits for shareholder wealth.[158] Whether the former or the latter prevail in the so-called 'polder model' of corporate governance is still an open question.[159]

2.4.4. Managerial Control of Anglo-American Firms

a) Limited Scope for Controlling Shareholders

Corporate governance in both the US and the UK is remarkably different from continental Europe. The average size of the largest voting block is significantly lower (accounting for about 15% of voting rights) and clearly insufficient, as such, to guarantee the unchallenged exercise corporate control. In addition, the distribution of top voting blocks is highly skewed. Median values are about one third lower than the average, this meaning that in the majority of listed firms voting power is far more dispersed than on average. Similar results holds for ownership, provided that deviations from 'one share–one vote' are a negligible phenomenon in the UK

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[157] See Chirinko, R., van Ees, H., Garretsen, H. and Sterken E. [2004], *op. cit.*, for a survey of these techniques and illustration of their effects on stock market performance. Specifically, this analysis challenges the mainstream 'law matters' view that weaker shareholder protection should lead to both higher ownership concentration and lower stock returns (see, e.g., La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R. [2000a], *op cit.*). See *infra*, in Chapter Four, a detailed discussion of the theoretical and empirical background of this strand of literature.

[158] Kabir, R., Cantrijn, D. and Jeunink, A. [1997], *Takeover Defenses, Ownership Structure and Stock Returns in the Netherlands: An Empirical Analysis*, in STRATEGIC MANAGEMENT JOURNAL, vol. 18, 97–109.

[159] For the historical development of the 'polder model' of CG, see de Jong, A. and Röell, A. [2005], *Financing and Control in The Netherlands: A Historical Perspective*, in R. Morck (ed.), A HISTORY OF CORPORATE GOVERNANCE AROUND THE WORLD: FAMILY BUSINESS GROUPS TO PROFESSIONAL MANAGERS, NBER Conference Volume, University of Chicago Press, 467-506.

and, even though they can be substantial in the US, they only account for less than 8% of firms listed on American stock markets.[160] It is worth noting that the basic traits of this picture match the distribution of corporate ownership in the Netherlands, where the mean and median values of the largest stake are almost doubled but exhibit the same distance (about one third) from each other – that is, the majority of listed firms have much below-average ownership concentration.

The Anglo-American average largest shareholder is also very weak relative to *other* large shareholders. In at nearly one half of British listed companies, a coalition of the second and third largest shareholders would be sufficient to outvote the largest one.[161] In the US, it seems that the size of voting blocks by rank declines somewhat more rapidly, especially if median values are considered, but anyway not as rapidly as in continental Europe. The potential for coalition of moderately large shareholders is then quite an issue for the *vast majority* of Anglo-American listed firms, whereas it is so at most for a tiny minority of firms listed in continental Europe.[162] However, whether or not such a potential is exploited in practice, and how, is another question. The answer depends on contestability of corporate control.

The above picture about Anglo-American corporate governance yields three conventional – but far from undisputed – conclusions. The first is that in both the US and in the UK, the vast majority of listed firms are under managerial control, provided that no controlling shareholder is around.[163] The second is that, differently from continental Europe (where a controlling shareholder typically holds on a majority of share capital), corporate control is normally contestable in Britain and the US: allegedly, shareholders may anytime oust the management they are dissatisfied with, by coalescing and voting them out.[164] The third is that, consequently, the basic corporate governance pattern is the same in the US and in the UK.[165] Only the first conclusion is essentially correct, subject to one major qualification about the different impact of regulatory biases in the US and the UK. The second is apparently contradicted by empirical evidence on takeovers in Britain and the US. Finally, the standard belief that the US and the UK share a common pattern of corporate governance is manifestly wrong.

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[160] The effect of dual class shares on control enhancement is nonetheless accounted for in the statistics labeled as USA (2) in Table 4 and Figure 2. See *supra*, note 103.
[161] Goergen, M. and Renneboog, L. [2001], *op. cit*, 266-276
[162] Becht, M. and Mayer, C. [2001], *Introduction*, cit., 18-20.
[163] Id., at 36-38.
[164] Shleifer, A. and Vishny, R. [1997], *op. cit.*, 764.
[165] See, e.g., Morck, R., Wolfenzon, D. and Yeung, B. [2005], *op. cit.*

b) The False Impression of Contestability

Corporate governance is indeed quite different between the US and the UK, and a better understanding of those differences helps to find out why corporate control of most Anglo-American firms is actually far from contestable.[166] On the one hand, ownership concentration appears to be slightly higher in the US than in the UK, when only the position of the largest shareholder is considered. The potential for shareholder coalitions is instead higher in the UK than in the US.[167] More importantly, regulation of corporate governance is substantially different.[168] On the other hand, contestability of corporate control appears to play a minor role in *both* countries, where the overwhelming majority of takeovers ultimately take place *with the consent* of the incumbent management and, therefore, they are by no means hostile.[169]

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[166] For a very accurate analysis of both economic and regulatory factors affecting the market for corporate control in the US and the UK, Franks, J., Mayer, C. and Renneboog, L. [2001], *Who Disciplines Management in Poorly Performing Companies?*, in JOURNAL OF FINANCIAL INTERMEDIATION, vol. 10, 209-245.

[167] Becht, M. and Mayer, C. [2001], *Introduction*, cit., 18-20.

[168] Franks, J. and Mayer, C. [2002], *op. cit.*, 11-15.

[169] The rarity with which hostile takeovers occur in the real world is very often asserted, but little documented by the literature. Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 70-78, review most notable exceptions. The standard view is that "hostile bids are primarily an Anglo-American phenomenon and occasional events even in these countries." Burkart, M. and Panunzi, F. [2006b], *op. cit.*, 2. This may seem to support the idea that the hostile takeover mostly operates as a threat, which would be enough to keep incumbent managers on their toes (see *supra*, Chapter One, section 1.4.5). That is, hostile takeovers are a disciplinary mechanism of *last resort* on managerial misbehavior (Fama, E.F. [1980], *Agency Problems and the Theory of the Firm*, in JOURNAL OF POLITICAL ECONOMY, vol. 88, 294-295), which is of course unavailable in those systems that – unlike Anglo-Saxon countries – do not feature managerial capitalism. However, in spite of long-standing theoretical predictions of such a kind (see *infra*, Chapter Three, for a more detailed discussion), about thirty years of empirical research have failed to deliver the support of evidence.

To begin with, it is highly questionable that hostile takeovers have ever performed any disciplinary role. In fact, they appear to have been mostly driven by firm size and merger waves, and unrelated to firm performance, in both the US and the UK. See Burkart, M. and Panunzi, F. [2006b], *op. cit.*, 4-5; Franks, J., Mayer, C. and Renneboog, L. [2001], *op. cit.*; Comment, R. and Schwert, G.W. [1995], *Poison or Placebo? Evidence on the Deterrence and Wealth Effects of Modern Antitakeover Measures*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 39, 3-43. More importantly, hostile takeovers appear to have enjoyed some glory in the past, especially in the corporate America of the 80s – where, however, they rarely involved more than 1.5% of listed companies (Comment, R. and Schwert, G.W. [1995], *op. cit.*, 4-5) and never accounted for more than 30% of Merger and Acquisition deals every year (Schwert G.W. [2000], *Hostility in Takeovers: In the Eyes of the Beholder?*, in JOURNAL OF FINANCE, vol. 55, 2608). Nonetheless, they seem to be definitively out of fashion nowadays. Holmström, B. and Kaplan, S. [2001], *Corporate Governance and Takeovers in the USA: Making Sense of the 80's and 90's*, in JOURNAL OF ECONOMIC PERSPECTIVES, vol. 15, 121-127, document that US merger activity experienced a "steep but brief drop" around 1990; then, while takeovers rebounded to much higher

Inside ownership and takeover defenses explain both the differences and the lack of contestability in British and American corporate governance. In a nutshell, the two are substitutes as far as takeover resistance is concerned. An incumbent management may either be allowed to implement takeover defenses or hold on enough shares to make potential takeovers unprofitable for the aggressor.[170] The management of a typical US corporation does not need to resort to the latter strategy, for it is entitled to takeover defenses as long as it controls the board of directors – which it most often does.[171] The management of a public company in the UK has instead almost no choice but inside ownership to shield from a takeover, since takeover defenses are not available to the board of directors under British law.[172] What is puzzling is how this situation did not result in concentrated ownership structures like in most part of the European continent. Perhaps one major reason why, differently from the rest of Europe, unavailability of takeover defenses did not prevent dispersion of ownership in the UK is that the concentration of voting power in the hands of a controlling shareholder has been *disfavored* by the British regulation of listed firms.[173]

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levels than in the 80s, "hostility declined substantially" – namely, from between 15% and 40% of tender offers during the 80s to between 5% and 15% during the 90s.

The British case does not look any different. Weir, C. and Laing, D. [2003], *Ownership structure, board composition and the market for corporate control in the UK: an empirical analysis*, in APPLIED ECONOMICS, vol. 35, 1750-1752, document that hostile takeovers accounted for an average 10% of merger activity in the period 1990-1998, the percentage falling to less than 5% in the last two years.

170 Franks, J., Mayer, C. and Renneboog, L. [2001], *op. cit.* (citing Stulz, R. [1988], *Managerial Control of Voting Rights: Financing Policies and the Market for Corporate Control*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 20, 25-54).

171 On the differences in takeover regulation between the US and the UK, which are often overlooked by the mainstream literature, see Miller, G.P. [2000], *Takeovers: English and American*, in EUROPEAN FINANCIAL MANAGEMENT, Vol. 6, 533-541, and, most recently, Armour, J. and Skeel, D.A. [2006], *Who Writes the Rules for Hostile Takeovers, and Why? The Peculiar Divergence of US and UK Takeover Regulation*, ECGI Law Working Paper No. 73/2006, available at www.ssrn.com and www.ecgi.org.

172 Goergen, M. and Renneboog, L. [2003], *op. cit.* See *infra*, Chapters Seven and Eleven, for a more detailed legal analysis.

173 According to the British commentators, this disfavor towards concentration of voting power was due, historically, to the pressure exerted by institutional investors on the regulatory authorities of the London Stock Exchange. The extraordinary power of institutional investors in the UK was due, in turn, to their prominent role in financing mergers and acquisition in the middle of last century. These two factors ultimately led to dispersion of ownership in the UK, which was supported by limited, but essential regulation. See Franks, J., Mayer, C. and Rossi, S. [2005a], *op. cit.* It should be noted that the rules governing British listed firms used to be in the domain of self-regulation, but are no longer so. On the one hand, the Financial Services Authority (FSA) has taken over all the regulatory authority of the former *Self Regulatory Organizations* since the late 90s; on the other hand, even the rules established by the *City Panel on Take-overs and Mergers* (which is still a self-regulatory body) have been recently granted statutory authority in order to comply with the requirements of the Takeover Directive (Directive 2004/25/EC of the European Parliament and of

Managerial ownership plays an important role in British corporate governance, whereas it does not seem to be equally important in the US. Directors are the second most important category of owners in the UK, following institutional investors,[174] and they account for an average aggregate stake of about 11% in established companies and 22% in recent Initial Public Offerings. Comparable figures are not available for the US, but, according to the data reported in Barca-Becht, US directors jointly hold *more* than 10% of voting rights in just 30% of the firms listed at the NASDAQ and in 10% of those listed at the NYSE. In addition, one should not forget that, in about 8% of US listed firms, directors have their voting power enhanced through dual class shares (which on average confer upon them more than 50% of voting rights), so that they are basically to be regarded as controlling shareholders.[175]

The few economists that have realized this fundamental difference between the US and the UK claim that the underlying reason is essentially regulatory.[176] Contrary to conventional wisdom, the legal discipline of corporate governance is in fact very different in the two countries.[177] Two points have been especially highlighted by this strand of literature. The first is the special character of minority shareholder protection in the UK, which is achieved by disfavoring both the acquisition and the maintenance of a controlling position by large shareholders. The second is the very management-friendly regulation of takeover defenses in the US. I shall elaborate upon these and related differences from the Seventh Chapter onwards. For the moment, it should be sufficient to present the resulting patterns of corporate governance.

In both the US and the UK managerial control largely prevails over shareholder control, but this does not also involve that corporate control is contestable.[178] Similarly to controlling shareholders in continental Europe, Anglo-American managers

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the Council of 21 April 2004 on takeover bids – the so-called Thirteenth Directive on Company Law, whereupon *infra,* Chapter Eleven, section 11.4).

On the difference in the regulation of controlling shareholding between Britain and continental Europe, see also Wymeersch, E. [2003], *Do we need a law on groups of companies?*, in K. Hopt and E. Wymeersch (eds.), CAPITAL MARKETS AND COMPANY LAW, Oxford University Press, 573-600.

174 Investment and Pension Funds own a combined shareholding of about 20% in the average British listed company. Goergen, M. and Renneboog, L. [2001], *op. cit.*

175 Figures reported by the empirical literature range between 6% and 8% over the 90s and the early 2000s. Compare Gadhoum, Y., Lang, L.H.P. and Young, L. [2005], *op. cit.*, with Gompers, P.A., Ishii, J. and Metrick, A. [2006], *op. cit.*

176 Franks, J. and Mayer, C. [2002], *op. cit.*

177 See Becht, M. and Mayer, C. [2001], *Introduction*, cit. Lawyers have recently started speculating on these differences. See, e.g., Bebchuk, L.A. [2005a], *The Case for Increasing Shareholder Power*, in HARVARD LAW REVIEW, vol. 118, 833-914; and Armour, J. and Skeel, D.A. [2006], *op. cit.*

178 Becht, M. and Mayer, C. [2001], *Introduction*, cit., 36-38.

are entrenched more often than not. However, managerial entrenchment is achieved in two quite different manners in the US and in the UK. In Britain, managers entrench themselves by forming informal coalitions within the board of directors that hold enough voting power to confront with outside shareholder interference and to resist a potential takeover.[179] In fact, very few takeovers are actually hostile in the UK. Apparently, during the 90s, hostile takeovers accounted for less than 5% of changes in control in Britain.[180] As a result, board turnover appear to be inversely related to inside ownership but basically unrelated to firm performance (apart from cases of considerable underperformance).[181]

US managers can afford a much easier life, since they do not need much voting power either to exert or to maintain corporate control – all they need is to control the board of directors.[182] Under US law, board members can count on a number of advantages over outside shareholders, the most important being perhaps takeover defenses – which are apparently implemented pre-bid by the majority of US listed firms, and can anyway be employed post-bid.[183] As a result, there seems to be no more hostility in US takeovers than "in the eyes of the beholder."[184] Also in the US

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[179] Crespi-Cladera R., Renneboog L. [2003], *op. cit.*

[180] Weir, C. and Laing, D. [2003], *op. cit.*

[181] Franks, J., Mayer, C. and Renneboog, L. [2001], *op. cit.*

[182] See *infra*, Chapter Seven, section 7.3.1.

[183] Daines, R. and Klausner, M. [2001], *Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs*, in JOURNAL OF LAW ECONOMICS AND ORGANIZATION, vol. 17, 83–120; Field, L.C. and Karpoff, J.M. [2002], *Takeover Defenses at IPO Firms*, in JOURNAL OF FINANCE, vol. 57, 1857-1889.

[184] Schwert, G.W. [2000], *op. cit.* From a purely conceptual point of view, Professor Schwert argues that the distinction between hostile and friendly takeovers is not entirely obvious. Id., at 2599-2601. Some friendly deals would not be feasible if not under the threat of hostile acquisition; whereas the characterization of a takeover as hostile may reflect more of a *bargaining* strategy of either the bidder or the target firm than of an actual feature of the acquisition. Id., at 2638-2639, concludes that, at least as far as Mergers and Acquisitions in the US are concerned, the latter hypothesis (efficient negotiation) seems to prevail over the former (inefficient entrenchment):

> "Most of the characteristics of takeover offers that are related to hostility seem to reflect strategic choices made by the bidder or the target firm to maximize their respective gains from a potential transaction. There are probably some transactions in this large dataset that exhibit non-value-maximizing target management entrenchment, but they are dominated by cases where strategic bargaining is the motivation for hostility in the sample averages and regression estimates."

In such a perspective, even the few hostile takeovers that we observe nowadays (or at least some of them) might be actually negotiated deals, where the incumbents typically get something for themselves and target shareholders unambiguously benefit. See Burkart, M. and Panunzi, F. [2006b], *op. cit.*, 24-26. Once this is supplemented by the growing evidence that control block transactions – which must be negotiated by definition – are mostly driven by prospective improvements of the firm management (Id., at 17-23), a quite radical change in perspective seems to be in order. What appears to matter the most is not whether or not control of listed firms is actually 'contestable' (i.e., subject to the threat of hostile takeover), but rather whether the same control will be eventually up board turnover is inversely related to inside ownership but, very noticeably, the same turnover appears to be more related to underperformance than in the UK.[185] Albeit far from hostile, US takeovers seem to feature quite an efficient market for corporate control.[186]

2.5. Comparative Stock Market Performance

The picture of the comparative economics of corporate governance in most representative European countries and in the US could seem to be completed by now. Yet, one important piece of information is still missing. We have a fairly good idea about how listed firms are owned and controlled in most developed countries of the world, but we do not know yet anything about how much equity finance is raised from the market in each system. In other words, we lack information about stock market performance.

Stock market performance means different things to different purposes. Performance indicators likewise differ depending on the phenomena they are intended to describe. To the purposes of the present inquiry, one can just rely on the simplest proxy for each country's stock market performance, namely the stock market capitalization of national listed firms relative to the Gross Domestic Product (GDP).[187] This gives an idea about the relative weight of equity finance in one economy. However, one important bias of this indication is worth noting. Stock market capitalization does not only account for *external* financial resources accruing to national listed firms, but also for the corporate controller's financial commitment and the firm's retained earnings.[188] The bias is clearly the more pronounced the higher the frequency of controlling shareholders and the larger their ownership stake.

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for sale. As we will see in the theoretical discussion of the next Chapters, one thing is out of question: an active market for corporate control is a fundamental requirement of an efficient CG. However, it is at least debatable whether this market should also feature hostility, and to what extent. See *infra*, Chapters Three and Five.

185 Franks, J., Mayer, C. and Renneboog, L. [2001], *op. cit.*

186 Schwert, G.W. [2000], *op. cit.*

187 See the 'Market Capitalization of Listed Companies as a Percentage of GDP,' reported in World Bank [2006], *World Development Indicators*, The World Bank (also available at www.worldbank.org).

188 This has been highlighted, among others, by Hellwig, M. [2000], *op. cit.*

Some economists have indeed attempted to calculate a performance index based on 'external' stock market capitalization.[189] Although the idea is interesting, its implementation is still much too rough. In theory, external stock market capitalization should be derived by subtracting the average proportion of share ownership in the hands of the corporate controllers. The reader should be aware by now of the difficulties in calculating such a proportion for different corporate governance systems. All the more so as, country averages need to be weighted by *each firm's* market capitalization.

In practice, the only comparative indicator of *external* stock market capitalization available in the empirical literature is still that provided by La Porta *et al.* in the development of the 'law matters' argument. This indicator is based on the same limited data set originally employed by these authors in their assessment of corporate governance patterns around the world.[190] As a result, for each country, ownership concentration is crudely assessed upon the average ownership of common stock retained by the three largest shareholders in the 10 largest listed firms.[191] In the light of the refinements of previous discussion, that estimate of ownership concentration is highly unsatisfactory and it would make almost no sense to subtract it to the stock market capitalization.[192] Since more reliable estimates of how much stock is actually in the hands of corporate controllers are almost impossible to calculate on a standardized basis, we will have to rely on *total* stock market capitalization bearing in mind that this overestimates the availability of equity finance where ownership structures are most typically concentrated. Data are reported in Figure 4 below, and they refer to a ten-year period to account for dependence of stock market performance on the economic cycle.[193]

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189 La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R. [1997], *Legal Determinants of External Finance*, in JOURNAL OF FINANCE, vol. 52, 1131-1150.

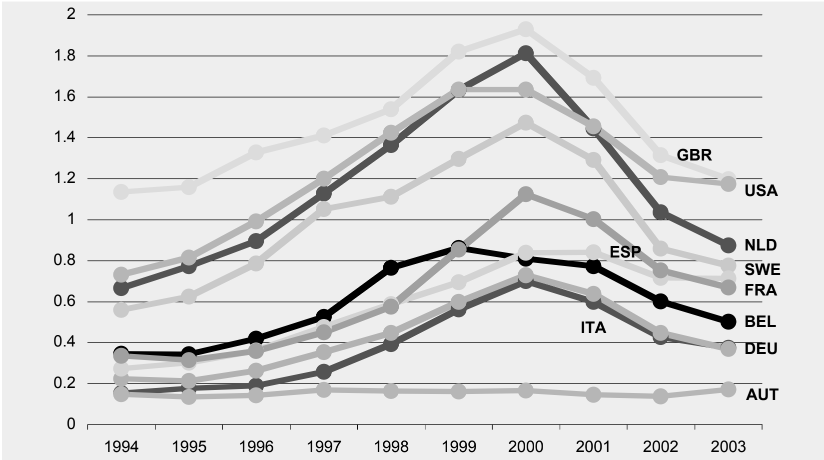
190 La Porta, R., Lopez-de-Silanes, F. and Shleifer, A. [1999], *op. cit.*

191 This quite rough measure of ownership concentration was introduced by La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R. [1998], *op. cit.*, and has been always relied upon by La Porta *et al.* since then. For a more comprehensive criticism of such an assessment of ownership concentration (which is, by the way, a standard reference in comparative CG), see *infra*, Chapter Four, section 4.3.3.

192 This is, however, how stock market performance continues to be assessed in the papers by La Porta *et al.* See, e.g., La Porta, R., Lopez-De-Silanes, F. and Shleifer, A. [2006], *What Works in Securities Laws?*, in JOURNAL OF FINANCE, vol. 61, 1-32. More recently, the authors have abandoned this measure in favor of total stock market capitalization: see Djankov, S., La Porta, R., Lopez-de-Silanes, F. and Shleifer, A. [2006], *op. cit.*

193 I owe this suggestion to Silvia Giacomelli. Data are retrieved from Beck, T., Demirgüç-Kunt, A. and Levine, R. [2000], *A New Database on Financial Development and Structure*, WORLD BANK ECONOMIC REVIEW, vol. 14, 597-605, and its subsequent updates. The database is updated yearly, and it is publicly available online at www.worldbank.org (Home > Data & Research > Research > A New Database on Financial Development and Structure).

Figure 4
Stock market capitalization to GDP in Europe and in the US



Source: World Bank [2006b], *World Development Indicators*, The World Bank (also available at www.worldbank.org).

Notwithstanding the bias documented above, data show that stock markets are the most developed where corporate ownership is the most dispersed – namely, in the US and in the UK. This is not surprising, indeed. Dispersion of ownership actually nurtures equity finance. Perhaps more surprisingly, the Dutch stock market appears to be almost as developed as the American is. In part, the result might be distorted by the higher proportion of controlling shareholders in the Netherlands. But, arguably, Dutch listed firms have anyway the highest access to external equity finance in continental Europe.[194] Sweden has the second highest stock market capitalization to GDP in continental Europe. Even though controlling shareholders dominate Swedish corporate governance, the latter is based on extensive separation of voting power from ownership stakes.[195] In this regard, one should recall that more than one half of stock market capitalization is controlled with an average fi-

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[194] The high development of stock markets in the Netherlands is well acknowledged by the literature. See, e.g., de Jong, A., Kabir, R., Marra, T. and Röell, A. [2001], *op. cit.*

[195] For an interesting comparison of the Dutch with the Swedish history of CG, see Högfeldt, P. [2005], *Financing and Corporate Control in the Netherlands: Extreme Exception to the Rule? Discussion of Financing and control in the Netherlands: A historical perspective*, in R. Morck (ed.), A HISTORY OF CORPORATE GOVERNANCE AROUND THE WORLD: FAMILY BUSINESS GROUPS TO PROFESSIONAL MANAGERS, NBER Conference Volume, University of Chicago Press, 507-515.

nancial commitment lower than 5%. The very high development of the Swedish stock market should not be surprising in this perspective.[196] The rest of continental Europe lags far behind the above-mentioned countries. Germany, Italy, and even more so Austria – which have all top-concentrated ownership structures – exhibit in particular the lowest rates of stock market capitalization to GDP.

2.6. Does the Evidence Match the Theory?

The stylized picture of corporate governance across most developed countries still contrasts the US and the UK with continental Europe.[197] Anglo-American listed firms are typically widely held, and then the vast majority of them are under managerial control. Nearly all of their equity is placed with the investing public so that stock markets are highly developed. Both ownership and voting power are dispersed, since deviations from the 'one share–one vote' rule are exceptional. As a result, in both the US and the UK corporate control is assumed normally contestable, at least to the extent that takeover defenses available to incumbent managers are not powerful enough to short-circuit contestability.[198]

In the Old Continent, listed firms have typically a controlling shareholder (and possibly a group of them acting as a coalition). Relatively little equity is placed with the investing public, and then stock markets are underdeveloped. Voting power is

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[196] The argument that the Swedish stock market is highly developed is very often resorted to in order to criticize the 'law matters' thesis. See, e.g., Holmén, M. and Högfeldt, P. [2005], *op. cit.*, and Holmén M. and Högfeldt P. [2004], *A Law and Finance Analysis of Initial Public Offerings*, in JOURNAL OF FINANCIAL INTERMEDIATION, vol. 13, 324-358. See also *infra*, Chapter Four, for discussion.

[197] See Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*

[198] To be sure, the lack of contestability of the US market for corporate control is nowadays acknowledged by more and more commentators.

> "Most commentators praising the Anglo-American model of corporate governance single out hostile takeovers as a key feature of this model. Yet, starting in the early 1990s the market for corporate control in the U.S. has essentially collapsed. Indeed, […]most U.S. corporations are now extremely well protected against hostile takeovers. Their control is generally no longer contestable. In contrast, in the U.K. the City Code prevents post-bid action that might frustrate the bid and few companies have put in place pre-bid defences, thus making the U.K. the only OECD country with an active and open market for corporate control."

Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 62-63. See also Holmström, B. and Kaplan, S. [2001], *Corporate Governance and Takeovers in the USA: Making Sense of the 80's and 90's*, in JOURNAL OF ECONOMIC PERSPECTIVES, vol. 15, 121-144. But see Weir, C. and Laing, D. [2003], *Ownership Structure, Board Composition and the Market for Corporate Control in the UK: An Empirical Analysis*, in APPLIED ECONOMICS, vol. 35, 1747-1759, for the view that hostile takeovers are very infrequent also in the UK.

often held in excess of ownership, and both of them are concentrated in the hands of controlling shareholders. As a result, corporate control is assumed only exceptionally contestable in continental Europe, at least inasmuch as the incumbent controller enjoys so much voting power to avoid being outvoted by an insurgent shareholder taking over.[199]

This is already enough to question the standard view of corporate governance as a principal-agent relationship between inside management and outside shareholders. On the one hand, in the European continent, corporate control does not appear to be delegated to professional managers on behalf of the *entire* shareholder constituency, but, if anything, just on behalf of a controlling shareholder (with the exclusion of non-controlling owners). On the other hand, even when managers are in charge – like most often in the US and the UK – outside shareholders may still be unable to exert any discipline on their supposed agents, to the extent that the latter manage to insulate themselves from the threat of ouster. Both circumstances cannot be ultimately reconciled with any sort of delegation of corporate control and, therefore, with an agency paradigm.

After our systematic review of the empirical evidence on comparative corporate governance, all we can say is that the two above circumstances are even more frequent than they appear at first glance. To begin with, we discovered that controlling shareholders play an important role in Anglo-American corporate governance too. In addition, at least in the US, departures from 'one share–one vote' are not so uncommon, albeit far less frequent than in continental Europe. Finally, managerial control does not involve contestability, as it is often believed. In fact, controlling

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[199] To be sure, a few commentators argue that hostile takeovers have recently acquired an unprecedented importance in continental Europe, just when they started to disappear from the American market. See, e.g., Holmström, B. and Kaplan, S. [2001], *op. cit.*, 18-21; and Becht, M., Bolton, P. and Röell, A. [2002], *op cit.*, 70. Indeed, Rossi, S. and Volpin, P.F. [2004], *Cross-country determinants of mergers and acquisitions*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 74, 280–281, document that, during the 90s, *attempted* Hostile takeovers as a percentage of traded companies were in many European countries not much lower than in the US and in the UK (where they accounted on average for about 6.4% and 4.4% of listed firms).
However, listed companies in continental Europe are *much fewer* than in both the US and the UK. The picture looks quite different once one considers that takeovers over the same 10-year period were in order of magnitude of a few *hundreds* in either the US or the UK, whereas they just accounted for a few *tens* in the entire European continent. Schneper, W.D. and Guillén, M.F. [2004], *Stakeholder Rights and Corporate Governance: a Cross-National Study of Hostile Takeovers*, in ADMINISTRATIVE SCIENCE QUARTERLY, vol. 49, 263-295. And, in fact, one study focused on just largest deals shows that, during the 90s, 77% of European domestic hostile bids and nearly one half of cross-border ones were targeted at either Irish or British firms (McCahery, J.A. and Renneboog, L. (with P. Ritter and S. Haller) [2003], *op. cit.*).
In conclusion, hostile takeovers seem to be still a typically Anglo-Saxon phenomenon. But in fact, even in those countries, they are much less frequent than they may appear at first glance.

managers are entrenched in the US and in the UK, too. In the US, they are routinely shielded behind a wide array of takeover defenses. In the UK, they are likewise able to resist takeovers by forming powerful coalitions. As a result, hostile takeovers are highly exceptional not only in continental Europe, but also in Anglo-American corporate governance.

In continental Europe, controlling shareholders generally dominate the corporate governance arena. But there are exceptions. For instance, the majority of Dutch listed firms appear to be under managerial control. In addition, stock markets are not always underdeveloped relative to the US and the UK: this is true for some countries (like Italy), but not for others (most noticeably, Sweden and the Netherlands). Finally, also systems based on controlling shareholders allow for different degrees of separation of ownership and control. The presence of a controlling shareholder normally involves high concentration of voting power, but this does not necessarily mean that concentration of ownership be as high. Extensive deviations from 'one share–one vote' in Swedish corporate governance provide a prominent example of how controlling shareholder systems can also feature a significant degree of separation of ownership and control.

A more precise description of comparative corporate governance shows then fewer differences than one would expect from the stylized facts. One would therefore expect a theoretical framework both to predict regularities and to explain remaining differences. But this is not the case as far as Corporate Law and Economics is concerned. We are about to see that the mainstream economic account of corporate governance – the agency theory – predicts outcomes which are quite different from the picture that have just been described. Even when supplemented with consideration for the role of corporate law, this theoretical paradigm is still unable to provide us with a univocal explanation of the different patterns of corporate governance, which we observe around the world.

CHAPTER THREE – Agency Costs and Incomplete Contracts: Theory

3.1. Foundations of the Agency Theory of Corporate Governance

3.1.1. An Overview

Economic theory of corporate governance approaches separation of ownership and control as a problem of separation of *firm management* from *firm finance*.[1] While this is undoubtedly the core problem of corporate governance, most economists (and, as we will see, the overwhelming majority of Law and Economics scholars) take quite a narrow view of the matter, by stressing the latter term (finance) and overlooking the former (management).[2] Managers and financiers of course need each other. It is generally recognized that a manager (or an entrepreneur) "needs the financiers' funds, since he either does not have enough capital of his own to invest or else wants to cash out his holdings."[3] However, the focus of the corporate governance debate is rather on how managers are *hired* by financiers, and on what terms. As a result, not differently from other long-term contractual relations, corporate governance is typically regarded as an agency problem: financiers act as the principals, hiring one or more agents to generate returns on their funds.[4]

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1 Shleifer, A. and Vishny, R. [1997], *A Survey of Corporate Governance*, in JOURNAL OF FINANCE, vol. 52, 740.

2 For a review of the literature, see Marks, S.G. [2000], *The Separation of Ownership and Control*, in B. Bouckaert and G. De Geest (eds.), ENCYCLOPEDIA OF LAW AND ECONOMICS, vol. V, No. 5630, 692-724.

3 Shleifer, A. and Vishny, R. [1997], *op. cit.*, 740.

4 Id., at 740-748.

In this perspective, the manager's position might look not much different from that of a high-rank employee. However, what distinguishes managers from the rest of the company's employees is their position on top of the firm hierarchy. Corporate managers are vested with enormous discretionary powers, for they bear ultimate responsibility of how the firm is managed.[5] This discretion is the very essence of firm control.[6] Curiously enough, the conventional approach to corporate governance deals more with how this discretion is *constrained* than with why and how it is *exercised*.[7] According to the mainstream economic theory of corporate governance, the special feature of management compared to the other constituencies of the corporate enterprise is their direct accountability to one kind of financiers. Managers are basically regarded as shareholder agents.[8]

Why shareholders, and only shareholders, should be the manager's principals?[9] As we already know, shareholders are the firm's owners and, therefore, the residual claimants on its assets. However, lacking both coordination and the necessary expertise, they do not know how to manage them in such a way as to maximize their value as an open-ended stream of profits.[10] Managers are in charge of managing those assets, although they are not residual claimants unless to a limited extent. Either they lack the funds to own the firm's assets altogether or they simply do not want to commit too a large portion of their wealth to the company's affairs.[11] Consequently, managers are induced to enjoy the assets under management rather than maximizing their value. Although there is quite an extensive debate about whether

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5 Rock, E.B. and Wachter, M.L. [2001], *Islands of Conscious Power: Law, Norms and the Self-Governing Corporation*, in UNIVERSITY OF PENNSYLVANIA LAW REVIEW, vol. 149, 1658.

6 See *supra*, Chapter One, section 1.4.3.

7 Shleifer, A. and Vishny, R. [1997], *op. cit.*, 743.

8 Id., at 737-740.

9 This has been always a central issue in Corporate Law and Economics: whether the ultimate goal of corporate governance (hereinafter CG) should be protecting shareholder interest or, rather, that of all other constituencies participating in the corporate enterprise (so-called 'stakeholders'). The debate is "almost as old as the first writings on corporate governance." See Becht, M., Bolton, P. and Röell, A. [2002], *Corporate Governance and Control*, ECGI Finance Working Paper No. 02/2002, available at www.ssrn.com and www.ecgi.org, as published in G. Constantinides, M. Harris, and R. Stulz (eds.) [2003], HANDBOOK OF ECONOMICS AND FINANCE, North-Holland, 9 (and references cited therein). For the basic terms of this debate compare, in economics, Williamson, O.E. [1985], THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING, Free Press (chapter 12 – '*Corporate Governance*'), with Aoki, M. [1984], THE COOPERATIVE GAME THEORY OF THE FIRM, Oxford University Press; in the Law and Economics literature, Easterbrook, F.H. and Fischel, D.R. [1991], THE ECONOMIC STRUCTURE OF CORPORATE LAW, Harvard University Press, with Blair, M.M. [1995], OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY, Brookings.

10 Easterbrook, F.H. and Fischel, D.R. [1991], *op. cit.*, 8-15.

11 Hart, O. [1995], FIRM, CONTRACTS, AND FINANCIAL STRUCTURE, Oxford University Press, 8-9.

other providers of input (the so-called *stakeholders*) are also interested in the firm's residual, many economists and lawyers continue to believe that only shareholders should be.[12] The economic rationale for this position will be illustrated at the end of the present Chapter.

In the meantime, let us assume with the mainstream theory that the fundamental principal-agent relationship in corporate governance is established between managers and shareholders and, more in general, between those who decide about the firm's management without (entirely) owning its assets and those who (partly) own the firm's assets but do not participate in their management.[13] This last definition is

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[12] It is often suggested that consideration for stakeholder interest in CG arises from the problem of contractual incompleteness (whereupon *infra*, section 3.5). Provided that contracts are incomplete – the argument runs – stakeholders' position within the firm may be endangered by a discretionary management only accountable to shareholders. Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 16-19 and 48-57. Ironically, however, authoritative economists supporting a 'stakeholder society' are randomly distributed among incomplete contract theorist and those sticking to a more traditional agency framework. Compare, e.g., Zingales, L. [1998], *Corporate Governance*, in P. Newman (ed.), THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW, Macmillan, 497-503, with Tirole, J. [2001], *Corporate Governance*, in ECONOMETRICA, vol. 69, 1-35. Same is true for the advocates of shareholder value in the economics of CG. Compare, e.g., Williamson, O.E. [1985], *op. cit.* (chapter 12 – '*Corporate Governance*'), with Jensen, M.C. [2001], *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, in EUROPEAN FINANCIAL MANAGEMENT, vol. 7, 297-317. In the legal literature, support for the shareholder value maximization norm is found in either the agency framework (Easterbrook, F.H. and Fischel, D.R. [1991], *op. cit.*, 1-39), an incomplete contract setting (Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1656-1660), or in a mixture of both (Bainbridge, S.M. [2002a], CORPORATION LAW AND ECONOMICS, Foundation Press, 191-240). On the contrary, stakeholder advocates unambiguously criticize the agency framework and base their claim on contractual incompleteness (Blair, M.M. and Stout, L.A. [1999], *A Team Production Theory of Corporate Law*, in VIRGINIA LAW REVIEW, vol. 85, 247-328).

[13] The statement in the text requires an important qualification. The focus of the present work is *business corporations*, that is to say investor-owned enterprises. Traditionally, this has been considered the most important form of enterprise ownership. Chandler, A.D. Jr. [1990], SCALE AND SCOPE: THE DYNAMICS OF INDUSTRIAL CAPITALISM, Harvard University Press (Belknap). This primacy is being questioned nowadays. Rajan, R.G. and Zingales, L. [2000], *The Governance of the New Enterprise*, in X. Vives (ed.), CORPORATE GOVERNANCE: THEORETICAL AND EMPIRICAL PERSPECTIVES, Cambridge University Press, 201-232. At any rate, investor ownership is neither a necessary condition for large-scale business, nor the only form of ownership that we observe in real-world enterprises. *Cooperatives* are the case in point. A broader definition of ownership would consider business corporations as a special kind of cooperatives. "A cooperative is a firm in which ownership is assigned to a group of the firm's patrons, and the persons who lend capital to a firm are just one among various classes of patrons with whom the firm deals." Hansmann, H. [1996], THE OWNERSHIP OF ENTERPRISE, Harvard University Press, 15. However, corporations differ from cooperatives in one fundamental respect, in that ownership belongs to only one group of "patrons" with very homogeneous interests: the shareholders. Different ownership arrangements of course call for different consideration of stakeholders' interests. But this lies outside the scope of the present inquiry. The book by Henry Hansmann is still the leading reference in this regard. For a recent application to the governance of cooperatives, see Hendrikse, G. W.J. [2005], *Boards in Agricultural Cooperatives:*

sufficiently general to account also for a manager whose ownership stake is so large to qualify as *controlling shareholder*.

The typical problem of agency relationships is the *conflict of interest* of the agent when it comes to performing some task on the principal's behalf. Scope for exploiting the conflict of interest is provided by *asymmetric information*. The agent may pretend to be more skilled than he actually is (*hidden information*), in order to be hired – or not to be replaced. Alternatively, he may cheat on the principal by underperforming his obligations, or not performing them at all, to the extent that he has some chances of not being caught (*hidden action*).[14] As I mentioned in the last Chapter, the two problems are respectively known as adverse selection and moral hazard. Delegation of management responsibilities is the source of both problems in corporate governance. The managers might easily abuse their superior knowledge at the principals' expenses, by staying in charge – or attempting to take over – when more capable managers are available, or by enjoying both pecuniary and non-pecuniary benefits of their position while failing to maximize shareholders' profits.

Based on those conflicts of interest, two major conclusions are drawn. First, the ultimate goal of corporate governance should be coping with agency problems in such a way as to guarantee *maximization of shareholder value*, for the latter corresponds to the sum of residual claims on the firm's assets – that is, the firm value.[15] Secondly, the implementation of the above goal requires a *discipline of managerial discretion*, aimed at preventing managerial adverse selection and moral hazard. At its very core, then, the agency approach to corporate governance is based on the defense of shareholders' interest from managerial misbehavior.[16]

Most common instances of such misbehavior have been neatly summarized by Jean Tirole:

> "There is now widespread awareness that managers, say, may take actions that hurt shareholders. They exert *insufficient effort* when overcommitting themselves to external activities, when finding it convenient to accept over-

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Competence, Authority, and Incentives, Working Paper, Erasmus University (ERIM series), available at http://hdl.handle.net/1765/6883.

14 Arrow, K.J. [1985], *The Economics of Agency*, in J. Pratt and R. Zeckhauser (eds.), PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS, Harvard University Press, 37-51.

15 Easterbrook, F.H. and Fischel, D.R. [1991], *op. cit.*, 35-39.

16 Tirole, J. [2001], *op. cit.*, 1. While providing a detailed, formal analysis of the conflict between management and shareholders (Id., at 5-23), Jean Tirole considers the traditional shareholder value approach as "too narrow a view for an economic analysis of corporate governance." Id., at 4. Therefore, he extends the traditional agency framework to account also for stakeholders' interests, stakeholders' participation in firm control, and protection of so-called "non-controlling stakeholders." Id., at 23-32.

staffing, or when overlooking internal control. They may collect *private benefits* by building empires, enjoying perks, or even stealing from the firm by raiding its pension fund, by paying inflated transfer prices to affiliated entities, or by engaging in insider trading. Last, they may *entrench* themselves by investing in mature or declining industries that they are good at running, by taking risk that is either excessive (as when their position is endangered) or insufficient (as when it is secure), or by bending over backwards to resist a takeover."[17]

While extremely popular among both economists and lawyers, the agency theory of corporate governance has many shortcomings. I shall focus on them throughout this Chapter. To this purpose, I shall start from where the agency approach was first applied to corporate governance.

3.1.2. Agency Costs and Separation of Ownership and Control

In a seminal article, Michael Jensen and William Meckling first developed a comprehensive theory of separation of ownership and control based on agency costs.[18] Agency costs are just the way economists look at agency problems. They both arise from the divergence of interests between who is responsible of performing a service – the agent – and the person(s) on whose behalf the service should be performed – the principal(s). Whenever the relevant information is asymmetrically distributed between the parties, coping with this conflict of interests is *costly*, for it involves resources to be devoted to *contracting*, *monitoring* by the principals, and taking credible commitments (so-called '*bonding*') by the agent, plus an unavoidable *residual loss* of the transaction surplus.[19] Agency costs are present in every conflicted principal-agent relationship characterized by asymmetric information. One field where their relevance is most intuitive is the employer-employee relation.

In a firm, both forms of outside financing (debt and equity) are performed under asymmetric information, and thus they involve agency costs.[20] Financiers (the principals) cannot make sure they get from the entrepreneur (the agent) whatever he promised in return for their investment.[21] Since monitoring the agent's behavior is a costly activity, financiers will never implement it in such a way as to *exclude* the

[17] Id., at 1-2.
[18] Jensen, M.C. and Meckling, W.H. [1976], *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 3, 305-360.
[19] Id., at 308-309.
[20] Id., at 312-330.
[21] Shleifer, A. and Vishny, R. [1997], *op. cit.*, 740-748.

agent's underperformance. The same argument holds for bonding expenditures by the agent. Contracting upon the entrepreneur's incentives is also costly, and therefore cannot entirely solve the problem. However, the equity contract provides an important advantage in this regard.

In principle, debt holders have a fixed claim on the firm's assets. In a debt contract, the principals-creditors are just concerned about having their loans repaid with the interests, whereas the agent-entrepreneur (assuming he is the sole owner of the firm) wants to make profits on top of that, even at risk of not being able to meet his obligations with the lenders. Given that monitoring and contracting upon the borrower's incentives is burdensome, this conflict of interests determines the agency costs of debt, and therefore restricts the availability of debt finance to firms.[22]

Because of their very nature, equity contracts do not involve this specific kind of conflict of interests – as we will see shortly, they give rise to a different one. Equity holders have an open-ended claim on the value of the firm's assets, so they are interested, pro-rata, in the maximization of the firm's profits. This is true for *both* outside shareholders (the principals) *and* for who is in charge of managing the firm's assets (the controller, i.e. the agent), provided that the latter also holds equity to some extent. Equity ownership then partly aligns the agent's incentives with the interest of outside shareholders.[23]

The effect of incentive alignment provided by equity contracts is limited. It is obviously decreasing in the amount of funds raised relative to the inside ownership retained by the entrepreneur. The same effect thus *reduces*, but does not *eliminate* the conflict of interest between the borrower and the financiers. Therefore, provided that monitoring/bonding costs are positive also as far as equity is concerned, agency costs can be minimized but never eliminated via the equity contract.

The resulting separation of ownership from control is, therefore, a second best outcome where the owner-manager is not entirely maximizing the firm's profits (the value of shareholders' residual claim), but also pursuing some private interests to the outside shareholders' disadvantage.[24] *Private benefits of control* are then the realm

[22] Jensen, M.C. and Meckling, W.H. [1976], *op. cit.*, 308-310.

[23] Id., at 333-343.

[24] Id., at 343-351. The notion of 'second best' is derived from welfare economics. The theory of second best was developed in the 1950s as a way to deal with real-world situations where the optimality conditions of one economic model are not satisfied. The general theorem for the second best optimum is stated as follows:

> "[I]f there is introduced into a general equilibrium system a constraint which prevents the attainment of one of the Paretian conditions, the other Paretian conditions, though still attainable, are in general, not desirable."

of the conflicts of interest between the corporate controller and non-controlling shareholders. Asymmetric information is what enables the former to enjoy these benefits at the expenses of the latter. As we already know from the First Chapter, private benefits that reduce shareholder value arise either from outright diversion of the firm's residual (so–called 'stealing') or from subtler distortions in its production (due to on-the-job consumption of managerial perquisites – broadly speaking, 'shirking'). Both stealing and shirking ultimately depend on moral hazard and adverse selection problems in a principal-agent relation.[25]

In the presence of private benefits arising from either stealing or shirking, agency costs cannot but be positive and, to the extent they are anticipated by investors with rational expectations, they raise *ex ante* the cost of equity capital and limit the overall availability of outside finance to entrepreneurs. However, according to Jensen and Meckling, this is the best of all possible worlds. Equity finance allows some profitable investment opportunities to be pursued, which would be foregone otherwise, because of the agency costs of debt, the opportunity cost (in terms of risk diversification and liquidity) of the entrepreneur's own capital, and the same entrepreneur's wealth constraint.[26]

Lipsey, R.G. and Lancaster, K. [1956], *The General Theory of Second Best*, in REVIEW OF ECONOMIC STUDIES, vol. 24, 11.

[25] *Private benefits of control* are a convenient way to look at how the agent may profit from exploiting the principal's mandate. Private benefits from *moral hazard* account for how much any owner-manager can actually steal or shirk given the burden of monitoring costs on outside shareholders. Private benefits from *adverse selection* – which were not explicitly considered by Jensen and Meckling – account for stealing and shirking that would have been spared, if investors had been able to select a more loyal and diligent (i.e., competent) owner-manager; or, in other words, if screening the quality of owner-managers had been cheaper.

Although CG may involve more than moral hazard and adverse selection problems, principal-agent models allow for nothing else to be considered. In the same vein, other kinds of private benefits of control not arising from stealing or shirking cannot find any room within the agency theory of CG, and can only be featured by a different account of CG. See Mayer, C. [1999], *Firm Control*, Inaugural Lecture at the University of Oxford (February 18, 1999), available at www.finance.ox.ac.uk, as published in J. Schwalbach (ed.) [2001], CORPORATE GOVERNANCE: ESSAYS IN HONOR OF HORST ALBACH, Springer-Verlag, 7-8. As I have already mentioned (*supra*, Chapter One, section 1.4.5), other kinds of private benefits may be also very important. Both their rationale and why they have been so far neglected by the literature will get clearer throughout the following discussion.

[26] Jensen, M.C. and Meckling, W.H. [1976], *op. cit.*, 349-350 and 351-352. Perhaps misled by the initial quotation of the famous Adam Smith's passage about the management of "other people's money" (see *supra*, Chapter One, section 1.1.2), conventional wisdom often credits Jensen and Meckling with some skepticism about the overall efficiency of the corporate structure. And yet, Jensen and Meckling never raised such a concern in their 1976 article, whose conclusion was instead: "Whatever its shortcomings, the corporation have thus far survived the market test against potential alternatives." Id., at 357. Indeed, a few years later, only Michael Jensen expressed his concern about the growth of agency costs in public companies. Jensen, M.C. [1989], *The Eclipse of the Public Corpora-*

3.1.3. The Theory of the Firm as a Nexus of (Complete) Contracts

The above explanation of separation of ownership from control highlights a very important point: efficiency of equity finance depends on *minimization of agency costs* – i.e., on keeping extraction of private benefits of control as low as possible. Apparently, this should be the basic goal of corporate governance. After the publication of Jensen and Meckling's fundamental article, this is how the problem of corporate governance has been analyzed in mainstream Law and Economics.[27] What I will try to show in the following discussion is that the corporate governance problem is far more complicated, and agency costs are just one part of it.[28]

In its original formulation, Jensen and Meckling's agency theory of corporate governance provides a *positive* explanation of separation of ownership and control (i.e., why *it is* out there), but it carries no *normative* implication (i.e., how *it should be* out there).[29] In the Jensen and Meckling model, agency costs are always minimized through an appropriate mix of debt and equity finance and, ultimately, by means of the very special nature of the equity contract.[30] In a broader perspective, Jensen and Meckling consider the firm as a *nexus of complete contracts*, where all possible future contingencies *can* be contracted upon (although they do not actually *need* to).[31] This implies two important consequences.

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tion, in HARVARD BUSINESS REVIEW, vol. 67, 60-70; Jensen, M.C. [1993], *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, in JOURNAL OF FINANCE, vol. 48, 831-880.

27 See, most notably, Easterbrook, F.H. and Fischel, D.R. [1991], *op. cit.*, 1-39.

28 Likewise, private benefits of control (hereinafter PBC) are not just a curse for CG, but they may turn out to be necessary to make separation of ownership and control workable.

29 Jensen, M.C. and Meckling, W.H. [1976], *op. cit.*, 310. This point is often overlooked by the authors referring to Jensen and Meckling's seminal article. Quite to the contrary, this article is commonly referred to for its alleged normative implications, namely that corporate law should be only about minimizing agency costs. The premise being incorrect, opinions of Law and Economics scholars unsurprisingly diverge as to how law should pursuit that goal (see *infra* Chapter Four, section 4.5.). On the logical mistakes underlying the standard reference to Jensen and Meckling's agency costs analysis, see Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1624–1626.

30 This is the so-called asset-substitution effect (see *supra* Chapter One, section 1.2.3). In this view, asymmetric information and related agency costs provide a positive explanation of why – contrary to Modigliani and Miller Theorem – the *firm's capital structure does matter.* Zingales, L. [2000], *In Search of New Foundations*, in JOURNAL OF FINANCE, vol. 55, 1626-1633.

31 As Jensen and Meckling put it:

> "It is important to recognize that most organizations are simply legal fictions which serve as a *nexus for a set of contracting relationships* among individuals." Jensen, M.C. and Meckling, W.H. [1976], *op. cit.*, at 310 (emphases added).

And:

> "What is important for the problems addressed here is that specification of individual rights determines how costs and rewards will be allocated among the participants in any organiza-

First, the contract between the owner-manager and non-controlling shareholders is as complete as any other contract entered into by the firm. As a result, allocation of control rights over the firm's assets (the 'residual' right to decide upon its management in future contingencies not addressed by any contract entered into by the firm) is not really a matter of concern.[32] When contracts are complete, even the *ex post* exercise of discretion is actually contracted for *ex ante* and thus it is anything but a 'residual' variable. Since "all decisions are made *ex ante* and only executed *ex post*," contractible discretion is in fact no discretion at all.[33] In this perspective, the agency problem affecting equity finance is just one of the many contractual issues characterizing corporate governance.[34]

> tion. Since the specification of rights is generally effected through contracting (implicit as well as explicit), individual behavior in organizations, including the behavior of managers, will depend upon the nature of these contracts. We focus in this paper on the behavioral implications of the property rights specified in the contracts between the owners and managers of the firm."

Id., at 307-308. Therefore, as Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1629, scrupulously noticed, Jensen and Meckling "do not deal with the issue of contractual incompleteness and, indeed, the issue is not raised in the article."

32 Zingales, L. [2000], *op. cit.*, 1631-1632.

33 To be sure, in the same perspective, even the term 'governance' is not appropriate: since every matter is completely dealt with *ex ante* by the nexus of contracts, there is actually no scope for non-contractible discretionary actions affecting the firm's relationships *ex post*:

> "Only in a world where some [complete] contracts contingent on future observable variables are costly (or impossible) to write ex-ante, is there room for governance ex-post. Only in such a world, are there quasi-rents that must be divided ex-post and real decisions that must be made. Finally, only in a world of incomplete contracts can we define what a firm is and discuss *corporate governance* as being different from *contractual governance*. Not surprisingly, the theory of governance is intimately related to the emergence and evolution of the incomplete contracts paradigm."

Zingales, L. [1998], *op. cit.*, 498-499 (emphases added). See also the discussion in the next section.

34 However, provided that in this view shareholders are the only residual claimants – those who contract for the rights to net cash flow, instead of for any specified payoff, and are therefore the firm's "residual risk bearers" – their agency problem has to be dealt with (contractually, indeed, but) in a special fashion. In particular, "this agency problem is controlled by decision systems that separate the management (initiation and implementation) and control (ratification and monitoring) of important decisions at all levels of the organization." Fama, E.F. and Jensen, M.C. [1983b], *Agency Problems and Residual Claims*, in JOURNAL OF LAW AND ECONOMICS, vol. 26, 331; see also Fama, E.F. and Jensen, M.C. [1983a], *Separation of Ownership and Control* in JOURNAL OF LAW AND ECONOMICS, vol. 26, 301-325. The problem with this approach is that it does not explain *why* shareholders should be ultimately in control (or what should this mean). Luigi Zingales efficaciously made such a point:

> "While widely popular, [Jensen and Meckling's] explanation is unsatisfactory. The contractual protection provided to [non-shareholder constituencies] involved in the nexus of contracts is only complete if contracts are complete. But if contracts are complete, then the statement that shareholders are in control is meaningless. In fact, in a world of complete

The second implication of the nexus of (complete) contracts theory of the firm is that law plays a very uninteresting role. If contracts are complete, penalties are always set in such a way that no deviation from the behavior contracted for *ex ante* can take place *ex post*. The only requirement for the legal system is that courts enforce contracts as written. When this condition is met, no rational actor would actually ever litigate a contract.[35]

3.2. Corporate Governance and Contractual Incompleteness

3.2.1. Why Contracts Are Incomplete?

The foregoing picture obviously does not match what we observe in the real world, where – at least in the corporate field – non-contractible (i.e., 'real') discretion in decision-making does play a role, who is entitled to it is not a matter of indifference, and, above all, contracts are in fact litigated. One of the reasons of this discrepancy, and perhaps the fundamental one, is that contracts can never be complete. Economic theory to date has not yet reached an agreement on why contracts are incomplete.[36] But at least we know what contractual incompleteness means. To put it in the simplest way, it means non-contractibility of all possible variables that affect the production of the exchange surplus – the so-called 'gains from trade,' which are supposed to be captured by entering into a contract.[37] Parties cannot in fact write contracts specifying the actions to be taken in every future state of nature, which will affect both the amount of actual gains from trade and how they are divided between contract parties.

> contracts all the decisions are made ex-ante, and thus shareholders are no more in control than are the workers: everything is contained in the initial grand contract."

Zingales, L. [1998], *op. cit.*, 500.

35 Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, at 1628-1629 and 1638.

36 In his contribution to the theory of CG, Zingales, L. [1998], *op. cit.*, 502, takes this explicitly into account. More generally, in highly formalized terms, see the theoretical criticism of the incomplete contract framework by Maskin, E. and Tirole, J. [1999], *Unforeseen Contingencies and Incomplete Contracts*, in REVIEW OF ECONOMIC STUDIES, vol. 66, 83-114. According to Hellwig, M. [2000], *On the Economics and Politics of Corporate Finance and Corporate Control*, in X. Vives (ed.), CORPORATE GOVERNANCE: THEORETICAL AND EMPIRICAL PERSPECTIVES, Cambridge University Press, 96-98, both the incomplete and the complete contracts approach share excessive reliance on the parties' ability to assign entitlements suitable for all circumstances that can arise over time, and therefore provide us with too narrow a framework for analyzing CG.

37 Zingales, L. [1998], *op. cit.*, 498-499.

While the last statement could seem rather obvious, the underlying reasons and their implications for economic efficiency are still disputed among prominent contract theorists.[38] A technical inquiry on the terms of such a debate would fall outside the scope of this work. To our purposes, it is sufficient to summarize the basic reasons why contracts are incomplete, even at risk of overlooking important disagreements in this regard.

First, parties cannot *foresee* all relevant future *contingencies* and, even if they could (being unboundedly rational), it would be too costly for them to *describe* such contingencies in a contract.[39] Could we ever think of a manager contractually instructed in every single task he has to perform? Alternatively, could we imagine that all the contingencies he has not been instructed about were actually accounted for and left to him to handle in a predetermined way?[40] Secondly, some variables defining one party's behavior (like, for instance, the employee's effort) are not just costly to describe *ex ante*, but also *unobservable ex post* by the counterparty because of asymmetric information.[41] Although most contract theorists would disagree that this is a problem of contractual incompleteness, many Law and Economics scholars believe it is.[42] In fact, contracts are normally contingent on observable but imperfect proxies of relevant behaviors (e.g., output), rather than directly on behaviors that would be overly costly, if not impossible, to monitor (e.g., effort). Thirdly, many aspects of

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38 By contract theorist I mean economists in the field of contract theory. For the essential terms of the debate, compare Tirole, J. [1999], *Incomplete contracts: Where Do We Stand?*, in ECONOMETRICA, vol. 67, 741-781, with Hart, O. and Moore, J. [1999], *Foundations of Incomplete Contracts*, in REVIEW OF ECONOMIC STUDIES, vol. 66, 115-138.

39 Hart, O. and Moore, J. [1988], *Incomplete Contracts and Renegotiation*, in ECONOMETRICA, vol. 56, 755-785.

40 This would be ultimately a complete contracting approach. See Myerson, R. [1979], *Incentive Compatibility and the Bargaining Problem*, in ECONOMETRICA, vol. 51, 1767-1797.

41 Tirole, J. [1999], *op. cit.*, 750-751 and 763-764.

42 As Jean Tirole summarizes it:

> "The important feature of *complete* contracting is that the *only* impediments to perfectly contingent contracting are that agents may have private information at the date of contracting (*adverse selection*), receive future information that cannot be directly verified by contract enforcement authorities, that this information may be private information (*hidden knowledge*) and that agents may take actions that cannot be verified (*moral hazard*). There is no limitation on the parties' ability to foresee contingencies, to write contracts, and to enforce them."

Tirole, J. [1999], *op. cit.*, 754 (emphases added). The standard Law and Economics approach is quite different, though. See, e.g., Ayres, I. and Gertner, R.E. [1989], *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, in YALE LAW JOURNAL, vol. 99, 729-773 (where contractual incompleteness is used as a basis for information revelation), and Schwartz, A. and Scott, R.E. [2003], *Contract Theory and the Limits of Contract Law*, in YALE LAW JOURNAL, vol. 113, 605-608 (pointing at how asymmetric information impinges on the parties' ability to invest under contractual incompleteness).

contractual performance may be observable by counterparties, but are non-verifiable by a third party: for instance, how could a judge verify how often an employee is physically absent from his workplace? As a result, many otherwise desirable provisions cannot be implemented in a contract, since they would not be enforceable in courts.[43]

3.2.2. Transaction Costs and the Theory of the Firm

The outlined three reasons for contractual incompleteness fall within a broader notion: that of transaction costs.[44] What do exactly transaction costs account for is

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[43] Strictly speaking, incomplete contracts models assume *symmetric* information. This setting is customarily described by the notion of "observable but non-verifiable" variables. See Hart, O. and Moore, J. [1988], *op. cit.*, and Tirole, J. [1999], *op. cit.*, for a discussion of the theoretical implications. However, it is highly questionable that mutual observability would exclude informational problems in contracting, when parties are unable to assert the existence of information to a third party. The claim by Schwartz and Scott that "information is asymmetric when it is *either* unobservable *or* unverifiable" might be thus a theoretically inaccurate statement which fares quite better in describing the implications of asymmetric information in the real world's contracting (Schwartz, A. and Scott, R.E. [2003], *op. cit.*, 605): We might both know that you were lazy or dishonest, but this may not prevent me from being tricked as long as I cannot prove it to a court. For a non-technical discussion of how asymmetric information interacts with incomplete contracts (the related problems being mostly unresolved by economic theory to date), see Schmitz, P.W. [2001], *The Hold-Up Problem and Incomplete Contracts: A Survey of Recent Topics in Contract Theory*, in BULLETIN OF ECONOMIC RESEARCH, vol. 53, 1-17.

[44] Within contractual incompleteness, transaction costs are intended as the costs of writing a perfectly state-contingent contract when the parties have access to the same information. Hart, O. and Moore, J. [1988], *op. cit.*, 756. However, the notion of transaction costs is much broader and much older than that underlying incomplete contract models. It is generally believed that transaction costs was discovered by Coase, R.H. [1937], *The Nature of the Firm*, in ECONOMICA, vol. 4 (New Series), 386-405, and subsequently developed by Williamson, O.E. [1979], *Transaction-Cost Economics: The Governance of Contractual Relations*, in JOURNAL OF LAW AND ECONOMICS, vol. 22, 233-261. Neither statement is completely true. Ronald Coase did not mention transaction costs in his early writings, although he conceptually introduced them as the "cost[s] of using the price mechanism." Coase, R.H. [1937], *op. cit.*, 390. Without questioning Coase's role as the founder of economic analysis of transaction costs, it is worth noting that at least one neoclassical economist was already aware of the problem, claiming that individuals might be "deterred from investing money for short periods, partly because of brokerage charges and stamp duties, partly because it is not worth the bother." Hicks, J.R. [1935], *A Suggestion for Simplifying the Theory of Money*, in ECONOMICA, vol. 2, 6. Transaction cost economics has been the core of Oliver Williamson's work, which has enormously contributed to the integration of transaction cost analysis into economic theory. Also, the modern study of institutions (the so-called 'New Institutional Economics') owes most of its achievements to Williamson. See, e.g., Williamson, O.E. [2000], *The New Institutional Economics: Taking Stock, Looking Ahead*, in JOURNAL OF ECONOMIC LITERATURE, vol. 38, 595-613. But it would be a mistake to conclude that all we know about transaction costs can be found in (or was derived from) Williamson's work.

also quite debated in the economic theory.[45] However, the basic underlying intuition is now widely accepted. Contrary to one standard assumption of the neoclassical economic theory, we do not live in a world where transactions are costless. Performing any exchange of resource (namely, a transaction in its broader meaning) involves costs invariably reducing the parties' gains from trade. Thus, the same (transaction) costs affect the decision on whether, and on what terms, the exchange is performed.[46]

Sources of transaction costs are manifold.[47] Most common costly activities re-

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45 For a detailed illustration of alternative definitions, different uses and implications of the notion of transaction costs in economics, see Allen, D.W. [2000], *Transaction Costs*, in B. Bouckaert and G. De Geest (eds.), ENCYCLOPEDIA OF LAW AND ECONOMICS, vol. I, No. 0740, 893-926.

46 This is the fundamental insight of Ronald Coase's work. See Coase, R.H. [2005], *The relevance of transaction costs in the economic analysis of law*, in F. Parisi and C.K. Rowley (eds.), THE ORIGINS OF LAW AND ECONOMICS, Elgar, 199-221.

47 Economists also disagree upon the sources of transaction costs, depending on how they look at the matter. See Allen, D.W. [2000], *op. cit.* Demsetz, H. [1968], *The Cost of Transacting*, in QUARTERLY JOURNAL OF ECONOMICS, vol. 82, 33-53, takes quite broad an approach to the matter. Later he maintained that transaction costs include all "the costs of coordinating resources through market arrangements". Demsetz, H. [1995], THE ECONOMICS OF THE BUSINESS FIRM, Cambridge University Press, 4. One rather customary classification of transaction costs is the following:

1) *Search costs* – the costs of finding exploitable gains from trade.
2) *Bargaining costs* – the costs of arranging the terms of exchange.
3) *Verification costs* – the costs of verifying the efficient execution of the transaction.

It could seem, at first glance, that in all of the above dimensions informational problems underlie transaction costs. After all, in the neoclassical world of perfect information, there was no room for transaction costs (Coase, R.H. [1960], *The Problem of Social Costs*, in JOURNAL OF LAW AND ECONOMICS, vol. 3, 1-44). The treatment of information as a scarce resource owes much to the work by Stigler, G.J. [1961], *The Economics of Information*, in JOURNAL OF POLITICAL ECONOMY, vol. 69, 213-225. And yet, information costs ought to be distinguished from transaction costs (Allen, D.W. [2000], *op. cit.*, 906-907). The former are in fact a necessary but not sufficient condition for the latter. Information costs would have no bearing on transaction costs in a Robinson Crusoe world, where no transaction could ever be implemented – at least, until Friday showed up. See Cheung, S. N.S. [1992], *On the New Institutional Economics*, in L. Werin and H. Wijkander (eds.), CONTRACT ECONOMICS, Blackwell, 48-65. In other words, costly information does not necessarily lead to inefficiency, whereas transaction costs do it inasmuch as gains from trade are foregone.

Transaction costs are not just due to costly information, but also to a number of assumptions characterizing both individual behavior and the transactional environment. The first category of assumptions includes: i) *Bounded Rationality* (human beings are "*intendedly* rational but *limitedly* so" – Simon, H.A. [1957], MODELS OF MAN, John Wiley & Sons, xxiv); ii) *Opportunism* (people act not just in their self-interest, but also "with guile" – Williamson, O.E. [1975], MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS, Free Press, 26); iii) *Risk Attitude* (Aoki, M.[1984], *op. cit.*). None of them would add to transaction costs in the absence of at least one of the following characteristics of the environment: a) *Uncertainty* about future states of the world (Knight, F.H. [1921], RISK, UNCERTAINTY, AND PROFIT, Houghton Mifflin) which are incomputable due to bounded rationality; b) *Asymmetric information* between the exchange parties (Arrow, K.J. [1985], *op. cit.*, 37-51) which gives scope to opportunism; c) *Measurement problems* (Barzel, Y. [1982], *Measurement Cost and* lated to a typical transaction are *seeking* for counterparties, *screening* the quality of the goods or services to be exchanged, *negotiating* and *drafting* the contract terms, *monitoring* and *enforcing* contractual performance, and possibly *renegotiating* the contract terms at a later stage. Some transaction costs (e.g., monitoring) are more dependent on the problem of asymmetric information; some others (e.g., renegotiation) are mostly due to the problem of unforeseen contingencies.[48] While many important analytical results in economic contract theory have been achieved by separating the two problems, in practice they always come together.[49] For instance, non-contractibility of unforeseen contingencies makes the monitoring more burdensome; conversely, both negotiation (*ex ante* contracting) and renegotiation (*ex post* bargaining) get harder and costlier under asymmetric information. As we cannot limit ourselves to the analysis of the problem of asymmetric information in a complete contracts setting, we cannot either dismiss it as a secondary matter once we introduce the problem of contractual incompleteness. As it will become clearer in the subsequent discussion, this is particularly true in corporate governance.

Whatever their source, transaction costs are ubiquitous.[50] Their presence explains the limits of contracting in the marketplace and the nature of the firm. This is one major insight of economic theory dating back to the seminal article of Ronald Coase in 1937.[51] The theory of incomplete contracts, albeit still underdevel-

the Organisation of Markets, in JOURNAL OF LAW AND ECONOMICS, vol. 25, 27-48) which translates information costs into transaction costs and are worsened by low frequency of exchanges (Williamson, O.E. [1979], *op. cit.*, 245-253); d) *Incomplete property rights* (Alchian, A.A. and Demsetz, H. [1972], *Production, Information Costs, and Economic Organization*, in AMERICAN ECONOMIC REVIEW, vol. 62, 777-795) which brings into play the role of institutions in affecting transactions and their cost; e) *Asset specificity* – undoubtedly one major discovery by Williamson (Williamson, O.E. [1985], *op. cit.*, 52-56) – which creates a wedge between *ex ante* and *ex post* efficiency by means of a "fundamental transformation" in the parties' relationship (Id., 61-63), and then calls for special institutions (governance structures) aimed at minimizing transaction costs. Id., chapters 2 (*"Contractual man"*) and 3 (*"The Governance of Contractual Relations"*).

48 Ricketts, M. [2002], THE ECONOMICS OF BUSINESS ENTERPRISE, Elgar, 27-38.

49 For a comprehensive overview, see Tirole, J. [1999], *op. cit.* Id., at 764, admits that "there might be an interesting interaction between 'unforeseen contingencies' and asymmetric information," but this is still an "unknown territory" for economic contract theory.

50 Oliver Williamson proudly claims that Transaction Costs Economics is an "empirical success story" (Williamson, O.E. [2000], *op. cit.*, 605). For a survey of the empirical literature see Allen, D.W. [2000], *op. cit.*, 910-912.

51 Coase, R.H. [1937], *op. cit.* However, as Ronald Coase subsequently noticed, his 1937 paper on the firm was often cited, but little used. Coase, R.H. [1972], *Policy Issues and Research Opportunities in Industrial Organization*, in V. Fuchs (ed.), ECONOMIC RESEARCH: RETROSPECTIVE AND PROSPECT, vol. 3, NBER General Series No. 96, Cambridge National Bureau of Economic Research, 59-73.

oped, helps to shed some more light on this issue. It does so by providing us with an explanation of *why* firms exist as an alternative to market exchange.[52]

A theory of the firm is essential for understanding how firms are governed and financed, that is for understanding corporate governance.[53] I shall therefore put aside, for the moment, the traditional agency costs explanation of separation of ownership and control, whose underlying theory of the firm (the nexus of contracts) was at least originally based on the unrealistic framework of complete contracting.[54] Once we allow contractual incompleteness to enter the framework, agency costs due to asymmetric information become indeed just a part of the corporate governance problem and probably – contrary to conventional wisdom – not even the most important one. Agency costs cannot explain what is special about governing a firm instead of any other contractual relationship.[55] Nor can they explain why any such relationship should be 'governed.'[56] Contractual incompleteness can explain both issues. The focus of the following discussion will be then the role of firm's governance in coping with the problem of contractual incompleteness.

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52 This line of research has developed from the analysis of the problem of *vertical integration*. Two milestone publications are worth mentioning in this regard: Williamson, O.E. [1971], *The Vertical Integration of Production: Market Failure Considerations*, in AMERICAN ECONOMIC REVIEW, vol. 61, 112-123; Grossman, S.J. and Hart, O. [1986], *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, in JOURNAL OF POLITICAL ECONOMY, vol. 94, 691-719.

53 On the importance of such a link, see Zingales, L. [2000], *op. cit.*, 1626-1630.

54 To be sure, contractual incompleteness is never ignored in either law or economics of CG. However, in the conventional agency framework, "contractual incompleteness [is allowed] to creep in through the back door." Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1630. According to Rock and Wachter, this is especially true for corporate law scholarship, which generally assumes incompleteness in the corporate contract being dealt with by courts "more or less as they do in a commercial market context." Id., at 1631. Economists likewise make more or less explicit reference to contractual incompleteness in their discussions of CG as an agency problem. See, e.g., Jensen, M.C. and Meckling, W.H. [1976], *op. cit.*, 338; Shleifer, A. and Vishny, R. [1997], *op. cit.*, 741.

55 Few economists in the field of CG recall that Ronald Coase had already made this point long before principal-agent models were introduced in the economic theory:

> "Of course, it is not possible to draw a hard and fast line which determines whether there is a firm or not. There may be more or less direction. It is similar to the *legal* question of whether there is the relationship of master and servant *or* principal and agent."

Coase, R.H. [1937], *op. cit.*, 392 (emphases added). Conversely, lawyers seem to get this point quite right: Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1626; Blair, M.M. and Stout, L.A. [2006], *Specific Investment: Explaining Anomalies in Corporate Law*, in JOURNAL OF CORPORATION LAW, vol. 31, 719-744. This might be due to the different (and narrower) approach to the principal-agent relationship that lawyers traditionally take compared to economists. Ricketts, M. [2002], *op. cit.*, 47. And yet, this is not just semantic. One thing is a contract, or a web of contracts. Another thing is the firm, where contractual exchange is superseded by 'direction', or 'authority.' Coase, R.H. [1937], *op. cit.*, 390-392.

56 Zingales, L. [1998], *op. cit.*, 498.

This will provide us later on with a possible key for understanding separation of ownership and control.

3.3. Incomplete Contract Theories of the Firm

3.3.1. Transaction Costs Economics

Building on Ronald Coase's basic insight, Oliver Williamson – followed by other leading economists – developed a theory of the firm based on the comparative advantage of business organizations over market institutions in saving transaction costs.[57] This approach, named Transaction Cost Economics, is largely based on the analysis of *one* specific source of transaction costs (as we have just seen, there are many), potentially leading to a market/contracting failure: the so-called *asset specificity*.[58]

By asset specificity, economists mean idiosyncratic, relation-specific investments whose value in a long-term relationship exceeds the value of the best alternative use.[59] This excess value is called *quasi-rent*.[60] The prospective reward that quasi-rents provide to the parties committed to the relationship is the reason why relation-specific investments are undertaken in the first place. Indeed, the same investments are sunk costs, so they cannot be redeployed outside the relationship.[61] Excess value arising from asset specificity is also the major source of the competitive advantage of a long-term relationship over spot market contracting on stan-

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57 The most comprehensive illustration of Williamson's work is contained in his oft-cited book: *The Economic Institutions of Capitalism*. Williamson, O.E. [1985], *op. cit*. On the impact of Transaction Cost Economics (hereinafter TCE) on economic theory, see , e.g., Carroll, G.R., Spiller, P.T. and Teece, D.J. [1999], *Transaction Cost Economics: Its Influence on Organizational Theory, Strategic Management, and Political Economy*, in G.R. Carroll and D.J. Teece, FIRMS, MARKETS, AND HIERARCHIES: THE TRANSACTION COST PERSPECTIVE, Oxford University Press, 60-77.

58 Williamson, O.E. [2002], *The Theory of the Firm as a Governance Structure: From Choice to Contract*, in JOURNAL OF ECONOMIC PERSPECTIVES, vol. 16, 171-195.

59 Williamson, O.E. [1979], *op. cit.*, 238-245 ('*The Economics of Idiosyncrasy*').

60 This concept was popularized by Klein, B., Crawford, R.G. and Alchian, A.A. [1978], *Vertical integration, appropriable rents and the competitive contracting process*, in JOURNAL OF LAW AND ECONOMICS, vol. 21, 297–326. But the notion of quasi-rents has a long-standing tradition in the economic theory. See *supra*, Chapter 1, section 1.4.5.

61 Ricketts, M. [2002], *op. cit.*, 36-37.

dardized assets.[62] Notice that this holds for specific investments in both physical and human capital.[63] The importance of this specification will become clear shortly.

Realization of the excess value *ex post* depends on the relation-specific investments being made *ex ante*. If contracts were complete, it would be always possible to achieve this result by devising *ex ante* an appropriate incentive scheme. When contracts are incomplete, in some unforeseen, unobservable, or unverifiable state of nature, one party has the right to decide what to do with the assets brought into the relation and he will exercise this right in such a way as to appropriate the largest possible share of the quasi-rents.[64] In other words, circumstances not contracted upon *ex ante* give rise to one party's *ex post* bargaining power to decide over the division of quasi-rents, to the counterparties' disadvantage. In extremely simplified terms, this is the *hold-up problem* arising from contractual incompleteness.[65]

The hold-up problem can lead to suboptimal relation-specific investments, due to one or more parties' inability to secure their share of the prospective reward contractually. According to Transaction Cost Economics, the firm emerges as a response to this non-contractibility problem.[66] As an alternative to *consensus*-based market contracting, the firm is based on the exercise of *authority*. In the firm, a hierarchical governance structure of relation-specific investments is established, where quasi-rents are divided through a set of internal organization rules that discipline

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[62] This involves a tradeoff, though. Standard contracting is in fact cheaper, and may involve transaction costs which are very low, if not nil, at the margin. See, in this regard, Williamson, O.E. [1981], *Contract Analysis: The Transaction Cost Approach*, in P. Burrows and C.G. Veljanovski (eds.), THE ECONOMIC APPROACH TO LAW, Butterworths, 39-60; and MacNeil, I.R. [1981], *Economic Analysis of Contractual Relations*, in P. Burrows and C.G. Veljanovski (eds.), THE ECONOMIC APPROACH TO LAW, Butterworths, 61-92.

[63] Williamson, O.E. [1979], *op. cit.*, 240.

[64] Zingales, L. [1998], *op. cit.*, 498-499.

[65] To our purposes, no further specification is needed. The hold-up problem was first analyzed by Klein, B., Crawford, R.G. and Alchian, A.A. [1978], *op. cit.* It became then the basis for the incomplete contract theories of the firm. See Grossman, S.J. and Hart, O. [1986], *op. cit.*; Hart, O. and Moore, J. [1990], *Property Rights and the Nature of the Firm*, in JOURNAL OF POLITICAL ECONOMY, vol. 98, 1119-1158; Williamson, O.E. [2002], *op. cit.* For a discussion of the implications on contractual relationship, see Klein, B. [1996], *Why hold-ups occur: The self-enforcing range of contractual relationships*, in ECONOMIC INQUIRY, vol. 34, 444-463; Klein, B. [1998], *Hold-up problem*, in P. Newman (ed.), THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW, Macmillan, 241-244.

[66] Actually, in Williamson's view, the firm emerges as a solution to a tradeoff between adaptability, incentive intensity, and administrative control. Hierarchies score better on the first account (which includes transaction costs arising from asset specificity), whereas markets normally perform better on both incentive intensity ('high-powered' vs. 'low-powered' incentives) and administrative costs (the cost of the bureaucracy). Williamson, O.E. [1991], *Comparative Economic Organization: The Analysis of Discrete Structural Alternatives*, in ADMINISTRATIVE SCIENCE QUARTERLY, vol. 36, 269-296. For the classical divide between 'high-powered' and 'low-powered' incentives, see Milgrom, P. and Roberts, J. [1982], ECONOMICS, ORGANIZATION, AND MANAGEMENT, Prentice-Hall.

the exercise of authority, instead of a sheer number of expensive contract terms allocating *ex post* bargaining power.[67] By means of that set of rules, a hierarchical "governance structure" is created, whose major task is to cope with both *ex ante* and *ex post* problems arising from idiosyncratic investments (asset specificity).[68] Corporate governance is actually one such governance structure, aimed at providing *both* shareholders and the management with the necessary safeguards of their firm-specific investments. The former need protection "against expropriation and egregious mismanagement" of the funds they provide to the firm;[69] but the latter also need "discretion," especially inasmuch the managers' investments in human capital are highly firm-specific.[70] According to Williamson, the board of directors serves as a safeguard for the interest of both constituencies in the modern corporation.[71]

This approach is clearly at odds with the nexus of contracts theory of the firm. Transaction Cost Economics has, however, one major weakness: it does not specify the *source* of the authority within the firm.[72] As such, the theory lends itself to an easy criticism, promptly raised by 'contractarians.' Bearing in mind a well-known example made by Armen Alchian and Harold Demsetz, I shall refer to this criticism as to the 'grocer argument.' The argument sounds nearly as follows: authority exercised within a firm (where the employer can sue or fire an insubordinate or lazy employee) is by no means different from the authority exerted in the marketplace (where a customer dissatisfied with his grocer can sue or 'fire' him simply by withdrawing from his business).[73] Therefore, in the governance of *every* economic relationship, consensus and authority should be regarded as two sides of the same coin.

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67 Williamson, O.E. [1985], *op. cit.*, chapter 4 ('*Vertical integration: Theory and Policy*') and chapter 6 ('*The Limits of The Firm: Incentives and Bureaucratic Features*').

68 Id., chapter 3 ('*The Governance of Contractual Relations*'), 68-84.

69 Id., chapter 12 ('*Corporate Governance*'), 305.

70 Id., chapter 12, 312-319.

71 Id., chapter 12, 298-325. Indeed, reliance on the central role of the board of directors in CG is also shared by supporters of the agency approach. See, most prominently, Fama, E.F. [1980], *Agency Problems and the Theory of the Firm*, in JOURNAL OF POLITICAL ECONOMY, vol. 88, 288–307 and *infra*, section 3.4.3.

72 Professor Williamson would hardly agree on that. To begin with, he would probably deny that TCE deals with misleading notions such as 'authority' or 'power.' More precisely, Williamson describes hierarchies as the domain of "fiat" whereby transactions are decided and executed, instead of bargained for. In addition, fiat is a distinguishing feature of a hierarchical organization which requires no other source than the organization (contractual) setup. If anything, it requires *deference* to this setup as a complementary feature – i.e., in Williamson's words, "forbearance." Forbearance simply means that "hierarchy is its own court of ultimate appeal." It is consistently established by the "contract law*s*" (plural) disciplining governance structures at the outset. Williamson, O.E. [1991], *op. cit.*, 274-276. I owe much of the above understanding to the Williamson's lectures that I had the honor to attend as visiting scholar at the University of Berkeley, in 2003.

73 Alchian, A.A. and Demsetz, H. [1972], *op. cit.*, 777.

3.3.2. The Property Rights Theory of the Firm

An important application of the theory of incomplete contracts has provided a way out of the 'grocer argument.' Sanford Grossman and Oliver Hart, subsequently joined by John Moore, identified in the property rights held by the entrepreneur the distinctive feature of the firm's governance as opposed to market contracting. One source of authority within a firm is in fact the ownership of key *physical* assets by the entrepreneur.[74] The owner of the enterprise can always threaten employees and other suppliers of inputs to walk away with the specialized assets where the firm value comes from, while the reverse threat would not be credible. Why? Because ownership involves residual rights of control over the assets, and so the power to decide upon any matter concerning the use of the same assets which have not been previously contracted upon with other providers of inputs.[75] This involves that the owner is also entitled to a favorable allocation of the quasi-rents arising from his specialized investments in *both* physical and human capital. Quasi-rents will include the share of the firm's surplus having not been allocated contractually (the residual claim).[76] Ownership provides then both a solution to the problem of incomplete contracts and a theory of the firm: the Property Rights Theory.[77]

One problem with the property rights theory is that it is a theory of the firm that does not explain separation of ownership from control,[78] whereas, albeit under unrealistic assumptions, the nexus of contracts/agency theory of the firm did. The

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[74] See Grossman, S.J. and Hart, O. [1986], *op. cit.*

[75] Hart, O. and Moore, J. [1990], *op. cit.*

[76] Hart, O. [1995], *op. cit.*, 29-55.

[77] It is worth noting that the scope of the Property Rights Theory (hereinafter PRT) is much narrower than that of TCE. To begin with, PRT describes just one of the possible instruments whereby firms are established, namely property rights, whereas TCE allows for a wider choice due to extensive reliance on private ordering. Next, vertical integration is intended in a 'directional' way, allowing no scope for cooperation (that is, "either A buys B or B buys A, and it matters which way this is done" Williamson, O.E. [2002], *op. cit.*, 606). Finally, the underlying account of contractual incompleteness is much more limited under PRT. Grossman, Hart and Moore set aside bounded rationality from their analysis of transaction costs and assume both common knowledge and costless *ex post* bargain. See, e.g., Hart, O. and Moore, J. [1988], *op. cit.*, 757. This framework is suitable for analyzing *ex ante* inefficiencies arising from contractual incompleteness, but only on condition that no inefficiency can take place *ex post*. TCE instead also accounts what Williamson defines as "*ex post* maladaptation". TCE, however, is an informal theory, whereas PRT introduced formal modeling into the analysis of incomplete contracting. Williamson, O.E. [2002], *op. cit.*, 605-607.

[78] One of its developers has explicitly acknowledged this: Hart, O. [1989], *An Economist's Perspective on the Theory of the Firm*, in COLUMBIA LAW REVIEW, vol. 89, 1757-1774. A considerable part of Professor Hart's work in the past twenty years has been devoted to extending PRT to separation of ownership and control. See *infra*, section 3.4. But see also *infra*, Chapter Five, section 5.6, for a more promising approach, and Chapter Six, section 6.2, for the alternative framework suggested in this dissertation.

property rights theory was first developed as an entrepreneurial theory, where the entitlement to residual control rights follows the residual claim on the firm's assets.[79] A second problem, which is only apparently unrelated, is that the property rights theory does not account for the possibility that idiosyncratic investments in human capital (which cannot be 'owned') are more important for the firm's success than physical asset specificity, and still the provider(s) of firm-specific human capital cannot afford to buy those assets that would be efficient for him (them) to own.[80]

However, in an incomplete contracts framework, the property rights theory of the firm brings to light two major insights that are extremely useful for understanding the problem of corporate governance. The first one is that authority is featured by contractual incompleteness and is established through residual rights of control. As a result, *control matters* in corporate governance. The second is that residual rights of control require support (and possibly, further discipline) by legal entitlements. This is exactly what property rights are, after all. Therefore, *law* also *matters* in corporate governance. Let us focus on the analysis of the first issue; the meaning of the second will become clear accordingly.

3.4. Separating Ownership and Control in an Incomplete Contracts Setting

3.4.1. Delegation of Corporate Control

It might seem surprising to a non-economist, but one typical way in which economists deal with unexplained facts of an otherwise insightful theory is by assuming them away from the framework and leaving them for further research. It is exactly in this way that the property rights theory of the firm has been adapted to account for separation of ownership and control.

Under the property rights theory, corporate governance *does not* actually involve separation of residual control rights from the residual claim on the corporate assets. Both belong to the firm owners, namely the corporate shareholders, and thus identification of control with ownership is preserved. However, being shareholders unwilling (or incapable) of managing the firm's assets, they *delegate* residual rights of

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[79] Zingales, L. [2000], *op. cit.*, 1638.
[80] Rajan, R.G. and Zingales, L. [2000], *op. cit.*, 214-220.

control to a manager who is in charge of managing those assets at his discretion, but always on shareholders' behalf. Being delegated, such discretion entails *effective control* but not also (residual) *control rights*.[81] Consequently, the same discretion should carry no entitlement to non-contractible quasi-rents generated by the specialization of the firm's assets. Those rents are allocated to shareholders, who has the right to withdraw the assets from the manager's control and, therefore, to hold him up.[82]

Clearly, the above framework does not allow for any investment in firm-specific human capital by the manager. That kind of investment would require non-contractible quasi-rents being allocated to the manager, instead of shareholders. In other words, the manager should be entitled to enjoy his own benefits from operating the firm's assets, benefits that are neither contracted for nor shared with the owners. This is another instance of *private benefits of control*, which is considered by just a minority of the literature on corporate governance.[83] However, differently from those originating from moral hazard and adverse selection, these benefits depend more on the problem of contractual incompleteness than on that of asymmetric information. Therefore, the only way in which they can be secured from *ex post* expropriation by shareholders is through assignment of control rights to the manager. Otherwise, if those rights were simply delegated, delegation could be withdrawn anytime and so would be the assets from whose management private benefits are reaped.[84] The problem is that, to the extent the manager is not also the (sole) owner of the firm, securing private benefits of control through residual control rights would be against the basic tenets of the property rights theory of the firm.[85]

A way out of this impasse is to assume that entitlement to private benefits of control is *not needed* to have the firm efficiently run by a non-owner manager. Differently from the case of an entrepreneur, managers of large, public companies are apparently not required to be 'innovative and inventive', given that the management of those companies most often involves routine decision-making.[86] Therefore, the

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[81] Hart, O. [1995], *op. cit.*, 127. See also Aghion, P. and Tirole, J. [1997], *Formal and Real Authority in Organizations*, in JOURNAL OF POLITICAL ECONOMY, vol. 105, 1-29.

[82] Under PRT, the conclusion is straightforward. This is not quite so under the assumptions of TCE, which allow a much wider scope for private ordering. See, e.g., how CG is dealt with in Williamson, O.E. [1985], *op. cit.*, chapter 12 ('*Corporate Governance*').

[83] See *supra* Chapter One, section 1.4.5, and, in more detail, *infra* Chapter Five.

[84] Burkart, M., Gromb, D. and Panunzi, F. [1997], *Large Shareholders, Monitoring, and the Value of the Firm*, in QUARTERLY JOURNAL OF ECONOMICS, vol. 112, 693-728.

[85] Aghion, P. and Bolton, P. [1992], *An Incomplete Contracts Approach to Financial Contracting*, in REVIEW OF ECONOMIC STUDIES, vol. 59, 473-494.

[86] Hart, O. [1995], *op. cit.*, 126.

analysis of corporate governance based on the property rights theory of the firm "take[s] the view that in the case of a public company the issue of allocating control rights to managers in order to give them a chance to enjoy private benefits may not be of primary importance."[87]

In this perspective – the leading one in both law and economics – control rights are definitively allocated to the owners (the shareholders) and private benefits enter as an *impediment* to maximization of shareholder value. In the absence of further rents to be allocated to the managers, private benefits of control can only account for either profit diversion from shareholders or suboptimal production of the same profit.[88] Private benefits of control just arise from the managers *abusing* their delegated discretion. Therefore, not differently from the more traditional principal-agent framework, also in the incomplete contracting setting private benefits are sources of agency costs due to either moral hazard, adverse selection, or both. Investigation of a different case – where private benefits are a *structural* consequence of non-contractibility of managerial investments, and thus they may play an *incentive* role not only in entrepreneurial firms, but in publicly held corporations too – is left for future research.[89]

Without questioning the importance of management abusing its discretion to the disadvantage of non-controlling shareholders, I posit that that the problem of non-contractible managerial incentives is no less important in corporate governance. Therefore, I shall reconsider the notion of private benefits of control and its implications for separation of ownership and control. But that will be dealt with only at a later stage of this inquiry.[90] Before that, I am going to show how failure to account for managerial incentives in the form of private benefits of control leaves too many facts of worldwide corporate practice unexplained. This requires that problems of delegation of corporate control be first analyzed. The following discussion will show that extraction of private benefits of control at the expenses of non-controlling shareholders actually undermines the efficiency of both corporate governance and finance. However, corporate controllers around the world seem unwilling to commit at the outset to mechanisms that would constrain the extraction of private benefits of control. This is puzzling, provided that corporate controllers internalize *ex ante* the consequences of such a behavior in the form of higher cost of capital. There must be something in corporate governance that the

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[87] Id., at 126.

[88] Shleifer, A. and Vishny, R. [1997], *op. cit.*, 742-744.

[89] This is the case where "it might be efficient to allocate control rights to managers in order to allow them to enjoy their private benefits, or to motivate them to undertake relationship-specific investments." Hart, O. [1995], *op. cit.*, 207.

[90] See *infra*, Chapter Five.

principal-agent framework, even when it is corrected to account for contractual incompleteness, fails to explain.

3.4.2. The Reappraisal of Agency Theory under Contractual Incompleteness

a) *Monitoring and Corporate Control*

To make the problem of delegation of corporate control interesting, separation of ownership from (effective) control should take place to a meaningful extent. This means that both a corporate controller and non-controlling owners need to exist.[91]

An issue too often overlooked by American economists (and lawyers) is that managerial control of a public company is just *one* model of corporate governance, whereas also shareholder control should be accounted for. A related problem is that 'controlling' shareholders are not clearly distinguished from shareholders that are just 'large,' but do not really exert any control over the firm decision-making and, therefore, are still 'non-controlling' shareholders.[92] The dichotomy between

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91 When one single shareholder is the 100% owner of the firm, management could be indeed delegated, but the manager would not be more in control that a plumber we hire for fixing our own bathtub: anything he does will have to be approved by the owner. Similarly, when a shareholder has an ownership stake large enough to have always the last word about how the firm should be managed, he might have to resort to a professional management to implement his will. But, at the end of the day, that will be the way the firm is actually managed: at his own will. As a result, the controlling shareholder, and not the managers he hires, gets effective control over the firm's assets; should any delegation take place, it would be from non-controlling shareholders to the controlling one – in the terminology being employed here, the corporate controller. Finally, the role of the corporate controller can be effectively played by the managers, but this requires that no shareholder has an ownership stake large enough to control the company or to interfere anyway with its management – that is, the corporation is own just by non-controlling shareholders. For a relatively similar framework, see , e.g., Burkart, M. and Panunzi, F. [2006a], *Agency Conflicts, Ownership Concentration, and Legal Shareholder Protection*, in JOURNAL OF FINANCIAL INTERMEDIATION, vol. 15, 1-31.

92 Shleifer, A. and Vishny, R. [1997], *op. cit.*, 754-755, have undoubtedly contributed to highlighting the importance of ownership concentration for a deeper understanding of CG. What is still unclear in their analysis – and in the many theoretical and empirical investigations that followed – is exactly the distinction between '*large*' and '*controlling*' shareholders. This distinction involves both theoretical and empirical difficulties. On the one hand, there is "the obvious difficulty of distinguishing between large shareholders who are *associates* of management and large shareholders who are *controllers* of management". Hellwig, M. [2000], *op. cit.*, 102 (emphases added). On the other hand, there is the "deeper difficulty of distinguishing between investor-driven and management-driven correlations in financial data": are deviations from the 'one share–one vote' rule a matter of weak investor protection (as they are normally understood) or, rather, a way to implement separation of ownership and control without fear of being taken over? Id., at 102. I shall deal with both problems throughout the analysis that follows. For a detailed empirical analysis of alternative models of CG, see *supra*,

corporate controllers and non-controlling shareholders that I have introduced since the very beginning of this work is just intended to cope with these problems. On the one hand, the notion of corporate controller points at the exercise of *real authority* in the firm decision-making. As a result, it includes shareholders that are actually 'in control' while excluding shareholders that are just 'large.' On the other hand, the same notion is *neutral* to the two basic models of separation of ownership and control. 'Corporate controller' is in fact a suitable definition for either managers or a controlling shareholder having the last word over firm decision-making. We have just seen in the last Chapter that understanding corporate governance requires consideration for *both* models of corporate control, and not just for one of them.

That being said, delegation of residual rights of control from non-controlling shareholders to a corporate controller is motivated by the owners' wealth constraints, liquidity needs and risk aversion (the ultimate reason why their financial investments are diversified).[93] Not only entrepreneurs (and managers) may be not rich enough or otherwise unwilling to own all of the firm's assets. Investors are too, and that is the reason why large, publicly held companies have many and small non-controlling shareholders.[94] We already know that ownership dispersion of large companies leads to the problem of shareholders' rational apathy.[95] Within the property rights approach, this generates likewise a principal-agent problem. Oliver Hart describes it very clearly in the stylized case of a public company subject to managerial control:

> "[Dispersed ownership] creates two […] problems that [are] not relevant in the case of a private company. First, those who *own* the company, the shareholders, are too small and too numerous to exercise control on a day-to-day basis. Given this, they delegate day-to-day (residual rights of) control to a board of directors who in turn delegate it to management. […] Second, dispersed shareholders have little or no incentive to monitor management. The reason is that monitoring is a public good: if one shareholder's monitoring leads to improved company performance, all shareholders benefit. Given that monitoring is costly, each shareholder will free ride in the hope that *other* shareholders will do the monitoring. Unfortunately, all shareholders think the

Chapter Two. For the theoretical implications of the distinction between large and controlling shareholders, see *infra*, Chapter Five, section 5.6.

93 Few arguments enjoy the same degree of convergence between the economists' and lawyers' opinions. Compare Easterbrook, F.H. and Fischel, D.R. [1991], *op. cit.*, 8-15 with Hart, O. [1995], *op. cit.*, 126-127.

94 Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 20-21.

95 See *supra*, Chapter One, section 1.5.2.

> same way and the net result is that no – or almost no – monitoring will take place."[96]

Although it may seem less intuitive, a similar reasoning applies to those companies where a controlling shareholder is in charge. Non-controlling shareholders are normally no less dispersed, and thus they are induced to delegate residual control rights to the controlling shareholder while abstaining from monitoring his behavior.[97] In theory, the latter might be less of a problem compared to the case where managers are in charge with (almost) no shareholding, due to the large ownership stake that must be maintained to support the position of a controlling shareholder.[98] While a non-owner manager may waste too many resources in enjoying perquisites or building empires at the shareholders' expenses, a controlling shareholder will refrain from doing so to the extent he loses more as an owner than he gains as a controller.[99] Apparently, then, the exercise of corporate control by a large shareholder requires *less monitoring* by the other owners.[100] In practice, however, the difference in incentives between the two models of corporate governance is more apparent than real.[101]

On the one hand, the ownership stake of controlling shareholders is always limited by their wealth constraints and risk diversification needs. Based on Jensen and Meckling's original insight, standard theory holds that ownership concentration

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96 Hart, O. [1995], *op. cit.*, 127.

97 To be sure, this is not how models of CG based on concentrated ownership are described in theoretical economics. A large (controlling) shareholder is supposed to *monitor* the managers, thereby benefiting other dispersed shareholders who will free ride. Of course, this is quite a rosy picture wherein the core conflict of interest is overlooked. In fact, a controlling shareholder will most often *collude* with the managers he chooses and minority shareholders will bear all the, presumably negative, consequences of such collusion. See Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 41-45, for an excellent survey of this issue. Comparative lawyers are more pragmatic. Instead of trying to extend the analysis of management-shareholder conflicts to concentrated ownership structures, they directly point to a *different* conflict of interest as a source of agency problems: that established between a controlling shareholder and minority shareholders. See Kraakman, R.H., Davies, P., Hansmann, H., Hertig, G., Hopt, K.J., Kanda, H. and Rock, E.B. [2004], THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH, Oxford University Press (hereinafter, Kraakman *et al.* [2004], *The Anatomy*), 21-23 and 60-61.

98 Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 31-38.

99 Roe, M.J. [2004b], *The Institutions of Corporate Governance*, Harvard Law and Economics Discussion Paper No. 488, available at www.ssrn.com, 2-4.

100 Shleifer, A. and Vishny, R. [1997], *op. cit.*, 753-758. One might recall that this is the basic insight underlying Jensen and Meckling's theory of separation between ownership and control: the largest the manager's ownership stake, the more his incentives will be aligned to the interest of the other owners.

101 Hellwig, M. [2000], *op. cit.*, 99-100, makes a similar point.

arises as a solution of a tradeoff between enhanced *monitoring* incentives of large owners and reduced *liquidity* of their investment. In that perspective, a controlling shareholder may even be preferable to a completely dispersed ownership structure, if only he could be subsidized to hold larger blocks.[102] However, the empirical evidence shows us a somewhat different picture. The reader may recall from previous discussion that legal devices most often supporting shareholder control – such as dual class shares or pyramidal group structures – help satisfying liquidity preferences or constraints of the corporate controller. This of course dilutes the corporate controller's incentives as a residual claimant, by allowing control to be exercised and maintained with a limited ownership stake.[103] In fact, one recent comparative study on corporate control patterns presents "examples in which the cash flow rights of the controlling family in some of the pyramid member firms are comparable to the stakes of the managers of the most diffusely held of US corporations."[104]

On the other hand, where managers are in charge with a tiny (or even no) ownership, their incentives can be nonetheless aligned with shareholder interest by putting them on an incentive scheme contingent on the realization of shareholder value.[105] This mechanism has also an important limit. "[I]f managers have a strong interest in power, empire, and perks, a very large bribe may be required to persuade managers to give up these things."[106] Beyond a certain threshold, shareholders will prefer to share a smaller pie rather than awarding managers most part of a larger one.

The above results are consistent with the generality of Jensen and Meckling's analysis. *Whatever* the model of corporate governance (i.e., the degree of separation of ownership and control), the incentives of the corporate controller can never be perfectly aligned with the interest of non-controlling owners.[107] Unfortunately, this

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[102] Bolton, P. and von Thadden, E.-L. [1998a], *Blocks, Liquidity, and Corporate Control*, in JOURNAL OF FINANCE, vol. 53, 1-25.

[103] Bebchuk, L.A., Kraakman, R.H. and Triantis, G. [2000], *Stock Pyramids, Cross-Ownership, and Dual Class Equity: the Mechanisms and Agency Costs of Separating Control from Cash-flow Rights*, in R. Morck (ed.), CONCENTRATED CORPORATE OWNERSHIP, NBER Conference Volume, University of Chicago Press, 295-315. See also Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 78-85.

[104] Morck, R., Wolfenzon, D. and Yeung, B. [2005], *Corporate Governance, Economic Entrenchment and Growth*, in JOURNAL OF ECONOMIC LITERATURE, vol. 43, 678.

[105] Shleifer, A. and Vishny, R. [1997], *op. cit.*, 744-745.

[106] Hart, O. [1995], *op. cit.*, 128. See also *supra*, Chapter One, section 1.4.5.

[107] Adding consideration for outright expropriation would not change this conclusion. It is often argued that controlling shareholders are more inclined to 'steal' from minority shareholders' investment (Shleifer, A. and Vishny, R. [1997], *op. cit.*, 758-761), especially when they have disproportional voting rights relative to their ownership (Bebchuk, L.A., Kraakman, R.H., Triantis, G. [2000], *op. cit.*). However, it is always the legal system, and not just ownership concentration, that deter-

framework does not completely explain the *choice* of ownership structure. In theory, this should just depend on minimization of agency costs across the board. In practice, however, agency costs minimization does not tell us why managerial control with dispersed outside ownership prevails in a few countries, whereas the governance of most publicly held companies around the world features controlling shareholders even with limited inside ownership.

b) *Allocation and Regulation of Control Rights*

By placing more emphasis on control considerations, the incomplete contracts approach featured by the property rights theory of the firm may possibly help us to solve this fundamental puzzle. Delegation of residual rights of control from the owners to a corporate controller involves that agency problems be still reckoned with in the first place. Once he is in charge, the controlling agent could easily take advantage of his position by extracting private benefits, which ultimately come at the expenses of the principals' interest (shareholder value). Like in every principal-agent setting, it is asymmetric information that prevents dispersed shareholders from better disciplining the agent's behavior. However, provided that exercise of residual control rights (i.e., 'real' discretion) is involved in that behavior, the problem must be dealt with differently from the traditional agency approach based on complete contracting. By definition, exercise of control rights cannot be disciplined contractually, for the same rights are 'residual' with respect to any feasible contract.[108] As a result, agency problems arising from delegated exercise of control rights cannot be completely dealt with *ex ante* via a 'mechanism design' contingent on all possible future states of the world. Rather, they need to be solved *ex post*, when an inefficient misbehavior, which was not accounted for, materializes.[109]

Under incomplete contracting, then, agency costs minimization depends on additional factors that are not contractible at the outset. These factors need to make sure that the corporate controller's discretion is *disciplined* in such a way as to pre-

mines the corporate controller's incentives to steal. See Roe, M.J. [2003c], POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE, Oxford University Press, 169-182. The problem is, rather, that managerial control would not emerge when shareholder expropriation is not adequately policed by corporate law and the institutional framework. See Bebchuk, L.A. [1999], *A Rent-Protection Theory of Corporate Ownership and Control*, NBER Working Paper No. 7203. A controlling shareholder might end up stealing more, but still be more concerned with the management efficiency compared with a non-owner manager (in standard terminology, he would retain higher incentives to monitor – Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 36-39). Once again, the agency framework does not provide guidance to the solution of this tradeoff. See also *infra*, Chapter Five, section 5.2.3.

[108] 'Residuality' of control rights just depends on contractual incompleteness. See Hart, O. and Moore, J. [1990], *op. cit.*, 1121.

[109] Zingales, L. [1998], *op. cit.*, 501-502.

vent *ex post* deviations from shareholder value maximization.[110] There are two possible ways of achieving this. The first one is to allow for third-party intervention aimed at punishing outright abuses of firm control, thereby ruling out most outrageous instances of corporate controller's misbehavior. Clearly, the legal system – that was unimportant in a complete contracting framework – plays now a key role by *regulating* the company management in such a way as to prevent shareholder expropriation. This leads to the famous '*law matters*' proposition, which have been dominating the corporate governance debate over the last ten years, and that will be discussed in more detail in the next Chapter.[111] The second way to make sure that shareholder value is maximized under contractual incompleteness is to have control taken over when its exercise is no longer efficient. Whether the corporate controller is induced to give up, or forced to do so, ultimately determines the way in which *'control matters'* in corporate governance.[112] It might be less evident, but this also depends on the legal system and, specifically, on how entitlements to (residual) control rights are *allocated* by corporate law.

The property rights approach thus makes one important addition to the complete contracting framework of traditional principal-agent models. Both the constraints on the ongoing exercise of corporate control and its reallocation at certain points of the firm lifecycle do not completely depend on private ordering, and thus they may be not univocally determined across the board by agency costs minimiza-

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[110] *Discipline* is the key word. In the standard agency approach to CG, incentives set *ex ante* are but one mechanism to protect shareholder interest from managerial misbehavior. Based on Jensen and Meckling, executive director shareholding cannot perfectly align their incentives with shareholder interest. Monitoring should also be implemented, for instance by appointing on the board a proportion of non-executive directors, independent of firm management. Fama, E.F. [1980], *op. cit.*, 134–145; Fama, E.F. and Jensen, M.C. [1983a], *op. cit.*, 301-325. Monitoring is costly, however, and then it will not solve the agency problem completely. Managerial discipline by the market of corporate control operates as a mechanism of last resort, which polices agency costs *ex ante* by correcting (well, promising to correct…) managerial failure *ex post*. Manne, H.G. [1965], *Mergers and the Market for Corporate Control*, in JOURNAL OF POLITICAL ECONOMY, vol. 76, 110-120; Jensen, M.C. [1986], *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, in AMERICAN ECONOMIC REVIEW, vol. 76, 323-329; Scharfstein, D. [1988], *The Disciplinary Role of Takeovers,* in REVIEW OF ECONOMIC STUDIES, vol. 55, 185-200. Consideration for contractual incompleteness shows that incentive, monitoring, and disciplinary mechanisms in CG are in fact more related to each other than they would appear in a purely agency framework. More importantly, inasmuch as contractual incompleteness brings discretionary power to the corporate controller, all of them require support by the legal system (Hellwig, M. [2000], *op. cit.*, 112).

[111] In this regard, see , e.g., Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 19-20; La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R. [2000a], *Investor Protection and Corporate Governance*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 59, 3–27.

[112] On how control matters, compare the mainstream view summarized by Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 24-38 and 69-83 with the path-breaking essay by Hellwig, M. [2000], *op. cit.*, 107-112 and 118-121. For extensive discussion of this key issue, see *infra*, Chapter Six.

tion. Entitlements to control power and its constraints provided for by the legal system (for instance, in the form of property rights) just make the difference. This allows the choice of ownership structure to vary from country to country, depending on different corporate laws – a result consistent with the empirical evidence. We will see in the next Chapter that institutions are a broader determinant of this choice.

However, property rights are definitely not the only available institution for allocating entitlements to firm control and for regulating their exercise. To be sure, there is not even a compelling reason to consider *entitlements* to control rights (aimed at fostering their efficient allocation over time) and *regulation* of their exercise (aimed at preventing their abuse) as a unique problem from the owner's standpoint. A corporate controller may be a thief, but still the most talented manager available; alternatively, he might be utterly honest, but also very incompetent. Of course, any shareholder would ever want neither a dishonest nor an incompetent manager, but the fact is that – at least in the view which is being presented here – *most misunderstandings in the economic and legal theory of corporate governance arise from confusing the following two issues*. On the one hand, how the ongoing exercise of control rights is *regulated* by corporate law. On the other hand, how control rights are *allocated* by corporate law.[113] This problem just depend on one basic assumption of the property rights theory, namely that residual rights of control can only reside with the owners. Yet this assumption is theoretically unwarranted and, even more importantly, it does not really match the positive structure of corporate law. I shall further speculate on this key point in introducing a broader framework for the economic analysis of corporate law.[114]

Mainstream theory of corporate governance nowadays follows the property rights approach and its reappraisal of agency theory under contractual incompleteness. In this perspective, allocation and regulation of residual control rights are no separate issues. Both of them should empower the owners' position relative to that of the managers. Unfortunately, similarly to the Jensen and Meckling complete contracting model, the theoretical implications of this reasoning are quite different from the outcomes that we observe in the real world.

[113] Two otherwise excellent surveys of corporate governance, respectively from a legal and an economic perspective, can be regarded as illustration of this point. See Kraakman *et al.* [2004], *The Anatomy*, cit., 21-31, and Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 22-23 and 92-93.

[114] See *infra*, Chapter Five.

3.4.3. Property Rights and Allocation of Corporate Control

Based on the property rights theory of the firm, ultimate control rights can only be allocated to the company's owners. Therefore, corporate control is an issue in that it is *delegated* by shareholders to one or more managers. When effective control of the corporation is merely delegated to an agent by non-controlling shareholders, the solution to the agency problem is apparently straightforward: *ex post* misbehavior negatively affecting shareholder value should be policed by (the threat of) withdrawing control rights from the agent.[115] The legal system is supposed to do little more than empowering shareholders in that fashion.[116] In theory, under a credible threat of ouster, no rational corporate controller would ever misbehave. Under asymmetric information (both actual and prospective managers always know more than shareholders about their own skills and effort), this would provide a second best solution of both moral hazard and adverse selection problems at the same time.[117] On the one hand, the corporate controller will refrain from shirking (and stealing) too much, for fear of being replaced with a more diligent (or loyal) manager. On the other hand, incompetent managers will have ultimately to yield to more efficient ones.

The major weakness of this approach is that, in most situations characterizing corporate governance in the real world, the credibility of the threat of ouster is highly questionable. Ousting an inefficient corporate controller is clearly not an option until non-controlling shareholders remain dispersed; rational apathy prevents small, individual shareholders from voting out a corporate controller they may be dissatisfied of. However, collective action problems, affecting individual shareholders' incentives to monitor the corporate controller's misbehavior, would be coped with by legal or contractual mechanisms for *coordinating* outside shareholder.[118] These mechanisms are very often available in corporate law jurisdictions

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[115] Hart, O. [1995], *op. cit.*, 186-209.

[116] Shleifer, A. and Vishny, R. [1997], *op. cit.*, 750-753.

[117] See, in both respects, Grossman, S.J. and Hart, O. [1980a], *Disclosure Laws and Takeover Bids*, in JOURNAL OF FINANCE, vol. 35, 323-334 (discussing moral hazard); and Grossman, S.J. and Hart, O. [1981], *The Allocational Role of Takeover Bids in Situations of Asymmetric Information*, in JOURNAL OF FINANCE, vol. 36, 253-270 (discussing adverse selection).

[118] Typical mechanisms of coordination are *proxy voting* and *boards of directors*. The former allows voting power of dispersed shareholders to coalesce in order to challenge the incumbent management's position and/or decisions; monitoring is supposedly exerted by a relatively large shareholder who takes the initiative of soliciting proxies to contrast the corporate controller's will (so-called 'proxy fight' or 'proxy contest'). The latter is a delegated monitoring mechanism, based on the appointment of directors independent of the corporate controller. Authoritative scholars have traditionally argued in favor of independent directors. See, e.g., among the economists, Fama, E.F. [1980], *op. cit.*, and Fama, E.F. and Jensen, M.C. [1983a], *op. cit.*; among the lawyers, Eisenberg, M.A. [1976],

but, in practice, the power of non-controlling shareholders is very seldom enhanced by them.[119] As we will see in the Chapters devoted to legal analysis, the most prominent instances of these mechanisms (like proxy voting and board composition arrangements) have proven generally ineffective to that purpose and, if anything, they seem to empower managers more than shareholders.[120]

THE STRUCTURE OF THE CORPORATION, Little, Brown and Company. Academics (but apparently, not also regulators – see *infra*, Chapter Nine) are today far more skeptical about the possibility of achieving real independence on the board. See Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 41-45. Trust in proxy fights was dismissed much earlier. After Manne, H.G. [1965], *op. cit*, 114-115, famously argued against proxy fights, they have enjoyed very little support in both legal and economic analysis of CG. See Bebchuk, L.A. and Kahan, M. [1990], *A Framework for Analyzing Legal Policy towards Proxy Contests*, in CALIFORNIA LAW REVIEW, vol. 78, 1073-1135. Later, proxy voting was related to the broader issue of institutional shareholder activism. See Black, B.S. [1992], *Agents Watching Agents: The Promise of Institutional Investor Voice*, in UCLA LAW REVIEW, vol. 39, 811-893. Proxy voting then became one of the six distinctive features of 'good' quality of corporate law according to La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R. [1998], *Law and Finance*, in JOURNAL OF POLITICAL ECONOMY, vol. 106, 1113-1155. The two questions of institutional investor activism and the board composition have also been related to each other: see, e.g., Gilson, R.J. and Kraakman, R.H. [1991], *Reinventing the Outside Director: An Agenda for Institutional Investors*, in STANFORD LAW REVIEW, vol. 43, 863-906.

119 See, most explicitly, Hellwig, M. [2000], *op. cit.*, 96-98. Reliance of authoritative economists on managerial labor market as the ultimate guarantee of efficiency of the corporate form seems then to be unwarranted, at least on the basis of 'classical' mechanisms of coordinating shareholder action – like boards of directors and proxy voting. Eugene Fama famously invoked markets in "outside directors" as the instrument whereby managers are efficiently selected and replaced by the company's owners. Outside directors "are in their turn disciplined by the market for their services which prices them according to their performance as referees." Fama, E.F. [1980], *op. cit.*, 294. Conversely, Fama argued that takeovers be considered merely as a "discipline of last resort." Id., at 295. Takeovers are a way to overcome collective action problems without having to coordinate shareholder action; but they involve a completely different set of costs and benefits. See *infra* in the text.

120 Proxy fights are very rare in the US and almost unheard of in the rest of the world. Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 89-90. In fact, proxy solicitation is costly and the US "might be *the only* jurisdiction to permit corporations to compensate successful insurgents *ex post* for their campaign costs." Kraakman *et al.* [2004], *The Anatomy*, cit., 43 (emphasis added). Still, proxy contests appear to be customarily associated with hostile takeovers in the US (Mulherin, H.J., and Poulsen, A.B. [1998], *Proxy Contests and Corporate Change: Implications for Shareholder Wealth*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 47, 279-313), provided that winning the contest for the appointment of board members is needed to remove impediments to the acquisition (Bebchuk, L.A. and Hart, O. [2001], *Takeover Bids vs. Proxy Fights in Contests for Corporate Control*, NBER Working Paper No. 8633). Otherwise, a proxy fight alone is bound to provide insufficient incentives for a takeover and, even more so, for challenging the incumbent management's decisions (Bebchuk, L.A. and Kahan, M. [1990], *op. cit.*; for the intuition, see Manne, H.G. [1965], *op. cit.*, 114-115).

The literature on boards is significantly more underdeveloped – or, perhaps, the matter is simply more complicated. For a survey, see Hermalin, B.E. and Weisbach, M.S. [2003], *Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature*, in FEDERAL RESERVE BANK NY – ECONOMIC POLICY REVIEW, April 2003, 7-26. This stands in striking contrast with the wide-

Yet, collective action problems would be "overcome by someone who acquires a large stake in a company and takes it over."[121] Large shareholdings can be acquired in many different ways. We know that acquisitions straightly aimed at ousting an incumbent controller against his will are called *hostile takeovers*.[122] How credible is the threat of ouster for policing the corporate controller's behavior then ultimately depends on the ease with which hostile takeovers can occur.

Since the very beginning of economic and legal research on this topic, hostile takeovers have been considered one of the most important mechanisms of corporate governance, if not the most important one.[123] However, even one of the most

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spread reliance on independent directors displayed by the international regulation (Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 41-45). Many commentators are rather skeptical about the possibility of achieving real independence of non-executive directors from the corporate controller (see, e.g., Hart, O. [1995], *op. cit.*, 128). Directors appear to be most often 'captured' by the company's insiders (i.e., the management, with or without a controlling shareholder in the backstage), who are ultimately responsible of information provision and, more importantly, of director's nomination for reappointment. See Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 41-42. On purely theoretical grounds, it does not seem that delegated monitoring by independent directors can set effective and enduring constraints on the corporate controller's behavior. Hermalin, B.E. and Weisbach, M.S. [1998], *Endogenously Chosen Boards of Directors and Their Monitoring of the CEO*, in AMERICAN ECONOMIC REVIEW, vol. 88, 96-118; Adams, R.B. [2001], *The Dual Role of Boards as Advisers and Monitors*, University of Chicago, PhD. Dissertation, subsequently published as Adams, R.B. and Ferreira, D. [2007], *A Theory of Friendly Boards*, in JOURNAL OF FINANCE, vol. 62, 217-250. The matter gets even more complicated when directors need be independent of a controlling shareholder. And it is anyway too complicated to be dealt with here (see *infra*, Chapters Eight and Nine). Empirical studies on the relationship between board composition and performance are only available for the US and the UK (Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 95-96). The empirical evidence on the bearing of independent directors on CG is, at best, inconclusive, and provides no support for the view that directors' independence is beneficial for firm performance.

121 Hart, O. [1995], *op. cit.*, 127.

122 For the definition of 'hostile takeover', 'contestability' and 'entrenchment' of corporate control, see *supra*, Chapter One, section 1.4.5.

123 Already in the 60s it was suggested that takeovers might be much more effective at disciplining corporate management than an ideal, but unattainable, 'shareholder democracy'. Rostow, E.V. [1959], *To Whom and for What Ends Are Corporate Managements Responsible?*, in E.S. Mason (ed.), THE CORPORATION IN MODERN SOCIETY, Harvard University Press, 47, for instance argued:

> "The raider persuades the stockholders for once to act as if they really were stockholders, in the black-letter sense of the term, each with the voice of partial ownership and a partial owner's responsibility for the election of directors."

See also Manne, H.G. [1964], *Some Theoretical Aspects of Share Voting*, in COLUMBIA LAW REVIEW, vol. 64, 1427-1445 (claiming at 1445 that "vote selling […] negatives many of the criticisms often leveled at the public corporation"), and Manne, H.G. [1965], *op. cit.* (stating at 113 that "only the takeover scheme provides some assurance of competitive efficiency among corporate managers and thereby affords strong protection to the interest of vast numbers of small, non-controlling shareholders"). For a detailed account of the debate of those years, and of Manne's pathbreaking contribution therein, see Carney, W.J. [1999], *The Legacy of "The Market for Corporate Control" and the Origins of the Theory of the Firm*, in WESTERN RESERVE LAW REVIEW, vol. 50, 217-237.

prominent theorists of hostile takeovers – Oliver Hart – recognizes that "the take-over mechanism does not always work well" and that "in many cases the managers or the board of directors of a public company can pursue their own goals, possibly at the expenses of those of shareholders, with little or no outside interference."[124] Apparently, the reason is that (hostile) takeovers are often made so expensive that the benefits they may provide to the acquirer are largely offset by the costs of the acquisition. "In practice – Oliver Hart adds – the ease with which a take-over can occur depends on a variety of factors, including the range of defensive measures available to management, the attitudes of the courts, the existence of anti-takeover legislation, the ability of a successful bidder to expropriate minority shareholders, etc."[125]

3.4.4. Hostile Takeovers: A Myth?

a) Lack of Contestability in the Market for Corporate Control

I shall deal with both economic and legal impediments to the functioning of hostile takeovers at a later stage of this inquiry, after having introduced a more comprehensive framework for the analysis of the market for corporate control.[126] In anticipation of a more detailed analysis, let me just sketch out the major problems with hostility in takeovers.

To begin with, the empirical evidence shows that the hostile takeover might be not yet an extinct phenomenon, but it is surely an endangered species.[127] At least in the US, hostile takeovers were very fashionable during the 80s, but they have almost disappeared since beginning of the 90s. Some of the studies in the history of US corporate finance suggest that, also in the 80s, hostile takeovers may have been motivated more by restructuring of conglomerates than by the need to police

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[124] Hart, O. [1995], *op. cit.*, 127-128.

[125] Id., at 186-187.

[126] Law and Economics of takeovers will be extensively discussed in the two final Chapters of this dissertation, where, however, only friendly deals will be considered. Indeed, one of the major claims of the present inquiry is that the functioning of the market for corporate control features very little hostility, if any at all. That hostile takeovers are typically ruled out of corporate governance has been already shown in Chapter Two. The theoretical underpinnings of this result will be analyzed in Chapter Five, where the shortcomings of hostile takeovers will be highlighted under the hypothesis of efficient protection of private benefits of control (section 5.5.). An alternative theoretical framework for the market for corporate control, based on bargaining in friendly takeovers, will be introduced in Chapter Six. The legal devices for shielding corporate control from hostile takeovers will be analyzed in Chapter Seven.

[127] See *supra*, Chapter Two, section 2.4.4.

managerial inefficiency.[128] Maybe even more surprisingly, careful analysis of available information about Mergers and Acquisitions (M&A) activity shows that most takeovers in the 80s – and nearly all of them from the 90s on – were not even 'hostile', or at least not in the way in which this term is normally understood.[129] Similar results hold for the UK.[130]

Secondly, hostile takeovers are far from a general mechanism for policing the corporate controller's misbehavior.[131] They are only possible in the absence of a controlling shareholder who owns (directly or indirectly) the majority of voting rights – no hostile takeover could ever succeed in such a situation. We have just seen in the last Chapter that this is uncommon outside the US and the UK.[132] In most countries of the Wealthy West, corporate governance is based on shareholder control models where hostile takeovers are generally not possible. Even in those few situations in which they could be abstractly, their actual occurrence is very infrequent; therefore, hostile takeovers are unlikely to represent a general threat to the incumbent's control.[133] In Anglo-Saxon countries, where publicly held companies have typically no controlling shareholder, hostile takeovers can be (and most often are) likewise ruled out by the incumbent management's ability to resist ouster.[134] We have also seen that this conclusion holds whether or not takeover defenses are explicitly allowed by the legal system.[135]

The above evidence is very difficult to reconcile with a theory of corporate governance based on delegation of residual rights of control from shareholders to an agent. One could hardly speak of delegation in the absence of a meaningful mechanism of withdrawing control rights from the agent.[136] One explanation of this puz-

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[128] See Bhagat, S., Shleifer, A., Vishny, R., Jarrel, G., Summers, L. [1990], *Hostile Takeovers in the 1980s: The Return to Corporate Specialization*, in BROOKINGS PAPERS ON ECONOMIC ACTIVITY: MICROECONOMICS, Special Issue (1990), 1-84. For a broad overview of interpretations given to the merger wave of the 80s, and the analysis of decline in hostile takeovers during the following years, see Holmström, B. and Kaplan, S. [2001], *Corporate Governance and Takeovers in the USA: Making Sense of the 80's and 90's*, in JOURNAL OF ECONOMIC PERSPECTIVES, vol. 15, 121-144.

[129] Schwert, G.W. [2000], *Hostility in Takeovers: In the Eyes of the Beholder?*, in JOURNAL OF FINANCE, vol. 55, 2599-2640.

[130] Weir, C. and Laing, D. [2003], *Ownership structure, board composition and the market for corporate control in the UK: an empirical analysis*, in APPLIED ECONOMICS, vol. 35, 1747-1759.

[131] Burkart, M. and Panunzi, F. [2006b], *Takeovers*, ECGI Finance Working Paper No. 118/2006, available at www.ssrn.com and www.ecgi.org.

[132] See *supra*, Chapter Two, section 2.4.

[133] Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 70-71.

[134] Becht, M. and Mayer, C. [2001], *Introduction*, in F. Barca and M. Becht (eds.), THE CONTROL OF CORPORATE EUROPE, Oxford University Press, 12-13 and 36-38.

[135] See *supra*, Chapter Two, section 2.4.4. See *infra*, Chapter Seven, for a more detailed analysis of the legal arrangements supporting this result.

[136] Hellwig, M. [2000], *op. cit.*, 98 and 107-112.

zle – and, indeed, the most common one – is that the corporate controller's behavior aimed at ruling out hostile takeovers (so-called 'entrenchment') is *inefficient*.[137] This might be true when entrenchment arise *ex post*, from the corporate controller's behavior *after* he has taken control of the company.[138] However, inefficiency is much more difficult to argue when entrenchment is established *ex ante*, and outside shareholders nonetheless entrust their money to controlling shareholders resistant to any possible hostile takeover or to managers powerfully entrenched via takeover defenses or equivalent devices.[139]

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137 Conceptually, this point was made by Stulz, R. [1988], *Managerial Control of Voting Rights: Financing Policies and the Market for Corporate Control*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 20, 25-54. Shleifer, A. and Vishny, R. [1989a], *Management Entrenchment: The Case of Manager-Specific Investments*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 25, 123–139, further speculated on managerial entrenchment strategies. More recently, Morck, R., Wolfenzon, D. and Yeung, B. [2005], *op. cit.*, 679, summarized most typical instances of entrenchment:

> "Top executives who own large blocks of equity are effectively tenured. Non-value-maximizing managers with little stock can be removed in proxy fights by disgruntled institutional investors or ousted by hostile raiders attracted by a depressed share price. Top executives with large blocks of equity cannot be cast out in these ways. […] Entrenchment problems can [also] take on a qualitatively distinct air, for entrenchment can lock in control by honest but inept insiders as well as clever self-serving insiders. For example, entrenchment problems occur if a firm's controlling founder bequeaths her stock to an egregiously incompetent, but power hungry son. This sort of entrenchment is especially difficult to counter. [Finally], without maintaining a dominant voting share, the CEO of a widely held firm could also dominate the board through sheer force of personality and push through an array of antitakeover defenses, such as poison pills, staggered boards, and the like, to deter raiders and activist shareholders."

However, the view that entrenchment is detrimental for CG is not uncontroversial. Empirically, the effects of takeover threat on firm performance are ambiguous (see *supra*, Chapter Two, section 2.4.4). And there are a few theoretical arguments in favor of takeover resistance. One of them, which was first highlighted by Shleifer, A. and Summers, L.H. [1988], *Breach of Trust in Hostile Takeovers*, in A.J. Auerbach (ed.), CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES, University of Chicago Press, 33-56, is protection of firm-specific investments by the company's stakeholders. The extension of this argument to the management constituency (in the spirit of Laffont, J.-J. and Tirole, J. [1988], *Repeated Auctions of Incentive Contracts, Investments, and Bidding Parity with an Application to Takeovers*, in RAND JOURNAL OF ECONOMICS, vol. 19, 516-537) is indeed the main focus of the present study. But see Burkart, M. and Panunzi, F. [2006b], *op. cit.*, for a comprehensive and up-to-date survey of the literature on takeover threat.

138 For a review of the arguments, see Bebchuk, L.A. [2002a], *The Case against Board Veto in Corporate Takeovers*, in UNIVERSITY OF CHICAGO LAW REVIEW, vol. 69, 973-1035.

139 See, most authoritatively, Grossman, S.J. and Hart, O. [1988], *One Share–One Vote and the Market for Corporate Control*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 20, 200-201. Bebchuk, L.A. [2003a], *Why Firms Adopt Antitakeover Arrangements*, in UNIVERSITY OF PENNSYLVANIA LAW REVIEW, vol. 152, 713-753, admits that there may be efficiency-based explanations of anti-takeover arrangements implemented *ex ante*, although he contends that the costs of such arrangements are quite likely to outweigh their benefits. On how the choice might be inefficient also *ex ante*, see Bebchuk, L.A.

b) Why Contestability Should Be Established at the Outset

This is actually the point wherein mainstream theory and widespread practice of corporate governance exhibit the highest rate of discordance.[140] *Ex ante*, the controller's entrenchment can be either accounted for or ruled out by the corporate charter, depending on whether takeover defenses or security-voting structures that shield the company from hostile takeovers are allowed. In theory, allowing for entrenchment devices should never be optimal *ex ante*. In the wording of Oliver Hart:

> "Before a company goes public, it is in the interest of the company's initial owner to design the security-voting structure in such a way that future management is subject to an appropriate amount of pressure from the market for corporate control, and to ensure that changes in management occur *in the right situations*."[141]

That is, the security-voting structure that maximizes the likelihood of efficient takeovers (i.e., changes in control 'in the right situations') should also maximize the entrepreneur's proceeds from taking his company public. Under a reasonable set of assumptions, the security-voting structure providing optimal incentives to value-enhancing takeovers (thereby maximizing shareholder value *ex ante*) is based on a single class of shares regulated by the 'one share–one vote' principle. In this situation, every share have the same chance of being decisive for taking over corporate control, and then, like in perfect competition, none of them (and no shareholder) is pivotal for the success of the acquisition.[142]

[2002b], *Asymmetric Information and the Choice of Corporate Governance Arrangements*, Harvard Law and Economics Discussion Paper No. 398, available at www.ssrn.com.

140 Easterbrook, F.H. and Fischel, D.R. [1991], *op. cit.*, 71-74 bluntly claim that arrangements which insulate management from the pressure of hostile takeovers are "rare" in the US. They then add: "If antitakeover provisions are not beneficial to investors, they will depress the price of the stocks affected by them. […] Firms that excessively insulate their management from […] the pressure of takeovers will falter in their product market, their stock will decline in value, and they will change course, or fail, or be acquired. In the long run, useful provisions will dominate" Id., at 167. Their prediction has never been borne out by the empirical evidence: even in the US, publicly held firms are allowed to be takeover-proof and the vast majority of them actually are. See Coates, J.C. IV [2003], *Ownership, Takeovers and EU Law: How Contestable Should EU Corporations Be?*, ECGI Law Working Paper No. 11/2003, available at www.ssrn.com and www.ecgi.org, reprinted in E. Wymeersch and G. Ferrarini (eds.) [2004], COMPANY AND TAKEOVER LAW IN EUROPE, Oxford University Press, 20-23.

141 Hart, O. [1995], *op. cit.*, 187 (emphasis added).

142 See Grossman, S.J. and Hart, O. [1988], *op. cit.*

For the same reason, takeover defenses should also be non-optimal, at least in theory.[143] Having them allowed (that is, not ruled out) by the corporate charter is roughly equivalent to awarding the corporate controller a super-voting share.[144] Like security-voting structures deviating from the 'one share–one vote' model, takeover defenses then operate as a barrier to entry undermining competition in the market for corporate control. To the extent that the incumbent's consent is pivotal for the success of the acquisition, there is no guarantee that corporate control will be always allocated to the most efficient manager. Not differently from deviations from 'one share–one vote', the cost of anti-takeover arrangements should be borne by the initial owner in the form of reduced proceeds from the stock placed with the investing public.[145]

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143 Here the argument is that takeover defenses reduce the probability of acquisition, thereby undermining the disciplinary effect of the market for corporate control on management behavior. See, e.g., Easterbrook, F.H. and Fischel, D.R. [1991], *op. cit.*, 162-211. Empirical analysis is also available, at least for the US. Bebchuk, L.A. and Cohen, A. [2005], *The costs of entrenched boards*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 78, 409–433, show that takeover-proof board structures are associated with "an economically meaningful reduction in firm value." This result parallels other studies showing that firms with a dual class security-voting structure sell at a discount in IPOs. See, e.g., Smart, B.S. and Zutter, C.J [2003], *Control as a Motivation for Underpricing: A Comparison of Dual- and Single-Class IPOs*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 69, 85–110. However, one important point has been made in this regard:

> "The fact of that discount suggests that IPO investors are not being fooled (at least fully) into paying more than they should for shares of a firm that may never be taken over, even when a takeover would increase the value of the firm in the hands of outside investors. And the presence of the discount on new DC firms says nothing about whether those firms are adding to or reducing social welfare."

Coates, J.C. IV [2003], *op. cit.*, 21. The same reasoning could be extended to anti-takeover arrangements, to the extent that they are implemented *before*, and not *after*, the company's going public. As matter of fact, it seems that most of them are set up before the IPO stage, at least in the US. See *infra*, next subsection and accompanying notes.

144 This might seem too much of an oversimplification. For a more detailed comparison between takeover defenses and deviations from 'one share–one vote' see, e.g., Bebchuk, L.A. [1999], *op. cit.*, 31-36. The fact that takeover defenses substitutes for managerial control of voting rights is often overlooked by the literature. And yet this point has a long-standing tradition. See, e.g., Stulz, R. [1988], *op. cit.*, 46-48.

145 According to Easterbrook, F.H. and Fischel, D.R. [1991], *op. cit.*, 204-205, stock markets in the US do not like anti-takeover arrangements: "Firms go public in easy to acquire form: no poison pill securities, no supermajority rules or staggered boards. Defensive measures are added later, a sequence that reveals much." At least in this description, they were wrong. "[The empirical] evidence indicates that many firms deploy takeover defenses at the time of their IPOs, and firms do not substantially change their defensive postures during the five years after their IPOs. This is inconsistent with the view that IPO firms do not have takeover defenses. Rather, it indicates that managers take efforts to increase their authority over unsolicited takeover offers even at the IPO stage." Field, L.C. and Karpoff, J.M. [2002], *Takeover Defenses at IPO Firms*, in JOURNAL OF FINANCE, vol. 57, 1862.

c) How Contestability Actually Fails to Be Established

Nevertheless, firms that actually go public normally allow for various forms of entrenchment of corporate control.[146] The security-voting structure of many companies listed outside the US and the UK departs from the 'one share–one vote' arrangement.[147] This result is easily achieved when (and to the extent that) dual class shares are allowed by the legal system. Alternatively, the 'one share–one vote' rule is circumvented through pyramidal groups, cross-ownership and other similar devices for separating voting rights from ownership claims.[148] Even in the US, a few but important public companies have dual class security-voting structures that insulate them from hostile takeovers;[149] and, very often, corporate charters at the IPO (Initial Public Offering) stage allow for takeover defenses likewise shielding the incumbent management from the competitive pressure of the market for corporate control.[150] The situation in the UK is only apparently different.[151] True, US-style takeover defenses are not available to the management, and significant departures from 'one share–one vote' security-voting structures are uncommon among listed companies.[152] However, for a number of regulatory reasons, incumbent managers al-

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146 For a discussion of the empirical evidence supporting this claim, see *supra*, Chapter Two, sections 2.3 and 2.4.

147 See, e.g., Faccio, M. and Lang, L. [2002], *The Ultimate Ownership of Western European Corporations* in JOURNAL OF FINANCIAL INTERMEDIATION, vol. 65, 365-395; Claessens, S., Djankov, S., Fan, J. and Lang, L. [2000], *The Separation of Ownership and Control in East Asian Corporations*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 58, 81–112; and, lately, Bennedsen, M. and Nielsen, K.M. [2005], *The Principle of Proportionality: Separating the Impact of Dual Class Shares, Pyramids and Cross-ownership on Firm Value across Legal Regimes in Western Europe*, Working Paper, University of Copenhagen, Centre for Industrial Economics, available at www.econ.ku.dk/cie/Discussion%20Papers/2005/

148 La Porta, R., Lopez-de-Silanes, F. and Shleifer, A. [1999], *op. cit.*; Becht, M. and Mayer, C. [2001], *op. cit.*

149 Gompers, P.A., Ishii, J. and Metrick, A. [2006], *Extreme Governance: An Analysis of Dual-Class Companies in the United States*, American Finance Association 2005 Philadelphia Meetings Paper, available at www.ssrn.com; Gadhoum, Y., Lang, L. and Young, L. [2005], *Who Controls US?*, in EUROPEAN FINANCIAL MANAGEMENT, vol. 11, 339-363.

150 Field, L.C. and Karpoff, J.M. [2002], *op. cit.*, 1857-1889; Daines, R. and Klausner, M. [2001], *Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs*, in JOURNAL OF LAW ECONOMICS AND ORGANIZATION, vol. 17, 83–120.

151 See Brennan, M. and Franks, J. [1997], *Underpricing, Ownership and Control in Initial Public Offerings of Equity Securities in the UK*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 45, 391-413.

152 See, e.g., Goergen, M. and Renneboog, L. [2001], *Strong Managers and Passive Institutional Investors in the UK*, in F. Barca and M. Becht (eds.), THE CONTROL OF CORPORATE EUROPE, Oxford University Press, 259-284. In particular, pyramidal structures and cross-ownership appear to be highly unpopular; whereas dual class shares have a long-standing tradition of being opposed by institutional investors. Franks, J., Mayer, C. and Rossi, S. [2005a], *Spending Less Time with the Family: The Decline of Family Ownership in the UK*, in R. Morck (ed.), A HISTORY OF CORPORATE GOVERNANCE AROUND THE WORLD: FAMILY BUSINESS GROUPS TO PROFESSIONAL MANAGERS, NBER Conference Vol-

ways enjoy a competitive advantage over insurgent shareholders, stock ownership being equal.[153] As a result, the management of British public companies is also typically entrenched.[154]

3.4.5. Entrenchment and Private Benefits of Control

A few theoretical contributions attempt to investigate the reasons underlying the departure from an otherwise optimal 'one share–one vote' security-voting structure.[155] Intuitively, such a departure can only make sense if the original owner expects to derive significant benefits from availing himself superior voting stock or being otherwise entrenched – i.e., private benefits of control.[156] Outside sharehold-

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ume, University of Chicago Press, 581-607 (also available as NBER Working Paper No. 10628). To be sure, a significant proportion of British listed firms still appear to employ dual class security-voting structures, even though they have a negligible effect on voting power enhancement. Faccio, M. and Lang, L. [2002], *op. cit.* One possible explanation of this apparent puzzle is that dual class shares are not employed for control purposes in the UK – which would explain also why they are tolerated by institutional investors. See Bennedsen, M. and Nielsen, K.M. [2005], *op. cit.*, 10, and *supra*, Chapter Two, section 2.2.3.

153 See, e.g., Franks, J., Mayer, C. and Renneboog, L. [2001], *Who Disciplines Management in Poorly Performing Companies?* , in JOURNAL OF FINANCIAL INTERMEDIATION, vol. 10, 240-245. A more detailed analysis of this point will be provided *infra*, in Chapter Seven, section 7.3.2.

154 Crespi-Cladera R., Renneboog L. [2003], *Corporate Monitoring by Shareholder Coalitions in the UK*, ECGI Finance Working Paper No. 12/2003, available at www.ssrn.com and www.ecgi.org.

155 It should be noticed that optimality of 'one share–one vote' is derived on two alternative, but related grounds (see *supra* Chapter One, note 119): on the one hand, as a way to provide the right incentives to take decisions (Easterbrook, F.H. and Fischel, D.R. [1991], *op. cit.*, 67-72); on the other hand, as a way to foster competition on the market for corporate control (Hart, O. [1995], *op. cit.*, 189). In the latter respect, optimality does no longer hold when both the incumbent and the would-be acquirer have significant PBC. In this case, departure from 'one share–one vote' "can increase the intensity of competition in the market for corporate control and enable shareholders to extract some of the incumbent's and the rival's private benefits." Hart, O. [1995], *op. cit.*, 188 and 200-202. However, this tells us little about deviations from 'one share–one vote' that we observe in the real world, where they "[do] not correspond to a situation in which widely held securities [have] different effective voting rights, [but rather] to a situation in which the incumbent [have] all the effective votes necessary to maintain control." Id., at 207. See *supra*, Chapter Two, for a comparative review of the empirical evidence in this regard. As Oliver Hart noticed:

> "The evidence suggests that forces responsible for a deviation from one share–one vote may be not those [dependent on] the incumbent's and the rival's private benefits [being] both significant, so much as [that] it might be efficient to allocate control rights to managers in order to allow them to enjoy their private benefits, or to motivate them to undertake relationship-specific investments."

Id, at 207 (citing Laffont, J.-J. and Tirole, J. [1988], *op. cit.*, "for a similar idea").

156 Mayer, C. [1999], *op. cit.*, 5.

ers will pay much less for inferior voting stock (in general, in the presence of entrenched control) than they would do should everybody hold the same class of voting shares (in general, under a more competitive control structure). On condition that private benefits of control arise out of expropriation of outside shareholders, such a strategy might be privately optimal (from the initial owner's standpoint) but socially inefficient (*ex post* redistribution of shareholder value, in the form of private benefits of control, undermines *ex ante* the incentives to its production).[157] This is how deviations from 'one share–one vote' (as well as takeover defenses) are generally understood.[158]

However, the lack of a comprehensive welfare analysis of private benefits of control in the economics of corporate governance is also recognized.[159] As I suggested since the First Chapter – and a few economists acknowledge as well – *private*

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[157] Bebchuk, L.A. [1999], *op. cit.*, 14-17.

[158] Maybe surprisingly, this line of research is significantly underdeveloped. The mainstream view is quite negative about separation of voting rights from ownership claims, on the basis that they generate "Controlling Minority Structures," which in turn bring about significant increases in agency costs. Bebchuk, L.A., Kraakman, R.H., Triantis, G. [2000], *op. cit.* However, Oliver Hart once argued on the WSJ (Hart, O. [1988], *SEC May Kill Shareholders with Kindness*, in THE WALL STREET JOURNAL, Jul. 14, 1988) that deviations from 'one share–one vote' might also be helpful for a family-owned firm – "such as Ford in the 1950s" – "which needs new capital but is unprepared to relinquish control." He seems to have kept such a view till more recent times (Bebchuk, L.A. and Hart, O. [2002], *A Threat to Dual Class Shares,* in FINANCIAL TIMES, May 31, 2002), without endeavoring to investigate it further (Hart, O. [1995], *op. cit.*, 208). The more general idea that takeover-proofness may work as inducement to deconcentrate ownership is often mentioned but seldom investigated as a theoretical matter. See Georgakopoulos, N.L. [2001], *Corporate Defense Law for Dispersed Ownership,* in HOFSTRA LAW REVIEW, vol. 30, 11-120; Bebchuk, L.A. [2003a], *op. cit.*, 730-733; Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 29-30. There are, however, a few exceptions in both the legal and the economic literature. See, e.g., Coates, J.C. IV [2003], *op. cit.* (considering both takeover defenses and deviations from 'one share–one vote' as a device for efficient rent protection); and Zingales, L. [1995], *Insider Ownership and the Decision to Go Public*, in REVIEW OF ECONOMIC STUDIES, vol. 62, 425–448 (only considering disproportional security-voting structures as a strategy to extract control rents having just distributional consequences).
A closely related line of research tries to investigate takeover resistance as a way to protect specific investments in human capital. See, e.g., Knoeber, C.R. [1986], *Golden Parachutes, Shark Repellents, and Hostile Tender Offers*, in AMERICAN ECONOMIC REVIEW, vol. 76, 155-167; Schnitzer, M. [1995], *'Breach of Trust' in Takeovers and the Optimal Corporate Charter*, in JOURNAL OF INDUSTRIAL ECONOMICS, vol. 43, 229-259. However, Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 30, claim that "protection of specific human capital is just too easy an excuse to justify managerial entrenchment. Little or no work to date has been devoted to the question of identifying which actions or investments constitute 'entrenchment behaviour' and which do not." The present work endeavors a way out of this bind through a *qualitative* analysis of PBC, positing the existence of idiosyncratic control rents whose protection is efficient in order to promote the investment of human capital *ex ante*. For more details, see *infra*, Chapter Five.

[159] Zingales, L. [2000], *op. cit.*, 1640.

benefits of control need not reduce shareholder value.[160] In terms of positive analysis, private benefits of control that do not directly reduce the wealth of outside shareholder are sufficient to explain a dual class security-voting structure as a strategy aimed at maximizing the initial owner's proceeds from going public.[161] It is worth noting that, in one important model from where this implication is derived, "the level of private benefits has no efficiency consequences, but only distributional ones."[162] Based on a similar framework, some attempts have been made to demonstrate the *ex post* inefficiency of securing control rents that *ex ante* do not affect the production of firm's surplus. This has been argued on grounds that the farther from 'one share–one vote' the security-voting structure is, the more the same rents reduce the likelihood of control transfers that would eventually increase firm value.[163] Nobody, however, at least to my knowledge, has attempted to investigate that result any further and, more importantly, to combine it with an account of private benefits of control as an *ex ante* incentive mechanism for the production of the firm's surplus. I have repeatedly suggested that this often-neglected perspective may tell us much about how entrepreneurship is featured in corporate governance, and the role played by corporate law in this regard. For this reason, the characterization of private benefits of control as idiosyncratic control rents will be deeply investigated starting from the Fifth Chapter.

Given the state of economic research in corporate governance, all we know about idiosyncratic control rents not affecting shareholders' profits is just that they account for further, non-verifiable surplus to be divided;[164] and that the entitlement to this surplus depends on the allocation of residual rights of control. *How* that surplus should be divided, and what the *consequences* of such a division are for its production *ex ante* and its enhancement *ex post* is still to be assessed. Therefore, the most efficient criterion for allocating residual rights of control is likewise to be assessed. We simply lack normative grounds to conclude that entrenchment of corporate control always leads to *inefficient* rent protection.[165] In the Sixth Chapter, I will try to demonstrate that – under certain conditions – the opposite is true.

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[160] See *supra*, Chapter One, sections 1.3 and 1.4.5, and – in more detail – *infra*, Chapter Five, section 5.2.

[161] Zingales, L. [1995], *op. cit.*, 427-431.

[162] Dyck, A. and Zingales, L. [2004], *Private Benefits of Control: An International Comparison*, in JOURNAL OF FINANCE, vol. 59, 541 (citing Zingales, L. [1995], *op. cit.*).

[163] Bebchuk, L.A. and Zingales, L. [2000], *Ownership Structures and the Decision to Go Public: Private versus Social Optimality*, in R. Morck (ed.), CONCENTRATED CORPORATE OWNERSHIP, NBER Conference Volume, University of Chicago Press, 55-75 (also available as NBER Working Paper No. 5584).

[164] Zingales, L. [1998], *op. cit.*, 498.

[165] Two quite opposite views among Law and Economics scholars are worth mentioning in this regard. On the one hand, Coates, J.C. IV [2003], *op. cit.*, 21, contends that:

3.5. Would Any 'Stakeholder' Accept the Deal?

3.5.1. Abuse of Power by the Corporate Controller

In the foregoing analysis, I have suggested that the assignment of residual control rights to a corporate controller may be necessary to have him investing his entrepreneurial talent notwithstanding separation of ownership and control. Elaborating on the economic and legal implications of this intuition is all that the remainder of this work will be about. For the moment, let us just assume that such allocation of control rights is necessary in order to feature entrepreneurship in corporate governance, and not to have it just confined to debt, close-knit or even self-finance.[166]

> "[T]he presence of the discount on new dual class firms says nothing about whether those firms are adding to or reducing social welfare. In order to know that, one would have to know the size of the PBC that the control shareholders retain, and the idiosyncratic value that they place on those PBC; only if the discount was larger than those PBC would one be able to make any statement about the relative efficiency of dual class structures."

He then extends the same reasoning to the analysis of the most characterizing device for takeover resistance in the US: the combined use of staggered boards and poison pills.
On the other hand, Bebchuk, L.A. [2003a], *op. cit.*, 730-744, identifies two efficiency-based explanations of takeover-proofness established at the IPO stage in the form of Board Veto (BV), as opposed to two agency-based and two information-based explanations leading to suboptimal results. Focusing on the US regulation of anti-takeover devices, he then concludes:

> "To be sure, under the two efficiency-based explanations discussed above, even though BV arrangements do not increase the value of shares under dispersed ownership, it is desirable to allow and respect the adoption of BV arrangements at the IPO stage. However, each of the two agency-based explanations – and each of the two information-based explanations – indicates that some limitations on the freedom to adopt antitakeover provisions might be desirable. More empirical evidence on the extent to which each of the six explanations plays a role in the real world is needed before definite conclusions can be reached about the optimal limits on BV arrangements. The available state of knowledge, however, does justify a reasonable measure of skepticism toward claims of unlimited contractual freedom to adopt antitakeover charter provisions. For now, when public officials attach substantial likelihood to the undesirability of some arrangements, it would be sensible not to include them in the menu of permissible choices for charter provisions. A case in point might be the use of staggered boards."

Id., at 750-751. On the function of staggered boards in US corporate governance, see *infra* Chapter Seven, section 7.3.1.

[166] See Ricketts, M. [2002], *op. cit.*, 124-129 for a non-technical discussion. See also Aghion, P. and Bolton, P. [1992], *op. cit.*, and Hart, O. [1995], *op. cit.*, 95-125, for a formal analysis of entrepreneurial finance. The approach being suggested here will be more extensively discussed in Chapter Six. But at least two alternative approaches to the problem are worth mentioning. In his work with Rajan (Rajan, R.G. and Zingales, L. [1998], *Power in a Theory of the Firm*, in QUARTERLY JOURNAL OF ECONOMICS, vol. 113, 386-432), Zingales argues that firm-specific investments can be fostered by

While necessary, this is not also sufficient. What we still need to know is how this solution is made acceptable to other providers of firm inputs, in the presence of opportunities for mismanagement by the corporate controller. Basically, once in charge, the latter could wastefully play with the firm's assets (shirking), appropriate them fully or in part (stealing), or simply be incompetent but unwilling to give up the benefits from stealing and shirking (inefficient entrenchment). The next question is what category of investors is most likely to be endangered by managerial misbehavior.

3.5.2. Shareholders vs. Stakeholders: What Is Special about the Corporate Contract

In standard corporate governance terminology, some providers of firm inputs (e.g., creditors, employees, and long-term suppliers) are labeled 'stakeholders' as long as, whatever they invest in the firm, this is at least partly placed at hazard.[167] In this respect, stakeholders are contrasted to shareholders. Shareholders are stakeholders themselves, but their investment is highly peculiar: it is a share of the firm's equity – that is, of its *own* capital. Unsurprisingly, we will discover that some special protection of shareholders' investment, setting non-contractual constraints on the exercise of entrepreneurial/managerial discretion, is required to make equity finance

providing 'owners' of specialized human capital with privileged access to a 'critical resource' as a source of control power, without need of creating 'new' residual rights of control independent of firm ownership. Their view is based on a reappraisal of both the property rights theory of the firm (Grossman, S.J. and Hart, O. [1986], *op. cit.*; Hart, O. and Moore, J. [1990], *op. cit.*) and the major insights by Hansmann, H. [1996], *op. cit.*. Zingales, L. [2000], *op. cit.*, 1648. Conversely, Blair, M.M. and Stout, L.A. [2006], *op. cit.*, posit that firm-specific investments are protected through a corporation with "entity status" where a board of directors – and not shareholders – is ultimately in control and provides all stakeholders with protection and reward of their investments. See also Blair, M.M. and Stout, L.A. [1999], *op. cit.* (building upon two cornerstone publications in economic theory of the firm: Alchian, A.A. and Demsetz, H. [1972], *op. cit.*; Holmström, B. [1985], *Moral Hazard in Teams*, in BELL JOURNAL OF ECONOMICS, vol. 13, 324-340). The two matters of allocation of control rights and *ex post* distribution of (quasi) rents are of course related (see *supra*, section 3.3). Nonetheless, under separation of ownership and control, the major conflict of interest in this regard is established between the entrepreneur and outside shareholders (see *infra*, Chapter Six, section 6.2). In order to see why it is so, we should discuss the role of so-called 'stakeholders' in CG.

167 According to mainstream view, this depends on *all* contracts entered into by the firm – and not just the contract with shareholders – being incomplete, thereby exposing also stakeholders to hold-up risk. See, e.g., Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 16-19 and Zingales, L. [1998], *op. cit.*, 501. But there is at least one notable exception. According to Tirole, J. [2001], *op. cit.*, 3, the economic rationale for allowing consideration of stakeholder interest in CG is the problem of externalities. We are going to discuss both arguments in turn.

viable. Maybe more surprisingly, at least for those who claim that stakeholders should be entitled to the same degree of protection as shareholders, we will see that such a kind of protection is not also required to induce stakeholders to invest.[168] Or, at least, this should not be a matter of corporate governance.

The corporate manager is not the only one who may be required to make specific investments for the firm's success. In the view which is being presented here, he is the one whose investments may be the most indispensable (the 'magic' glue that makes unique a combination of assets within a firm) and – in the absence of full ownership – the least protected from subsequent hold-up.[169] Since a significant part of his entrepreneurial talent is unverifiable, it cannot be rewarded contractually, but only through idiosyncratic control rents. Once residual rights of control are allocated to an entrepreneur/manager for these reasons, we might have the glue but still lack enough assets to be combined.[170] In other words, we need somebody else willing to provide the assets, and to have them specialized and managed at the controller's discretion.[171] To this purpose, investors of both physical and human capital need some degree of protection from mismanagement. Such a protection could be contractual, leading to a standard principal-agent relationship (à la Jensen and Meckling). Alternatively, given contractual incompleteness and the unavailability of residual rights of control, protection could be achieved by allowing for a lesser de-

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[168] For an authoritative contrarian view, see Blair, M.M. and Stout, L.A. [1999], *op. cit.*

[169] See *supra*, section 3.4.1, and Chapter One, section 1.4.5. I am borrowing the 'glue' metaphor from Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1636. But I have to be honest: their view of the 'glue' is tied to the property rights theory of the firm. In this perspective, the entrepreneur can be regarded as 'glue' only inasmuch he 'owns' the firm's key *physical* assets. This is quite difficult to reconcile with separation of ownership and control. One possible way out of this bind is to consider the entrepreneur's *human* capital as enough of glue for assembling all stakeholders' investments together. The implications of this approach – the one being articulated in this work – are that entrepreneurs are still vested with residual control rights, but physical capital is provided for by shareholders in exchange for residual claimancy. Zingales suggests a different approach, wherein shareholders should keep residual rights of control in their capacity as ultimate owners of the firm's physical assets. In this perspective, equity capital would still work "as a glue to preserve the rents of an organization from being dissipated by competition among different stakeholders." Zingales, L. [2000], *op. cit.*, 1647. Stakeholders (including entrepreneurs and managers) would be entitled to different sources of control rights, in that they control access to critical resources for the firm's success. Rajan, R.G. and Zingales, L. [1998], *op. cit.*, 422-425.

[170] Of course this depends on residual control rights being separated from ownership of the firm's key physical assets. Indeed, the view of entrepreneurship being presented here departs from mainstream property rights theory, in order to explain how a brainy but penniless entrepreneur can also raise equity funds. This is how the problem is framed, e.g., by Aghion, P. and Bolton, P. [1992], *op. cit.*, 475-479. See also the previous note.

[171] Zingales, L. [2000], *op. cit.*, 1645.

gree of asset specificity: the less specialized (locked-in) to the firm are the assets, the easier they are to redeploy outside the firm by a dissatisfied investor.[172]

Non-controlling owners, namely outside shareholders, are the firm's stakeholders most severely ill equipped in both respects.[173] As far as contractual protection is concerned, it should be noticed that equity contracts are almost empty at their core.[174] In exchange for the resources they provide, shareholders receive only residual claims on the firm's assets, together with a vague promise that the value of their claims will be maximized through the firm management. Such a promise is supported by almost no contractual commitment by the manager.[175] One should not be surprised though: the pursuit of a prospective, open-ended stream of profits requires discretion.[176] The only contractual safeguards that can be allowed are those intended to align the exercise of this discretion with the shareholders' interest. In any case, these safeguards are negatively affecting either the overall prospective value of the residual claim (some potentially profitable business opportunities might be foregone because of too many constraints on the manager's discretion), or the share of this residual claim available to shareholders (the larger the share of the residual claim they give to the manager, the smaller what is left for themselves). Because of these tradeoffs, the degree of alignment of managerial incentives that can be reached contractually will always be much less than perfect.[177]

The weakness of contractual safeguards available to shareholders is only partly due to the agency costs arising from asymmetric information.[178] It is mostly due to the particular features of the problem of contractual incompleteness affecting the

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172 For this kind of framework, see Williamson, O.E. [1985], *op. cit.*, 298-325.

173 I am not considering a conventional third ground for arguing shareholder primacy in CG, namely their investment as owners of the corporation being 'more valuable.' As Zingales puts it, this argument is "clearly unfolded," for there is no reason "to dismiss human capital investments as second order to financial investments." Zingales, L. [1998], *op. cit.*, 501. See Blair, M.M. [1995], *op. cit.*, 262-267 for a review of the empirical evidence on quasi-rents generated by human capital relative to those created by virtue of physical assets.

174 Bratton, W.B. and McCahery, J.A. [2001a], *Incomplete Contracts Theories of the Firm and Comparative Corporate Governance*, in THEORETICAL INQUIRIES IN LAW, vol. 2, n. 2, *Protecting Investors in a Global* Economy, 14.

175 Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1654-1660.

176 This is actually the ultimate reason why issuing residual claims is efficient: that is, "to direct decisions towards the interest of residual claimants" (i.e., the firm's profit) instead of allocating a number of state-contingent claims which specify payoffs for each possible future state of the world." Fama, E.F. and Jensen, M.C. [1983a], *op. cit.*, 302-303. See also Fama, E.F. and Jensen, M.C. [1983b], op. *cit.*, 328-329.

177 Jensen, M.C. and Meckling, W.H. [1976], *op. cit.*, 327-330

178 In this, we know, shareholders could even enjoy some advantages over stakeholders, especially over creditors. See, again, Jensen, M.C. and Meckling, W.H. [1976], *op. cit.*, 333-343, and *supra*, section 3.1.2.

provision of equity capital.[179] True, lacking a general theory of why contracts are incomplete, we should not be entitled to say thoroughly whether one kind of contract is *more* incomplete than another is.[180] However, I feel rather confident about claiming that equity contracts are at least *particularly* incomplete. This is not because shareholders' basic obligations ('provision of funds') are unspecified, but because the manager's ('making profits') are.[181] And it could not be otherwise, since profit is – and must be – a residual variable.[182]

What is 'residual' is not simply unspecified; it is non-specifiable. Indeed, either you specify in advance how much of the cake do you want, and then you can ask the baker to provide some guarantees he will not produce less than that. Alternatively, you go for a share of what is left after all promised slices are handed over, but then you cannot get from the baker any meaningful guarantee that the cake would be as big as possible.[183] Apparently, shareholders prefer the second alternative, stakeholders the first one.

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179 Managerial discretion is a crucial feature of CG in an incomplete contracts perspective. Constraining its exercise is not just a matter of agency costs, but mostly a question of frustrating management initiative and firm-specific investments. See, illustratively, Bratton, W.B. and McCahery, J.A. [2001a], *op. cit.*, 30-34, and references cited therein. The flip side of the coin is that, once unconstrained managerial discretion is allowed in the maximization of shareholder residual claim, shareholders can no longer be in control and risk being expropriated of their investment. The situation of other stakeholders is different inasmuch as they have state-contingent claims.

180 According to Zingales, L. [1998], *op. cit.*, 501, this is the reason why the usual claim that "stakeholders can protect their investments better through contracts" cannot be proved on a sound theoretical basis. However, he admits that the argument is also difficult to dismiss for the same reason.

181 Compare this argument with the weak objection raised by Zingales, L. [1998], *op. cit.*, 501, against the alleged shortage of contractual safeguards to shareholders: "If there is a contingency that is easily verifiable, it is the provision of funds. Thus, it is not obvious why providers of funds are at a comparative disadvantage."

182 Notice that, if profit were not a merely residual variable, failing to provide shareholders with a contractually specified return on their investment would ultimately trigger bankruptcy. Issuing outside equity is just aimed at avoiding this result. This is independent of control considerations (the insider's control rights being unquestioned) and is only due to the fact that "it is costly, if not impossible, to write contracts representing claims on a firm which clearly delineate the rights of holders for all possible contingencies." Jensen, M.C. and Meckling, W.H. [1976], *op. cit.*, 340. The literature on contractual incompleteness subsequently showed that residual claimancy has a bearing on the optimal allocation of control rights. Hart, O. [1995], *op. cit.*, 29-55. However, what risks to be overlooked by the emphasis on control considerations is that also the existence of residual claims owes to the problem of contractual incompleteness, and that allocation of residual control rights matters only as a consequence.

183 Still, you would like to have the baker interested in producing as much surplus cake as he can, unable to steal your share of it, and induced to change his job as soon as a more talented baker becomes available. This problem will be the subject-matter of the Sixth Chapter.

For shareholders, trying to avoid being locked-in their own firm-specific investment is also not an option.[184] Equity investment is unavoidably characterized by a considerable degree of asset specificity, which is independent of shareholders' will.[185] This might seem counterintuitive. Shares of equity capital are often exchanged for cash in secondary markets. After all, what shareholders typically invest is the least specialized commodity: money. The first claim is not pertinent to shareholders as a group: 100% of the firm's shares could be sold, at most, in a highly illiquid market for firms.[186] The second argument is also misguided. What matters for asset specificity is not what shareholders invest, but the entitlements that they receive in exchange for their investments. These entitlements do not include any right on whatever (money or anything else) shareholders provided to the firm, but only a residual claim on the firm's assets. An open mandate to specialize those assets is conferred to the manager. This means that, once shareholder investment is placed under the corporate controller's management, it is committed either to the purchase of highly firm-specific assets or to be (almost irreversibly) combined with them.[187]

Simply put, whatever shareholders invest, they are never *entitled* to get it back.[188] Even if they had residual rights of control, they could only liquidate the firm's assets after they have been specialized, thereby losing most part of the value of their

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[184] In the review by Zingales, this is the third ground for arguing 'special treatment' of shareholders relative to stakeholders, and is indeed the "most convincing" one: "Other stakeholders have other sources of power *ex post* that protects their investments." Zingales, L. [1998], *op. cit.*, 501.

[185] This point, which is still the most powerful argument for shareholder primacy over stakeholders, was first raised by Oliver Williamson. According to Williamson, "suppliers of finance bear a unique relation to the firm." The productive assets of non-financial stakeholders "normally remain in the suppliers' possession." However, while debt-holders usually avail themselves long-term contractual safeguards, this is not an option for stockholders. The reason is twofold. On the one hand, "stockholders […] are the only voluntary constituency whose relation with the corporation does not come up for periodic renewal." On the other hand, "stockholders are also unique in that their investments are not associated with particular assets." Williamson, O.E. [1985], *op. cit.*, 304-305. According to Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 18, "an obvious question raised by Williamson's argument is that if it is possible to get better protection by signing debt contracts, why not encourage all investors in the firm to take out debt contracts?" The answer is that every firm has a limited indebtedness capacity, due to the costs of financial distress which in turn owe to contractual incompleteness. See *supra* Chapter One, section 1.2.

[186] Williamson, O.E. [1985], *op. cit.*, 304.

[187] Economists and lawyers share this as a common argument for shareholder primacy over all stakeholders other than management. See, respectively, Williamson, O.E. [1985], *op. cit.*, 305 and Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1658-1660. For the view that management (and entrepreneurs) is a special stakeholder constituency, see *infra*, section 3.5.3.

[188] See, e.g., Shleifer, A. and Vishny, R. [1997], *op. cit.*, 764.

initial investment.[189] The difference between the latter and the liquidation value of shareholders residual claim is a sunk cost.[190] This means that the same difference is lost forever once the firm is set up, no matter of the allocation of residual rights of control. Conversely, allocation of residual rights of control matters a lot for the production of any unverifiable surplus by an entrepreneur or a manager: this surplus would never come to light without the protection afforded by residual rights of control.[191] Shareholders are willing to give up residual rights of control because this is the only way they can commit themselves not to hold up the entrepreneur in case he is successful.[192] Then their position becomes extremely weak. They cannot prevent the manager from uselessly exploiting their investment, by making it even more sunk than necessary.[193] This is, however, just a part of a broader problem: that of avoiding the managers' misuse of shareholders resources, in both bad and good states of the world, due to either opportunistic behavior or incompetence.[194] To this purpose, shareholders desperately need protection of their residual claim, and that protection can be obtained neither through more detailed contractual provisions nor by means of residual rights of control.

Stakeholder position is different. To begin with, stakeholders typically do not get a residual claim on the firm's assets.[195] That makes the return on their investment

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[189] Notice that, as a matter of law, shareholders of a publicly held corporation do not have such a right. Individually, they have no entitlement to being bought out, apart from the exceptional circumstances that trigger exit rights (basically, the appraisal rights in the US and the mandatory bid and sell-out rights in Europe). As a group, "they cannot compel the dissolution of the firm, except by unanimous consent." Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1655. Therefore, shareholders can only command liquidation of the firm's assets on condition that they have a controlling position which is also strong enough to squeeze-out minority shareholders and take the company private. This is the typical outcome of a successful takeover. Therefore, whether or not shareholders are vested with residual control rights depends on their being determinant for the success of a takeover. We will see that actually they are not, whereas the corporate controller's consent is. Given that non-controlling shareholders do not have the last word on takeovers, they also do not have residual rights of control. See *supra*, Chapter Two, section 2.4, for a review of the evidence, and *infra*, Chapters Five and Six, for discussion of the underlying rationale.

[190] See *supra* Chapter One, section 1.4.5.

[191] For a similar approach (albeit with different implications), see Aghion, P. and Bolton, P. [1992], *op. cit.*, 479-786.

[192] See *infra*, Chapter Six, section 6.2.

[193] See, e.g., Shleifer, A. and Vishny, R. [1989a], *op. cit.*

[194] Tirole, J. [2001], *op. cit.*, 5-23.

[195] Jensen, M.C. and Meckling, W.H. [1976], *op. cit.*, 311. One important exception is the mutual enterprise, i.e. cooperatives. But there stakeholders also qualify as firm's owners. See Hansmann, H. [1996], *op. cit.*, 11-22. As I mentioned at the beginning of this Chapter, the present work only deals with business corporations. Nevertheless, cooperatives and the role of stakeholders in CG are two closely related subjects. See *infra*, notes 200-201.

easier to protect contractually.[196] This is indeed the traditional argument against stakeholder involvement in corporate governance, whose virtue has been questioned with the advent of the literature on contractual incompleteness. When all contracts are incomplete – the argument goes – there is no compelling reason to exclude stakeholders from what is left after the contractual obligations are fulfilled, that is from residual claimancy.[197] However, a second argument for making a distinction between stakeholders and shareholders is decisive, and it explains also why only the latter should be considered as residual claimants, whereas the former should be not.

Differently from shareholders, stakeholders are able to set limits on how much their investment can be specialized by the firm's manager, thereby improving their *ex post* bargaining power.[198] For instance, creditors normally ask for easy-to-liquidate collateral, most promising young executives often ask their employers to pledge for an MBA. The reason why they can easily do this, without worrying too much of

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[196] Easterbrook, F.H. and Fischel, D.R. [1991], *op. cit.*, 24-25 and 67-72.

[197] See, illustratively, Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 16-21. The underlying rationale is that – not differently from shareholders' – stakeholders' investments are characterized by a high degree of asset specificity. In the spirit of Williamson, O.E. [1985], *op. cit.*, 298-325, it is exactly this point that I am going to criticize in the text. Unsurprisingly, the idea that all stakeholders may have to undertake firm-specific investments under contractual incompleteness has led to quite different, and somewhat opposite, implications for the allocation of control rights. According to Zingales, L. [2000], *op. cit.*, 1645-1651 (building upon his work with Rajan: Rajan, R.G. and Zingales, L. [1998], *op. cit.*; Rajan, R.G. and Zingales, L. [2001], *The Firm As a Dedicated Hierarchy: A Theory of the Origins and Growth of Firms*, in QUARTERLY JOURNAL OF ECONOMICS, vol. 116, 805-851) stakeholders are *actual* residual claimants whose specific investments are protected by their controlling access to a critical resource and are bound to each other by the owner's (the shareholders') residual rights of control. According to Blair, M.M. and Stout, L.A. [2006], *op. cit.*, stakeholders are *potential* residual claimants whose specific investments are protected by assigning control rights to a "mediating hierarchy" – the board of directors – which is committed to reward *all* members of the corporate team out of the firm's residual, and not just shareholders. See also Blair, M.M. and Stout, L.A. [1999], *op. cit.*

[198] In other words, stakeholders' investments are easier to protect from subsequent hold-up compared to shareholders'. This is wonderfully illustrated by Williamson, O.E. [1985], *op. cit.*, 298-325, who contrasts shareholder position with that of other firm's stakeholders. The argument is agreed upon also by advocates of consideration for stakeholder interest in CG, like Zingales, L. [1998], *supra op. cit.*, 501 and Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 16-20 (claiming, however – as I also do –, that this is not enough of a reason for vesting shareholders with residual control rights). Notice that this is equivalent to turning upside down Easterbrook and Fischel's argument that stakeholders can better protect themselves contractually. It is not the absence of residual claimancy that makes stakeholder position stronger. Stakeholders simply *choose* to have a better outside option. Stakeholder investment is subject to a lesser degree of asset specificity, either because stakeholders retain ownership of the assets or they set constraints to their specialization, and then they have no residual claim on the firm's assets. Differently from shareholders, they are not interested in such a claim, but rather in getting their investment back together with a predetermined return.

constraining managerial discretion over the assets they provide, is that they are not interested in the maximization of an open-ended stream of profits.[199] Therefore, stakeholders' lower exposure to hold-up risk (relative to stakeholders) and the absence of residuality in their claims on the firm's assets are just two sides of the same coin. Stakeholders simply *choose* not to have a residual claim in order to improve their bargaining position *ex post*.

Stakeholders unhappy with what they get from their contracts can always give up their position and become shareholders. We do not have necessarily to assume any discontinuity here. Creditors, employees, or suppliers can and sometimes do take a *hybrid* position, whenever a residual claim is necessary to induce them to accept further (discretionary) specialization of their assets, but still they do not want to commit the whole of their investment to the firm. We are thus back to the fundamental alternative between markets (consensus) and hierarchies (authority) that explains the firm's existence. In this regard, the analysis of hybrid stakeholder-shareholder positions would be a very interesting topic for a theory of business organizations.[200]

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[199] This point is made explicitly by Bainbridge, S.M. [2002a], *op. cit.*, 469-472. But it is implicit also in Williamson's analysis. Managerial discretion (or power) is a key feature of the theory of the firm. It is both the reason why the firm exists – Coase, R.H. [1937], *op. cit.* – and the source of its surplus value over market exchange – Williamson, O.E. [1975], *op. cit.* There is nowadays little question about the accuracy of these basic insights. And yet, some of their implications for CG are often overlooked. As residual claimants, shareholders are primarily interested in featuring management with discretion, whereas stakeholders are not. But management is also interested in its own discretion, and this interest may differ from that of shareholders. This implies that management is to be regarded as a stakeholder constituency, too. Surprising as it may appear, this perspective is normally neglected in both the studies and the policy debates concerning CG. There are at least two reasons for this omission. On the one hand, "management is thought to be in effective control of the corporation," and this makes it difficult to treat it as a constituency to be protected by CG. Williamson, O.E. [1985], *op. cit.*, 312-319. On the other hand, managers do not like to be addressed as stakeholders on their own. Rather, they want "to divert attention away from the fact that management is a player in its own right, interested in keeping control of the company's assets and wanting to remain in charge." Hellwig, M. [2000], *op. cit.*, 128.

Management is a stakeholder, nevertheless, albeit a very special one. Management is "centrally implicated" in all contracts entered into by the firm, and that centrality "distinguishes it from all other constituencies." Williamson, O.E. [1985], *op. cit.*, 318. Its relationship with shareholders is particularly important, for it may easily involve bilateral asset specificity. When managers are required to make firm-specific investments, in return they will ask for safeguards, possibly without undermining shareholder protection. According to Williamson, these safeguards may take the form of golden parachutes, board representation and, under certain conditions, takeover resistance. The present work elaborates on this intuition. See *infra*, Chapter Six.

[200] This issue is very often neglected by the literature on CG, but is not novel. Still the best available illustration of the matter is provided by Hansmann, H. [1996], *op. cit.*, 11-49. In his broad discussion of alternative forms of firm ownership, Hansmann analyzed the divergence of interests among different categories of parties entitled to control rights. As a positive matter, firms may be owned by

However, to the purposes of corporate governance, the two positions of shareholder and stakeholder should be considered separately.[201] As stakeholders, provid-

different categories of "patrons" – which is simply another way to describe stakeholders. Investors are just one kind of patrons – providers of capital. Likewise, investor-owned firms are just one way of allocating ownership rights. In fact, ownership rights can also be allocated to different patrons, like workers, suppliers, or customers. And this is how they are actually allocated in cooperatives, as opposed to business corporations. As a normative conclusion, cooperatives might be the most efficient CG arrangements in certain situations, namely when one class of patrons have the lowest cost of ownership (due to decision-making and monitoring costs) and the highest cost of market contracting (due to asset specificity and asymmetric information). However, in large-scale business it is optimal to allocate ownership despite of costs of both ownership and contracting being high because of asymmetric information, depending on which category is most likely to be locked-in its own investments and has the lowest cost of decision-making. Shareholders have both these features, being the constituency with the most homogeneous interests and the highest exposure to the problem of asset specificity. That explains why business corporations are the prevailing form of organizing large-scale enterprises, but there is a myriad of smaller firms organized in a cooperative form. Hansmann, H. [1996], *op. cit.*, 46-49. For further discussion of cooperatives and their governance, see Hendrikse, G. W.J. [2005], *op. cit.*; Hendrikse, G. W.J. and van Oijen, A. A.C.J. [2002], *Diversification and Corporate Governance*, Working Paper, Erasmus University (ERIM series), available at http://hdl.handle.net/1765/202.

201 There is at least a contrarian view that is worth discussing in detail, for it is closely related to the analysis of optimal allocation of control rights that will be undertaken in Chapter Six. In a very interesting series of articles, Rajan and Zingales have tried to carry Hansmann's insights further. On the one hand, they argue that the 'new enterprise' looks nowadays more similar to a cooperative than to a traditional business corporation, due to the increased importance of human capital. Rajan, R.G. and Zingales, L. [2000], *op. cit.* On the other hand, they maintain that ownership should reside with shareholders, any other (hybrid) arrangement being suboptimal. Rajan, R.G. and Zingales, L. [1998], *op. cit.* However, their argument differs from Hansmann's in that they posit that there are multiple sources of control rights within a firm. Then, allocating ownership is not just a matter of minimizing decision making costs among one single class of stakeholders but, rather, of avoiding dissipation of rents due to competition among different categories of stakeholders (like, for instance, the entrepreneur, management, and labor). Vesting the owners (that is, shareholders) with residual control rights is then a solution for avoiding disruptive fighting *ex post* which would undermine firm-specific investments *ex ante*. On the one hand, owners do not decide how much management and labor will specialize, but they are committed to fire them if they do not – they can easily replace them through the market. On the other hand, no matter of how powerful management and labor becomes by specializing the critical resource whose access they control, they would not be able to take over the owners' position – unless they buy them out. Rajan, R.G. and Zingales, L. [2001], *op. cit.*

This approach to the theory of the firm is extremely suggestive, and a very promising line for future research. Unfortunately – as also Zingales recognize – it just "an attempt to develop […] a theory which does not yet exist." Zingales, L. [2000], *op. cit.*, 1645. One fundamental question that such a theory should address is "how power is maintained and enhanced, and how it is lost." Id., at 1644. Rajan and Zingales just provide a partial answer to this question. The reason is twofold. First of all, their notion of access to a critical resource as a source of power does not explain how this power is maintained over time if not by virtue of incremental specialization of human capital and secrecy of underlying information ("divide and conquer," as they put it). See Rajan, R.G. and Zingales, L. [1998], *op. cit.*, 395-406, and Rajan, R.G. and Zingales, L. [2001], *op. cit.*, 805-812. However, ers of firm inputs can negotiate with the manager both limited asset specificity and detailed contractual protection.[202] As shareholders, the same investors are instead at

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it is at least doubtful that this process can continue indefinitely (markets, and especially financial markets, live on information leakage – see, in general terms, Gilson, R.J. and Kraakman, R.H. [1984], *The Mechanisms of Market Efficiency*, in VIRGINIA LAW REVIEW, vol. 70, 549-644). Secondly, the dynamic way out of this impasse just features a pattern of internal growth of the firm. Rajan and Zingales demonstrate that entrepreneurs, by selecting a certain form of hierarchy, are committed to sell firm control to the best bidder within the internal organization instead of replacing the management. It is therefore the chance of getting control eventually by means of an *internal* sale that should ultimately motivate firm-specific investments and explain firm's growth. Rajan, R.G. and Zingales, L. [2001], *op. cit.*, 835-840. But what about *external* growth, that is Mergers & Acquisitions, and takeovers? Curiously enough, the matter is neglected in the otherwise comprehensive review by Zingales, L. [2000], *op. cit.* And yet, one of the few uncontested evidences about takeovers is that the incumbent management is replaced thereafter. Therefore, a theory of the firm based on access to critical resources where stakeholders are bound to stick together for fear of losing the owner's (shareholders') support can only explain how organizations are created and evolve over time to exploit growth opportunities, but not also how they are bought and sold to the same purpose. As such, this framework is more suitable for a theory of business organizations than for a theory of corporate entrepreneurship. Even though Zingales claims that their theory would be also very useful to explain the process by which "new firms are created to exploit growth options that existing firms cannot or do not want to exploit," (Id., at 1650-1651) it is not clear why it should be. As wee will see in Chapter Six, section 6.2, access to a critical resource is simply not enough to support entrepreneurship in the absence of ownership, whereas residual rights of control are needed to protect the investment of entrepreneurial/managerial talent from *ex post* exploitation by the owners.

202 Of course, this does not involve that stakeholders are not exposed to hold-up risk, but just that they may contract for a *lower* exposure relative to shareholders. I am not questioning that contractual incompleteness is pervasive in the web of relationships that characterize economic (and human) interaction in the real world. I am just claiming that CG is a very peculiar way to deal with this problem, anytime the hold-up risk is too high to be dealt with by market contracting. In the spirit of Coase and Williamson, this is why a firm is created. The reason why it is created in the corporate form is that corporations provide, in addition, an incentive compatible way for dealing with high hold-up risk affecting the investments of both entrepreneurs and financiers. This arrangement is not replicable by market contracting, where either labor or capital risk being underinvested due to hold-up problems involved in employment and debt contracts. The corporate form features a much higher degree of asset specificity in the relationship between the entrepreneur (management) and its financiers (shareholders), provided that both categories of players enjoy sufficient protection of their investment. As such, corporations cannot be merely regarded as "nexuses of contracts." Neither should they be regulated as if they were, namely by borrowing rules and principles from the legal discipline of commercial transactions. The latter may be possibly aimed at filling in the gaps in stakeholder (incomplete) contracts with the firm, thereby promoting more relationship-specific investments in labor, credit, supply, and product markets. But corporations are 'gap-fillers' themselves, which allow for asset specificity being enormously higher than in the purchase of inputs or in the sale of output. On the risks of confusing the two domains (markets and hierarchies) when extending the legal discipline of commercial transaction to corporate law, see Rock, E.B. and Wachter, M.L. [2002], *Dangerous Liaisons: Corporate Law, Trust Law, and Inter-doctrinal Legal Transplants*, in NORTHWESTERN UNIVERSITY LAW REVIEW, vol. 96, 651-673. See also *infra*, Chapter Four, section 4.5.4.

the controlling entrepreneur's mercy. The whole of their investment *qua* shareholders is potentially sunk, detailed contractual safeguards are not (and cannot be made) available, and they have even to relinquish their residual rights of control in the hope for some profits.

In this perspective, only a third category of investors can be considered as relevant stakeholders in corporate governance. This is the management, to the extent that it performs an entrepreneurial function. Managerial skills may be likewise characterized by a formidable degree of asset specificity but, differently from shareholders' investments, their prospective value is not verifiable and thus a commensurate reward can only be granted via residual control rights.[203] While this solution would not affect the position of other stakeholders, featuring management with residual control rights is extremely risky for shareholders. In the absence of other protections of shareholders' residual claim, nobody would be willing to supply the firm with equity funds, separation of ownership and control would be impaired, and entrepreneurial innovation would be confined to debt and self-finance. For this reason, I believe that shareholder protection from managerial misbehavior lies at the core of the corporate governance problem, whereas stakeholder protection does not. Management is no exception to this statement. Even considering entrepreneurs and managers as stakeholders, they should not be protected from their own misbehavior but, rather, from hold-up by shareholders. Therefore, I shall continue to characterize corporate governance as a relationship between a corporate controller and non-controlling shareholders, leaving stakeholders out of the play.

[203] There is little question about entrepreneurial and managerial talent being, at least partially, unobservable and unverifiable. See, e.g., Laffont, J.-J. and Tirole, J. [1988], *op. cit.*, 529-531 and Hart, O. [1995], *op. cit.*, 95-125. Disagreement arises on the implications of this circumstance on the efficient location of control rights. For instance, according to Aghion, P. and Bolton, P. [1992], *op. cit.*, 486-490, this should lead to a state-contingent allocation of control rights (in the form of debt contracts) featuring entrepreneurs with residual control rights and investors with adequate protection only in bad states of the world. Conversely, Rajan, R.G. and Zingales, L. [1998], *op. cit.*, 422-423, allow for separation of ownership and control featuring investors with residual control rights, and entrepreneurs and managers with the power to withdraw access to their unverifiable skills. I try to develop a different solution by vesting residual control rights in the management, and protecting otherwise shareholders' residual claim. This is somewhat closer to the original intuition by Laffont, J.-J. and Tirole, J. [1988], *op. cit.*, (who however assume complete contracting, and thus do not feature residual control rights), subsequently developed among others by Schnitzer, M. [1995], *op. cit.*, in an incomplete contracts setting. See *infra*, Chapter Six.

3.5.3. Externalities of the Corporate Contract: Are There Any?

By focusing on the relationship between the corporate controller and non-controlling shareholders, we risk to overlook an important problem. That relationship could produce negative externalities on stakeholders, since they are not at the bargaining table together with the entrepreneur and the outside shareholders.[204] Negative externalities would lead, in turn, to both suboptimal provision of stakeholders' investments and the overall reduction of social welfare. There are many examples of such externalities. For instance, increasing debt/equity ratio, or undertaking overly risky projects, may undermine the interest of outstanding creditors; managerial incompetence might lead to unemployment; reacting (or failure to react) to changed circumstances might drive efficient long-term suppliers out of business; development of hazardous activities or products can damage health and safety of either the customer or the members of an entire society.

While I do not question the importance of these and similar issues, I believe that corporate governance should not deal with them. The reason is straightforward: none of these externalities arise from separation of ownership and control, which is the object of the bargaining table stakeholders are missing from – and, in my view, also the core problem of corporate governance. Given that limited liability is also available to the entrepreneurial firm, I cannot see why a corporate controller, non-controlling shareholders, or both should be less concerned of stakeholders than an entrepreneur with full ownership. Actually, when stakeholders are entitled to interfere with the management of a non-entrepreneurial firm, the reverse might become true. Most often, however, when ownership is separated from control higher consideration for stakeholders is just the alleged reason for preserving the corporate controller's interest. Accountability to many is in fact accountability to none. Therefore, the standard argument against a "stakeholder society" is that it would leave management with too much discretion.[205] As Hellwig puts it, "The CEO of a corporation may defend himself in one year against shareholder interference by citing stakeholder interest, and in the next year announce layoffs in the name of shareholder value."[206] Consideration for stakeholders in corporate governance is then merely a device for empowering management and disenfranchising

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[204] See, in these terms, Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 19-20 and 48-57. See also Tirole, J. [2001], *op. cit.*, 23-33.

[205] See, e.g., Jensen, M.C. [2001], *op. cit.*, 14; Macey, J.R. [1992], *An Economic Analysis of the Various Rationales for Make Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, in STETSON LAW REVIEW, vol. 21, 23-44; Tirole, J. [2001], *op. cit.*, 25.

[206] Hellwig, M. [2000], *op. cit.*, 128.

shareholders.[207] This might be even not too bad in some circumstances, but certainly has little to do with the protection of any stakeholder but the management.

Conversely, one might argue that stakeholder involvement in corporate governance is the price to pay for large-scale equity finance. After all, large publicly held corporations are likely to produce more dangerous externalities than small entrepreneurial firms. This is quite often asserted in debates on public policy. A more refined version of the argument is provided by Shleifer and Summers.[208] In their capacity as financiers, outside shareholders may wish to redistribute wealth from stakeholders to themselves, and the market for corporate control may provide them with a succulent opportunity to do so. Shareholders of takeover targets may just gain from externalizing on stakeholders the negative effects of changes in control. This requires that takeovers be hostile. An owner-manager would be committed not to take advantage of stakeholders he has established a relationship with, whereas outside shareholders simply would not care.

The argument has some virtue, but one major shortcoming: it neglects all stakeholders that are yet to be born.[209] Takeovers are a dynamic process whereby entrepreneurship is implemented under conditions of separation of ownership and control.[210] As such, they involve "creative destruction" of stakeholders as well.[211] But the problem has to be put in the right perspective. Specific investments on stakeholder side are no more exposed to hold-up in takeovers than they would be in the general case of alteration of labor, inputs, or product market conditions faced by an entrepreneurial firm. The only difference is that, upon such changes, takeovers promote *overall* reallocation of resources supplied by stakeholders, which is efficient *ex post* inasmuch as takeovers are motivated by maximization of the firm value. As a result, new stakeholders will emerge and some others will disappear, depending on whose resources are valued the most. There will be winners and losers, but stakeholders as a class will hardly be worse off, provided that shareholders as a class are better off. [212]

Competition between actual and potential stakeholders underlies the above process and just involves pecuniary externalities, like the entry of a new competitor

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[207] "The 'residual power' of management to disenfranchise outside shareholders is significantly related to its ability to rally stakeholder interests to its support in political and judicial controversy." Id., at 125

[208] Shleifer, A. and Summers, L.H. [1988], *op. cit.*

[209] Hellwig, M. [2000], *op. cit.*, 125.

[210] For this approach, see Ricketts, M. [2002], *op. cit.*, 301-302.

[211] For the famous notion of entrepreneurship as 'creative destruction' see Schumpeter, J.A. [1943], CAPITALISM, SOCIALISM, AND DEMOCRACY, Unwin University Books, 82-85. In this regard, see also *infra* Chapter Five, section 5.2.5.

[212] Hellwig, M. [2000], *op. cit.*, 125, apparently analyzes the problem in a similar perspective.

in a market. Rents will be redistributed among market participants, but social welfare will be enhanced overall. Externalities are instead non-pecuniary when competition forces redistribution of quasi-rents from one class of stakeholders to another, thereby making the former unwilling to make any firm-specific investment. As we know, this applies to stakeholders just to the extent that the resources they provide to the firm have no alternative use. Employees, lenders, suppliers, and customers are rarely so much locked-in to the firm. Whatever protection from (takeover) externalities they cannot get contractually, it will be retained in the form of property rights on redeployable assets;[213] corporate governance adds little, if anything, to this outcome.[214]

The situation is different for management situated on top of the firm's hierarchy. Here the argument of takeover exploitation by shareholders is more forceful, for it equally applies to present and would-be management constituencies.[215] Human capital investment is hardly redeployable once it is committed to uncovering new profit opportunities available to one specific firm. Contractual protection is also not an option, given that these opportunities are both unobservable and unverifiable by definition. Property rights could still do inasmuch as managerial human capital is bundled with ownership of the firm's physical assets to which it is committed. Yet separation of ownership and control makes also this arrangement unattainable. Paradoxically, then, management may be in charge of engineering the entrepreneurship process while being otherwise at the owners' mercy.[216] Should takeover gains be just divided between shareholders of the target and those of the aggressor, neither incumbency nor insurgency could provide managers with a re-

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213 Notice that this is ultimately an application of the Coase Theorem. When transaction costs are high – and this is the certainly case when idiosyncratic investments are involved – the allocation of property rights *does matter* for the efficiency of the exchange, whereas it would not in a zero transaction costs environment. Quoting directly from Coase:

> "In these conditions the initial delimitation of legal rights does have an effect on the efficiency with which the economic system operates. One arrangement of rights may bring about a greater value of production than any other. But unless this is the arrangement of rights established by the legal system, the costs of reaching the same result by altering and combining rights through the market may be so great that this optimal arrangement of rights, and the greater value of production which it would bring, may never be achieved."

Coase, R.H. [1960], *op. cit.*, 16. See also Williamson, O.E. [1975], *op. cit.*

214 Cooperatives may be considered as an important exception to this statement. See *supra*, section 3.5.2.

215 To be sure, Shleifer, A. and Summers, L.H. [1988], *op. cit.*, did not include management among the constituencies which risk being exploited by shareholders in a takeover contest. And yet, the subsequent literature extended their argument to the management and its firm-specific investments. See, e.g., Schnitzer, M. [1995], *op. cit.*

216 See, illustratively, Ricketts, M. [2002], *op. cit.*, 301-321.

ward for firm-specific investments (which, therefore, they would never make at the outset). Either entrepreneurship or separation of ownership and control would be impaired, the two being ultimately incompatible. If there is a problem involved by takeovers, it does not concern the externalities that shareholders may impose on stakeholders, but the management's bargaining position relative to that of outside shareholders.[217] However, to the extent that the two constituencies sit at the same 'bargaining table,' this can be hardly characterized as problem of externalities.

In conclusion, separation of ownership and control does not involve further externalities on the firm's stakeholders. For this reason, the problem of adverse effects of corporate management on stakeholders should be dealt with by regulating the firm's activity, not the way in which this activity is governed or financed. In other words, whatever non-contractual protection stakeholders may need, that should be *neutral* to corporate governance arrangements and be rather pursued through alternative devices like, for instance, competition law, tort law, employment law, bankruptcy law, and so on.

3.6. The Core Conflict of Interest: Shareholders and the Corporate Controller

Now we know why shareholders need to be protected in corporate governance. *But what should shareholders be protected from?* Before focusing our attention on the kind of protection that is necessary to make sure that shareholders are willing to invest, we need a better understanding of the corporate controller's behavior that *really* endanger shareholders' investment.

One should be very careful here. Inefficient managerial misbehaviors (moral hazard and adverse selection) should be challenged to the extent shareholders can only imperfectly constrain them by means of incomplete contracts, for the same behaviors are sources of agency costs that ultimately undermine the provision of equity finance.[218] Once contractual incompleteness is taken into account, the agency paradigm teaches us that prospective extraction of private benefits of control, which would reduce shareholder value, makes shareholders less willing to invest at the outset. [219] Inability of the corporate controller to commit not to extract private

[217] Hellwig, M. [2000], *op. cit.*, 112-122 and 125.
[218] Shleifer, A. and Vishny, R. [1997], *op. cit.*, 740-748.
[219] Roe, M.J. [2004b], *op. cit.*, 3-4.

benefits of control at the shareholders' expenses then raises the cost of outside equity capital without providing any countervailing benefit.[220]

However, contractual incompleteness has also another consequence, which has little to do with agency costs. It calls for authority – that is, discretionary exercise of decision-making power in the firm management. Hence, the corporate controller's discretion should not be constrained more than necessary by outside shareholders. Their excessive interference with that discretion would expose the corporate controller to hold-up, thereby undermining his incentives either to undertake firm-specific investments or to involve outside shareholders in corporate finance.[221] Another way to put it is that the corporate controller should be entitled to protect his idiosyncratic control rents (which do not affect shareholder value at the outset), while refraining from extracting private benefits that come at the shareholders' expenses. This involves a qualitative distinction between categories of private benefits of control that will only be introduced in Chapter Five.

For the moment, I wish to make a much simpler point. Separation of ownership and control requires the exchange of company's stock between willing buyers and willing sellers. However, their expectations as to the *ex post* division of the firm surplus may be frustrated due to contractual incompleteness. This structural uncertainty involved by separation of ownership and control leaves the basic conflict of interest between shareholders and the corporate controller unresolved, and may compromise the exchange of the company's stock at the outset. *Institutions* must then be devised to police this conflict of interests by striking the appropriate balance of powers between the two categories of players. This would allow gains from trade to be captured by separating ownership and control, and economic efficiency to be enhanced as a result. In such a perspective, institutions would bear ultimate responsibility of different patterns of separation of ownership and control that we observe around the world. This will be therefore the subject-matter of the next Chapter. Understanding why institutions matter for separation of ownership and control is clearly a precondition for assessing the role of one key aspect of the institutional framework, which is also the focus of the present inquiry: that is, how *corporate law* matters for corporate governance and its efficiency.

[220] La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R. [2000a], *op. cit.*, 13-17.
[221] Hart, O. [1995], *op. cit.*, 9.

CHAPTER FOUR – **Comparative Institutional Analysis: 'Law Matters'**

4.1. Why Do We Care about Institutions in Corporate Governance?

4.1.1. Institutional Arrangements and the Institutional Environment

Separation of ownership and control is implemented through the exchange of the company's stock between an owner-manager and non-controlling shareholders. This exchange is affected by both agency problems and contractual incompleteness. The corporate contract would suffice to cope with agency problems in a world of complete contracts.[1] Contractual incompleteness makes agency problems harder to deal with as a matter of mechanism design, provided that changed circumstances may undermine *ex post* the efficiency of such a mechanism.[2] It is for this reason that authority matters – it allows incomplete contracts to be adapted to changed circumstances.[3] Authority, however, does not come out of nowhere. It has to be established in the first place and relied upon over time. Given the unavailability of perfectly state-contingent contracts, the fulfillment of the two above conditions re-

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1 Jensen, M.C. and Meckling, W.H. [1976], *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 3, 305-360; Easterbrook, F.H. and Fischel, D.R. [1989], *The Corporate Contract*, in COLUMBIA LAW REVIEW, vol. 89, 1416–1448.

2 Zingales, L. [1998], *Corporate Governance*, in P. Newman (ed.), THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW, Macmillan, 501-502.

3 Williamson, O.E. [2000], *The New Institutional Economics: Taking Stock, Looking Ahead*, in JOURNAL OF ECONOMIC LITERATURE, vol. 38, 595-613.

quires an external set of constraints upon people's choice of action. These constraints are named *institutions*.[4]

Institutions are quite popular in the modern study of economics. Unfortunately – as one of the founding fathers of New Institutional Economics recently confessed – "we are still very ignorant about institutions."[5] A detailed account of economics of institutions would fall outside the scope of the present inquiry. To our purposes, it may suffice to consider institutions as a set of constraints that determines the way in which a certain game is played among participants in a relationship – that is, the way in which discretion (and then, authority) is exercised at every stage of the game.[6] Institutions enter this framework in at least two different fashions. On the one hand, they set the 'rules of the game', thereby determining the range of feasible choices on how to play it (i.e., *constraining* authority). On the other hand, they allow 'the game to be played' by providing the instruments to implement a particular choice (i.e., *supporting* authority).[7] An example of the first kind of institutions is the property rights system; an example of the second is the firm. More conventionally, the first is a matter of *institutional environment* shaped by social norms, customs, legal rules and their enforcement; the second is a matter of *institutional arrangements* based on how parties allocate the entitlements provided for by the institutional environment.[8] This suggests that the way in which authority is exercised de-

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[4] The study of institutions in economics owes much to Douglass North. He describes them as follows:

> "Institutions are the humanly devised constraints that structure political, economic and social interaction. They consist of both informal constraints (sanctions, taboos, customs, traditions, and codes of conduct), and formal rules (constitutions, laws, property rights). Throughout history, institutions have been devised by human beings to create order and reduce uncertainty in exchange. Together with the standard constraints of economics they define the choice set and therefore determine transaction and production costs and hence the profitability and feasibility of engaging in economic activity. They evolve incrementally, connecting the past with the present and the future; history in consequence is largely a story of institutional evolution in which the historical performance of economies can only be understood as a part of a sequential story. Institutions provide the incentive structure of an economy; as that structure evolves, it shapes the direction of economic change towards growth, stagnation, or decline."

North, D.C. [1991], *Institutions*, in JOURNAL OF ECONOMIC PERSPECTIVES, vol. 5, 97.

[5] Williamson, O.E. [2000], *op. cit.*, 595.

[6] Aoki, M. [2004], *Comparative Institutional Analysis of Corporate Governance*, in A. Grandori (ed.), CORPORATE GOVERNANCE AND FIRM ORGANIZATION: MICROFOUNDATIONS AND STRUCTURAL FORMS, Oxford University Press, 31-44.

[7] Williamson, O.E. [2000], *op. cit.*, 599.

[8] Compare Williamson, O.E. [1991], *Comparative Economic Organization: The Analysis of Discrete Structural Alternatives*, in ADMINISTRATIVE SCIENCE QUARTERLY, vol. 36, 269-296, with North, D.C. and Davis, L.E. [1971], INSTITUTIONAL CHANGE AND AMERICAN ECONOMIC GROWTH, Cambridge University Press, 6-7.

pends on the *interaction* between institutional constraints ('law and order') and institutional choice ('private ordering') – the latter being of course dependent on the former. The growing interest in the law showed by economists over the past decades is ultimately rooted in this intuition.

What is surprising is the rarity with which the above two dimensions of institutional analysis have been brought together in economics.[9] One important exception is the Property Rights Theory of the firm, wherein residual rights of control that feature authority are backed by the property rights system.[10] As we know, however, this is a too narrow account of both the institutional environment (which includes more than property rights) and the spectrum of institutional choice (which, at least in corporate governance, may feature control rights also in the absence of ownership). A broader account of institutions is supplied by Williamson, who considers the institutional environment just as a "set of parameters" affecting the "comparative costs of governance" under alternative institutional arrangements.[11] Unfortunately, this framework is of little use unless we define the game which is being played by choice of institutional arrangement, given the institutional environment. To our purposes, corporate governance is the game at issue.

So far, the 'corporate governance game' has been framed as a relationship between a corporate controller and a number of non-controlling shareholders. In this perspective, separation of ownership and control describes how the game is being played in terms of institutional arrangements. Most characteristically, this means whether a controlling shareholder or the inside management is in charge. The outcome depends on two conditions, possibly in conflict with each other, being simultaneously satisfied. On the one hand, the ownership structure should feature the corporate controller's ultimate authority over the management of firm's assets. On the other hand, agency costs should be minimized for outside shareholders to be willing to provide (funds to buy) the assets. A corporate controller featured with firm-specific investments would stop diluting his ownership stake as soon as this leaves him with insufficient authority to protect control and its idiosyncratic value

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9 The work by Douglass North mostly focuses on the *institutional environment*. See, e.g., North, D.C. [1991], *op. cit.*, 98-102; more generally, North, D.C. [1990], INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE, Cambridge University Press. Oliver Williamson is more concerned with *institutional arrangements*: see, e.g., Williamson, O.E. [2000], *op. cit.*, 595-600; more generally, Williamson, O.E. [1985], THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING, Free Press.

10 As Zingales noticed, an "appealing feature" of the property rights theory is that it provides a definition of the firm "that corresponds very closely with the legal definition." Zingales, L. [2000], *In Search of New Foundations*, in JOURNAL OF FINANCE, vol. 55, 1638.

11 Williamson, O.E. [1991], *op. cit.*, 286-294.

from subsequent hold-up.[12] However, non-controlling shareholders would be unwilling to buy the company's stock when the corporate controller's authority can be exercised in such a way as to extract private benefits at the expenses of either security or profitability of their investment.[13]

Scope for welfare-enhancing transactions between the two above categories of players thus depends on both controlling authority being secured from outside shareholder interference and non-controlling shareholders being protected from abuse of this authority. By determining both opportunities for and constraints to the exercise of corporate authority in a given corporate governance system, the institutional environment provides the set of parameters within which the above conditions are fulfilled – that is, the range of choices wherein ownership *can be* separated from control. Gains from trade are then captured by means of institutional arrangements, determining how and to what extent ownership *is actually* separated from control.

In this simplified framework, institutions just enter as determinants of a range of feasible choices regarding the balance of powers between the corporate controller and outside shareholder. Clearly, that choice has also implications on the distribution of the firm's surplus. This is a key point for both positive and normative analysis of corporate governance. However, as we are about to see, fully understanding these implications and the role of institutions therein requires a more comprehensive account of private benefits of control than a mere agency cost perspective would grant. This will be introduced in the next Chapter.

4.1.2. Comparative Institutional Analysis of Corporate Governance

One nice feature of institutions is that they naturally lend themselves to comparison.[14] This has proved particularly useful after the discovery of the high rate of variation of corporate governance patterns around the world. As it was shown in Chapter Two, the last ten years of empirical research have clarified that separation of ownership and control is implemented in different ways and to different extents in different countries. From a purely theoretical standpoint, this evidence was diffi-

[12] For two different, but closely related, approaches to this problem (i.e., a two-stage strategy of going public vs. the issuance of state-contingent claims – debt), see respectively Zingales, L. [1995], *Insider ownership and the decision to go public*, in REVIEW OF ECONOMIC STUDIES, vol. 62, 425–448, and Aghion, P. and Bolton, P. [1992], *An Incomplete Contracts Approach to Financial Contracting*, in REVIEW OF ECONOMIC STUDIES, vol. 59, 473-494.

[13] Shleifer, A. and Vishny, R. [1997], *A Survey of Corporate Governance*, in JOURNAL OF FINANCE, vol. 52, 740-753.

[14] Aoki, M. [2001], TOWARDS A COMPARATIVE INSTITUTIONAL ANALYSIS, MIT Press.

cult to reconcile with the standard principal-agent framework that we have just reviewed, which allowed for multiple tradeoffs, but one unique kind of solution determined by agency costs minimization. However, it seemed that institutional analysis could uncover different abilities to cope with agency costs in different corporate governance systems, depending on the relative strength of investor protection under the pertinent corporate law jurisdiction. Apparently, this could explain variation in the worldwide patterns of separation of ownership and control without having to reconsider the underlying theoretical framework.

Provided that institutions affect economic behaviors, it is indeed quite tempting to consider different outcomes and performances of economic systems as a result of alternative institutional arrangements, whose practicability depends in turn on the institutional environment.[15] Then it comes with no surprise that such an approach has rapidly become very popular in the analysis of corporate governance.[16] Most of the debate in both law and economics of corporate governance has today a comparative dimension – or, at the very least, bears one or more comparative references. This has led to so-called 'cross-reference' in the institutional analysis of corporate governance.[17] Corporate governance systems, regarded as institutional arrangements, differ substantially around the world as to both their characteristics and performance. Institutional environments also differ, and it seems that some institutions are better suited to corporate governance than others. As a result, shopping for 'best' institutions is as of now the most fashionable approach to both economic and legal policy of corporate governance.[18]

There is nothing wrong with this approach, save that it is risky. When the role of institutions is interpreted on the basis of the wrong paradigm, policy implications

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[15] Glaeser, E.L., La Porta, R., Lopez-de-Silanes, F. and Shleifer, A. [2004], *Do Institutions Cause Growth?*, in JOURNAL OF ECONOMIC GROWTH, vol. 9, 271-303.

[16] The literature on the institutional foundations of corporate governance (hereinafter CG) is extensive, and characterizes nowadays the standard approach to corporate law and finance. It would be impossible to survey it here. See, e.g., in the economic literature, Beck, T., Demirgüç-Kunt, A., and Levine, R. [2005], *Law and Firm's Access to Finance*, in AMERICAN LAW AND ECONOMICS REVIEW, vol. 7, 211-252; in the legal literature, Roe, M.J. [2004a], *Explaining Western Securities Markets*, in A. Grandori (ed.), CORPORATE GOVERNANCE AND FIRM ORGANIZATION: MICROFOUNDATIONS AND STRUCTURAL FORMS, Oxford University Press, 279-296 (first presented as *Institutional Foundations for Securities Markets in the West*, Public Lecture, 20th Meeting of the European Association of Law and Economics, Nancy, September 2003).

[17] See, illustratively, Bratton, W.B. and McCahery, J.A. [2001a], *Incomplete Contracts Theories of the Firm and Comparative Corporate Governance*, in THEORETICAL INQUIRIES IN LAW, vol. 2, n. 2, *Protecting Investors in a Global Economy*.

[18] See Mayer, C. and Sussman, O. [2001], *The Assessment: Finance, Law, and Growth*, in OXFORD REVIEW OF ECONOMIC POLICY, vol. 17, 457-466, for a historical/theoretical survey.

would also be incorrect. In fact, understanding institutions and comparatively assessing their quality is much more difficult than it may appear at first glance.

If one just looks at *institutional arrangements*, separation of ownership and control is far from a standard phenomenon. Differently from what theory would predict, it is not even so frequent. The vast majority of businesses in the world appear to be managed by their owners.[19] The agency theory suggests that it would be efficient to have firm management separated from firm finance,[20] but in fact, only a few companies are run by professional managers with no support of one or more controlling shareholders.[21] More importantly, managerial capitalism appears to be concentrated in very few locations of the world, most notably in the US and the UK, where it still concerns a minority of firms but the largest portion of the Gross Domestic Product (GDP).[22] The last circumstance is consistent with the agency theory. Beyond a certain firm size, the entrepreneur's wealth constraint becomes binding, opportunity cost of liquidity and risk diversification rises, agency costs of debt increase too. All these factors contribute to the relative advantages of equity in financing projects with a larger scale.[23] It is not surprising, then, that separation of ownership and control is not an issue for small businesses – at least, until they wish (or need) to grow up.

However, agency theory alone cannot explain why firms do actually *grow* – for instance, by merging with other firms – instead of simply expanding their web of contracts.[24] Even adding consideration for contractual incompleteness and the importance of residual control rights in defining the boundaries of the firm, agency costs hardly tell us why managerial capitalism exists in some countries, but has

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19 See, most recently, Holderness, C.G. [2006], *A Contrarian View of Ownership Concentration in the United States and around the World*, AFA 2006 Boston Meetings Paper, available at www.ssrn.com. See also *supra*, Chapter Two, section 2.2.

20 Easterbrook, F.H. and Fischel, D.R. [1991], THE ECONOMIC STRUCTURE OF CORPORATE LAW, Harvard University Press (hereinafter Easterbrook, F.H. and Fischel, D.R. [1991], *The Economic Structure*), 8-15.

21 See, in the European context, Barca, F. and Becht, M. (eds.) [2001], THE CONTROL OF CORPORATE EUROPE, Oxford University Press. More in general, on the concentration of corporate control in the hands of few wealthy families outside the US and the UK, see Morck, R., Wolfenzon, D. and Yeung, B. [2005], *Corporate Governance, Economic Entrenchment and Growth*, in JOURNAL OF ECONOMIC LITERATURE, vol. 43, 657–722. See also *supra*, Chapter Two, section 2.4.

22 La Porta, R., Lopez-de-Silanes, F. and Shleifer, A. [1999], *Corporate Ownership around the World*, in JOURNAL OF FINANCE, vol. 54, 471-517. For a more detailed analysis, see *supra*, Chapter Two, section 2.3.

23 Becht, M., Bolton, P. and Röell, A. [2002], *Corporate Governance and Control*, ECGI Finance Working Paper No. 02/2002, available at www.ssrn.com and www.ecgi.org, as published in G. Constantinides, M. Harris, and R. Stulz (eds.) [2003], HANDBOOK OF ECONOMICS AND FINANCE, North-Holland, 20-21.

24 Zingales, L. [2000], *op. cit.*, 1637-1638.

never emerged in most part of the world where it seems not to be an option even for the largest businesses.[25] Neither can the incomplete contracts perspective help principal-agent models to explain why, regardless of whether inside management or a controlling shareholder is in charge, corporate control is very seldom – if ever – contestable.[26] Surprising as this may appear, even in the face of this compelling evidence, most part of economic theory still does not dare to depart from the agency paradigm in analyzing corporate governance.

Yet, a full account of contractual incompleteness suggests that the explanation could be found elsewhere, if only at least *two* institutional dimensions were considered.[27] On the one hand, there is the institutional setup at the individual company's level: that is, to what extent and on what terms entrepreneurs *choose* to raise equity funds from the market, with or without relinquishing firm control. On the other hand, there are the institutional constraints at the environmental level: that is, how and to what extent entrepreneurs *can* profitably separate ownership from control. Largely, this framework would at least allow variety to be efficient.

Mainstream research on comparative corporate governance prefers instead to focus on just one institutional dimension, the institutional environment, based on the assumption that institutional arrangements would *always* minimize agency costs subject to the environmental constraints.[28] According to this view, the ultimate rea-

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25 One explanation, and indeed the prevailing one, is that the quality of legal protection of outside shareholders makes the difference. La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R. [1998], *Law and Finance*, in JOURNAL OF POLITICAL ECONOMY, vol. 106, 1113-1155 (hereinafter La Porta *et al.* [1998], *Law and Finance*). For three different, but all pertinent criticisms of the incompleteness of this argument, see: Coffee, J.C. Jr. [2001b], *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, in YALE LAW JOURNAL, vol. 111, 1-82; Roe, M.J. [2002], *Corporate Law's Limits*, in JOURNAL OF LEGAL STUDIES, vol. 31, 233-271; and Franks, J., Mayer, C. and Rossi, S. [2005b], *Ownership: Evolution and Regulation* (March 25, 2005), Working Paper, available at www.ssrn.com (earlier versions: ECGI Finance Working Paper No. 09/2003; EFA 2004 Maastricht Meetings Paper No. 3205; AFA 2003 Washington, DC Meetings).

26 According to the agency theory, lack of contestability is just inefficient in CG. See, e.g., Bebchuk, L.A. [1999], *A Rent-Protection Theory of Corporate Ownership and Control*, NBER Working Paper No. 7203. But see also, for a different view, Coates, J.C. IV [2003], *Ownership, Takeovers and EU Law: How Contestable Should EU Corporations Be?*, ECGI Law Working Paper No. 11/2003, available at www.ssrn.com and www.ecgi.org, reprinted in E. Wymeersch and G. Ferrarini (eds.) [2004], COMPANY AND TAKEOVER LAW IN EUROPE, Oxford University Press.

27 Cf., for this framework, Williamson, O.E. [2000], *The New Institutional Economics: Taking Stock, Looking Ahead*, in JOURNAL OF ECONOMIC LITERATURE, vol. 38, 595-613 (considering *four* levels of institutional analysis) and, more specifically, Williamson, O.E. [1991], *Comparative Economic Organization: The Analysis of Discrete Structural Alternatives*, in ADMINISTRATIVE SCIENCE QUARTERLY, vol. 36, 269-296.

28 See, La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R. [2000a], *Investor Protection and Corporate Governance*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 59, 3–27 (hereinafter La Porta *et*

son why modes and degrees of separation of ownership and control differ from country to country lies in the relative quality of the *institutional environment*. The reasoning has also a normative side: get institutions right and efficient corporate governance will follow. Needless to say, the 'right' institutions are those whereby agency costs are minimized, namely those featuring the highest possible degree of outside shareholder protection from the management misbehavior and/or underperformance. This kind of institutions should enable, in turn, private ordering to feature both dispersed ownership structures and contestability of corporate control – as predicted by the agency theory. [29] Shareholder-friendliness of a given institu-

al. [2000a], *Investor Protection*); and, for a broader view, Roe, M.J. [2004b], *The Institutions of Corporate Governance*, Harvard Law and Economics Discussion Paper No. 488, available at www.ssrn.com.

[29] This underlies the current debate about so-called *convergence* of CG institutions (rules and standards) across the world. Advocates of convergence are quite numerous among Law and Economics scholars, especially in the US. Perhaps the most appealing formulation of the convergence thesis is contained in Hansmann, H. and Kraakman, R.H. [2001], *The End of History for Corporate Law*, in GEORGETOWN LAW JOURNAL, vol. 89, 439-468, predicting *formal* convergence of legal rules towards the US standards which over time proved most successful in coping with agency problems of publicly held corporations. See also a very recent update by Hansmann, H. [2006b], *How Close is the End of History*, in JOURNAL OF CORPORATION LAW, vol. 31, 745-752. But competing formulations are equally important: they predict convergence to take place more on *functional* or *contractual* terms rather than by means of legal change. See, e.g., Coffee, J.C. Jr. [1999b], *The Future as History: The Prospects for Global Convergence in Corporate Governance*, in NORTHWESTERN UNIVERSITY LAW REVIEW, vol. 93, 641-708, and Gilson, R.J., [2001], *Globalizing Corporate Governance: Convergence of Form or Function?*, in AMERICAN JOURNAL OF COMPARATIVE LAW, vol. 49, 329-357. In fact, a widely accepted proposition is that path-dependency is at least slowing down the process of legal change, and may actually impede it at all. See Bebchuk, L.A. and Roe, M.J. [1999], *A Theory of Path Dependence in Corporate Ownership and Governance*, in STANFORD LAW REVIEW, vol. 52, 127-170. Other commentators are even more skeptical about convergence in whatever form. See Branson, D.M. [2001], *The Very Uncertain Prospect of 'Global' Convergence in Corporate Governance*, in CORNELL INTERNATIONAL LAW JOURNAL, vol. 34, 321–362 (on legal grounds); and Bratton, W.B. and McCahery, J.A. [2001a], *op. cit.* (on economic grounds). Finally, doubts are cast about whether convergence should take place toward a norm of shareholder empowerment or, rather, of director autonomy. Bainbridge, S.M. [2002c], *Director v. Shareholder Primacy in the Convergence Debate*, in TRANSNATIONAL LAWYER, vol. 62, 45-62.

The debate is also very lively in Europe. See, e.g., Wymeersch, E. [2002], *Convergence or divergence in corporate governance patterns in Western Europe?* in J. McCahery, P. Moerland, T. Raaijmakers and L. Renneboog (eds.), CORPORATE GOVERNANCE REGIMES: CONVERGENCE AND DIVERSITY, Oxford University Press, 230–250 (finding evidence of formal convergence of legal rules across European jurisdictions, as well as of functional convergence in self-regulation promoted by national stock exchanges); Wójcik, D. [2006], Convergence in Corporate Governance: Evidence from Europe and the Challenge for Economic Geography, in JOURNAL OF ECONOMIC GEOGRAPHY, vol. 6, 639-660 (finding evidence of *de facto* convergence across Europe, at the individual company's level); Goergen, M., Martynova, M. and Renneboog, L. [2005], *Corporate governance convergence: Evidence from takeover regulation reforms in Europe*, in OXFORD REVIEW OF ECONOMIC POLICY, vol. 21, 1-27 (discussing how formal convergence in takeover regulation may actually lead to persistent diversity in models of CG prevailing in different European countries).

tional environment may depend on a number of factors, the most important of which being social norms, politics, and the law.[30] Sticking to the agency paradigm implies that variety in corporate governance patterns can only be determined by shortcomings at the level of institutional environment. In this perspective, however, variety may have one or more institutional responsible, but certainly no virtue.

More and more commentators are showing discomfort with such a deterministic view.[31] While nowadays nobody would question that institutions matter for both

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30 See, for a broad overview, North, D.C. [1990], *op. cit.*

31 Most of them are lawyers reacting to the conventional wisdom. The latter apparently "suggests that developing countries can achieve financial development and economic growth by adopting a corporate law regime similar to the United States, which has the broadest and deepest securities markets in the world." Paredes, T.A. [2004], *A Systems Approach to Corporate Governance Reform: Why Importing U.S. Corporate Law Isn't The Answer*, in WILLIAM AND MARY LAW REVIEW, 1070-1071.

In fact, this view has been upheld by prominent International Organizations: see, e.g., Organization for Economic Cooperation and Development [2004], OECD PRINCIPLES OF CORPORATE GOVERNANCE - 2004 EDITION, available at www.oecd.org; The World Bank [2002], *World Development Report 2002: Building Institutions for Markets*, The World Bank (also available at www.worldbank.org). As Lynn Stout puts it: "[I]t is a tempting prospect to think that, by modifying their rules to more closely approximate U.S.-style corporate law, [developing] nations might spur the process of economic development." However, financial and economic development depends on more that corporate law. Stout, L.A. [2003], *On the Export of U.S.-Style Corporate Fiduciary Duties to Other Cultures: Can A Transplant Take?*, in C. Milhaupt (ed.), GLOBAL MARKETS, DOMESTIC INSTITUTIONS: CORPORATE LAW AND GOVERNANCE IN A NEW ERA OF CROSS-BORDER DEALS, Columbia University Press, 46-76. Culture is another and too often neglected factor. Licht, A.N. [2001], *The Mother of All Path Dependencies: Toward a Cross-Cultural Theory of Corporate Governance Systems*, in DELAWARE JOURNAL OF CORPORATE LAW, vol. 26, 147-205. Whether CG institutions (not only the law, but also culture, politics, and social norms) should promote just the enhancement of shareholder value or, rather, a broader view of the stakeholder society is also questioned. Blair, M.M. [2003], *Shareholder Value, Corporate Governance, and Corporate Performance: A Post-Enron Reassessment of the Conventional Wisdom*, in P.K. Cornelius and B. Kogut (eds.), CORPORATE GOVERNANCE AND CAPITAL FLOWS IN A GLOBAL ECONOMY, Oxford University Press, 53-82. But the far most controversial issue is that concerning *transplant* of corporate law across jurisdictions. As in biology, legal 'transplantation' may easily lead to 'rejection crisis.' Both facts and theory show that legal transplants very seldom produce the desired outcome: the resulting equilibrium is often unaffected by changes in the 'law on the books', and it is sometimes unpredictable. See, in different contexts: Coffee, J.C. Jr. [1999a], *Privatization and Corporate Governance: The Lessons from Securities Market Failure*, in JOURNAL OF CORPORATION LAW, vol. 25, 1-39; Pistor, K. [2002], *The Standardization of Law and Its Effects on Developing Economies*, in AMERICAN JOURNAL OF COMPARATIVE LAW, vol. 50, 97-130; Xu, C. and Pistor, K. [2004], *Incomplete Law*, in N.Y.U. JOURNAL OF INTERNATIONAL LAW AND POLITICS, vol. 35, 931-1013; Xu, C. and Pistor, K. [2003], *Managers' Fiduciary Duty and the Enforcement of Incomplete Corporate Law*, in C. Milhaupt (ed.), GLOBAL MARKETS, DOMESTIC INSTITUTIONS: CORPORATE LAW AND GOVERNANCE IN A NEW ERA OF CROSS-BORDER DEALS, Columbia University Press, 77-106; Kanda, H. and Milhaupt, C. [2003], *Re-examining Legal Transplants: The Director's Fiduciary Duty in Japanese Corporate Law*, in AMERICAN JOURNAL OF COMPARATIVE LAW, vol. 51, 887-901.

A more comprehensive version of the transplant argument is that institutions have 'system logic.' For a thorough analysis of that underlying US corporate governance, finance, and law, see Paredes, T.A. [2004], *op. cit.*, 1075-1103. Systemic issues are quite well-known in the economic analysis of in-the shape and the efficiency of a corporate governance system, there is not much agreement on the actual bearing of the institutional environment on corporate governance arrangements and their variation around the world.[32] To be sure, even the most basic questions seem yet to await an answer. *What* kind of institutions matters the most in corporate governance? Is it law, social norms, politics or something else? Do perhaps different institutional environments allow for different answers to the last question? Next, *how* do institutions affect separation of ownership and control? Are institutions supporting concentrated ownership – where a controlling shareholder is in charge – any better (or any worse) than institutions supporting dispersed ownership – where inside management is in charge? Are they really to promote contestability of corporate control, and how much? Finally, and more importantly, are there any 'best' institutions for corporate governance?

We are still too ignorant about the role of institutions in both law and economics to endeavor a comprehensive answer to the above questions. The ambition of this work is much narrower. It is focused on just one specific feature of the institutional environment wherein corporate governance is implemented: corporate law. This is not because other features of the institutional environment are believed to be less important, or not at all. The reason is, rather, that the role of corporate law in determining both the characteristics and the performance of corporate governance systems is now universally recognized by the Law and Economics scholarship, but it seems to be not yet completely understood. As a result, supporters of the view that law is the key institutional determinant of both corporate governance patterns and their efficiency, inasmuch as it guarantees high standards of investor protection (the so-called 'law matters' argument), tend to understate the importance of extralegal institutions in corporate governance nearly as much as critics of the same

stitutions: see, e.g., North, D.C. [1991], *op. cit.*; Aoki, M. [2004], *op. cit.* Originally, they were raised to explain the peculiarities of Japanese economy. See Milgrom, P. and Roberts, J. [1994], *Complementarities and Systems: Understanding Japanese Economic Organization*, in ESTUDIOS ECONOMICOS, vol. 9, 3-42.

Economists are also concerned with complementarities in the analysis of law and its temporal and spatial evolution. See, e.g., Alesina, A. and Angeletos, G.-M. [2005], *Fairness and Redistribution*, in AMERICAN ECONOMIC REVIEW, vol. 95, 960-980, for the claim that the interaction of tax policies with social beliefs may lead to multiple equilibria. With special reference to law and finance, see also Berkowitz, D., Pistor, K. and Richard, J.-F. [2003], *The Transplant Effect*, in AMERICAN JOURNAL OF COMPARATIVE LAW, vol. 51, 163-204; and Rajan, R.G. and Zingales, L. [2003], *The great reversals: the politics of financial development in the twentieth century*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 69, 5–50.

[32] See Paredes, T.A. [2004], *op. cit.*, for an excellent survey of the most important open questions about the role of institutions in US vs. worldwide CG.

view tend to overstate it.[33] While unquestionable in principle, institutional complementarities in corporate governance would deserve a more systematic analysis than one can afford here.[34] But one should first get the corporate law's role right.

The following discussion will show that a number of steps must be taken to this purpose. First, comparative legal analysis must be taken more seriously than it has been done so far. Second, the narrow set of assumptions underlying the agency paradigm must be departed from, thereby putting investor protection in the right perspective. Third, the entire range of implications of contractual incompleteness must be taken into account, thereby featuring not just constraints to control power, but also opportunities for its exercise. At a later stage, this will allow us to devise a more comprehensive framework where variety in corporate governance (i.e., different patterns of separation of ownership and control) is explained by efficient institutional choice (private ordering), given the set of opportunities and constraints provided for at the level of institutional environment (corporate law).

4.2. 'Law Matters:' The Standard View

4.2.1. Lawyers and Economists Meet Each Other (Do They?)

Curiously enough, 'law matters' is a slogan coined by economists.[35] Maybe that is just because nobody would ever doubt the importance of his daily bread, but

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33 See, e.g., on the one hand, Djankov, S., La Porta, R., Lopez-de-Silanes, F. and Shleifer, A. [2006], *The Law and Economics of Self-Dealing*, Working Paper, Harvard School of Economics, available at http://www.economics.harvard.edu /faculty/shleifer/papers, forthcoming in JOURNAL OF FINANCIAL ECONOMICS, 2008 (hereinafter Djankov *et al.* [2006], *Self-Dealing*); on the other hand, Cheffins, B.R. [2003], *Law as Bedrock: The Foundations of an Economy Dominated by Widely Held Public Companies*, in OXFORD JOURNAL OF LEGAL STUDIES, vol. 23, 1-23.

34 See Paredes, T.A. [2004], *op. cit.*, for an interesting attempt (1103-1121) and a tentative framework (1122-1155) for CG reform in developing countries.

35 It is worth referring to the very first version in which *Law and Finance*, undoubtedly one of the most cited papers in Corporate Law and Economics, appeared: La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R. [1996], *Law and Finance*, NBER Working Paper No. 5661. More precisely, the authors argued – and, apparently, demonstrated – that legal rules and the origin of the legal family (which is significantly related to their substantive contents) *matter* for financial performance. That become the milestone of the 'law matters' thesis. The paper was published two years later as La Porta *et al.* [1998], *Law and Finance*, cit.

corporate lawyers did already know it since ever.[36] So did most legal scholars in the corporate field, although the advent of Law and Economics brought about some debate on whether legal rules were beneficial or detrimental for corporate governance.[37] A more serious account of this story would tell that, by and large, economists have become interested in the law since they discovered market and contracting failures, thereby starting to investigate the role of institutions in determining both economic outcomes and their efficiency.[38] Legal scholars have become doubtful about the primacy of law since they started to be concerned with efficiency, thereby wondering whether regulating economic behaviors improves or, rather, impairs the welfare of the society.[39]

However, on the one hand, the majority of economists lack time, expertise or just interest for going through the complications that make a 'legal system' out of a bounce of written rules, judicial cases, and scholarly interpretations. On the other hand, the majority of lawyers do not even dare to confront with the technicalities of economic theory. As a result, how does law really matters for the economic performance is still far from clear. Even in the corporate field, where the 'law matters' statement was first enunciated, both economists and lawyers (within their own group!) have often very different ideas about what matters in corporate law, how it matters, and – above all – why it is so. In the next pages, I will try to articulate the key aspects of the law matter thesis, highlighting the major points of criticism and disagreement, while reserving a comprehensive presentation of my own view on this account for the next Chapters.

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36 See, e.g., two classical books in corporate law: Clark, R.C. [1986], CORPORATE LAW, Little, Brown and Company; and Eisenberg, M.A. [1976], THE STRUCTURE OF THE CORPORATION, Little, Brown and Company.

37 In this last respect, cf. Easterbrook, F.H. and Fischel, D.R. [1991], *The Economic Structure*, cit.

38 See, most notably, the collection of Ronald Coase's articles in Coase, R.H. [1988], THE FIRM, THE MARKET, AND THE LAW, University of Chicago Press.

39 The first handbook of Law and Economics appeared in 1972: Posner, R.A. [1972], ECONOMIC ANALYSIS OF LAW, Little, Brown and Company. The last edition has been just published: Posner, R.A. [2007], ECONOMIC ANALYSIS OF LAW, 7th edn., Aspen Publishers. Many handbooks of Law and Economics followed Judge Posner's classic. Curiously enough, all the leading references are authored by economists, although they feature quite different approaches to the economic analysis of law. See Polinsky, A.M. [2003], AN INTRODUCTION TO LAW AND ECONOMICS, 3rd edn., Aspen Publishers; Cooter, R.D. and Ulen, T.S. [2004], LAW AND ECONOMICS, Addison Wesley; and Shavell, S. [2004], FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW, Harvard University Press (Belknap).

4.2.2. Equity Finance and the Quality of Corporate Law

The very idea that law plays a role in corporate governance comes from the application of the agency theory to an incomplete contracts setting.[40] Under asymmetric information, shareholders (the principals) cannot perfectly monitor the manager's (the agent's) behavior, and therefore they are willing to buy stock only at a discount. The source of the discount is the agency cost.[41] In theory, agency costs could be minimized by an incentive-compatible contract between shareholders and the manager. If the corporate contracts were complete, minimization of agency costs would take place without the aid of mandatory legal rules, provided that it is in the common interest of both parties to do so.[42] However, given contractual incompleteness, optimal shareholders protection cannot be reliably achieved *ex ante* through the corporate contract.[43] What is optimal today might not be optimal tomorrow. It is just for this reason that managers are vested with discretionary authority in corporate governance.[44] Consequently, minimization of agency costs requires that some external constraints on the managers' behavior be established through institutions and, in particular, by corporate law.[45]

When these legal constraints are insufficient to discipline the managers' conflict of interest with outside shareholders, separation of ownership and control may be impaired. On the one hand, shareholders fearing the corporate controller's misbehavior would be willing to pay less for the company's stock. Intuitively, when the discount gets high enough, selling shares to the investing public would become unattractive for the entrepreneur, and therefore ownership could not further separate from control.[46] On the other hand, in the absence of reliable legal protection of the

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[40] Shleifer, A. and Vishny, R. [1997], *op. cit.*, 741; Zingales, L. [1998], *Corporate Governance*, in P. Newman (ed.), THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW, vol. 1, Macmillan, 497-503.

[41] This is an extreme simplification of the agency theory of the corporation. For a more precise illustration, see *supra*, Chapter Three, section 3.1.

[42] Easterbrook, F.H. and Fischel, D.R. [1989], *The Corporate Contract*, in COLUMBIA LAW REVIEW, vol. 89, 1416–1448.

[43] Gordon, J.N. [1989], *The Mandatory Structure of Corporate Law*, in COLUMBIA LAW REVIEW, vol. 89, 1549-1598.

[44] Shleifer, A. and Vishny, R. [1997], *op. cit.*, 742-744.

[45] Originally, the same argument was applied to debt finance, and therefore the 'law matters' thesis included consideration for bankruptcy laws. See La Porta *et al.* [1998], *Law and Finance*, cit. More recently, the argument has been extended to securities law: La Porta, R., Lopez-De-Silanes, F. and Shleifer, A. [2006], *What Works in Securities Laws?*, in JOURNAL OF FINANCE, vol. 61, 1-32 (hereinafter La Porta *et al.* [2006], *What Works*).

[46] On this account, see *infra*, Chapter Six, section 6.4.

shareholder interest, maintaining a large share holding is the only way for the corporate controller to commit to a policy of fair dealing with outside shareholders.[47]

The above line of reasoning is perfectly consistent with the agency framework.[48] Unconstrained opportunities for the managers to abscond with shareholders' money, or to place them to suboptimal use, make investors unwilling to sink equity capital in the firm. More technically, too a high risk of moral hazard and adverse selection going unchecked contractually limits the corporate controller's ability to raise equity finance through separation of ownership and control, by making equity capital much costlier. 'Law matters' is an appealing way to say that failure of national corporate laws to protect non-controlling shareholders from expropriation is responsible of ownership concentration and stock market underdevelopment.[49] To the extent that external equity funds are needed to finance uncertain growth opportunities available to the firm, this would ultimately lead to inefficient allocation of financial resources within an entire economy.[50]

The adverse effects of bad quality of corporate law on financial development and, consequently, on economic growth are thus the ultimate focus of normative analyses based on the 'law matters' argument.[51] Its original formulation was slightly different, though. It was about the way in which certain features of corporate law, considered as being essential across the board, affect both ownership concentration and the relative availability of external equity funds to firms situated in different countries of the world.[52] Four economists – Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny (hereinafter La Porta *et al.*) – managed to prove empirically that different patterns and performances of corporate governance systems actually depended on those specific features of corporate law and on the quality of their enforcement, which were both determined, in turn, by the historical tradition of the legal system. According to their results, good law and good enforcement of shareholder rights characterize legal systems whose roots lie in English common law, while the reverse apparently holds for systems based on the civil law tradition. That should explain why Anglo-American firms are featured with diffuse ownership and managers in control, whereas the lower quality of corporate

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47 La Porta *et al.* [1998], *Law and Finance*, cit., 1147.

48 Shleifer, A. and Vishny, R. [1997], *op. cit.*, 740-748.

49 This was the first elaboration on the results of *Law and Finance*. See La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R. [1997], *Legal Determinants of External Finance*, in JOURNAL OF FINANCE, vol. 52, 1131-1150 (hereinafter La Porta *et al.* [1997], *Legal Determinants*).

50 Levine, R. [1999], *Law, Finance, and Economic Growth*, in JOURNAL OF FINANCIAL INTERMEDIATION, vol. 8, 8-35.

51 See Mayer, C. and Sussman, O. [2001], *op. cit.*, for a comprehensive review of the theoretical, empirical, and policy issues of this debate.

52 La Porta *et al.* [1997], *Legal Determinants*, cit.

law only allows for controlling shareholders and concentrated ownership in continental Europe.

This work gave birth to a massive strand of literature named after the first, and still the most famous, of the numerous articles that the above-mentioned four economists have written in this field: *Law and Finance*.[53] Then the thesis was rapidly extended from 'law and finance' to 'law, finance, and growth.'[54] The technicalities of the relationship between corporate finance and economic growth are far beyond the scope of the present inquiry about the effects of regulation on corporate governance and its efficiency. To our purposes, it is just worth noting that the efficiency of corporate governance also 'matters' for overall economic growth and, therefore, it is extremely important to get it right.

That being said, the role of the legal system in determining the degree of separation of ownership from control does not seem to be confined to such a standardized account of investor protection. On the one hand, legal protection of outside shareholders may take different forms in different institutional contexts.[55] On the other hand, other legal factors, unrelated to shareholder protection and possibly in contrast with it, may also affect the relationship between law and equity finance.[56]

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53 *Law and Finance* inaugurated a very lucky series of article by Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny, customarily referred to as La Porta *et al.*, LLSV, or even 'The Gang of Four.' They dominated the economic literature on CG during the late 90s, and exerted an unparalleled influence on the legal literature of the same years. *Law and Finance* was first circulated in 1996 as a working paper (NBER Working Paper No. 5661, *op. cit.*), and then published with some modifications as La Porta *et al.* [1998], *Law and Finance*, cit.
The other articles of the series are: La Porta *et al.* [1997], *Legal Determinants*, cit.; La Porta *et al.* [2000a], *Investor Protection*, cit.; La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R. [2000b], *Agency Problems and Dividend Policies Around the World*, in JOURNAL OF FINANCE, vol. 55, 1-33; La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R. [2002], *Investor Protection and Corporate Valuation*, in JOURNAL OF FINANCE, vol. 57, 1147-1170.
In the 2000s Robert Vishny left the crew. But the 'law and finance spirit' continued as strong as ever. See http://www.economics.harvard.edu/faculty/shleifer/papers.html for a complete list of publications and most recent working papers. Professor Vishny was eventually replaced by other co-authors, namely Simon Johnson, Edward Glaeser, and Simeon Djankov. References to more recent work by the remainder of 'The Gang of Four' (always including Professor Shleifer) are spread throughout this book, which clearly does not subscribe the Law and Finance view. See below, in this Chapter, for discussion of the reasons, and *infra* Chapter Five, for introduction of an alternative framework of analysis.

54 See, e.g., Beck, T., Demirgüç-Kunt, A. and Levine, R. [2001], *Legal Theories of Financial Development*, in OXFORD REVIEW OF ECONOMIC POLICY, vol. 17, 483-501; and Beck, T., Demirgüç-Kunt, A., and Levine, R. [2005], *op. cit.* For a good illustration of this strand of literature from the lawyer's point of view, see Paredes, T.A. [2004], *op. cit.*, 1061-1075.

55 Baums, T. and Scott, K.E. [2005], *Taking Shareholder Protection Seriously? Corporate Governance in the U.S. and Germany*, in AMERICAN JOURNAL OF COMPARATIVE LAW, vol. 53, 31-76.

56 Cools, S. [2005], *The Real Difference in Corporate Law between the United States and Continental Europe: Distribution of Powers*, in DELAWARE JOURNAL OF CORPORATE LAW, vol. 30, 697-766.

In fact, there are several clues that the causal link between the quality of corporate law and firm access to equity finance (i.e., separation of ownership and control) may be not yet completely understood.

To begin with, discomfort with the standard 'law matters' view is widespread among both economists and legal scholars. Since *Law and Finance* appeared in the literature on corporate governance, disagreement has been always extensive on the hypotheses of the 'law matters' argument, the generality of the thesis, and, more importantly, the methodology of legal comparison.[57]

In addition, a deeper inquiry into the models of ownership and control prevailing around the world – like the one which was presented in Chapter Two – shows that the variety with which outside shareholders are protected by the legal system is, at best, an incomplete account of the comparative picture. On the one hand, most countries of the developed world still apparently do not feature models of corporate governance based on completely dispersed ownership structures.[58] Provided that at least some of them (like Sweden) have highly developed stock markets with willing buyers of company's shares, it is quite hard to believe that ownership concentration is just due to insufficient investor protection.[59] On the other hand, countries that indeed feature managerial capitalism (like the US) nonetheless allow for a significant portion of publicly held firms to be managed under the responsibility of a controlling shareholder.[60] Legal protection of outside investors being equal under the two corporate governance arrangements, it must be something else that explains the choice of concentrated ownership.[61]

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57 See, for a survey, Paredes, T.A. [2004], *op. cit.*, 1061-1075.

58 Continental Europe is the case in point. See Becht, M. and Mayer, C. [2001], *Introduction*, in F. Barca and M. Becht (eds.), THE CONTROL OF CORPORATE EUROPE, Oxford University Press, 1-45.

59 Gilson, R.J. [2006], *Controlling Shareholders and Corporate Governance: Complicating the Taxonomy*, in HARVARD LAW REVIEW, vol. 119, 1641-1679.

60 For two recent empirical analyses showing high frequency of controlling shareholding in the US (albeit on different grounds and data), see: Gadhoum, Y., Lang, L.H.P. and Young, L. [2005], *Who Controls US?*, in EUROPEAN FINANCIAL MANAGEMENT, vol. 11, 339-363; Holderness, C.G. [2006], *op. cit*. See also *supra*, Chapter Two, sections 2.3 and 2.4.

61 To be sure, some commentators report that legal protection of non-controlling shareholders in the US is not *neutral* as to whether managers or controlling shareholders are in charge. See, most notably, Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 21-25 and 37, and Becht, M. and Mayer, C. [2001], *op. cit.*, 11-15 (making the same point for the UK). For the view that US securities regulation *discourages* the holding of large blocks, and that should explain why controlling shareholders are *in*frequent in the governance of publicly held companies in the US, see the classical arguments by Black, B.S. [1990a], *Shareholder Passivity Reexamined*, in MICHIGAN LAW REVIEW, vol. 89, 529-591 (relating to the burden of fiduciary duties once a large shareholder is considered as being in control under US securities regulation), and Roe, M.J. [1994], STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE, Princeton University Press (considering the heavy burden of US regulation of financial intermediaries since the 'New Deal' legislation of

Finally, there is a further and very often neglected point. Corporate Law and Economics *preexisted* to the presentation of the 'law matters' argument before an audience of astonished financial economists. And, contrary to what is often believed, it was definitely not about how legal rules *do not* matter for the efficiency of corporate governance.[62] The traditional debate in Corporate Law and Economics is actually subtler. It is about whether, and to what extent, corporate law should *support* freedom of contract or, rather, *constrain* it.[63] This involves a distinction between mandatory and enabling rules that have been always a major matter of concern in the economic analysis of corporate law. Of course, both typologies of rules matter for corporate governance. It is unfortunate that *Law and Finance* considered this distinction as unimportant in order to assess the bearing of legal rules *whatsoever* on corporate governance; and that the vast majority of financial economists subscribe

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the 30s). However, it should be noticed that their arguments apply to monitoring by *large* shareholders more that to the exercise of decision-making by *controlling* shareholders. We have already learned that the two positions differ significantly from each other (see *supra*, Chapter Two, Box 1, and Chapter Three, section 3.4.2). It may be that US securities regulation discourages the exercise of monitoring through holding of large blocks by financial intermediaries; but this has little impact on the exercise of corporate control through concentration of voting power. As the authorities cited in the previous note have recently shown, the latter is not so infrequent in the US.

As I mentioned, misinterpretation of the effects of laws and regulations on corporate governance very often obtains from theoretical confusion between *allocation* and *regulation* of control rights in a much too narrow principal-agent framework (see *supra*, Chapter Three, section 3.4.2). In a broader perspective, the problem is that the mainstream literature tends to treat private benefits of control (hereinafter PBC) just as expropriation of the owners (the principals) by the controller (the agent): therefore, the legal system either constrains their extraction, thereby promoting dispersed ownership, or leaves some scope for it, thereby nurturing the building of control blocks. Bratton, W.B. and McCahery, J.A. [2001a], *op. cit.* But, indeed, the notion of PBC includes much more than shareholder expropriation (see *infra*, Chapter Five, section 5.2). Once other sources of control rents are allowed, their exploitation in corporate governance depends on how control rights are allocated (*distribution* of powers) more than on how they are regulated (*discipline* of powers). See *infra*, Chapter Five, section 5.5. From this point of view, neither financial regulation nor fiduciary duties in the US are too burdensome for a controlling shareholder, inasmuch as the benefits that he derives from his control position do not depend on shareholder expropriation. See *infra*, Chapter Nine, section 9.2, for discussion. Non-neutrality of the legal system as to the patterns of corporate ownership is more of a problem in jurisdictions other than the US. Indeed, this does not depend on the strength of shareholder protection from expropriation, but on the latter being obtained by means of distributions of corporate powers unfavorable to controlling shareholders. In fact, this is what happens in the UK. See *infra*, Chapter Seven, section 7.3.2.

62 La Porta *et al.* made such a point, but undoubtedly they twisted Corporate Law and Economics. See La Porta *et al.* [1998], *Law and Finance*, cit., 1121-1126, compared with Easterbrook, F.H. and Fischel, D.R. [1989], *op. cit.*, 1437-1446 and Easterbrook, F.H. and Fischel, D.R. [1991], *The Economic Structure*, cit., 90-108.

63 The most important symposium on this matter was held, already in 1989, at the University of Columbia. Symposium [1989], *Contractual Freedom in Corporate Law*, in COLUMBIA LAW REVIEW, vol. 89, 1395-1774 (November 1989.

to this view.[64] In fact, we are about to see that how contractual incompleteness is dealt with by corporate law just depends on this distinction. Curiously enough, we owe this fundamental intuition to legal research; even though understanding its positive and normative implications requires an enhanced paradigm of economic analysis, allowing for more than just agency costs to be considered.[65]

To sum up, there are three basic points of criticism that can be raised against the classical 'law matters' thesis. I will attempt to take stock of all of them in the remainder of this Chapter. The first is the accuracy with which the quality of legal protection of outside shareholders is assessed across different countries. The second is whether investor protection being established on a legal basis is all that matters for having ownership separated from control. The third is whether corporate law matters in that its rules are mandatory, enabling, or both. We are going to discuss each of them in turn.

4.3. The Economist's Approach to Legal Comparison

4.3.1. Measuring the Quality of Law and Its Impact on Separation of Ownership and Control

Few papers in either law or economics have ever enjoyed the popularity of *Law and Finance*. After about ten years, it is still considered a milestone publication in comparative corporate law.[66] *Law and Finance* contains the first attempt to 'measure'

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[64] It is remarkable that, in the very last paper of the Law and Finance series – where this point of criticism is specifically addressed –, the authors maintain:

> "We recognize that firms may, in their charters, opt out of the default rules set in the law. Firms may also enhance investor protection by including in their charters provisions favorable to shareholders. However, it has been shown theoretically (Bergman and Nicolaievsky 2006) and established empirically – including in this paper – that the actual rules do matter for financial development."

Djankov *et al.* [2006], *Self-Dealing*, cit., 30-31 (citing Bergman, N. and Nicolaievsky, D. [2004], *Investor Protection and the Coasian View*, Working Paper No. 4476-04, Department of Economics at the MIT, forthcoming in JOURNAL OF FINANCIAL ECONOMICS, 2008).

[65] See, most notably, Rock, E.B. and Wachter, M.L. [2001], *Islands of Conscious Power: Law, Norms and the Self-Governing Corporation*, in UNIVERSITY OF PENNSYLVANIA LAW REVIEW, vol. 149, 1619–1700.

[66] See, most recently, Georgakopoulos, N.L. [2006], *Statistics of Legal Infrastructures: A Review of the Law and Finance Literature*, in AMERICAN LAW AND ECONOMICS REVIEW, vol. 8, 62-80. But see also Kraakman, R.H., Davies, P., Hansmann, H., Hertig, G., Hopt, K.J., Kanda, H. and Rock, E.B. [2004], THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH, Oxford Uni-

the quality of corporate law across different countries. The assessment was based on the assignment of scores on standardized indexes of legal variables defining what the authors *believed* were the most important features of outside shareholder protection from the corporate controllers' misbehavior. Indexing was originally performed across 49 countries with different legal traditions.[67] Econometric analysis showed that ownership concentration was strongly related to the quality of corporate law as measured by those indexes, and – as expected – the relationship was negative (i.e., lower quality implied higher ownership concentration).[68]

Notwithstanding legitimate concerns about reverse causality, this was considered enough of a proof of the 'law matters' thesis.[69] Those concerns were in fact overcome by the observation that the ultimate factor affecting the relationship was plainly exogenous to ownership structure, and yet significantly related to the quality of corporate law. This factor was the 'legal origin,' namely the 'family' to which a legal system belongs historically.[70] In particular, legal systems based on the *common*

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versity Press (hereinafter Kraakman *et al.* [2004], *The Anatomy*), 217-222 and Siems, M. [2005], *Numerical Comparative Law - Do We Need Statistical Evidence in Order to Reduce Complexity?*, in CARDOZO JOURNAL OF INTERNATIONAL AND COMPARATIVE LAW, vol. 13, 521-540 – both with a critical attitude towards the approach, the methodology, and the results.

67 The coverage of the sample has very much increased over time thanks to the support of the World Bank, which has endorsed this methodology of research in the Doing Business Project. The project is intended to provide "objective measures of business regulations and their enforcement" across the most part of the world. See World Bank [2004], *Doing Business in 2004 – Understanding Regulations*, The World Bank (also available at www.worldbank.org); World Bank [2005], *Doing Business in 2005 – Removing Obstacles to Growth*, The World Bank (also available at www.worldbank.org); World Bank [2006], *Doing Business in 2006 – Creating Jobs*, The World Bank (also available at www.worldbank.org); World Bank [2007], *Doing Business in 2007 – How to Reform (Overview)*, The World Bank (also available at www.worldbank.org). The analysis of regulation is divided in ten categories, including Investor (Shareholder) Protection, and indicators are calculated for as many as 175 countries as of 2007. See www.doingbusiness.org for utmost detailed information on data, methodology, and policy implications. In the scientific literature forming the basis of the work published by the Word Bank, the comparison concerning legal protection of shareholders has been performed so far for 72 countries. See Djankov *et al.* [2006], *Self-Dealing*, cit.

68 La Porta *et al.* [1998], *Law and Finance*, cit.

69 Is it law that determines economic performance or just the other way around? There is no clear-cut answer to this question, even though the problem is addressed by the econometric methodology. The problem is known as 'endogeneity' in the jargon of econometrics. For a specific analysis of the endogeneity problem in *Law and Finance*, see Spamann, H. [2006], *On the Insignificance and/or Endogeneity of La Porta et al.'s 'Anti-Director Rights Index' under Consistent Coding*, Harvard Law School, Working Paper No. 7 (Fellows Series), available at www.ssrn.com.

70 Legal origin is too much of a *structural* variable to be influenced by economic performance. See La Porta *et al.* [1998], *Law and Finance*, cit., 1126. The point is whether it is assessed accurately (Siems, M. [2006], *Legal Origins: Reconciling Law & Finance and Comparative Law*, CBR Working Paper No. 321, University of Cambridge, available at www.ssrn.com) and, even more importantly, whether it matters (Kraakman *et al.* [2004], *The Anatomy*, cit., 221-222).

law tradition systematically provided non-controlling shareholders with better protection compared to those based on *civil law tradition*.[71] Subsequent analyses by the authors have both reiterated the empirical strength of this conclusion and tried to put it in a theoretical framework.[72] Nowadays, this is the prevailing explanation of why significant separation of ownership and control is quite a widespread phenomenon among large firms in Anglo-Saxon countries with a common law tradition, whereas it takes place to a much narrower extent in the rest of the world.[73]

The above proposition is widely shared among economists, especially the American ones – European economists are in fact more skeptical about it.[74] Contrariwise, lawyers on both side of the Atlantic very often label such an approach to legal comparison as naïve.[75] Actually, they are right. Not only the technique adopted for the quantitative 'measurement' of legal variables does not (and probably, could not) follow a *functional* approach, and has therefore not much to do with the basic tenets of legal comparison.[76] Also the *relevance* of the variables selected is highly

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[71] For a comprehensive criticism of reliance on legal families (or 'legal origins,' as economists prefer to call them) for assessing the historical roots of legal protection of outside investors, see, in comparative law, Siems, M. [2006], *op. cit.*

[72] See, e.g., La Porta *et al.* [2000a], *Investor Protection*, cit.

[73] This is not uncontroversial, though. See, e.g., Becht, M. and Mayer, C. [2001], *op. cit.*, 4-7, for a summary illustration.

[74] See, most notably, Hellwig, M. [2000], *On the Economics and Politics of Corporate Finance and Corporate Control*, in X. Vives (ed.), CORPORATE GOVERNANCE: THEORETICAL AND EMPIRICAL PERSPECTIVES, Cambridge University Press, 95-134.

[75] See, e.g., Paredes, T.A. [2004], *op. cit.*, 1073-1074, and Cheffins, B.R. [2003], *op. cit.*

[76] On the functional approach to legal comparison, see Zweigert, K. and Kötz, H. [1998], INTRODUCTION TO COMPARATIVE LAW, 3rd edn. (translated from German by T. Weir), Oxford University Press. Kraakman *et al.* [2004], *The Anatomy*, cit., 216, argue that "while legal comparativists recognize the need for functional analysis, they traditionally relied upon jurisdiction-by-jurisdiction or, at best, legal family approaches." Not even Zweigert and Kötz are fully immune from this criticism. Another problem is that legal comparison is easily distorted by "labels-oriented approaches:" students of comparative law tend to rely upon assonances between legal categories across the board, and are most often misled by them. Id., at 217. Overcoming doctrinal parochialism has traditionally proved very difficult for lawyers. See the critical remarks in Mattei, U. [1999], COMPARATIVE LAW AND ECONOMICS, University of Michigan Press, 77-78; and Merryman, J.H. [1969], THE CIVIL LAW TRADITION, Stanford University Press.

And yet, the worst of all worlds is when comparison is undertaken without sufficient legal training by the economists. Then categorization of legal families, traditions, and rules becomes extremely naïve. Not only the significance of comparison is undermined by 'labels-orientation,' but the labels themselves are often incorrect, so that very functioning of each system is misinterpreted. An illustrative example is provided by Glaeser, E.L. and Shleifer, A. [2002], *Legal Origins*, in QUARTERLY JOURNAL OF ECONOMICS, vol. 117, 1193-1230. Unsurprisingly, this article is quite often cited by the economists, but almost completely ignored by the lawyers (see, e.g., www.scholar.google.com – 217 citations as of May 2007). Anybody who takes the effort to compare the paper with the more technical discussion of legal origins (and their implication for the legal process) in Zweigert and Kötz's classic would easily understand why.

questionable, for they do not account for the legal institutions that most effectively protect outside shareholders.[77] These two technical problems ultimately make this approach to legal rules – which has been efficaciously labeled as "numerical comparative law" – unsuitable to the comparison of Law and Economics of corporate governance between different countries.[78]

4.3.2. 'Numerical' vs. 'Functional' Comparative Law

In *Law and Finance*, La Porta *et al.* reported many statistics on alternative sources of legal protection of outside investors. However, it was a particular combination of substantive rules in corporate law that had the strongest explanatory power in the econometric analysis. Such a combination seemed to explain why ownership is dispersed in some countries and concentrated in some others;[79] and, similarly, why some countries have more developed stock markets than others.[80] The combination at issue was based on a selection of six legal rules allegedly aimed at constraining management power exerted through the board of directors. It was measured by an

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[77] Here the question is: 'What matters in corporate law?' The answer is clearly far from simple. Anyway, it requires both economic *and* legal expertise. Economists are often too unsophisticated in their legal analyses to go beyond a 'labels-oriented' approach, thereby undermining *functional* comparison. However, at least they know what to look for among the labels. Lawyers may understand better the functional differences among legal systems (at least to the extent they manage to overcome doctrinal parochialisms – see the previous note), but they are lost when it comes to the selection of *relevant* issues, for this requires a theoretical paradigm which cannot be found *inside* the law, but needs to be searched for *outside* legal knowledge. The Law and Economics approach is an extremely powerful way to bridge this chasm when the (comparative) regulation of economic phenomena is at issue. However, this just can work on condition that Law and Economics properly *merges* legal understanding with an economic paradigm of analysis. See, for illustration and discussion, Mattei, U. and Cafaggi, F. [1998], *Comparative Law and Economics*, in P. Newman (ed.), THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW, Macmillan, vol. 1, 346-352. Unfortunately there are not many authors featuring a 'true' comparative Law and Economics approach in the CG field. But let me cite at least three prominent exceptions in the recent literature: Kraakman *et al.* [2004], *The Anatomy*, cit.; Gilson, R.J. [2006], *op. cit.*; and Cools, S. [2005], *op. cit.* Their work will be discussed throughout the following analysis of this book. All of them perform legal comparison with a functional methodology, albeit with different scope; and all of them feature relevance criteria for selecting the law that matters. However, all of them stick to the standard agency approach for analyzing legal rules across different systems and jurisdictions.
One major novelty of the comparative Law and Economics approach taken in the present investigation is that CG is interpreted through the lens of a *different economic paradigm*, wherein principal-agent problems are just a part of the story and, to be sure, not even the most important one. See *infra*, Chapter Six, for a detailed discussion.

[78] The expression was nicely coined by Siems, M. [2005], *op. cit.*

[79] La Porta *et al.* [1998], *Law and Finance*, cit.

[80] La Porta *et al.* [1997], *Legal Determinants*, cit.

index where a score of 1 or 0 was assigned depending on whether each 'anti-director' rule was present or not in national corporate laws. Therefore, the index proxying for the corporate law's quality was termed 'Anti-director Rights Index' and this is how it is still referred to by the international literature. Legal systems whose origins lies in the common law tradition scored much better on the Anti-director Rights Index than those based on civil law tradition, and in fact, the former have on average much lower ownership concentration and better developed stock markets than the latter. Thus, superiority of the Anglo-American legal origin in the regulation of corporate finance sprang out as a powerful corollary of the 'law matters' thesis.[81]

The methodology of *Law and Finance* was highly innovative and its thesis extremely provocative. Criticisms of both methodology and implications abound in the literature. Accounting for such a broad debate would lead us too far away from the focus of the present inquiry.[82] Nevertheless, the major methodological problems with the Anti-director Rights Index are worth a brief notice, for they illustrate

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81 The reader should be cautioned that most of the work authoritatively co-authored by Professor Shleifer over the past ten years is based on this intuition. See, most representatively, Glaeser, E.L. and Shleifer, A. [2002], *op. cit.*; Djankov, S., La Porta, R., Lopez-de-Silanes, F. and Shleifer, A. [2003], *Courts*, in QUARTERLY JOURNAL OF ECONOMICS, vol. 118, 453-518.; Djankov, S., Glaeser, E., La Porta, R., Lopez-de-Silanes, F., Shleifer, A. [2003], *The New Comparative Economics*, in JOURNAL OF COMPARATIVE ECONOMICS, vol. 31, 1-37. Some American lawyers have apparently subscribed to this view. See, e.g., Mahoney, P.G. [2001], *The Common Law and Economic Growth: Hayek Might be Right*, in JOURNAL OF LEGAL STUDIES, vol. 30, 503-25.

82 At least one important contradiction about the implications is worth mentioning, though. None of the rules included in the Anti-director Rights Index – which are going to be discussed in more detail in the next few pages – has anything to do with common law. See, e.g., Coffee, J.C. Jr. [2001b], *op. cit.* In both the American and the British legal systems, the rules at issue entered by means of statutory law: that is to say, the Delaware General Corporation Laws in the US and the Companies Act of 1985 in the UK. Therefore, the law-making process underlying the fundamental features of shareholder protection according to La Porta *et al.* is not different between common law and civil law systems. In both situations the relevant rules were possibly enacted by the legislature, but not certainly developed by the courts on a case-by-case basis. One might object that the legal tradition affects the accuracy with which the same rules are enforced in the two systems. Roe, M.J. [2003b], *op. cit.*, suggests that this may be the explanation. This interpretation, however, calls into play different features of Anglo-American law, which are indeed germane to the common law tradition, but are definitively *not* included in the Anti-director Rights Index. These are the *fiduciary duties* of Anglo-Saxon corporate laws, which are ultimately intended to police the corporate controllers' misbehavior. However, on the one hand, fiduciary duties were historically developed from the law of equity, and only subsequently merged into the common law. See Zweigert, K. and Kötz, H. [1998], *op. cit.* On the other hand, their present implementation in corporate lawsuits varies substantially across common law jurisdictions, and it is particularly different between the US and the UK. See Franks, J. and Mayer, C. [2002], *Corporate Governance in the UK – Contrasted with the US System*, in CESIFO FORUM No. 3/2002, 13-22. We will come to this key point in the Eight Chapter.

the most common mistakes incurred by economists when they attempt to assess the quality of law numerically.

To begin with, the six legal rules whereupon shareholder protection is supposed to be dependent are not accurately 'measured' across countries.[83] Some countries received a score of 1 on shareholder rights which are only optional under corporate law, whereas some others scored 0 on shareholder entitlements that are not codified but are nonetheless plainly granted by jurisprudence.[84] Technically speaking, both case-law and the distinction between mandatory, default, and optional rules are not accounted for in the definition of components of the Anti-director Rights Index, even though nobody with a moderate legal training would ever doubt that this qualifies as pertinent law – especially in the field of shareholder protection![85]

Further points of criticism are more radical. First, who tells that in *every* country shareholder protection depends on exactly the *same* rules to the *same* extent? And why should they be just *those six* rules? Could not an equivalent degree of protection be granted by a different, but foregone set of rules? Then, how should the importance of each rule in a given country be weighted within each set? These problems are probably impossible to overcome within any 'indexing' methodology – unless indexes are allowed extraordinary wideness and complexity.[86] But one thing is for sure: the celebrated index by La Porta *et al.* has little, if anything, to do with functional comparison and, therefore, it is a very inaccurate proxy for legal protection of non-controlling shareholders in different countries.

Measurement problems with the Anti-director Rights Index have been extensively documented by the recent literature, and they were ultimately corrected for (albeit just partly) by Shleifer and a different combination of co-authors (Simeon Djankov instead of Robert Vishny). A revised version of the index is just being circulated with the last paper of the 'law and finance' series.[87] The other problems are

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83 This kind of mistakes in the analysis by La Porta *et al.* has been highlighted by a number of papers, of which the most recent is Spamann, H. [2006], *op. cit.* But see, e.g., Enriques, L. [2002a], *Do Corporate Law Judges Matter? Some Evidence from Milan*, in EUROPEAN BUSINESS ORGANIZATION LAW REVIEW, 756-821 (esp. note 43); Braendle, U.C. [2006], *Shareholder Protection in the USA and Germany – "Law and Finance" Revisited*, in GERMAN LAW JOURNAL, vol. 7, 257-278.

84 The work by Spamann, H. [2006], *op. cit.*, specifically addresses the problem of consistency in coding the index across jurisdictions.

85 Lately, Professor Shleifer and his old and new co-authors admitted this problem in the construction of the Anti-director Rights Index, and tried to revise it accordingly. See Djankov *et al.* [2006], *Self-Dealing*, cit. However, it should be noticed that the authors do not consider this as an essential issue, and apparently have only addressed it to show that their thesis hold in spite of methodological criticisms. See, especially, section 5 of the paper – 'Other measures of investor protection.'

86 Cools, S. [2005], *op. cit.*, 704-736

87 Djankov *et al.* [2006], *Self-Dealing*, cit. For a brief survey of the literature on measurement problems, see Spamann, H. [2006], *op. cit.*, 1-3.

much harder to cope with, since they cast doubt on the very relevance of each component of the index as to investor protection.[88] The six components of the Anti-director Rights Index are: (i) the right of shareholders to mail their proxy vote to the firm; (ii) the individual right to participate in the general meeting without having shares blocked in advance; (iii) proportional shareholder representation in the board of directors (or so-called 'cumulative voting'); (iv) judicial venues against unfair conduct by directors actionable by shareholders accounting for no more than 10% of share capital; (v) preemptive rights in new issues of stock; (vi) the right to call an extraordinary general meeting granted to shareholders representing no more than 10% of share capital.[89]

Surprisingly enough, the relevance of the above rights as to shareholder protection has been questioned even for the US, on whose typical corporate governance model the selection of legal rules was clearly based.[90] Many American legal scholars stressed that corporate lawyers would not consider *any* of the components of the Anti-director Rights Index among the principal tools of investor protection provided for by US law.[91] The criticism went even further in continental Europe. Not only rules other than those considered by La Porta *et al.* seemed to be actually responsible of the quality of minority shareholder protection,[92] but some of the rules included in the Anti-director Rights Index were just going in the opposite direction.[93]

One prominent example is proxy voting. This is allowed in many countries but does not have always to do with investor protection. In France and in Germany, for instance, proxy voting is regulated in such a way that it can only support incumbent controllers.[94] To be sure, in the Seventh Chapter we will discover that proxy voting most often works to the advantage of insiders rather than of outside investors, and that this is especially true in the US and in the UK.[95] Another example of a shareholder right that may turn out to be against outside investor protection is proportional representation in the board, or cumulative voting. This might be helpful for

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88 See, illustratively, Cools, S. [2005], *op. cit.*, 751-755

89 La Porta *et al.* [1998], *Law and Finance*, cit., 1122-1125.

90 Paredes, T.A. [2004], *op. cit.*, 1073-1074.

91 See, e.g., Coffee, J.C. Jr. [2001b], *op. cit.*, 8 ("The specific 'anti-director' rights that [La Porta *et al.*] identify as the central factors distinguishing common-law from civil-law systems strike many commentators as only tangentially related to effective legal protection for minority shareholders."); and Roe, M.J. [2002], *op. cit.*, 252, note 28 (pointing out that the components of the index are "not likely to be near the top of most American lawyers' lists of Delaware corporate law's most important legal protections").

92 Baums, T. and Scott, K.E. [2005], *op. cit.*, 68-75.

93 Cools, S. [2005], *op. cit.*, 751-755.

94 Kraakman *et al.* [2004], *The Anatomy*, cit., 41-44.

95 See *infra*, Chapter Seven, section 7.3.

minority shareholders in concentrated ownership structure, but is most likely to be counterproductive where ownership is dispersed and shareholder empowerment depends on the ability to coalesce and take full control of the board.[96] For similar reasons, preemptive rights are almost irrelevant for investor protection in dispersed ownership structures, where – absent a takeover contest – voting power concentration is much too low to risk dilution, whereas dilution of cash flow rights is policed by strict enforcement of fiduciary duties as a precondition for separating ownership from control.[97]

Professor Shleifer and his old and new co-authors have lately attempted to cope also with this criticism. However, instead of modifying their methodology, they rather searched for additional support of their reasoning in alternative lines of inquiry.[98] The methodology of *Law and Finance* was then first extended from corporate law to securities law and, most recently, to that part of corporate law specifically aimed at preventing expropriation of non-controlling shareholders – namely, conflicted interest transactions.[99] As a result, the standard reference for the cross-country assessment of the quality of corporate law – the Anti-director Rights Index – has been supplemented with a 'Revised Anti-director Rights Index,' two indexes of investor protection under securities law ('Disclosure in Prospectus' and 'Prospectus Liability'), and an index of legal policing of self-dealing ('Anti Self-Dealing Index'). All of these indexes show a significant correlation with stock market development and dispersion of corporate ownership, and continue to support the view that the common law tradition outperforms civil law countries as to the quality of investor protection and the availability of equity finance to the corporate enterprise.[100]

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96 Indeed, this is the traditional argument against cumulative voting: Easterbrook, F.H. and Fischel, D.R. [1983], *Voting in Corporate Law,* in JOURNAL OF LAW AND ECONOMICS, vol. 26, 395-427.

97 Cools, S. [2005], *op. cit.*, 753-754. However, a different conclusion may hold when fiduciary duties are not an effective safeguard against dilution. See Franks, J., Mayer, C. and Renneboog, L. [2001], *Who Disciplines Management in Poorly Performing Companies?* , in JOURNAL OF FINANCIAL INTERMEDIATION, vol. 10, 244-245.

98 Djankov *et al.* [2006], *Self-Dealing*, cit., 29-37, explicitly acknowledge the criticism of the "*ad hoc*" nature of the Anti-director Rights Index, having to do more with how minority shareholders are empowered in decision-making than with how they are protected from expropriation. However, they find that the new and more focused indexes calculated in La Porta *et al.* [2006], *What Works*, cit., and Djankov *et al.* [2006], *Self-Dealing*, cit., not only do provide a more theoretically grounded description of shareholder protection, but also confirm the results first obtained through the Anti-director Rights Index with more robust statistics.

99 See, respectively, La Porta *et al.* [2006], *What Works*, and Djankov *et al.* [2006], *Self-Dealing*, cit.

100 However, it is worth noting that both stock market development and CG patterns continue to be assessed on the basis of the very crude proxy for ownership concentration originally set up in La Porta *et al.* [1998], *Law and Finance*, cit., 1145-1146. See section 4.3.3 below.

To be sure, the construction of the last indexes by La Porta *et al.* is based on some improvements in the methodology, which suggest a somewhat more functional approach. The two indexes of quality of securities law refer to *categories* of tools available to investors for preventing or challenging a standard securities fraud.[101] The Anti Self-Dealing Index is based on *a number* of both *ex ante* and *ex post* remedies in the face of a stylized case of self-dealing.[102] Unfortunately, not all possible reactions of each legal system to either securities frauds or conflicted interest transactions are accounted for. Neither do I believe that they could ever be. Even worse, the weighting of each kind of reaction is standardized – although nobody would doubt that the relative importance of each category of remedies varies from country to country.

As far as the first problem is concerned, both American and comparative lawyers acknowledge that a major strength of investor protection under US securities law comes from a rather unique combination of class action suit with the lawyers' contingent fees.[103] However, this issue is deliberately dismissed from the numerical assessment of the quality of securities law on grounds that, statistically, it bears no significant relation with cross-country stock market development.[104]

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[101] See La Porta *et al.* [2006], *What Works*, cit., 5-13, for illustration.

[102] Djankov *et al.* [2006], *Self-Dealing*, cit., 5-7 and Figure I. For a more detailed discussion of the definition of the stylized case, and of the policy implications derived thereof, see *infra* Chapter Nine, section 9.4.1.

[103] See Coffee, J.C. Jr. [2001a], *Do Norms Matter? A Cross-Country Evaluation*, in UNIVERSITY OF PENNSYLVANIA LAW REVIEW, vol. 149, 2164–2165; and the Kraakman *et al.* [2004], *The Anatomy*, cit., 114-118 and 210-212.

[104] La Porta *et al.* [2006], *What Works*, cit., 11, note 8. This is not surprising, indeed, for availability of contingent fees is assessed with reference to completely unrelated categories of legal suit: the 'eviction of a tenant' and the 'collection of a bounced check.' To be sure, this is not entirely obvious from the paper. But it is clear from the underlying data, made publicly available (http://post.economics.harvard.edu/faculty/shleifer/Data/securities_data1.xls), and from the overall work of Andrei Shleifer and his co-authors for the World Bank (www.doingbusiness.org) over the past few years. In cooperation with the firms of the Lex Mundi Association (www.lexmundi.com), La Porta *et al.* have assessed the quality of enforcement just by studying the two above-mentioned procedures. Djankov, S., La Porta, R., Lopez-de-Silanes, F. and Shleifer, A. [2003], *op. cit.* Eventually, that became the methodological basis for the index "Enforcing Contracts," published by the World Bank within the *Doing Business* Project (http://www.doingbusiness.org/ExploreTopics/EnforcingContracts/). An amazing result of this methodological stretch is that, for instance, US securities law scores 0 on the contingent fee account (see the database source cited above). Yet, if neither the 'eviction of a tenant' nor the 'collection of a bounced check' allows for contingent fees in the US, a securities case certainly does! See *infra*, Chapter Nine, section 9.2.3. Also the dummy for 'class action suit' seems to bring together different situations depending on each country's civil procedure, which – regardless of the *nomen juris* – may be not always equally effective in overcoming collective action problems of dispersed investors. For example, aggregation of investors' claims is structurally different in the US and in the UK, where contingent fees are not available and the various forms of 'collective' action are not to be confused with the US-style 'class' ac-

As far as weighting is concerned, how effectively self-dealing is policed by the legal system is not just a matter of *how many* safeguards are available but, rather, of how they are *combined*. For instance, Swedish score on Anti Self-Dealing Index is even lower than in Italy (33% and 42% respectively, as opposed to 65% for the US and 95% for the UK) whereas the Netherlands scores almost as bad as emerging countries (20% – that is, less than a half of the world average).[105] However, as I will clarify in the Eight Chapter, both the Netherlands (by means of a special procedure and a specialized Court) and Sweden (by means of severe public enforcement supporting powerful social norms) functionally provide investors with good protection from expropriation. On the contrary, Italy, whose law is formally featured with anti-self-dealing provisions that are often short-circuited in practice, does not – or, at least, not yet.[106]

In a more general perspective, the problem with 'numerical comparative law' is that it does not *allow* comparisons to be performed functionally and therefore meaningfully.[107] Apparently similar rules most often *mean* different things in each legal system and, more importantly, they *work* differently. This point has been recently made just with reference to the Anti-director Rights Index by La Porta *et al.*:

> "[E]ven with the scores revised, the index does not reflect all the protective mechanisms that a legal system offers. The existence of a slight differentiation in a seemingly identical or similar mechanism, or even a different context gives an identical or similar rule a totally or slightly different meaning. 'Cross-reference,' as it is called, is not always possible. To quote Bradley: 'We are tempted to think that we understand what the rules are in another legal culture because we think they are like our own, or we think we understand how they are different. But the reality is usually more complex than we could ever imagine. […] It is not enough to read the foreign rules, because even when the rules appear to be written in our own language they are not.'"[108]

tions. See Clifford Chance [2006], *Are "class actions" on the way to Europe?*, available at www.cliffordchance.com, for a brief illustration. Indeed, this is one of the reasons why investor protection in Britain is not channeled through private enforcement in courts. See Franks, J. and Mayer, C. [2002], *op. cit.*, and, in more detail, *infra* Chapter Nine, section 9.3.2. And yet, both the US and the UK score 1 on the account of availability of class actions (see the database source cited above).

105 Djankov *et al.* [2006], *Self-Dealing*, cit., table III.

106 See *infra*, Chapter Nine, sections 9.3.3, 9.3.4, and 9.3.5.

107 Siems, M. [2005], *op. cit.*

108 Cools, S. [2005], *op. cit.*, 735-736 (quoting Bradley, C. [1999], *Transatlantic Misunderstandings: Corporate Law and Societies*, in UNIVERSITY OF MIAMI LAW REVIEW, vol. 53, 269-314).

Of course, one should avoid exaggerating in the opposite direction. Some lawyers might be tempted to overstate the differences between legal systems, to make sure that they are not blamed for superficiality. But where superficiality undermines the significance of the analysis, meticulousness impairs the understanding of comparison. Two completely different objects can just be *described*, but they need to have something in common to be *compared*. Economic analysis can help to bridge the gap, by setting the yardstick for the comparison of legal rules.[109] In this perspective, the terms of a functional approach to the comparison of legal rules aimed at constraining outside shareholder expropriation have been nicely summarized by Ronald Gilson:

> "For purposes of this inquiry, I have in mind the legal realist's broader concept of law than typically reflected in the law and finance literature. […] Good law must specify *substantive standards*; require sufficient *disclosure* that those with the power to enforce the standards know of violations; and provide an effective *enforcement* process. This can be accomplished through detailed legislation, as with European laws governing corporate groups, or by judicially developed principles of fiduciary duty, as in the United States."[110]

Comparison of legal rules in the present work will follow that approach. This will be evident when we will discuss the rules specifically affecting the protection of non-controlling shareholders.[111]

4.3.3. How It Worked Out

In the face of all methodological criticisms, and of their even obvious strength, the research papers by La Porta *et al.* worked pretty well. One could randomly select one article of their long series of contributions to the literature to find very elegant empirical proofs of their major thesis as well as of the specific corollary being tested. Comparative lawyers may not care much, provided that the substantive con-

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[109] In other words, economic analysis should work as a *tertium comparationis*. I owe this insight to Roberto Pardolesi, and more specifically to his comparative law lectures, which I attended during my undergraduate studies. Professor Pardolesi has introduced and instructed me in the economic analysis of law since then.

[110] Gilson, R.J. [2006], *op. cit.*, 1653. For discussion of the European laws on corporate groups, in the same comparative perspective, see also Wymeersch, E. [2003], *Do we need a law on groups of companies?*, in K. Hopt and E. Wymeersch (eds.), CAPITAL MARKETS AND COMPANY LAW, Oxford University Press, 573-600, and Kraakman *et al.* [2004], *The Anatomy*, cit., 101-130.

[111] See *infra*, Chapter Eight.

tents of legal rules are very often misinterpreted and, in any case, they are incorrectly compared between different legal systems. Any scientist would look with utmost skepticism to statistical inference when he knows for sure that the grounds upon which it has been undertaken are misguided. However, this would leave economists with an equally strong point. If their methodology was truly incorrect, how have La Porta *et al.* possibly managed to obtain robust statistical results on such a basis? After all, empirical economists may in their turn not care much about how sophisticated legal comparison is, provided that the statistical results which it delivers are robust.

At first glance, this may seem one additional example of incommunicativeness between economic and legal expertise. To be sure, this is actually how the issue is apparently dealt with. The majority of comparative lawyers do not take the work by La Porta *et al.* seriously.[112] Contrariwise, economists never take stock of comparative law to question the results of the same work.[113] Those in Corporate Law and Economics who disagree on their thesis question its historical, factual, or theoretical basis; sometimes, they also question the econometrics.[114] Yet there is a much simpler explanation of why *Law and Finance* and the literature that followed have so far performed very well in showing empirical dependence of ownership concentration on the quality of legal rules, despite of the latter being assessed upon an incorrect account of comparative law. The reason is that also the dependent variable – ownership concentration – is not measured very scrupulously. At the very least, it is not measured as scrupulously as I attempted to do in Chapter Two.

The standard reference for cross-country econometric analysis of institutional determinants of corporate governance is still ownership concentration as it was first assessed by La Porta *et al.* in *Law and Finance* and *Corporate Ownership around the World*.[115] Consequently, the far most popular measure of ownership concentration

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[112] At times, they even try to make it ridiculous. West, M. [2002], *Legal Determinants of World Cup Success*, Working Paper No. 02/009, University of Michigan Law School, available at www.ssrn.com, is one illustrative example of the paradoxical results that can be obtained by relying on legal origins for statistical interference.

[113] Nevertheless, some very appealing explanations of the institutional determinants of financial development have been put forward by departing from the legal origin hypothesis. See the authoritative contributions by Acemoglu, D., Johnson, S. and Robinson, J.A. [2001], *The Colonial Origins of Comparative Development: An Empirical Investigation*, in AMERICAN ECONOMIC REVIEW, vol. 91, 1369-1401, and by Beck, T., Demirgüç-Kunt, A. and Levine, R. [2003], *Law, Endowments, and Finance*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 70, 137-181.

[114] See, e.g., Cheffins, B.R. [2003], *op. cit.*; Mayer, C. [2005], *op. cit.*; Paredes, T.A. [2004], *op. cit.*; Spamann, H. [2006], *op. cit.*

[115] See *supra*, Chapter Two, section 2.2.2. In La Porta *et al.* [1998], *Law and Finance*, cit., ownership concentration was assessed on the basis of the data collected in the companion paper La Porta, R., Lopez-de-Silanes, F. and Shleifer, A. [1999], *Corporate Ownership around the World*, in JOURNAL OF

is based on the average percentage of common stock held by the three top shareholders in the 10 largest non-financial, privately owned listed companies in each country as of 1995. We have already discussed in Chapter Two the weaknesses of this measure.[116] However, exactly *that* measure appears to be significantly related to all of the indexes of corporate law's quality that La Porta *et al.* have elaborated over time.[117] When ownership concentration is assessed with some greater precision, the 'law matters' proposition does not always hold across developed countries. Quite to the contrary, it seems to be contradicted by many situations that we observe in the real world.[118]

Some countries have allegedly 'good' corporate law, but nonetheless ownership and voting power remain concentrated. For instance, during the latest developments of numerical comparative law, France and Spain were awarded quite high scores on some indexes of legal protection of minority shareholders.[119] However,

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FINANCE, vol. 54, 471-517. In spite of subsequent developments in the empirical research, that account of ownership concentration has been never updated by La Porta *et al.*

[116] See *supra*, Chapter Two, section 2.5.

[117] The problem also affects regression analysis concerned with stock market development. In all but the very last paper of the Law and Finance series, stock market development is measured as *external* stock market capitalization. See, e.g., La Porta *et al.* [1998], *Legal Determinants*, cit., and La Porta *et al.* [2006], *What Works*, cit. This means that the figures for stock market capitalization to GDP are discounted by the measure of ownership concentration, in order to capture the portion of equity capital held by non-controlling shareholders. See *supra*, Chapter Two, section 2.5. Unfortunately, to the extent that the average stake held by the three top shareholders in the 10 largest non-financial, privately owned listed companies does not represent an accurate estimate of controlling ownership, this measure of stock market performance is also unreliable. Apparently, in Djankov *et al.* [2006], *Self-Dealing*, cit., the authors have abandoned this measure in favor of a more traditional index of *total* stock market capitalization to GDP.

[118] The standard measures of ownership concentration established by the Law and Finance literature (see, most recently, Djankov *et al.* [2006], *Self-Dealing*, cit., table VI) are often significantly different from the results presented in Chapter Two (see, especially, section 2.4.2 and accompanying tables). For instance, Sweden appears to feature rather dispersed ownership structures (28% of common shares held on average by the *three largest* shareholders, as opposed to about 20% in the US and the UK). However, we know that voting power concentration in Swedish companies is among the highest in continental Europe (the average *largest* block accounting for about 50% of voting rights). France is also characterized by a relatively dispersed CG structure (34% of stock ownership held on average by the three largest shareholders); but we know that nearly 4/5 of listed firms have one single controlling shareholder who holds at least 25% of voting rights and that the average size of the largest voting blocks is well above 50%. The Netherlands is always considered by the Law and Finance literature as a CG system based on rather concentrated ownership (nearly 40% of voting rights held on average by the three largest shareholders). However, on the basis of a more refined analysis of ownership and control in the Dutch stock market, the Netherlands may be the only country in continental Europe featuring a majority of listed firms with dispersed ownership (see Chapter Two, Box 2 and Figure 6.3 therein).

[119] Specifically, Spain has one of the highest ranking on the Revised Anti-director Rights Index. See Djankov *et al.* [2006], *Self-Dealing*, cit., table XIII. Even more surprisingly, France was awarded a

we know from the Second Chapter that separation of ownership and control is limited in both countries. Then there are other countries – like Sweden – where, according to La Porta *et al.*, shareholders are granted an intermediate level of legal protection. However, differently from what La Porta *et al.* have always reported, we know fairly well by now that control of Swedish listed firms is extremely concentrated, and is mostly in the hands of a few wealthy families.[120] Finally, there are countries where legal protection of outside shareholders is allegedly 'bad,' and yet many, if not most, listed companies are widely held. La Porta *et al.* continue to report the Netherlands as a country with a very concentrated pattern of corporate ownership and control, but we know that this depiction of Dutch corporate governance is incorrect.[121]

It should be noted that this problem with the cross-country assessment of ownership concentration extends well beyond the work by La Porta *et al.* It biases many of the attempts that, following the publication of *Law and Finance*, have been made either to confirm or to falsify the 'law matters' thesis on empirical grounds.[122] Therefore, we will not be surprised to discover in the following pages that authoritative commentators apparently worked out more comprehensive, and even empirically more robust, accounts of the institutional determinants of corporate governance; but, in the end, also these explanations are not completely satisfactory.

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score nearly as high as that of the UK as regards the Anti Self-Dealing Index, at least when this index was first calculated. This somewhat counterfactual result was only reported in the very first version of Djankov, S., La Porta, R., Lopez-de-Silanes, F. and Shleifer, A. [2005], *Law and Economics of Self-Dealing* (November 4, 2005), mimeo, informally circulated in autumn 2005 (on file with the author). Very notably, in the subsequent versions of the paper, France has been significantly downgraded as to the Anti Self-Dealing Index (from 85% to 38%), even though the description of the legal instruments for shareholder redress is basically unchanged in the text. See Djankov *et al.* [2006], *Self-Dealing*, cit., 19-20 and table III.

120 This circumstance is now quite settled in the literature. See, e.g., Agnblad, J., Berglöf, E., Högfeldt, P. and Svancar, H. [2001], *Ownership and Control in Sweden: Strong Owners, Weak Minorities, and Social Control*, in F. Barca and M. Becht (eds.), THE CONTROL OF CORPORATE EUROPE, Oxford University Press, 228-258; Holmén, M. and Högfeldt, P. [2005], *Pyramidal Discounts: Tunneling or Agency Costs?*, ECGI Finance Working Paper No. 73/2005, available at www.ssrn.com and www.ecgi.org; and Morck, R., Wolfenzon, D. and Yeung, B. [2005], *op. cit.*

121 Compare Djankov *et al.* [2006], *Self-Dealing*, cit., table VI, with Chapter Two, section 2.4.2.

122 The majority of the empirical studies on institutional determinants of separation of ownership and control rely on the figures for ownership concentration reported in La Porta *et al.* [1998], *Law and Finance*, cit. See, e.g., Roe, M.J. [2003c], POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE, Oxford University Press; and Dyck, A. and Zingales, L. [2004], *Private Benefits of Control: An International Comparison*, in JOURNAL OF FINANCE, vol. 59, 537-600.

4.4. What Is Missing from the 'Law Matters' Framework

4.4.1 Are We Forgetting Anything?

It would be premature to conclude that, if only the features of legal protection of outside shareholders were assessed more accurately, this account of corporate law would suffice to explain the variation in corporate governance patterns around the world and, within the particular scope of this inquiry, between continental Europe and the US/UK.[123] Indeed, the major problem with the standard 'law matters' argument may be not technical, but conceptual: legal protection of outside shareholders may be just not the *only* institutional factor affecting the choice of corporate governance arrangements and its efficiency.[124] Even abstracting from the weakness of comparative law analysis, the argument seems to be incomplete in that it fails to explain too many facts of corporate governance in the real world, let alone their efficiency or inefficiency.

On the one hand, there are some countries where – regardless of the estimates by La Porta *et al.* – investor protection appears to be functionally equivalent, and nonetheless the ownership and control structure of publicly held companies is significantly different.[125] For instance – as I will show in Chapter Nine – in both Sweden and the US expropriation of minority shareholders does not seem to be a major problem.[126] However, while the typical Swedish company has a controlling shareholder, the vast majority of US corporations do not have one. Based on the theoretical framework underlying the 'law and finance' literature, one could hardly explain that result – which, incidentally, differs from that reported by La Porta *et al.* on *both* the legal and the factual account. Neither, of course, could one say which system is the best.

Conversely, in some other countries, investor protection is obtained in completely different ways, and nonetheless the ownership of publicly held companies exhibits similar patterns.[127] As we will see in the final Chapters of the present dissertation, contrary to the oft-cited contention of *Law and Finance*, the two countries

[123] Cools, S. [2005], *op. cit.*, 755-762 and 765-766.

[124] As Paredes, T.A. [2004], *op. cit.*, 1075, has noticed: "Billions of shares exchange hands daily on the New York Stock Exchange and Nasdaq, not because of strong laws on the books that favor shareholders, but despite weak ones."

[125] Gilson, R.J. [2006], *op. cit.*, 1652-1661 (making a special point of the Swedish case, compared with the American one).

[126] One customary explanation of shareholder protection in Sweden is based on the power of social norms. See Coffee, J.C. Jr. [2001a], *op. cit.*

[127] Gilson, R.J. [2001], *op. cit.*

where dispersed corporate ownership is most pervasive in the world – the US and the UK – actually provide outside shareholders with different modes and intensity of legal protection.[128] Once again, how do these results possibly obtain? Even more importantly, is the British system any better than the American one, or it is just the other way around?[129]

These and other contradictions have led many commentators, on both the economic and the legal side, to conclude that the importance of legal rules for corporate governance has been exaggerated.[130] Alternative hypotheses thus emerged on the institutional determinants of corporate governance. They are definitely too many to be reviewed here.[131] I am just going to address briefly two of the most popular ones. The first focuses on the broader institutional determinants of private benefits of control; the second on the political stance towards shareholders *vis à vis* stakeholders.

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128 See *infra*, esp. Chapters Nine and Eleven. As of now this is a quite settled point, although it was not only a few years ago. British commentators have provided an invaluable contribution to uncovering the differences in investor protection between the US and the UK. See, most notably, Franks, J. and Mayer, C. [2002], *op. cit.*, and Franks, J., Mayer, C. and Renneboog, L. [2001], *op. cit.*. In Djankov *et al.* [2006], *Self-Dealing*, cit., the difference has been finally acknowledged also by the *Law and Finance* literature. Surprisingly, however, this important difference comes with no implication for the classical 'law matters' thesis – legal origin turns out to matter all the same.

129 Others have tried to answer this question. See, most recently, with specific reference to takeover regulation, Armour, J. and Skeel, D.A. [2006], *Who Writes the Rules for Hostile Takeovers, and Why? The Peculiar Divergence of US and UK Takeover Regulation*, ECGI Law Working Paper No. 73/2006, available at www.ssrn.com and www.ecgi.org.

130 See, e.g., Cheffins, B.R. [2003], *op. cit*; Coffee, J.C. Jr. [2001b], *op. cit.*; Mayer, C. [2005], *op. cit.*; Holderness, C.G. [2006], *op. cit.*; Roe, M.J. [2002], *op. cit.*; Klausner, M. [2004], *The limits of Corporate Law in Promoting Good Corporate Governance*, Working Paper No. 300, Stanford Law School, available at www.ssrn.com, as published in J.W. Lorsch, L. Berlowitz, and A. Zelleke (eds.) [2005], RESTORING TRUST IN AMERICAN BUSINESS, MIT Press.

131 See, e.g., Licht, A.N. [2001], *op. cit.*; Roe, M.J. [2003c], *op. cit.*; Milhaupt, C.J. [2001], *Creative Norm Destruction: The Evolution of Nonlegal Rules in Japanese Corporate Governance*, in UNIVERSITY OF PENNSYLVANIA LAW REVIEW, vol. 149, 2083-2129; Bratton, W.B. and McCahery, J.A. [2001a], *op. cit.*; Desai, M., Dyck, A. and Zingales, L. [2005], *Theft and Taxes* (October 2005), available at www.ssrn.com, forthcoming in JOURNAL OF FINANCIAL ECONOMICS, 2008 (earlier versions: EFA 2005 Moscow Meetings Paper, forthcoming; ECGI Finance Working Paper No. 63/2004; NBER Working Paper No. 10978). A very interesting line of inquiry is based on the political economy of institutional evolution, more than on the single factors affecting corporate governance. See Rajan, R.G. and Zingales, L. [2003], *op. cit.*; and Pagano, M., and Volpin, P. [2005], *The Political Economy of Corporate Governance*, in AMERICAN ECONOMIC REVIEW, vol. 95, 1005-1030.

4.4.2. Alternative Explanations

a) Private Benefits of Control

A broader and, in a sense, less rudimentary account of the 'law matters' story is based on the bearing of *a number* of institutions (*including* the law) on private benefits of control.[132] The reader will recall the notion of private benefits of control introduced at the beginning of this work as being broad enough to include also control rents which are neutral to shareholder wealth. However, he will also recall that the mainstream agency framework *only* features private benefits of control as arising out of the agent's conflict of interest with the principals, thereby leading to either underproduction of the firm's surplus or to its outright diversion from shareholders' pockets.[133] The next Chapter will discuss the problems with this assumption, in light of a more comprehensive account of private benefits of control in corporate governance.

Even under this restrictive assumption, when corporate governance is featured with high private benefits of control the ownership structure cannot but be concentrated. This does not just depend on shareholders being reluctant to take non-controlling stakes in a company for fear of being expropriated. More importantly, the entrepreneur who expects to enjoy high private benefits of control will not be willing to deconcentrate ownership beyond a certain extent, for this would involve leaving corporate control and its private value up for grabs. Therefore, the ultimate reason of ownership concentration is that protection of control rents requires that contestability of corporate control be ruled out at the outset.[134]

The standard view about private benefits of control is that the corporate controller is unable to commit to a policy of 'no shareholder expropriation' when it would be efficient to do so, thereby selling both ownership and (prospective) control to the market. In this perspective, gains from trade are foregone due to institutions – including corporate law – failing to police *inefficient* extraction of private benefits, which leads in turn to suboptimal separation of ownership and control.[135] Here is the point of tangency with the basic claim of *Law and Finance*, that 'weak' protection of minority shareholders – via its effect on agency costs – is ultimately

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[132] This has been comprehensively explored by Armour, J. and Skeel, D.A. [2006], *op. cit.*

[133] Mayer, C. [1999], *Firm Control*, Inaugural Lecture at the University of Oxford (February 18, 1999), available at www.finance.ox.ac.uk, as published in J. Schwalbach (ed.) [2001], CORPORATE GOVERNANCE: ESSAYS IN HONOR OF HORST ALBACH, Springer-Verlag. See also *supra*, Chapter Two, section, 3.4.1.

[134] Bebchuk, L.A. [1999], *A Rent-Protection Theory of Corporate Ownership and Control*, NBER Working Paper No. 7203.

[135] Roe, M.J. [2004b], *op. cit.*, 6-15.

responsible of ownership concentration.[136] This view completely neglects the possibility that extraction of private benefits of control may be efficient, in that it is necessary to feature entrepreneurship in corporate governance – what we introduced as idiosyncratic private benefits of control.[137]

A few attempts have been made to quantify private benefits of control empirically, on a cross-country basis.[138] Unfortunately, they basically capture pecuniary values realized on the stock market that, as such, tell us little about idiosyncratic private benefits of control that are still to be realized.[139] Conversely, they should

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[136] Becht, M. and Mayer, C. [2001], *op. cit.*, 4.

[137] See *supra*, Chapter One, section 1.4.5. Ownership concentration would also depend on the size of PBC under a second assumption, which is often overlooked by the literature, but is in fact *neutral* as to their welfare implications (Zingales, L. [1995], *op. cit.*, 428). The assumption is that, regardless of commitment devices provided by institutions, the corporate controller may have basically no choice but keeping ownership concentrated when his PBC cannot be otherwise compensated by the stock market (Mayer, C. [1999], *op. cit.*; Gilson R.J. [2006], *op. cit.*; Holderness, C.G. [2003], *A Survey of Blockholders and Corporate Control*, in FEDERAL RESERVE BANK NY – ECONOMIC POLICY REVIEW, April 2003, 51-64). This is not necessarily inefficient, for instance as long as such PBC cannot be traded if not at a later stage along with corporate control – i.e., they are idiosyncratic to the corporate controller. As I mentioned (*supra* Chapter Three, section 3.4.5), idiosyncrasy of PBC has been little explored by the literature, so that all that we can say about it is that – not differently from other kinds of PBC – it involves entrenchment of corporate control (see *infra* Chapter Five, section 5.2.5). However, whether this also leads to ownership concentration may depend not just on how large are these PBC, but also on how control and its transfer are regulated by corporate law. The matter will be deeply investigated in the Sixth Chapter, but it should be already quite intuitive that such an account of PBC has little to do with the agency framework underlying the standard *Law and Finance* approach.

[138] To date, there are two major comparative studies on the size of PBC: Nenova, T. [2003], *The Value of Corporate Votes and Control Benefits: A Cross-Country Analysis*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 68, 325–351; and Dyck, A. and Zingales, L. [2004], *op. cit.* They include, respectively, 18 and 39 developing and developed countries.
The two studies are based on different methodologies. The work by Tatiana Nenova measures the value of voting rights, assessed on the basis of price differentials between shares carrying high and low voting power (multiple voting shares vs. common stock or common stock vs. limited voting shares). After a number of corrections, this measure is considered as a fair estimate of PBC. This methodology was pioneered by Zingales, L. [1994], *The Value of the Voting Right: A Study of the Milan Stock Exchange Experience*, in REVIEW OF FINANCIAL STUDIES, vol. 7, 125–148; but it was never applied before on a cross-country basis.
Dyck and Zingales have tried instead to measure private benefits on the basis of the premium paid over market price for the purchase of a block of shares suitable for the transfer of corporate control. This is defined as control premium and, once a number of potential biases are controlled for, it is another way to measure the size of PBC. This methodology was pioneered by Barclay, M. and Holderness, C. [1989], *Private Benefits of Control of Public Corporations*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 25, 371–395; but Dyck and Zingales have refined and extended it to the comparison between different countries.

[139] See Gilson R.J. [2006], *op. cit.*, 1664. Even the analysis based on the size of control premium cannot fully account for idiosyncratic values, given that regulation of corporate control transactions differ

fully account for the present value of expected cash flow diversion.[140] In addition, these empirical studies have some methodological problems that hinder a precise estimate of private benefits of control in a cross-section. This make them of little use in the comparison of developed countries where – with the noticeable exception of Italy – private benefits of control are always quite low (even though they are moderately higher in continental Europe than in the US and in the UK).[141] Nevertheless, on a worldwide basis, even this rather crude proxy for the real size of private benefits of control appears to be more significantly related to ownership concentration than 'poor' legal protection of outside shareholders as measured by the most popular index of *Law and Finance* – the Anti-director Rights Index. Since these indicators essentially point at expropriation of non-controlling shareholders from two different angles, this cannot but mean that corporate law *is not* the only institutional factor that affects cash flow diversion.

Indeed, the empirical analysis shows that private benefits of control depend not only on the quality of investors' legal protection and of its enforcement, but also on a number of *other* factors that curb the expropriation of shareholder investment – like social norms, product market competition, an independent financial press, and a high rate of tax compliance.[142] All of these factors contribute to the minimization

from country to country and this affects both the frequency of corporate control transactions and the control premium that may be paid out. As a result, the idiosyncratic value of control rents is systematically underestimated (and may end up being completely foregone) by the empirical analysis. Dyck, A. and Zingales, L. [2004], *op. cit.*, 542.

140 Dyck, A. and Zingales, L. [2004], *op. cit.*, 537-543, put this quite nicely. In theory, "[a] controlling party can appropriate value for himself only when this value is not verifiable (i.e., provable in court). If it were, it would be relatively easy for non-controlling shareholders to stop him from appropriating it." In practice, however, the empirical analysis shows that PBC are a "real phenomenon, which can be consistently estimated:" the two international estimates based on the value of voting rights and on control premia turn out to be "remarkably similar." Institutional differences across countries seem to explain why private benefits matter so much. "Interestingly, the premium paid for control is higher when the buyer comes from a country that protects investors less (and thus is more willing or able to extract private benefits)." Indeed, "a controlling party would find it possible to subtract corporate resources to his or her benefit only when it is difficult or impossible to prove that this is the case." According to the authors, the corporate controller's ability to divert resources from outside shareholders depends not just on the law, but also on a number of other institutional factors. See *infra* in the text.

141 For a general criticism of the results that can be obtained by the two methodologies, see Nicodano, G. and Sembenelli, A. [2004], *Private Benefits, Block Transaction Premiums and Ownership Structure,* in INTERNATIONAL REVIEW OF FINANCIAL ANALYSIS, vol. 13, 227-244; and Nicodano, G. [1998], *Corporate groups, Dual-class Shares and the Value of Voting Rights*, in JOURNAL OF BANKING AND FINANCE, vol. 22, 117-137.

142 Dyck, A. and Zingales, L. [2004], *op. cit.*, 539. To the debate on extra-legal institutions affecting CG, the authors add "public opinion pressure" and "corporate tax compliance." For a comprehensive analysis of the tax compliance variable, on both theoretical and empirical grounds, see Desai, M., Dyck, A. and Zingales, L. [2005], *op. cit.* As regards the role of the media, see, illustratively, Zin-

of agency costs, at least when they come in the form of 'stealing.' A remarkable result is that, once the effect of extralegal institutions is also accounted for in the econometrics, the size of private benefits of control is no longer correlated with the origin of each country's legal system.[143] That is to say, systems based on English common law display no superiority in the overall policing of private benefits of control and thereby in fostering dispersion of ownership. The only group of countries that show some statistically significant advantage in this regard is Scandinavia, where some further extralegal institution may possibly drive the result.[144]

While demonstrating the narrowness of the standard 'law matters' account, the empirical literature on private benefits of control still lacks a comprehensive theoretical framework for analyzing the determinants of this phenomenon and its bearing on comparative corporate governance.[145] Surely, abnormally high levels of private benefits of control – nurtured, among other things, by weak legal protection of non-controlling shareholders – are inconsistent with dispersion of ownership (like in Italy). However, private benefits apparently do no longer explain corporate governance patterns when they are low enough, especially once ownership concentration is measured more accurately than La Porta *et al.* have done so far.[146] Moderately low private benefits of control allow for the typical ownership structure being either dispersed (like not only in the US and the UK, but to a lesser extent also in the Netherlands) or concentrated (like for instance in Germany, in France, and in Sweden). In addition, whether managers or controlling shareholders are in charge, corporate control is almost never contestable.[147] It seems that private benefits of control are a fruitful line of inquiry for understanding ownership and control structures in different countries, but our knowledge of the matter to date is still too lim-

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gales, L. [2005], *The Importance of Bad News*, in G. Owen, T. Kirchmaier and J. Grant (eds.), CORPORATE GOVERNANCE IN THE US AND EUROPE, Palgrave Macmillan, 96-100.

143 Dyck, A. and Zingales, L. [2004], *op. cit.*, 587-588.

144 Id., at 588.

145 To be sure, the empirical literature explicitly recognizes it. This is how Dyck, A. and Zingales, L. [2004], *op. cit.*, 590, conclude their oft-cited article:

> [I]n this paper we do not try to distinguish between the three potential sources of private benefits: psychic value, perquisites, and dilution. That private benefits are smaller in a country with better protection of investors, better tax enforcement, and more media pressure suggests that not all private benefits are psychic. Further work, however, is needed to establish the importance of dilution and its welfare implications.

I am going to venture this distinction between different categories of PBC in the next Chapter.

146 See Gilson, R.J. [2006], *op. cit.*, 1652-1661, for a similar point.

147 Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 70-71. To be sure, the same authors claim (at 63) that "The U.K. [may be] the only OECD country with an active and open market for corporate control." However, as regards the British market for corporate control, see *supra* Chapter Two, section 2.4.4, and *infra* Chapter Seven, section 7.3.2, and Chapter Eleven, section 11.3.

ited for fully assessing their role in corporate governance and, above all, their interaction with corporate law. This topic deserves indeed a special investigation, which will be undertaken in the next two Chapters.

b) Political Theory

Another very popular strand of literature does not only claim that institutions other than corporate law matter too for investor protection, but also that the institutional framework shapes the law and its evolution.[148] While corporate law may and should indeed protect investors from expropriation, shareholders do not simply care of not being expropriated; they want the value of their investment to be maximized. In the latter respect, corporate law – especially if regarded as a mere anti-expropriation tool – seems to play almost no role.[149] According to this view, *politics* does indeed.[150] Social democracy typically brings stakeholders – creditors, employees – into corporate governance. If shareholders want to keep their primacy and, more importantly, to have the firm managed in their interest, they need to be large enough to challenge stakeholders' power. This should explain why ownership cannot disperse in continental Europe, where stakeholders are entitled to various degrees of interference in corporate governance and they might prevail in the absence of a controlling shareholder. Conversely, the same account suggests that political support for shareholder value allows for dispersion of ownership and managerial control in both the US and in the UK; there, it seems that stakeholders have never been granted any important role in corporate governance. In this perspective, politics should matter more than law for corporate governance. At the end of the day, how friendly to shareholders is the institutional environment seems to depend on politics, first, and on the law only consequently.[151]

Yet this line of inquiry fares no much better than the former ones. The idea that both regulation and patterns of corporate governance are ultimately determined by politics, and in particular by social democracy, is not borne out by the evidence.[152]

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[148] This account was first developed in an oft-cited contribution by Mark Roe, where the interaction between politics and the law in determining the patterns of corporate governance was comprehensively explored with respect to the American case. Roe, M.J. [1994], STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE, Princeton University Press.

[149] Roe, M.J. [2002], *op. cit.* See also Klausner, M.D. [2004], *op. cit.*, making a similar point.

[150] Roe, M.J. [2003c], *op. cit.*

[151] Roe, M.J. [2004b], *op. cit.*, 17-21 (referring to politics as a source of "Institutional Legitimacy").

[152] Gilson, R.J. [2006], *op. cit.*, 1644, points out:

> "As Professor Roe notes, we observe controlling shareholder regimes in jurisdictions with good law, so law cannot completely explain the distribution. At the same time, we observe controlling shareholder regimes in countries without serious social democratic movements, so politics is likely not all of the answer either."

Stakeholder involvement in corporate governance is compatible both with systems characterized by the presence of controlling shareholders (like Sweden and Germany) and with those featuring managerial control (like the Netherlands). Contrariwise, the absence of stakeholder involvement in corporate governance comes with ownership structures that are either very dispersed (like in the UK) or very concentrated (like in Italy).[153] One may of course disagree on the meaning of 'stakeholder involvement,' on how this should be 'measured' or 'indexed' in the empirical analysis, as well as on how and to what extent stakeholders' power in corporate governance owes to politics. Overall, it seems fair to conclude that politics has an influence on the choice of corporate governance patterns; but certainly it does not explain everything of that choice, let alone how this relates to corporate law.[154]

4.4.3. May Law Still Matter?

Provided that extending the 'law matters' framework to complementary institutions still does not provide a clear-cut explanation of the determinants of separation of ownership and control, one could doubt that cross-reference is the right analytical approach.[155] Different institutions may matter in different spatial and temporal contexts, and this may lead to rather unique results in each corporate governance system.[156] This crucial point parallels the debate upon so-called 'convergence' of corporate governance rules and standards across the board. This debate is too extensive to be reviewed here.[157] One rather extreme position within this debate is that law may not matter at all for separating ownership from control. This has been argued with some virtue on historical grounds. Apparently, dispersed ownership arose in the absence of strong legal protection of outside shareholders in both the

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However, it is worth noting that Mark Roe's is definitively not the only political theory of corporate governance. Others have taken a more straightforward perspective of political economy (as Professor Roe also did for the US in Roe, M.J. [1994], *op. cit.*). See Rajan, R.G. and Zingales, L. [2003], *op. cit.*, and Pagano, M., and Volpin, P. [2005], *op. cit.*

153 See *infra*, Chapter Seven.

154 See, for a critical review, Bianco, M. [2004], *Book Review ("Rassegna bibliografica") on M. Roe's 'Political Determinants of Corporate Governance'*, in RIVISTA DI POLITICA ECONOMICA, March-April 2004, 357-373.

155 See, e.g., Bratton, W.B. and McCahery, J.A. [2001a], *op. cit.*

156 One way to look at the matter is the so-called institutional complementarities assumption. See, e.g., Schmidt, R.H. and Spindler, G. [2002], *Path Dependence, Corporate Governance and Complementarity*, in INTERNATIONAL FINANCE, vol. 5, 311–333. For a survey of the complementarities critique, see Paredes, T.A. [2004], *op. cit.*, 1105-1109.

157 See *supra*, section 4.1.2, for a brief discussion of the terms of debate.

US and the UK that – as we know – are the two countries where ownership appears to be mostly separated from control.[158] This plainly contradicts the conceptual framework of the inferences by La Porta *et al.*, inasmuch as they claim that the common law tradition is ultimately responsible of the superior quality of outside investors' legal protection in the US and in the UK.[159] On the one hand, the patterns of this protection are currently very different in the two countries;[160] on the other hand, this protection was definitely not in place when ownership started separating from control in both the US and the UK.[161]

This argument shows that 'history matters' in the institutional analysis and that the way in which it matters has been not correctly assessed by the 'law and finance' literature. However, it does not also demonstrate that law does not matter in corporate governance.[162] In fact, the legal system currently features a high level of investor protection in both the US and the UK, although by means of different rules and enforcement mechanisms in corporate and securities law.[163] Arguably, they were not in place when dispersed ownership emerged; but eventually they sprang out to support that outcome. Why?

The two propositions, 'history matters' and 'law matters', may not be incompatible with each other.[164] Rather, they may be combined in a theory of institutional evolution. As any other institution, law is 'path-dependent:' changes take place only gradually, on a path where complementary institutions are always in equilibrium.[165] External shocks may change the equilibrium path over time.[166] But, in general, legal change will follow the path which has been established at the outset. Path-dependency may indeed have adverse effects on the quality of corporate law, in as

[158] Coffee, J.C. Jr. [2001b], *op. cit.*; Franks, J., Mayer, C. and Rossi, S. [2005b], *op. cit.*

[159] For a more technical criticism of the approach based on legal origins, see instead Siems, M. [2006], *op. cit.* (and comparative law's references cited therein).

[160] Franks, J. and Mayer, C. [2002], *op. cit.*

[161] For a very interesting historical illustration of Anglo-American corporate finance, see Sylla, R. and Smith, G.D. [1993], *The Transformation of Financial Capitalism: An essay on the History of American Capitalism*, in FINANCIAL MARKETS, INSTITUTIONS & INSTRUMENTS, vol. 2, 1-61; and Sylla, R. and Smith, G.D. [1994], *Information and Capital Market Regulation in Anglo-American Finance*, in M.D. Bordo and R. Sylla (eds.), ANGLO AMERICAN FINANCIAL SYSTEMS, Irwin.

[162] Brian Cheffins has authoritatively argued the opposite. See Cheffins, B.R. [2001], *Does Law Matter? The Separation of Ownership and Control in the United Kingdom*, in JOURNAL OF LEGAL STUDIES, vol. 30, 459-484.

[163] For a description, see Kraakman *et al.* [2004], *The Anatomy*, cit., 101-130 and 193-214.

[164] See Becht, M. and Mayer, C. [2001], *op. cit.*, 5, for a similar view.

[165] Bebchuk, L.A. and Roe, M.J. [1999], *A Theory of Path Dependence in Corporate Ownership and Governance*, in STANFORD LAW REVIEW, vol. 52, 127-170.

[166] See Rajan, R.G. and Zingales, L. [2003], *op. cit.*; and Roe, M.J. [1998], *Backlash*, in COLUMBIA LAW REVIEW, vol. 98, 217-241.

much as vested interests oppose the process of efficient legal change.[167] However, it may also strengthen the complementarily of institutions over time, for instance by fostering the introduction of legal rules and enforcement mechanisms that better suit the finance and the governance of the firms subject to a certain jurisdiction, while opposing inefficient ones.[168] Which of the two effects prevails is still an open question, whose answer would require a separate inquiry about the determinants of (corporate) law evolution.[169]

To our purpose, it is sufficient to point out that the evolutionary and complementary dimensions of corporate law make it difficult, if not impossible, to understand its role in corporate governance by testing the effects of just one set of legal rules across different countries, with or without interaction with other institutional variables.[170] In the jargon of econometrics, it is difficult to escape problems of either 'reverse causality' or 'omitted variables:' no matter of the strength and significance of the correlations that we observe, we may be ultimately unable to ascertain what determines what. Taking this approach to the extreme conclusions, not only would any expectation of convergence be unwarranted, but even cross-reference would be compromised as analytical tool. To be sure, this has been authoritatively argued by Frank Easterbrook.[171] In his view, it is the efficiency of capital markets that determines the prevailing corporate governance pattern and, in turn, the corporate law's features, not the other way around. Both contents and enforcement of corporate law would be demand-driven, depending on the needs of capital markets as far as corporate governance is concerned. In principle, no system of legal rules would be better than another, provided that it is the output, and not the input, of a process of efficient selection of corporate governance patterns by the financial markets.

However, as I am going to show, also this conclusion is not completely satisfactory.[172] There seems to be a number of *functional* regularities in the relationship be-

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[167] Bebchuk, L.A. and Roe, M.J. [1999], *op. cit.*

[168] This is at least one part of the arguments developed in Hansmann, H. and Kraakman, R.H. [2001], *op. cit.* For a very critical view on the convergence thesis, see Branson, D.M. [2001], *op. cit.*

[169] See, e.g., Pistor, K. [2004], *op. cit.* Professor Hansmann has recently summarized the terms of the convergence hypothesis. See Hansmann, H. [2006b], *op. cit.*

[170] For a detailed discussion of the systems approach to comparative CG, see Paredes, T.A. [2004], *op. cit.*

[171] Easterbrook, F.H. [1997], *International Corporate Differences: Markets or Law?*, in JOURNAL OF APPLIED CORPORATE FINANCE, vol. 9, 23–30.

[172] I also agree that there is no 'best system' in comparative corporate governance. But the same conclusion can also be derived without questioning the importance of corporate law for economic efficiency. See, e.g., Becht, M. and Mayer, C. [2001], *op. cit.*, 4-7; Carlin, W. and Mayer, C. [2000], *How do Financial Systems Affect Economic Performance*, in X. Vives (ed.), CORPORATE GOVERNANCE: THEORETICAL AND EMPIRICAL PERSPECTIVES, Cambridge University Press, 137-160; Mayer, C. [2000],

tween institutions, and especially corporate law's rules, and both corporate governance patterns and stock market performance.[173] In order to assess what is at least the most plausible direction of causality, a broader discussion of major weaknesses of the classical 'law matters' argument, and of its fundamental strength, is in order.

4.4.4. Why Legal Protection of Outside Shareholders Is Important, but It Is Not Enough

a) Investor Protection Is Necessary for Dispersed Ownership

One important shortcoming of the 'law matters' thesis is that it does not distinguish *stealing* from *shirking*.[174] Both are sources of agency costs that should be minimized through protection of outside shareholders, for separation of ownership and control to be any preferable to sole proprietorships.[175] Unfortunately, while appropriate legal rules can possibly set effective constraints on diversion of the firm's surplus once it is produced (stealing), no legal mechanism could ever substitute for suboptimal exercise of managerial discretion over the production of the same surplus (shirking).[176] Conversely, ownership concentration provides high-powered incentives to put effort in the firm's management, but does not limit the corporate controller's ability to divert cash flow from outside shareholders' pockets.[177] As a result, an effective legal protection of non-controlling shareholders does not necessarily lead to dispersion of ownership, whereas ownership concentration alone provides no guarantee against minority shareholders expropriation. As Mark Roe has efficaciously pointed out, legal regulation of stealing in the corporate context does not provide but a partial explanation of separation of ownership and control.[178]

Bundling stealing and shirking together has another consequence. In the standard 'law matters' framework, private benefits of control arising from agency prob-

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Ownership Matters, mimeo, Inaugural Lecture of the Leo Goldschmidt Chair in Corporate Governance at the *Université Libre de Bruxelles* (on file with author).

173 On this fundamental account, see *infra*, Chapter Six, section 6.7.

174 Roe, M.J. [2002], *op. cit.* 242-246.

175 Roe, M.J. [2004b], *op. cit.*, 2-6.

176 Authoritative commentators have subscribed to, and elaborated upon, Mark Roe's contention. See Klausner, M.D. [2004], *op. cit.*, and Rock, E.B. and Wachter, M.L. [2001], *op. cit.*

177 This point is also made by Roe, M.J. [2003c], *op. cit.* In theory, the controlling shareholder's incentives to cash flow diversion are also inversely related to his ownership stake. But this holds on condition that an upper bound is set on stealing. Even when you are entitled to 99% of the firm's profits, you will still be induced to steal the remaining 1% in the absence of effective penalties for such a behavior.

178 Roe, M.J. [2003c], *op. cit.*

lems are alike.[179] It makes no difference whether they are obtained by outright expropriation of the company's cash flow (stealing) or, rather, by 'playing' with the assets under management (shirking). Limiting the extraction of private benefits of control by the corporate controller and minimizing agency costs are in fact two sides of the same coin.[180] This means that promotion of equity finance by the legal system requires not only behavioral constraints on shareholder expropriation by the manager but, even more so, allocation of residual rights of control to shareholders: the latter should be entitled to replace the manager when he is stealing or shirking too much.[181]

To put it simply, legal institutions should be supportive of hostile takeover. Contestability of corporate control would ultimately make sure that no private benefits of control can be secured by any controller, and would consequently encourage separation of ownership and control.[182] Alternatively, inasmuch as corporate control can be shield from hostile takeover, selling shares to the investing public would not be profitable enough for the entrepreneur to give up his private benefits of control, and ownership will thus stay concentrated.[183]

The problem with the above reasoning is that – as I have repeatedly suggested – *any* legal system provides the corporate controller with *some* way to insulate from hostile takeover.[184] If La Porta *et al.* had put some more effort in undertaking a functional legal comparison, they would have probably realized that permissible deviations from a 'one share–one vote' security-voting structure (which they considered) and takeover defenses available to the board of directors (which they *did not* consider) are *both* entrenchment devices that allegedly undermine separation of ownership and control.[185] However, while the first ones are associated to corporate ownership structures that are on average more concentrated, the second ones (prevailing in the US) certainly are not.[186]

Entrenchment of corporate control may be (and normally is) allowed on different conditions by the legal system, but it is ultimately a matter of choice. From the

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[179] See, e.g., La Porta *et al.* [2000a], *Investor Protection*, cit.

[180] Shleifer, A. and Vishny, R. [1997], *op. cit.*, 740-748.

[181] Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 24-31.

[182] Grossman, S.J. and Hart, O. [1988], *One Share–One Vote and the Market for Corporate Control*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 20, 175-202.

[183] Pagano, M. and Röell, A. [1998], *The Choice of Stock Ownership Structure: Agency Costs, Monitoring, and The Decision To Go Public*, in QUARTERLY JOURNAL OF ECONOMICS, vol. 113, 187-225.

[184] See *supra*, Chapter One, and, more in detail, *infra*, Chapter Seven.

[185] Compare La Porta *et al.* [1998], *Law and Finance*, cit., with Bebchuk, L.A., Kraakman, R.H. and Triantis, G. [2000], *Stock Pyramids, Cross-Ownership, and Dual Class Equity: the Mechanisms and Agency Costs of Separating Control from Cash-flow Rights*, in R. Morck (ed.), CONCENTRATED CORPORATE OWNERSHIP, NBER Conference Volume, University of Chicago Press, 295-315.

[186] See *supra*, Chapter Two, section 2.4.

entrepreneur's standpoint, insulating from hostile takeovers when going public might then just be preferable to committing to a policy of contestable control.[187] Contestability is, in fact, always an option. Entrenchment devices mostly need to be opted in by the corporate charter and, more importantly, they can be normally opted out once and for all by the same charter when the firm's stock is first sold to the investing public.[188] Entrenchment may be sometimes (but, indeed, very seldom) not an option.[189] However, should entrenchment devices be prohibited (or made extremely costly) by the regulation of publicly held firms, an entrepreneur concerned with exposure to hostile takeovers will at the very least refrain from taking his company public, or he will rapidly take private any company he has acquired on the market. One should recall from the theoretical discussion of the agency framework in the previous Chapter that in at least one situation this entrenchment strategy is privately optimal while socially inefficient, namely in the presence of expropriation of minority shareholders.[190]

Significant opportunities for expropriating outside shareholders always involve that hostile takeovers be ruled out by the corporate controller.[191] Private benefits from stealing are perfectly transferable control rents, so why should an incumbent controller leave them up for grabs, instead of having them compensated by the subsequent controller in a negotiated transfer (i.e., in a friendly takeover)?[192] Even more importantly, why should outside investors accept the deal once they know

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[187] Hart, O. [1995], FIRM, CONTRACTS, AND FINANCIAL STRUCTURE, Oxford University Press, 206-209. More recently, see Boot, A., Gopalan, R. and Thakor, A. [2006], *The Entrepreneur's Choice between Private and Public Ownership*, in JOURNAL OF FINANCE, vol. 61, 803-836; and, for empirical evidence, Brau, J.C. and Fawcett, S.E. [2006], *Initial Public Offerings: An Analysis of Theory and Practice*, in JOURNAL OF FINANCE, vol. 61, 399-436.

[188] See, for illustration about the US, Daines, R. and Klausner, M. [2001], *Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs*, in JOURNAL OF LAW ECONOMICS AND ORGANIZATION, vol. 17, 83–120; and Field, L.C. and Karpoff, J.M. [2002], *Takeover Defenses at IPO Firms*, in JOURNAL OF FINANCE, vol. 57, 1857-1889.
Sometimes, entrenchment devices can be very difficult to opt out. One prominent example in this regard is the so-called 'structured regime' of the board of directors in the Netherlands. See *infra*, Chapter Seven, section 7.3.3.

[189] It is quite often believed that managerial entrenchment is not an option for British public companies, since takeover resistance is forbidden and pre-takeover defenses are otherwise uncommon. Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 62-63. However, this view is at least misleading. See, e.g., Becht, M. and Mayer, C. [2001], *op. cit.*, 11-15; and Goergen, M. and Renneboog, L. [2001], *Strong Managers and Passive Institutional Investors in the UK*, in F. Barca and M. Becht (eds.), THE CONTROL OF CORPORATE EUROPE, Oxford University Press, 259-284. See also *infra*, Chapter Seven, section 7.3.2.

[190] See *supra*, Chapter Three, section 3.4.5.

[191] Roe, M.J. [2003c], *op. cit.*

[192] Bebchuk, L.A. [1999], *op. cit.*

they will be robbed soon or late?[193] Whether or not the legal system favors hostile takeovers by allocating residual rights of control to shareholders, separation of ownership and control will always occur to a limited extent, if not at all, in the presence of expropriation of non-controlling shareholders.[194] Therefore, the corporate controller's diverting cash flow from outside shareholders cannot be disciplined by hostile takeovers – which would be anyway ruled out *ex ante* – and must be dealt with differently by the legal system for having ownership separated from control. Curbing extraction of these private benefits of control is, indeed, a *precondition* for contestability of corporate control.[195]

This is enough to conclude that, regardless one's own ideas about how the market for corporate control should work, *contestability is not the point* for having ownership separated from control, at least in the presence of opportunities for cash flow diversion.[196] Yet law matters (and a lot!) in the latter respect.[197] *Dispersed ownership – and so widespread equity finance – could never arise in the absence of effective legal constraints on cash flow diversion by the corporate controller.*[198] Among developed economies, Italy is a case in point – and, maybe for this reason, one of the most cited ones to support the standard 'law matters' argument.[199] Given the wide scope for expropriation of outside shareholders allowed by the legal system, ownership of even the largest Italian firm listed at the national stock exchange is very concentrated and, worse enough, very few of the numerous Small-Medium Enterprises therein dare to resort to the market of equity capital to finance their expansion.[200]

b) Investor Protection Is Not Sufficient for Dispersed Ownership

This is, however, just a part of the story. More technically, *avoiding cash flow diversion by the corporate controller is just a necessary, but not sufficient, condition for the emergence of*

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[193] La Porta *et al.* [1998], *Law and Finance*, cit.
[194] Shleifer, A. and Vishny, R. [1997], *op. cit.*
[195] Bebchuk, L.A. [1999], *op. cit.*
[196] See, for a comprehensive discussion of this issue, Coates, J.C. IV [2003], *op. cit.*
[197] La Porta *et al.* [2000a], *Investor Protection*, cit.
[198] The majority of commentators agree on this issue, whether or not they subscribe to the Law and Finance point of view. See, e.g., Bebchuk, L.A. [1999], *op. cit.*; Roe, M.J. [2003c], *op. cit.* Others disagree on historical grounds (see Franks, J., Mayer, C. and Rossi, S. [2005b], *op. cit.*; Coffee, J.C. Jr. [2001b], *op. cit.*), even though they do not deny the functional importance of investor protection for having ownership separated from control. For investigation of functional substitutes of corporate law, see Gilson, R.J. [2001], *op. cit.*
[199] See, most notably, Johnson, S., La Porta, R., Lopez-de-Silanes, F., and Shleifer, A. [2000], *Tunneling*, in AMERICAN ECONOMIC REVIEW, vol. 90, 22–27.
[200] For a thorough investigation of this issue, see Bianchi, M., Bianco, M., Giacomelli, S., Pacces, A.M. and Trento, S. [2005], PROPRIETÀ E CONTROLLO DELLE IMPRESE IN ITALIA, Il Mulino.

dispersed ownership structures.[201] Suppose that the scope for minority shareholder expropriation is actually minimized through the high-quality standards of corporate law. This would not help also as far as other distortions in the maximization of shareholder value are concerned. In other words, the corporate controller may be effectively prevented from diverting cash flow from shareholders' pockets, but be still able to shirk by consuming perquisites, misusing free cash, or building empires instead of maximizing shareholder value.[202] Law apparently can do little, if anything, to prevent consumption of this kind of private benefits of control.[203]

There is, however, another fundamental difference between shirking and stealing. By definition, shirking involves opportunity costs for shareholders which are potentially much larger than the benefits they provide to the corporate controller (on-the-job consumption would be just efficient otherwise).[204] Then, in theory, should expropriation of outside shareholders be effectively banned (or nearly so) by the legal system, committing to a no-shirking policy through exposure to hostile takeover would be also privately optimal: it would allow entrepreneurs to raise more equity capital at a lower cost (i.e., to get a higher price for the firm's stock).[205] But we know that, in practice, this policy is almost never adopted by firms going public.[206] Control of most of these firms around the world is made far from contestable since the very beginning, even in those countries characterized by an extensive recourse to equity finance and by an otherwise active market for corporate control.[207]

Those countries are most prominently the US and the UK, where – consistently with the estimates by La Porta *et al.* – the risk of expropriation of non-controlling shareholder is ostensibly very low. Therefore, expropriation of outside shareholders cannot explain why control of Anglo-American corporations is so often entrenched

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201 Roe, M.J. [2004b], *op. cit.*

202 Mayer, C. [1999], *op. cit.*

203 Roe, M.J. [2002], *op. cit.*

204 Jensen, M.C. and Meckling, W.H. [1976], *op. cit.*, 312. See also Hellwig, M. [2000], *op. cit.*, 118-122, and *infra* Chapter Five, section 5.4.

205 Grossman, S.J. and Hart, O. [1988], *op. cit.*

206 See *supra* Chapter Two, section 2.4.

207 Empirical evidence in this respect is available for both dispersed and concentrated ownership systems. See, on the one hand: Daines, R. and Klausner, M. [2001], *op. cit.*; Field, L.C. and Karpoff, J.M. [2002], *op. cit.*; Brennan, M. and Franks, J. [1997], *Underpricing, Ownership and Control in Initial Public Offerings of Equity Securities in the UK*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 45, 391-413. On the other hand, as regards continental Europe: Holmén M. and Högfeldt P. [2004], *A Law and Finance Analysis of Initial Public Offerings*, in JOURNAL OF FINANCIAL INTERMEDIATION, vol. 13, 324-358; Roosenboom, P. and van der Goot, T. [2003], *Takeover Defences and IPO Firm Value in the Netherlands*, in EUROPEAN FINANCIAL MANAGEMENT, vol. 9, 485–511; Pagano, M., Panetta, F. and Zingales, L. [1998], *Why Do Companies Go Public? An Empirical Analysis*, in JOURNAL OF FINANCE, vol. 53, 27-64.

and, nonetheless, their ownership is on average more dispersed than anywhere else in the world.[208] A different, but equally puzzling situation is observed in Sweden, where also minority shareholder expropriation does not seem to be an issue according to both empirical and anecdotal evidence (reporting no single instance of expropriation of non-controlling shareholders), but corporate control is likewise entrenched while ownership structures are, on average, significantly more concentrated than in Anglo-Saxon countries.[209] It may be that Swedish capitalists exhibit a stricter preference for empire building compared to their Anglo-American colleagues, and therefore no further separation of ownership and control is allowed in Sweden – as well as in many other countries of the European continent – by the higher rate of on-the-job consumption of control perquisites involved in the corporate culture.[210] Maybe, but then why is corporate control most often entrenched *also* in the US and the UK? More probably, the answer lies somewhere else.

4.4.5. What If Law Mattered (Also) in Some Other Respect?

Law may not matter much apart from preventing corporate controllers from expropriating outside shareholders outright. Then the actual patterns of corporate governance that we observe around the world would also be determined by how the remainder of agency costs (shirking) is dealt with by different, and possibly non-legal, institutional variables.[211] For instance, the *political support* for shareholder value as opposed to the protection of different constituencies of firm's stakeholders (workers, consumers, etc.);[212] or the *social norms* embedded in each country's financial community that may, as may not, provide the same support.[213] While I do not doubt the importance of these and other non-legal institutional factors in shaping corporate governance, I believe that consideration for one important element of the theory of the firm is missing from the institutional analysis and that law also affects the way in which it is implemented in corporate governance. This element is entrepreneurship.

No question about the importance of corporate law in policing expropriation of minority shareholders, something else seems to be at play in corporate governance.

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208 See, e.g., Coates, J.C. IV [2003], *op. cit.*

209 Agnblad, J., Berglöf, E., Högfeldt, P. and Svancar, H. [2001], *op. cit.*; Cronqvist, H. and Nilsson, M. [2003], *Agency Costs of Controlling Minority Shareholders*, in JOURNAL OF FINANCIAL AND QUANTITATIVE ANALYSIS, vol. 38, 695-719.

210 See, for this interpretation, Holmén, M. and Högfeldt, P. [2005], *op. cit.*

211 Klausner, M.D. [2004], *op. cit.*

212 Roe, M.J. [2003c], *op. cit.*

213 Coffee, J.C. Jr. [2001a], *op. cit.*

This depends more on the problem of contractual incompleteness than on that of agency costs. I have repeatedly suggested that idiosyncratic control rents may be required to foster firm-specific investments by the corporate controller (i.e., the investment of his entrepreneurial/managerial talent), anytime the business is characterized by a high rate of uncertainty.[214] In this situation, at least part of the corporate controller's investments for the firm's success would be both idiosyncratic (i.e., non-redeployable) and unverifiable (i.e., non-contractible). Likewise, part of its reward should come in the form of idiosyncratic control rents. How large are idiosyncratic control rents relative to the verifiable stream of profits that can be expected from a business venture, and therefore be contracted upon with investors, is a key determinant of the firm's optimal ownership structure.[215] However, to the extent that non-contractible investments by the corporate controller are not negligible, entrenchment of corporate control will always obtain *no matter of the ownership structure*.[216] Entrenchment is the only way in which appropriation of idiosyncratic control rents can be secured from *ex post* hold-up.[217] This predicts that a corporate controller should be durably in charge in most situations characterizing the real world's corporate governance. This result is in fact consistent with the empirical evidence.

Being entrenchment ultimately a matter of allocation of residual rights of control, an economist (but certainly not a lawyer) might wonder what law could possibly have to do with it and, even more so, with the choice of the ownership structure.[218] Indeed, at least to my knowledge, none of the few economists that have raised this point has ever claimed (or even hinted) that law should play any role in this regard.[219] Quite to the contrary, Luigi Zingales observed that "although it

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214 See Chapter One, section 1.4.5 and Chapter Three, section 3.4.5.

215 Mayer, C. [1999], *op. cit.*

216 Zingales, L. [1995], *op. cit.*

217 See, e.g., Schnitzer, M. [1995], *'Breach of Trust' in Takeovers and the Optimal Corporate Charter*, in JOURNAL OF INDUSTRIAL ECONOMICS, vol. 43, 229-259.

218 Consideration for the role of regulation, and of corporate law, is minimal in the otherwise comprehensive review of corporate governance by Luigi Zingales. The matter is discussed just in the perspective of *correction* of inefficiencies of private contracting. See Zingales, L. [1998], *op. cit.*, 502. However, as I am going to argue, the importance of corporate law is also in that it *supports* the exercise of control powers, and not just in that it *constraints* their abuse. See *infra*, section 4.7.

219 One important exception is Hellwig, M. [2000], *op. cit.*, 100 (emphasis added): "A comparative institutional analysis that takes observed differences at face value may miss these functional similarities and overlook the *universality* of, e.g., a phenomenon like management working to emancipate itself from the control of its financiers." This phenomenon is customarily supported by apparently different, but functionally similar, legal rules: "Seemingly different institutional arrangements in different countries may serve similar functions, catering to similar interests." The effect is, anyway, that "management has the effective power to set the rules of decision making so as to immunize itself against unwanted interference from outsiders." Id., at 98-99. Hellwig, however, apparently ap-

would be foolish to ignore the importance of corporate law in the entire governance debate, this should not be at the expense of other important factors."[220] These factors most prominently include bargaining power over the allocation of unverifiable surplus, and legal rules apparently enter just as a constraint on rather than as a source of such a power.[221] That sources of power within a corporate enterprise are not (or, at least, not necessarily) legal in character is taken as a prior.[222] However, a more careful investigation of the law would show that it is not so, or at least not as far as corporate control is concerned.

Definitive entitlements to corporate control are only established through residual rights of control (i.e., ownership-like powers) over the firm's assets.[223] By means of a special combination of mandatory and enabling rules, corporate law determines the way in which those rights are allocated between those who owns the corporations and those who actually control them, thereby affecting the ownership structure that can be afforded by a corporate controller concerned with his idiosyncratic control rents.[224] However, entering in such fashion, corporate law also sets a constraint on the choice of ownership structure, and this possibly implies that more efficient ownership structures are foregone.

As we are about to see, all but the last point were raised in the end – albeit only very recently – by *legal* scholars. Their work, however, lacks either a comparative dimension (failing thus to deliver a robust positive theory of Corporate Law and Economics) or an appropriate account of the problem of contractual incompleteness in the governance of corporate enterprises (missing then the opportunity to formulate normative implications). Bringing together these two ingredients, in the next two Chapters I will endeavor to show how law also matters in that it *supports* corporate control with entitlements suitable for alternative ownership structures, thereby allowing for the most efficient one to be selected according to the firm's financial needs.

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proaches this issue from just a positive standpoint. Based on the same factual observation, and on a similar discomfort with the standard theoretical paradigm (Id., at 95-100), I am instead deriving normative implications too. See *infra*, Chapter Six, section 6.7.

220 Zingales, L. [2000], *op. cit.*, 1627.

221 Rajan, R.G. and Zingales, L. [1998], *Power in a Theory of the Firm*, in QUARTERLY JOURNAL OF ECONOMICS, vol. 113, 386-432.

222 Access to a critical resource is considered to be one such source. Rajan, R.G. and Zingales, L. [2001], *The Firm As a Dedicated Hierarchy: A Theory of the Origins and Growth of Firms*, in QUARTERLY JOURNAL OF ECONOMICS, vol. 116, 805-851. See Chapter Three, section 3.5.2, for the implications as to the stakeholder theory of CG. See also *infra* Chapter Six, section 6.2, for further discussion.

223 Rock, E.B. and Wachter, M.L. [2001], *op. cit.*

224 Cools, S. [2005], *op. cit.*, has developed a similar insight, arguing that the legal distribution of corporate powers may be one key determinant of different patterns of separation of ownership and control.

4.5. The Legal Perspective: Corporate Law and Economics in the US

4.5.1. The Enabling Approach to Corporate Law

The majority of legal scholars analyzing corporate governance with a Law and Economics approach teach in the United States of America. Most of them take an agency perspective.[225] That means that the basic goal of corporate law should be minimization of agency costs.[226] To be sure, a few American law professors have always disagreed on that contention.[227] Yet, even within the mainstream agency approach, opinions of legal scholars vary as to both whether and how legal rules matter for corporate governance.

Traditional Corporate Law and Economics suggests that law should take mostly an enabling approach. This is based on a view of the corporation as a nexus of contracts.[228] The shareholder-management relationship is regarded as a part of the nexus, which is disciplined by the corporate contract. The latter enjoys a presumption of efficiency, for the corporate structure would not have emerged otherwise. Both the managers and shareholders are happy with how they deal with agency costs: managers are in charge, but when they fail to provide shareholder with the return they expect, they will lose their job. Externalities on third parties are excluded by contractual safeguards stipulated by other members of the nexus. In such a scenario, there is practically no need of mandatory legal rules. Still, law does play a role. Since contracting is costly, law should minimize transaction costs by providing off-the-rack contract terms that better suits the corporate structure. In this perspective, corporate law is mostly to be regarded as a collection of *default rules*.[229]

Such a hands-off approach to corporate law has always been criticized by the anti-contractarians and, to be sure, never completely upheld by the same contrac-

[225] See, e.g., two prominent handbooks on Corporate Law and Economics: Easterbrook, F.H. and Fischel, D.R. [1991], *The Economic Structure*, cit.; and Bainbridge, S.M. [2002a], CORPORATION LAW AND ECONOMICS, Foundation Press.

[226] This had an unparalleled influence on the comparative analyses of Corporate Law and Economics. See, most notably, Kraakman *et al.* [2004], *The Anatomy*, cit., 17-19 and 21-31.

[227] Clark, R.C. [1986], *op cit.*; Eisenberg, M.A. [1976], *op. cit.*

[228] Easterbrook, F.H. and Fischel, D.R. [1989], *The Corporate Contract*, in COLUMBIA LAW REVIEW, vol. 89, 1416–1448.

[229] Easterbrook, F.H. and Fischel, D.R. [1991], *The Economic Structure*, cit. This view is authoritatively subscribed to by Posner, R.A. [2003], ECONOMIC ANALYSIS OF LAW, 6th edn., Aspen Publishers, 426-428.

tarians.[230] For the moment, I am not going to speculate on the debate about the two opposing views of the corporate structure (nexus of contracts vs. artificial entity).[231] In fact, the same nexus of contracts view allows for a big deal of uncertainty about whether or not mandatory rules are required in corporate law. Simply put, one might question that shareholders of a publicly held corporation do actually contract anything at all.[232] Even if they do it in some way, one might doubt that the outcome of the contracting process is always efficient.[233] The answer to the first question is that the corporate charter should be regarded as a standard form contract.[234] Unfortunately, this also involves that the second kind of concerns cannot be easily dismissed. Asymmetric information might impair the efficiency of contract terms entered into by uninformed shareholders.

However, the matter is much more complicated than it would appear at first glance. Outside shareholders are not directly responsible of screening the corporate charter. Other people, namely the professionals of the securities industry, are doing that on shareholders' behalf.[235] This has two major consequences. On the one hand, the information problem affecting shareholder choice is partly shifted to the investors' relationship with securities intermediaries; however, this is a matter of securities regulation, not of corporate law.[236] On the other hand, the most difficult task for securities intermediaries is not actually screening the quality of the corpo-

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[230] See, on the one hand, Eisenberg, M.A. [1989a], *The Structure of Corporation Law*, in COLUMBIA LAW REVIEW, vol. 89, 1461-1525: on the other hand, Bebchuk, L.A. [1989a], *The Debate on Contractual Freedom in Corporate Law*, in COLUMBIA LAW REVIEW, vol. 89, 1395-1415.

[231] In most jurisdictions the contractual approach is quite settled as of now. One important exception is the Netherlands, where corporations are regarded as legal entities and definitely not as a nexus of contracts; see *infra*, Chapter Seven, section 7.3.3. The debate has been revamped very recently in Corporate Law and Economics. See, most notably: Blair, M.M. and Stout, L.A. [2006], *Specific Investment: Explaining Anomalies in Corporate Law*, in JOURNAL OF CORPORATION LAW, vol. 31, 719-744; Armour, J. and Whincop, M.J. [2005], *The Proprietary Foundations of Corporate Law*, CBR Working Paper No. 299, University of Cambridge, available at www.ssrn.com

[232] Bebchuk, L.A. [1989b], *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, in HARVARD LAW REVIEW, vol. 102, 1820–1860.

[233] Bebchuk, L.A. [2002b], *Asymmetric Information and the Choice of Corporate Governance Arrangements*, Harvard Law School, Working Paper No. 398 (Faculty Series), available at www.ssrn.com.

[234] There is a considerable literature on this point. See, e.g., Kahan, M. and Klausner, M. [1997], *Standardization and Innovation in Corporate Contracting (or "The Economics of Boilerplate")*, in VIRGINIA LAW REVIEW, vol. 83, 713-770; Klausner, M. [1995], *Corporations, Corporate Law, and Networks of Contracts*, in VIRGINIA LAW REVIEW, vol. 81, 757-852. For quite a suggestive approach to the corporate contract, see, most recently, Hansmann, H. [2006a], *Corporation and Contract*, in AMERICAN LAW AND ECONOMICS REVIEW, vol. 8, 1-19.

[235] Gordon, J.N. [1989], *op. cit.*, 1556-1564.

[236] I have discussed elsewhere this kind of agency problem. See Pacces, A.M. [2000], *Financial Intermediation in the Securities Markets: Law and Economics of Conduct of Business Regulation*, in INTERNATIONAL REVIEW OF LAW AND ECONOMICS, vol. 20, 479-510.

rate contract, but rather assessing the corporate controller's managerial skills (the manager's capabilities) and monitoring his performance of the corporate contract (the manager's loyalty and effort). This is what is ultimately meant for by agency costs in corporate governance, namely the costs of managerial adverse selection and moral hazard.

Provided that the terms of the corporate contract are bargained for between professionals, asymmetric information alone does not provide enough grounds for mandatory rules in corporate law.[237] Sophisticated financiers could always claim enough monitoring rights in return for the funds they provide; or require the managers to take some credible commitment to information revelation. Supporting financial exchange through these or similar contractual provisions is in the interest of both parties. Properly chosen default rules could help economizing on transaction costs. Mandatory rules would be instead of no help as far as agency costs are concerned. Quite unsurprisingly, the nexus of contracts theory of the corporation yields the same results as the nexus of contracts theory of the firm upon which it is built: law does not matter much.[238] However, as we already know, the nexus of contract theory provides an unsatisfactory explanation of corporate governance and, consequently, of the economics of corporate law.

4.5.2. Mandatory Rules within the Nexus of Contracts Theory of the Corporation

Legal pragmatism fares quite better than the scrupulousness of economic theorists in dealing with the loopholes of an incomplete paradigm. When the 'law matters' thesis first appeared in the economics of corporate governance, only about ten years ago, the legal debate on the role of mandatory rules in corporate law had already reached its peak. The advent of Corporate Law and Economics in the US leaded to a definitive symposium on "Contractual Freedom in Corporate Law," whose major contributions are contained in the 1989 issue of the Columbia Law Review.[239] In that context, even Frank Easterbrook and Daniel Fishel – perhaps the most prominent advocates of the enabling approach to corporate law – suggested that some mandatory rules protecting outside shareholders might be needed to pre-

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[237] Romano, R. [1989], *Answering the Wrong Question: The Tenuous Case for Mandatory Corporate Laws*, in COLUMBIA LAW REVIEW, vol. 89, 1599-1617.

[238] Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1629.

[239] Symposium [1989], *Contractual Freedom in Corporate Law*, in COLUMBIA LAW REVIEW, vol. 89, 1395-1774 (November 1989.

serve the efficiency of the corporate contract.[240] In their view, efficiency of corporate governance could be undermined by *ex post* rising of agency costs due to charter amendments favoring the incumbent management or the latter's resistance to takeovers. Corporate law should therefore prevent such an outcome and, in particular, prohibit takeover defenses of any kind.[241]

While a few legal scholars agree, many others disagree on the above contention.[242] But this is not the point. The classical specification of the agency model does not provide grounds for mandatory rules in corporate law. If they are needed for any purpose, the underlying reason is contractual incompleteness.[243] Implicit in Easterbrook and Fishel's reasoning is a concern for the exploitation of contractual incompleteness by incumbent managers to the shareholders' disadvantage. That is to say, corporate law should enable shareholders' residual rights of control, awarding them in the form of voting rights, protecting them by means of a judicially enforced system of fiduciary duties, and – finally – preventing those rights from being *de facto* short-circuited by takeover defenses.[244] In such a framework, however, what residual rights of control have to do with agency costs is theoretically unclear.

Curiously enough, most supporters of mandatory rules in Corporate Law and Economics take the same perspective. Paralleling Easterbrook and Fischel's concern that 'latecomer terms' (i.e., opportunistic charter amendments) could represent "a potential problem in a contractual approach to corporate law," they almost invariably focus on the incompleteness of the corporate contract.[245] However, corporate law should not only fill in the charter's gaps (default rules would suffice to this purpose), but also prevent the incumbent managers from doing the same to their exclusive advantage. In other words, self-interested opting-out of corporate law provisions should not be allowed. [246]

Ex post judicial scrutiny plays a key role in this regard. According to Jack Coffee Jr., "because [the corporate contract] is necessarily incomplete, the court's role becomes that of preventing one party from exercising powers delegated to it for the

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[240] Easterbrook, F.H. and Fischel, D.R. [1989], *op. cit.*, 1434-1446.

[241] Easterbrook, F.H. and Fischel, D.R. [1981], *The Proper Role of a Target's Management in Responding to a Tender Offer*, in HARVARD LAW REVIEW, vol. 94, 1661-1204. For discussion of some of the criticisms raised by other commentators, see also Easterbrook, F.H. and Fischel D.R. [1982b], *Auctions and Sunk Costs in Tender Offers*, in STANFORD LAW REVIEW, vol. 35, 1-21.

[242] See, e.g., Gilson, R.J. [1982], *Seeking Competitive Bids versus Pure Passivity in Tender Offer Defense*, in STANFORD LAW REVIEW, vol. 35, 51-67; Bebchuk, L.A. [1982], *The Case for Facilitating Competing Tender Offers: A Reply and Extension*, in STANFORD LAW REVIEW, vol. 35, 23-50.

[243] Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1637-1640.

[244] See the excellent, systematic approach to Corporate Law and Economics developed in the oft-cited classic by Easterbrook, F.H. and Fischel, D.R. [1991], *The Economic Structure*, cit.

[245] See Easterbrook, F.H. and Fischel, D.R. [1989], *op. cit.*, 1444.

[246] Bebchuk, L.A. [1989a], *op. cit.*, 1399-1404.

mutual benefit of all shareholders for purely self-interested ends."[247] In the same vein, Jeffery Gordon points out: "Fiduciary duties [administered by US courts] provide a set of standards to restrain insiders in exercising their discretionary power over the corporation and its shareholders in contingencies not specifically foreseeable and thus over which the parties could not contract."[248]

For the same reason, charter amendments aimed at relaxing the above judicial scrutiny should not be allowed.[249] As Jeffery Gordon puts it, "since insiders have substantial control over the amendment process, they are continually tempted to relax fiduciary standards that govern their behavior and expose them to liability."[250] Lucian Bebchuk provides an even broader view of the opportunistic amendments issue: "Unlike initial charters, charter amendments cannot be viewed as contracts: […] the director's decision might be shaped not only by the desire to maximize corporate value but also by the different interests of officers and dominant shareholders. […] The optimal arrangement [the law should provide] thus involves an element of precommitment not to adopt in midstream, at least not in certain circumstances, opt-out provisions with respect to certain issues."[251]

To my knowledge, none of the above authors has ever questioned the nexus of contracts framework. Actually, Lucian Bebchuk made quite the opposite point: "The deregulators [i.e., the advocates of contractual freedom in corporate law] do not have a monopoly over the contractual framework of analysis."[252] No doubt on the correctness of this statement, it would hold true also for general contract law. In the corporate field, however, I still believe that the nexus of contracts view of the corporation overlooks the importance of contractual incompleteness in corporate governance, as well as its regulatory implications.

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[247] Coffee, J.C. Jr. [1989], *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, in COLUMBIA LAW REVIEW, vol. 89, 1621.

[248] Gordon, J.N. [1989], *op. cit.*, 1593.

[249] Eisenberg, M.A. [1989a], *op. cit.*, 1474-1480, also reaches the same conclusion, discussing "The Limits of Shareholder Consent."

[250] Gordon, J.N. [1989], *op. cit.*, 1593.

[251] Bebchuk, L.A. [1989a], *op. cit.*, 1400-1401. See also, in more detail, Bebchuk, L.A. [1989b], *op. cit.*, 1835-1851.

[252] Bebchuk, L.A. [1989a], *op. cit.*, 1399.

4.5.3. Corporate Law's Account of Contractual Incompleteness

This crucial point has been recently highlighted in Corporate Law and Economics:

> "Despite the strict and limited assumptions of the [nexus of contracts] model, the corporate law scholarship that relies on it generally allows contractual incompleteness to creep in through the backdoor. Entering in this fashion, related conceptual issues are ignored. The nexus's governance apparatus that deals with the incompleteness is assumed to be contractual, with courts filling in the contractual gaps more or less as they do in a commercial market context."[253]

Differently from general contract law, contractual incompleteness in corporate law involves more than legal rules just 'filling in the gaps.'[254] The corporate structure is itself a contractual gap-filler.[255] It is based on a system of power allocation *alternative* to market contracting.[256] It is upon that system that the firm's governance is established. Before asking whether and how that system should be regulated and corporate powers possibly constrained, one should first understand why such a power exists, how it is exerted, maintained, and lost.[257] Advocates of mandatory regulation of corporate governance recognize that those who are in charge of managing the corporate affairs enjoy a significant power, and therefore corporate law

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253 Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1629-1630.

254 This expression was famously coined by Ayres, I. and Gertner, R.E. [1989], *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, in YALE LAW JOURNAL, vol. 99, 729-773, a milestone publication in the economic analysis of contract law.

255 Building on the criticism of the nexus of contracts approach in Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1628-1630, Rock, E.B. and Wachter, M.L. [2002], *op. cit.*, explicitly warn against "dangerous liaisons" and "inter-doctrinal legal transplants" between corporate law and the general contract law.

256 This insight is based on Williamson, O.E. [1985], *op. cit.*, 298-325 (chapter 12 – '*Corporate Governance*'), as an application and extension of Coase, R.H. [1937], *The Nature of the Firm*, in ECONOMICA, vol. 4 (New Series), 386-405.

257 According to Zingales, L. [2000], *op. cit.*, 1644, this is one of the fundamental questions of the theory of the firm, as related to the study of corporate governance. The work by Luigi Zingales (most often co-authored by Raghuram Rajan) is very seldom accounted for by students of corporate governance on the legal side. One important exception is Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1634. Neither does Zingales seem to regard economic analysis of law as a central issue in the study of corporate governance: as he argues, "[I]t would be foolish to ignore the importance of corporate law", but "this should not be at the expenses of other important factors." Zingales, L. [2000], *op. cit.*, 1644. However, see also Zingales, L. [1998], *op. cit.*, 502, discussing the potential role of legal intervention in CG, in an incomplete contracts setting.

should prevent them from abusing it. Few of them wonder why outside shareholders let the corporate controller exert such a broad power with their money.[258] Almost none of them dare to abandon the nexus of contracts approach to find out that this is just the way it should be.[259]

Luckily, there are at least a few exceptions within the corporate law scholarship. Let me briefly mention the position of those who attempted to sketch out an alternative theoretical background. I shall elaborate upon their implications as to specific issues of corporate governance regulation throughout the following Chapters.

In the early 90s, Michael Dooley suggested that there are two theoretical models of corporate governance: an *Authority Model* – where inside management is in charge; and a *Responsibility Model* – centered on the shareholder franchise.[260] "Neither model exists in pristine form in the real world."[261] Actual corporate governance systems are to be regarded as a mixture of both. Authority and responsibility are ultimately impossible to reconcile. This apparently leads to a paradox, for the two values are both essential and antithetical in corporate law. Economic analysis helps solving the paradox. Building on Kenneth Arrow's theory of organizational decision-making, Dooley posits that the antithesis between authority and responsibility is the basic tradeoff of corporate governance.[262] How this tradeoff is dealt with by the legal system determines how authority and responsibility are combined in shaping the actual corporate governance models that we observe in the real world. Dooley only focuses on the model of corporate governance prevailing in the US and, in this regard, he concludes that "[p]reservation of the board [of directors]'s authority will necessarily sacrifice some degree of Responsibility."[263] However, to avoid ending up with a paradox, we need to escape the assumption that shareholders are "disciplinarians of the board and of the management team it selects."[264] That is to say:

> "The Responsibility criterion is satisfied if conditions exist that reward managers for increasing shareholder wealth and impose costs on them for decreasing shareholder wealth. […] The necessary conditions for accountability are supplied by competitive forces in the product market, in the internal end

[258] This issue is raised quite bluntly by Hellwig, M. [2000], *op. cit.*, 107.
[259] Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1629-1630 make a similar point in their comprehensive inquiry of the theoretical underpinnings of Corporate Law and Economics.
[260] Dooley, M.P. [1992], *Two Models of Corporate Governance*, in THE BUSINESS LAWYER, vol. 47, 461-527.
[261] Id., at 463.
[262] Arrow, K.J. [1974], THE LIMITS OF ORGANIZATION, Norton and Company.
[263] Dooley, M.P. [1992], *op. cit.*, 524-525.
[264] Id., at 525.

> external markets for managers and, ultimately, in the market for corporate control."[265]

Michael Dooley's article is does not certainly belong to the most cited contributions to Corporate Law and Economics. One should not be surprised, though. While not taking any explicit position on the nexus of contracts theory, the alternative framework he proposes implicitly rejects it. There is no room for 'real' authority in the nexus of contract theory. Delegated authority just fits the responsibility model, for it is in fact no authority at all.[266]

More recently, building upon Dooley's insights, Stephen Bainbridge attempted to reconcile authority with the nexus of contracts framework, by placing the board of directors at the center of the nexus.[267] On this basis, he argues that the mainstream tenet of corporate law economics – 'shareholder primacy' – should be replaced with 'director primacy.'[268] In Bainbridge's view, "neither shareholders nor managers control corporations – boards of directors do."[269] Still, the firm is to be managed in the shareholders' interest: directors are intended as "Platonic guardians" of that interest.[270] To this purpose, shareholders *irrevocably* delegate authority to the board. The latter's accountability to the shareholder interest is not guaranteed by direct monitoring, but rather through a web of economic and legal mechanisms that do not undermine discretionary authority. Again, "establishing the proper mix of discretion and accountability thus emerges as the central corporate governance question."[271]

The major weakness of Bainbridge's approach lies in his assumption of directors' independence from any corporate controller featured with a significant human capital investment in firm management.[272] His attempt to preserve the metaphor of the firm as a nexus of contracts ultimately shares one of the weaknesses of the conventional approach the he meant to criticize: as within the nexus of contracts framework, Bainbridge's firm appear to be "without a core and without insiders."[273]

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[265] Id., at 525-526.

[266] On the economist's side, see Zingales, L. [1998], *op. cit.*, 498-499.

[267] Bainbridge, S.M. [2002a], *op. cit.*, 197-206.

[268] Bainbridge, S.M. [2002b], *Director Primacy: The Means and Ends of Corporate Governance,* in NORTHWESTERN UNIVERSITY LAW REVIEW, vol. 97, 547-606.

[269] Bainbridge, S.M. [2002a], *op. cit.*, 191-240.

[270] Id., at 204.

[271] Id., at 207.

[272] Curiously enough, the author is quite skeptical of the legal requirement that directors be independent. See Id., at 223-230. For a more detailed discussion of this issue, see *infra*, Chapter Eight, section 8.5.3.

[273] Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1628.

However, such a core – the insiders – does exist in real-world corporations, whose board members are captured by powerful managers or simply puppets of a controlling shareholder. Proper consideration for that core requires a straight departure from the nexus of contracts theory of the firm.

4.5.4. The Corporation Is More than Just a Nexus of Contracts

In a comprehensive, but much unheeded contribution, Edward Rock and Michael Wachter finally attempted such a departure.[274] They first recalled the visiting economist's (Oliver Hart's) contribution to the 1989 Symposium on Contractual Freedom in Corporate Law ("largely ignored by the other participants"), "where the nexus of contracting model of the firm is dismissed as seriously incomplete."[275] The authors then provide an extensive review of the alternative theories of the firm (basically, the Property Rights approach and Transaction Costs Economics), as well as of their weaknesses. Their survey of the topic is similar to the discussion that we had in the previous Chapter.[276] Their conclusions are too. They summarize their position as follows:

> "Our claim in this Article is not that agency costs do not matter in the firm, nor that corporate law does not address agency costs. Neither statement would be true. Rather, we argue, agency costs are *not the only thing that matters* in corporate law and, standing alone, are either unable to explain major areas of corporate law or even misleading."[277]

According to Rock and Wachter, the firm is to be regarded as a response to pervasive contractual incompleteness.[278] When ownership is separated from control, the need to preserve the incentives to make firm-specific investments has two consequences. The first is that the owners (i.e., the shareholders) cannot retain residual rights of control, for they have to be assigned to a central decision-making authority (namely, a corporate controller) that is in charge of having the firm's assets specialized, and is safe from *ex post* expropriation "of the surplus created by the match

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[274] Rock, E.B. and Wachter, M.L. [2001], *op. cit.*
[275] Id., at 1625 (citing Hart, O. [1989], *An Economist's Perspective on the Theory of the Firm*, in COLUMBIA LAW REVIEW, vol. 89, 1757-1774).
[276] See *supra*, Chapter Three, section 3.3.
[277] Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1622 (emphasis added).
[278] Id., at 1638.

investments."[279] Still, shareholders are the residual claimants, so the firm is to be managed in their interest. The second consequence of separation of ownership and control under contractual incompleteness is, then, that shareholders' residual claim ought to enjoy some form of external protection for all that cannot be achieved contractually. This could be possibly framed as an agency problem, provided that the corporate controller's authority remains out of question.

Rock and Wachter also make an important point. They claim that the exercise of managerial discretion by the corporate controller is aligned with the shareholder interest by means of a complex interplay of *legal rules* and *social norms*.[280] For this reason, they disagree on Dooley's contention that the relationship between authority and responsibility needs to be regarded as a tradeoff.[281] A sense of responsibility would be ultimately internalized by the corporate controller, once most tempting instances of misbehavior are adequately policed by the legal system.[282] I am relatively more skeptical about the reliability of social norms in corporate governance, especially in a comparative perspective – which, incidentally, is not the one that Rock and Wachter take.[283] I rather believe that incentive alignment of corporate controllers ultimately depends on the market for corporate control, where a tradeoff between private benefits (control rents) and security benefits (shareholder value) is to be solved.[284] This point will get clearer over the next Chapters.[285] For the moment, it is important to bear in mind that Rock and Wachter were the first to recognize, based on economic analysis, that corporate law should support *both* the controller's discretionary authority *and* its accountability to the interest of outside shareholders.

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[279] Id., at 1654.

[280] Id., at 1653-1663. The authors had previously articulated this view in Rock, E.B. and Wachter, M.L. [2000], *Corporate Law as a Facilitator of Self Governance*, in GEORGIA LAW REVIEW, vol. 34, 529-545.

[281] Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1656.

[282] For a similar conclusion, see Eisenberg, M.A. [1999], *Corporate Law and Social Norms*, in COLUMBIA LAW REVIEW, vol. 99, 1253-1292.

[283] For the role of social norms as an institutional support of regulation of related-party transactions, see *infra*, Chapter Nine.

[284] For the analysis of takeovers and their legal discipline in this perspective, see *infra*, Chapters Ten and Eleven.

[285] A change in the theoretical approach to corporate governance is going to be introduced in the next Chapter. The framework of legal analysis will be then discussed in the Sixth Chapter.

4.6. The European View of Corporate Law and Economics

4.6.1. Agency and Just Agency: The Problem of Minority Shareholders

One might wonder then where European Law and Economics scholarship stands in this debate. To my knowledge, European legal scholars – at least, those concerned with economic analysis of law – almost invariably take the agency perspective on corporate governance at face value. To some extent, this is understandable. In continental Europe, the legal and economic analysis of corporate governance is confronted with a major problem: the characteristic presence of one or more controlling shareholders in the governance of publicly held corporations – that is, the apparently inexplicable absence of public companies subject to managerial control.[286] This brings the core of the debate to how the agency framework should be adapted from the managers-shareholders conflict to the relationship between controlling and non-controlling shareholders.[287] The problem is often referred to as *minority shareholder protection*. As a positive matter, such a protection should explain the economic rationale underlying most provisions of corporate law.[288] From a normative perspective, the same protection should be the basic goal of corporate governance regulation.[289] Conversely, limited separation of ownership and control and the persistence of controlling shareholders in continental Europe's corporate governance should depend on corporate law's failure to achieve that goal.

While the positive strand of analysis has ultimately produced some interesting – albeit partial – results, the normative account of the minority shareholders protection thesis (the lawyers' version of the 'law matters' argument) cannot escape a number of factual contradictions. Let me just recall a couple of them, postponing further speculation on this issue to a later stage of the present inquiry. First, contrary to conventional wisdom, minority shareholders protection does not seem a fundamental concern of US corporate law, whereas it certainly is in UK company law.[290] In both countries' corporate governance, publicly held corporations do not typically have a controlling shareholder.[291] Secondly, there is no anecdotal evidence

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[286] Hopt, K.J. [2000], *Modern Company Law Problems: A European Perspective*, Keynote Speech at the OECD Conference on Company Law Reform in OECD Countries, Stockholm 7-8 December 2000, available at www.oecd.org/dataoecd/21/28/1857275.pdf

[287] Kraakman *et al.* [2004], *The Anatomy*, cit., 54-61 and 67-70.

[288] Baums, T. and Scott, K.E. [2005], *op. cit.*, 35-36.

[289] For an interesting discussion of the implications on a peculiar feature of the European continent's CG (corporate groups), see Wymeersch, E. [2003], *op. cit.*

[290] Franks, J. and Mayer, C. [2002], *op. cit.*

[291] Barca, F. and Becht, M. (eds.), THE CONTROL OF CORPORATE EUROPE, Oxford University Press.

whatsoever of minority shareholder expropriation in Sweden (although it is unclear whether this is due to the quality of the legal system or, rather, to powerful social norms).[292] Nonetheless, controlling shareholders are the norm in the governance of publicly held Swedish companies.[293] Apparently, then, minority shareholders protection is neither a necessary nor a sufficient condition for the emergence of public companies – that is, of a model of corporate governance based on complete dispersion of ownership among financial investors. That conclusion would be excessive, though. Again, the reason of this paradox is that the agency perspective does not provide sufficient grounds for understanding corporate governance. Albeit important, protection of minority shareholders is just a part of the story.

4.6.2. The Comparative Approach to Corporate Law and Economics

By carefully avoiding drawing normative implications of any kind, a group of seven prominent legal scholars, from five different countries, has provided the most comprehensive comparative analysis of Corporate Law and Economics available to date: *The Anatomy of Corporate Law*.[294] Although just three of the authors are actually European, the comparative flavor of this work fits much better the European debate on corporate governance than that one going on in the US.

Their analysis of corporate law in five major jurisdictions is carried out from an agency perspective.[295] Nonetheless, the legal part of the present work will extensively draw on that analysis. The reason is threefold. First, *The Anatomy* provides just a positive account of the legal techniques aimed at minimizing agency costs in corporate governance; therefore, I can take it as a partial explanation of the matter – as I believe it is. Secondly, the comparison of key corporate law institutions is based on a thoughtful premise: agency conflicts are not alike. In particular, conflicts of interest between managers and shareholders can ultimately be regarded as *similar* to those opposing controlling to non-controlling shareholders, but must be dealt with *differently* by corporate law.[296] As a result, in *The Anatomy*, legal comparison is accurately conducted from a functional perspective – just the way it should be. Thirdly, the authors' explanation of mandatory rules in corporate law is at least intriguing: those rules should "make credible the entrepreneur's commitment not to

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[292] Coffee, J.C. Jr. [2001a], *op. cit.*

[293] See Gilson, R.J. [2006], *op. cit.*, who also speculates on this contradiction. Gilson's interpretation will be discussed in more detail in the next Chapter, section 5.1.

[294] Kraakman *et al.* [2004], *The Anatomy*, cit.

[295] Id., at 1-5.

[296] Id., at 21-23.

change [certain] terms."[297] While I definitively agree on this statement, I seriously doubt that it can fit in an agency framework, where credible commitments are costly, indeed, but can always be taken contractually.[298]

Again, contractual incompleteness is "creeping in through the backdoor" of the nexus of contracts paradigm.[299] Although *The Anatomy* does not take any explicit account of distribution of powers within the corporate structure, it does so implicitly. The authors' understanding of the legal techniques that may effectively constrain the abuse of corporate controller's powers is in fact based on the knowledge of how this power is allocated in the first place in different jurisdictions.[300]

To my knowledge, the only European work providing for explicit consideration of distribution of corporate powers in the analysis of corporate governance is – quite ironically – a Harvard LL.M. paper by a very young Belgian scholar: Sofie Cools.[301] Her work supplies two important contributions to comparative corporate governance, which are unheard of also in the flood of the US literature on Corporate Law and Economics. First, it contains a detailed critique, from both a legal and an economic perspective, of the way in which the quality of corporate laws was measured by La Porta *et al.* in their pioneering work on the 'law matters' thesis. Secondly, and more importantly, Sofie Cools argues that, even if correctly accounted for, legal protection of outside shareholders is certainly not the only way in which law matters for corporate governance, and probably not even the most important determinant of separation of ownership and control.

Legal distribution of powers between the board of directors and the general meeting of shareholders is what determines the ownership structure necessary to support corporate control.[302] In most, if not all, continental Europe's jurisdictions, managerial control of the corporation would not be technically possible without a controlling shareholder standing behind the scenes. Although the analysis by Sofie Cools bears no reference to any particular economic theory of the firm, nor does she question the standard nexus of contracts/agency approach to Corporate Law and Economics, most of her conclusions come very close to those that will be presented in the following Chapters.

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[297] Id., at 31.

[298] See *infra*, Chapter Eight, section 8.1.3.

[299] See, for this expression, Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1629.

[300] Kraakman *et al.* [2004], *The Anatomy*, cit., 32-70.

[301] Cools, S. [2005], *op. cit.* An earlier version of '*The Real Difference in Corporate Law between the United States and Continental Europe: Distribution of Powers*' was written for the LL.M. program at Harvard law School, circulated as Law and Economics Discussion Paper No. 490 (available at www.ssrn.com), and awarded the *Irving Oberman Memorial Award* at Harvard Law School and the *Ius Commune Prize* at the Universities of Maastricht, Leuven, and Utrecht.

[302] Id., at 755-765.

4.7. Reconciling Economic Analysis with Corporate Law and Economics

It should be clear from the foregoing analysis that economists and lawyers approach the question of contractual incompleteness in corporate governance from two different and, in a sense, opposite angles. For the economists, contractual incompleteness is ultimately a matter of allocation of control power, or authority. Legal rules enter the framework as an *ex post* constraint on such a power, necessary to make incomplete contracting viable *ex ante*.[303] In this perspective, investors and managers contract upon the allocation of powers and expect the law to keep on enforcing this allocation over time. For the lawyers, power is normally taken as given and it typically risks to be abused.[304] Power is the unintended consequence of incomplete contracting and this is the ultimate reason why the corporate contract should be regulated. In this perspective, investors and managers contract upon legal entitlements and expect the law to prevent each party from abusing those entitlements over time. Therefore, *economic centralism* features *power* as a solution to contractual incompleteness and legal rules as a device to correct for possible inefficiencies. *Legal centralism* features *law* as a solution to contractual incompleteness and power as a source of possible inefficiencies.

True, there are exceptions on both sides. Let me mention just two of them. On the one hand, law professors Edward Rock and Michael Wachter recall Oliver Williamson's contention that the role of the judge (and of the law, in general) with respect to contractual incompleteness should be 'forbearance' – that is, "to leave the parties to work it out themselves." On this matter, they add that "for judges to intervene in the exercise of [corporate] power is, in essence, a category mistake."[305] On the other hand, economists Colin Mayer and Oren Sussman point out: "The incomplete-contracts model suggests that […] effective financial markets need to strike the right *balance of power* between managers, block-holders, dispersed investors, and all the other 'stakeholders.' […] This raises a deeper question: should *law* interfere in *establishing* that 'optimal' balance or should it leave to the stakeholders to work out for themselves by way of contracts?"[306]

As the above two examples may testify, economic and legal centralism in the analysis of corporate governance can be ultimately reconciled. This is what I will attempt to do in the remainder of this work. According to the view that is now going to be presented, both power (i.e., control) and law matter in corporate govern-

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[303] See, e.g., Zingales, L. [1998], *op. cit.*, 502.
[304] See, e.g., Gordon, J.N. [1989], *op. cit.*, 1593-1597.
[305] Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1650.
[306] Mayer, C. and Sussman, O. [2001], *op. cit.*, 465.

ance. Together, they shape the patterns of corporate ownership and control that we observe in the real world; and they influence the efficiency of the corporate contract's arrangements underlying those patterns. Law needs therefore *both* to support the exercise and maintenance of corporate control *and* to constrain the abuse of corporate powers by the corporate controller. The first is a matter of allocation of powers, which is compatible with motivating firm-specific investments by the corporate controller. The second is a question of how to induce outside shareholders to place their money under the corporate controller's discretionary management. Only the latter could be possibly regarded as an agency problem, to the extent it does not affect the first task. But this is a condition that never holds in practice. The interplay between the two above issues has therefore to be regarded as a key subject-matter in Corporate Law and Economics. This involves a positive and a normative account of corporate governance that depart from the mainstream view. I will endeavor to introduce both of them in the next two Chapters.

PART II

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RETHINKING 'LAW MATTERS' IN A THEORY OF PRIVATE BENEFITS OF CONTROL

CHAPTER FIVE – 'Law Matters' Revisited: Private Benefits of Control

5.1. A Different Framework of Analysis

5.1.1 Revamping the 'Law Matters' Argument

In whatever configuration, the standard 'law matters' argument has failed so far to deliver a consistent explanation of how prevailing corporate governance arrangements vary from country to country. As we know, this has led some commentators to reject the cross-reference approach altogether, suggesting that law may not even matter at all for both the shape and the efficiency of corporate governance.[1] However, comparative institutional analysis may just suffer from the lack of an adequate theoretical paradigm. The aim of this Chapter is trying to cope with this problem, in order to revitalize the explanatory power of the 'law matters' proposition. On this basis, we will see in the following pages that law matters in at least two different, but complementary, respects in corporate governance.

As I argued, investor protection by the legal system is far from unimportant in corporate governance. Actually, it seems that dispersed ownership structures could not emerge and, even if they could, they would not be sustainable for long in the absence of this protection. However, ownership concentration also obtains in those institutional contexts where investor protection is apparently strong. To account for this one does not have to throw the baby with the bath water. Rather, we may look for what else is needed, at the legal-institutional level, for ownership to be separated from control when investor protection is not an issue to worry about. I have repeatedly suggested that also managers should be protected to some extent, in order for entrepreneurship to be featured in the absence of full ownership of the com-

[1] See *supra*, Chapter Four, section 4.4.3, and the references cited therein.

pany's assets. This double need of protection may be integrated in the discussion of one single feature of corporate governance which has been always kept in the background during the foregoing analysis, but that is going to be in the forefront from now on. This is private benefits of control (henceforth PBC). To this purpose, however, the notion of PBC needs to be broad enough to include all kinds of benefits accruing exclusively to the corporate controller by means of his staying in charge of the company management, and not just those who result in reduction of shareholder value.[2]

Once PBC are defined in such a fashion, they may account for both the corporate controller's motivation to undertake firm-specific investments and for expropriation of non-controlling shareholders. Consequently, one analysis of corporate governance based on PBC can provide us with three fundamental advantages compared to the standard, and much narrower, agency framework. First, a theoretical framework of corporate governance that accounts for investor protection, but allows also for non-contractible incentive mechanisms of managerial firm-specific investments to be considered.[3] Second, a positive theory of corporate law, which allows for both variety and regularities in each system where separation of ownership and control is implemented. Variety should depend on the amount of private benefits necessary to motivate the undertaking, in the corporate form, of a specific business venture characterized by high uncertainty. Regularities should depend on both opportunities for and constraints to the extraction of PBC provided for by corporate law, which would determine in turn the willingness of outside shareholders to provide equity capital and of corporate controllers to deconcentrate ownership.[4] Third, a normative theory of corporate law, which tells how PBC should be regulated depending on a qualitative distinction between different categories of them and on their implications for economic efficiency.[5]

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2 For such a broad notion, see Coates, J.C. IV [2003], *Ownership, Takeovers and EU Law: How Contestable Should EU Corporations Be?*, ECGI Law Working Paper No. 11/2003, available at www.ssrn.com and www.ecgi.org, reprinted in E. Wymeersch and G. Ferrarini (eds.) [2004], COMPANY AND TAKEOVER LAW IN EUROPE, Oxford University Press, 13.

3 Cf., for a similar approach (albeit not explicitly mentioning private benefits of control), Rock, E.B. and Wachter, M.L. [2001], *Islands of Conscious Power: Law, Norms and the Self-Governing Corporation*, in UNIVERSITY OF PENNSYLVANIA LAW REVIEW, vol. 149, 1619–1700.

4 See, in similar terms, Mayer, C. [1999], *Firm Control*, Inaugural Lecture at the University of Oxford (February 18, 1999), available at www.finance.ox.ac.uk, as published in J. Schwalbach (ed.) [2001], CORPORATE GOVERNANCE: ESSAYS IN HONOR OF HORST ALBACH, Springer-Verlag.

5 This has been recently attempted by Gilson, R.J. [2006], *Controlling Shareholders and Corporate Governance: Complicating the Taxonomy*, in HARVARD LAW REVIEW, vol. 119, 1641-1679.

5.1.2. Complicating the Comparative Taxonomy

Most recent advances in Corporate Law and Economics have just suggested that a qualitative distinction between different categories of private benefits of control may fare much better in explaining alternative corporate governance patterns than the standard 'law matters' account, according to which PBC just arise from the weakness of institutions and, specifically, from the failure of corporate law to police minority shareholder expropriation. The embarrassment with that thesis, in the face of the prevalence of controlling shareholders even in those systems that are credited with excellent investor protection, has been recently summarized by Ronald Gilson in a very efficacious sentence: "When the world seems more complicated than what our theory can explain, we probably do not yet understand the world."[6]

A broader account of private benefits of control in corporate governance may possibly provide a way to understand the world better. To this purpose, however, the "comparative taxonomy" has to be "complicated."[7] Professor Gilson essentially argues that the classical divide between controlling shareholder systems and widely held control structures is too a parsimonious account of corporate governance and it is most likely to be wrong. In particular, controlling shareholders are not alike. They might be bad for corporate governance, but only when they arise as a response to inadequate investor protection. However, this is not the only reason why controlling shareholders are there. Their presence may indeed be efficient in corporate governance, when no expropriation of minority shareholders is involved. *Inefficient* controlling shareholders avail themselves 'pecuniary' private benefits that necessarily come at the outside shareholders' expenses thereby increasing agency costs, whereas *efficient* controlling shareholders reduce agency costs by exploiting a different kind of PBC that involves no cash flow diversion. According to Ronald Gilson, these benefits are 'non-pecuniary.'

The efficiency explanation of controlling shareholders should tell why they still prevail in European countries where expropriation of outside shareholders has never been a matter of concern (like, for instance, in Sweden), and they have not completely disappeared even in the US and the UK, which apparently feature investors with a high quality of legal protection. Non-pecuniary PBC are the key for understanding the puzzle. Their presence in the system is allegedly endogenous, and so is shareholder control, for they both depend on whether the nature of the busi-

[6] Gilson, R.J. [2006], *op. cit.*, 1650.
[7] Id., at 1652-1661.

ness better suits a dispersed or a concentrated ownership structure.[8] Only pecuniary PBC depend on the quality of corporate law. Should it be assessed functionally rather than by synthetic indexes, that would show how controlling shareholders persist in spite of their inefficiency when expropriation of minority shareholders is not adequately policed by the legal system, but dispersed ownership does not arise in spite of good investor protection when non-pecuniary PBC are high.[9]

Gilson's criticism of standard comparative institutional analysis highlights two fundamental points. The first one is that legal comparison has to be performed with a functional approach, and this is ultimately at odds with 'indexing' the overall quality of corporate law. The second one is that legal protection of outside shareholder, even when accurately accounted for, affects just one kind of PBC and, therefore, cannot explain alone why controlling shareholders prevail in some (to be sure, in most) systems while managerial control prevails in some others. Complicating the comparative taxonomy requires then both a more precise assessment of how investor protection is, or is not, achieved by different corporate law systems and what else – either legal or non-legal – determines ownership concentration.[10]

That being said, there are still two problems with Gilson's analysis. To begin with, not all 'non-pecuniary' benefits are harmless to outside shareholders.[11] As he recognizes, they may involve significant opportunity costs inasmuch as they lead to non profit-maximizing corporate decisions.[12] This is what, so far, has been referred to as 'shirking,' which include any possible instance of on-the-job consumption of personal benefits by the corporate controller (managerial perquisites, misuse of free cash, empire building, etc.).[13] Consistently with the standard agency framework, high non-pecuniary benefits of such a kind are only compatible with limited separa-

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[8] Id., at 1657-1660. This point is taken from the classic study by Demsetz H. and Lehn, K. [1985], *The Structure of Corporate Ownership: Causes and Consequences*, in JOURNAL OF POLITICAL ECONOMY, vol. 93, 1155-1177.

[9] Gilson, R.J. [2006], *op. cit.*, 1660-1667.

[10] It is worth noting that this position parallels the research agenda set forth by Cools, S. [2005], *The Real Difference in Corporate Law between the United States and Continental Europe: Distribution of Powers*, in DELAWARE JOURNAL OF CORPORATE LAW, vol. 30, 765-766 (who, however, does not consider PBC).

[11] Ehrhardt, O. and Nowak, E. [2003], *Private Benefits and Minority Shareholder Expropriation (or What Exactly are Private Benefits of Control?)*, Working Paper, Humboldt University and University of South Switzerland Lugano, available at www.ssrn.com, actually question that any such instance of 'harmless' PBC can possibly exist. However, as I am going to argue, the matter is simply more complicated. Once we depart from the traditional agency framework, PBC which do not immediately harm non-controlling shareholders are theoretically allowed. See *infra* in the text.

[12] Gilson, R.J. [2006], *op. cit.*, 1665.

[13] Cf. Roe, M.J. [2004b], *The Institutions of Corporate Governance*, Harvard Law School, Working Paper No. 488 (Faculty Series), available at www.ssrn.com, reprinted in C. Menard and M.M. Shirley (eds.) [2005], HANDBOOK OF NEW INSTITUTIONAL ECONOMICS, Springer, 3-4.

tion of ownership and control where the owner-manager bears a significant part of their opportunity costs. This is how efficient controlling shareholding is obtained at the outset.[14] However, as Gilson also acknowledges, efficiency may get compromised dynamically. The reason is that – as he argues – non-pecuniary private benefits are idiosyncratic to the corporate controller, but their opportunity costs may rise over time. At some point, it would be efficient that control changes hands. Yet idiosyncrasy of private benefits may prevent this from happening: on the one hand, the incumbent controller would not part with control unless his private benefits are fully compensated; on the other hand, the same private benefits cannot be compensated just because they are idiosyncratic, and this makes them unsuitable for exchange.[15]

However, the assumption that all non-pecuniary private benefits are idiosyncratic to the corporate controller is problematic, and it is most likely to be incorrect. If non-pecuniary PBC – like, e.g., consumption of managerial perquisites – have a negative balance with opportunity costs, this means that at least one corporate controller exists who can compensate the incumbent and still be better off by taking over and reducing on-the-job consumption to the efficient level.[16] The reason why this may not happen is that *another* kind of PBC is involved, like, for instance, the personal pride of uncovering the success potential of the company, which the market is not yet able to price.[17] Until the market is unable to set a price for change in control, that kind of private benefits has no alternative use and, therefore, no opportunity cost. Only *these* private benefits are truly *idiosyncratic*. By sticking to the traditional agency framework, Ronald Gilson fails to distinguish between non-pecuniary benefits arising from non value-maximizing behavior and those rewarding firm-specific investments whose value is not yet acknowledged by the market,

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14 For a comprehensive, non-technical, discussion of this result, see Bratton, W.B. and McCahery, J.A. [2001a], *Incomplete Contracts Theories of the Firm and Comparative Corporate Governance*, in THEORETICAL INQUIRIES IN LAW, vol. 2, n. 2, *Protecting Investors in a Global Economy*, 11-28.

15 Gilson, R.J. [2006], *op. cit.*, 1667-1770.

16 It is Gilson himself to make this point. Id., at 1670-1672.

17 Other commentators have better speculated on this point. Mayer, C. [1999], *op. cit.*, 13, suggests to characterize at least some of the non-pecuniary benefits of control as a prospective reward for entrepreneurship, alternative to financial returns (at least until uncertainty prevents these returns from being anticipated by financial markets). However, this is not also the line of inquiry followed by Gilson, R.J. [2006], *op. cit.*, 1663, who considers "psychic" satisfaction as a main source of non-pecuniary benefits that are efficient inasmuch as they do not involve higher opportunity costs in terms of shareholder value. The view of PBC as an "incentive to invest in activities that markets are unable to sustain" (Mayer, C. [1999], *op. cit.*, 19) is absent from Gilson's framework. Indeed, differently from Colin Mayer, Ronald Gilson considers just two, and not three, categories of private benefits of control. See *infra* in the text.

but may be possibly recognized in the future.[18] In fact, the latter category of private benefits of control is incompatible with a principal-agent paradigm and can only make sense in an incomplete contract setting.[19]

A second, and related, problem with Gilson's analysis is that he does not allow corporate law to play a role also as far as non-pecuniary PBC are concerned.[20] In his view, non-pecuniary private benefits are just endogenous and, therefore, they can only evolve in connection with the controller's *tastes* (specifically, when corporate control is transferred to the founder's heirs). To be sure, this is consistent with the typical patterns of evolution of ownership structures that we observe in Continental Europe.[21] Yet it is not with respect to controlling shareholders situated in different institutional environments – like, for instance, in the US. Therefore, one may conjecture that non-pecuniary PBC can also evolve in connection with the controller's *pockets* (that is, by means of a change in control), provided that corporate law allows for those benefits to be compensated by means of a control sale.[22]

In order to understand how this may work, and the implications for corporate law, we need to complicate the taxonomy of PBC further. Corporate law may not only be concerned with curbing private benefits from shareholder expropriation, but may also have to do, on the one hand, with protecting private benefits which are idiosyncratic to the corporate controller and, on the other hand, with having shirking and other perquisites minimized through control transactions whereby private benefits are exchanged for larger security benefits. This account involves *three*, and not just two, *categories* of PBC: those arising from stealing, those depending on shirking, and those idiosyncratic to the corporate controller.[23] Similarly to Gilson's,

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18 Compare Gilson, R.J. [2006], *op. cit.*, with Mayer, C. [1999], *op. cit.*

19 See, most notably, the definition of PBC in an incomplete contract setting, provided by Aghion, P. and Bolton, P. [1992], *An Incomplete Contracts Approach to Financial Contracting*, in REVIEW OF ECONOMIC STUDIES, vol. 59, 476 – reported *supra*, Chapter One, note 97. See also, on this issue, Hart, O. [2001], *Financial Contracting*, in JOURNAL OF ECONOMIC LITERATURE, vol. 39, 1085.

20 Gilson, R.J. [2006], *op. cit.*, 1663.

21 Mayer, C. [1999], *op. cit.*, 10-15, makes a similar point, although he gives more credit to the regulatory determinants of this outcome (Id., at 16-19).

22 See *infra*, Chapter Six – for the theoretical framework of this scenario – and Chapter Ten – for a detailed discussion of Law and Economics of control transactions.

23 See *infra*, in the text, for presentation and discussion of this taxonomy. In the literature, I am only aware of two commentators – a lawyer and an economist – who have tried to interpret corporate governance (hereinafter CG) on the basis of three categories of PBC (Hart, O. [2001], *op. cit*, 1084-1090, also describes three instances of private benefits, but he attempts neither a qualitative categorization nor an investigation about the consequences of the distinction). On the legal side, Coates, J.C. IV [2003], *op. cit.*, 13-16, distinguishes between "bad", "good", and "inherent" PBC – even though the distinction between the two last categories is not entirely clear (see *infra*, section 5.2.4). On the economists' side, Mayer, C. [1999], *op. cit.*, 7-10, distinguishes between the "distortionary" and the "diversionary" kind allowed by the agency framework, and adds a third, unlabeled, cate-

this framework also posits that the efficient ownership structure be ultimately endogenous.[24] However, the tripartite account of PBC further implies that corporate law can distort the choice of ownership structure in at least two ways: not only in that expropriation is not adequately policed; but also in that it fails to support control and its idiosyncratic benefits, as well as a market for corporate control providing for their efficient evolution.[25] Clearly, idiosyncrasy of private benefits is the novel and crucial hypothesis being explored here. However, we need to depart from the agency paradigm and to fully embrace an incomplete contracts perspective in order to understand how idiosyncratic investments by the corporate controller, and their likewise idiosyncratic reward, are of vital importance in corporate governance.

5.2. Private Benefits of Control: The 'Good', the 'Bad', and the 'Ugly'

5.2.1. The Missing Piece of the Puzzle

There is at least one piece of evidence that is almost impossible not to reckon with. The two basic patterns of corporate governance prevailing around the world feature either the top management or a controlling shareholder being in *definitive* control of the corporate assets. This evidence is at odds with the standard theoretical approach to separation of ownership and control, according to which share-

gory, which he just characterizes as "power for the good." I am going to follow the latter categorization and further explore its positive and normative implications for CG.

24 Coates, J.C. IV [2003], *op. cit.*, and Mayer, C. [1999], *op. cit.*, posit the existence of PBC having an *idiosyncratic* character, although none of them explicitly define PBC in such a fashion. In fact, they hold them as *endogenous* to the business. As in Gilson, R.J. [2006], *op. cit.*, this assumption is based on the work by Demsetz, H. [1983], *The Structure of Ownership and the Theory of the Firm*, in JOURNAL OF LAW AND ECONOMICS, vol. 26, 375-390, subsequently tested empirically in Demsetz, H. and Lehn, K. [1985], *op. cit.* See *infra*, Chapter Six, section 6.5.3.

25 Others have made very similar points about how corporate law may matter *beyond* mere investor protection. See Rock, E.B. and Wachter, M.L. [2001], *op. cit.* – law may fail to support self-governance and protection of the controller's specific investments thereof. See also Cools, S. [2005], *op. cit.* – law may fail to provide an appropriate distribution of power suitable for the exercise and maintenance of corporate control under dispersed ownership structures. Although none of these works is based on the analysis of PBC, the same conclusions are better explained on the basis of idiosyncratic control rents: the framework that we are going to discuss provides a more powerful interpretation of comparative corporate governance and of corporate laws, as well as a more consistent set of policy implications in each respect.

holders *as a group* should eventually be able to exercise their control rights as owners. Control over the corporate assets does not appear to be even implicitly delegated by principals – the outside shareholders – to one or more agents – the corporate insiders. Quite to the contrary, outside shareholders seem to be involved in corporate finance just up to the point where the insiders' position is not endangered by the risk of shareholder insurgency.[26] In other words, corporate control is most often (if not always) entrenched.[27] In addition, thanks to legal devices separating either control or voting rights from ownership claims, corporate control is often exerted without a substantial financial interest in the firm's residual.[28]

Why then should a corporate controller bother of maximizing the firm's profit when this would benefit non-controlling shareholders more than himself? And, more importantly, why should outside shareholders accept to place their money under the corporate controller's management, the latter being so little interested in the firm's profits while so much insulated from the threat of ouster? To put it briefly: are we sure that corporate governance in the real world has anything to do with shareholder empowerment, at least as this is generally understood in both economic and legal theory?

As Colin Mayer puts it, "Faced with a threat to theory, the first reaction of economists is naturally to doubt the evidence. As one eminent theoretical economist said, 'I do not trust anything that works in practice unless it works in theory.'"[29] However, there is one theoretical argument whose role in explaining separation of ownership and control has not yet been completely explored. "Concentration of control in the hands of a few investors who have little direct financial interest can be justified if they derive other benefits – what economists term 'private benefits'."[30] Entrenchment of corporate control is required, in turn, to secure those benefits from *ex post* expropriation by insurgent shareholders.[31] Finally, the *quality* of

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[26] Hellwig, M. [2000], *On the Economics and Politics of Corporate Finance and Corporate Control*, in X. Vives (ed.), CORPORATE GOVERNANCE: THEORETICAL AND EMPIRICAL PERSPECTIVES, Cambridge University Press, 100-103.

[27] Becht, M. and Mayer, C. [2001], *Introduction*, in F. Barca and M. Becht (eds.), THE CONTROL OF CORPORATE EUROPE, Oxford University Press, 36-38. On the legal side, see Coates, J.C. IV [2003], *op. cit.*, 13-23. For the definition of entrenchment, see *supra*, Chapter One, section 1.4.5.

[28] Morck, R., Wolfenzon, D. and Yeung, B. [2005], *Corporate Governance, Economic Entrenchment and Growth*, in JOURNAL OF ECONOMIC LITERATURE, vol. 43, 678.

[29] Mayer, C. [1999], *op. cit.*, 5. Interestingly, the author does not cite the economist in question. Perhaps this is because the vast majority of theoretical economists would subscribe to that statement, as if it came from their own mouth.

[30] Id., at 5.

[31] This proposition has been proved analytically by Bebchuk, L.A. [1999], *A Rent-Protection Theory of Corporate Ownership and Control*, NBER Working Paper No. 7203.

those benefits matters.[32] By definition, PBC are not shared with non-controlling shareholders (they would not be 'private' otherwise). However, they might or might not reduce the firm's surplus available to shareholders as a whole. Determining whether PBC always reduce firm value, or – alternatively – they might also enhance it, is of fundamental importance in order to assess their efficiency.

5.2.2. Private Benefits Cannot Be Just 'Bad'

a) The Theoretical Account

Apparently, the extraction of private benefits by the corporate controller cannot be but 'bad', for it always comes at the outside shareholders' expenses. Control benefits can arise from more or less directly 'stealing' the corporate assets, thereby *diverting* profits from non-controlling shareholders.[33] Let us refer to these benefits, from now on, as *diversionary PBC*. When outright theft is effectively ruled out by the legal system, PBC can still harm non-controlling shareholders by *distorting* the management choices. The smaller the corporate controller's equity interest in the firm, the more he will tend to manage the corporate assets in such a way as to maximize his own goals (empire building, luxury expenses, extravagant perquisites) rather than the firm's profits.[34] To this point, this behavior has been broadly referred to as 'shirking.' Henceforth, I shall call *distortionary PBC* any personal utility that a corporate controller may derive from failing to maximize shareholder value – i.e., shirking in the broadest possible meaning. Based on a straightforward agency approach, diversionary and distortionary benefits are the only two ways in which private benefits of control can be understood in corporate governance.[35]

It is therefore quite difficult to imagine that rewarding the corporate controller with private benefits could possibly enhance the efficiency of corporate govern-

[32] This point is too often overlooked in the literature. Most notable exceptions are those referred to in the previous section. See also *supra*, Chapter One, section 1.4.5.

[33] This has become nowadays the most popular dimension of PBC, especially in the international debate. For a rather spectacular illustration, see Johnson, S., La Porta, R., Lopez-de-Silanes, F., and Shleifer, A. [2000], *Tunneling*, in AMERICAN ECONOMIC REVIEW, vol. 90, 22–27.

[34] This is actually how PBC were first understood in CG. See Jensen, M.C. and Meckling, W.H. [1976], *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 3, 312-313.

[35] This point have been efficaciously summarized by Colin Mayer:

> "In the principal-agent model, private benefits are viewed as creating wedges between shareholder and managers' interests, which are at best *diversionary* and at worst *distortionary*. They reward managers without enhancing or by reducing shareholder returns."

Mayer, C. [1999], *op. cit.*, 7 (emphases added).

ance.[36] True, the problem to solve seems to be quite the opposite: "The crucial issue – Oliver Hart argues – may be how the company's investors can design financial structure so as to *limit* management's ability to pursue its own goals at the expenses of investors."[37] This is currently the leading approach to PBC.[38]

Following this approach one important issue is foregone. Curbing private benefits of control might improve the position of outside investors, but it undermines the entrepreneurial incentives to undertake specific investments for the firm's success. We might assume – as Oliver Hart and many other economists do – that specialization of managerial skills is of limited importance in the case of large firms, where ownership is significantly separated from control due to the financing needs of large-scale investments.[39] However, if we take the view that the management of a corporate enterprise most often cannot be dealt with as a matter of routine, rewarding the managerial talent (and entrepreneurship in general) becomes a crucial issue regardless of the firm size. Then, private benefits of control cannot simply be dismissed as an impediment to the efficiency of corporate governance. What we are

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[36] According to many, if not most economists, private benefits cannot but negatively affect the efficiency of CG, on grounds that maximizing of the sum of PBC and the corporate controller's share of firm value will always diverge from maximization of firm value alone. See, authoritatively, Jensen, M.C. [2001], *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, in EUROPEAN FINANCIAL MANAGEMENT, vol. 7, 297-317. But see, *contra*, Holderness, C.G. [2003], *A Survey of Blockholders and Corporate Control*, in FEDERAL RESERVE BANK NY – ECONOMIC POLICY REVIEW, April 2003, 55: "It must be cautioned […] that private benefits need not reduce the wealth of minority shareholders. This is an assumption of some analyses, but it is wrong." More recently, Ehrhardt, O. and Nowak, E. [2003], *op. cit.*, have argued that good PBC cannot exist, because a corporate controller is always interested in a *limited* share of the residual claim on the firm's assets, so that PBC sought for by a rational controller cannot but come at the expenses of maximization of *overall* shareholder value. A non-economist (Coates, J.C. IV [2003], *op. cit.*, note 39) correctly contends that "this argument pushes logic beyond its limit." Hellwig, M. [2000], *op. cit.*, 118-122, has convincingly demonstrated that this argument is also incorrect from a purely economic standpoint. As he puts it, the efficiency implications of management discretion over the use of the firm's assets need to be evaluated upon the following observations: 1) "Money in the company still is not the same as money in the manager's pockets"; and 2) "the incumbency horizon of management is shorter than the horizon of the firm." 3) More than *on-the-job consumption*, the problem is the *market for corporate control*: here "incumbency is likely to be a source of distortion." 4) However, "[f]rom a price theoretic perspective, the problem is that the *transfer of control* from one CEO to the next *is not accompanied by any compensation* that would correspond to the effective value of the company at the time of the transfer" (emphases added). For a more comprehensive discussion on how PBC can enhance CG efficiency in this perspective, and under which conditions, see *infra* in the text and, in further detail, Chapter Six.

[37] Hart, O. [1995], FIRM, CONTRACTS, AND FINANCIAL STRUCTURE, Oxford University Press, 126 (emphasis added).

[38] Shleifer, A. and Vishny, R. [1997], *A Survey of Corporate Governance*, in JOURNAL OF FINANCE, vol. 52, 742-744.

[39] Hart, O. [1995], *op. cit.*, 126-129.

facing here is a *gap in the economic theory of corporate governance*.[40] One of its most authoritative exponents – Oliver Hart – is well aware of this problem:

> "In future work, it would be desirable to incorporate the entrepreneurial incentives and private benefits [into a model of separation of ownership and control]. [For instance, it] would be interesting to see whether the optimal security-voting structure consists of a single class of shares that are widely held, together with a class of superior voting stock held by insiders. Such a result would appear to be consistent with empirical evidence." [41]

b) The Empirical Evidence

The empirical evidence about the different patterns of separation of ownership and control around the world actually calls for a reappraisal of PBC. As far as developed economies are concerned, data shows that private benefits are on average higher in continental Europe than in the US and the UK.[42] It is generally argued, on both theoretical and empirical grounds, that higher control benefits lead to a lesser degree of separation of ownership and control, as well as to more frequent occurrence of devices for separating voting rights from ownership claims – like dual class shares and pyramidal groups.[43] However, on the one hand, it is true that the governance of publicly held companies in continental Europe is typically characterized by the presence of a large, controlling shareholder (or a coalition of them) holding disproportionate voting power, whereas management-controlled public companies

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40 See, in quite similar terms, Zingales, L. [2000], *In Search of New Foundations*, in JOURNAL OF FINANCE, vol. 55, 1637-1640 (wherein the illustration of how the gap could be possibly filled in).

41 Hart, O. [1995], *op. cit.*, 208.

42 As I have discussed earlier (*supra*, Chapter Four, section 4.4.2), only two empirical studies have attempted so far to measure cross-country the size of PBC. The first study is based on price differentials of dual class shares (having different voting rights attached): Nenova, T. [2003], *The value of corporate votes and control benefits: A cross-country analysis*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 68, 325–351. The second study is based on control premiums (over adjusted market prices) in block transactions: Dyck, A. and Zingales, L. [2004], *Private Benefits of Control: An International Comparison*, in JOURNAL OF FINANCE, vol. 59, 537-600. Unfortunately, neither methodology can provide us with a completely reliable comparison of the average size of PBC in different countries. See Nicodano, G. [1998], *Corporate groups, Dual-class Shares and the Value of Voting Rights*, in JOURNAL OF BANKING AND FINANCE, vol. 22, 117-137; Nicodano, G. and Sembenelli, A. [2004], *Private Benefits, Block Transaction Premiums and Ownership Structure,* in INTERNATIONAL REVIEW OF FINANCIAL ANALYSIS, vol. 13, 227-244. However, the general statement in the text is hardly questionable.

43 For the theory, see Bebchuk, L.A. [1999], *op. cit.*; and Bebchuk, L.A., Kraakman, R.H. and Triantis, G. [2000], *Stock Pyramids, Cross-Ownership, and Dual Class Equity: the Mechanisms and Agency Costs of Separating Control from Cash-flow Rights*, in R. Morck (ed.), CONCENTRATED CORPORATE OWNERSHIP, NBER Conference Volume, University of Chicago Press, 295-315. For the econometric analysis, see Nenova, T. [2003], *op. cit.*; and Dyck, A. and Zingales, L. [2004], *op. cit.*

are rare outside Anglo-Saxon countries.[44] On the other hand, we already know from the last Chapter that the estimated average size of PBC in each country cannot explain a number of other differences.[45]

A few points are worth recalling in this regard. For instance, a relatively low degree of separation of ownership and control in Scandinavian countries coexists with levels of private benefits being on average not much higher than in the US and the UK, but significantly lower than in other countries on the European continent – namely, Italy.[46] Dual class shares and pyramids are quite common in Sweden and Italy (regardless the difference in the average size of PBC),[47] dual class shares (but not pyramids) are sometimes adopted by US companies,[48] while both dual class shares and pyramids are very little used in the UK.[49] Is this just a matter of *how large* PBC are? And, more importantly, are 'large' PBC always that bad? If private benefits of control were only to be considered as a curse for corporate governance, we would expect significant differences in economic performance between the Old Continent and Anglo-Saxon countries. Colin Mayer makes this point quite bluntly:

> "In the presence of significantly higher private benefits, the economic performance of continental European economies should have been markedly worse than that of the UK. At best they should have been subject to more

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44 This circumstance was first highlighted by La Porta, R., Lopez-de-Silanes, F. and Shleifer, A. [1999], *Corporate Ownership around the World*, in JOURNAL OF FINANCE, vol. 54, 471-517. See also *supra*, Chapter Two, section 2.3.

45 See *supra*, Chapter Four, section 4.4.2.

46 Gilson, R.J. [2006], *op. cit.*, has recently made this point quite strongly. On the 'Swedish case' see also Coffee, J.C. Jr. [2001a], *Do Norms Matter? A Cross-Country Evaluation*, in UNIVERSITY OF PENNSYLVANIA LAW REVIEW, vol. 149, 2151–2178.

47 Holmén, M. and Högfeldt, P. [2005], *Pyramidal Discounts: Tunneling or Agency Costs?*, ECGI Finance Working Paper No. 73/2005, available at www.ssrn.com and www.ecgi.org; Bianchi, M., Bianco, M., Giacomelli, S., Pacces, A.M., Trento, S. [2005], PROPRIETÀ E CONTROLLO DELLE IMPRESE IN ITALIA*,* Il Mulino.

48 Gompers, P.A., Ishii, J. and Metrick, A. [2006], *Extreme Governance: An Analysis of Dual-Class Companies in the United States*, American Finance Association 2005 Philadelphia Meetings Paper, available at www.ssrn.com; Morck, R. and Yeung, B. [2005], *Dividend Taxation and Corporate Governance*, in JOURNAL OF ECONOMIC PERSPECTIVES, vol. 19, 163–180.

49 See, e.g., Goergen, M. and Renneboog, L. [2003], *Why Are the Levels of Control (So) Different in German and UK Companies? Evidence from Initial Public Offerings*, in JOURNAL OF LAW, ECONOMICS AND ORGANIZATION, vol. 19, 141-175. To be sure, dual class shares and pyramidal structures are not completely unheard of in the UK, but – differently from most countries in Continental Europe – they do not seem to be employed with the purpose of locking in corporate control. Bennedsen, M. and Nielsen, K.M. [2005], *The Principle of Proportionality: Separating the Impact of Dual Class Shares, Pyramids and Cross-ownership on Firm Value across Legal Regimes in Western Europe*, Working Paper, University of Copenhagen, Centre for Industrial Economics, available at www.econ.ku.dk/cie/Discussion%20Papers/2005/. See also *supra*, Chapter Two, 2.3.3.

empires, expenses, extravagance or worse to more cronyism, corruption and crime. Anyone who follows league tables of economic performance or just walks round the streets of Barcelona, Birmingham and Bonn can appreciate the problem with this thesis."[50]

5.2.3. Maybe Private Benefits Are 'Ugly'

Most recent comparative analysis of corporate governance has tried to solve the puzzle. According to William Bratton and Joseph McCahery, private benefits are to be regarded as the price to pay for a more focused management of the corporate enterprise.[51] PBC are then neither 'bad' nor 'good', but just the second best outcome of a tradeoff. From a first best perspective, they might be regarded as 'ugly', but one could not tell whether corporate governance in the real world would be any better without them.

Large shareholding (so-called 'blockholding') aligns the corporate controller's incentives with the interest of outside shareholders, but involves illiquidity and suboptimal diversification of financial investments.[52] Private benefits arising from diversion of the firm's cash flow should be understood exactly as a solution to this tradeoff. They are intended to reward the corporate controller's financial commitment to the firm. However, provided that private benefits always reduce the share of the surplus available to non-controlling shareholders, they involve a higher cost of outside equity capital and a lesser degree of separation of ownership and control. Conversely, in the absence of (diversionary) private benefits, there would be no incentive to stable blockholding, ownership would be spread among a large number of dispersed investors, and senior managers would enjoy substantial freedom in pursuing their own goals at the shareholders' expenses (distortionary PBC).[53]

On theoretical grounds, one could not say which of the above systems is the best. On the same grounds, the two systems are incompatible:

> "A system either controls access to [diversionary] private benefits for the purpose of protecting liquid trading markets or does not control [those] pri-

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[50] Mayer, C. [1999], *op. cit.*, 7.
[51] Bratton, W.B. and McCahery, J.A. [2001a], *op. cit.*, 34-38.
[52] See *supra*, Chapter Three, section 3.4.2. For a formal analysis of this tradeoff, see Bolton, P. and von Thadden, E.-L. [1998a], *Blocks, Liquidity, and Corporate Control*, in JOURNAL OF FINANCE, vol. 53, 1-25.
[53] Bratton, W.B. and McCahery, J.A. [2001a], *op. cit.*, 16-28.

> vate benefits, so as to nurture its blocks. The theory of the firm holds out no hospitable middle ground." [54]

A tradeoff between diversionary and distortionary benefits of control provides at least one explanation of why corporate governance systems based on concentrated ownership (i.e., on a controlling shareholder) does not exhibit significant underperformance compared to those based on dispersed ownership (i.e., on managerial control). But this cannot be the whole story. Corporate control is not simply a matter of financial commitment, for it could possibly involve none at all. What about a penniless entrepreneur with some great ideas on a new product, on how to improve the production, distribution or marketing of existing ones, or simply on how to revamp a troubled corporate business? How could he possibly combine an adequate reward for his talent with the need to raise equity funds for financing an highly uncertain business venture, should PBC be necessarily either diversionary or distortionary (if not both)?[55] Clearly, whenever corporate control has to be featured with entrepreneurship, its reward cannot entirely come at the expenses of non-controlling shareholders, for no equity finance could be raised otherwise.

5.2.4. What If Private Benefits Can Also Be 'Good'?

Based on the above concern, a few economists and lawyers have recently started to consider a third category of private benefits of control, which are neither diversionary nor distortionary. Let us call them, for the moment, the 'good PBC.' Their role in corporate governance should be just that of fostering entrepreneurship, while allowing for separation of ownership and control.[56] What exactly such a kind

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54 Id., at 12.

55 For an authoritative review of the main theoretical contributions in this perspective, see Hart, O. [2001], *op. cit.*, 1083-1090.

56 See the introductory discussion of this problem in Chapter One, section 1.4.5, above. In exactly the same perspective, Coates, J.C. IV [2003], *op. cit.*, 13-16, also claims that "good PBC" should be accounted for in CG. However, he considers two separate kinds of PBC having neither diversionary nor distortionary features: those arising out of "*synergies*" in the exercise of corporate control; and those due to some *"inherent"* value attached to corporate control. This distinction is indeed quite common among supporters of 'good' instances of PBC. See, e.g., Holderness, C.G. [2003], *op. cit.*, 55; Gilson, R.J. [2006], *op. cit.*, 1663-1664, Dyck, A. and Zingales, L. [2004], *op. cit.*, 540-541. However, Dyck and Zingales [2004], *op. cit.*, at 590, conclude their oft-cited paper by saying that the crucial issue in the welfare analysis of PBC is not "to distinguish between […] potential sources of private benefits", but rather "to establish the importance of dilution [of non-controlling shareholders]." By the same token, Zingales, L. [2000], *op. cit.*, 1640, describes PBC as evidence of an "appropriability problem" – whereof dilution is "the most extreme case" – that is still to be investi-

of benefits account for is still unclear in this literature.[57] Prestige and personal satisfaction for the firm's success are typical, albeit not exhaustive, examples. None of them involves reduction of outside shareholders' wealth, in the form of either suboptimal profits due to extravagant expenses or expropriation of their residual claim.[58] Therefore, the only way in which such a kind of benefits can affect non-controlling shareholders is by *indirectly* increasing the value of the firm's assets that they partly own.[59]

"Non-pecuniary" pride or "psychic" benefits of control are most common definitions of the private benefits at issue.[60] However, they are of little help for understanding the implications of 'non distortionary–non diversionary' private benefits for corporate governance. Colin Mayer's definition as "a power for good" sheds some more light on those implications:[61]

> "Desires to enhance family names and to pass on enterprises to offspring are powerful incentives to enterprise formation. […] They do not directly benefit investors but they may encourage actions and activities that indirectly do so. […] But they have also deficiencies. [Basically, they involve] continuing reliance on family as against professional managerial capitalism."[62]

In the absence of private benefits, control is purchased by those who attach the highest value to the management of a corporate enterprise – i.e., those who are able to manage it the best. Control is auctioned on "perfectly functioning markets in corporate control," and they "ensure that at any point in time the value of

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gated in order to understand the financial and governance structure of the firm. This is exactly the kind of problem that the present work is trying to analyze (*supra*, Chapter One, section 1.4.5). As it will become clearer from the following discussion, in this perspective it is quite pointless to distinguish between benefits from synergies in corporate control and those arising out of psychic satisfaction, provided that both are due to be realized eventually by excluding non-controlling shareholders from the takeover gains. On this point, see *infra*, Chapters Six and Nine.

57 This is probably what leads some economists to hastily conclude that 'good' PBC simply cannot exist. See *supra*, note 36.

58 See, e.g., Hart, O. [2001], *op. cit.*, 1085.

59 Holderness, C.G. [2003], *op. cit.*, 55.

60 Id., at 55; Gilson, R.J. [2006], *op. cit.*, 1663-1664.

61 As Mayer, C. [1999], *op. cit.*, 9, notices:

> "The significance of private benefits as a power for good should not be unfamiliar to academics. We might do our job for love but we certainly do not do it for much money. Recognition, honour, prestige are almost certainly more powerful influences than performance related pay."

62 Mayer, C. [1999], *op. cit.*, 9-10.

exercising control is maximized."[63] Conversely, the significance of private benefits as 'a power for good' implies that such a power is maintained over time, even when 'good' does no longer mean 'best' and parting with control would actually increase firm value. As Mayer puts it, "Control rents remain with the original entrepreneurs and are transferred through subsequent generations of owners."[64] *Even though they do not reduce shareholder wealth, and might possibly enhance it for some time, private benefits then undermine the efficient dynamics of control allocation.*[65] In fact, whatever their source (diversionary, distortionary, or 'a power for good'), control rents can only be secured through entrenchment of corporate control.[66]

However, when private benefits involve neither distortion nor diversion of the firm's surplus, they fill in the gaps of market (contractual) incompleteness. In other words, they account for some value that would have *not* been produced otherwise. Such a value depends on firm-specific investments by the entrepreneur. In the jargon of contract theory, the same value is 'non-verifiable,' and therefore it cannot be contracted upon at the outset.[67] *Ex post*, one might regret that private benefits provide no guarantee that firm (shareholder) value is always being maximized. But one should not forget that *ex ante*, in the absence of those benefits, there would have

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63 Id., at 12.

64 Id., at 12.

65 In this perspective, Ehrhardt, O. and Nowak, E. [2003], *op. cit.*, might seem to be right after all. Even allegedly 'good' PBC – wherever they come from – ultimately give the corporate controller an incentive to deviate from (dynamic) maximization of firm value, by holding on firm control regardless of its inefficiency. See *supra*, note 36. However, while this is undoubtedly inefficient *ex post*, it might be the only workable scenario *ex ante*. Welfare analysis cannot simply be limited to the *ex post* stage. See the following discussion in the text and the accompanying notes.

66 In the presence of private benefits, corporate control *needs* to be entrenched. The opposite solution (contestability – i.e., letting shareholders put control up for auction) may be preferable for *ex post* efficiency, but it would be disruptive of private benefits of any kind. See Laffont, J.-J. and Tirole, J. [1988], *Repeated Auctions of Incentive Contracts, Investments, and Bidding Parity with an Application to Takeovers*, in RAND JOURNAL OF ECONOMICS, vol. 19, 516-537.

67 See, most authoritatively, Hart, O. [1995], *op. cit.*, 95-120. On contractual incompleteness, and on its implications for the allocation of control rights in corporate governance, see *supra* Chapter Three, sections 3.2 and 3.4.1.

Whether the value of firm-specific investments is instead 'observable,' or when it is going to be so, is another question. Observability (common knowledge of the parties' payoffs in each state of nature) is normally assumed by the literature on incomplete contracts. However, this is certainly a too narrow assumption as far as the value of entrepreneurship is concerned. See, e.g., Aghion, P. and Bolton, P. [1992], *op. cit.*, 476 ("private benefits of the entrepreneur […] are not observable or verifiable by third parties"). Independent lines of inquiry – based on a different paradigm of *complete* contracting – posit that the value of firm-specific managerial investments is unobservable at the outset, but will become observable at a later stage: at this stage, the same value may be expropriated by shareholders. See Laffont, J.-J. and Tirole, J. [1988], *op. cit.*, 529-532. For a more detailed discussion of this problem, see *infra*, Chapter Six, section 6.2.

been no firm (or, at least, not *that* one) and no value to maximize.[68] This point has been nicely summarized in one assertion by Colin Mayer:

> "*Assertion […]: different forms of corporate control are associated with different types of economic activities*. Private benefits are required in the initial stage of development of corporations and economies before high financial returns are anticipated. […] The value of private benefits comes from their ability to encourage investments that would otherwise be subject to capital market failures."[69]

The crucial question is, than, what are the investments to be encouraged and how private benefits can actually encourage them. In order to answer this question, private benefits of control should be regarded as a solution to an *appropriability problem*, more than as a matter of physic satisfaction.[70] The founding reason for 'good' instances of private benefits in corporate governance is that, anytime firm control is separated from ownership, financial markets are unable to *price* further surplus brought about by the entrepreneurial talent. The entrepreneur would certainly prefer to get cash (or stock) in return for his effort (investments) in producing that surplus. However, provided that the same surplus is unverifiable (markets would be able to price it otherwise), it cannot be divided contractually.[71] This point will get clearer in the next Chapter. But, as I suggested from the very beginning of this inquiry, the result is that entitlement to unverifiable surplus can be only be secured through (residual) control rights over the firm's assets – i.e., the right to sell the assets at a premium above market price.

'Good' private benefits of control account exactly for that surplus. They are the idiosyncratic control rents that are needed to motivate the entrepreneur to undertake firm-specific investments for the firm's success.[72] They might be a matter of

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[68] The ultimate reason why the pursuit of *ex ante* efficiency may require some *ex post* inefficiency is that not all variables affecting the parties' payoffs are contractible at the outset. This is the problem of contractual incompleteness at its core, and it may depend on *both* unverifiability and unobservability of future states of nature (see *supra*, Chapter Two, section 3.2). In the presence of separation of ownership and control, allowing for control rents (PBC) might be necessary to achieve the efficient outcome *ex ante*. This is at least one way – and possibly the *only* one – in which PBC can be *beneficial* for CG. On how, in CG, *ex post* inefficiency may be necessary to achieve the efficient outcome *ex ante*, see Zingales, L. [1998], *op. cit.*, 498-499.

[69] Mayer, C. [1999], *op. cit.*, 13.

[70] Zingales, L. [2000], *op. cit.*, 1640. See also *supra* note 56.

[71] Whatever the source, this value is *idiosyncratic* to the corporate controller's identity. This is another reason why any distinction between controlling synergies and "inherent values" of corporate control is pointless. Compare with Coates, J.C. IV [2003], *op. cit.*, 14-17.

[72] On idiosyncrasy of control rents, as related to the theory of entrepreneurship, see *supra*, Chapter One, section 1.4.5.

pride, or psychic satisfaction, or whatever. In any case, when the firm proves successful, they will eventually translate into appropriable surplus: the value of firm control. Such a value has to be intended as a *deferred compensation* for the investment of managerial talent, contingent on the firm's success.[73]

5.2.5. Implications of 'Good' Private Benefits for Understanding Corporate Governance

In the above perspective, 'good' (i.e., neither distortionary, nor diversionary) instances of PBC get an important significance. Basically, we are speaking about the entrepreneurial reward mechanism that standard theory of corporate governance fails to account for. To the extent that such a reward is established through idiosyncratic control rents, I shall henceforth refer to them as to *idiosyncratic private benefits of control*.[74] Once we take those benefits into account, some apparently puzzling evidence about separation of ownership and control can be actually explained on efficiency grounds.

To begin with, entrenchment of corporate control is needed to protect idiosyncratic control rents as a reward for the investment of non-verifiable managerial talent. In this perspective, entrenchment of the corporate controller should not necessarily be regarded as disenfranchisement of outside shareholder, but possibly as a matter of *(efficient) protection of control rents* from subsequent expropriation by shareholder insurgency.[75]

Secondly, to the extent specialization of managerial skills is very often (if not always) an issue for the firm's success, there is no compelling reason to believe that the incentive role of idiosyncratic PBC is limited to the "initial stages of development of corporations."[76] If – as Schumpeter taught us – entrepreneurship is a con-

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[73] In nearly the same terms, see the formal discussion by Schnitzer, M. [1995], *'Breach of Trust' in Takeovers and the Optimal Corporate Charter*, in JOURNAL OF INDUSTRIAL ECONOMICS, vol. 43, 245-250. For illustration of the mechanisms of deferred compensation, see *infra* in the text and, more in detail, Chapter Six below.

[74] Cf. *supra*, Chapter One, section 1.4.5.

[75] Hart, O. [1995], *op. cit*, 188. See also, on the legal side, Bebchuk, L.A. [2003a], *Why Firms Adopt Antitakeover Arrangements*, in UNIVERSITY OF PENNSYLVANIA LAW REVIEW, vol. 152, 730-734; and Coates, J.C. IV [2003], *op. cit.*, 12-16.

[76] This is just how far Colin Mayer ventures to assert the importance of PBC in CG (Mayer, C. [1999], *op. cit.*, 13). Of course, this has a bearing on his view of the big picture, which he synthesized in Mayer, C. [2000], *Ownership Matters*, mimeo, Inaugural Lecture of the Leo Goldschmidt Chair in Corporate Governance at the *Université Libre de Bruxelles* (on file with author). Concentrated and dispersed ownership structures reflect a tension between periods over which control can be expected to be retained ("influence period") and those within the project's financial return is due to

tinuing process of 'creative destruction', innovation and related uncertainty may be involved at *every* stage of development of a business, and then financial incentives will be insufficient to reward managerial skills.[77] The importance of idiosyncratic control rents to keep motivating entrepreneurship in the corporate business may vary with the type of economic activity involved, but that is a difference in degree, not in kind.[78] The fact is that control of the vast majority of corporations around the world is held by managers or controlling shareholders with a limited (if not negligible) ownership stake and, nevertheless, it is typically entrenched.[79] Diversionary

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be realized ("realization period"). When the former is shorter than the latter, long-term projects are foregone – PBC may be necessary to avoid that result *ex ante*. When the reverse is true, PBC may hinder the efficient allocation of corporate control *ex post*. I do not question the existence of this tension. However, consideration for entrepreneurship in CG suggests that influence periods may be structurally longer than realization periods, thereby calling for a more pervasive role of (idiosyncratic) PBC. This may explain why "even in countries where voting power and ownership are dispersed, management control is often not contestable" (Becht, M. and Mayer, C. [2001], *op. cit.*, 37). Also the conclusion that very long influence periods featuring high PBC necessarily lead to inefficient control allocations is unwarranted, at least from a theoretical standpoint. High PBC hinder efficient control reallocations in as much as nobody is willing to pay for them out of his takeover gains. See the following discussion in the text.

77 Schumpeter, J.A. [1943], CAPITALISM, SOCIALISM, AND DEMOCRACY, Unwin University Books, 82-85. To be sure, Schumpeter did not intend 'creative destruction' as an endless process. Rather, he thought that it would have led to entrepreneurs becoming eventually obsolete. The reason is that, "innovation itself […] being reduced to routine, […] economic progress tends to become depersonalised and automatised' and large corporate entities progressively "oust the entrepreneur." Id., at 133-134. This is probably one of the most celebrated aspects of Schumpeter's work (Ricketts, M. [2002], THE ECONOMICS OF BUSINESS ENTERPRISE, Elgar, 68). However, we have not seen any such thing happening yet. Entrepreneurial success stories like Google stand against giant enterprises like Microsoft – which was no different form Google at the outset. The evidence seems then more consistent with a view of entrepreneurship going on indefinitely, with large corporations acting more as an opportunity than as a kill. According to Kirzner, I.M. [1979], PERCEPTION, OPPORTUNITY, AND PROFIT, University of Chicago Press, 105, the corporation is "an ingenious, unplanned device that eases the access of entrepreneurial talent to sources of large-scale financing." The economic literature on entrepreneurship is briefly illustrated *supra*, Chapter One, section 1.4.5.

78 Demsetz H. and Lehn, K. [1985], *op. cit.* It might be surprising, but the same point has also a longstanding tradition in Corporate Law and Economics. Specifically, Carney, W.J. [1988], *Controlling Management Opportunism in the Market for Corporate Control: An Agency Cost Model*, in WISCONSIN LAW REVIEW, vol. 1988, 418-419, observed:

> "Even managers in possession of relatively general managerial skills who have been successful and have risen to the status of officers at high levels of compensation may find that the market for their services is extremely thin. Powerful and highly paid positions often create quasi-rents simply by virtue of the thinness of the market for the incumbents." (footnotes omitted)

See *infra*, Chapter Six, section 6.6, for a more technical discussion.

79 Becht, M. and Mayer, C. [2001], *op. cit.*, 36-38. But see also Morck, R., Wolfenzon, D. and Yeung, B. [2005], *op. cit.*, 695-715, highlighting the negative implications of entrenchment on economic

and distortionary PBC only partially account for this phenomenon. A more general explanation is that *corporate control always has a value*, depending on the amount of idiosyncratic private benefits necessary to motivate business undertakings.

This leads me to the third and conclusive point. Since *idiosyncratic PBC are not just psychic, they can be compensated in cash*. This should provide a way out of control allocations that become inefficient over time. Idiosyncratic PBC do account for the prospective value of corporate control, which is neither verifiable nor contractible *ex ante*, but might become appropriable *ex post*.[80] As such, control rents need not be either enjoyed by the original entrepreneur or transferred to his descendants.[81] They can also be cashed in through a control sale. This requires a prospective buyer willing to bid more for the firm control than it is worth to the incumbent controller. It also requires that the latter be entitled to 'sell' firm control, thereby cashing in his idiosyncratic PBC. Corporate control transactions do in fact satisfy these two requirements.[82]

Corporate control is very seldom, if ever, taken over against the incumbent's will.[83] Most typically, it is bought and sold, with the incumbents getting some reward in return for their control rents.[84] *Golden parachutes* paid to outgoing management and *control premia* awarded to blockholders are prominent examples in this regard.[85] Intuitively, the larger the control rents to be rewarded, the more control transactions that would increase shareholder value will have to be foregone due to the corporate controller's entrenchment.[86] This might seem unfortunate (i.e., ineffi-

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growth when it is associated with stationary concentration of corporate control in the hands of a few wealthy families.

80 This is consistent with Luigi Zingales' approach to the matter. See Zingales, L. [2000], *op. cit.*, 1640, and Dyck and Zingales [2004], *op. cit.*, 590.

81 This is instead how 'good' PBC are considered by Mayer, C. [1999], *op. cit.*, and Gilson, R.J. [2006], *op. cit.*

82 For a detailed discussion, see *infra*, Chapter Ten.

83 See *supra*, Chapter Two, section 2.4.

84 Contrary to conventional wisdom in mainstream Corporate Law and Economics, the market for corporate control was originally described exactly in this way. See Manne, H.G. [1965], *Mergers and the Market for Corporate Control*, in JOURNAL OF POLITICAL ECONOMY, vol. 76, 112-114, and *infra*, section 5.5., for discussion of how his ideas have been misinterpreted by the subsequent literature.

85 On golden parachutes see, illustratively, Ricketts, M. [2002], *op. cit.*, 316; on control premia, see Coates, J.C. IV [1999], *Fair Value as an Avoidable Rule of Corporate Law: Minority Discounts in Conflict Transactions*, in UNIVERSITY OF PENNSYLVANIA LAW REVIEW, vol. 147, 1273-1277. For the empirical evidence, see respectively Hartzell, J., Ofek, E. and Yermack, D. [2004], *What's In It for Me? CEOs Whose Firms Are Acquired*, in REVIEW OF FINANCIAL STUDIES, vol. 17, 37-61; and Dyck, A. and Zingales, L. [2004], *op. cit.*

86 More formally, this also depends on the degree of separation between ownership and control. Any less-than-100% owner does not internalize the full benefits of an efficient change in control, and only cares about the effect on his ownership stake and PBC. See Bebchuk, L.A. [1994], *Efficient and Inefficient Sales of Corporate Control*, in QUARTERLY JOURNAL OF ECONOMICS, vol. 109, 957-993. For

cient) *ex post*. However, one should not forget that those rents that now prevent some efficient control transfer from taking place were needed in the first place, in order to induce the corporate controller to create a surplus that markets were unable to finance. On condition that the same surplus (and the underlying investments) is compensated, idiosyncratic PBC do not hamper efficient reallocations of corporate control.[87]

Similar conclusions of course do not hold for diversionary and distortionary PBC, whose welfare implications are completely different. Differently from their idiosyncratic companions, those kinds of PBC do not affect but negatively the production of shareholder value.[88] And they do not even have redeeming virtues as far as the corporate controller's incentives are concerned.[89] As we are about to see, the only behaviors they can motivate are either *stealing* the corporate assets or *shirking* from their efficient management.[90] Being a matter of conflict of interest between the corporate controller and non-controlling shareholders, diversionary and distortionary PBC are consistent with the standard agency framework.

However, it should be noticed that within the agency framework the corporate controller's misbehavior is not always characterized as extraction of private benefits. As we know, principal-agent models rather focus on the two problems arising out of asymmetric information, namely moral hazard and adverse selection. Diversionary and distortionary PBC are just a *consequence* of these two problems. This terminology is more suitable to the incomplete contracts perspective being adopted here, since the very notion of PBC involves a non-contractibility dimension. The reader will recall that, under contractual incompleteness, diversionary and distortionary PBC (like stealing and shirking from which they are generated) cannot be

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its discussion and implications on the regulation of corporate control transactions, see *infra*, Chapter Ten, section 10.3.2.

87 This is one key theoretical point of the present inquiry, which is normally overlooked by the literature. It will be dealt with in more detail in Chapter Six, sections 6.3 and 6.4.

88 With an understatement, Oliver Hart characterizes these private benefits as "less innocuous." See Hart, O. [2001], *op. cit.*, 1085.

89 To be sure, they might have some virtue in the absence of 'good' instances of PBC. However, this would confine us in a world of tradeoffs, where PBC are just 'ugly' and there is not much we can do about them. See Bratton, W.B. and McCahery, J.A. [2001a], *op. cit.*, and the discussion of their work *supra*, section 5.2.4.

90 The distinction between stealing and shirking as a source of PBC owes more to Corporate Law and Economics than to the economic theory of CG. And yet, it is extremely important. See Roe, M.J. [2004b], *op. cit.*, 3-4. For a formal analysis of PBC arising out of cash flow diversion, see Bebchuk, L.A. and Jolls, C. [1999], *Managerial Value Diversion and Shareholder Wealth*, in JOURNAL OF LAW, ECONOMICS, AND ORGANIZATION, vol. 15, 487-502. For a discussion of distorted management choices, with special reference to executive compensation, see Bebchuk, L.A., Fried, J.M. and Walker, D.I. [2002], *Managerial Power and Rent Extraction in the Design of Executive Compensation*, in UNIVERSITY OF CHICAGO LAW REVIEW, vol. 69, 751-846.

entirely coped with *ex ante* via mechanism design, but require institutions (and the law therein) to support efficient *ex post* bargaining over the allocation of quasi-rents.

Diversionary and distortionary PBC may sound somewhat different from the traditional agency approach to corporate governance; but, conceptually, they still belong to standard theory. What makes an important addition to the economic theory, and to its implications for corporate law, is the introduction of a *third* category of PBC in this framework, namely idiosyncratic (quasi-)rents of control. In order for idiosyncratic PBC to motivate firm-specific investments by the corporate controller, they should amount at the outset to a constraint on any subsequent bargaining over the allocation of quasi-rents. This is only possible to the extent that corporate law provides the right entitlements to protection of control rents. The important consequences of this reasoning for Corporate Law and Economics will get clearer at the end of this Chapter and, even more so, in the next one. But let us start by discussing the more conventional accounts of private benefits of control.

5.3. Private Benefits from Stealing: The 'Bad' Ones

5.3.1. Defining 'Diversionary' Private Benefits of Control

Perhaps the most intuitive instance of moral hazard in corporate governance is the corporate controller's *stealing* money from helpless outside shareholders, by diverting some or all of the firm's assets placed under his management to his personal and exclusive benefit.[91] This can be done in several possible ways. A typical instance is so-called 'tunneling.'[92] A manager is entitled to buy and sell firm's assets to anybody he likes and for any consideration he wishes. In theory, he could sell a valuable asset to a company he owns entirely for a consideration well below market prices. That would be equivalent to divert shareholder money directly to his pockets. Of course, in the presence of such opportunities for straight-out expropriation, not only equity investment, but also any other kind of outside finance would not be practicable. Stealing is the most dangerous (albeit not necessarily the most harmful) instance of corporate controller's misbehavior, because it involves the deepest conflict of interests: in the absence of constraints, absconding with the money is *always* preferable to providing financiers with the return they would expect.

91 Shleifer, A. and Vishny, R. [1997], *op. cit.*, 742-744.
92 Johnson, S., La Porta, R., Lopez-de-Silanes, F., and Shleifer, A. [2000], *op. cit.*, 22.

Most recent literature on corporate governance focuses on stealing as the most important source of PBC.[93] However, PBC need not arise from stealing resources that shareholders are entitled to.[94] As we should know quite well by now, there are many sources of PBC arising from the management of the firm's assets, and they are all equally important. Stealing is a very peculiar one. On the one hand, it always reduces the *ex post* firm value available to shareholders, thereby undermining their incentives to the equity investment *ex ante*. On the other hand, it is a purely pecuniary transfer from shareholders to the manager, which does not affect the production of their aggregate wealth. Stealing is therefore a source of pecuniary PBC whose extraction by the corporate controller has *no redeeming virtue*. Stealing is always inefficient *ex ante*.[95]

If stealing were the only instance of pecuniary PBC to be accounted for, it would be tempting to divide PBC into a pecuniary and a non-pecuniary kind. Indeed, this is how PBC are often categorized in Corporate Law and Economics.[96] However, not all *ex post* pecuniary transfers to the corporate controller come from stealing and are consequently inefficient *ex ante*. For instance, one should recall that manager's golden parachutes and large shareholder's control premia need to involve no stealing, but may be consciously awarded in return for firm-specific investments undertaken *ex ante* by the corporate controller. In addition, some non-pecuniary benefits accruing to the managers' utility reduce shareholder wealth by far a larger amount than stealing (e.g., shirking, empire building), while others do not affect shareholder wealth at all (e.g., idiosyncratic, namely non-verifiable and non-transferable control rents).[97] For these reasons, I do not think that the usual distinction between pecuniary and non-pecuniary PBC is particularly meaningful. Sticking

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93 See, e.g., La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R. [2000a], *Investor Protection and Corporate Governance*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 59, 3–27; Bebchuk, L.A. [1999], *op. cit*.

94 Dyck, A. and Zingales, L. [2004], *op. cit*, 540-541, make this point explicitly. They allow for PBC to be nurtured by either psychic values, perquisites (including cash flow diversion), or dilution. However, they conclude that, on the one hand, empirical analysis of the determinants of control premiums suggests that "not all private benefits are psychic;" and that, on the other hand, "further work is needed to establish the importance of dilution and is welfare implications." Id., at 590.

95 For a very good illustration of this point, see Fox, M.B. and Heller, M.A. [2006], *What Is Good Corporate Governance?*, in M.B. Fox and M.A. Heller (eds.), CORPORATE GOVERNANCE LESSONS FROM TRANSITION ECONOMY REFORMS, Princeton University Press,16-20. For a detailed welfare analysis of shareholder expropriation, see Bebchuk, L.A. and Jolls, C. [1999], *op. cit.*

96 See, e.g., Ehrhardt, O. and Nowak, E. [2003], *op. cit.*; and Gilson, R.J. [2006], *op. cit.*

97 Non-transferability depends on the idiosyncratic character of control rents at issue. See *supra*, Chapter One, section 1.4.5. Hart, O. [2001], *op. cit.*, 1086, also explicitly claims that these rents are "a nontransferable private benefit." As he puts it, this depends on their being unverifiable (which is always a feature of quasi-rents arising out of idiosyncrasy). See also Aghion, P. and Bolton, P. [1992], *op. cit.*, 476.

to the PBC taxonomy that I have just laid down, I shall continue to refer to the benefits the corporate controller derive from stealing as to 'diversionary', rather than pecuniary, PBC.[98]

5.3.2. Law and Institutional Constraints on Shareholder Expropriation

In theory, the stealing problem could be dealt with contractually. In practice, we already know that this is not generally possible because of contractual incompleteness and that, particularly in the case of shareholders, detailing behavioral constraints as a contractual safeguard against stealing is not an option.[99] True, a provision against managerial stealing is not difficult to draft; it is extremely difficult to implement. Would it suffice to state in the corporate charter that the controller is not entitled to cash in any larger portion of the firm's (verifiable) surplus than that one contracted for as profit sharing? Of course, it would not. While that is exactly the result shareholders would like to obtain, such a vague provision is clearly too easy to circumvent.[100]

Related-party transactions of the kind described in the previous section are the case in point.[101] Performance of those transactions is a part of managerial discretion that shareholders themselves are not willing to constrain. Nonetheless, shareholders might claim some monitoring rights on most dangerous transactions and have them included in the corporate contract. Apart from its unavoidable (agency) costs, this solution would be an efficient way to minimize opportunities for stealing if provisions in the corporate charter were stable over time. Unfortunately, they are not. Neither can they be.

Equity investments are residual claims over an indefinite time horizon: the firm's lifetime. Rules of decision-making about the firm management do affect the value of equity investments, but do not have the same characteristic: they might need to be changed over time.[102] Provisions intended to protect shareholders against stealing can be set up in the corporate charter (the equity contract) by means of rules of

98 Cf. Mayer, C. [1999], *op. cit.*, 7, for this terminology.

99 Williamson, O.E. [1985], THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING, Free Press, 304-306.

100 In fact, there are "a million and one ways to evade such a rule." Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1661.

101 See particularly Kraakman, R.H., Davies, P., Hansmann, H., Hertig, G., Hopt, K.J., Kanda, H. and Rock, E.B. [2004], THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH, Oxford University Press (hereinafter Kraakman *et al.* [2004], *The Anatomy*), 101-130.

102 Hansmann, H. [2006a], *Corporation and Contract*, in AMERICAN LAW AND ECONOMICS REVIEW, vol. 8, 8-9.

decision-making. Think, for instance, to a charter provision requiring unanimous shareholders consent to operate a merger – mergers allow for exquisite stealing opportunities. Such a kind of provisions of course constrains the exercise of managerial discretion. However, being agreed upon by both the entrepreneur and the outside shareholders, they were presumably efficient *at the time they were established* (no opportunity for a profitable merger was foreseeable at that time). When unforeseen business opportunities arise (like a profitable merger), provisions constraining their exploitation become suddenly outdated.[103]

Then there are two possibilities. The first one is the typical long-term contract solution of the unforeseen contingencies problem.[104] In this scenario, renegotiation of the original contract would be bargained for *ex post*, and shareholders (who enjoy a veto power) would be entitled to capture a larger share of the gains from the new opportunity by making a take-it or leave-it offer to the manager: either you part with control (getting your share of the profits, but giving up the control rents) or no merger would take place. However, no manager would ever invest *ex ante* to make such a hold-up opportunity available to shareholders.[105]

The governance structure of the firm provides an alternative. The manager could have the terms of the original contract changed when this is required for ex-

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[103] This is a crucial problem of contractual incompleteness in CG that is well illustrated by Becht, M., Bolton, P. and Röell, A. [2002], *Corporate Governance and Control*, ECGI Finance Working Paper No. 02/2002, available at www.ssrn.com and www.ecgi.org, as published in G. Constantinides, M. Harris, and R. Stulz (eds.) [2003], HANDBOOK OF ECONOMICS AND FINANCE, North-Holland. As they put it (Id., at note 23):

> "[L]imiting managerial discretion *ex ante* and making it harder to change the rules by introducing supermajority requirements into the corporate charter would introduce similar types of inefficiency as with debt."

See also, on the legal side, Gordon, J.N. [1989], *The Mandatory Structure of Corporate Law*, in COLUMBIA LAW REVIEW, vol. 89, 1573-1585 (discussing the inefficiency of a 'freeze rule' on charter provision, and the need of mandatory corporate laws to counter opportunistic amendments by those in control of the company). On the advantages of equity over debt as far as managerial discretion is concerned, see *supra*, Chapter One, sections 1.2 and 1.3.

[104] For an application to financial contracting, see Aghion, P. and Bolton, P. [1992], *op. cit.*, 475-486; Hart, O. [1995], *op. cit.*, 126-155. Notice that both approaches ultimately feature *debt* as a commitment device to guarantee incentive-compatibility. See also *infra* the following note.

[105] This hold-up potential would not be available to a creditor, even if he enjoyed the same veto power. The reason is that, unless the firm is bankrupt, debt typically does not involve a residual claim on the firm's assets. In theory, since a creditor would never be entitled to the gains arising from a new, profitable business opportunity, the corporate controller could easily get through her opposition by offering to buy her claim at a price slightly above its current value. Contrariwise, shareholders would be able to reject any offer not taking full account of their share of the prospective profits (thereby expropriating managerial control rents). In practice, given the imperfections in the capital market, creditors' bargaining power will always be stronger; but the difference in the hold-up potential, albeit less pronounced, will remain.

ploiting a new business opportunity without being exploited himself. This situation matches the corporate practice in the real world, where we usually do not observe unanimity provisions in corporate charters, while whoever controls a publicly held company (either inside management or a controlling shareholder) typically exerts a considerable influence over charter amendments.[106] This point was already highlighted in the First Chapter, where the basic allocation of control powers was first described. In the Seventh Chapter, I will describe how such a power is actually made available to corporate controllers in different corporate law jurisdictions.

This particular feature of corporate governance, as opposed to the governance of market relationships, has two implications. The first one is that the controller's residual rights of control include the power to modify also the rules of the game, or at least some of them.[107] The second one is that even the rules of decision-making established in the equity contract are not stable enough to prevent the corporate controller from abusing his power for stealing purposes.[108] Shareholders protection against straight-out expropriation requires therefore an *external* set of constraints disciplining the exercise of that power. Since those constraints need to be stable over time, they can only be provided by institutions.

In each society, stealing is dealt with by a different mix of institutions. However, in more developed ones, law plays a prominent role in constraining expropriation.[109] One may recall here that the need of institutional constraints on diversionary PBC is the very essence of the standard 'law matters' argument.[110] But then, that a number of additional conditions must be fulfilled in order for corporate governance to be efficient should also be recalled. We are gradually coming closer to a more comprehensive description of what this means.

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[106] Hellwig, M. [2000], *op. cit.*, 95-134.
[107] Id., at 98.
[108] Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1659-1660.
[109] For a discussion of alternative paths of institutional development, see North, D.C. [1991], *Institutions*, in JOURNAL OF ECONOMIC PERSPECTIVES, vol. 5, 102-108.
[110] See *supra*, Chapter Four, sections 4.1 and 4.2.

5.4. Private Benefits from Shirking: The 'Ugly' Ones?

5.4.1. How Shirking Differs from Stealing

Should legal rules (and their enforcement) be effective enough in constraining shareholder expropriation, the corporate controller could still harm shareholders in a subtler, but potentially much more detrimental way. Making profits requires *effort* by the manager.[111] While the benefits of this effort are shared with shareholders (depending on the division of the residual claim between them and the manager), its costs are borne entirely by the manager.[112] As a result, the manager will tend to shirk. Shirking in the broadest sense is the typical source of agency costs in the framework of Jensen and Meckling's analysis.[113]

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[111] Jean Tirole formally analyzes CG in this perspective. See Tirole, J. [2001], *Corporate Governance*, in ECONOMETRICA, vol. 69, 1-35 (and especially 5-23 for the 'shareholder-value perspective').

[112] Jensen and Meckling so describe the basic conflict of interest underlying "The agency costs of outside equity:"

> "If a wholly owned firm is managed by the owner, he will make operating decisions which maximize his utility. These decisions will involve not only the benefits he derives from *pecuniary* returns but also the utility generated by various *non-pecuniary* aspects of his entrepreneurial activities, such as the physical appointments of the office, the attractiveness of the secretarial staff, the level of employee discipline, the kind and amount of charitable contributions, personal relations ('love', 'respect', etc.) with employees, a larger than optimal computer to play with, purchase of production inputs from friends, etc. The optimum mix (in the absence of taxes) of the various pecuniary and non-pecuniary benefits is achieved when the marginal utility derived from an additional dollar of expenditure (measured net of any productive effects) is equal for each non-pecuniary item and equal to the marginal utility derived from an additional dollar of after tax purchasing power (wealth).
> If the owner-manager sells equity claims on the corporation which are identical to his (i.e., share proportionately in the profits of the firm and have limited liability) agency costs will be generated by the divergence between his interest and those of the outside shareholders, since he will then bear only a fraction of the costs of any non-pecuniary benefits he takes out in maximizing his own utility. If the manager owns only 95 percent of the stock, he will expend resources to the point where the marginal utility derived from a dollar's expenditure of the firm's resources on such items equals the marginal utility of an additional 95 cents in general purchasing power (i.e., his share of the wealth reduction) *and not one dollar*."

Jensen, M.C. and Meckling, W.H. [1976], *op. cit.*, 312 (emphases added).
Therefore, even though the extraction of non-pecuniary benefits may include more than just 'shirking,' their effect on shareholder wealth maximization are identical to the extent both involve the opportunity costs of more profitable courses of action being foregone. See *infra*, section 5.4.2.

[113] Id., at 309, acknowledge "close relationship" between agency costs and the problem of shirking due to monitoring costs of team production, as analyzed by Alchian, A.A. and Demsetz, H. [1972], *Production, Information Costs, and Economic Organization*, in AMERICAN ECONOMIC REVIEW, vol. 62, 777-

In the classical specification of the principal-agent model, shirking would be dealt with not differently from stealing. The original contract would *ex ante* both minimize opportunities for stealing available to the corporate controller and maximize his incentives to put effort in the firm management.[114] However, when contracts are incomplete, we know the matter is more complicated.

Stealing cannot be fully constrained through the corporate charter, since the latter is subject to opportunistic renegotiation by the holder of residual rights of control – who, as a positive matter, is the corporate controller. Here, however, outside shareholders are not completely at the corporate controller's mercy – why would they entrust him their money otherwise? Stealing affects the division of the firm's surplus *after* this is produced, so it is normally verifiable *ex post* by a third party (e.g., a judge). This implies that stealing can be coped with by the legal system, and specifically by corporate law, provided that both its rules and its enforcement are efficient.[115]

Shirking is a completely different story. On the one hand, it affects not the division, but the production of the firm's surplus. This, in turn, depends on the corporate controller's effort, which is only limitedly observable and intrinsically not verifiable. Therefore, although this is theoretically possible in some corporate law jurisdictions, questioning managerial shirking in courts hardly makes any economic sense.[116] Only an appropriate set of incentives, both internal (the corporate contract) and external (market institutions) to the firm, can contain the manager's inclination to shirk without possibly eliminating it.[117] On the other hand, the perspec-

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795. For the extension of the same reasoning to separation of ownership and control see Demsetz, H. [1983], *op. cit.*

[114] For the general framework, see Arrow, K.J. [1985], *The Economics of Agency*, in J. Pratt and R. Zeckhauser (eds.), PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS, Harvard University Press, 37-51.

[115] Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1661-1663. See *infra*, Chapter Eight, section 8.2, for a more detailed discussion of pluses and minuses of legal intervention in this respect.

[116] Roe, M.J. [2002], *Corporate Law's Limits*, in JOURNAL OF LEGAL STUDIES, vol. 31, 233-271. This point is very clearly illustrated from a comparative Law and Economics perspective by Kraakman *et al.* [2004], *The Anatomy*, cit., 52:

> "The only [legal] standard that qualifies as a general instrument of corporate governance is the duty of care, which sets the minimum quality threshold for the managerial decisions at some benchmark standard such as 'negligence' or 'gross negligence.' Defining and enforcing such a standard is notoriously difficult and, to our knowledge, is not done rigorously anywhere for good reason: evaluating business decisions *ex post* is difficult, and legal error in imposing liability is likely to make directors overly risk averse *ex ante*."

[117] Roe, M.J. [2004b], *op. cit.*; Klausner, M. [2004], *The limits of Corporate Law in Promoting Good Corporate Governance*, Working Paper No. 300, Stanford Law School, available at www.ssrn.com, as published in J.W. Lorsch, L. Berlowitz, and A. Zelleke (eds.) [2005], RESTORING TRUST IN AMERICAN BUSINESS, MIT Press.

tive of a favorable renegotiation of the corporate contract with shareholders may provide the corporate controller with additional incentives to put effort in firm management.[118] In a dynamic perspective, the manager's effort may improve his bargaining position in an eventual control transaction where valuable firm-specific investments by the corporate controller are due to be rewarded through the proceeds of an efficiency-enhancing control sale.[119] Such a reward usually takes the form of golden parachutes or control premia. Hence, the problem of shirking ultimately overlaps with managerial reward in the form of idiosyncratic PBC. How the dynamic efficiency of control allocation is affected by this mechanism depends on the market for corporate control.[120]

5.4.2. Defining 'Distortionary' Private Benefits of Control

Shirking is another source of private benefits of control. These benefits are non-pecuniary.[121] They come from enjoying the firm's assets under management without stealing any of them. As a result, shirking does not involve diversion of the firm's cash flow.[122] Even worse, it does involve suboptimal management of this cash flow and overall underproduction of firm's surplus.[123] Typical instances of such a kind of PBC are consumption of perquisites (such as plush carpets, company airplanes, and the like), expanding the firm beyond what is necessary (so-called 'empire building') and, more in general, misuse of free cash (selection of investment projects that enhance the controller's personal benefits, rather than shareholder profits).[124] They all involve *distorted management* (i.e., misallocation) of funds available to the firm, namely the cost of more profitable business opportuni-

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[118] See, e.g., Schnitzer, M. [1995], *op. cit.*

[119] See Almazan, A. and Suarez, J. [2003], *Entrenchment and Severance Pay in Optimal Governance Structures,* in JOURNAL OF FINANCE, vol. 58, n. 2, 519-47, for a formulation of this approach alternative to Schnitzer's.

[120] See *infra*, section 5.5. The reader should be alerted, however, that a detailed theoretical analysis of this mechanism is postponed to the next Chapter. See *infra*, Chapter Six, sections 6.3 and 6.4.

[121] Jensen, M.C. and Meckling, W.H. [1976], *op. cit.*, 312-330.

[122] The distinction between 'stealing' and 'shirking' is a very important point in CG. It has been highlighted especially by Mark Roe. See, e.g., Roe, M.J. [2004b], *op. cit.*, 3-4; and, for the theoretical underpinnings, Roe, M.J. [2003c], POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE, Oxford University Press, 168-182.

[123] Fama, E.F. [1980], *Agency Problems and the Theory of the Firm*, in JOURNAL OF POLITICAL ECONOMY, vol. 88, 288–307.

[124] Jensen, M.C. [1986], *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, in AMERICAN ECONOMIC REVIEW, vol. 76, 323-329.

ties being foregone.[125] In economic terms, the cost of distorted allocation of corporate funds is an *opportunity cost* borne by shareholders.

Misallocation of funds is not necessarily a feature of non-pecuniary PBC. Some of them do not come from shirking, like – for instance – the pride due to still unobservable firm's success, or the development of synergies (implying less effort, without shirking) in the management of two different corporations.[126] This kind of benefits is *idiosyncratic* to the corporate controller, and therefore their opportunity cost to shareholders is zero.[127] For this reason, to avoid possible confusion arising from the notion of non-pecuniary private benefits of control, I shall continue to refer to the PBC from shirking as to 'distortionary' PBC.[128]

5.4.3. The Limits of Institutions in Constraining Managerial Shirking

Distortionary PBC are extremely difficult to handle. One might have to live with them, and they might be 'ugly' for that reason. As I mentioned, legal rules are of little help due to non-verifiability of effort in the management of a firm. To be sure, foregone business opportunities (the cost of shirking to shareholders) are normally not even observable by shareholders. The best way to deal with the problem is, therefore, the provision of *incentives* to the corporate controller. To some extent, this can be done through the corporate contract, by making managerial compensation contingent on the realization of a future, observable variable correlated with his effort.[129] This variable is typically the firm performance. In a sense, this is equivalent to sharing the residual claim between shareholders and an owner-manager, and then – as Jensen and Meckling showed – it provides just a second best solution to the problem.[130]

Specifically, the entrepreneur/manager is risk averse, has a limited capacity to borrow and is wealth-constrained: indeed, these are the ultimate reasons for separating ownership from control. Therefore, he cannot pay for the residual claim up front. Shareholders, in their turn, are willing to award him only a limited share of

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[125] See, lately, Fox, M.B. and Heller, M.A. [2006], *op. cit.*, 8-16, for a good illustration.

[126] See, e.g., Holderness, C.G. [2003], *op. cit.*, 55.

[127] See *supra*, section 5.2.4.

[128] See Mayer, C. [1999], *op. cit.*, 7, for this terminology.

[129] Notice that this is a complete contracting approach. See Zingales, L. [1998], *Corporate Governance*, in P. Newman (ed.), THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW, vol. 1, Macmillan, 498-499.

[130] Jensen, M.C. and Meckling, W.H. [1976], *op. cit.*, 327-330.

the firm's profits.[131] Alternatively, when incentives provided in this way are not sufficient to have the firm run properly, separation of ownership and control will take place to a limited extent. The entrepreneur/manager will be able to raise a limited amount of funds from outside shareholders, thereby having to retain a significant share ownership. I shall elaborate later on the reasons underlying that choice.[132] In any case, the degree of alignment of managerial incentives that can be reached contractually, through profit sharing, is always imperfect.[133]

Other market institutions can improve the alignment of managerial incentives with shareholders interest. The most important one is *product market competition*.[134] Perfect competition would be more than enough to keep managers on their toes. When managers do not catch up with competitors, soon or late there will be no firm to manage. However, since competition is never perfect, this would happen rather late than soon. In the meantime, managers would be relatively free to enjoy distortionary PBC, while making shortsighted shareholders happy with their monopoly profits.

A similar argument applies to *capital market competition*. Any constraint on managerial misbehavior coming from the capital market requires that additional external finance be needed. Until investment projects can be financed through retained earnings (one should not forget that shareholders receive dividends just at the corporate controller's discretion), this constraint is not likely to be effective.[135] What makes competition in both the product and the capital markets an imperfect, albeit important, constraint on mismanagement is that resources permanently committed to the firm (i.e., equity capital) are sunk costs. This circumstance will give managers slack, until there is some free cash to mismanage without risk of losing their job.[136]

Debt could help making financial constraints binding on the corporate controller.[137] We already know from the Jensen and Meckling model that equity finance has a comparative advantage over debt, as far as agency costs are concerned. However, the source of this advantage, namely the incentive effect of equity holding by

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[131] This basically depends on uncertainty, which leads in turn to contractual incompleteness. See Hart, O. [2001], *op. cit.*, 1084-1090; and Bratton, W.B. and McCahery, J.A. [2001a], *op. cit.*, 13-16 (and references cited therein).

[132] See *infra*, Chapter Six, section 6.4.

[133] See *supra*, Chapter Three, section 3.4.2.

[134] See Roe, M.J. [2001], *Rents and Their Corporate Consequences*, in STANFORD LAW REVIEW, vol. 53, 1463-1494; Allen, F., and Gale, D. [2000], *Corporate Governance and Competition* in X. Vives (ed.), CORPORATE GOVERNANCE: THEORETICAL AND EMPIRICAL PERSPECTIVES, Cambridge University Press, 23-94.

[135] Hellwig, M. [2000], *op. cit.*, 100-112.

[136] Roe, M.J. [2004b], *op. cit.*, 7-8.

[137] See Hart, O. [1995], *op. cit.*, 126-155 for a formal analysis of this issue. See also Hart, O. [2001], *op. cit.*, for further developments about debt and dividend policies in CG.

the manager, decreases with separation of ownership and control. In contrast, no matter of how much external finance is raised by the firm, debt keeps its major advantage over equity: it has to be repaid. This is particularly relevant under contractual incompleteness, for it involves that debt-financed resources are not sunk costs.[138] Should the manager fail to pay back the firm's creditors, they will ultimately force the firm into bankruptcy and the manager will lose his job. In addition – given the firm's financial needs – the more indebted the firm, the less outside equity is needed. *Ceteris paribus*, debt both reduces the amount of free cash flow available for mismanagement and increases the manager's share of the residual claim (i.e., his incentives to make profits).[139]

As such, debt would look like a marvelous mechanism to reduce distortionary PBC. However, every firm has a limited indebtedness capacity.[140] When additional funds are needed, pushing financial leverage is not always the efficient solution. Also, beyond a certain leverage threshold, this would be not even an option, since no more credit would be available. Financing risky investment projects with debt increases not only managerial discipline but also the expected bankruptcy costs to shareholders, and therefore reduces firm value.[141] Highly leveraged firms tend to undertake overly risky projects (one instance is the so-called 'gambling for resurrection'), and this tendency makes creditors unwilling to provide funds when the firm is already much indebted. In this situation, also equity-holders may be reluctant to provide additional funds, since this would benefit outstanding creditors more than themselves. As a result, fewer funds are available to highly indebted firms for financing new profitable investment opportunities (so called 'debt-overhang' effect).[142] Finally, those who are in charge of deciding the firm's financial structure (the managers) do not like creditors breathing down their neck. Consequently, they will tend over time to emancipate themselves from creditors as, in general, from the need to resort to the capital market for doing business.[143] Such emancipation is possible as soon as retained earnings get sufficient to finance investments. This strategy is not necessarily inefficient. However, it implies that the disciplinary effect

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[138] See Aghion, P. and Bolton, P. [1992], *op. cit.*, analyzing the implications of this feature on the allocation of corporate control.

[139] Roe, M.J. [2004b], *op. cit.*, 16. According to Jensen, M.C. [1986], *op. cit.*, debt constraints managers' tendency to *over*-invest in projects with low returns and high PBC. But see Hellwig, M. [2000], *op. cit.*, 115, for the view that free cash flow may also lead to *under*-investment.

[140] Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 18.

[141] Hart, O. and Moore, J. [1995], *Debt and Seniority: An Analysis of the Role of Hard Claims in Constraining Management*, in AMERICAN ECONOMIC REVIEW, vol. 85, 567-585.

[142] Myers, S.C. [1977], *Determinants of Corporate Borrowing*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 5, 147-175.

[143] Hellwig, M. [2000], *op. cit.*, 103-112.

of debt over managerial misuse of free cash flow is not only limited in the first place, but also tends to shrink over time.

Taken together, equity ownership and related financial incentives, product and capital market competition, and the firm's financial structure do actually constrain shirking by the corporate controller. Equally true, all those constraints are insufficient to rule out distortionary PBC.[144] To some extent, this is unavoidable. It should be recalled that, in the Jensen and Meckling complete contracting model, the owner-manager always ends up pursuing some private interests to the outside shareholders' disadvantage, and this is reflected in the agency costs borne *ex ante* by the owner-manager.[145] However, when contracts are incomplete, not all *ex post* inefficiencies can be foreseen (and priced) *ex ante*. In other words, distortionary PBC are ultimately dependent on the exercise of managerial discretionary powers, and so they might exceed the amount originally foreseen in the corporate contract.[146] Some further solution to the problem of misuse of free cash by the corporate controller must be therefore devised *ex post*, in order to make equity finance viable *ex ante*.

Given contractual incompleteness, the problem of managerial shirking finally collapses into a problem of (re)allocation of corporate control.[147] Managers should be replaced (or induced to part with control) when their shirking becomes excessive relative to the best management alternative available on the market. More in general, incumbent managers need to be replaced when they prove themselves incompetent (i.e., a new manager could do a better job). In this perspective, the problems of managerial moral hazard and adverse selection affecting distortionary PBC are solved dynamically, provided that other institutions take care of the corporate controller's misbehavior when it comes to stealing (diversionary PBC). That is to say, on condition that stealing is otherwise ruled out of the system, even in a straight-

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144 See Roe, M.J. [2004b], *op. cit.*, 6-17, on the shortcomings of each set of institutions in constraining agency costs.

145 Jensen, M.C. and Meckling, W.H. [1976], *op. cit.*, 327-330.

146 See Zingales, L. [1998], *op. cit.*, 501-502, for a similar approach to the problem of contractual incompleteness in CG.

147 Hellwig, M. [2000], *op. cit.*, 112-122, makes quite a similar point in that he claims that misallocation of funds for investment ultimately depends on distortions in the dynamic allocation of corporate control. Specifically, management *incumbency* "is likely to be a significant source of distortions." Eventually, it becomes inefficient:

> "People who have been there for a while tend to pursue their own activities and to neglect new opportunities, sometimes because their perceptions are biased toward the things they know, sometimes because they do not want to nurture future rivals."

Id., at 121. This, in turn, leads to suboptimal performance of capital markets in the form of either *over*investment or *under*investment of funds channeled to firms (Id., at 115-118).

forward agency perspective efficiency of corporate governance would ultimately depend on *ex post* replacement of underperforming managers.

Replacement of inefficient managers takes place on a very special market: the market for corporate control. What makes it even more crucial to corporate governance is that this is also the place where idiosyncratic PBC are cashed in, thereby allowing for firm-specific investments by the corporate controller to be rewarded. However, this has nothing to do with agency theory.

5.5. Trading Ownership for Private Benefits: The Market for Corporate Control

5.5.1. Coasian Bargain and the Efficient Allocation of Corporate Control

The market for corporate control is the place where firm control change hands. The reason why it should help constraining distortionary PBC is very intuitive. Provided that managerial shirking is inefficient (its opportunity costs to shareholders are larger than its gains to the manager), it should always be possible to arrange a control transfer to a more efficient manager in such a way as to make everybody better off. What is crucial to this purpose is that the incumbent controller is awarded a compensation for its control rents, which is large enough to offset his personal benefits from inferior management and to reward his initial firm-specific investments.[148] A similar reasoning applies to incompetence. Whenever a more talented manager shows up, the additional profits he would bring about should provide gains from trade sufficient to induce the incumbent manager to part with control. In this perspective, efficient control transactions are regarded as Pareto improvements. This is an application of the well-known Coase Theorem: no matter what the initial allocation of property rights is (i.e., residual rights of control), the efficient outcome (i.e., efficient allocation of the firm's control) will be reached by

[148] Hellwig, M. [2000], *op. cit.*, 118-122 most explicitly recommends sticking to this perspective when assessing the efficiency of the market for corporate control. More precisely, he contends:

> "The incumbency horizon of management is shorter that the horizon of the firm. […] From a price-theoretic perspective, the problem is that the transfer of control from one CEO to the next is not accompanied by any compensation that would correspond to the effective value of the company at the time of the transfer"

Id., at 119. It is exactly this intuition that is being followed in the text.

the parties (i.e., both incumbent and insurgent managers, and outside shareholders) dealing with each other.[149]

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[149] The literature on the 'Coase Theorem' is extensive in both law and economics, and it would be impossible to review it here. In a sense, it would be fair to say that Law and Economics was born after the Coase Theorem. Most of the economic analysis of law is based on the tension between two alternative formulations of the so-called Coase Theorem. First: 'In a world of zero transaction costs, bargaining among people will lead to the efficient allocation of resources no matter of how property rights are originally assigned by the legal system' (Thesis). Second: 'In a world with positive transaction costs, the initial assignment of entitlements by the legal system may determine whether or not the final allocation of resources will be efficient' (Corollary). See Cooter, R.D. and Ulen, T.S. [2004], LAW AND ECONOMICS, 4th edn., Addison Wesley, chapter 4, for illustration. The Coase Theorem is based on one of Ronald Coase's fundamental writings: Coase, R.H. [1960], *The Problem of Social Costs*, in JOURNAL OF LAW AND ECONOMICS, vol. 3, 1-44. Apparently, however, Ronald Coase has never stated any such theorem – at least, not in writing (like Cooter, R.D. [1982], *The Cost of Coase*, in JOURNAL OF LEGAL STUDIES, vol. 11, 14, I was also told that he used to state his theorem explicitly in his seminars at the University of Chicago during the 70s). The statement closest to the 'Theorem' that can be found in *The Problem of Social Cost* is the following:

> "It is always possible to modify by transactions on the market the initial delimitation of rights. And, of course, if such market transactions are costless, such a rearrangement of rights will always take place if it would lead to an increase in the value of production."

Coase, R.H. [1960], *op. cit.*, 15. The statement has been characterized as, "profound, trivial, a tautology, false, revolutionary, wicked." De Meza, D. [1998], *Coase Theorem*, in P. Newman (ed.), THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW, vol. 1, Macmillan, 270. It was George Stigler that popularized it as 'Coase Theorem' (Stigler, G.J. [1966], THE THEORY OF PRICE, 3rd edn., Macmillan, 113), "and the accolade has undoubtedly helped publicize some of Coase's ideas[:] 'The Problem of Social Cost' […] appears to have been cited more often between 1981 and 1996 than any other paper written by an economist (statistical tests excepted)." De Meza, D. [1998], *op. cit.*, 270.

Outstanding insights always involve both praise and controversy, and indeed the Coase Theorem and its implications are still among the most controversial subjects in economics. See Id., at 270-282, for excellent illustration and discussion. However, perhaps the best way to summarize Coase's view on such a controversy is to quote from his own words at the public lecture delivered in Stockholm in 1991, when he received the Alfred Nobel Memorial Prize in Economic Sciences:

> "What I showed in [my 1960] article, as I thought, was that in a regime of zero transaction costs, an assumption of standard economic theory, negotiations between the parties would lead to those arrangements being made which would maximize wealth and this irrespective of the initial assignment of rights. This is the infamous Coase theorem, named and formulated by George Stigler, although it is based on work of mine. Stigler argues that the Coase theorem follows from the standard assumptions of economic theory. Its logic cannot be questioned, only its domain […]. I do not disagree with Stigler. However, I tend to regard the Coase theorem as a stepping stone on the way to an analysis of an economy with positive transaction costs. The significance to me of the Coase theorem is that it undermines the Pigovian system. Since standard economic theory assumes transaction costs to be zero, the Coase theorem demonstrates that the Pigovian solutions are unnecessary in these circumstances. Of course, it does not imply, when transaction costs are positive, that government actions (such as government operation, regulation, or taxation, including subsidies) could not produce a better result than relying on negotiations between individuals in the

The Coase Theorem holds on condition that transaction costs are nil. Since transaction costs are positive in the real world, allocation of residual rights of control may indeed matter for the achievement of the efficient outcome. If shareholders have residual rights of control, managers will stay in charge on condition that they maximize shareholder value, and will be replaced otherwise. However, provided that they cannot buy from shareholders the entitlement to idiosyncratic control rents (for they have no contractible value *ex ante* – i.e., transaction costs would be infinite), managers will refrain from undertaking firm-specific investments that cannot be contracted upon.[150] Conversely, if managers have residual control rights, they will have incentive to undertake firm-specific investments even though they are not contractible. However, provided that managers are now shielded from shareholder interference (managers with residual control rights are entrenched by definition), there is no guarantee that they will ever yield to a superior manager. Differently from the previous scenario, though, *the party with no entitlement can offer a side payment to the holder of control rights in order to achieve the efficient outcome*.[151] In fact, shareholders can offer to compensate managers of their control rents as soon as they get contractible; that is, as soon as shareholders are willing to bid for firm control more than it is worth to the incumbent management.[152] This would just require that, under a new management, overall shareholder value increase by an amount larger than the incumbent's control rents (I am still assuming that stealing is otherwise ruled out of corporate governance). Based on this intuition, I believe that the Coase Theorem is the right starting point for analyzing the market for corporate control; and this is how I will approach the problem in the next Chapter.

However, this is not also how the market for corporate control is described in mainstream literature on corporate governance. Most economists and lawyers do not only assume that the Coase Theorem breaks down in corporate control transac-

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> market. Whether this would be so could be discovered not by studying imaginary governments but what real governments actually do. My conclusion: let us study the world of positive transaction costs."

Coase, R.H. [1991], *The Institutional Structure of Production*, in AMERICAN ECONOMIC REVIEW, vol. 82, 717. See also Stigler, G.J. [1989], *Two Notes on the Coase Theorem*, in YALE LAW JOURNAL, vol. 99, 631-633.

[150] Hart, O. [1995], *op. cit.*, 9 and 95-125. Hart, O. [2001], *op. cit.*, 1086, explicitly considers this issue under the assumption of separation of ownership and control. However, in his discussion of optimal allocation of decision rights in CG, the issue of renegotiation is not considered. As he argues, "Renegotiation complicates the basic story, without changing the fundamental message that allocation of control matters" (Id., note 13). Contrariwise, the present work is fundamentally based on efficient renegotiation. See *infra* in the text and, in more detail, Chapter Six below.

[151] For a model formalizing this intuition, see Schnitzer, M. [1995], *op. cit.*

[152] For an alternative formalization of this mechanism, see Almazan, A. and Suarez, J. [2003], *op. cit.*

tions.[153] They also posit that the only way to achieve the efficient outcome is to assign residual rights of control to shareholders who ultimately own the corporation, even though they have it run by professional managers on a daily basis.[154] Basically – as we already know – standard theory of corporate governance considers firm-specific investment by corporate managers as 'unimportant' for the firm's success and leaves no room for protection of control rents.[155] Although I do not share this view (it does not really explain why a talented entrepreneur/manager should accept such a deal in the first place, giving away his non-contractible talent for no reward), it is worthwhile analyzing it in some details, for it leads to the probably most celebrated and debated institution of corporate governance: the hostile takeover. [156]

153 See, explicitly, Hart, O. [2001], *op. cit.*, 1086. With specific regard to control transactions, see, e.g., Shleifer, A. and Vishny, R. [1997], *op. cit.*, 743; and Easterbrook, F.H. and Fischel, D.R. [1981], *The Proper Role of a Target's Management in Responding to a Tender Offer*, in HARVARD LAW REVIEW, vol. 94, 1661-1204. For a more 'Coasian' approach, see, however, Carney, W.J. [1984], *Toward a More Perfect Market for Corporate Control*, in DELAWARE JOURNAL OF CORPORATION LAW, vol. 9, 593-612.

154 Shleifer, A. and Vishny, R. [1997], *op. cit.*, 750-753; Easterbrook, F.H. and Fischel, D.R. [1983], *Voting in Corporate Law*, in JOURNAL OF LAW AND ECONOMICS, vol. 26, 395-427.

155 Hart, O. [1995], *op. cit.*, 126-129.

156 See Burkart, M. and Panunzi, F. [2006b], *Takeovers*, ECGI Finance Working Paper No. 118/2006, available at www.ssrn.com and www.ecgi.org, for a broad survey considering both the traditional literature on hostile takeovers and the more recent discussion of consensual changes in control and block sales. As Burkart and Panunzi recognize, "[t]he academic literature on the market for corporate control and the term itself originate from Manne." Id., at 3, citing Manne, H.G. [1965], *Mergers and the Market for Corporate Control*, in JOURNAL OF POLITICAL ECONOMY, vol. 76, 110-120. However, it is worth noting that the origins of this literature were concerned with takeovers, but not just with *hostile* ones. Henry Manne actually considered *consensual* control transactions as the most promising venue for efficient changes in control. Id., at 117-119. This part of Manne's work has been completely forgotten by the subsequent literature. The received wisdom is that Manne was the first to argue in favor of contestability of corporate control, for this should induce managers to keep share prices high in order to avoid to be replaced in a hostile takeover. Macey, J.R. [1998], *Manne, Henry Girard*, in P. Newman (ed.), THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW, vol. 2, Macmillan, 609. Then, perhaps the best known part of his oft-cited work (if not the only one) is that "[o]nly the takeover scheme provides some assurance of competitive efficiency among corporate mangers and thereby affords strong protection to the interests of vast numbers of small, non-controlling shareholders." Manne, H.G. [1965], *op. cit.*, 113. Yet Manne explicitly wrote that "there are *several* mechanisms for taking over the control of corporations," and he described three of them: proxy fights, hostile tender offers, and mergers requiring "the explicit approval of those already in control of the corporation." Id., at 114 (emphasis added). Few commentators nowadays recall that he concluded that "mergers seem in many instances to be the most efficient of the three devices for corporate take-overs" Id., at 119.

In conclusion, Manne's work contains no advocacy of hostile takeovers. If anything, it is much more supportive of the Coasian bargain approach. Indeed, according to Manne, corporate control is a "valuable asset" subject to exchange on an "active market." Manne, H.G. [1965], *op. cit.*, 112. On the one hand, "holders of control blocks of shares would refuse to sell at a share price which did not pay them a premium at least sufficient to compensate them for the loss of net values pres-

5.5.2. Why Hostile Takeover Is Not the Answer

The hostile takeover is, in theory, a terrific mechanism for replacing inefficient managers, since by definition it does not require that managers agree on being taken over.[157] Its basic functioning is extremely simple. When the incumbent manager is availing him of too many distortionary PBC, stock prices will go down and this will make profitable for a more efficient manager to buy the firm out. This manager will be able to capture the efficiency gains by acquiring the firm's stock and replacing the old manager.[158] In this perspective, hostile takeovers would actually suffice to keep incumbent managers constantly on their toes, thereby solving

ently being received from their position in the corporation." Id., at 117. On the other hand, "the managers are in a position to claim almost the full market value of control, [provided that] they have it in their power to block the merger […]. *When we find incumbents recommending a control change it is generally safe to assume that some side payment is occurring.*" Id., at 118 (emphasis added). For a more accurate illustration of Manne's work along this line, see Carney, W.J. [1999], *The Legacy of "The Market for Corporate Control" and the Origins of the Theory of the Firm*, in WESTERN RESERVE LAW REVIEW, vol. 50, 2225-237.

[157] For illustration, see Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 24-31.

[158] This simple, but fundamental, intuition dates back to Manne, H.G. [1965], *op. cit.*, 112-113, although it has been often misunderstood. Indeed, hostile takeovers are not the only way in which this mechanism can work. Manne's critical insight is that motivation for a takeover depends on the expected capital gain in the stock purchase. "The lower the stock price, relative to what it could be with more efficient management, the more attractive the take-over becomes to those who believe that they can manage the company more efficiently." Id., at 113. Hostility is not required to capture those gains. Quite to the contrary, being control a "valuable asset," a 'premium' must be paid to purchase it together with the company's stock. Whoever is ultimately in charge of the company management (either a controlling shareholder or the management itself) will be able to claim it from the potential acquirer. While this clearly reduces prospective takeover gains, it does not suffice to impede efficient reallocations of control (although it may do if the same premium must be paid to non-controlling shareholders too – see *infra* in the text, and Chapter Ten for the regulatory implications). To the extent that the gains from trading corporate control are higher than its value under current management, efficient changes in control may take place not just by means of hostile takeovers but also thanks to side payments to the incumbents. Both mechanisms "[provide] some assurance of competitive efficiency among corporate managers and thereby [afford] strong protection to the interests of vast numbers of small, non-controlling shareholders". Id., at 113. This is mostly positive analysis, though, since the simplicity of Manne's framework provides little reason to prefer side payments to hostile takeover, if not just cost or information advantages in dealing with the incumbent management instead of with dispersed and uninformed shareholders. Id., at 118. Indeed, Manne did not even attempt to explain *why* control is a valuable asset and a premium must be paid for it, although he apparently had in mind a market for corporate control populated by entrepreneurs/managers searching for "new opportunities" for the firms under their management. Id., at 118-119. However, once we explicitly allow for control premium to foster entrepreneurship, thereby serving efficiency purposes *ex ante*, side payments become essentially the only way to reconcile *ex ante* with *ex post* efficiency in CG. See *infra*, Chapter Six, section 6.3.

the problem of distortionary PBC. No manager would actually shirk, for if he did it, he would immediately lose his job.

Even more importantly, hostile takeovers make sure control is always allocated to the best possible manager. Firm performance does not only depend on the manager's effort, but also on his capabilities. At least in theory, the set of incentives underlying hostile takeovers is such that the corporate controller is replaced whenever a slightly better manager is available. Apparently, hostile takeovers solve two major problems of corporate governance at the same time: on the one hand, they *discipline* managerial behavior (coping with the problem of moral hazard); on the other hand, they guarantee the efficient *allocation* of corporate control in a dynamic perspective (providing a solution to the adverse selection problem).[159]

Unfortunately, as I mentioned in the last Chapter, hostile takeovers are not as helpful with respect to diversionary PBC, anytime they are not effectively coped with by the legal system.[160] Stealing could be policed by hostile takeovers on condition that the acquirer buys *all* of the company's shares at *one single* price accounting for the current value of the firm.[161] Yet this is not required for the success of a takeover. On the contrary, such a requirement makes takeovers less likely to succeed.[162] This puts us in a bind. For hostile takeovers to police stealing, a strict prin-

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[159] Jensen, M.C. and Ruback, R.S. [1983], *The Market for Corporate Control: The Scientific Evidence*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 11, 5-50.

[160] See *supra*, Chapter Four, section 4.4.4.

[161] Bebchuk, L.A. [1985], *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, in HARVARD LAW REVIEW, vol. 98, 1693-1808. A more conventional way to look at stealing in takeovers is so-called 'looting.' See, e.g., Easterbrook, F.H. and Fischel, D.R. [1991], THE ECONOMIC STRUCTURE OF CORPORATE LAW, Harvard University Press, 129-131. But this is just a part of a more general problem with takeovers: shareholders may be induced to tender their shares even when this would result in an inefficient outcome. The problem is known as 'pressure to tender', and is a typical example of prisoner's dilemma. Shareholders will tender for fear of being entrapped in the acquired company as minority shareholders when other shareholders tender their shares and allow the acquisition to succeed, even though non-tendering would be the most efficient strategy for shareholders as a whole. Equal treatment of shareholder in tender offers is exactly aimed at avoiding that outcome. Unfortunately, equal treatment also generates another problem, namely shareholder free riding on the acquirer's effort. See *infra* in the text. Therefore, Lucian Bebchuk advocates a more complex solution to the problem, based on shareholder voting. See Bebchuk, L.A. [1987], *The Pressure to Tender: An Analysis and a Proposed Remedy*, in DELAWARE JOURNAL OF CORPORATE LAW, vol. 12, 911-949. For a broad overview of Bebchuk's position on takeovers, see Bebchuk, L.A. [2002a], *The Case against Board Veto in Corporate Takeovers*, in UNIVERSITY OF CHICAGO LAW REVIEW, vol. 69, 973-1035. On the two problems of free riding and pressure to tender in takeovers, see extensively *infra*, Chapter Ten, section 10.3.

[162] See Easterbrook, F.H. and Fischel, D.R. [1982], *Corporate Control Transactions*, in YALE LAW JOURNAL, vol. 91, 698-737. Henry Manne was already aware of the problem, when he criticized Berle's contention that "any premium received by an individual for a sale of control belongs in equity to all of the shareholders." Manne, H.G. [1965], *op. cit.*, 116 (referring to Berle, A.A. Jr. [1958], *'Control' in*

ciple of shareholder equal treatment should be implemented. However, this may end up frustrating any takeover attempt, whether it is hostile or not. Given that, the market for corporate control cannot work well whenever diversionary PBC are being extracted.[163] Hostile takeovers may actually make the problem even worse. If anything, acquisitions that go unchecked by the incumbent controllers are more likely to be motivated by looting purposes and, therefore, to result in an outcome highly detrimental to shareholders. Corporate governance simply needs to feature different solutions to the stealing problem.

Takeovers are considerably more problematic in the real world, where the mechanisms of acquisition are not as simple as in the stylized picture that I have just depicted. The actual functioning of hostile takeovers encounters a number of difficulties both *ex post* (when control should be reallocated) and *ex ante* (when separation of ownership and control is decided by the entrepreneur). The first kind of problems makes hostile takeovers much less effective in both disciplining shirking managers and replacing incompetent ones.[164] *Ex ante*, hostile takeovers can even hinder separation of ownership and control, at least when protection of idiosyncratic control rents is an issue for the entrepreneur.[165]

Corporate Law, in COLUMBIA LAW REVIEW, vol. 58, 1212-1225, and to Berle, A.A. Jr. and Means, G.C. [1932], THE MODERN CORPORATION AND PRIVATE PROPERTY, MacMillan, 244). As he put it:

> "[In the US,] there are numerous judicial statements to the effect that one may claim a premium for control. [But a] number of legal writers, following Berle, continue to press for a rule of equality in share purchase price when an outsider buys control in a corporation. *The economic result of such a rule could be most unfortunate.* Many holders of control blocks of shares would refuse to sell at a share price which did not pay them a premium at least sufficient to compensate them for the loss of net values presently being received from their position in the corporation. If all non-controlling shareholders must accordingly pay a premium over the market price of their shares, then in a substantial number of cases the purchaser will not conclude the bargain."

Manne, H.G. [1965], *op. cit.*, 116-117. Over forty years later, Manne's words are extremely topical. At first glance, this may seem to apply no longer to the US as much as to Europe, where the legal and economic debate on regulation of mandatory takeover bids and on the related equality principle has reached its peak, pending the implementation of the Takeover Directive (Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids) by EU Member States. However, the debate on control premia is still very heated in the US. See, e.g., Carney, W.J. and Heimendinger, M. [2003], *Appraising the Nonexistent: The Delaware Courts' Struggle with Control Premiums*, in UNIVERSITY OF PENNSYLVANIA LAW REVIEW, vol. 152, 845-880. Also, Delaware case-law on this issue appears to be nowadays on a quite dangerous evolutionary path. I shall discuss extensively both the European and the American approach to the control premium in Chapter Eleven.

163 This point will be discussed in more detail in Chapter Six, section 6.4.4.

164 Roe, M.J. [2003c], *op. cit.*, 174-175.

165 Coates, J.C. IV [2003], *op. cit.*, 12-23 ('Why do takeover proof exists?').

To be workable, hostile takeover requires both a very high degree of separation of ownership and control and regulatory support. To begin with, it requires that the corporate controller's ownership be not sufficient to resist a hostile acquisition (or to make it unprofitable for the acquirer). In addition, non-controlling shareholders need not be in the position to holdout, since otherwise they will not let the acquirer cheaply buy their stock in order to replace the incumbent manager.[166]

The first requirement is a matter of ownership and control structure, which has been deeply investigated in the Second Chapter. In models of corporate governance based on a controlling shareholder (like in continental Europe) or on coalitions of owners-managers (like in the UK), hostile takeovers can be easily ruled out by means of devices allowing incumbents to exert disproportionate voting power (e.g., dual class shares in Sweden and many other European countries) or preventing insurgents from taking over unless they put together nearly all of the company's shares (e.g., rules disfavoring controlling shareholding at the London Stock Exchange).[167]

The second requirement is a matter of appropriation of takeover gains by the acquirer, which ultimately motivates the acquisition. Basically, non-controlling shareholders may be able to claim a large fraction of those gains – if not all of them, pro-rata – either because they are large enough to holdout, or because they are alerted by the launch of a formal bid or by the incumbent management that the company is undervalued, or finally because either the incumbent management or the legal system make some or all of them entitled to capture takeover gains in the form of a premium on their shares.[168] When these factors are at work, a prospective acquirer may fail to recover the costs of the acquisition, and therefore he will desist from it in the first place.

Even when favorable conditions were realized on the two above accounts, hostile takeover would still work far from perfectly. To begin with, hostile takeovers are extremely costly. Even though they are dispersed, shareholders are not completely stupid: why should they sell their shares at current prices, letting the acquirer get all the gains from the takeover? Shareholders would rather demand a premium for tendering their shares. In fact they always do. The underlying theoretical problem is known as 'free riding.' Shareholders who do not tender will benefit from the

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[166] See Burkart, M. and Panunzi, F. [2006b], *op. cit.*, 12-23, for accurate illustration of these two impediments to hostile changes in control.

[167] See, for an excellent overview, Becht, M. and Mayer, C. [2001], *op. cit.*, 7-15. How this is in fact allowed by different corporate laws will be discussed, in more detail, in Chapter Seven.

[168] By and large, this is how takeover defenses work in the US, and the regulation of mandatory bids shapes takeovers outside the US. See, for broad illustration, Kraakman *et al.* [2004], *The Anatomy*, cit., 163-184.

efficiency gains brought about by the acquirer, so the latter has to 'bribe' them in order to succeed.[169] In practice, the free rider problem makes takeover premia always substantial and this confines the disciplinary effect of hostile takeovers (if any) just to the major instances of underperformance.[170]

Secondly, hostile takeovers do not guarantee that only efficient control transfers take place. The acquirer might be more interested in enhancing his PBC (from both stealing and shirking) rather than the firm value.[171] This is because, for succeeding in a hostile takeover, a prospective acquirer needs neither to buy all of the company's stock nor to pay for the incumbent's PBC.[172] Notice that this problem is overcome not only when the acquirer is forced to bid for all of the company's shares at the same price (the underlying rationale for mandatory bids with equal treatment of outstanding shareholders), but also when the acquirer has to pay for the incumbent's PBC, on condition that stealing is otherwise ruled out by the legal system.[173] On this condition, takeovers can only be profitable when the acquirer buys enough shares on the stock market (possibly, all of the firm's outstanding shares) to compensate the incumbent's private benefits with the enhanced security benefits of a more efficient management. Given that taking over firm control re-

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[169] Grossman, S.J. and Hart, O. [1980b], *Takeover Bids, the Free Rider Problem, and the Theory of the Corporation*, in BELL JOURNAL OF ECONOMICS, vol. 11, 42–69. The free rider problem makes some 'pressure to tender' upon shareholders necessary for viability of takeovers. But see *supra*, at note 161, the drawbacks of this solution. The two problems will be discussed together, in more detail, once we will get to the regulatory analysis of corporate control transactions (see *infra*, Chapters Ten and Eleven).

[170] For two equally skeptical perspectives on takeovers as an instrument of managerial discipline, see, e.g., on the economists' side, Shleifer, A. and Vishny, R. [1997], *op. cit.*, 756-757; and, on the lawyers' side, Roe, M.J. [2004b], *op. cit.*, 10-12.

[171] Shleifer, A. and Vishny, R. [1988], *Value Maximization and the Acquisition Process*, in JOURNAL OF ECONOMIC PERSPECTIVES, vol. 2, 7-20; Jensen, M.C. [1993], *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, in JOURNAL OF FINANCE, vol. 48, 831-880.

[172] Either requirement would have, of course, important chilling effects on the acquirer's incentives. The underlying tradeoffs are quite different, though. For a comprehensive illustration of both cases, see Coffee, J.C. Jr. [1997], *Transfers of Control and the Quest for Efficiency: Can Delaware Law Encourage Efficient Transactions While Chilling Inefficient Ones?*, in DELAWARE JOURNAL OF CORPORATE LAW, vol. 21, 359-425; and Coffee, J.C. Jr. [1984], *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, in COLUMBIA LAW REVIEW, vol. 84, 1145-1296. For discussion of regulatory implications on the legal discipline of corporate control transactions, see *infra* Chapter Ten.

[173] Indeed, this is a crucial point of the present inquiry. It will be discussed in detail *infra*, Chapter Ten, section 10.2.3. In the real world, outright elimination of diversionary PBC is not attainable. See *infra*, Chapter Eight, section 8.2.2. However, for purposes of efficiency of a (friendly) takeover process, it is sufficient that value diversion from minority shareholders is not allowed to increase by means of a change in control. This condition can be satisfied, for instance, by allowing an accurate judicial scrutiny of corporate control transactions upon allegation of looting. See *infra*, Chapter Ten, section 10.4.5, for discussion.

quires the purchase of at least the incumbent's ownership stake, and anyway of enough shares to gain control of the board of directors,[174] the acquirer would have no choice for recovering takeover expenses but reducing the opportunity costs of shirking or otherwise increasing shareholder value.[175] Clearly, to the extent the incumbent's PBC need to be compensated upfront, this takeover mechanism allows for no hostility.

Thirdly, hostile takeovers require that a huge amount of funds be raised to finance the stock acquisition.[176] Even where capital market are deep and liquid enough, takeovers need to bring about quite large efficiency gains to pay back the funds raised. However, as I have just pointed out, hostile acquisitions provide no guarantee in this respect. Changes in control by hostile takeover are not necessarily efficient, whereas – under certain conditions – negotiated control transfers (so-called 'friendly takeovers') always are.

5.5.3. Friendly Takeovers and the Protection of Control Rents

The most important impediments to hostile takeover are not in its *functioning* when ownership has been already separated from control. They are in its *tolerance* by the entrepreneur when separation is decided in order to access equity finance on a

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[174] Trading of both voting rights and corporate offices is prohibited in any corporate law jurisdiction. See, for the US, Easterbrook, F.H. and Fischel, D.R. [1991], *op. cit.*, 74-76 and 132-134. See also Hart, O. [1995], *op. cit.*, 205-205 for the economic implications (i.e., if votes can be completely unbounded from shares, the security-voting structure is irrelevant). Notice that vote selling is the extreme case of separation of voting rights from cash flow rights. In practice, this separation is allowed to some limited extent by all corporate law's jurisdictions, through dual class shares, cross ownership, pyramiding, and the like. See *supra*, Chapter Two, section 2.3.3, and *infra*, Chapter Seven, section 7.4.3. But, as it will be shown in Chapter Ten, section 10.2.1, the assumption in the text always holds. Whatever the ownership structure, control of a publicly held company can only be acquired by coalescing a non-negligible ownership stake.

[175] There is indeed a third alterative: the insurgent may just aim at extracting a larger amount of PBC than the incumbent, and this would suffice to motivate the acquisition. See Bebchuk, L.A. [1994], *op. cit.*, for illustration of how this can lead to inefficient changes in control. This fundamental work by Professor Bebchuk will be discussed *infra*, Chapter Ten, section 10.3.2. One may already notice, however, that I hypothesized in the text that diversionary PBC are otherwise ruled out by the legal system, and that distortionary PBC must be compensated by the insurgent for the acquisition to succeed. The latter circumstance leaves no room for further shirking, to the extent it would depress rather than enhance the price of acquired stock, thereby making the acquisition financially unprofitable. The only instance of PBC that is left out of this highly stylized mechanism is idiosyncratic ones. Their bearing on changes in control is going to be analyzed *infra*, Chapter Six, sections 6.2, 6.3, and 6.4.

[176] Shleifer, A. and Vishny, R. [1997], *op. cit.*, 756.

large scale (that is, when the company 'goes public' and its shares are listed on a stock exchange).

Hostile takeovers are based on contestability of control. The theory of contestable markets teaches us that no monopoly rent can be maintained under perfect contestability.[177] This is true also in the market for corporate control: once control is made (perfectly) contestable, there is no way for the corporate controller to secure private benefits (i.e., control rents) of any kind.

However, like monopoly rents in product market competition, control rents are not always a bad thing for corporate governance. In particular, we already know that protection of idiosyncratic control rents is needed to foster entrepreneurial innovation.[178] When those rents are substantial, *the entrepreneur might be unwilling to separate ownership from control if this necessarily involves being subject to hostile takeover*. True, going public may provide the entrepreneur with benefits sufficient to offset the loss of his idiosyncratic PBC.[179] However, this is not always the case. To be sure, the

[177] Baumol, W.J., Panzar, J.C. and Willig, R.D. [1982], CONTESTABLE MARKETS AND THE THEORY OF INDUSTRY STRUCTURE, Harcourt Brace Jovanovich. On the role of potential competition in Law and Economics see, in general, Van den Bergh, R.J. and Camesasca, P.D. [2006], EUROPEAN COMPETITION LAW AND ECONOMICS: A COMPARATIVE PERSPECTIVE, Sweet and Maxwell, 90-94.

[178] The rents at issue are rather 'quasi-rents,' though, the crucial difference being that protection of *quasi-rents* promotes innovation whereas *rents* just distort competition. This fundamental distinction dates back to Marshall, A. [1893], *On Rents*, in ECONOMIC JOURNAL, vol. 3, 76-78. See *supra* Chapter One, section 1.4.5.

[179] This result is derived, e.g., by Pagano, M. and Röell, A. [1998], *The Choice of Stock Ownership Structure: Agency Costs, Monitoring, and The Decision To Go* Public, in QUARTERLY JOURNAL OF ECONOMICS, vol. 113, 187-225. However, they assume that PBC are *inefficient* and going public is a way for the entrepreneur to commit not to extract them at the expenses of security benefits. Other models where PBC extraction has not efficiency consequences, but only distributional ones, yield different results as to the allocation of control rights. See, e.g., Aghion, P. and Bolton, P. [1992], *op. cit.*, and Zingales, L. [1995], *Insider Ownership and the Decision to Go Public*, in REVIEW OF ECONOMIC STUDIES, vol. 62, 425–448.

A recent theoretical analysis of the decision to go public abstracts from the role of PBC: Boot, A., Gopalan, R. and Thakor, A. [2006], *The Entrepreneur's Choice between Private and Public Ownership*, in JOURNAL OF FINANCE, vol. 61, 803-836. Its core insight is that entrepreneurs may refrain from going public for fear to give up managerial autonomy. The intuition is quite similar to that being explored in the present work. However, the authors do not consider PBC. Rather, their model is based on divergence of expectations as to the optimal management strategy between the entrepreneur and public shareholders credited with the entitlement to interfere with firm management. Even though the entrepreneur's choices are 'renegotiation proof' in their model (whereas they are not in models that feature unverifiable PBC), such a way to deal with the problem of contractual incompleteness in CG does not really explain where entrepreneurial reward for allegedly superior expectations should come from; on the contrary, the same reward is always obtained by means of renegotiation when PBC are allowed. Thus, I conjecture that PBC are the only possible source of entrepreneurial reward in the corporate structure, and that inability to secure them from subsequent expropriation by shareholders is itself a good reason (and maybe the most important one) for the entrepreneur to forego separation of ownership and control.

empirical evidence on entrenchment of corporate control rather suggests that most often this is *not* the case. Thus, we need to investigate whether the market for corporate control can also work through mechanisms other than hostile takeovers.

By introducing this topic with a reference to the Coase Theorem, I have already suggested that it can. A market for corporate control can only be reconciled with the incumbent controller's entrenchment when takeovers are friendly, that is when changes in control are performed with the incumbent's consent. Friendly takeovers guarantee that idiosyncratic PBC are safeguarded. Provided that the incumbent's firm-specific investments are rewarded, *friendly takeovers can also guarantee that control changes hands when (and only when) this is efficient*, thereby enhancing the overall efficiency of corporate governance. This is a crucial point I shall further speculate upon in the next Chapter. But let me stress, once again, how the scope for *diversionary* PBC (i.e., stealing opportunities available to any corporate controller) must be otherwise minimized by the legal system for that result to hold.

The importance of effective legal policing of cash flow diversion for the efficiency of corporate governance is the realm, and indeed the fundamental strength, of the classical 'law matters' thesis.[180] As we know, however, this argument tells us little about how *distortionary* PBC are dealt with, since in theory the only way legal rules can cope with them is by supporting shareholder insurgency, but in practice hostile takeovers and similar instances of outside shareholder interference are most often ruled out in *any* corporate governance system.[181] Now that idiosyncratic PBC have been introduced in the analysis, we know also *why* this is so frequent. What we still do not know is how incentive compatibility is guaranteed under these conditions; that is, whether and how protection of idiosyncratic control rents can be reconciled with the incentives of the corporate controller to maximize shareholder value.

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180 La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R. [2000a], *op. cit.*, 6-12.

181 Roe, M.J. [2003c], *op. cit.*, 168-182.

5.6. Idiosyncratic Private Benefits: The 'Good' Ones

5.6.1. Costly Shareholder Intervention, Managerial Rent Protection, and the Over-Monitoring Theory

Although the implications of control rents for the overall efficiency of corporate governance have been so far not yet completely explored, economic theory sometimes acknowledges the importance of their protection for fostering *ex ante* firm-specific investment by an entrepreneur or a manager, notwithstanding separation of ownership and control.[182] It might be surprising – given that the same author prefers to consider the case where the manager's preferences are 'unimportant' for the firm's success – but perhaps the most lucid description of how managerial control rents may have indeed efficient motivations, and how this could explain the disproportion between control rights and corporate ownership that most frequently we observe in practice, is provided by Oliver Hart:

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[182] This is particularly evident once the importance of entrepreneurship is accounted for in the analysis of CG. In his handbook, Martin Ricketts puts it very efficaciously:

> "If the firm is a vehicle for the exercise of entrepreneurship we have to get used to the idea that a significant proportion of the income received by those who work in the firm is entrepreneurial profit. […] The important thing is that entrepreneurs have the means of transferring their insights into personal gain. To consider the mechanisms by which this can be accomplished requires us to investigate in much more detail the nature of property rights and the way that different types of organization reflect different structures of rights."

Ricketts, M. [2002], *op. cit.*, 81. This has at least two fundamental implications for CG. On the one hand, control rents should be protected inasmuch they are intended to reward firm-specific investments of entrepreneurial skills. Then "if takeovers are perceived as a threat to firm-specific quasi-rents, modification to company constitutions may be sought to make takeovers more difficult." Id., at 268. This matches Hellwig's observation that management is ultimately in control of charter amendments, whatever the legal and institutional environment, and that management uses its power strategically, "to immunize itself against control from outsiders." Hellwig, M. [2000], *op. cit.*, 98-100. On the other hand, raiders in corporate takeovers are also to be regarded as "Kirzenerian entrepreneurs," who "will gain if his or her judgment is different from that of other people and it proves to be correct." Ricketts, M. [2002], *op. cit.*, 302. For a similar view, see Manne, H.G. [1965], *op. cit.*, 118.

In other words, the market for corporate control is the ultimate source of entrepreneurial reward when ownership is separated from control. This holds for both the incumbent and the insurgent controller on condition that they are entitled to secure control rents in corporate control transactions. As we will see, different combinations of incumbent's entrenchment and side payments from the rival may allow for takeovers to work in this way, whereby firm control is (voluntarily) exchanged in the exercise of "pure entrepreneurship, for which ownership is never a condition." Kirzner, I.M. [1979], *op. cit.*, 94. See *infra*, Chapter Six.

> "In some companies it may be efficient to allocate control rights to managers in order to allow them to enjoy their private benefits, or to motivate them to undertake relationship-specific investments. Alternatively, the company's initial owner may 'sell' the private benefits to a large investor, along with voting control, so that the investor can consume the private benefits without risk of expropriation. If managers and investors are wealth-constrained and cannot afford to purchase a large equity stake (or if they are risk-averse), it may be necessary to depart from one share–one vote to achieve these outcomes." [183]

Building on the same insight, three European economists – Mike Burkart, Denis Gromb, and Fausto Panunzi – developed a theory of separation of ownership and control where delegation of control rights *cannot* be withdrawn by outside shareholders if not in certain states of the world, i.e. only when it is profitable for shareholders to do so.[184] This is supposed to happen when shareholders are much dispersed and ousting the incumbent management would be not worth the expenses of a hostile takeover, unless the firm is managed very badly. In all remaining situations, the corporate controller has *full* (and not just *delegated*) *discretion*, namely unchallenged effective control over the firm's assets.[185]

Moderately shielding the manager from the risk of outside shareholders' interference is *ex ante* beneficial for both parties. The former will have incentive to undertake firm-specific investments, like searching for new business opportunities, without risk of being subsequently expropriated of his private benefits by insurgent shareholders taking over. The latter will have to reap some of the benefits of the manager's initiative in the form of profits, since below a certain stock return threshold shareholders would find profitable to hold up the manager (thereby depriving him of *all* control rents).[186] *Ex post*, this arrangement also involves some costs. Shareholders will have to yield to the manager's preferences for (moderately) high-PBC investment projects, thereby foregoing more profitable alternatives (possibly, brought about by a new manager) that would fail to compensate the incumbent manager for his initial investment. The basic intuition of this model is thus that "even if managerial discretion is *ex post* detrimental to shareholders, it can be

[183] Hart, O. [1995], *op. cit.*, 188.

[184] Burkart, M., Gromb, D. and Panunzi, F. [1997], *Large Shareholders, Monitoring, and the Value of the Firm*, in QUARTERLY JOURNAL OF ECONOMICS, vol. 112, 693-728. Hart, O. [2001], *op. cit.*, 1090-1098, has independently followed a similar line of inquiry, based on *costly intervention* by non-controlling shareholders. The conclusion he reaches, however, have more to do with dividend policies than with allocation of control rights. This problem would deserve a separate investigation, and therefore is not dealt with here.

[185] Burkart, M., Gromb, D. and Panunzi, F. [1997], *op. cit.*, 711-713.

[186] Id., at 699-702.

beneficial *ex ante* as it favors firm-specific investments, like searching for new investment projects."[187]

The above intuition is based on the property rights theory of the firm, and it tries to overcome its major shortcoming when it comes to separation of ownership and control:

> "[The property rights literature] argues that parties without ownership may be discouraged from undertaking firm-specific investments because the owners of the assets can use their control rights to hold them up. This theory, however, cannot capture the separation of ownership and control because it equates these two concepts. Following Aghion and Tirole [1997], we suggest that control rights translate into effective control only when their holders have the incentives to exercise them. We argue that the ownership structure is a powerful technology to allocate effective control in a way that mitigates the holdup problem." [188]

The implications of this reasoning are highly peculiar. The authors point to a so-called *over-monitoring problem*.[189] Managers would only undertake firm-specific investments that are not verifiable (and, therefore, not contractible) *ex ante* on condition they can secure an adequate reward for such a behavior in the form of PBC. In other words, they need to feel safe from subsequent hold-up by outside shareholders. However, if managers are closely monitored by shareholders, the latter will always be able to deprive *ex post* the former of their PBC, and unable to commit *ex ante* to any different policy (provided that holding managers up is always worth the effort – i.e., profitable *ex post*). As a result, managers would not take any unverifiable initiative when they are too closely monitored.

Monitoring is costly, and therefore not every shareholder is expected to implement it in the same way. A large shareholder is supposed to be a tighter monitor than small, dispersed ones (who are most likely to free ride). Given the monitoring costs, a dispersed ownership structure is a way to commit credibly to a policy of no-interference by outside shareholders, thereby promoting managerial incentive to undertake firm-specific investments.[190] Hostile takeovers and similar instances of

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[187] Id., at 693-694.

[188] Id., at 696 (citing Aghion, P. and Tirole, J. [1997], *Formal and Real Authority in Organizations*, in JOURNAL OF POLITICAL ECONOMY, vol. 105, 1-29). The distinction between formal and informal authority is very important in the economic theory. Another prominent reference in this regard is Baker, G.P., Gibbons, R. and Murphy, K.J. [1999], *Informal Authority in Organizations*, in JOURNAL OF LAW, ECONOMICS AND ORGANIZATION, vol. 15, 56-73.

[189] Id., at 719-720.

[190] Burkart, M., Gromb, D. and Panunzi, F. [1997], *op. cit.*, at 701.

shareholder intervention work just on the side of this mechanism. The scope of managerial discretion (and the size of PBC that managers are entitled to) is negatively related to the incentives to informed intervention by shareholders (that is, ownership concentration) and positively related to its costs – which also depend on how weak legal protection of outside shareholders is. This leads to the conclusion – quite unconventional, indeed – that not only large shareholdings may overkill managerial initiative (and, more broadly, entrepreneurial innovation), but also 'excessive' legal protection of shareholders could, unless it is matched by an extremely dispersed ownership structure. Therefore, the over-monitoring problem might explain why takeover defenses and other managerial entrenchment devices, while inefficient *ex post*, might prove efficient *ex ante*.[191]

While extremely insightful, once again this theory fails to explain many facts of corporate governance in the real world. A major problem with the above framework is that one of its basic assumptions is highly unrealistic: that is, "perfect congruence of interests between large and small shareholders."[192] Although this assumption has been removed in a subsequent paper by Burkart and Panunzi,[193] the underlying problem stays. Models of corporate governance based on the over-monitoring problem *fail* to account for the role of controlling shareholders.

Large investors, who are not also *controlling* shareholders, only monitor very mildly the firm management. Likewise, they can hardly be expected to challenge managerial control rents with a hold-up strategy.[194] Those (moderately) large share-

[191] Id., at 713. See also *infra*, section 5.6.2.

[192] Id., at 697 (the limits of this approach being highlighted at 719).

[193] Burkart, M. and Panunzi, F. [2006a], *Agency Conflicts, Ownership Concentration, and Legal Shareholder Protection*, in JOURNAL OF FINANCIAL INTERMEDIATION, vol. 15, 1-31. The authors analyze a complex setting characterized by a double agency problem. The traditional one is germane to the shareholder-management relationship. But there is also a second type of agency conflict: that between large and small shareholders. This was nicely highlighted in an earlier version of their paper: "While large shareholders mitigate the traditional corporate agency problem, they are also the source of another agency problem[:] large shareholders can use their influence also to pursue their own goals, possibly at the expense of the minority shareholders." (Burkart, M. and Panunzi, F. [2001], *Agency Conflicts, Ownership Concentration, and Legal Shareholder Protection*, CEPR Discussion paper No. 2708, available at www.ssrn.com). This dichotomy between agency problems has become quite popular also among lawyers. The distinction is sharper, though, for it has to do with shareholders being not just 'large' as opposed to 'small', but rather 'controlling' as opposed to 'minority' ones. See, most prominently, Kraakman *et al.* [2004], *The Anatomy*, cit., 33-70.

[194] Of course, this is not an issue where large shareholders do not have, even collectively, enough voting power to outvote the controlling shareholders, as it appears to be the case for many, if not most, companies listed in continental Europe. See *supra*, Chapter Two, section 2.4. However, passivity of non-controlling shareholders seems to hold even in those systems where a coalition of large investors may easily outvote the incumbent management. See, e.g. – for the US – Black, B.S. [1998], *Shareholder Activism and Corporate Governance in the United States*, in Newman P. (ed.), THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW, vol. 3, Macmillan, 459-465; and Romano,

holders – typically, institutional or otherwise very wealthy investors – just strive for getting the highest possible monetary return on their investment. In case they do not, they would not interfere with firm control by withdrawing from their support to the incumbent management; they would simply withdraw from their investment.[195]

Alternatively, shareholders may get *so large* that they do not simply monitor the firm management; they *control* it.[196] But then assuming that managers are still in charge of the firm's core decision-making, while subject to over-monitoring by a (significantly) large shareholder, becomes both an useless and a misleading fiction for describing corporate governance. It is useless, because making corporate managers accountable to a controlling shareholder – who takes the real decisions – is the ultimate reason for the acquisition of a controlling stake in the firm ownership, so that management over-monitoring can no longer be an issue.[197] It is misleading, because what matters in that situation is not the managers' initiative, but rather the controlling shareholder's incentive to undertake firm-specific investments.[198] As a

R. [2001a], *Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, in YALE JOURNAL ON REGULATION, vol. 18, 174-251. For the UK, see instead Black, B.S. and Coffee, J.C. Jr. [1994], *Hail Britannia: Institutional Investor Behavior under Limited Regulation*, in MICHIGAN LAW REVIEW, vol. 92, 1997-2087; Stapledon, G.P. [1996], INSTITUTIONAL SHAREHOLDERS AND CORPORATE GOVERNANCE, Oxford University Press; and, more recently, Crespi-Cladera R., Renneboog L. [2003], *Corporate Monitoring by Shareholder Coalitions in the UK*, ECGI Finance Working Paper No. 12/2003, available at www.ssrn.com and www.ecgi.org.

195 The major problem with institutional monitoring is that fund managers have very little incentives to interfere with firm management. See Coffee, J.C. Jr. [1991], *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, in COLUMBIA LAW REVIEW, vol. 91, 1277-1368; and Stapledon G.P. [1996], *op. cit.*, 252-269.

196 I have already mentioned that controlling shareholders are often confused with shareholders that are just 'large.' But, in fact, they play two completely different roles in CG. See *supra*, Chapter Three, section 3.4.2. This has been only recently highlighted in the literature. See Holderness, C.G. [2006], *A Contrarian View of Ownership Concentration in the United States and around the World*, AFA 2006 Boston Meetings Paper, available at www.ssrn.com. He contends that "we should not expect most blockholders to monitor management—typically, blockholders *are* the managers." Id., at 26 (emphasis added). According to Holderness, this makes perfect sense in a market economy. However, he also recognizes that "some blockholders are neither directors nor officers." Their role in CG is therefore an issue worthy of future research. One also very interesting research venue concerns hedge funds. "[Recent] press reports [of US companies] suggest that hedge funds are rapidly increasing their large-percentage holdings and becoming increasingly active in corporate affairs." Id. at 28.

197 Shleifer, A. and Vishny, R. [1997], *op. cit.*, 764.

198 The analysis by Burkart, M. and Panunzi, F. [2006a], *op. cit.*, is based on quite a strong assumption:

> "Our model […] assumes that the *large shareholder* and the *manager* are *distinct* parties, irrespective of the block size. In our view, this definition of *insider* and *outsider* is not refuted by the observation that many controlling owners are Board Members and participate in management. Being a Board Member or even its Chairman is quite different from being the

result, the hold-up problem affects the relationship between controlling and non-controlling shareholders, rather than that between managers and large shareholders. It is highly questionable that this problem can also be interpreted as a matter of over-monitoring.

5.6.2. Entrenchment and the Manager's Incentive-Compatibility

Over-monitoring could be the wrong way to look at the right problem.[199] As Burkart and Panunzi recognized in an earlier version of their paper, "In a firm with

> CEO of the firm, and their interests are likely to differ. This does, however, not preclude that they may on occasions collude at the expense of the small shareholders."

Id., at 3 (emphases added). This assumption is justified by two related claims. On the one hand, that not every controlling shareholder directly participates in the board; on the other hand, that even those who do need not be necessarily in charge of firm management. However, while this obviously shows that the interest of corporate managers may, and often do differ from that of controlling owners, it does not also suffice to refute that controlling shareholders are the 'true' insiders of the company they control, regardless of the identity of top management and board members. Likewise, collusion between management and controlling shareholders cannot be treated as just an *'occasional'* event, conditional on private benefits being 'transferable' from the former to the latter (Id., at 22). This transfer may be unnecessary when private benefits are directly enjoyed by controlling shareholders, and firm management is just compensated as employee. More importantly, collusion would not occur "on occasions" – being rather the *typical* outcome – if large shareholders are not just corporate monitors, but corporate controllers. It is quite difficult to believe that firm managers can afford *not* to collude with a controlling shareholder who is ultimately in charge of either keeping or removing them from office at his own will! Notice that this holds regardless of whether the controlling shareholder participate in the board and of whether he does or does not delegate managerial decision-making. The example that Burkart and Panunzi make to substantiate their claim (Id., note 2) does in fact contradict it. In the 70s, Carlo De Benedetti – the CEO of FIAT, the largest publicly held company in Italy at that time – tried indeed to gain control of the firm at the expenses of the controlling family – the Agnelli. But, in the end, he had to quit his position.

[199] The over-monitoring literature yields very interesting results on the relationship between the quality of legal protection of shareholder rights and the ownership structure, based on the fundamental tradeoff between shareholder monitoring and managerial incentives to undertake firm-specific investments (entrepreneurial initiative). Although I do not believe this is the right formulation of the tradeoffs affecting the choice of CG arrangements (including the ownership structure), the results are similar to those I derive by advocating the existence of a different tradeoff: namely, that between managerial discretion featured with residual control rights and accountability to shareholders in the form of contractual and legal protection of their share of the residual claim (see *infra*, Chapter Six). Specifically, in both frameworks, also 'excessive' legal protection of outside shareholder rights might lead to ownership concentration. However, this does not quite depend on incentive to shareholder *monitoring* being weakened by very protective legal rules and being restored by means of *outside* ownership concentration, but rather on managerial discretion being frustrated by legal entitlements to shareholder *interference* and restored by means of *inside* ownership concentration. See *infra*, the discussion in the text and accompanying notes.

a manager-owner and otherwise dispersed small shareholders, neither lacking initiative nor excessive shareholder interference are essential issues."[200] But, then, what protects the owner-manager's investment from subsequent hold-up by outside shareholders? The answer lies in the corporate controller's entrenchment.

Entrenchment is in fact a more powerful commitment device than dispersed ownership. While the latter makes holding up the incumbent management *more expensive* to shareholders (that is, too costly to be implemented, unless the firm is managed very badly), the former makes it just *impossible* (that is, too costly to be implemented *in any case*). Entrenchment is also a more general way to protect firm-specific investments by the corporate controller. It works under both dispersed and concentrated ownership structures (i.e., those 'with a manager-owner and otherwise dispersed small shareholders'), provided that the managers of a public company and the controlling shareholder of an otherwise publicly held corporation are respectively shielded from hostile takeovers.

Of course, allowing for straight entrenchment of corporate control is much riskier than committing to a 'soft' policy of management replacement through dispersed ownership. Once residual control rights are delegated to an absolutely entrenched corporate controller, there is practically no way for shareholders to withdraw from that delegation. True, entrenchment involves a *definitive* assignment of residual rights of control, rather than their mere delegation. While this would wonderfully protect the corporate controller's firm-specific investments, thereby promoting entrepreneurial innovation and managerial initiative, apparently it would also expose non-controlling shareholders to an unacceptable hold-up risk. Facing no treat of ouster, an incumbent controller would appear to be able to appropriate the firm's *entire* surplus in the form of PBC, while failing to provide outside shareholders with *any* return on their investment.[201]

If that was the case, we would not observe either entrenched controllers or outside equity finance in the governance of corporate enterprises. In fact, however, we do observe both.[202] The reason is that corporate governance allows for many factors preventing an otherwise entrenched corporate controller from holding up non-

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[200] Burkart, M. and Panunzi, F. [2001], *op. cit.*, 13. They are somewhat less explicit in the published version:

> "[W]e consider a blockholder as an outsider, unless he is an executive officer, e.g., the CEO. Moreover, our theory presupposes *outside* blockholdings. Hence, it cannot offer predictions about how the quality of the legal protection affects the likelihood of outside rather than inside ownership concentration. Accordingly, the prevalence of *inside* ownership in countries with poor legal protection is evidence *orthogonal* to our theory."

Burkart, M. and Panunzi, F. [2006a], *op. cit.*, 20 (emphases added).

[201] See, most notably on this account, Aghion, P. and Bolton, P. [1992], *op. cit.*, 480-483.

[202] See *supra*, Chapter Four, esp. section 2.4.

controlling shareholders more than it is necessary for having his firm-specific talent invested.[203] Taken together, those factors should induce or force the corporate controller to cut back his PBC when they reduce shareholder wealth by either diverting their profits (stealing) or distorting its production (shirking, empire building, etc.), without depriving him of residual control rights – what would undermine his incentives to unverifiable firm-specific investments. Compared to over-monitoring models, this result is not based on the *size* of PBC allowed by limited shareholder oversight (with just *moderate entrenchment* consequences), but it is rather obtained by implementing *absolute entrenchment* with a different treatment of PBC, depending on their *quality*.

Let me recall the PBC classification that was introduced in this Chapter. An ideal system of corporate governance will curb both diversionary and distortionary PBC (the 'bad' and the 'ugly' ones), so that entrenchment cannot be aimed at fostering those benefits at the shareholders' expenses.[204] In the absence of diversionary and distortionary PBC, the hold-up potential remaining available to an entrenched controller will concern just the unverifiable part of the surplus, whose protection promotes likewise unverifiable firm-specific investments.[205] As we know, idiosyncratic PBC (the 'good' ones) account exactly for that surplus and they ultimately motivate entrenchment as efficient protection of control rents. Eliminating – or, more realistically, minimizing – the amount of diversionary and distortionary PBC that can be extracted by a corporate controller is then a precondition for entrenchment to work efficiently. Luckily, as I mentioned before, a number of factors are at play in corporate governance, which are intended to guarantee that result; even though – as we will see in the final Chapters of this work – they are not always handled as they should by the legal systems.

To begin with, the typical controller's monetary compensation is partly contingent on the realization of profits accruing to the shareholder value. This is quite obvious when the corporate controller is a shareholder himself; but it is no less true in the case of a non-owner manager whose compensation depends on both current performance (think to 'pay-per-performance' incentive schemes, like stock options

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[203] See, e.g., Roe, M.J. [2004b], *op. cit.*, 6-16; and, similarly, Klausner, M. [2004], *op. cit.* This point was made much earlier in Corporate Law and Economics. It was Carney, W.J. [1988], *op. cit.*, 418-424, who, in the spirit of Klein, B., Crawford, R.G. and Alchian, A.A. [1978], *Vertical Integration, Appropriable Rents and the Competitive Contracting Process*, in JOURNAL OF LAW AND ECONOMICS, vol. 21, 297–326, first interpreted managerial opportunism in corporate governance as a problem of appropriable quasi-rents on investments in human capital.

[204] See, e.g., Fox, M.B. and Heller, M.A. [2006], *op. cit.*

[205] For two (slightly) different perspectives on this problem, compare Schnitzer, M. [1995], *op. cit.*, with Canoya, M., Riyanto, Y.E. and Van Cayseele, P. [2000], *Corporate Takeovers, Bargaining and Managers' Incentives to Invest*, in MANAGERIAL AND DECISION ECONOMICS, vol. 21, 1-18.

plans) and past track record (affecting his standing on the managerial labor markets, and thereby the amount of his fixed salary).[206] In general, failing to provide non-controlling shareholders with a return on their investment will also negatively affect the corporate controller's monetary compensation.[207] His consumption of distortionary PBC will then have to be traded off against direct and indirect consequences on profit sharing established via the equity contract.

Secondly, the compliance to the profit sharing rule originally contracted for is (or at least should be) guaranteed by a body of legal rules, commonly referred to as *fiduciary duties*, which *ex post* prevent the corporate controller from outright expropriating non-controlling shareholders of their share of the realized surplus.[208] Scope for expropriation unaccounted for in the equity contract is provided by contractual incompleteness, and that is the reason why law 'matters' for actively minimizing agency costs instead of merely enforcing contracts that have already achieved that result.[209] Given that, there is some confusion among economists about the role of legal rules in corporate governance, for they often consider as relevant 'law' whatever enhances, in a legally enforceable manner, outside shareholders' powers relative to those of the corporate controller.[210] Entering in that fashion, legal protection of outside shareholders can be also counterproductive for separation of ownership and control, to the extent that it threatens the corporate controllers' discretion and his incentives to undertake firm-specific investments.[211] This is actually an impor-

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206 Roe, M.J. [2004b], *op. cit.*, 6-8 and 12.

207 Hart, O. [1995], *op. cit.*, 95-120.

208 Rock, E.B. and Wachter, M.L. [2001], op. *cit.*, 1661-1663.

209 Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 19-20.

210 I have already mentioned how the confusion between allocation and regulation of control rights leads to important misunderstandings in Corporate Law and Economics. See *supra*, Chapter Three, section 3.4.2. Especially the economists tend to believe that regulation should just empower non-controlling shareholders, no matter how. See, illustratively, Shleifer, A. and Vishny, R. [1997], *op. cit.*, 750-753 and Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 89-93. However, as some legal scholars have recently suggested, preserving the exercise of control powers from outside shareholder interference is at least as important as investor protection. See Cools, S. [2005], *op. cit.*, and Rock, E.B. and Wachter, M.L. [2001], op. *cit*. This involves that corporate law should play *two* fundamental roles in fostering the efficiency of corporate governance: that is, supporting entitlements to corporate control *and* protecting non-controlling shareholders from expropriation. See *infra*, Chapter Six, section 6.5 (introduction of the 'dual role') and section 6.7 (discussion of the implications for legal analysis).

211 Burkart, M. and Panunzi, F. [2006a], *op. cit.*, 10-19, find a non-monotone relationship between the quality of legal protection of outside shareholders and ownership concentration. This means that ownership concentration may not only decrease, but also *increase* in the quality of law depending on whether monitoring and legal protection are complements or substitutes and, in the latter case, on what effect prevails. In particular, when legal rules substitute for monitoring in that they directly police PBC extraction by the management, the above relationship may be either inverse or direct,

tant result highlighted by the over-monitoring literature. However, legal protection of outside shareholders does not necessarily mean the right to interfere with the firm management. Quite to the contrary, most legal arrangements in corporate governance actually deal with how to short-circuit that right.[212] Fiduciary duties certainly do not involve any such interference.[213] When properly implemented by the legal system, they do not allow non-controlling shareholders to hold up the corporate controller; but they prevent the latter from holding up the former in that they counter diversion of the firm's profits (i.e., stealing).[214]

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depending on whether to curb PBC extraction or to avoid killing managerial incentives because of over-monitoring is more important in terms of efficiency.

> "[S]uch a non-monotone relationship between ownership concentration and legal protection does not conflict with the view that weaker legal rules require more monitoring. In fact, it is easy to see that the maximum level of monitoring that preserves managerial incentives is inversely related to the quality of the law. […] When the law becomes weaker, private benefits increase, and a higher monitoring intensity is required […]. Thus, our model concurs with the argument that more monitoring improves the return on equity when legal protection is weak. In addition, it offers an alternative interpretation: Only regimes of weak legal protection allow for close monitoring. In regimes with good protection, frequent shareholder interference would frustrate managerial initiative."

Id., at 16. I believe that the 'overkill' result is more general, for two fundamental reasons. On the one hand, PBC are not alike: some are required to preserve managerial incentives, whereas others are just inefficient. Regardless of how effective the law is in policing the latter, it may fail anyway to foster the former in the absence of significant managerial ownership (i.e., of a controlling shareholder). *Inside* ownership concentration may thus obtain under both weak and strong legal protection of outside shareholders. On the other hand, *monitoring* should be distinguished from *interference* with firm management. Whatever the ownership structure, outside shareholder interference is typically ruled out: either management or a controlling shareholder is in charge of decision-making. Ease of monitoring the extraction of *inefficient* PBC just affects outside shareholder willingness to pay for non-controlling shares, and thereby ownership dispersion that can be afforded by the insider, provided that his controlling position is not endangered. In this perspective, monitoring and legal protection of outside shareholders are always complementary in curbing PBC, and they both lead to *dispersion* of *outside* ownership. The argument by Burkart and Panunzi that legal protection may also work as a substitute for monitoring, possibly inducing *concentration* of *outside* ownership, does not really apply to monitoring, but just to interference: the higher the degree of interference that shareholders are (legally) entitled to, the higher will be the ownership concentration necessary to reap the benefits of such interference. But then, the only way to avoid management initiative being frustrated is to allow for *inside* rather than *outside* ownership concentration. Burkart and Panunzi consider this scenario as "orthogonal" to their theory (Id., at 20), whereas it characterizes the framework being presented here.

212 In this perspective, see, most notably, Hellwig, M. [2000], *op. cit.*, 107-112.

213 See, illustratively, *supra*, Chapter One, section 1.4.4; and *infra*, Chapter Eight, for a more detailed analysis from both the positive and the normative point of view.

214 This is basically unquestioned on the lawyers' side of Corporate Law and Economics. See, e.g., Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1656-1663. Economists instead continue to consider fiduciary duties as an instrument for managerial discipline. See, e.g., Shleifer, A. and Vishny, R. [1997], *op. cit.*, 751, and Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 23. At best, this is impre-

The above factors leave some further room for shareholders being held up. Once again, this is due to contractual incompleteness. We already know from the Jensen and Meckling model that ownership (profit) sharing is never sufficient to eliminate distortionary PBC.[215] Neither can institutions, whether they are legal or extra-legal, apparently fare any better in this respect. It is ultimately for this reason that – breaking off the gravity of the exposition – I have characterized these private benefits as 'ugly.' Entrenchment could just worsen this problem over time, and raise the related agency costs. The opportunity cost of perquisites consumption or empire building increases anytime a more efficient manager shows up. This might be due either to a moral hazard (the next manager would be more diligent) or to an adverse selection problem (the next manager would be more competent). In this situation, an entrenched controller would hold on his position while underperforming relative to his potential competitor, thereby enlarging his distortionary PBC at the non-controlling shareholders' expenses.[216] Provided that non-controlling shareholders are committed not to withdraw control rights from the incumbent management, they can no longer *force* a change in control even in case of considerable underperformance. However, they can *induce* it. And they actually do.

Under managerial control, incumbent managers often get sizeable severance payments (so-called 'golden parachutes') in return for their parting with control.[217] Under shareholder control, even larger control premiums are awarded when the controlling stake changes hand.[218] In the two cases, maximizing deferred compensation from an eventual control sale should induce the corporate controller both to invest his managerial talent (and effort) *ex ante* and to part with control when facing a significantly more efficient manager *ex post*.[219] Consistent with the incomplete

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cise. A fruitful way to look at the matter is that corporate law fares much better at policing 'stealing' than at disciplining 'shirking,' for the latter would involve second-guessing business judgments – something that courts are normally unwilling to do. See Roe, M.J. [2002], *op. cit.*, 233-271; and Kraakman *et al.* [2004], *The Anatomy*, cit., 52.

215 Jensen, M.C. and Meckling, W.H. [1976], *op. cit.*, 313-323. For the extension to an incomplete contract setting, see Schnitzer, M. [1995], *op. cit.*, 235.

216 This is the so-called 'management entrenchment hypothesis,' as opposed to the 'shareholder interest hypothesis' foe explaining takeover resistance. See, illustratively, Burkart, M. and Panunzi, F. [2006b], *op. cit.*, 6-12; Schnitzer, M. [1995], *op. cit.*, 229-232.

217 See, e.g., Hartzell, J., Ofek, E. and Yermack, D. [2004], *What's In It for Me? CEOs Whose Firms Are Acquired*, in REVIEW OF FINANCIAL STUDIES, vol. 17, 37-61.

218 See, e.g., Dyck, A. and Zingales, L. [2004], *op. cit.*

219 There is a little, but considerable strand of literature that attempts to explain: i) *takeover resistance* as a way to protect unobservable and unverifiable managerial investments *ex ante*; and ii) *severance payments* as a way to cash in their value *ex post*. The two factors enter in different fashions, depending on the model specification. See Knoeber, C.R. [1986], *Golden Parachutes, Shark Repellents, and Hostile Tender Offers*, in AMERICAN ECONOMIC REVIEW, vol. 76, 155-167; Laffont, J.-J. and Tirole, J. [1988], *op. cit.*; Schnitzer, M. [1995], *op. cit.*; Canoya, M., Riyanto, Y.E. and Van Cayseele, P. [2000], *op. cit.*;

contracts framework, both moral hazard and adverse selection problems are then solved dynamically, by *ex post bargaining* rather than by *ex ante contracting*.

In this perspective, distortionary PBC look quite less 'ugly' than they may appear at first glance. Still, contrary to the mainstream view, shareholders need not be entitled to hold up the corporate controller in order to counter their extraction. Actually, the reverse is true, albeit to a limited extent. To the same extent, some efficient control transfers will be foregone. This is just because some *ex post* inefficiency is necessary to preserve *ex ante* the right incentives on the corporate controller's side.[220] Like in the famous movie, from which inspiration for our qualitative distinction of private benefits is taken, the ugly is not necessarily an enemy of the good.

In the next Chapter, I will further investigate the entrenchment mechanism, in order to precise the conditions under which it can work efficiently. To this purpose, its motivations – in terms of different kinds of PBC that entrenchment is intended to protect – will be analyzed from both the outside shareholders' and the corporate controller's standpoint; positive implications will be derived for the corporate ownership structure; and, finally, both a positive theory and the normative goals of corporate law will be outlined on that basis. Yet I have already put on table the basic intuition: residual rights of control can be assigned from shareholders to a non-(entirely)-owner manager, preserving nonetheless the incentive-compatibility of corporate governance. For this to hold, appropriate constraints should be set on the corporate controller's behavior. As I mentioned, these constraints could be possibly analyzed in a standard agency framework, allowing for law and other institutions to make the difference because of contractual incompleteness. This is actually how they are dealt with in mainstream Law and Economics. However, a full account of contractual incompleteness involves that a corporate controller cannot be considered as a mere agent. His position needs to be featured with residual control rights if we want to induce him to invest any non-verifiable, firm-specific entrepreneurial talent.

Almazan, A. and Suarez, J. [2003], *op. cit.* See also, in earlier Corporate Law and Economics, Carney, W.J. [1988], *op. cit.*, 418-424.

[220] See, specifically on this point, Schnitzer, M. [1995], *op. cit.*, 238-243.

CHAPTER SIX – Control Matters Too: A Tale of Two Missions for Corporate Law

6.1. What Corporate Governance Is about (And Can Legal Rules Do Anything about That?)

The tripartite account of private benefits of control (PBC), which has been introduced in the last Chapter, forms the basis of a relatively novel framework for analyzing corporate governance. I have contended that this provides a better understanding of corporate governance and of its different patterns around the world. More importantly, a positive and a normative account of corporate law can be derived on that basis, at least from a Law and Economics standpoint. Both accounts differ substantially from the mainstream view. However, on the one hand, they respond to a number of questions raised in the most recent literature, to which the answers proposed so far are still not completely satisfactory.[1] On the other hand, they result in a number of theoretical propositions that can be tested against the empirical evidence.[2] As it will be shown in the remainder of this work, the test is positive – at least, as it appears from the five-country case study that is going to be

[1] See, most prominently, on the economists' side, Hellwig, M. [2000], *On the Economics and Politics of Corporate Finance and Corporate Control*, in X. Vives (ed.), CORPORATE GOVERNANCE: THEORETICAL AND EMPIRICAL PERSPECTIVES, Cambridge University Press, 95-134, and & Zingales, L. [2000], *In Search of New Foundations*, in JOURNAL OF FINANCE, vol. 55, 1623-1654; on the lawyers' side, Rock, E.B. and Wachter, M.L. [2001], *Islands of Conscious Power: Law, Norms and the Self-Governing Corporation*, in UNIVERSITY OF PENNSYLVANIA LAW REVIEW, vol. 149, 1619–1700, Cools, S. [2005], *The Real Difference in Corporate Law between the United States and Continental Europe: Distribution of Powers*, in DELAWARE JOURNAL OF CORPORATE LAW, vol. 30, 697-766, and Gilson, R.J. [2006], *Controlling Shareholders and Corporate Governance: Complicating the Taxonomy*, in HARVARD LAW REVIEW, vol. 119, 1641-1679.

[2] See *infra*, section 6.7.

set up.[3] The development of this theory, and of the set-up for testing its propositions, is the subject-matter of the present Chapter.

To start, let us discuss the leading definitions of corporate governance available in the economic theory. I have carefully avoided defining corporate governance so far. I have preferred to focus on the underlying core problem – separation of ownership and control – to find out how corporate governance should deal with it.[4] In order to preserve the functional character of the analysis, I shall still refrain from providing any definition on my own, for it would be, at any rate, either over-inclusive, under-inclusive, or both. Nevertheless, discussing the existing definitions and their shortcomings is a good way to both resume the main arguments of previous analysis, and to introduce a new paradigm for economic and legal analysis that may fare better in interpreting corporate governance in the real world.

6.1.1. The Agency Costs Perspective

Probably the most cited definition of corporate governance is that provided by Andrei Shleifer and Robert Vishny in their authoritative survey of the topic: "Corporate governance deals with the ways in which the suppliers of finance to corporations assure themselves of getting a return on their investment."[5] Their perspective on corporate governance is declaredly a "straightforward agency perspective."[6] However, they recognize that contracts are incomplete, and therefore financiers cannot reliably secure a given return on their investment contractually. The authors then conclude that *both* legal constraints on managerial misbehavior *and* residual rights of control are needed to protect outside shareholders, thereby minimizing agency costs and allowing equity funds to be raised efficiently by the corporate enterprises.[7]

There are two major problems with this view, which make it unsatisfactory from both a positive and a normative perspective. Starting from positive analysis, outside shareholders' powers in the actual governance of publicly held corporations hardly fit within the above description, at least as far as control rights are concerned.[8] Shleifer and Vishny seem to be aware of this problem when they acknowledge:

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[3] See *infra*, section 6.8.

[4] See *supra*, Chapter One, section 1.1.

[5] Shleifer, A. and Vishny, R. [1997], *A Survey of Corporate Governance*, in JOURNAL OF FINANCE, vol. 52, 737.

[6] Id., at 738.

[7] This is based on application of the principal-agent paradigm to an incomplete contracts setting. See *supra*, Chapter Three, section 3.4.2.

[8] See *supra*, Chapter One (and Chapter Two, for discussion of the empirical evidence).

"There may be limits […], but the fact is that managers do have most of the residual rights of control."[9] Nonetheless, they claim: "The principal reason that investors provide external financing to firms is that they receive control rights in exchange."[10] And, later on: "If legal protection does not give enough control rights to small investors to induce them to part with their money, then perhaps investors can get more effective control by being large."[11] Then, according to Shleifer and Vishny, the absence of large shareholders and separation of ownership and control thereby depend on how effectively outside shareholders' control rights are protected by the legal system. Joined by Rafael La Porta and Florencio Lopez-de-Silanes (hereinafter La Porta *et al.*), they published their first article on the 'law matters' thesis – *Legal Determinants of External Finance* – in the next issue of the Journal of Finance.[12]

6.1.2. Are Shareholders 'Stupid and Impertinent'?

A few years later, in a path-breaking essay, Martin Hellwig showed how promises of control for finance are in fact *not credible* even in most developed financial and legal systems.[13] This observation holds irrespective of the kind of finance (debt vs. equity) and of what institutions (banks vs. markets) provide for its allocation. As far equity finance is concerned, outside shareholder disenfranchisement is also independent of whether ownership is dispersed or concentrated. That is, large shareholders do not seem to make much difference in real-world corporate governance. As Hellwig puts it, "In the United States [where ownership is most often dispersed] as in continental Europe [where ownership is typically concentrated], ongoing changes of statutes [*scilicet*, of corporate charters] are used to buttress management independence from outside control and to dilute or void the control rights of outside shareholders."[14] Then, the author paraphrases the famous words of a German banker of the early twentieth century:

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9 Shleifer, A. and Vishny, R. [1997], *op. cit.*, 741.

10 Id., at 750.

11 Id., at 753.

12 La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R. [1997], *Legal Determinants of External Finance*, in JOURNAL OF FINANCE, vol. 52, 1131-1150. *Law and Finance* was written earlier (La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R. [1996], *Law and Finance*, NBER Working Paper No. 5661), but published later (La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R. [1998], *Law and Finance*, in JOURNAL OF POLITICAL ECONOMY, vol. 106, 1113-1155).

13 Hellwig, M. [2000], *op. cit.*, 107-112.

14 Id., at 111.

> "Shareholders are stupid and impertinent – stupid because they give their money to somebody else without any effective control over what this person is doing with it, and impertinent because they ask for a dividend as a reward for their stupidity."[15]

Hellwig adds that the peak of shareholders' impertinence is reached when "in opposition to management, they try to exert some control after all."[16] To my understanding, Hellwig did not mean to claim that shareholders are actually stupid or impertinent. Certainly, I do not. Rather, shareholders seem unwilling to make themselves understood by economists.

So let us try to understand them. A second problem with Shleifer and Vishny's view of corporate governance is conceptual, and relates to its normative implications. The circumstance that the whole of shareholders' investment is potentially placed at hazard involves that outside shareholders should be granted *some form of protection*, *not* that they should be protected via *residual rights of control*.[17] Shareholders sink their money in the firm, but do not decide how that money is invested and to what extent the firm's assets are specialized – nor do they want to.[18] The entrepreneur does, and to this purpose, he has to commit irreversibly his expertise to the venture. Investment of entrepreneurial talent is no easier to contract upon than the provision of equity funds. Reward of the latter (profits) is at least verifiable *ex post*, whereas compensation of the former typically includes some unverifiable component that cannot be contracted upon (private benefits of control – PBC).[19] Then it is the entrepreneur, and not shareholders, that needs residual rights of control.

Consider, for instance, a fishing enterprise. To avoid expropriation, shareholders need to make sure the fisherman cannot profit but from fishing and sharing the catch with them according to the contract. Shareholders need, therefore, effective protection of their share of the residual claim. Contrary to conventional wisdom,

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15 Id., at. 109. The original quotation is reported by Baums, T. and Scott, K.E. [2005], *Taking Shareholder Protection Seriously? Corporate Governance in the U.S. and Germany*, in AMERICAN JOURNAL OF COMPARATIVE LAW, vol. 53, 31: "Aktionäre sind dumm und frech. Dumm, weil sie Aktien kaufen, und frech, weil sie dann auch noch Dividende haben wollen." Carl Fuerstenberg (1850-1933). Schwerin von Krosigk, J.L.G. [1957], DIE GROßE ZEIT DES FEUERS - DER WEG DER DEUTSCHEN INDUSTRIE, Wunderlich, 646-47.

16 Hellwig, M. [2000], *op. cit.*, 109.

17 Zingales, L. [1998], *Corporate Governance*, in P. Newman (ed.), THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW, vol. 1, Macmillan, 497-503.

18 Williamson, O.E. [1985], THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING, Free Press (chapter 12 – '*Corporate Governance*').

19 See Zingales, L. [1998], *op. cit.*, 501, extending the same argument to all stakeholders who make firm-specific investments. But see *supra*, Chapter Three, section 3.5.2, for a critical discussion.

they do not also need residual control rights (i.e., the threat of ousting an underperforming fisherman) to this purpose. Eventually the fisherman will have to supply shareholders with their share of the revenues, on condition that his reward is tied to that supply by contract and straight-out expropriation is ruled out by law.[20] Such a reward would be enough for an agent, not for an entrepreneur.[21] The fisherman will have also to rig the fleet, select the crews, and set the fishing courses – that is, he will have to make firm-specific investments.[22] Apparently, mere delegation of control rights would suffice to have all this done.[23] However, to avoid being expropriated of his investments once the firm's goodwill has been established, the fisherman needs tenure.[24] He needs to be entitled from the beginning to the unverifiable surplus generated by the investment of his talent.[25] Protection of this surplus is not contractible, and therefore it requires residual rights of control being assigned, not merely delegated, from shareholders to the entrepreneur.[26] In this perspective, shareholders appear to be neither stupid nor impertinent any longer.

6.1.3. The Incomplete Contracts Perspective

The above approach is ultimately at odds with Shleifer and Vishny's definition of corporate governance. However, it is consistent with the alternative definition of corporate governance offered by another leading economist. According to Luigi Zingales, corporate governance is "the complex set of constraints that shape the *ex post* bargaining over the quasi-rents generated by a firm."[27]

Compared to Shleifer and Vishny's, this is a much broader definition. The reader should recall, from the Third Chapter, the meaning of quasi-rents as the excess value of the firm's assets over their market price, which is intended to reward non-redeployable (i.e., idiosyncratic) investments.[28] As such, Zingales' definition focuses on the division of non-contractible surplus rather than on the conflicts of interest affecting its production; that is, it deals more with contractual incompleteness (*ex post* bargaining) than with agency costs (*ex ante* contracting). In this perspec-

[20] See *supra*, Chapter One, section 1.3, for the intuition; and Chapter Four, sections 4.4 and 4.5, for discussion in the economic and the legal literature.
[21] See *supra* Chapter Three, section 3.1.1.
[22] See how this relates to the theory of entrepreneurship in Chapter One, section 1.4.5.
[23] See *supra*, Chapter Three, section 3.4.1.
[24] See *supra*, Chapter Three, section 3.4.5.
[25] See *supra*, Chapter Five, section 5.6.1.
[26] See *supra*, Chapter Five, section 5.6.2.
[27] Zingales, L. [1998], *op. cit.*, 498.
[28] See *supra*, Chapter Three, section 3.3.1.

tive, the set of constraints (both legal and contractual) is not just intended to keep the interest of the firm's manager aligned with those of the input providers, but rather to discipline the *ex post* division of the firm's surplus in such a way as to provide the incentives to maximize its overall production.[29] Whatever allocation of residual control rights is necessary to achieve that goal, it implies that a third party who is entrusted the firm management "should not be in the position of a mere agent, who owes a duty of obedience to the principal, but should be granted the independence to act in the interest of the firm."[30]

In his work with Raghuram Rajan, Luigi Zingales argues that maximization of the firm's surplus can be achieved notwithstanding retention of residual control rights by shareholders, provided that bargaining power over the division of the same surplus also stems from access to critical resources and that access is granted by suppliers of key human capital, including the entrepreneur.[31] This would involve that shareholder value is not the only argument of the firm's objective function. Quite to the contrary, the firm should be managed in the interest of all providers of specialized assets (the so-called stakeholders).[32] For the reasons that I am just going to mention, and that I shall be more specific about in the next section, I disagree on the first conclusion; while I have already argued, in the Third Chapter, that corporate governance should be freed from consideration for stakeholders' interests.

On the one hand, human capital resources are not bound to stay critical forever. Since nobody likes the idea finding him exploited of his talent when it is no longer indispensable (he would rather refrain from investing it in the first place), at least one category of suppliers of human capital – the entrepreneurs – should be protected via residual rights of control in order to secure a non-contractible surplus.[33] Only to the extent corporate law makes such a kind of entitlements available to a non-owner entrepreneur, ownership will be allowed to separate from control.[34]

On the other hand, once shareholders are deprived of residual rights of control, they would refuse to commit their money to the firm's discretionary management in the absence of a meaningful residual claim on the firm's assets. Shareholders need then to be entitled to the firm's *entire* verifiable surplus. Any stakeholder claiming a share of the firm's profits, in return for further specialization of his assets at

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29 Zingales, L. [1998], *op. cit.*, 501-502.

30 Id., at 501.

31 Rajan, R.G. and Zingales, L. [1998], *Power in a Theory of the Firm*, in QUARTERLY JOURNAL OF ECONOMICS, vol. 113, 419-424.

32 Rajan, R.G. and Zingales, L. [2001], *The Firm As a Dedicated Hierarchy: A Theory of the Origins and Growth of Firms*, in QUARTERLY JOURNAL OF ECONOMICS, vol. 116, 805-851.

33 See *supra*, Chapter Three, section 3.5.2, and esp. note 201, for criticism of Rajan and Zingales' view in this regard.

34 See *supra*, Chapter Four, section 4.4.5, and *infra*, section 6.2, for discussion.

the entrepreneur's discretion, will have to acquire a shareholder-like claim (e.g., pay-per-performance, stock options plans, and the like). The firm should be anyway managed in the interest of shareholders.[35] Corporate law (and the corporate contract) needs also to protect such an interest from the entrepreneur/manager's misbehavior for having ownership separated from control.[36] Stakeholders' protection is better left to other areas of the law.[37]

Notwithstanding the above disagreements upon the allocation of residual control rights and the role of stakeholders in corporate governance, the view of the matter that is being presented here is very close to Zingales'. The basic idea is that corporate governance should not be merely regarded as an agency problem, but, rather, as a matter of distribution of powers and constraints on their exercise.[38] As I have repeatedly suggested, law seem to matter in both respects: as a source of legal entitlements to corporate control powers alternative to direct ownership of the firm's assets; and as a source of legal constraints on those powers that could not be reliably established by contract, and yet are needed to induce outside shareholders to place their money under the corporate controller's discretionary management.[39] Only in the latter respect, corporate law could be possibly considered as a way to reduce agency costs in a world of incomplete contracts, thereby fostering equity finance and separation of ownership and control. However, in accepting this view, one should not forget that separation of ownership and control is only allowed in the first place on condition that the corporate controller retains residual rights of control.

Until now, the latter contention has been derived by exclusion. Players and problems that standard Corporate Law and Economics fails to account for have been presented.[40] Failure of mainstream theory to explain the variety that we observe in comparative corporate governance has been highlighted.[41] It has been demonstrated that the prevailing explanation of how law 'matters' in that respect is, at best, incomplete.[42] Finally, it has been shown that the standard account of private benefits of control is too parsimonious to capture the entire range of institutional choices, at the firm level, and institutional constraints, at the country level.[43] What I

[35] See *supra*, Chapter Three, section 3.5.2.
[36] See *supra*, Chapter Four, section 4.4.4.
[37] See *supra*, Chapter Three, section 3.5.3.
[38] This matches at least one of the views of corporate governance (hereinafter CG) in the legal literature. See Cools, S. [2005], *op. cit.*
[39] See *supra*, Chapter Four, section 4.7.
[40] See *supra*, Chapter One.
[41] See *supra*, Chapters Two and Three.
[42] See *supra*, Chapter Four.
[43] See *supra*, Chapter Five (and the discussion of institutions in Chapter Four, section 4.1)

have claimed so far is that all the above inconsistencies between theory and practice of corporate governance would be overcome if we only admitted that residual control rights may be allocated to a corporate controller regardless of his ownership stake.[44] What I am now going to show is how control rights can be allocated in such a fashion also in theory, why it should be so, and what are the implications for the institutional analysis and, especially, for corporate law.[45]

6.2. Who Should Be in Charge of Corporate Governance?

6.2.1. Sources of Power Alternative to the Firm's Ownership

Let us take the property rights theory of the firm as a starting point.[46] In addition to recalling the previous discussion of economic theory in this respect, the reader should also bear in mind one *legal* circumstance: that the corporate enterprise is featured with legal personality.[47] This is often dismissed as a useless fiction in Law and Economics, but it is actually quite important to feature control over corporate assets as separated from ownership of the enterprise.[48] The firm's assets belong to the corporation, and thus who *controls* the corporation also controls its assets whether or not he *owns* the corporation. This is how *real* separation of ownership and control is *legally* possible. The next step is to assess whether it is also desirable from an economic standpoint.

In economic terms, corporate control is the ultimate authority over the allocation of non-contractible surplus (so-called quasi-rents) generated by the firm's as-

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44 See *supra*, Chapter Five, section 5.6.2, for presentation of the intuition.

45 To this purpose, I shall resort to an *informal* contract theory framework. The major advantage of this approach is that it preserves the interdisciplinary flavor of the exposition, giving also the lawyers the opportunity to say their own word. As it will be clear from the next Chapters, the intuitions underlying this work owe to comparative legal analysis as much as to the study of economic theory. As an economist, instructed in Law and Economics by two law professors and currently employed in a law faculty, I definitively believe that the benefits of interdisciplinarity largely offset the costs of a less formal (but, hopefully, not also less rigorous) analysis. Formalization of the following arguments is left for future work.

46 See *supra*, Chapter Three, section 3.3.2.

47 See *supra*, Chapter One, section 1.4.2.

48 This point has been paid increasing attention in the Law and Economics literature (see the references cited *supra*, Chapter Four, section 4.5.1.), but it has an authoritative, long-standing tradition. See, broadly, Clark, R.C. [1986], CORPORATE LAW, Little, Brown and Company.

sets.[49] As we already know, such an authority is featured by *residual rights of control*: that is, the power to decide upon any matter concerning the use of the firm's assets that have not been previously contracted upon with other providers of inputs.[50] The key issue for corporate governance is, therefore, to determine whom residual rights of control should be allocated to: to the owners, or to somebody else?

The narrow set of assumptions of the property rights theory of the firm does not allow for *real* separation of ownership and control.[51] Control should be allocated to the party most indispensable to the production process (the entrepreneur) and he should *own* the firm's assets altogether (i.e., a corporation managed by an entrepreneur should be a sole proprietorship). This solution is necessary to promote the entrepreneur's firm-specific investments, where the firm value ultimately comes from.[52] However, when this individual is wealth-constrained, risk-averse, and has a limited capacity to borrow (i.e., he needs equity finance), the problem becomes more complicated. Apparently, it can only be solved by allowing for *delegation of authority* from the corporate owners (the shareholders) to some professional managers.[53] *Management* only, but not also *formal control*, should be then separated from ultimate ownership of the firm's assets.[54] Unfortunately, this solution does not allow for firm-specific investments to be undertaken by the managers, but only by shareholders irreversibly committing their resources to the firm.[55] Managers cannot play thus any entrepreneurial role under the property right theory of the firm.

However, recent advances in economic theory have shown that ownership is not the only possible source of power over the *ex post* allocation of the firm's quasi-rents and, therefore, not the only possible source of authority within a firm.[56] In many circumstances of today's real world, ownership seems even not to be the most important one (like, for instance, in many high-tech enterprises).[57] According

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[49] See *supra* Chapter Three, section 3.3.

[50] See *supra*, Chapter One, section 1.1.2.

[51] Hart, O. [1989], *An Economist's Perspective on the Theory of the Firm*, in COLUMBIA LAW REVIEW, vol. 89, 1757-1774.

[52] See *supra*, Chapter Three, section 3.3.2.

[53] See *supra*, Chapter Three, section 3.4.1.

[54] Hart, O. [1995], FIRM, CONTRACTS, AND FINANCIAL STRUCTURE, Oxford University Press.

[55] See *supra*, Chapter Five, section 5.6.1, for discussion of how the recent literature has attempted to cope with this problem, through a state-contingent allocation of control rights (Burkart, M., Gromb, D. and Panunzi, F. [1997], *Large Shareholders, Monitoring, and the Value of the Firm*, in QUARTERLY JOURNAL OF ECONOMICS, vol. 112, 693-728; and Hart, O. [2001], *Financial Contracting*, in JOURNAL OF ECONOMIC LITERATURE, vol. 39, 1079-1100).

[56] This is based on the work by Raghuram Rajan and Luigi Zingales. For a non-technical, but rather comprehensive illustration, see Zingales, L. [2000], *op. cit.*

[57] Rajan, R.G. and Zingales, L. [2000], *The Governance of the New Enterprise*, in X. Vives (ed.), CORPORATE GOVERNANCE: THEORETICAL AND EMPIRICAL PERSPECTIVES, Cambridge University Press, 201-232.

to Raghuram Rajan and Luigi Zingales, a broader definition of the source of authority is the right to provide *access to a critical resource*.[58] As long as some of these resources cannot be 'owned', this leads to a source of power alternative to ownership.

Human capital is the case in point. By having to grant access to a human capital resource in every single period, *provided the same resource remains irreplaceable*, the individual gains power within the organization.[59] This, in turn, provides him with incentives to specialize over time, which are even more powerful than those coming from ownership.[60] This approach has two major implications: a) there can be multiple sources of power in the organization of the firm, challenging the owner's residual rights of control; b) the firm's control need not necessarily to arise from ownership of its key physical assets.

While the first implication seems to yield quite promising results for the analysis of the employment relationships within a firm (leading eventually to a 'new' theory of business organizations), the second one could finally explain why firm control matters so much, and yet it can be separated from ownership (leading eventually to a 'new' theory of entrepreneurship and corporate governance).[61] Unfortunately, neither of the two above theories has yet been developed in any comprehensive fashion. Given the importance of firm control for understanding corporate governance, we cannot escape from dealing with the second matter here.

6.2.2. Featuring a Non-Owner Entrepreneur

The intuition that control need not arise from ownership is of fundamental importance. Eventually, some degree of separation between ownership and control will be needed for the firm's growth, but this does not necessarily involve that entrepreneurship become suddenly 'unimportant.'[62] In the above perspective, the en-

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[58] Rajan, R.G. and Zingales, L. [1998], *op. cit.*

[59] Rajan, R.G. and Zingales, L. [2001], *op. cit.*

[60] Since the owner is entitled to determine access now and in the future, he will have no incentive to further specialize his assets once he is in charge. Rajan, R.G. and Zingales, L. [1998], *op. cit.*, 406-413.

[61] Zingales, L. [2000], *op. cit.*

[62] Hart, O. [1995], *op. cit.*, 126 ("I take the point of view that in the case of a public company the issue of allocating control rights to managers in order to give them a chance to enjoy private benefits may not be of primary importance"). The author explicitly considers the problem of managerial reward in the form of private benefits in Hart, O. [2001], *op. cit.* However, the solution he provides is not based on allocation of control rights to others than financiers, but rather on a theory of dividends based on irregular payments. This should tackle unforeseen contingencies affecting the corporate contract. I find this view not entirely convincing. On the one hand this contradicts the em-

trepreneur could in fact retain control, even without ownership, until he keeps power over the access to the critical resource around which the firm is built.[63] However, as I am going to show, this power would be merely temporary, and therefore it does not guarantee that specific investments in human capital are made *ex ante* by a non-owner entrepreneur.[64]

To make the discussion more intuitive, I shall refer to this firm-specific critical resource as to entrepreneurial/managerial talent. There are two requirements for the exploitation of this resource: discretion and reward. *Discretion* is needed to transform the subjective talent into objective firm value, without having to incur in a huge amount of transaction costs contracting for complementary resources. *Reward* is needed as an incentive for the entrepreneur to concentrate efforts on managing the firm at his best, namely to invest and specialize his human capital over time without risk of being subsequently held up. To this purpose, reward has to be contingent on the firm's success and must be open-ended. Since the exercise of discretion cannot be contracted for by definition, its prospective reward is likewise non-contractible.[65]

With full ownership, a talented entrepreneur gets both discretion (residual rights of control) and open-ended prospective reward (residual claim). Without ownership he risks getting none of them. To be sure, discretion can be granted to the entrepreneur even without ownership, but just at the owner's will and on a *temporary* ba-

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pirical evidence that dividends are smooth and regular (Id., at 1098, also acknowledge that, but claims that "recent evidence suggests that things are changing"). On the other hand, the empirical evidence also suggests that changes in control are a significant part of corporate control's reward, and this can only be explained by an allocation of control rights favoring incumbent management. Oliver Hart has always suggested that this could be a promising venue for future research, but apparently he has never taken up on his own invitation. I am doing it, and will explore this intuition in what follows.

63 This perspective is effectively based on allocation of control powers, although the source of such powers is considered to be extralegal (i.e., residual rights of control are not allocated to any constituency other than the owners). Rajan, R.G. and Zingales, L. [1998], *op. cit.*, 404-426.

64 In the spirit of Williamson, O.E. [1991], *Comparative Economic Organization: The Analysis of Discrete Structural Alternatives*, in ADMINISTRATIVE SCIENCE QUARTERLY, vol. 36, 269-296, Rajan and Zingales solve this problem through the features of the firm organization. Rajan, R.G. and Zingales, L. [2001], *op. cit.* Their solution is based on a pattern of *internal growth*. As such, it is more suitable to a theory of business organizations than to combining the analysis of CG with consideration for entrepreneurship. I am speculating on a different solution, which is rather based on a pattern of *external growth* through the corporate acquisition process. However, as I am going to show, residual rights of control are necessary in order to feature protection of entrepreneurial rents in this process, and therefore they cannot be allocated to shareholders. For a more detailed discussion of how this perspective differs from Rajan and Zingales', see *supra*, Chapter Three, section 3.5.2., esp. note 201.

65 This is a quite straightforward consequence of the incomplete contracts perspective. See Zingales, L. [1998], *op. cit.*

sis. This is what is ultimately meant for by delegation of firm (corporate) control. However, delegation also involves that the entrepreneur has no *ex post* bargaining power to secure any share of the surplus not previously contracted for (his prospective reward).[66] As a result, no entrepreneurial talent will be invested in the first place. Let us see why.

At the beginning, it is in the owners' interest to let the entrepreneur do his job. This will hold until the owners believe sufficient results are achieved and can be maintained *without* the entrepreneur's contribution (or they simply realize there will never be any such result). Afterwards, they can easily get rid of the entrepreneur, since by then they will own a valuable (or an almost bankrupt) firm, while he will own just his exploited talent which is no longer needed for the firm's success.[67] Of course, no entrepreneur would ever accept to play such a game. *Mutatis mutandis*, there is no reason why this should be different for a talented manager to be hired at a later stage of the firm's lifecycle.

Therefore, in a world of incomplete contracts, the entrepreneur/manager cannot be merely regarded as an agent of who ultimately owns the firm's physical assets. Discretion is misplaced when you cannot secure enough benefits from its exercise.[68] When entrepreneurial discretion is delegated by the owners, its reward can neither be contracted upon *ex ante* nor bargained for *ex post*. On the one hand, entrepreneurial initiative is surrounded by too much uncertainty for being fully priced *ex ante*. The entrepreneur himself does not *know ex ante* whether he will be successful, and to what extent – although, as we will see shortly, he may have some subjective *beliefs* on the above matters. On the other hand, without residual control rights, there seems to be no way for the entrepreneur to secure his reward *ex post*, namely when the initiative has proven successful, access to the entrepreneurial resource is no longer critical, and then somebody else can take over. At least in this context, delegated discretion is in fact no discretion at all.[69]

In order to adequately combine entrepreneurial discretion and reward, our non-owner entrepreneur should be in charge. Delegation of control, if any, should be *irrevocable* without the entrepreneur's consent.[70] In particular, his discretion needs to

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66 See, in a similar vein, Burkart, M., Gromb, D. and Panunzi, F. [1997], *op. cit.*

67 Aghion, P. and Bolton, P. [1992], *An Incomplete Contracts Approach to Financial Contracting*, in REVIEW OF ECONOMIC STUDIES, vol. 59, 473-494, frame the problem in similar terms, although they focus on bankruptcy as the institutional underpinning of an incomplete contracts theory of debt.

68 Zingales, L. [1998], *op. cit.*

69 Id., at 498-499. Many other students of CG have also reached this conclusion. See, e.g., Dooley, M.P. [1992], *Two Models of Corporate Governance*, in THE BUSINESS LAWYER, vol. 47, 461-527; and Rock, E.B. and Wachter, M.L. [2001], *op. cit.*

70 Schnitzer, M. [1995], *'Breach of Trust' in Takeovers and the Optimal Corporate Charter*, in JOURNAL OF INDUSTRIAL ECONOMICS, vol. 43, 229-259.

cover the decision on whether, when, and at what price control over the assets should be transferred back to the owners. As we already know, this basically means *entrenchment of corporate control*. Entrenchment of his controlling position is in fact the only way in which the entrepreneur can secure the reward of his specific investments through *ex post* bargaining power over an eventual control sale.[71]

The constraint on the identity of the transferee is intended to make sure that, whenever control is transferred, the source of the entrepreneur's reward comes from the owners, thereby inducing him to increase the value of the residual claim on the firm's assets.[72] However, this is clearly not enough to rule out the entrepreneur's misbehavior. On the one hand, there is no guarantee the entrepreneur will *ever* part with control and not, rather, keep staying in charge while maximizing something else than the firm's profits (a typical agency problem).[73] On the other hand, even if control were ever transferred, the entrepreneur would be entitled to claim the whole of the firm's surplus from now powerless owners (a typical hold-up problem). Of course, no owner would ever be willing to sign such a contract.

6.2.3. Shared Ownership and Private Benefits of Control

A possible way out of this impasse would be a rule setting *ex ante* the pro-rata sharing of the firm's surplus between the entrepreneur and the owners.[74] This could be achieved by granting the controlling entrepreneur compensation fully contingent on the future realization of the firm's profits (think, for instance, to a stock options plan).[75] Notice that this solution corresponds to the award of a share of the owners' residual claim. Thus, it is roughly equivalent to shared ownership, provided the en-

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71 Almazan, A. and Suarez, J. [2003], *Entrenchment and Severance Pay in Optimal Governance Structures,* in JOURNAL OF FINANCE, vol. 58, n. 2, 519-47 (who, however, argue that this arrangement is efficient only under certain conditions).

72 This is the economic rationale of prohibitions of sale of office. See *supra*, Chapter Five, section 5.5.2 (esp. authorities cited at note 174). The importance of this requirement will become clearer in the subsequent analysis of corporate control transactions. See below, Chapter Ten, section 10.2.1.

73 Mayer, C. [1999], *Firm Control*, Inaugural Lecture at the University of Oxford (February 18, 1999), available at www.finance.ox.ac.uk, as published in J. Schwalbach (ed.) [2001], CORPORATE GOVERNANCE: ESSAYS IN HONOR OF HORST ALBACH, Springer-Verlag.

74 This is the traditional solution in a principal-agent setting. Jensen, M.C. and Meckling, W.H. [1976], *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 3, 305-360.

75 See Bratton, W.B. and McCahery, J.A. [2001a], *Incomplete Contracts Theories of the Firm and Comparative Corporate Governance*, in THEORETICAL INQUIRIES IN LAW, vol. 2, n. 2, *Protecting Investors in a Global Economy*, 14-15, for a discussion of this solution and of its practical shortcomings in an incomplete contracts perspective.

trepreneur's stake is always sold back to the owners whenever control returns to them.

In theory, one should be able to find a sharing rule apt to induce both the entrepreneur and the owners to invest *ex ante*. *Ex post*, such a compensation scheme would provide the entrepreneur with the incentive to both maximize the firm's profits and walk away with his reward once he cannot increase any further the value of his share of the residual claim. Since we are implicitly assuming no further surplus is to be divided, this solution would leave no room for *ex post* bargaining.[76]

This approach has a major shortcoming, which makes it just a partial solution to the problem. It is in fact a complete contracting approach.[77] It should be noticed that the way in which the award of a residual claim to the entrepreneur affects his incentive to invest his talent is *independent of* the allocation of residual rights of control. Owners could keep staying in control of the firm's assets, while taking a credible commitment not to remove the entrepreneur until they can profitably take over, paying him the stipulated share of firm value realized so far. As a result, similarly to the standard principal-agent approach to corporate governance, control does not really matter. This would work perfectly if the entrepreneur's capabilities and effort were entirely *observable* through firm performance.[78] Being the latter a *verifiable* variable, a long-term profit sharing contract (so-called 'pay-per-performance') would provide the optimal solution. However, firm performance is typically a *noisy* signal of the manager's investment.[79] There is always a part of managerial skills that is neither observable *ex ante* nor verifiable *ex post*, and therefore is not contractible.

More precisely, the exercise of managerial skills might uncover some business opportunities that become observable over time, but get verifiable only at a later stage. In the meantime, the same opportunities are up for grabs.[80] In the absence of alternative property rights protection (e.g., through the patent system), the reward of entrepreneurial innovation cannot be secured through a share of the residual claim on the firm's assets. Such an innovation will become eventually observable but not verifiable yet, and consequently it will not be reflected in objective firm value (the stock price).[81] Its reward requires that the entrepreneur retain not just a pro-rata residual claim, but residual rights of control on the firm's assets. Indeed,

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76 Zingales, L. [1998], *op. cit.*

77 See Myerson, R. [1979], *Incentive Compatibility and the Bargaining Problem*, in ECONOMETRICA, vol. 51, 1767-1797, for a comprehensive illustration of this point.

78 Laffont, J.-J. and Tirole, J. [1988], *Repeated Auctions of Incentive Contracts, Investments, and Bidding Parity with an Application to Takeovers*, in RAND JOURNAL OF ECONOMICS, vol. 19, 516-537.

79 Id., at 530. However, Almazan, A. and Suarez, J. [2003], *op. cit.*, argue that noisiness of firm performance is not always a sufficient reason to reward management through control rents.

80 Schnitzer, M. [1995], *op. cit.*

81 Laffont, J.-J. and Tirole, J. [1988], *op. cit.*

the unverifiable part of entrepreneurial talent is a source of control (quasi) rents.[82] When the entrepreneur loses control over the firm's assets, those rents are likewise lost. Therefore, if the entrepreneur is unable to safeguard his controlling position over time, he will not be willing to make specific investments whose results are not promptly verifiable.[83]

In the foregoing discussion, the above control rents have been characterized as idiosyncratic private benefits of control. As we already know, by definition, any effort intended to pursue such a kind of PBC is not reducing the verifiable part of firm value, but is not yet increasing it either. Meanwhile, idiosyncratic PBC are only accruing to the entrepreneur's (subjective) expected utility, as a byproduct of the firm's success. One could think, for instance, to the pride of establishing a successful and outliving firm.[84] For the moment, I am assuming the entrepreneur cannot reap any different kind of private benefits from the firm's control. We know this is not true, and that diversionary and distortionary PBC are also at play in corporate governance.[85] I shall add consideration for these other instances of PBC from the next section.

There are theoretically two possible ways for the entrepreneur to cash in the value of his idiosyncratic PBC. One is to work hard for the transformation of idiosyncratic PBC into objective (i.e., verifiable) firm's revenues, thereby increasing the value of his share of the residual claim.[86] The second, more promising way is to sell

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82 Schnitzer, M. [1995], *op. cit.*, characterizes these as information rents depending on managerial skill. This slightly different characterization has an impact on formalization, but does not affect the substance of the reasoning.

83 This is how Laffont, J.-J. and Tirole, J. [1988], *op. cit.*, interpret the problem of management short-termism in the governance of public companies. They advocate a case for managerial resistance to hostile takeover on this basis.

84 Mayer, C. [1999], *op. cit.*, 8, illustrate this with a very efficacious historical example:

> "In 1863, Werner Siemens wrote to his brother, Carl, of his long-standing ambition to 'build up an enterprise which will last, which may perhaps one day under the leadership of our boys become an enterprise of world renown like that of the Rothschilds and make our name known and respected in many lands…..For this great plan the individual, if he regards the plan as good, should be prepared to make sacrifices.' 136 years later, Siemens AG would appear to have fulfilled Werner Siemens' ambitions." (Footnote omitted).

85 See *supra*, Chapter Five.

86 However, this will never be sufficient to counter the tendency to shirk. As shown by the agency approach, separation of ownership and control can only lead to second best outcomes. See Jensen, M.C. and Meckling, W.H. [1976], *op. cit.* This result holds also if we depart from the agency framework. Suppose that diversionary PBC are ruled out by the legal system. In the absence of full ownership (or, alternatively, of a perfectly state-contingent managerial compensation), sharing with non-controlling shareholders the entire observable surplus as a verifiable profit stream will be still dominated by the consumption of some (unverifiable) distortionary PBC by the corporate controller. The importance of this qualification will become clearer in the next section.

control back to the owners, as soon as they can hire a new manager with better skills at producing verifiable value by controlling the firm's assets. Alternatively, the entrepreneur could sell control to the same manager after the latter has bought out the ownership of the firm – which comes closer to how takeovers actually work. The implementation of any of these strategies requires residual rights of control.[87]

Idiosyncratic PBC may ultimately result in a sizeable increase of firm value. However, without residual rights of control, idiosyncratic PBC cannot be appropriated by the entrepreneur. If the owners have residual rights of control, they can fire the entrepreneur anytime by just paying the current value of his share of the residual claim (the entrepreneur would lack the bargaining power to obtain anything more than that).[88] This means that eventually the owners (or the talented manager they will hire) will be able to exploit the business opportunities uncovered by the entrepreneur (observable but not verifiable), without having to pay any premium in return for his PBC. While this would be *ex post* efficient (control would always end up being allocated to the best manager), it would not be efficient also *ex ante*.[89] Without the possibility to secure PBC, less business opportunities (or none at all) would be uncovered by the entrepreneur. In other words, the unavailability of residual rights of control to the entrepreneur tends to kill entrepreneurial innovation.

Allocation of residual rights of control to the entrepreneur would solve the problem. Unfortunately, this solution has also adverse effects. Indeed, the controlling entrepreneur can entrench himself and hold up the owners in any subsequent control transaction. An inefficient outcome might then arise: the entrepreneur might be unwilling to part with control, unless he gets not only the idiosyncratic value of his PBC but also the extra surplus from the change in control. Apparently,

[87] This is pretty well understood by lawyers. See, e.g., Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, and Cools, S. [2005], *op. cit.* In Corporate Law and Economics, this issue was raised much earlier than the development of the incomplete contracts literature. See Carney, W.J. [1988], *Controlling Management Opportunism in the Market for Corporate Control: An Agency Cost Model*, in WISCONSIN LAW REVIEW, vol. 1988, 415-424 (who characterizes the problem of appropriable quasi-rents in terms of agency costs). In contemporary economics, the problem of appropriation of managerial quasi-rents is a prominent consequence of incompleteness of the contract between controllers and non-controlling shareholders. With the notable exception of Rajan, R.G. and Zingales, L. [2001], *op. cit.*, most economic models of changes in control taking managerial quasi-rents into account posit allocation of control rights to the incumbent management, whether they explicitly allow for renegotiation (Almazan, A. and Suarez, J. [2003], *op. cit.*; Schnitzer, M. [1995], *op. cit.*) or they don't (Laffont, J.-J. and Tirole, J. [1988], *op. cit.*).

[88] Almazan, A. and Suarez, J. [2003], *op. cit.*

[89] Schnitzer, M. [1995], *op. cit.*, very clearly highlights this tradeoff.

this could lead to a suboptimal frequency of efficient transfers of control (or even to none of them).[90]

However, from the entrepreneur's standpoint, the advantages of a hold-up strategy must be traded off against its negative effects on the cashable value of his share of the residual claim. Given that the entrepreneur now has bargaining power over the control transfer, that share must not be sold at current value, but can be sold at a premium on condition that the transfer does actually take place.[91] Since I am assuming that the controlling entrepreneur knows he cannot enrich himself by any amount larger than his PBC, while I am hypothesizing the owners can further increase firm value by appointing a new manager, the division of the extra surplus will be bargained for between the parties, and the transfer will take place anyway. In this scenario, the only transfers that do not take place are those whose surplus does not exceed the incumbent entrepreneur's PBC.[92] To the extent the latter are due to incorrect beliefs of the entrepreneur about his own managerial capabilities, some efficient control transfers would be always foregone. This is, however, the price to pay for fostering entrepreneurial innovation.

This overly simplified scenario will have to be qualified in the following discussion. However, the basic intuition holds: when residual rights of control are allocated to the incumbent entrepreneur retaining an equity interest in the firm, the only changes in control that do not take place are those whose transaction surplus does not exceed the value of his PBC.

6.3. Management Entrenchment and a Workable Market for Corporate Control

6.3.1. Is Entrenchment Necessarily Inefficient?

The mechanism that I have just introduced for promoting entrepreneurial incentives, notwithstanding separation of ownership and control, is based on the corpo-

[90] This result would obtain under the assumption of perfect competition on the buyers' side. However, the market for corporate control hardly has this feature. See Zingales, L. [1995], *Insider Ownership and the Decision to Go Public*, in REVIEW OF ECONOMIC STUDIES, vol. 62, 425–448, for illustration of the consequences of imperfect competition on bargaining over control rents.

[91] See Almazan, A. and Suarez, J. [2003], *op. cit.*, for a similar approach to control sales.

[92] See Schnitzer, M. [1995], *op. cit.* (who derives this result from bargaining over the management's information rents).

rate controller's ability to entrench himself. Entrenchment involves that corporate control be not contestable. As a result, the market for corporate control cannot allow for hostile takeovers. However, this does not exclude that the market for corporate control could work in some other way.[93]

Takeovers need not be hostile. They can also be friendly. As I have shown, hostile takeover is the exception in corporate practice, whereas friendly takeover is the rule.[94] Compared to hostile takeover, allocation of corporate control through friendly takeover is based on the *opposite* assignment of residual rights of control.[95] When residual rights of control are assigned to the corporate controller instead of to outside shareholders, the former is entitled to protect his idiosyncratic control rents: control cannot be transferred without his consent.[96] This arrangement eliminates the major disadvantage of separation of ownership and control from the entrepreneur/manager's standpoint: the risk of being subsequently taken over against his will and expropriated of his control rents thereby.

However, outside shareholders' point of view should also be taken into account. In an agency-like perspective – that was temporarily disregarded in the foregoing discussion – non-controlling shareholders worry about the distortionary and diversionary PBC that a corporate controller could extract at their expenses. Previous analysis of hostile takeovers has already delivered two important results concerning diversionary PBC.[97] First, hostile takeovers are not very helpful to police the extraction of diversionary PBC, since the aggressor might simply be a better thief than the incumbent is (the so-called 'looting' argument). Second, hostile takeovers are anyway disallowed in the presence of stealing opportunities available to the incumbent management: no good thief would ever leave his treasure up for grabs, once he sits on it (the so-called inefficient rent-protection argument). Since no regret for hostile takeovers seem to be justified just by the presence of diversionary PBC, let me set them aside for the moment. The following analysis will show that diversion-

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[93] This approach parallels Hellwig, M. [2000], *op. cit.*, who also observes that hostile takeovers are in fact most often disallowed in the corporate practice. Although he does not discuss this result from a normative standpoint, he also claims that the ultimate efficiency of corporate governance and corporate finance depends on the market for corporate control.

[94] See *supra*, Chapter Two, section 2.4, and Chapter Three, section 3.4.4.

[95] See, e.g., Schnitzer, M. [1996], *Hostile versus Friendly Takeovers*, in ECONOMICA, vol. 63 (New Series), 37-55.

[96] For a non-technical discussion, see Coates, J.C. IV [2003], *Ownership, Takeovers and EU Law: How Contestable Should EU Corporations Be?*, ECGI Law Working Paper No. 11/2003, available at www.ssrn.com and www.ecgi.org, as published in E. Wymeersch and G. Ferrarini (eds.) [2004], COMPANY AND TAKEOVER LAW IN EUROPE, Oxford University Press.

[97] See *supra*, Chapter Five, section 5.5.

ary PBC bears no different relationship with friendly takeovers and thus they should be policed otherwise.

What about distortionary PBC? Once the corporate controller is entrenched, he might just play with the firm's assets. Outside shareholders might then regret hostile takeovers. Indeed, one might doubt that a market for corporate control based on friendly takeover could play any role in both inducing managerial effort (*disciplinary* function of hostile takeover, policing moral hazard) and replacing inefficient managers with more capable ones (*allocative* function of hostile takeover, dealing with adverse selection).[98] Apparently the outcome would be quite the reverse: incumbent managers would hold on their positions, keeping (if not increasing) their private benefits from misuse of free cash while refusing to surrender control to a more efficient manager.[99]

This is the so-called 'management entrenchment hypothesis.'[100] According to the standard view of corporate governance, when the corporate controller is entitled to shield himself from hostile takeover (i.e., he is entrenched), shareholders lose twice. First, their shares are worth less because of excessive distortionary PBC being enjoyed by the corporate controller. Second, they forego the opportunity of profitable tender offers by more efficient managers willing to take over.

As I am going to show, both conclusions are premature.[101] Counterintuitive as it might appear, the corporate controller's entrenchment can result in a constrained-

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98 See *supra*, Chapter Five, section 5.5.2. For a broader illustration, see Becht, M., Bolton, P. and Röell, A. [2002], *Corporate Governance and Control*, ECGI Finance Working Paper No. 02/2002, available at www.ssrn.com and www.ecgi.org, as published in G. Constantinides, M. Harris, and R. Stulz (eds.) [2003], HANDBOOK OF ECONOMICS AND FINANCE, North-Holland.

99 Jensen, M.C. [1986], *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, in AMERICAN ECONOMIC REVIEW, vol. 76, 323-329.

100 See Schnitzer, M. [1995], *op. cit.*, 229-232, for discussion of this hypothesis; and Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 30, for a reply.

101 The following discussion parallels and extends the results of a few previous studies on entrenchment of corporate control. Some of them argue, in opposition to Jensen and Meckling's complete contracting model, that managerial entrenchment is necessary to achieve the second best when the corporate contract is incomplete – the first best conditions of incentive alignment being unattainable in a world of uncertainty (Schnitzer, M. [1995], *op. cit.*). Others claim that takeover resistance is likewise a second best outcome, where bidding competition is restricted at the takeover stage in order to promote unobservable investments by the management at the setup stage (Laffont, J.-J. and Tirole, J. [1988], *op. cit.*). Finally, another study derives the optimality of management entrenchment on the basis of minimization of the overall burden of managerial compensation to shareholders. (Almazan, A. and Suarez, J. [2003], *op. cit.*).
All of these studies are derived as private optimality of contracts between incumbent management and existing shareholders. As such, they may be challenged from a social welfare standpoint in at least two ways. One is the introduction of stakeholders in the framework (see, e.g., Shleifer, A. and Summers, L.H. [1988], *Breach of Trust in Hostile Takeovers*, in A.J. Auerbach (ed.), CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES, University of Chicago Press). However – as I explained

efficient outcome: that is to say, the most efficient result in terms of both incentives to managerial effort and dynamic allocation of corporate control, subject to the constraint of protection of idiosyncratic control rents.[102]

6.3.2. An Alternative to Hostile Takeovers: Cashing in Idiosyncratic Private Benefits of Control

When the corporate controller is able to entrench himself, what prevents efficient control transfers from taking place is the amount of PBC: they have to be compensated for the incumbent manager to part with control. However, this may be less problematic than it appears at first glance. As I suggested in the last Chapter, the market for corporate control can also be understood as an application of the Coase Theorem – although this is not how the mainstream theory tends to approach it.[103] Here comes the importance of that insight. Shareholders (or, directly, a

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in Chapter Three, section 3.5.3 –, the problem of externalities on stakeholders has little to do with separation of ownership and control, and it should not enter the analysis of corporate governance. A second challenge to efficiency of control entrenchment is not so easy to dismiss, provided that welfare analysis is based on shareholder value. Indeed, in a dynamic perspective, also insurgent controllers (i.e., prospective riders) and future shareholders should be considered. The only study that – at least to my knowledge – has attempted this inclusion so far is Bebchuk, L.A. and Zingales, L. [2000], *Ownership Structures and the Decision to Go Public: Private versus Social Optimality*, in R. Morck (ed.), CONCENTRATED CORPORATE OWNERSHIP, NBER Conference Volume, University of Chicago Press, 55-75 (also available as NBER Working Paper No. 5584). They demonstrate that insiders' entrenchment emerges as a privately optimal strategy, which unfortunately is socially inefficient. Neither entrepreneurs nor existing shareholders take the interest of newcomers into account, and this leads to the probability of efficient takeovers being lower than the social optimum. I am going to show that the harshness of this outcome depends on quite restrictive assumptions about information of the players, which are not verified in real-world corporate governance. Instead, I will suggest that, when this assumption is removed, the outcome is bound to be constrained-efficient in a multiple-stage sequence of changes in control. This result is derived under a major hypothesis about the dynamics of idiosyncratic PBC across the firm lifecycle, which is consistent with the theory of entrepreneurship. See *infra*, section 6.4.3.

102 Zingales, L. [1998], *op. cit.*, also contends that outcomes of CG are, at best, constrained-efficient. However, he does not consider rewards to entrepreneurship to be the only source of constraint. Constrained efficiency is a way to look at the second best problem in an incomplete contracts perspective. Crudely speaking, it is the solution of a tradeoff between *ex ante* and *ex post* efficiency. See Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 16, for a specific application to corporate governance. On the problem of second best see, in general, Lipsey, R.G. and Lancaster, K. [1956], *The General Theory of Second Best*, in REVIEW OF ECONOMIC STUDIES, vol. 24, 11-32.

103 See *supra*, Chapter Five, section 5.5.1. Shleifer, A. and Vishny, R. [1997], *op. cit.*, 743-744, also consider this as a possible solution, but they dismiss it on grounds that it would be irreconcilable with the management's fiduciary duties to shareholders. They claim that the ultimate rationale of these duties is to avoid an outcome where managers constantly threaten shareholders in order to be

manager who buys the company's stock) could offer to the incumbent manager a *side payment* to compensate his loss of PBC due to the control transfer. To the extent that the latter brings about gains from trade sufficient to offset the incumbent's PBC, efficient reallocation of corporate control will take place also when hostile takeovers are ruled out and friendly takeovers are the only way to implement changes in control.[104]

Intuitively, in this scenario, some efficient control transfers would be foregone. They would be at least those ones whose efficiency gains are not sufficient to compensate the incumbent's PBC.[105] This is not necessarily inefficient. After all, *ex post* protection of control rents is what induces the entrepreneur/manager to invest his talent *ex ante*.[106] In a dynamic perspective, what determines the efficiency of the outcome, in terms of both managerial effort and allocation of control, is rather the evolution of the firm's ownership structure (separation of ownership and control).[107] As we are about to see, this depends, in turn, on both the amount and the kind of PBC involved.

Like in the hostile takeover scenario, I am not considering *diversionary PBC* here. Provided that stealing is a purely pecuniary transfer, it would not hinder efficient control transactions in a friendly takeover regime. However, in the absence of legal constraints on expropriation by the corporate controller, stealing would make those transactions unattractive to outside shareholders: the higher the firm value, the more can be stolen from non-controlling shareholders. In addition, not differently from the case of hostile takeover, diversionary PBC would allow also for inefficient control transactions to take place: control could easily end up being allocated to the *best thief* instead of the best manager.[108] Looting may actually occur whether or not

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bribed. This perspective, which is quite popular among the economists involved in the study of corporate governance, is based on a fundamental misunderstanding of fiduciary duties. As I have already shown, the mistake depends on confusion between allocation and regulation of control rights (see *supra*, Chapter Five, section 5.6.2). Fiduciary duties only deal with the second aspect (see *infra*, Chapter Eight) and, on condition that no expropriation of non-controlling shareholders is involved, there is no reason why they should interfere with Coasian bargaining (see *infra*, Chapter Ten, section 10.4.2). See Carney, W.J. [1983], *Shareholder Coordination Costs, Shark Repellents, and Takeout Mergers: The Case against Fiduciary Duties*, in AMERICAN BAR FOUNDATION RESEARCH JOURNAL, vol. 1983, 341-392, for quite a similar view in Corporate Law and Economics.

104 See, most prominently on this account, Schnitzer, M. [1995], *op. cit.*

105 Almazan, A. and Suarez, J. [2003], *op. cit.*

106 Schnitzer, M. [1995], *op. cit.*

107 This is precisely what the present work adds to the existing literature on the economics of corporate governance.

108 Bebchuk, L.A., Kraakman, R.H. and Triantis, G. [2000], *Stock Pyramids, Cross-Ownership, and Dual Class Equity: the Mechanisms and Agency Costs of Separating Control from Cash-flow Rights*, in R. Morck (ed.), CONCENTRATED CORPORATE OWNERSHIP, NBER Conference Volume, University of Chicago Press, 295-315.

hostile takeovers are allowed, and need to be policed otherwise.[109] Therefore, scope for diversionary PBC does not only limit the entrepreneur's ability to raise equity finance *ex ante*; it also compromises the efficient allocation of corporate control *ex post*.[110] One might recognize the standard 'law matters' argument here. In the absence of appropriate constraints on shareholders expropriation, ownership cannot easily separate from control.[111] This proposition holds regardless of the character of takeovers.

The above-mentioned constraints need to arise from an external set of rules, which – consistently with the 'law matters' thesis – are mostly legal in character. Clearly, as far as stealing is concerned, Coasian bargaining could not lead to any improvement in the allocation of corporate control: provided that diversionary PBC are already a pecuniary transfer from shareholders to any corporate controller, side payments would of course be of no help.[112] To see how these payments affect the functioning of the market for corporate control I will therefore assume, from now on, that stealing purposes are ruled out of control transactions and, consequently, control transfer can only be efficiency enhancing (or, at worst, neutral in this respect).[113]

Side payments are extremely helpful as far as *idiosyncratic PBC* (which cannot be transferred, by definition) are concerned.[114] When the efficiency gains from the acquisition are sufficiently large, shareholders can 'bribe' the manager to give up control and its rents, and still be better off. As we already know, the reason why the manager should accept the bribe is that the acquisition would also increase the value of his share of the residual claim more that he would be able to do.[115] This can be illustrated by the example of anticipated vesting of stock options plans. In the hypothesized situation, 'selling' the residual claim by having all stock options

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[109] This argument has a long-standing tradition in Corporate Law and Economics. See Easterbrook, F.H. and Fischel, D.R. [1982a], *Corporate Control Transactions*, in YALE LAW JOURNAL, vol. 91, 698-737.

[110] See *infra*, section 6.4.4.

[111] See *supra*, Chapter Four, for a comprehensive discussion.

[112] Inefficiencies of corporate governance, which arise *ex ante* from purely redistributive behaviors occurring *ex post*, are nicely illustrated by Fox, M.B. and Heller, M.A. [2006], *What Is Good Corporate Governance?*, in M.B. Fox and M.A. Heller (eds.), CORPORATE GOVERNANCE LESSONS FROM TRANSITION ECONOMY REFORMS, Princeton University Press, 3-31.

[113] The reader will recall that this last consequence arise from the friendly character of takeovers, on condition that looting is otherwise policed by corporate law (see *supra*, Chapter Five, section 5.5.2.). In other words, I am assuming that legal constraints on diversionary PBC are effective enough to avoid control transactions that reduce firm value. This point will be further elaborated upon *infra*, in Chapter Ten, where the legal strategies most suitable for achieving this goal will also be discussed.

[114] This is a prominent consequence of idiosyncrasy. See *supra*, Chapter Five, section 5.5.1.

[115] See *supra*, section 6.2.3.

vested, accepting the bribe, and parting with control, is the most profitable option for a manager facing a (significantly) more skilled colleague.

This simple mechanism still does not guarantee that incumbent managers will maximize their effort in firm management. Provided that profit sharing is never sufficient to perfectly align managerial incentives with shareholder interest, managers will always shirk to a certain extent. A side payment from shareholders will make sure that the incumbent manager yields to a more efficient one, when the latter is able to compensate the former for the loss of his position: the incumbent manager will get his full reward without need to work anymore. However, this *ex post* side payment would provide no incentive to work harder. Until the incumbent manager stays in charge, it seems that he would prefer enjoying *distortionary PBC* to enhancing firm value.

6.3.3. Severance Payments as a Way to Reduce Managerial Shirking

The disciplinary function of hostile takeovers on managerial shirking is based on stick: the threat of ouster. Friendly takeovers may achieve a similar result, yet based on carrot: the prospective increase in deferred compensation for the controlling position. A process of dynamic allocation of corporate control based on negotiated transfer can also help to reduce distortionary PBC. To this purpose, the incumbent manager needs always to be granted a reward for his initial investment (idiosyncratic PBC) in case of change in control. On top of this, the expected proceeds of an eventual control sale should be allowed to *increase* further with managerial effort. Both conditions can be fulfilled through an appropriate setting of side payments from shareholders to the incumbent manager, in case of control transfer.[116] These payments are in fact very common in the corporate practice. I am referring to severance payments, better known as the managers' *golden parachutes*.

[116] This is a major achievement of the economic theory of managerial entrenchment, and it owes to the work by Almazan, A. and Suarez, J. [2003], *op. cit.* To be precise, the authors do not consider a direct relationship between management and shareholders. Provided that the latter are supposed to be too dispersed to take decisions, they are represented by a board of directors – whose incentives are perfectly aligned to the shareholders' interest by assumption. This assumption is highly questionable, and is unwarranted to the purposes of the following discussion. I shall therefore maintain (in the spirit of Hart, O. [1995], *op. cit.*, 128) that the board of directors normally represents the management's interest, and exclude it from the analysis. As a consequence, I shall discuss the model of Almazan and Suarez holding shareholders and the management as the relevant decision-makers. The discussion will show that shareholders are not supposed to take any non-predetermined decision once they are dispersed, so they are not really in need of representation.

To see how golden parachutes can reduce managerial shirking, "one has to start from the observation that money in the company is still not money in the manager's pockets."[117] Distortionary PBC (misuse of free cash) are worth less to the manager than they cost to shareholders (foregone profitable opportunities). For this gap to be reduced, the manager needs to be entitled to a larger share of the firm's surplus.[118] Contrary to the standard agency framework (the basic insight of Jensen and Meckling), increasing the manager's share of the residual claim *is not* the only way to achieve this result. Also entrenchment can raise the diligent manager's prospective reward, when it is combined with a severance payment high enough to compensate him for the initial investment of his talent (idiosyncratic PBC), but low enough to induce further effort (foregoing some distortionary PBC).[119] Such a combination would provide *only* the manager who does not shirk with the opportunity to exploit his bargaining power in a subsequent control sale. Eventually, a diligent manager would be entitled to appropriate a larger share of firm value through bargaining over the proceeds of an efficient control sale. Conversely, the same opportunity would *not* be available to a manager who shirks after having invested his talent. On condition that the severance payment is properly set up in advance, he would simply take his golden parachute and leave.[120]

Assume that a severance payment is set up *ex ante* in the corporate contract as to cover both idiosyncratic PBC and the manager's share of the profits corresponding to his minimal effort. This is equivalent to granting the incumbent manager a put option on his share of the residual claim, conditional on a takeover bid (once again, the example of anticipated vesting of a stock options plan should do).[121] If the

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[117] Hellwig, M. [2000], *op. cit.*, 119.

[118] Id. The author, however, does not carry this intuition any further.

[119] This is the contracting strategy discussed by Almazan, A. and Suarez, J. [2003], *op. cit.*, who, however, do not distinguish between categories of PBC, but only between (non-diversionary) control rents and managerial effort(the flip side of managerial shirking, and therefore of distortionary PBC)

[120] *Ibidem*. This result depends on the manager's *outside option*, which is bound not to be any higher than the compensation package negotiated at the outset for the case where he does not put additional (unobservable) effort. Intuitively, bargaining power in renegotiation always depends on having a better option *outside* the relationship. However, discussion of outside options in formal contract theory lies outside the scope of the present inquiry. See Hart, O. and Moore, J. [1988], *Incomplete Contracts and Renegotiation*, in ECONOMETRICA, vol. 56, 755-785.

[121] Laffont, J.-J. and Tirole, J. [1988], *op. cit.*, 530, very nicely characterize the role, and the limits, of stock options in the takeover context:

> "We believe that stock options encourage the incumbent managers to internalize the positive externality of *observable* investment on the raider's posttakeover performance. Our point is that stock options provide insufficient incentives to induce managers to internalize the effect of investments that are *not observable* by the market."
> (emphases in the original; footnote omitted).

manager does not put more effort in the firm management, he will suddenly leave when shareholders offer him the severance payment. This will happen as soon as the efficiency gains brought about by a subsequent manager are just sufficient to offset the incumbent's idiosyncratic PBC (the lower bound on pay-per-performance does not affect shareholders' decision, for it is a sunk cost). Provided that a shirking manager would not get anything more than his severance if he stays, he will certainly leave.

When the manager puts more effort in the firm management, this will raise the value of his share of the residual claim and he will be therefore committed *not* to accept the severance payment originally contracted for. He would profit more by staying (e.g., keeping his stock options plan unchanged) than by leaving (e.g., having his stock options vested in advance and liquidated at a discount). To induce him to part with control when a better manager shows up, *renegotiation of the severance payment* must occur. This means that by not shirking a manager will be entitled to a larger share of the surplus involved by an eventual control transaction. Renegotiation of his severance payment provides an additional expected compensation of his effort.

However, the higher the effort, the higher must be the trade surplus that makes the control transfer acceptable to the incumbent manager, while leaving both shareholders and the acquirer better off. Since the probability of finding a considerably better manager is always lower than that of finding a slightly better one, the incentive effect of the deferred compensation will decrease with the manager's effort. As a result, not differently from pay-per-performance, renegotiation of severance payments can never eliminate managerial shirking.[122]

Nonetheless, *moderate* unobservability of managerial effort is more cheaply dealt with through a renegotiable severance payment rather than through plain pay-per-performance, for the former allows idiosyncratic control rents to enter explicitly the compensation package.[123] In addition, renegotiation of severance payments is better

The authors conclude, on this basis, that allowing resistance to hostile takeovers may be efficient in order for the incumbent management to count *ex ante* on future extraction of additional rewards in the form of golden parachutes, depending on the performance potential uncovered by bidders *ex post*. I am operationalizing the same intuition through the notion of idiosyncratic PBC, and I take stock of the mechanisms envisaged by the subsequent literature (combination of entrenchment and severance payments) to describe how the incumbent's control rents can be efficiently cashed in on the occasion of a takeover.

[122] This result also obtains in a different, and relatively more parsimonious, framework. See Schnitzer, M. [1995], *op. cit.* (who does not consider the possibility of setting *ex ante* a lower bound on the size of golden parachutes as an inducement for shirking managers to part with control *ex post*).

[123] A moderate size of control rents is one of the conditions under which Almazan, A. and Suarez, J. [2003], *op. cit.*, argue that entrenchment is efficient – golden parachutes at the setup stage would be just too expensive otherwise.

at coping with contractual incompleteness.[124] Being both open-ended and independent of profit sharing with shareholders, the incumbent's deferred compensation makes sure that shirking does not increase over time with free cash available for mismanagement. Whatever the increase in the amenities potential brought about by retained earnings, renegotiated severance payments supply the manager with countervailing incentives to additional effort. The larger the free cash flow available to the firm, the more attractive it gets as a target for a (friendly) takeover, the richer the renegotiated golden parachute that the incumbent manager will be entitled to bargain for provided that he is not shirking.[125]

Unfortunately, an incentive mechanism based on severance payments is not always feasible.[126] To begin with, severance payments are *costly* to shareholders. To induce further effort by the manager, shareholders must be willing to forego *ex ante* the gains of future profitable takeovers up to the amount of the manager's idiosyncratic PBC. According to our definition, idiosyncratic PBC represent the unobservable value of managerial talent, and therefore they are not contractible. The value of control rents claimed by the manager need then to be accepted by shareholders on a take-it or leave-it basis. Additional costs are incurred *ex post*. The extra surplus of efficient control transfers that take place will have to be shared with the manager. Intuitively, when the overall costs of a severance payment mechanism become too high, shareholders might be unwilling to accept the deal.

In addition, the probability of an efficient takeover does not only decrease with the incumbent manager's effort. It is also inversely related to the value of his idiosyncratic PBC (the higher they are the larger must be the efficiency gains necessary

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124 This leads to the second condition for efficiency of management entrenchment: performance should be a very noisy signal of effort (pay-per-performance would be always cheaper than golden parachutes otherwise). See Almazan, A. and Suarez, J. [2003], *op. cit.*

125 This follows quite straightforwardly from the framework being described. Quite surprisingly, the point is not made by Almazan and Suarez, but by Hellwig, M. [2000], *op. cit.*, 119-122, who considers the opposite scenario in which management will tend to misuse free cash when their position is *not* secure. Conversely, Hellwig is worried that the "incumbency bias" of tenured management may determine distortions in the allocation of corporate control. Hellwig, however, does not consider the potential benefits of golden parachutes for solving both problems simultaneously. Indeed, golden parachutes are quite sufficient to ease the takeover process, provided that they are renegotiable *ex post* (Schnitzer, M. [1995], *op. cit.*). In the framework discussed by Almazan, A. and Suarez, J. [2003], *op. cit.*, the lower bound set on its amount when the manager is hired also serves to induce effort. As a result, free cash flow does not determine mismanagement, but simply raise the probability of a takeover ('cash cows' are more attractive as targets), which will be the more profitable for incumbent management the less they shirk. Consistent with the auspices of Martin Hellwig, this perspective simply turns the traditional view of free cash flow on its head. Compare with Jensen, M.C. [1986], *op. cit.*

126 Almazan, A. and Suarez, J. [2003], *op. cit.*, consider this as an optimal solution only when control rents are low enough, and performance is a very noisy signal of effort.

to have a feasible control transaction). This circumstance harms shareholders in two ways. When idiosyncratic PBC are high, not only will a larger number of profitable control transactions be foregone, but also the incumbent manager – facing a lower probability of a favorable renegotiation of his severance payment – will tend to shirk more. High PBC make therefore severance payment both costlier to shareholders and less effective in inducing a diligent behavior by the managers.[127]

6.4. High Control Rents and the Need of a Controlling Shareholder

6.4.1. Entrenchment without Severance Payments

When idiosyncratic PBC are high and the probability of an efficient takeover is relatedly low, the combination of managerial entrenchment with a severance pay-

[127] When control rents are high enough Almazan, A. and Suarez, J. [2003], *op. cit.*, contend that entrenchment would not be optimal. In this situation, it is better (i.e., less expensive) to have the management replaced by shareholders, or by their agents, in the wake of a takeover bid. Management should be rewarded by traditional pay-per-performance when performance is a fairly good signal of effort. Conversely, a golden parachute should still be granted when performance is a noisy indicator of effort. In this situation, however, managers are no longer entrenched, and therefore they will have no bargaining power for renegotiating the severance payment.
Golden parachutes in the absence of entrenchment had been already considered in the literature as a way for shareholders to commit to a deferred compensation of management. See Knoeber, C.R. [1986], *Golden Parachutes, Shark Repellents, and Hostile Tender Offers*, in AMERICAN ECONOMIC REVIEW, vol. 76, 155-167. Yet this is insufficient to induce the management to make firm-specific investments whose value is unknown at the outset. See Schnitzer, M. [1995], *op. cit.* This is the limit of an otherwise very interesting analysis. Almazan, A. and Suarez, J. [2003], *op. cit.*, do not consider control rents as a motivation for firm-specific investments, but only as a way for shareholders to save on managerial compensation. Therefore, they do not even contemplate the possibility that golden parachutes without entrenchment may leave management with insufficient incentives to make specific investments which are neither observable nor verifiable. In fact, noisiness of firm performance and a higher amount of control rents are two sides of the same coin, and cannot be treated separately.
True, when the prospects of a business are overly uncertain (i.e., performance is an extremely noisy signal of effort), upfront compensation of control rents is too expensive to be an option. While this clearly excludes managerial severance payments as a solution, it is no sufficient reason to dismiss the problem of non-contractible rewards to the entrepreneur's investments. In what follows, I will try to articulate an alternative solution. This is based on control premia in ownership structures characterized by the presence of a controlling shareholder. Like golden parachutes in managerial control structures, this is one circumstance that we regularly observe in real-world corporate governance.

ment is too costly for shareholders to sustain. Since idiosyncratic PBC are significant, contestable control would still not be an option. Without entrenchment, an entrepreneur-manager would be unable to secure an adequate reward for his initial investment, and therefore he would be reluctant to separate ownership from control. In contrast, entrenchment without severance payment is hardly acceptable to shareholders. On the one hand, in the absence of side payments, control would not be transferred even to a significantly more efficient manager. On the other hand, in the absence of deferred compensation, the incumbent manager would extract too many distortionary PBC to the shareholders' disadvantage. Therefore, an alternative mechanism must be devised to achieve the best possible result in terms of both corporate control allocation and managerial effort, despite of the high level of idiosyncratic control rents.

In this situation, corporate governance would bear a *lesser degree of separation of ownership and control*.[128] Whether or not severance payments are available, control rents have to be cashed in anyway by an entrenched entrepreneur/manager for control to be eventually transferred. Being aware of this, shareholders are reluctant to provide equity finance in the presence of high control rents. Because of those rents, they will have to forego many profitable control transactions. Therefore, idiosyncratic PBC *always* make outside shareholders willing to pay a lower (i.e., a discounted) price for the company's equity.[129] The discount can be offset by the promise of a side payment, which would directly compensate the manager for the loss of control rents in the event of a takeover (i.e., a severance payment). However, this particular case holds until idiosyncratic PBC claimed by the entrepreneur/manager becomes too large for being compensated up front.

For any given level of idiosyncratic PBC, shareholders willingness to pay for the firm's stock decreases with the share of the residual claim retained by the entrepreneur/manager.[130] Intuitively, idiosyncratic PBC must be low enough to make always preferable for shareholders to directly bribe the entrepreneur/manager with a sev-

[128] Lawyers sometimes derive this result by simple means of intuition. See, e.g., Coates, J.C. IV [2003], *op. cit.*

[129] This holds irrespective of the nature of control rents. See, e.g., Pagano, M. and Röell, A. [1998], *The Choice of Stock Ownership Structure: Agency Costs, Monitoring, and the Decision to Go* Public, in QUARTERLY JOURNAL OF ECONOMICS, vol. 113, 187-225.

[130] This result is based on Jensen, M.C. and Meckling, W.H. [1976], *op. cit.*, and does not depend on the size of idiosyncratic control rents (which are nil in standard principal-agent settings). Let us take this as the starting point of our discussion. It is the cornerstone of models of ownership structure based on asymmetric information, whether separation of ownership and control is regarded as a moral hazard or as an adverse selection problem.

erance payment, instead of buying less stock from him at a discount.[131] That is to say, the severance payment claimed by a manager relinquishing his entire ownership stake should be *lower* than the highest possible discount on the trading of a limited amount of shares between the owner-manager and outside shareholders. This would mean that, notwithstanding the costs of the severance payment, complete separation of ownership and control still brings about gains from trade. Otherwise, only a limited amount of the firm's stock will be traded between the manager and outside shareholders, and thus ownership will not completely separate from control.[132]

6.4.2. Why a Limited Separation of Ownership and Control?

The reason why shareholders willingness to pay for the firm's stock decreases with separation of ownership and control is twofold, and it is related to both idiosyncratic and distortionary PBC.[133] First of all, in the absence of renegotiable sever-

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[131] Bratton, W.B. and McCahery, J.A. [2001a], *op. cit.*, 14-16, informally discuss this point. But the discussion is based on Hart, O. [1995], *op. cit.*, who allows for a 'bribe' equal to the management's private benefits in order to align its incentives with the interest of outside shareholders.

[132] See Pagano, M. and Röell, A. [1998], *op. cit.* (who, however, derive this result in a principal-agent framework, carrying the restrictive assumption that extraction of PBC is always inefficient).

[133] The event determining significant separation of ownership and control is the transformation of a close corporation into a publicly held company (see *supra*, Chapter One, section 1.6.1, for the distinction). This transformation happens when the controller of the company decides to take it public. There are two major strands of literature analyzing the decision to go public. One is based on asymmetric information. See, e.g., Pagano, M. and Röell, A. [1998], *op. cit.* The other is based on control considerations. See, e.g., Zingales, L. [1995], *op. cit.* Apparently, the empirical evidence shows that both issues are important. See, e.g., Pagano, M., Panetta, F. and Zingales, L. [1998], *Why Do Companies Go Public? An Empirical Analysis*, in JOURNAL OF FINANCE, vol. 53, 27-64; Brennan, M. and Franks, J. [1997], *Underpricing, Ownership and Control in Initial Public Offerings of Equity Securities in the UK*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 45, 391-413; and, more recently, Brau, J.C. and Fawcett, S.E. [2006], *Initial Public Offerings: An Analysis of Theory and Practice*, in JOURNAL OF FINANCE, vol. 61, 399-436. The following discussion takes stock of both insights, but it frames them in a theory of private benefits of control which departs from the mainstream view (see *supra*, Chapter Five).
Other commentators have recently tried to develop, on different grounds, novel theories of the decision to go public. Boot, A., Gopalan, R. and Thakor, A. [2006], *The Entrepreneur's Choice between Private and Public Ownership*, in JOURNAL OF FINANCE, vol. 61, 803-836, have tried to address control considerations in terms of autonomy of decision-making instead of on the basis of private benefits. Maug, E. [2001], *Ownership Structure and the Life-Cycle of the Firm: A Theory of the Decision to Go Public*, in EUROPEAN FINANCE REVIEW, vol. 5, 167–200, has analyzed the effect of IPO underpricing on the decision to go public as determined by different degrees of asymmetric information at different stages of the firm's lifecycle. Failure to consider private benefits of control is the major shortcoming of these models.

ance payments, the higher the corporate controller's ownership, the higher the likelihood that control will be effectively transferred when the efficiency gains brought about by a subsequent manager are larger than the incumbent's PBC.[134] Indeed, the higher the ownership stake involved in a control transaction, the more gains from trade will be available for being divided between the incumbent and the insurgent. Neither party actually cares about the impact of the control transaction on outside shareholders.[135] Secondly, when a severance payment *cannot* be set *ex ante* as to compensate idiosyncratic PBC, the perspective of bargaining over the proceeds of an eventual control sale would not induce any further effort by the manager.[136] Consequently, to avoid excessive shirking (i.e., distortionary PBC), the manager's ownership must be increased.[137] Again, a larger share of the manager's residual claim substitutes for the incentives that would be provided by a mechanism based on renegotiable severance payments.

Notice that what makes share ownership preferable to severance payments for inducing efficient behavior by the corporate controller is the *significant* unobservability of managerial effort.[138] This circumstance is due to high noisiness of performance as a proxy of managerial effort. It involves that *both* idiosyncratic control rents claimed by the entrepreneur/manager *and* the discount rate requested by outside shareholders be higher, thereby ruling out the advantages of compensating those

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[134] Zingales, L. [1995], *op. cit.*

[135] Bebchuk, L.A. [1994], *Efficient and Inefficient Sales of Corporate Control*, in QUARTERLY JOURNAL OF ECONOMICS, vol. 109, 957-993. But see *infra*, Chapter Ten, 10.3.2, for a critical discussion of the normative implications of this model.

[136] Almazan, A. and Suarez, J. [2003], *op. cit.*

[137] Jensen, M.C. and Meckling, W.H. [1976], *op. cit.*, originally considered inside ownership as a mechanism to preserve the manager's incentives to put effort in running the firm. This can be also framed as an adverse selection problem. See, e.g., Maug, E. [2001], *op. cit.* In a similar vein, ownership concentration arises as a device to improve monitoring of the management. Shleifer, A. and Vishny, R. [1986a], *Large Shareholders and Corporate Control*, in JOURNAL OF POLITICAL ECONOMY, vol. 94, 461-488. However, this creates two additional problems in an incomplete contracts perspective. One is the tradeoff between liquidity and monitoring. Bolton, P. and von Thadden, E.-L. [1998a], *Blocks, Liquidity, and Corporate Control*, in JOURNAL OF FINANCE, vol. 53, 1-25 (see *supra*, Chapter Three, section 3.4.2). The other is the over-monitoring problem, which ultimately kills the management's incentives to undertake unverifiable investments. Burkart, M., Gromb, D. and Panunzi, F. [1997], *op. cit.* (see *supra*, Chapter Five, section 5.6.1). For an illustration of how these two problems cannot be ultimately reconciled, see Bratton, W.B. and McCahery, J.A. [2001a], *op. cit.* For this reason, the following discussion abstracts from monitoring, and advocates a different explanation of corporate ownership structures and of their evolution.

[138] This is based on a long-standing, authoritative explanation of ownership structure, which is sometimes dismissed as outdated by the contemporary literature. Demsetz, H. [1983], *The Structure of Ownership and the Theory of the Firm*, in JOURNAL OF LAW AND ECONOMICS, vol. 26, 375-390 (who, however, did not consider severance payments).

control rents upfront through a severance payment.[139] All the more so as, where managerial skills and effort are mostly unobservable through the firm performance in the short run, having them simply compensated by a state-contingent contract (i.e., pay-per-performance with no tenure) is not an option.[140]

Overall, managerial share ownership provides a better alignment of the corporate controller's incentives with the interest of outside shareholders, making shareholders willing to pay a higher price for the company's stock. However, share ownership is costly for the entrepreneur/manager to maintain, for he will have to forego the benefits of liquidity and risk diversification, not to speak about the investment projects beyond his self-financing capacity.[141] Thus, provided that corporate control remains unchallenged (i.e., that control rents are not endangered), the entrepreneur/manager will always prefer to dilute his ownership stake selling shares to the investing public, *until the discount requested by outside shareholders gets so large to make further selling unattractive*. When the stock price falls below the value of the expected stream of verifiable profits that it represents, the corporate controller will be better off by keeping his share of the firm's ownership.[142] In this situation, the discount on outside stock will be *already* equal to the manager's idiosyncratic PBC.[143] An equivalent way to look at this difference is the premium on the corporate controller's stock (the so-called control premium), which cannot be lower than idiosyncratic PBC in equilibrium. That means, in turn, that further separation of ownership and control cannot be efficiently achieved through a severance payment. As a result, ownership will separate from control just to a limited extent.

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[139] The two issues of extraction of control rents, due to contractual incompleteness, and discounted stock price at IPO, due to adverse selection, are often considered separately. See, respectively, Zingales, L. [1995], *op. cit.*; and Maug, E. [2001], *op. cit.* Alternatively, the extraction of control rents is considered as a *determinant* of the discount. Private benefits of control thus become a different way to address principal-agent problems in separation of ownership and control. See Pagano, M. and Röell, A. [1998], *op. cit.*; Bebchuk, L.A. [1999], *A Rent-Protection Theory of Corporate Ownership and Control*, NBER Working Paper No. 7203.

[140] Aghion, P. and Bolton, P. [1992], *op. cit.*

[141] Bolton, P. and von Thadden, E.-L. [1998a], *op. cit.*

[142] Maug, E. [2001], *op. cit.*

[143] This depends on our definition of idiosyncratic PBC as unobservable and unverifiable future profits ('profits in the entrepreneur's head'). They do not enter in asymmetric information models, which do not allow for uncertainty to generate further value in the form of quasi-rents to entrepreneurship. See, e.g., Maug, E. [2001], *op. cit.* They bear no relationship with the adverse selection discount in incomplete contracts models, which assume symmetric information between the players. See, e.g., Zingales, L. [1995], *op. cit.*

6.4.3. Endogenous Dynamics of the Firm's Ownership Structure.

Idiosyncratic PBC are typically high when the firm's prospective revenues are surrounded by a deep uncertainty. In this scenario, shareholders request a higher discount rate on the firm's stock price, while higher specificity of human capital investments by the entrepreneur/manager calls for higher control rents. Both effects go in the same direction, namely *against* separation of ownership and control. As a result, the corporate controller has to be an owner-manager to a certain extent. This implies that the firm's *ownership structure must feature a controlling shareholder*.[144]

Notice that the ownership stake retained by the controlling shareholder is not determined by control considerations. Here I am taking the corporate controller's entrenchment as given, provided it is necessary to protect his idiosyncratic control rents.[145] Entrenchment of corporate control needs also to be supported by the legal system, but I am not yet considering this problem. In this setting, the entrepreneur/manager should be able to maintain his controlling position also with a very tiny share of the corporate ownership.[146] However, outside shareholders will not go for this deal when it is be too expensive to compensate entrenchment of corporate control with a severance payment accounting for the manager's idiosyncratic PBC. Shareholders would rather require that a significant share ownership be associated to the controller's entrenchment. This block of shares (control block) will trade at premium (control premium) to account for the controlling shareholder's PBC. In this perspective, the firm's ownership structure is determined *endogenously*. It is the outcome that maximizes firm value for both the corporate controller and the outside shareholders, given the amount of idiosyncratic PBC.[147]

The outcome is clearly efficient *ex ante*. Neither more, nor less separation of ownership and control could improve both parties' aggregate wealth. To see

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144 Demsetz, H. [1983], *op. cit.*

145 Few models of the decision to go public make the same assumption. One important exception is Zingales, L. [1995], *op. cit.* Boot, A., Gopalan, R. and Thakor, A. [2006], *op. cit.*, also assume that entrenchment affects the entrepreneur's decision to go public. Their model, however, does not feature private benefits of control. Entrenchment is ultimately motivated by the desire to keep autonomy of decision-making. As the authors admit, this autonomy is not backed by *ex ante* incentives.

146 This option is actually available to the corporate controller in many legal systems, which allow for wide opportunities for separating voting rights from ownership claims. Sweden and the US are two prominent examples in this regard (see *infra*, Chapter Seven). However, the resulting potential for separation of ownership and control does not appear to be fully exploited by publicly held companies (see *supra*, Chapter Two). This observation is consistent with the theoretical argument developed in the text.

147 See Demsetz H. and Lehn, K. [1985], *The Structure of Corporate Ownership: Causes and Consequences*, in JOURNAL OF POLITICAL ECONOMY, vol. 93, 1155-1177, for discussion of this proposition also with the support of empirical evidence.

whether this holds true also *ex post*, one has to investigate the dynamics of ownership structure and control allocation.

It has been demonstrated that, when the controlling shareholder is able to entrench himself, separation of ownership and control is a strategy for maximizing the incumbent's proceeds from an eventual control sale.[148] The underlying intuition is straightforward. The price of outside shares includes the expected gains from a profitable takeover, provided that non-controlling shareholders will be able to free ride on them.[149] Therefore, by selling shares to the investing public, the corporate controller is able to appropriate one part of those anticipated gains. The remainder of the gains will be impounded in the ownership stake retained by the controlling shareholder – the control block – and are due to be shared between the incumbent and the insurgent on the occasion of the control sale.

For an efficient change in control to take place, the size of control block needs to be large enough to allow for a value increase offsetting the difference between the incumbent's and the insurgent's PBC.[150] However, the lower that size, the higher the gains that can be extracted from the investing public in anticipation of future takeovers.[151] Thus, the structure of the corporate controller's incentives leads to an overall reduction of the private surplus available for efficient changes in control. By minimizing his ownership stake, the incumbent controller prefers to forego moderately efficient control transfers in order to maximize his anticipated revenues from the most efficient ones only. Apparently, this would result in excessive separation of ownership and control and, in turn, to a suboptimal frequency of efficient control transfers.[152]

The dynamic inefficiency of ownership structures based on a controlling shareholder only holds when *all* the parties involved share the same information.[153] In

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[148] Zingales, L. [1995], *op. cit.*

[149] Grossman, S.J. and Hart, O. [1980b], *Takeover Bids, the Free Rider Problem, and the Theory of the Corporation*, in BELL JOURNAL OF ECONOMICS, vol. 11, 42–69.

[150] Bebchuk, L.A. [1994], *op. cit.*

[151] Zingales, L. [1995], *op. cit.*

[152] Bebchuk, L.A. and Zingales, L. [2000], *op. cit.*

[153] Bebchuk, L.A. and Zingales, L. [2000], *op. cit.*, assume symmetric information. Also, they consider private benefits to be pure rents, which as such do not affect *ex ante* the incentives of either the incumbent or the insurgent controller to take actions that may increase the firm value. Although they define PBC as broadly as to allow their extraction to be just a matter of distribution (cf. Zingales, L. [1995], *op. cit.*), their conclusion on the inefficiency of the dynamic outcome are driven by the two restrictive assumptions specified above. By removing these assumptions, I only manage to *suggest* that the outcome may be not necessarily inefficient. And it should definitely not be so if we further assume that the insurgent's idiosyncratic PBC are systematically lower than those of the incumbent. This assumption is consistent with the modern theory of entrepreneurship (see *infra*, notes 155-157 and accompanying text). However, the formal modeling of this insight is beyond the scope of this interdisciplinary inquiry on the Law and Economics of corporate control. It is probably one of the

the real world, we observe far less separation of ownership and control than the theory would predict. I conjecture this is due to asymmetric information, which should set a lower bound to the above mechanism of inefficient separation of ownership and control. Under asymmetric information, shareholders do not know how large the corporate controller's PBC are. So the expected gains from any possible takeover should be *discounted* by the same rate.[154] The discount factor is supposed to be increasing in separation of ownership and control, provided that the corporate controller stays entrenched – which is most often true for a controlling shareholder. For any level of the incumbent's PBC, this would limit the amount of the surplus that can be extracted ahead of future control sales. The inefficiency arising from separation of ownership and control in the presence of high control rents should be reduced accordingly.

It is worth noting that the same inefficiency can never be completely eliminated by this mechanism. Idiosyncratic PBC unavoidably draw a wedge between the controlling shareholder's interest (having *only* those changes in control that maximize *his* share of the surplus) and that of outside equity holders (having control *always* transferred when this is efficient). However, while this difference is due to the necessity to promote the *initial* investment of unobservable entrepreneurial talent, it might shrink *over time* as long as such a talent gets easier to recognize and to reward through the firm performance.[155] To the extent this is eventually reflected in a

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most important avenues that the present work would suggest for future research in the economics of corporate governance.

[154] More technically, this can be interpreted as a pooling equilibrium determined by the purchasers' inability to distinguish between different sizes of the sellers' PBC. For a non-technical review of the major contributions to the literature on adverse selection by three Nobel laureates, see Lofgren, K.-G., Persson, T., and Weibull, J.W. [2002], *Markets with Asymmetric Information: The Contributions of George Akerlof, Michael Spence and Joseph Stiglitz*, in SCANDINAVIAN JOURNAL OF ECONOMICS, vol. 104, 195-212.

[155] This is the connection with the theory of entrepreneurship, which is typically missing in the mainstream analyses of corporate governance (see *supra*, Chapter One, section 1.4.5). I interpret this connection by the assumption – which is going to be made explicit in the text – that idiosyncratic PBC progressively decrease at every change in control. Because of reliance on the subjectivism of the Neo-Austrian School – see most prominently: von Mises, L. [1996], HUMAN ACTION: A TREATISE ON ECONOMICS, 4th edn., The Foundation for Economic Education (first published in 1949); von Hayek, F.A. [1996], INDIVIDUALISM AND ECONOMIC ORDER, University of Chicago Press (first published in 1948) – the traditional theory of entrepreneurship is unable to support this assumption. See, e.g., Kirzner, I.M. [1979], PERCEPTION, OPPORTUNITY, AND PROFIT, University of Chicago Press. Nevertheless, Schumpeter had in mind progressive obsolescence of entrepreneurship as a result of the 'creative destruction' process. Schumpeter, J.A. [1943], CAPITALISM, SOCIALISM, AND DEMOCRACY, Unwin University Books. The contemporary theory of entrepreneurship has attempted to overcome the Neo-Austrian subjectivism, by characterizing the entrepreneur as an individual (or, more broadly, an entity) especially skilled at exploiting new *opportunities* for coordination of resources, which are *objectively* available in one economy. Casson, M.C. [1982], THE ENTREPRE-

lower discount on outside stock price, it would make further separation of ownership and control profitable for both the corporate controller and outside shareholders, and therefore efficiency-enhancing.

There are two possible ways of efficiently reducing the discount requested by shareholders. One is limiting the scope for shirking. The other one is directly reducing the control premium. The first option involves that the corporate controller takes credible commitments to put additional effort in the firm management. By adopting such a strategy, the controlling shareholder would trade some benefits from shirking (distortionary PBC) for a larger share of the anticipated gains from an eventual control sale. The overall size of the control premium would be unchanged, but the corporate controller would be able to sell more shares to the investing public, thereby reducing his ownership stake.[156] Fewer efficient changes in control would take place, but the overall firm value would slightly increase with separation of ownership and control.

The implementation of the above strategy requires that managerial effort become over time easier to observe through the firm performance and, therefore, easier to contract upon. In such a scenario, a more promising enhancement of the efficiency of ownership structure comes from the reduction of idiosyncratic PBC (i.e., of the control premium). We should not forget that improved observability of managerial effort may reduce not only the inefficiencies of shirking, but even more so the value of idiosyncratic control rents necessary to induce the initial investment of entrepreneurial talent.[157]

NEUR: AN ECONOMIC THEORY, Martin Robertson. A recent paper has attempted to bridge the gap between the entrepreneurship literature (traditionally claiming that opportunities are *exogenous*) and the literature on economic growth (mostly suggesting that opportunities are *endogenous*) through the notion of information spillovers in innovation. Zoltan, J., Acs, Z.J., Audretsch, D., Braunerhjelm, P, and Carlsson, B. [2006], *The Knowledge Spillover Theory of Entrepreneurship*, CESIS Working Paper No. 77, available at www.infra.kth.se/cesis/cesis/publications. Similarly, I am trying to bridge the gap between the theory of the firm and the theory of entrepreneurship through the notion of private benefits of control. The uncovering of new opportunities is thereby *endogenized* in corporate governance: information spillovers progressively reduce the scope for idiosyncrasy in innovation and the need of concentration of controlling ownership; at the same time, they nurture the takeover process. See *infra* in the text.

156 In other words, the per-share value of the control premium would be higher. That will reduce the likelihood of efficient changes in control. What should enable, nonetheless, the controlling shareholder to cash out a larger fraction of his holdings should be just his improved ability to commit to a more focused management contractually (like, e.g., in his capacity as CEO). This is more easily said than done.

157 When this kind of investment is no longer necessary, there is no need to assume the presence of idiosyncratic PBC in corporate governance. In this case, entrenchment would be not only socially inefficient, but also undesirable from the standpoint of entrepreneurs taking their company public. See, most prominently, Hart, O. [1995], *op. cit*, 186-209. Hart does not exclude that idiosyncratic

Ceteris paribus, a lower control premium would raise the probability of efficient control transfers, thereby inducing outside shareholders to pay a higher price for the firm's stock. Reduction of control rents is of course not an option for the *incumbent* controller, whose idiosyncratic PBC are determined *ex ante* as a reward of his unobservable initial investment. However, the role of unobservable investments and related control rents in promoting the firm's success is likely to become less important in subsequent stages of the firm's lifecycle. When there is less uncertainty on future firm performance, a lower amount of idiosyncratic PBC will be required for having the firm run by the *next* manager.

Therefore, reduction of the control premium does not arise from incumbency, but from insurgency. It should emerge from a process of dynamic allocation of corporate control based on negotiated transfers (that is, friendly takeovers). In the absence of radical changes in the firm's core business (and provided that stealing purposes are ruled out of control transactions), successive takeovers are likely to bring about increases in the verifiable stream of profits more than offsetting the decreases in idiosyncratic PBC. While this is a sufficient condition for the incumbent to cash in his control premium, it also involves that the same control premium be reduced in any subsequent change in control. With the resulting increase in the likelihood of next efficient takeovers, a higher degree of separation of ownership and control will become gradually workable. Eventually, the control premium might become low enough to be directly compensated through a severance payment. Ownership would then be allowed to completely separate from control.

6.4.4. One Final Note about Shareholder Expropriation: The Market for 'Lemons'

Throughout the foregoing analysis, I have been assuming that no scope for expropriation of non-controlling shareholders was allowed by the legal system. Unfortunately, this assumption hardly holds in the real world. To be sure, diversion of profits from outside shareholders' pockets is a major problem in most systems of corporate governance. This problem is certainly more acute in developing and

PBC may be necessary to promote entrepreneurial investments. However, he assumes that under separation of ownership and control there is no need of investments of such a kind. I am making the opposite assumption. Although I do not deny that, in some special circumstances, the corporate business can be managed as a matter of routine (and this would actually make idiosyncratic PBC unnecessary), I believe that most often this is not the case. Therefore, I do consider idiosyncratic PBC as decreasing across the firm's lifecycle, but I do not allow them to be eliminated by the maturity of the business. More technically, I am assuming that idiosyncratic PBC are *asymptotically* decreasing in subsequent stages of the firm's lifecycle.

emerging economies, but it actually does not spare even those countries that are economically most developed.[158] Even within that restricted sample, dishonesty of the corporate controller(s) enters in different fashions: either as a widespread pattern of ordinary misbehavior (affecting *every* publicly held company in the same way, or at least perceived as such by the investing public); or as occasional, and therefore unanticipated corporate scandals of big proportions.[159]

Realistically, the enforcement of the best fiduciary standards that we could imagine for corporate law will never be so rigorous to rule out the latter.[160] Nevertheless, a good system of fiduciary duties in corporate law should be effective enough to police the former.[161] Only on that condition, corporate scandals will be regarded by investors as exceptional events (like the Enron and WorldCom cases in the US), instead of as the peak of an endemic disease of corporate governance (like the Parmalat case in Italy).[162] The conclusions of the standard 'law matters' argument will hold otherwise. Ownership will only moderately (and, presumably, to a suboptimal extent) separate from control, and the bad quality of legal protection of non-controlling shareholders will be responsible for the underdevelopment of equity finance.

What I am claiming here is that – contrary to conventional wisdom – the functioning of the market for corporate control under alternative arrangements (hostile vs. friendly takeovers) does not affect the above result. [163] This holds unless we posit a tradeoff between shareholder protection and efficient allocation of corporate control; a tradeoff which – as it will be shown in the two last Chapters of the present dissertation – we are not necessarily confined to.[164] This approach has two major implications. On the one hand, it allows for a *separate treatment* of the problem

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[158] See, illustratively, Fox, M.B. and Heller, M.A. [2006], *op. cit.*

[159] Enriques, L. [2003], *Bad Apples, Bad Oranges: A Comment from Old Europe on Post-Enron Corporate Governance Reforms*, in WAKE FOREST LAW REVIEW, vol. 38, 911-934.

[160] Neither would this be efficient. See Enriques, L. [2000], *The Law on Company Directors' Self-Dealing: A Comparative Analysis*, in INTERNATIONAL AND COMPARATIVE CORPORATE LAW JOURNAL, vol. 2, 297-333.

[161] Easterbrook, F.H. and Fischel, D.R. [1991], THE ECONOMIC STRUCTURE OF CORPORATE LAW, Harvard University Press, 90-108.

[162] Pardolesi R., A.M.P. (alias Alessio M. Pacces), Portolano, A. [2004], *Latte, lacrime (da coccodrillo) e sangue (dei risparmiatori). Note minime sul caso Parmalat*, in MERCATO, CONCORRENZA, REGOLE, vol. 1/04, 193-216.

[163] For the standard contrarian view, see, e.g., Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 24-38.

[164] This is, however, the mainstream view in both economic and legal analyses of the market for corporate control. See, respectively, Burkart, M. and Panunzi, F. [2006b], *Takeovers*, ECGI Finance Working Paper No. 118/2006, available at www.ssrn.com and www.ecgi.org; and Kraakman, R.H., Davies, P., Hansmann, H., Hertig, G., Hopt, K.J., Kanda, H. and Rock, E.B. [2004], THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH, Oxford University Press (hereinafter Kraakman *et al.* [2004], *The Anatomy*), 157-191.

of corporate control allocation and of that of diversionary PBC.[165] On the other hand, it leaves unprejudiced one of the fundamental conclusions of Corporate Law and Economics. When legal protection of non-controlling shareholders from the extraction of diversionary PBC is weak, the efficiency of the market for corporate control is unavoidably impaired.[166]

Having diversionary PBC curbed by an effective system of fiduciary duties is in fact a *precondition* not only for separation of ownership and control, but also for the efficient functioning of the market for corporate control.[167] None of the conclusions that I have presented in this regard would hold in the presence of diversionary PBC. Corporate control would still be entrenched but the resulting ownership structure would provide no guarantee of being efficient. Entrenchment would be aimed at protecting stealing opportunities or, at best, at preventing further looting from occurring. Not much scope would be left for fostering entrepreneurship. Being unable to distinguish thieves and looters from honest entrepreneurs and managers, shareholders will assume that all corporate controllers are just 'average' (i.e., something in between).[168] They will offer lower prices for the firm's stock and, as a result, most talented entrepreneurs and managers will exit the market for corporate control or even refrain from entering the stock market in the first place. Both the stock market and the market for firm control will be regarded as "markets for lemons."[169] Then ownership could not separate from control, if not – to a limited extent – in those few cases where non-legal commitments not to expropriate minority shareholders can be taken. This would impair both equity finance available to large firms and the pursuit of growth opportunities by Small and Medium Enterprises (SMEs). That is quite likely to be the situation characterizing, for instance, the Italian economy.[170]

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165 See *infra*, Chapter Ten, section 10.4.5.

166 Bebchuk, L.A. [1999], *op. cit.*

167 Roe, M.J. [2003c], POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE, Oxford University Press, 159-196.

168 Black, B.S. [2001], *The Legal and Institutional Preconditions for Strong Securities Markets*, in UCLA LAW REVIEW, vol. 48, 781-855.

169 Akerlof, G.A. [1970], *The Market for 'Lemons': Quality Uncertainty and the Market Mechanism*, in QUARTERLY JOURNAL OF ECONOMICS, vol. 84, 488–500.

170 Bianchi, M., Bianco, M., Giacomelli, S., Pacces, A.M. and Trento, S. [2005], PROPRIETÀ E CONTROLLO DELLE IMPRESE IN ITALIA*,* Il Mulino.

6.5. Institutional Analysis Revisited

6.5.1. The Dual Role of Legal Rules in Promoting Separation of Ownership and Control

So far I have implicitly assumed absolute freedom of the corporate contract in determining the allocation of control rights between the entrepreneur/manager and outside shareholders, whatever the firm's ownership structure. This assumption was an extreme oversimplification, for it neglects the role of the institutional environment and of corporate law therein in determining the corporate governance arrangements.[171] In fact, allocation of residual rights of control is highly dependent on the legal entitlements respectively available to the corporate controller and the outside shareholders under the pertinent corporate law jurisdiction. This is what I termed as 'legal distribution of corporate powers' in the previous Chapters, and of course it has a bearing on the range of choice available to the contracting parties as to corporate ownership and control.[172] However, the 'freedom of contract' assumption has proven extremely useful to understand the basic mechanisms underlying such a choice. That is, first, what should induce a corporate controller to profitably manage a firm that he does not own completely; and, second, what makes sure that outside shareholders are willing to invest their money in a firm that they do not control.

I have argued that the answer to those questions depends on the role played by private benefits of controlling a corporation (PBC).[173] Indeed, the taxonomy of PBC being adopted in the present inquiry appears to be sufficiently inclusive to account for the major determinants of separation of ownership and control – namely, of *institutional choice* as to the corporate governance pattern.[174] Some PBC (idiosyncratic control rents) are needed to create firm value from the investment of unobservable managerial talent, and therefore must be protected through residual rights of control. Some others (benefits from shirking and stealing) reduce firm value to the shareholders' disadvantage and thus must be restrained by means of either incentives (e.g., raising the controller's ownership stake) or external constraints (e.g., legal rules constraining shareholders expropriation). What should induce the corporate controller to manage the firm in the shareholders' interest is a ban on their expropriation (minimizing the scope for diversionary PBC), incentives

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[171] See *supra*, Chapter Four, section 4.1.
[172] See *supra*, Chapter One, section 1.6.2, and Chapter Four, sections 4.5-4.6.
[173] See *supra*, Chapter Five.
[174] See *supra*, Chapter Four, section 4.1.1.

based on profit sharing (optimizing the extraction of distortionary PBC) and, ultimately, the perspective of eventually cashing in his idiosyncratic PBC through the surplus brought about by an efficient change in control (thereby policing both moral hazard and adverse selection in a dynamic setting). Given the firm's financial needs, the choice as to separation of ownership and control will depend on how the above categories of PBC interact together and they are consequently dealt with.

Private ordering does not explain everything about institutions. Institutional choice does not take place in a vacuum, but only within the range of feasible choices determined by the *institutional environment*. Likewise, the available patterns of separation of ownership and control are determined by the legal system.[175] Protection of outside shareholders from the corporate controller's abusing his power (i.e., stealing) is a precondition for separation of ownership and control. However, the legal discipline of diversionary PBC is just one part of the story.[176] It deals with how to prevent expropriation of non-controlling shareholders, in order to make them willing to invest in the corporate firm. True, this is the typical way in which law 'matters' in standard Law and Economics of corporate governance. According to this view, legal protection of non-controlling shareholders is coupled with their entitlement to residual rights of control as owners of the firm. Provided that legal protection is intended to restore outside shareholders' control rights *notwithstanding* delegation of the *de facto* control to a non-owner manager, this approach does not question the role of the legal system in allocating residual rights of control.

This is clearly different from the view of corporate governance that is being presented here.[177] Provided that protection of control rents is necessary to promote firm-specific investments by the entrepreneur/manager, residual rights of control cannot simply be delegated, but need to be assigned from the beginning to whoever is in charge of managing the firm. Therefore, outside shareholders have to be granted a different kind of protection. Within this framework, legal rules play a *dual role* in corporate governance. They matter not only in a dimension that is *restrictive* of control powers, so as to protect outside shareholders from the corporate controller's misbehavior. They also matter in an *enabling* dimension, in that they allow the corporate charter to allocate definitive entitlements to residual rights of control independently of corporate ownership.

The way in which ownership *can* be separated from control is determined by the two above sets of legal rules. This separation would occur to a limited extent in the absence of adequate legal protection of outside shareholders.[178] However, a similar

[175] See *supra*, Chapter Four, section 4.1.2.
[176] See *supra*, Chapter Four, section 4.4.
[177] See *supra*, sections 6.2-6.4.
[178] See, for the intuition, La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R. [1998], *op. cit.*

result would hold when the legal entitlements available to the corporate controller does not allow the entrepreneur/manager to secure idiosyncratic control rents without a significant share ownership.[179]

As such, the revised 'law matters' thesis enters as a positive statement: the legal system shapes the *opportunities* for separation of ownership and control available to the firms. On condition that the scope for diversionary PBC is minimized, the *efficient* degree of separation of ownership and control depends on a number of non-legal variables: the firm's financial needs as opposed to the entrepreneur's wealth constraints and degree of risk aversion; the uncertainty about the prospects of the firm's success and the related extent of idiosyncratic PBC; the unobservable features of managerial effort and the scope for distortionary PBC. Therefore, the 'law matters' argument has also an extremely important normative implication: the legal system should allow the selection of the efficient degree of separation of ownership and control.

6.5.2. Efficient vs. Inefficient Protection of Control Rents

Previous discussion of comparative corporate governance shows that perfect contestability of corporate control is more in the finance textbooks than in the real world.[180] Consistently with the view of corporate governance presented in the foregoing analysis, I posit that this is due to imperfect observability of entrepreneurial and managerial talent.[181] When its investment cannot be adequately rewarded through the price of outside stock sold to the investing public, motivating unobservable effort by an entrepreneur/manager under dispersed ownership structures requires that a non-contractible deferred compensation be secured by means of residual control rights.[182] In this perspective, legal protection of outside shareholders' control rights (i.e., the entitlement to oust an underperforming manager) does not explain separation of ownership and control and, actually, it might lead to quite the opposite result.

Within the agency framework from where the standard 'law matters' argument was originally derived, control rents that do not reduce shareholder wealth are not accounted for. PBC can just be 'bad' for corporate governance. On the same account, Lucian Bebchuk has developed a formal "Rent-Protection Theory of Corpo-

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[179] For a similar, but less structured approach, see Cools, S. [2005], *op. cit.*

[180] Compare Chapter Two, section 2.4, with Chapter Three, section 3.4.4.

[181] See *supra*, Chapter Five.

[182] See the previous discussion in sections 6.2-6.4.

rate Governance."[183] This theory has demonstrated one of the basic claims of the present work: when PBC of *any* kind are high enough, contestable control cannot emerge as a stable equilibrium. However, according to Lucian Bebchuk, this circumstance is also responsible of *suboptimal* separation of ownership and control. Ownership concentration is a privately optimal strategy to secure PBC by short-circuiting contestability. Yet, to the extent that shareholder value under more dispersed ownership structures would increase by a higher amount than those PBC, the same strategy is also socially inefficient.[184]

The way in which the above results are derived assumes that control rents are transferable.[185] On this condition, no controller would dilute his ownership stake in such a way as to leave control rents up for grabs. He would rather keep a controlling stake large enough to claim adequate compensation of the private benefits transferred with firm control. As such, the theory and its normative implications are mostly applicable to diversionary PBC.[186] Unless the legal system is effective enough in constraining shareholder expropriation (thereby providing a credible commitment device against diversionary PBC), concentrated ownership would be the only possible outcome even though a higher degree of separation of ownership and control would be efficient. In the end, Bebchuk's contention provides an alternative formulation of the 'law matters' thesis, from the corporate controller's standpoint instead of that of outside shareholders.

In addition, Bebchuk's rent-protection theory does not consider that PBC can also be 'good' for corporate governance.[187] Yet control rents also include idiosyncratic PBC, and they are different from the diversionary kind in a number of respects. First, while diversionary PBC are based on unproductive transfers of the firm's cash flow, idiosyncratic PBC represent the unobservable value (and motivation) of entrepreneurship. Therefore, their effects on the firm's ownership structure *are not* unambiguously inefficient. Second, idiosyncratic control rents (like, for in-

[183] Bebchuk, L.A. [1999], *op. cit.*

[184] See *supra*, Chapter Four, section 4.4.2.

[185] Bebchuk, L.A. [1999], *op. cit.*, always assumes that control rents are transferred with corporate control. However, not all control rents have such a feature. See, e.g., Hart, O. [2001], *op. cit.*, 1085-1086; and *supra*, the discussion of idiosyncratic PBC in Chapter Five.

[186] Bebchuk, L.A. [1999], *op. cit.*, also considers rents that dissipate some value (e.g., in the form of extraction of control perquisites). However, this kind of rents (distortionary PBC) should not drive the results of his model. In the absence of stealing (and of other kinds of control benefits), extraction of distortionary PBC is always dominated by a commitment to a fully contestable ownership structure. See Hart, O. [1995], *op. cit.*, 186-189.

[187] This is also excluded by assumption in the relatively richer framework of Bebchuk, L.A. and Zingales, L. [2000], *op. cit.*, where control rents are not necessarily extracted at the owners' expenses, but anyway determine inefficient control allocations *ex post*. See *supra*, section 6.4.3, for a critical analysis.

stance, the founder's pride of managing 'his' business creation) are never up for grabs, for they depend on the identity of the corporate controller – i.e., they are not transferable by definition.[188] However, in case of hostile takeover, they would be simply lost. Idiosyncratic control rents thus do not fit within Bebchuk's rent-protection theory, but they result in a similar outcome. When idiosyncratic rents are significant, contestability of corporate control likewise needs to be excluded. This is not because PBC would be 'up for grabs' otherwise. Rather, there would be no way to have them 'priced' at the outset.[189] As a result, also in the presence of high idiosyncratic PBC ownership cannot separate from control if not to a limited extent.

The reader would recognize that similarities between diversionary and idiosyncratic PBC end with the positive analysis. Apparently, both categories of PBC lead to ownership concentration. On normative grounds, however, *only* diversionary PBC are unambiguously inefficient since they distort the choice of ownership structure with no redeeming virtue. Conversely, one could not say whether a pattern of rent-protection based on idiosyncratic PBC is efficient or not without assessing merits of the latter. Therefore, consideration for idiosyncratic PBC must be added to the 'law matters' framework. An adequate discipline of diversionary PBC by the legal system is a necessary, but not also a sufficient condition for efficient separation of ownership and control.

6.5.3. The Dark Side of the 'Law Matters' Argument

High idiosyncratic control rents also entail limited separation of ownership and control, but that is not necessarily inefficient. The economic theory of PBC is still very much underdeveloped in this regard. It should be recalled from previous discussion that, in one of the few contributions available on the relation between idiosyncratic control rents and the firm ownership structure, PBC with neither stealing nor shirking implications have no efficiency consequences, but only distributional ones. They involve that control is never sold piecemeal, but rather, through a strategy aimed at cashing in the highest possible share of the surplus from a negotiated control sale.[190]

Whether or not this leads to an efficient outcome depends on the role played by idiosyncratic control rents in corporate governance. I posit that they are motivating the investment of unobservable managerial talent, thereby fostering entrepreneurial

[188] See, e.g., Gilson, R.J. [2006], *op. cit.*
[189] Mayer, C. [1999], *op. cit.*
[190] Zingales, L. [1995], *op. cit.*

innovation, and are therefore efficient *ex ante*. It might seem that this does not hold also *ex post*, for idiosyncratic PBC involve that some efficient changes in control be foregone.[191] However, I have conjectured that – in the absence of major business innovations – unobservability of managerial talent shrinks over the firm's lifecycle and so does the amount of idiosyncratic PBC required to induce any subsequent manager to invest his talent. In each change in control, production of a larger verifiable income should substitute for idiosyncratic control rents and consequently allow for more outside stock to be sold at higher prices (i.e., cheaper equity finance). Over time, this would not only improve the process of dynamic allocation of corporate control, but also lead to a higher degree of separation of ownership and control.[192]

Dynamic evolution of idiosyncratic PBC thus also explains separation of ownership and control. The mechanism, which has been presented here, is driven by *ex post* exploitation of gains from trade by all the parties involved, subject to the *ex ante* constraint of protection of idiosyncratic control rents by the incumbent. Therefore, it is constrained-efficient. For such a result to hold, law needs not only to guarantee protection of outside shareholders from expropriation by the corporate controller. Controllers need also to be entitled to secure idiosyncratic control rents by entrenching themselves whatever their ownership stake. Otherwise, they would stop diluting their ownership stake as soon as this involves the risk of being taken over.[193]

The scope of entrenchment devices available to secure the entrepreneur/manager's residual rights of control is determined by the legal system. Protection of corporate control from hostile takeover may require close ownership (no listing on a stock exchange), majority ownership, minority ownership, or no ownership at all. This depends on the *entitlements to control rights* provided for by corporate law and available to whom is in charge of managing the corporation.[194] Those entitlements affect the degree of separation of ownership and control that a corporate

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[191] Many commentators have made this point with regard to non-diversionary PBC that are either neutral or even increasing shareholder wealth *ex ante*. See Mayer, C. [1999], *op. cit.*; Gilson, R.J. [2006], *op. cit.*; Bebchuk, L.A. and Zingales, L. [2000], *op. cit.*

[192] See *supra*, section 6.4.3.

[193] Other commentators and I have suggested elsewhere that this may provide a good interpretation of patterns and evolution of Italian CG. Bianchi, M., Bianco, M., Giacomelli, S., Pacces, A.M. and Trento, S. [2005], *op. cit.*

[194] Legal devices of the kinds that have been discussed at the very beginning of this inquiry (e.g., takeover defenses, dual class shares, etc.), which determine the distribution of powers within the corporation, play exactly this role by allowing separation of control rights from voting rights, and of voting rights from cash flow rights. See Chapter One, section 1.6.2, and *infra*, Chapter Seven, for a more detailed legal analysis. See also Cools, S. [2005], *op. cit.*, for a similar (but not as inclusive) view of the matter.

controller can afford without risk of being subsequently expropriated of his control rents. Legal entitlements to control rights consequently affect the selection of the firm's ownership structure; their inadequacy (or worse, unavailability) might impair the efficiency of that structure.

I do not claim any originality about the idea that every firm has an optimal ownership structure and that it is determined endogenously, depending on the firm's characteristics. This idea has actually a long-standing tradition. It dates back to the 80s, when Harold Demsetz, subsequently joined by Kenneth Lehn, first made such a point.[195] These studies also pointed out the importance of control rents in determining ownership concentration, due to 'noisiness' of the business environment and imperfect foreseeability of factors affecting the firm's success. My definition of idiosyncratic PBC – depending on unobservability of managerial talent – makes a no different point. What this work attempts to demonstrate further is that corporate law influences the process of ownership dispersion, and possibly undermines its efficiency, also by requiring that a significant ownership stake be maintained for protecting idiosyncratic control rents.

This is the dark and, at least to my knowledge, unexplored side of the 'law matters' argument. Efficiency of corporate governance may not only depend on agency costs being minimized, but also on residual rights of control being allocated in such a way as to promote the investment of unobservable managerial talent. If this is true – as appropriate consideration for entrepreneurship in corporate governance suggests it should be – legal entitlements to control rights should be independent of the firm's ownership structure for efficient separation of ownership and control to emerge. What matters for separation of ownership and control, possibly even more than a strict legal discipline of diversionary PBC, is then distribution of legal entitlements to discretionary decision-making between shareholders and the corporate controller.

[195] Demsetz, H. [1983], *op. cit.*, and Demsetz H. and Lehn, K. [1985], *op. cit.*

6.6. Reframing Corporate Law and Economics

6.6.1. A Different Framework for Analyzing Legal Rules (and Their Efficiency)

The last conclusion suggests that both *power* and *law* matter, in two complementary respects, for corporate governance.[196] In the foregoing discussion I have explained how this is consistent with a theoretical analysis of separation of ownership and control that goes beyond the traditional agency framework, and how, once contractual incompleteness is fully accounted for, power and law are no longer independent of each other. Specifically, law does not only matter as a *constraint* on the corporate controller's power, but also as a *support* of the same power. Although the way power is supported on legal grounds (*entitlements* to residual rights of control) is different from the way it is constrained (*duties* owed to the non-controlling shareholders), the *dual* role of legal rules in corporate governance ultimately involves a tradeoff. Economic analysis then supports the view of some legal scholars that corporate law is to be regarded as a solution of a discretion-accountability tradeoff.[197] The analysis of this tradeoff, from both a positive and a normative Law and Economics perspective, will be the subject-matter of the next Chapters.

Positive analysis will speculate on how corporate law influences the models of corporate governance prevailing in different countries of the Wealthy West of the world. The foregoing analysis of the economics of corporate governance has shown on what basis the efficient structure of corporate ownership *should* be selected, and evolve endogenously. However, the legal system determines to what extent that process *can* take place. On the one hand, legal rules need to prevent the corporate controller from expropriating non-controlling shareholders by disciplining the extraction of diversionary PBC. Unconstrained opportunities for stealing would in fact undermine separation of ownership and control. On the other hand, separation of ownership and control need also be supported by legal entitlements to discretionary management and control safeguard (entrenchment). In this respect, law shapes the actual patterns of corporate governance by vesting ultimate deci-

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[196] Other commentators have recently suggested this conclusion, in both law and economics. See *supra*, Chapter Four, section 4.7. I am simply carrying this intuition further, by investigating both its theoretical underpinnings and its regulatory implications.

[197] See Dooley, M.P. [1992], *op. cit.*, and subsequently Bainbridge, S.M. [2002a], CORPORATION LAW AND ECONOMICS, Foundation Press. The reader should be reminded, though, that none of these authors has ever questioned the principal-agent framework. Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, do; however, they do not explicitly characterize the CG problem as a discretion-accountability tradeoff.

sion-making power in one or more controlling shareholders (through the shareholders meeting), or in the corporate managers (through the board of directors).

The flip side of the coin is that both opportunities for expropriation of non-controlling shareholders and entrenchment devices available to the corporate controller influence, in turn, the dynamics of control allocation over time (i.e., the ultimate source of efficiency in corporate governance). Through the comparison of some representative systems of corporate governance, I will therefore investigate the corporate law's role in determining whether the interest of non-controlling shareholders is adequately protected from expropriation, as well as how control is exerted by the entrepreneur/manager, how it is maintained and, ultimately, transferred. Alternative solutions of the discretion-accountability tradeoff will be analyzed accordingly.

One might then wonder whether there is an optimal solution of the above tradeoff – that is, an *optimal regulation of corporate governance*. This is the question underlying an efficiency-based normative analysis: how should corporate law be?[198] Such a question ought not to be confused with an only apparently related inquiry: whether or not there is an *optimal model of corporate finance, ownership, and governance*.[199] To be sure, if there was such an optimal model, we would expect also one optimal regulation across the board. However, economic theory to date cannot say whether dispersed corporate ownership is preferable to ownership staying concentrated.[200] The most credited answer to this dilemma – or at least, the one that sounds most convincing to me – is that different models suit different needs.

This does not exclude, however, that corporate law can be optimized in at least one way: namely, by providing *alternative legal solutions* which allow for the efficient selection of the corporate governance model. In this perspective, I will investigate what legal instruments should be made available to firms for them to select the model of ownership and control most suitable to their needs. The normative analysis will be likewise based on the comparison of some representative corporate law jurisdictions.

Is this framework of analysis consistent with the empirical evidence? Two important steps need be taken in order to answer this question. First, one should check whether the underlying assumptions are not contradicted by the evidence.

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[198] This is how the matter is typically framed in Corporate Law and Economics. See Kraakman *et al.* [2004], *The Anatomy*, cit. The authors, however, refrain from normative analysis throughout their otherwise enlightening book, and only make suggestive remarks for future research in this field in the last chapter.

[199] This is in fact another question. See, illustratively, Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 59-65.

[200] Id., at 83-85.

Secondly, once we feel confident enough about the strength of our assumptions, we might be able to investigate whether the effects of alternative legal arrangements on corporate governance are consistent with what our theory would predict. To this purpose, I shall first outline the theoretical predictions, and then identify a methodology for testing both their positive and normative implications for corporate law.

6.6.2. The Main Hypothesis of the Framework

The above framework for analyzing the impact of corporate law on corporate governance and its efficiency rests on a very strong assumption. The assumption is that, whatever the degree of separation of ownership and control, *entrepreneurship matters* and has to be rewarded in the form of control rents so long as it cannot be 'priced' by financial markets.[201] This assumption would be rejected by empirical evidence if one optimal ownership structure existed across business, regardless of the investments in human capital required from entrepreneurs and managers. Conversely, when every firm has *its own* optimal structure of ownership, this should allow consideration for firm-specific factors including entrepreneurship. If we just focus on entrepreneurship, the optimal ownership structure will depend on the amount of control rents necessary to reward idiosyncratic investments by the corporate controller; that is to say, necessary to motivate business undertakings that cannot be just self-financed out of debt and personal funds, but also require some degree of external equity.

I have operationalized this intuition through the concept of *idiosyncratic PBC*, claiming that their existence and amount is specific to the combination of entrepreneurial talent with the firm's assets and then determines the *efficient* degree of separation of ownership and control. Whenever high idiosyncratic PBC are required to motivate very uncertain business undertakings, equity finance should be relatively more expensive and this should lead, in turn, to higher ownership concentration, typically featured with a controlling shareholder in charge of fundamental decision-making. The opposite outcome (ownership dispersion and managerial control) is supposed to emerge when managing the business does no longer require a high degree of innovativeness and inventiveness and, therefore, idiosyncratic PBC are low. In this perspective, the firm's ownership structure is supposed to be *endogenous*. That is, as Harold Demsetz and subsequently Kenneth Lehn showed, ownership concentration is not systematically related to firm performance. Endogeneity of

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[201] Within the existing literature, the closest formulation of this assumption can be found in Mayer, C. [1999], *op. cit.* (arguing, however, that ownership concentration naturally obtains on these grounds).

ownership structure then underlies, not only conceptually but also empirically, the existence of idiosyncratic PBC.

Apparently, however, Demsetz and Lehn's proposition and results were contradicted by subsequent studies on the empirical relationship between ownership structure and firm performance.[202] Earlier work, mainly based on the analysis US listed companies, found empirical support for the argument that firm performance initially increases but then rapidly decreases in ownership concentration.[203] This account would clearly reject the basic assumption of inexistence of an optimal ownership structure across businesses, for moderately dispersed ownership with contestable control (where managers are in charge) would be *always* superior to concentrated ownership with entrenched control (where a controlling shareholder is in charge). However, albeit still very popular especially among American economists, this view is not supported by more recent empirical analyses.[204]

Improved knowledge of the nuances of corporate governance, as well as more sophisticated econometrics, have shown that finding an unbiased, systematic relationship between corporate ownership and performance is far from easy. At best, the empirical evidence available to date is inconclusive. This is especially true when the relationship is investigated cross-country – as it tends to be in the recent empirical work.[205] Different patterns of corporate ownership and control apparently bear no relationship with firm performance when (most) countries of Western Europe are compared,[206] whereas they show a negative effect of control by large shareholders in East Asia and a positive effect of ownership stakes retained by con-

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[202] Shleifer, A. and Vishny, R. [1997], *op. cit.*, 759-761. The prevailing alternative account of the ownership-performance relationship is that ownership structure affects firm performance in two opposite ways. At first, ownership concentration improves performance, for it better aligns the corporate controller's incentives with the interest of outside shareholders. However, as soon as ownership concentration rises to the point where the corporate controller gets uncontested control over the firm's assets, performance declines due to higher extraction of PBC at the outside shareholder's expenses. As a result, the relationship between ownership structure and firm performance should be 'hump' or 'roof'-shaped, being optimized at the level of ownership concentration where the incentive alignment effect is (marginally) offset by the entrenchment-PBC effect. This level is supposedly low enough to allow for contestable control, while featuring the corporate controller with moderate share ownership. See Stulz, R. [1988], *Managerial Control of Voting Rights: Financing Policies and the Market for Corporate Control*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 20, 25-54.

[203] Morck, R., Shleifer, A. and Vishny, R. [1988], *Management Ownership and Market Valuation: An Empirical Analysis*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 20, 293-315.

[204] Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 84-85.

[205] See Morck, R., Wolfenzon, D. and Yeung, B. [2005], *Corporate Governance, Economic Entrenchment and Growth*, in JOURNAL OF ECONOMIC LITERATURE, vol. 43, 657–722, for a recent survey and a rather peculiar interpretation of the entrenchment effects of ownership concentration.

[206] Faccio, M. and Lang, L.H.P. [2002], *The Ultimate Ownership of Western European Corporations*, in JOURNAL OF FINANCIAL INTERMEDIATION, vol. 65, 365-395.

trolling shareholders in a sample of 27 wealthy economies.[207] Although those results are not necessarily in contradiction with each other, they do not show any univocal path either.

In addition, the same results have to be taken with extreme caution. Whether performed on a within-country or a cross-country basis, all of the available studies on the empirical relation between ownership structure and firm performance suffer from one or more of the following biases: a) definition of ownership structure;[208] b) definition of corporate control;[209] c) reverse causality.[210]

If the empirical analysis does not reject the hypothesis that the ownership structure is endogenous, and then that concentrated ownership can be as efficient as dispersed ownership, casual empiricism mildly support this view. As I mentioned in Chapter Five, at least within most developed economies, corporate governance systems where dispersed ownership prevails (namely, the US and the UK) do not significantly outperform those typically based on a more concentrated ownership structure (i.e., developed countries of continental Europe).[211] However, this does not mean that we live in the best of all possible worlds. In fact, I claim that legal regulation of corporate governance, interplayed with other institutional factors, creates *biases* that might prevent the efficient ownership structure from being chosen.

6.6.3. Ownership and Performance: Testing the Wrong Hypotheses?

Specifically, law may produce both *shortcomings* and *constraints* that undermine the selection of the efficient ownership structure. Shortcomings may lead to 'excessive' ownership concentration due to weak protection of outside shareholders from expropriation by the corporate controller (i.e., too much scope for diversionary PBC).

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[207] See, respectively, Claessens, S., Djankov, S., Fan, J.P.H. and Lang, L.H.P. [2002], *Disentangling the Incentive and Entrenchment Effects of Large Shareholdings*, in JOURNAL OF FINANCE, vol. 57, 2741-2771; and La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R. [2002], *Investor Protection and Corporate Valuation*, in JOURNAL OF FINANCE, vol. 57, 1147-1170.

[208] Bianchi, M., Bianco, M., Giacomelli, S., Pacces, A.M. and Trento, S. [2005], *op. cit.*, 66-69. Basically, the question is: How much ownership concentration is required for having a controlling shareholder instead of a dispersed ownership structure?

[209] "What matters is not whether ownership and/or voting power are more or less concentrated on a permanent basis but the ability of shareholders to intervene and exercise control over management when required." Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 83. But, then, what if corporate control is entrenched more often than not?

[210] Basically, this is the core of Demsetz's argument framed as a chicken-egg problem: is the ownership structure that determines firm performance, or the other way around? Demsetz H. and Lehn, K. [1985], *op. cit.*

[211] See *supra*, Chapter Five, section 5.5.2., and Mayer, C. [1999], *op. cit.*

Constraints may lead to both 'excessive concentration' and 'excessive dispersion', depending on whether entitlements to corporate control (that is, to idiosyncratic PBC) are only available to a controlling shareholder or, alternatively, to a management-controlled board of directors. Empirical analyses so far have only attempted to integrate the first problem into the study of the relationship between corporate ownership and performance, while completely neglecting the second one.[212] This might provide a further explanation of why the empirical evidence on this matter is inconclusive.

Failure to account for idiosyncratic PBC in the empirical analyses of ownership structure is not surprising, indeed. As we already know, those PBC are *not* in the theory of corporate governance, or at least not in the mainstream one. As such, empirical work available to date is likely to test the wrong hypotheses. Adequately testing the empirical relationship between ownership structure and corporate performance would require that the role of idiosyncratic PBC be taken into account. Although this would be interesting, I am not venturing in this territory here. Rather, the remainder of this work will try to assess how corporate laws affect the selection of the ownership and control structure of the firm, depending on their ability to curb the potential for diversionary PBC and to support the exploitation of idiosyncratic PBC. This kind of legal analysis is going to provide empirical support for a theory of corporate governance based on interaction of the three categories of PBC that are assumed to be at play. As it will be shown, two of them (the diversionary and the idiosyncratic kinds) are directly affected by regulation, whereas the third one (distortionary PBC) is dealt with indirectly through the market for corporate control – whose features are also determined by regulation. On the normative side, this approach has major policy implications, which will be illustrated in turn. To this purpose, I shall always maintain that the optimal ownership structure depends on the amount of idiosyncratic PBC necessary to motivate business, and it is therefore endogenous. Adequately testing this proposition within the above framework is a matter for future research.

6.6.4. Testable Propositions

The foregoing discussion brings about some key propositions about how corporate law affects separation of ownership and control. They initially enter just as

[212] Other studies have attempted to investigate the matter in a broader perspective. However, they normally conclude that excessive ownership concentration is the problem, and that its costs outweigh the benefits. See Morck, R., Wolfenzon, D. and Yeung, B. [2005], *op. cit.* For a more even view of the problem, see Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 78-89.

cause-effect relationships and, thus, as a number of positive statements. Adding consideration for the efficient degree of separation of ownership and control makes then possible to uncover their normative implications. As I showed, efficient separation of ownership and control requires credible commitments being taken not to expropriate non-controlling shareholders of their share of the pie (curbing diversionary PBC), prospective reward being secured by the corporate controller in return for his firm-specific investments (protecting idiosyncratic PBC), and corporate control being transferred when a more efficient manager is available (cashing in idiosyncratic PBC as a more profitable alternative to inefficient exploitation of distortionary PBC).

Whenever any of the above conditions is not, or is just imperfectly satisfied, separation of ownership and control may take place to an inefficient degree. Too much scope for diversionary PBC can only lead to less separation than it would be desirable (outside shareholders are less willing to invest when they face the risk of being robbed). Inability to secure idiosyncratic PBC from subsequent expropriation by a prospective raider typically restricts the opportunities for separating ownership from control.[213] But it may also lead to a system where high idiosyncratic PBC (and most innovative businesses) are incompatible with the stock market, being dispersed ownership the only option for the governance of a listed firm.[214] Finally, difficulties in cashing in idiosyncratic PBC through control sales that nurture the evolution of the firm's ownership and control structure undermine the efficient dynamics of corporate control allocation. Similarly to the previous case, this may lead to either excessive ownership concentration,[215] or to excessive ownership dispersion.[216]

Once again, it should be noticed that the notion of 'excessive' ownership concentration (or dispersion) refers to an optimal ownership structure that is not known at the outset, for it is endogenous by assumption. My point here is simply that inadequate treatment of the above kinds of PBC is likely to determine a departure from the efficient outcome, although it does not so necessarily. That being said, I posit that inadequate treatment of PBC mostly depends on legal regulation

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[213] At the very least, a talented entrepreneur would hold on his position of majority shareholder in the absence of alternative safeguards for his control rents. See Coates, J.C. IV [2003], *op. cit.*

[214] See *infra*, Chapter Eleven, section 11.3.4.

[215] With corporate control being stuck in the hands of a few founders' families, whose descendants presumably did not inherit entrepreneurial talent together with the firm's stock. See Morck, R., Wolfenzon, D. and Yeung, B. [2005], *op. cit.*

[216] Where managerial control is featured with both low incentives to risky innovation and high consumption of distortionary PBC. See, e.g., Franks, J., Mayer, C. and Renneboog, L. [2001], *Who Disciplines Management in Poorly Performing Companies?*, in JOURNAL OF FINANCIAL INTERMEDIATION, vol. 10, 209-245.

of corporate governance. From this contention, three fundamental predictions arise about the role of corporate law for separation of ownership and control. They consist of both positive statements and normative implications.

6.7. Three Predictions on How Corporate Law Affects Separation of Ownership and Control

6.7.1. Protecting Investors (Law and Diversionary Private Benefits of Control)

> **Prediction 1:**
>
> Law matters as a device supporting protection of non-controlling shareholders against *diversionary private benefits* that may be extracted by the corporate controller. Effective protection makes separation of ownership and control a workable way to finance business, whereas ineffective protection hampers it.
>
> The prediction is not novel: it lies at the core of the standard 'law matters' argument.

a) Theoretical Background

Legal (mandatory) protection of non-controlling shareholders from expropriation of their investment is a *precondition* for a model of corporate finance based on separation of ownership and control.[217] In the absence of such a protection of outside providers of equity finance, the corporate controller will hardly be able to take credible commitments that non-controlling owners will be dealt with fairly. The reason is that corporate contracts are incomplete, and only the corporate controller is in charge of managing its adaptation to changed circumstances. As a result, households will be ultimately unwilling to invest their savings in corporate stock,

[217] Although the opportunities for cash-flow diversion available to the corporate controller depend also on a number of complementary institutional factors (e.g., social norms, reputation, tax enforcement, disclosure available through the financial press) whose role in curbing diversionary PBC appears to have been historically – and still to be, to some extent – at least as important as that played by the law for equity finance to emerge in the first place, it seems that the sustainability of separation of ownership and control in the long run ultimately requires that substantive standards of corporate law against 'stealing' be set appropriately and reliably enforced. Compare Black, B.S. [2001], *op. cit.*, with Franks, J., Mayer, C. and Rossi, S. [2005b], *Ownership: Evolution and Regulation* (March 25, 2005), Working Paper, available at www.ssrn.com (earlier versions: ECGI Finance Working Paper No. 09/2003; EFA 2004 Maastricht Meetings Paper No. 3205; AFA 2003 Washington, DC Meetings).

for fear of being subsequently expropriated, whereas entrepreneurs will refrain from selling their firm's shares for lack of adequate consideration.

b) Positive Implications

Weak protection of non-controlling shareholders from expropriation by the corporate controller determines a high level of diversionary PBC in the system. High diversionary PBC have three major consequences for corporate governance:
1) They make access to equity finance costlier.[218]
2) For listed firms, they involve concentration of ownership in the hands of the corporate controller.[219]
3) They undermine the efficient functioning of the market for corporate control.[220]

c) Normative Implications

There is no such thing as a 'good purpose' for expropriation. Diversionary PBC are always 'bad' (i.e., inefficient) for corporate governance. Nonetheless, policing diversionary PBC through the legal system is costly, and that explains why the normative goal cannot be to eliminate them outright, but it should be rather to *minimize their amount in a cost-efficient manner*. The costs involved by an anti-expropriation legal policy are both direct and indirect. The *direct* ones arise from setting up a system of legal controls and providing for its enforcement. Of course, such a system should make corporate finance cheaper, not costlier.[221]

Indirect costs of curbing diversionary PBC are the most difficult to handle. Absolute prevention of mismanagement ultimately involves a close scrutiny on management. Inasmuch as this undermines managerial discretion, such a scrutiny would be

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[218] This leads, in turn, to stock markets underdevelopment and few firms going public to finance expansion and/or to cash out the founder's initial investment. La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R. [1997], *Legal Determinants of External Finance*, in JOURNAL OF FINANCE, vol. 52, 1131-1150.

[219] The larger the corporate controller's ownership stake, the lower his incentive to divert resources from non-controlling owners; the fewer the shares sold to the investing public, the higher the consideration that can be obtained. Shleifer, A. and Vishny, R. [1997], *op. cit.* (but see also the objection raised by Roe, M.J. [2003c], *op. cit.*, discussed on Chapter Four, section 4.4.4).

[220] When diversionary PBC are involved, control might end up being allocated to the best thief, instead of to the best manager; as a result, takeovers – albeit friendly – are likely to be very infrequent, and not necessarily beneficial, events. Bebchuk, L.A., Kraakman, R.H. and Triantis, G. [2000], *op. cit.*

[221] Here the argument is that shareholders are like people walking in the street at night. Both categories of individuals would prefer taking 'some' risk of being robbed rather than paying for a policeman standing at every corner. Becker, G.S. [1968], *Crime and Punishment: An Economic Approach*, in JOURNAL OF POLITICAL ECONOMY, vol. 76, 169-217.

in the interest of neither the corporate controller nor of non-controlling shareholders, for they both would not like the merits of corporate decision-making being systematically reviewed by a judge and, more in general, by anybody else than the market. Therefore, although virtually all corporate transactions may involve expropriation by the corporate controller, only the most dangerous should be subject to legal (judicial or procedural) controls, mostly with a hands-off approach aimed at detecting cash flow diversion without interfering with business judgment.[222] The efficient policing of diversionary PBC is based on the optimal solution of a discretion-accountability tradeoff.[223]

6.7.2. Supporting Control (Law and Idiosyncratic Private Benefits of Control)

Prediction 2:

Law also matters for separation of ownership and control in that it protects the corporate controller's *idiosyncratic private benefits*. Corporate law is a source of entitlements to firm control independent of corporate ownership, affecting the distribution of powers between the corporate controller and non-controlling owners. Once shareholders have been protected from expropriation of their investment, distribution of corporate powers determines the degree of separation of ownership and control that can be afforded by entrepreneurs concerned with their control rents.

The prediction is partly novel: although the importance of distribution of legal powers for separation of ownership and control has been recently highlighted by the literature, no connection with the role of control rents in corporate governance has yet been made.[224]

a) Theoretical Background

Low diversionary PBC are just a necessary, but not sufficient, condition for separation of ownership and control. Idiosyncratic PBC must be also considered. Their protection is necessary to motivate the undertaking of highly uncertain business (unobservable and unverifiable firm-specific investments). Having this combined with separation of ownership and control requires that entitlements to control rents be available to a corporate controller who is not also the corporate owner.

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[222] Rock, E.B. and Wachter, M.L. [2001], *op. cit.*

[223] Prohibiting everybody from walking in the street at night is too much of an extreme solution to prevent robbery; having individual behavior checked (or constrained) just in most suspicious situations will certainly leave some scope for robbery, but at least will preserve most people's liberty. Cooter, R.D. and Ulen, T.S. [2004], LAW AND ECONOMICS, 4th edn., Addison-Wesley, 445-477.

[224] See Cools, S. [2005], *op. cit.* Conversely, the literature on control rents in CG draws no implication about the allocation of legal entitlements. See, illustratively, Zingales, L. [2000], *op. cit.*

Those entitlements need to be stable over time (for otherwise control rents risk to be eventually expropriated by the owners taking over), and thus must be legal in character. They determine a range of alternative distributions of legal powers between the corporate controller and the corporate owners.

Legal devices aimed at empowering corporate controllers, freeing them from non-controlling shareholders' interference, basically comes in two forms: a) separation of voting rights from ownership claims; b) separation of control rights from voting rights.[225] The former typically allows for *shareholder control* being exerted through dominance of the general meeting (where votes are cast) with a limited ownership stake; it may also lead to *managerial control* when voting rights can be stripped outright from share ownership. The latter makes control available to the corporate managers, featuring boards of directors with little need for support by the general meeting of shareholders and with the power to have supporting resolutions both initiated and passed whenever they are needed.

When corporate law falls short of providing legal entitlements to corporate control independently of share ownership, separation of ownership and control can only take place to a limited extent, no matter of how low is the potential for the extraction of diversionary PBC. This might impair the selection of the efficient ownership structure by corporate enterprises.

b) Positive Implications

There might be little separation of ownership and control also in those systems where diversionary PBC are low. I hypothesize this is due to legal entitlements to corporate control being too closely linked to share ownership. The following results are therefore expected:[226]

1) Listed firm will be governed by controlling shareholders anytime legal devices for separating control rights from voting rights are not available.[227]
2) Ownership will be relatively less concentrated, and stock markets relatively more developed, to the extent that controlling shareholders are allowed to partly separate voting rights from ownership claims.
3) The investing public will not let the (legal) potential for separation of voting rights from ownership claims be fully exploited under a shareholder control structure.[228]

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[225] See *supra*, Chapter One, section 1.6.2.

[226] Even though opportunities for expropriation of non-controlling shareholders are otherwise minimized; that is, where the normative part of Prediction 1 holds.

[227] Managerial control is not practicable when only shareholders can be in charge. See Cools, S. [2005], *op. cit.*

4) Fully dispersed ownership can only arise on condition that separation of control rights from voting rights (or having the latter definitively stripped from share ownership) is an option to support managerial control structures.[229]

c) Normative Implications

Since we do not know what the optimal ownership structure is, we cannot say whether corporate law should favor shareholder control or managerial control, or whether corporate ownership should be more or less concentrated. This matter should be left for firms to decide. In order to be efficient, such a decision should be taken when corporate controllers and outside shareholders contract with each other, namely when firms resort to the market for equity capital by going public (Initial Public Offerings – IPOs), raising additional funds from the stock market (Seasoned Equity Offerings – SEOs), reducing their market capitalization (stock repurchase), or going private. In those situations, share ownership that the corporate controller *is willing* to maintain relative to outside shareholders will depend on how favorable the stock price is (taking the amount of idiosyncratic PBC into account). Share ownership that he *has to* maintain in order to keep firm control undisputed (whatever the amount of idiosyncratic PBC) will depend instead on corporate law. Clearly, when the two above levels are inconsistent with each other, this may prevent the efficient ownership structure from being chosen.

Most often, ownership will be more concentrated than desirable, provided that the majority of corporate law systems are biased towards shareholder control of publicly held firms. But also the reverse outcome can occur (i.e., ownership more dispersed than desirable), when regulation of listed companies is biased towards managerial control.[230] An optimal regulation of corporate governance should avoid

[228] When firms are governed by a controlling shareholder, idiosyncratic PBC may prospectively undermine maximization of shareholder value through efficient control sales. A minimum share ownership needs to be retained by the corporate controller as a commitment to go for a value-increasing control transaction in the face of his control rents; no matter of how low they are, the equity interest of the controlling shareholder must be always commensurate to them (see *supra*, section 6.4.2).

[229] Under managerial control structures, prospective maximization of shareholder value through efficient control sales does not necessarily require that a minimum share ownership be maintained by the corporate controller, but can also be induced by renegotiable severance payments – provided that idiosyncratic PBC are low enough (see *supra*, section 6.3.3).

[230] In the former scenario, idiosyncratic PBC may fail to evolve to a (lower) amount consistent with dispersed ownership, for managerial control structures are not featured by corporate law (see *infra*, the discussion for Sweden and Italy in Chapter Seven). In the latter, there might be simply not enough room for highly innovative (and uncertain) business in the stock market, provided that shareholder control supporting high idiosyncratic PBC with concentrated ownership structures is disfavored by corporate law (see *infra*, the discussion for the UK in Chapter Seven).

both kinds of biases. In particular, corporate law should provide for alternative arrangements suitable for *both shareholder control* with different degrees of ownership concentration *and managerial control* featured with outright dispersed ownership, in order for the optimal ownership structure to be selected by publicly held companies.

As we will see in the later discussion, not all of these arrangements are equally efficient. Some of them (like, for instance, dual class shares and anti-takeover provisions in the corporate charter) are mostly due to be implemented *ex ante*, when equity funds are raised from outside investors, and therefore the resulting ownership and control structure is likely to be efficiently priced by the stock market. Some others (like, for instance, pyramidal groups and anti-takeover charter amendments) can be more easily implemented *ex post*, by altering the balance between control rights and ownership claims originally 'sold' to the market; therefore, they are more likely to come at the expenses of outstanding, non-controlling shareholders.[231]

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[231] For example, adding a layer at the bottom of the pyramid may result in all minority shareholders except those of the newly set up company being prejudiced by an empire building policy decided by the controlling shareholder at the apex. Holmén, M. and Högfeldt, P. [2005], *Pyramidal Discounts: Tunneling or Agency Costs?*, ECGI Finance Working Paper No. 73/2005, available at www.ssrn.com and www.ecgi.org. Adding one or more layers at the top of the pyramid can ease the ownership constraint of the corporate controller, likewise leading to higher distortionary PBC being exploited at the outstanding shareholders' expenses. Almeida, H. and Wolfenzon, D. [2006], *A Theory of Pyramidal Ownership and Family Business Groups*, in JOURNAL OF FINANCE, vol. 61, 2637-2681. Of course, the picture gets even worse when also diversionary PBC are at play (typically in the form of 'tunneling' – Bertrand M., Mullainathan S. [2003], *Pyramids*, in JOURNAL OF THE EUROPEAN ECONOMIC ASSOCIATION, vol. 1, 478-483). Anti-takeover charter amendments potentially lead to a similar outcome, to the extent they can be implemented by the management *after* selling the controlling block to the investing public. Luckily – as we will see – this is most often impossible, for such a kind of amendments typically faces a very strong opposition by institutional investors. The matter is slightly more complicated as far as dual class shares are concerned. For a broad discussion of the implementation of these techniques in different regulatory environments, see *infra*, Chapter Seven.

6.7.3. Promoting a Market for Corporate Control (Law and Distortionary Private Benefits of Control)

Prediction 3:

Law does not only matter statically, in that it supports the exercise of power by the corporate controller and constrains its abuse. It also matters dynamically, in the same two respects, in that it promotes the allocation of corporate control to the best managers while preventing non-controlling owners from being exploited through unfair control transactions. *Insufficient protection* of non-controlling shareholders leads to concentrated ownership structures where the efficiency of the market for corporate control is impaired by value diversion. However, *excessive shareholder protection* may prevent insurgents from compensating the incumbents' control rents through the proceeds of efficient control transactions. Eventually, this leads to excessive consumption of *distortionary private benefits* under too dispersed or too concentrated ownership structures.

The prediction is basically novel: both the consequences of managerial control rents on the takeover mechanism and the effects of minority shareholder protection on the acquirer's incentives have been dealt with in previous literature, but they have always been considered separately.[232]

a) Theoretical Background

Whether corporate governance is based on shareholder control or on managerial control, the corporate controller most often ends up being entrenched. I suppose this is due to the ubiquity of non-trivial idiosyncratic PBC (although the same result holds also in the presence of high diversionary PBC). While protecting the manager's firm-specific investments is *ex ante* beneficial for corporate governance, his entrenchment might impair the efficient allocation of corporate control *ex post*. Over time, more and more *distortionary* PBC may be enjoyed by an entrenched corporate controller through misuse of free cash, thereby compromising the efficient management of the firm. The market for corporate control provides a dynamic solution to this problem, by re-allocating corporate control when its exercise is no longer efficient. However, contrary to standard theory, this is not necessarily based on (the threat of) hostile takeover – that would not be compatible with the protection of idiosyncratic control rents – but, rather, on a system of friendly takeovers where idiosyncratic PBC are cashed in through the surplus of an *efficient* control sale, and distortionary PBC are minimized as a result.

Cashing in the incumbent's control rents is crucial for the efficiency of this takeover mechanism. Provided that takeovers are friendly (and therefore at least the

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232 For illustration, see Burkart, M. and Panunzi, F. [2006b], *op. cit.* (in economic theory); and Kraakman *et al.* [2004], *The Anatomy*, cit., 157-191 (for Corporate Law and Economics).

incumbent's ownership stake need be transferred), they only make sense when their gains to the acquirer are large enough to offset both the incumbent's PBC and the cost of the stock purchased. On condition that expropriation of non-controlling shareholders is adequately policed, those gains can only arise from increased value of corporate stock under the new management. How much of those gains can be appropriated by a prospective acquirer – and, therefore, the likelihood of an efficient change in control – depends on both the amount and the price of the stock purchased for the acquisition. The role of corporate law in this mechanism is therefore not only that of protecting non-controlling shareholders from unfair exploitation (in the form of 'looting' or similar instances of expropriation), but also that of preventing outside shareholder from free riding on either the incumbent's control premium or the acquirer's takeover gains.[233]

b) Positive Implications

A theory of the market for corporate control that accounts for the role of idiosyncratic PBC in corporate governance leads to the following expectations:

1) Regardless of whether a controlling shareholder or the management is in charge, hostile takeovers are the exception, while friendly takeovers are the rule.[234]
2) A necessary, but not sufficient, condition for an active market for corporate control is that diversionary PBC are also policed by regulation of corporate control transactions.[235]
3) Takeovers may improve the allocation of corporate control depending on the ease with which idiosyncratic PBC can be cashed in by a less efficient incumbent. Rules providing for the equal treatment of outstanding shareholders undermine that ease,[236] and so the efficiency of the market for corporate control;[237]

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[233] The analysis of free riding problems in takeovers has an authoritative, long-standing tradition. Grossman, S.J. and Hart, O. [1980b], *op. cit.* See *infra*, Chapter Ten, for a broader discussion.

[234] As we have already seen, the empirical evidence unambiguously bears out this implication. See *supra*, Chapter Two, section 2.4.

[235] Alternatively, the corporate controller needs to commit to a 'no-looting' policy (resulting in a nearly 'no-takeover' policy), by maintaining a very high degree of ownership concentration. See Bebchuk, L.A. [1999], *op. cit.*

[236] This is achieved, for instance, by requiring that the control premium be shared also with non-controlling shareholders and/or restricting the possibility of 'bribing' the incumbent management with a severance payment. See the discussion of this issue in Chapter Ten. For an authoritative contrarian view, see Bebchuk, L.A. [1994], *op. cit.*, and Bebchuk, L.A. [2002a], *The Case against Board Veto in Corporate Takeovers*, in UNIVERSITY OF CHICAGO LAW REVIEW, vol. 69, 973-1035.

[237] As some commentators have recently highlighted, those rules are only illusionary conductive to higher contestability of corporate control. Coates, J.C. IV [2003], *op. cit.* As I am going to show (see *infra*, Chapter Ten), all they lead to is an either inefficient or just inactive market for corporate control, depending on whether ownership is dispersed (and takeovers need to focus on cheapest tar-

4) Limited appropriability of takeover gains by the acquirer likewise reduces the frequency of efficient changes in control.[238]
5) Paradoxically, excessive protection of non-controlling shareholders in takeovers reduces the chances that distortionary PBC are policed by the market for corporate control. Ownership may result either in too concentrated structures,[239] or in too dispersed ones.[240]
6) Differential treatment of the corporate controller and non-controlling shareholders in takeovers (favoring both cashing in of idiosyncratic PBC by the incumbent and appropriation of takeover gains by the acquirer) makes it easier to re-concentrate ownership when this is needed, but *might only potentially* lead to a subsequent transition from concentrated ownership to dispersed ownership structures. In fact, this result is conditional on the availability of entitlements supporting managerial control.[241] When controlling shareholders are unable to transfer control to professional management, they (and their heirs) will eventually have almost no choice but building empires or otherwise enjoying distortionary PBC.[242]

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gets to buy out at one single price rather than on most inefficient managers that may require a higher compensation to part with control) or concentrated (and having *all* shareholders awarded a presumably substantial control premium is most often too a high price to pay for a takeover). See, most prominently in this regard, the discussion for the UK and Italy in Chapter Eleven, below.

[238] Mandatory bid for all outstanding shares, limitations on the power to squeeze out non-tendering shareholders, and inability to take full control of the board of directors even with the incumbent's consent may indeed serve the purpose to avoid exploitation of non-controlling shareholders (thereby preventing inefficient takeovers from taking place) but they also make acquisitions either more expensive or less profitable to the prospective acquirer (thereby inhibiting efficient takeovers as well). See Easterbrook, F.H. and Fischel, D.R. [1991], *op. cit.*, 109-144.

[239] Where compensating control premia with higher stock market returns accruing to the acquirer is made too expensive or not enough profitable by regulation. See the discussion of European regulation of takeovers in Chapter Eleven.

[240] Where having managerial control rents compensated by increased profitability of a shareholder control structure is not always an option, due to regulatory constraints on either the distribution of takeover gains, or the powers of controlling shareholders, or both. See the discussion for the UK in Chapter Eleven, below.

[241] In the absence of legal entitlements supporting managerial control, idiosyncratic PBC enjoyed by the controlling shareholder may hardly be compensated by a professional manager with the intention of re-selling all of the firm's stock back to the investing public: it makes almost no sense to pay for firm control when you are going to lose it (for free) the day after. See the discussion for Sweden in Chapters Seven and Eleven, below.

[242] Notice that this result does not depend on the identity of the controlling shareholder, and therefore does not allow for correction by a more efficient controlling shareholder taking over. Any controlling shareholder would do the same, provided there is no potential for further dispersion of ownership. Idiosyncratic PBC may be cashed in just in two ways:

i) through the sale of a control block, but then the minimum ownership stake that needs be maintained as a commitment to the next control sale acts as a constraint on the prospective

c) Normative Implications

Normative implications of the above reasoning are straightforward. An efficient discipline of the market for corporate control should not be concerned with contestability. People may disagree on whether contestability of corporate control is a desirable feature of corporate governance, but certainly, it cannot be *imposed* by regulation. Even in those environments where customarily dispersed ownership is more favorable to contestable control, this option appears to be neglected by the vast majority of publicly held companies. Quite to the contrary, most often they deliberately choose to *exclude* contestability.

Nevertheless, an efficient market for corporate control – albeit not based on contestability – should not be a foregone goal of corporate law. The legal discipline should then focus on friendly takeovers, with the aim of promoting the occurrence of efficient ones while preventing inefficient ones from taking place. When takeovers are friendly, the two above goals are not incompatible with each other. Avoidance of value-decreasing takeovers can be guaranteed simply by extending the legal policing of diversionary PBC to corporate control transactions. This would make sure that non-controlling shareholders could not be expropriated of the current value of their shares by collusion between the seller and the purchaser of corporate control. Then takeovers can only be efficient, provided that *both* the incumbent's equity interest in the firm *and* his PBC need to be bought out: the acquirer cannot perform worse than the incumbent on both accounts, for he would lose otherwise.[243] However, if he performs better, he risks being unable to reap the gains

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gains to the acquirer (sooner or later there will be no controlling shareholder willing to take over);

ii) through a severance payment that would relieve the aforesaid constraint, but then managerial control needs to be featured by corporate law.

When controlling shareholders becomes unable to realize the idiosyncratic value of corporate control (since ownership is already as dispersed as it can be under shareholder control and transition to managerial control is not an option), that value will have to be exploited in the form of distortionary PBC. See the discussion for Sweden in Chapters Seven and Eleven, below.

[243] To be sure, the acquisition could be motivated by higher idiosyncratic PBC. However, this is unlikely in the absence of major business innovations. Even in this case, that idiosyncratic value will have to be sooner or later cashed in through the security benefits of the next acquisition. Most often, the acquisition will be motivated by an expected increase in the stock price more than offsetting a decrease in the amount of idiosyncratic PBC (see *supra*, section 6.4.3). Provided that at least the incumbent's equity interest is involved in the transaction (and normally more than that is required to make it profitable to the acquirer), the acquirer would have no choice for covering takeover expenses but reducing the opportunity costs of shirking or otherwise increasing shareholder value. The only condition for this to hold is that no cash flow diversion is involved in the transaction (i.e., efficient policing of diversionary PBC). See *supra*, Chapter Five, section 5.5.1, and *infra*, Chapter Ten, section 10.2.3.

of his performance, since non-controlling shareholders will free ride. We might then observe far less takeovers than it would be desirable.

The role of corporate law is crucial for avoiding that outcome. To this purpose, the costs of acquisition of corporate control should be minimized, and the gains to the prospective acquirer enhanced. An efficient regulation of corporate control transactions should provide for *differential treatment* of the corporate controller and non-controlling shareholders. The former should be exclusively entitled to cash in his idiosyncratic PBC in a negotiated control sale; whereas it should be possible induce the latter to tender at a limited premium over market price, under the credible threat of being squeezed out on the same terms when they do not tender. Both categories would get so their share of the transaction surplus. More importantly, all of the remaining gains would be left to the acquirer. Any legal impediment to the above mechanism should be removed.

6.8. Comparative Corporate Law

6.8.1. Regulatory Objects to Be Compared

The three predictions that I have just outlined are aimed at carrying further the basic 'law matters' insight that, after *Law and Finance*, took over both the economic and the legal debate on corporate governance. They depart from the standard account of Corporate Law and Economics in that they posit that investor protection is definitely not all that matters, at least as far as corporate law is concerned. In order to support separation of ownership and control, law needs also to feature entitlements to control and its rents under both concentrated and dispersed ownership structures, and to provide for a smooth functioning of a market for corporate control where those rents can be cashed in through negotiated transactions. On the one hand, most entrepreneurs would not accept to separate ownership from control when this involved giving up their idiosyncratic PBC. On the other hand, non-controlling shareholders would not just be content with good legal policing of diversionary PBC, should the market for corporate control fail to police distortionary PBC by allowing firm control to change hands when this is efficient.

Testing this view against the empirical evidence requires that corporate laws be compared across different countries that, according to the empirical evidence, are characterized by different patterns of corporate governance. However, not only – in the spirit of Ronald Gilson – the 'taxonomy' of those patterns has been by now 'complicated' enough to set us free from the simplistic dichotomy between concentrated and dispersed ownership.[244] Also the following approach to the legal analysis will be sophisticated enough to allow departure from the standard methodology of comparison set by La Porta *et al.* in *Law and Finance* and its subsequent developments. Sticking to the fundamental tenets of comparative law, the bearing of national corporate laws on the above three predictions will be analyzed in a purely *functional* perspective.[245] Having now clear in mind what the underlying economic problems are, we should know exactly what to look for: not just legal rules that almost *look the same* in different systems, but legal rules that *affect equivalent phenomena* within each national context.[246]

Let us refer to those phenomena as to 'regulatory objects.' Three are the main regulatory objects to be compared in order to check whether corporate law actually affects corporate governance according to the above predictions. Any of these objects may possibly call into play completely different categories of legal rules within each country – and in fact, as we will see shortly, very often they do. The objects at issue can be outlined as follows:

a) Entitlements to corporate control (i.e., the legal distribution of corporate powers).
b) Safeguards against non-controlling shareholder expropriation (i.e., the legal discipline of conflicted interest transactions).
c) Support for a market for corporate control (i.e., the regulation of corporate control transactions).

It would be nice to apply this methodology of comparison to as many countries as possible; or at least, to all of the countries that exhibit comparable levels of economic development and reliability of the rule of law.[247] However, functional legal comparison is particularly burdensome. Numerical comparison of the kind of *Law and Finance* is based on a very simplistic account of corporate laws, which easily allows for indexing the quality of legal rules. As such, 'numerical comparative law' just requires collecting information about *single* categories of legal rules in different countries. It is then not surprising that this kind of comparison of corporate laws has been performed to date for as many as 72 countries.[248]

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[244] Gilson, R.J. [2006], *op. cit.*

[245] For a recent overview of the functional methodology in comparative law, see Michaels, R [2006], *The Functional Method of Comparative Law*, in M. Reimann and R. Zimmermann (eds.), THE OXFORD HANDBOOK OF COMPARATIVE LAW, Oxford University Press, 339-382.

[246] See *supra*, Chapter Four, section 4.2.

[247] See *supra*, Chapter Two, section 2.2.3.

[248] Djankov, S., La Porta, R., Lopez-de-Silanes, F. and Shleifer, A. [2006], *The Law and Economics of Self-Dealing* (November 13, 2006), Working Paper, Harvard School of Economics, available at

Functional comparison is far more demanding. For each country, it requires that the *entire* corporate law system be understood, in order to find out which rules have *actually* a bearing on the regulatory objects to compare.[249] This may prove ultimately irreconcilable with econometrics. For sure, it is now, given the state of our knowledge of comparative corporate law. But the situation is likely to be unchanged in the near future, at least until a group of researchers gain such an understanding of corporate law systems around the world, which is sufficiently deep to allow for meaningful comparisons and sufficiently broad to allow for statistical inference. In the meantime, one should forget about broad statistical inferences and rather stick to a narrower case study methodology.

6.8.2. A Five-Country Case Study

For the purposes of the comparative legal inquiry that follows, five countries are selected. The selection is based on a *falsification* criterion. I pick five countries that, for different reasons, cast some doubt on the validity of the standard 'law matters' account – that is, investor protection by the legal system being the major determinant of both ownership concentration and stock market development.[250] The analysis will show that what mainstream theoretical and empirical analysis fails to explain is instead consistent with the above-mentioned three predictions about how corporate law functionally affects corporate governance. These countries are Italy, the US, the UK, Sweden, and the Netherlands.

a) Italy

Among top-developed countries, Italy is the case in point of the standard 'law matters' argument.[251] Its stock market is considerably underdeveloped relative to the rest of the Wealthy West; and ownership of publicly held corporations is highly concentrated. Traditionally, this picture is coupled with weak legal protection of outside shareholders. According to *Law and Finance*, the bad quality of Italian corporate law is witnessed by the very low score it gets on the Anti-Director Rights

www.economics.harvard.edu/faculty/shleifer/papers, forthcoming in JOURNAL OF FINANCIAL ECONOMICS, 2008.

[249] This is how so-called 'micro-comparison' is understood by comparative lawyers. See Zweigert, K. and Kötz, H. [1998], INTRODUCTION TO COMPARATIVE LAW, 3rd edn. (translated from German by T. Weir), Oxford University Press.

[250] See *supra*, Chapter Four, sections 4.3.3 and 4.4.1.

[251] See, e.g., Roe, M.J. [2003c], *op. cit.* (who, however, also advocates a complementary political explanation).

Index (one out of six).[252] Even those who disagree on the methodology of numerical comparative law share nonetheless the view that the poor standards of investor protection are responsible for the backwardness of Italian equity market and corporate governance.[253] This account is mostly correct.

And yet, there are some puzzles. The quality of investor protection in Italy has significantly improved after 1998, when a major reform of the regulation of listed companies was undertaken.[254] The improvement is also reflected in the Revised Anti-Director Rights Index (now two out of six) and the new indexes allegedly accounting for the quality of securities law and legal policing of self-dealing.[255] Nevertheless, this has brought about almost no change in the basic patterns of corporate governance. Ownership of Italian listed firms is still very concentrated and stock market capitalization continues to lag far behind the rest of developed countries.[256] There are two possible explanations for that. One is that there are discontinuities in investor protection. Improvements in the law of Italian listed companies might have been not enough to cope effectively with the problem of expropriation of non-controlling shareholders. The second is that there may be something else going on. On the one hand, Italian corporate law does not support managerial control.

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[252] On the main indexes calculated in the Law and Finance literature, see generally *supra*, Chapter Four, section 4.3.

[253] Gilson, R.J. [2006], *op. cit.*

[254] Legislative Decree No. 58/1998 ("Testo unico delle disposizioni in materia di intermediazione finanziaria").

[255] Italy scores 42% on the Anti Self-Dealing Index (worldwide average: 44%), 67% on the Prospectus Disclosure Index (worldwide average: 60%), and 22% on the Prospectus Liability Index (worldwide average: 47%). The reader will easily gather, from the discussion of the other counties of the sample, that these figures are definitely not too bad. And yet, they tell us little about what is really going on.

As far as Anti-Director Rights are concerned, it should be noticed that the new score assigned on the Revised Index does not entirely reflect the improvements of shareholder protection in substantive law. On the one hand, the definition of the components has been significantly changed from *Law and Finance*. As of May 2003 (the reference date for SD), Italy would have scored at least 5 out of the 6 components of the old index. On the other hand, also according to the definition of the new index, Italian corporate law should have scored between 4 and 5 (depending on the characterization of judicial redress for oppressed minority) as of May 2003; whereas the current law (as of May 2007) would certainly score a full 6!

As we will see, Italian law does not yet protect minority shareholders efficiently in spite of that, and the overall effect of shareholder empowerment in the most recent reforms of company law may have been just that of biasing distribution of powers further against managerial control (see *infra*, Chapters Seven and Nine). The bottom line is that, in both the earlier and the later configuration, the Anti-Director Rights Index says very little about the real 'quality' of corporate law. And so do the other, and more sophisticated, indexes of the Law and Finance literature. See *supra*, Chapter Four, section 4.3, and *infra* Chapter Nine, section 9.4.1.

[256] Bianchi, M., Bianco, M., Giacomelli, S., Pacces, A.M. and Trento, S. [2005], *op. cit.*, 115-154.

On the other hand, it does not allow for a smooth functioning of a market for corporate control.[257]

b) The US and the UK

The US and the UK stand just on the opposite side of the standard 'law matters' argument. These two countries have probably the most dispersed ownership structures and the highest rate of stock market development in the world, and almost for sure they exhibit the highest frequency of listed firms under managerial control.[258] They both have 'good' quality of corporate law, assessed in terms of investor protection.[259] This is even truer once we abandon a simple indexing methodology in favor of a more functional approach to comparison.[260] Functional legal comparison shows, however, that the two systems achieve that result through completely different, and somewhat opposite, legal strategies. On the one hand, good standards of investor protection are met by means of a different legal policing of self-dealing by the corporate controllers. The discipline of conflicts of interest is 'transaction-based' (i.e., ultimately relying on judicial scrutiny of most dangerous transactions) in the US, whereas it is more 'governance-based' (i.e., depending on empowerment of non-controlling shareholders) in the UK.[261] On the other hand, the legal discipline of corporate control is very friendly to the management in the US, whereas it is quite unfriendly to controlling shareholders in the UK.[262]

Formerly identical and today still relatively similar scoring on the indexes by La Porta *et al.* seems then a much too coarse explanation of the causes of Anglo-American corporate governance.[263] What is more likely to explain the rise of dis-

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[257] Id., at 183-190. See *infra*, Chapters Seven (section 7.4), Nine (section 9.3.5), and Eleven (section 11.5.3).

[258] See *supra*, Chapter Two (where references to the empirical literature abound).

[259] See La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R. [1998], *op. cit.*; La Porta, R., Lopez-de-Silanes, F. and Shleifer, A. [2006], *What Works in Securities Laws?*, in JOURNAL OF FINANCE, vol. 61, 1-32; and Djankov, S., La Porta, R., Lopez-de-Silanes, F. and Shleifer, A. [2006], *op. cit.*

[260] Franks, J. and Mayer, C. [2002], *Corporate Governance in the UK – Contrasted with the US System*, in CESIFO FORUM No. 3/2002, 13-22.

[261] Kraakman *et al.* [2004], *The Anatomy*, cit., 68 (as detailed at 101-130 and 193-214).

[262] Armour, J. and Skeel, D.A. [2006], *Who Writes the Rules for Hostile Takeovers, and Why? The Peculiar Divergence of US and UK Takeover Regulation*, ECGI Law Working Paper No. 73/2006, available at www.ssrn.com and www.ecgi.org.

[263] Originally, the US and the UK both scored 5 out of 6 on the Anti-Director Rights Index. The revised figures are 3/6 and 5/6, respectively. As far as securities law is concerned, the UK scores 83% on Prospectus Disclosure and 66% on Prospectus Liability, whereas the US gets a full mark (100%) on both accounts. The results of the tournament are reversed when it comes to regulation of related-party transactions: the UK gets 95% on the Anti Self-Dealing Index, as opposed to 65% of the US. But see *infra*, Chapter Nine, section 9.4.1.

persed ownership in so different legal environments is instead, among other things, *analogous* legal support for managerial control coupled with *equivalent* (i.e., neither identical nor just similar) levels of outside shareholders' legal protection.[264] Neither of these issues is accounted for by numerical legal comparison. Nor could they be, since both of them are based on *different combinations* of legal rules in the US and in the UK.

c) Sweden and the Netherlands

Finally, at least two countries in well-developed continental Europe plainly contradict the standard account of *Law and Finance*. One is Sweden, whose functionally excellent degree of investor protection does not come with any managerial control or dispersion of voting power.[265] The other is the Netherlands, whose allegedly 'bad' quality of corporate law has not inhibited the emergence of managerial capitalism.[266]

The Swedish case is often referred to as the most compelling evidence *against* the 'law matters' thesis. Sweden is featured with a fairly good development of stock market but with one of the highest rate of voting power concentration in the developed world.[267] Managerial control is basically unheard of and separation of ownership and control is achieved by means of extraordinary deviations from 'one share–one vote' security-voting structures – which are normally considered as a clue of 'bad' quality of corporate law.[268] Numerical comparative law then credits Sweden with just an intermediate degree of legal protection of minority shareholders.[269] Nobody doubts, however, that this account seriously underestimates investor protection in Sweden. There is in fact no single anecdotal evidence of cash flow diver-

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264 See *infra*, Chapters Seven and Nine.

265 Gilson, R.J. [2006], *op. cit.*

266 Few commentators have realized this circumstance. Indeed, the Dutch model of CG is heavily criticized not only in the scientific literature, but also in public opinion. See, e.g., *The Dutch Discount; Investor Activism*, in THE ECONOMIST, April 8, 2006, 72. The only commentator I am aware of, who has made the point that the Dutch model actually features both strong protection of minority shareholders and managerial capitalism, is a Swedish economist: Högfeldt, P. [2005], *Financing and Corporate Control in The Netherlands: Extreme Exception to the Rule?*, in R. Morck (ed.), A HISTORY OF CORPORATE GOVERNANCE AROUND THE WORLD: FAMILY BUSINESS GROUPS TO PROFESSIONAL MANAGERS, NBER Conference Volume, University of Chicago Press, 507-515. This should be not too surprising in the light of the following discussion.

267 See *supra*, Chapter Two.

268 Bebchuk, L.A., Kraakman, R.H. and Triantis, G. [2000], *op. cit.*

269 Sweden scores 33% on the Anti Self-Dealing Index (worldwide average: 44%), 58% on the Prospectus Disclosure Index (worldwide average: 60%), and 28% on the Prospectus Liability Index (worldwide average: 47%). The performance on the Anti-Director Rights Index is 3/6 (original) and 3.5/6 (revised).

sion from non-controlling shareholders ever reported for Swedish companies.[270] According to all national and international commentators, expropriation of minority shareholders is not an issue in Swedish corporate governance.[271] One conventional explanation of the Swedish case is powerful social norms.[272] However, we will discover that the strength of moral constraints upon stealing – that surely helps – is in fact supported by legal institutions in the background, which make sure that any cheating would be promptly realized and severely punished.[273] But then, why does not Sweden allow for managers being in charge of large publicly held corporations? The answer – as we will see – lies in the legal distribution of corporate power that does not feature managerial control.[274]

The Netherlands exhibits an exceptionally high degree of stock market development and perhaps the highest rate of ownership dispersion in continental Europe.[275] Puzzling enough, the numerical assessment of the quality of Dutch corporate law is very low.[276] According to those measures, outside shareholder protection in the Netherlands is almost as weak as in Italy and, as far as legal policing of self-dealing is concerned, even much weaker.[277] However, this assessment is incorrect. Non-controlling shareholders are actually quite well protected from expropriation in the Netherlands.[278] As we will see, both a special procedure and a specialized Court are provided for to this purpose by Dutch corporate law.

The latter feature of Dutch corporate governance has not received much attention by economists, who generally prefer to stress the weakness of shareholder position when it comes to interfering with the firm management. It is for this reason

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[270] See, e.g., Holmén M. and Högfeldt P. [2004], *A Law and Finance Analysis of Initial Public Offerings*, in JOURNAL OF FINANCIAL INTERMEDIATION, vol. 13, 324-358.

[271] Agnblad, J., Berglöf, E., Högfeldt, P. and Svancar, H. [2001], *Ownership and Control in Sweden: Strong Owners, Weak Minorities, and Social Control*, in F. Barca and M. Becht (eds.), THE CONTROL OF CORPORATE EUROPE, Oxford University Press, 228-258; Gilson, R.J. [2006], *op. cit.*; Dyck, A. and Zingales, L. [2004], *Private Benefits of Control: An International Comparison*, in JOURNAL OF FINANCE, vol. 59, 537-60.

[272] Coffee, J.C. Jr. [2001a], *Do Norms Matter? A Cross-Country Evaluation*, in UNIVERSITY OF PENNSYLVANIA LAW REVIEW, vol. 149, 2151–2178.

[273] See *infra*, Chapter Nine, section 9.3.4.

[274] See *infra*, Chapter Seven, section 7.4.1.

[275] See *supra*, Chapter Two.

[276] Dutch law scores 20% on the Anti Self-Dealing Index (worldwide average: 44%), 50% on the Prospectus Disclosure Index (worldwide average: 60%), and 89% on the Prospectus Liability Index (worldwide average: 47%). The performance on the Anti-Director Rights Index is 2/6 (original) and 2.5/6 (revised).

[277] Cf. *supra*, note 255.

[278] Timmerman, L. and Doorman, A. [2002], *Rights of Minority Shareholders in the Netherlands*, in ELECTRONIC JOURNAL OF COMPARATIVE LAW, vol. 6.4, 181-211, available at www.ejcl.org/64/art64-12.html.

that Dutch commentators agree on the conclusion that corporate law's quality is 'bad' in the Netherlands.[279] However, such a weakness has little to do with the potential for cash flow diversion by corporate controllers and may instead be responsible for the emergence of managerial capitalism.[280] We know that investor protection is not sufficient to achieve dispersion of ownership. Differently from Sweden, Dutch corporate law does not only police expropriation but also supports managerial control by shielding the firm management from interference by non-controlling shareholders.[281] However, some of the ways in which such a support is created give rise to rigidities that hinder the smooth functioning of the market for corporate control and, consequently, the transition from shareholder control to managerial control.[282]

Time is now ripe to get into the hearth of the matter. The next Chapters will be devoted to the functional comparison of corporate laws in the above five countries.

[279] See, e.g., Roosenboom, P. and van der Goot, T. [2003], *Takeover Defences and IPO Firm Value in the Netherlands*, in EUROPEAN FINANCIAL MANAGEMENT, vol. 9, 485–511. But see also, for the view that Dutch CG and its regulation might be not so bad after all, Chirinko, R., van Ees, H., Garretsen, H. and Sterken E. [2004], *Investor Protections and Concentrated Ownership: Assessing Corporate Control Mechanisms in the Netherlands*, in GERMAN ECONOMIC REVIEW, vol. 5, 119–138.

[280] See *infra*, Chapter Seven, section 7.3.3.

[281] See *infra*, Chapter Nine, section 9.3.3.

[282] See *infra*, Chapter Eleven, section 11.5.2.

PART III

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CORPORATE LAW AND ECONOMICS REVISITED

CHAPTER SEVEN – Legal Distribution of Corporate Powers

7.1. Introducing the Legal Analysis

Our framework of analysis of the economics of corporate governance is based on three kinds of private benefits of control (PBC).[1] The first has to do with 'stealing', that is diverting profits from non-controlling shareholders (diversionary PBC). The second one has to do with rewarding the corporate controller of his firm-specific investments (idiosyncratic PBC). The third kind has to do with 'shirking', that is misusing free cash with either over-investment or under-investment implications (distortionary PBC). This threefold account of PBC generates three predictions about how corporate law affects separation of ownership and control and its efficiency. They were amply discussed in the last Chapter,[2] but it is nonetheless useful to summarize them below.

To begin with, *outside investors need to be protected*. Separation of ownership and control would always be less than optimal, and possibly undermined, when regulation of conflicted interest transactions is not effective at curbing diversionary PBC. Secondly, *control needs to be supported*. Separation of ownership and control is also affected by availability of legal entitlements to exert control and to protect its rents (idiosyncratic PBC) independent of the ownership structure. Finally, *a market for corporate control needs to be promoted*. Either too much or too little separation of ownership and control may emerge over time. This may lead to excessive exploitation of distortionary PBC by the corporate controller, when selling corporate control to a more efficient manager is not a preferable alternative to 'playing' with the firm's assets.

The analysis performed in the foregoing Chapters shows that comparative empirical evidence about top developed countries basically *rejects* the mainstream view

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1 See *supra*, Chapter Five.

2 See *supra*, Chapter Six, section 6.7.

that corporate law affects separation of ownership and control *only* on the first prong; that is, that ownership is dispersed in those countries where legal protection of non-controlling shareholders is 'strong,' and concentrated where it is 'weak' (the standard 'law matters' argument). On this basis, I have selected five countries for a more in-depth investigation.[3] Two of them – Sweden and the Netherlands – plainly reject the standard 'law matters' thesis in two opposite directions (respectively as good law/concentrated ownership and bad law/dispersed ownership combinations). Other two – the US and the UK – seem to support it, albeit by means of completely different legal arrangements. The last one – Italy – provides perhaps one of the strongest support for the 'law matters' thesis among developed countries, and yet something else seems to be going on there, too. The analysis of this and the following Chapters is aimed both at uncovering the legal shortcomings in the prevailing account of the economics of corporate law and at performing a qualitative empirical test of the alternative explanation that has been suggested. This test is based on comparative law.

As I have repeatedly pointed out, the problem with the standard explanation of the role of corporate law in corporate governance is basically twofold. On the one hand, legal protection of minority shareholders from expropriation might be inaccurately measured – and it is indeed very doubtful whether it could ever be 'measured' by an index.[4] On the other hand, such a protection might be not the only way in which corporate law matters for separation of ownership and control.[5] The evi-

[3] The reader will recall that these countries have been selected on the basis of objective criteria of falsification of the standard 'law matters' thesis (see *supra*, Chapter Six, section 6.8.2). This involves consideration of two jurisdictions presenting a considerable language barrier for an Italian researcher, namely the Netherlands and Sweden. I have been able to collect legal information for these two countries only to the extent that it is available in English. Unfortunately, there is no updated translation of either Dutch or Swedish corporate law made available for international research. The only option to keep discussion up-to-date is to refer to sources which are often fragmentary and bear little reference to the original formulations in both statutory and case law. While always acknowledging reference to these sources in this and the following Chapters, I am cross-checking the information they report with the Organization for Economic Cooperation and Development [2006], *Corporate Governance and Company Law Database*, The OECD's Directorate for Financial and Enterprise Affairs and The Stockholm Centre of Commercial Law (hereinafter OECD [2006], *Database*), available at http://oecd.eddy.se – restricted access, on file with author (last accessed May 1, 2007). The OECD database is a precious source of comparative legal information, which I will often refer to in the absence of other reliable sources in English. The database is announced to become publicly available in the near future.

[4] See *supra*, Chapter Four, section 4.3.

[5] See *supra*, Chapter Four, section 4.4.

dence about our five-country sample shows that these two concerns may not be unsound.[6]

As far as 'measurement' problems are concerned, most recent advances in the 'law matters' thesis have finally realized that investor protection is actually dealt with very differently in the US and in the UK. Surprisingly, however, 'American' corporate law now scores significantly worse on investor protection than British law.[7] The two countries exhibit nonetheless very similar patterns of elevated separa-

6 The following two paragraphs summarize the contradictions between comparative corporate governance (hereinafter CG) and the standard account of how law 'matters.' Compare Chapter Four with Chapter Two, above.

7 See Djankov, S., La Porta, R., Lopez-de-Silanes, F. and Shleifer, A. [2006], *The Law and Economics of Self-Dealing* (November 13, 2006), Working Paper, Harvard School of Economics, available at www.economics.harvard.edu/faculty/shleifer /papers, forthcoming in JOURNAL OF FINANCIAL ECONOMICS, 2008.

Formally, there is no such thing as an 'American corporate law.' US legislation actually features 50 corporate law statutes – one for each state. This depends on interpretation of the Constitution of the United States (the so-called 'internal affairs doctrine'). Also for constitutional reasons, the source of securities regulation is federal legislation. The technicalities underlying the division of competences between the state and the federal level are outside the scope of the present inquiry. For a summary illustration, see Bainbridge, S.M. [2002a], CORPORATION LAW AND ECONOMICS, Foundation Press, 13-18. However, on the one hand, it should be noted that corporate law in the US is mostly Delaware law, as far as both statutory provisions and judicial administration is concerned; whereas securities regulation is mostly established by federal acts (most notably the Securities Act of 1933 and the Securities Exchange Act of 1934), implemented by a federal agency (the Securities and Exchange Commission – SEC), and ultimately administered by the federal courts. On the other hand, the distinction between corporate law and securities regulation is not always so clear-cut when it comes to the Law and Economics of CG. See *infra*, Chapter Eight.

The peculiarity of the US case as regards corporate law jurisdictions (and regulatory competition among incorporating states) is nicely summarized by Paredes, T.A. [2004], *A Systems Approach to Corporate Governance Reform: Why Importing U.S. Corporate Law Isn't The Answer*, in WILLIAM AND MARY LAW REVIEW, vol. 45, 1097 (note 114):

> "Corporate law in the United States has traditionally been left to the states. The states, and not the federal government, have primary responsibility for the substantive regulation of corporate governance. […] Companies can choose which state's corporate law to be subject to by their choice of where to incorporate, with Delaware emerging as the jurisdiction of choice. The resulting regulatory competition among the states for corporate charters is another enabling feature of the U.S. system of corporate governance. Whether it is better characterized as a 'race to the top' or 'to the bottom,' regulatory competition helps ensure that corporate law does not become too management-friendly and constrains what otherwise could be legislative and judicial swings in the law that could harm shareholders if there were no 'market check' on regulators."

As Troy Paredes acknowledges, the literature on charter competition in US corporate law is extensive. See, most prominently, Romano, R. [1993], THE GENIUS OF AMERICAN CORPORATE LAW, AEI Press; Bebchuk, L.A., Cohen, A., Ferrel, A. [2002], *Does the Evidence Favor State Competition in Corporate Law?*, in CALIFORNIA LAW REVIEW, vol. 90, 1775-1821; Cary, W.L. [1974], *Federalism and Corporate Law : Reflections Upon Delaware*, in YALE LAW JOURNAL, vol. 83, 663-705; Fisch, J.E. [2000], tion of ownership and control, as well as of stock market development. The Netherlands is still characterized as a legal system where shareholder protection is 'weak.' And yet, Dutch corporations are featured with perhaps the highest average degree of separation of ownership and control within continental Europe, let alone stock market capitalization relative to gross domestic product (GDP) being in the Netherlands almost as high as in the US. Swedish law apparently provides minority shareholders with just some intermediate degree of legal protection, and yet stock market capitalization relative to GDP is slightly below the figures for the above three countries – even though the typical Swedish ownership structure is highly concentrated. Finally, the Italian case (weak legal protection of minority shareholders, high ownership concentration, and stock market underdevelopment) appears to be not as strong as it used to be in the past.[8]

Even if the measurement problems were fixed, the empirical analysis would still leave us with some puzzling evidence very hard to reconcile with the standard 'law

The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters, in UNIVERSITY OF CINCINNATI LAW REVIEW, vol. 68, 1061-1100; Kahan, M. and Kamar E. [2002], *The Myth of State Competition in Corporate Law*, in STANFORD LAW REVIEW, vol. 55, 679-749; Seligman, J. [1990], *The Case for Federal Minimum Corporate Law Standards*, in MARYLAND LAW REVIEW, vol. 49, 947-974; Winter, R. Jr. [1977], *State Law, Shareholder Protection, and the Theory of the Corporation*, in JOURNAL OF LEGAL STUDIES, vol. 6, 251-292. For the more recent view that competition in law-making does not take place among states, but between Delaware and the federal government, see Roe, M.J. [2003a], *Delaware's Competition*, in HARVARD LAW REVIEW, vol. 117, 588-646.

Whatever the drivers of regulatory competition, Delaware primacy is nowadays out of question. For this reason, the analysis of US corporate law will mostly focus on Delaware jurisdiction. See Bebchuk, L.A. and Hamdani, A. [2002], *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, in YALE LAW JOURNAL, 553-615, for discussion of Delaware's unchallenged monopoly in the production and enforcement of corporate law and of regulatory implications at the federal level. The other competing regulatory sets – among which the Revised Model Business Corporations Act (hereinafter MBCA), which is adopted by a large number of American states – lag far behind in terms of number of incorporated listed companies: "Delaware has by far the largest stake of incorporations: 58 percent of all firms, 59 percent of Fortune 500 firms, and even a higher percentage – 68 percent – of firms that went public in the period 1996–2000." Bebchuk, L.A. and Cohen, A. [2003], *Firms' Decisions Where to Incorporate*, in JOURNAL OF LAW AND ECONOMICS, vol. 46, 389. Most importantly, the substantial contents of American corporate laws do not differ from those of Delaware if not in aspects that can be considered as marginal to our purposes. The richness of Delaware case-law is unparalleled by other jurisdictions, which makes Delaware Chancery Court the standard judicial reference for American corporate lawyers. Most commentators agree that this is the most important trait of Delaware's primacy in the production of corporate law. See, for illustration, Dibadj, R. [2005], *Delayering Corporate Law*, in HOFSTRA LAW REVIEW, vol. 34, 469-533, and references cited therein. Delaware General Corporation Law (hereinafter DGCL) can thus be considered roughly as *the* American corporate law. However, see Hamilton, R.W. [2000], THE LAW OF CORPORATIONS, West Group, for systematic comparisons between DGCL and the MBCA.

[8] Bianchi, M., Bianco, M., Giacomelli, S., Pacces, A.M. and Trento, S. [2005], PROPRIETÀ E CONTROLLO DELLE IMPRESE IN ITALIA, Il Mulino (hereinafter Bianchi *et al.* [2005], *Proprietà*).

matters' argument. The US and the UK actually display different styles and intensities of investor protection by corporate law but, at the same time, Anglo-American ownership structures are extremely dispersed more often than not and stock markets are probably the most developed in the world. Under both Swedish and Dutch corporate law, non-controlling shareholders actually enjoy high standards of protection from expropriation of their investment. This may possibly explain the high stock market development, but still Sweden and the Netherlands are characterized by two opposite patterns of corporate governance. In Italy, significant improvement in investor protection over the last few years have brought almost no change in either the ownership structures or in the trend of stock market development.

I shall start from dealing with the second problem in this Chapter. The reason of this choice is straightforward. I believe that what is missing from the agency theory of corporate governance, and consequently from the standard 'law matters' argument, is appropriate consideration for idiosyncratic control rents. How these control rents can be protected in corporate governance – i.e., under what ownership structure such a protection is allowed – depends on the legal distribution of corporate powers, regarded as a source of legal entitlements to corporate control. Understanding that distribution in each legal system is also a precondition for an accurate analysis of outside investor protection. Only when you know how power is exerted you can meaningfully say how its abuse should be prevented. For this reason, the investigation about legal constraints on expropriation of non-controlling shareholders will have to be postponed to the next two Chapters. In Chapters Ten and Eleven, I shall finally discuss how the protection of the corporate controller's powers (and of his idiosyncratic PBC) can be ultimately reconciled with an efficient dynamics of the market for corporate control.

7.2. Legal Distribution of Powers

7.2.1. What Does It Mean?

Supreme decisions about how to 'run' a company are taken by two categories of players: the directors and the shareholders.[9] Corporate law features directors with

[9] In traditional Law and Economics, shareholders and the management were characterized as the two main players in CG. Easterbrook, F.H. and Fischel, D.R. [1989], *The Corporate Contract*, in COLUMBIA LAW REVIEW, vol. 89, 1416–1448. Corporate Law and Economics has switched to the shareholders-directors relationship only recently. Bainbridge, S.M. [2002a], *op. cit*, 191-240. This

both the authority over the firm's centralized management and the responsibility for the exercise of this authority.[10] Responsibility is most often established towards the shareholders that provide the firm with its own capital, even though in some systems also other stakeholders enter the play.[11] These are typically the company's employees and, especially in the presence of the risk of bankruptcy, its creditors. However, neither shareholders nor stakeholders are entitled to exert *direct* authority over the firm management, thereby bypassing the directors. That would be against one of the basic tenets of corporate law's structure: the company's *centralized management*.[12]

Shareholders and stakeholders who are granted governance rights by corporate law may only *indirectly* influence the exercise of that authority, either by vetoing directors' decisions when their support is required or by removing incumbent directors and having them replaced by new ones.[13] The last option always favors shareholders over stakeholders. Even under the more stakeholder-oriented corporate laws, at least the majority of directors are appointed by or without the opposition of shareholders.[14] The most important source of ultimate authority within the corpo-

parallels the growing interest of economists in the study of boards of directors (Hermalin, B.E. and Weisbach, M.S. [1998], *Endogenously Chosen Boards of Directors and Their Monitoring of the CEO*, in AMERICAN ECONOMIC REVIEW, vol. 88, 96-118) and of shareholders participation in decision-making (Becht, M., Bolton, P. and Röell, A. [2002], *Corporate Governance and Control*, ECGI Finance Working Paper No. 02/2002, available at www.ssrn.com and www.ecgi.org, as published in G. Constantinides, M. Harris, and R. Stulz (eds.) [2003], HANDBOOK OF ECONOMICS AND FINANCE, North-Holland). However, differently from directors' board structure, remuneration, and appointment, the mechanisms of shareholder participation are mostly studied by lawyers. Baums, T. [2000], *General Meetings in Listed Companies: New Challenges and Opportunities*, Working Paper No. 103, Frankfurt University, Institut für Bankrecht.

10 Bainbridge, S.M. [2002b], *Director Primacy: The Means and Ends of Corporate Governance,* in NORTHWESTERN UNIVERSITY LAW REVIEW, vol. 97, 547-606

11 Kraakman, R.H., Davies, P., Hansmann, H., Hertig, G., Hopt, K.J., Kanda, H. and Rock, E.B. [2004], THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH, Oxford University Press (hereinafter Kraakman *et al.* [2004], *The Anatomy*), 13-15.

12 Id., at 11-13

13 Id., at 33-70.

14 The statement in the text is a brachylogy, but not a stretch. See, for codetermination laws in Germany (where the Chairman of the supervisory board is entitled to a tie-breaking vote, and he is normally selected from the 50% of directors appointed by the shareholders), Hopt, K.J. [1994], *Labor Representation on Corporate Boards: Impacts and Problems for Corporate Governance and Economic Integration in Europe*, in INTERNATIONAL REVIEW OF LAW AND ECONOMICS, vol. 14, 203-214. For the Netherlands (where shareholders have been recently entitled to veto a major quota of the nominations to the supervisory board in the structured regime, and were not completely powerless even before that reform), see Kemperink, G. [2004], *The Companies and Business Court and codetermination law*, in THE COMPANIES AND BUSINESS COURT FROM A COMPARATIVE LAW PERSPECTIVE, Kluwer, 59-91, and *infra*, section 7.3.3. For Sweden (where the appointment of labor representatives resembles the German regulation, apart from the one-tier structure of the board), see Karnell, G. [1981],

ration remains thus *shareholder ownership*, often also referred to as 'shareholder franchise';[15] the reader will recall that this is another fundamental tenet of the corporate law's structure.[16] Creditors' almost fully taking over shareholder franchise in bankruptcy is no exception to this principle: when a company is bankrupt, the creditors' position resembles in fact that of the shareholders.[17]

The fundamental question about the balance of powers in corporate law concerns then directors and shareholders. Stakeholders only apparently represent a separate source of authority. In no system of corporate law directors can manage the company's affairs just relying on stakeholders' support. However, directors may be much less in need of shareholder support when stakeholders also have a say in corporate governance.[18] As it often happens, having two bosses means being accountable to none of them. Similarly, stakeholders' involvement in corporate governance does not actually establish a different balance of powers. It merely tilts the existing balance between directors and shareholders in favor of the former.[19] Shareholders may react to this, by making sure that only directors they trust are appointed and can manage the firm without their opposition; or they may simply give up, thereby leaving directors more powerful than ever. As we are about to see, *which* of the two outcomes occurs does not really depends on stakeholders' involvement in corporate governance, although this involvement may possibly affect *how* either shareholders or directors are empowered.

From now on, governance rights granted to stakeholders by corporate law will only be considered in this instrumental perspective.[20]

The Law of Associations, with Special Regard to Company Law, in S. Strömhold (ed.), AN INTRODUCTION TO SWEDISH LAW, vol. 2, Kluwer, 336-338, and OECD [2006], *Database*, cit., for up-to-date information. Worker representation on the board is not provided for in the US, and – as far as Europe is concerned – only in the UK, Portugal, Belgium, and Italy. Kraakman *et al.* [2004], *The Anatomy*, cit., 62. But see art. 2349 of the Italian Civil Code (hereinafter ICC).

15 Easterbrook, F.H. and Fischel, D.R. [1991], THE ECONOMIC STRUCTURE OF CORPORATE LAW, Harvard University Press, 63-89.

16 See *supra*, Chapter One, section 1.4.4.

17 See Kraakman *et al.* [2004], *The Anatomy*, cit., 71-100. For a formal economic interpretation, see Aghion, P. and Bolton, P. [1992], *An Incomplete Contracts Approach to Financial Contracting*, in REVIEW OF ECONOMIC STUDIES, vol. 59, 473-494.

18 Hellwig, M. [2000], *On the Economics and Politics of Corporate Finance and Corporate Control*, in X. Vives (ed.), CORPORATE GOVERNANCE: THEORETICAL AND EMPIRICAL PERSPECTIVES, Cambridge University Press, 95-134.

19 Roe, M.J. [2003c], POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE, Oxford University Press.

20 For a similar approach, see Cools, S. [2005], *The Real Difference in Corporate Law between the United States and Continental Europe: Distribution of Powers*, in DELAWARE JOURNAL OF CORPORATE LAW, vol. 30, 762-765.

7.2.2. Organization and Competence: The Company's Organs

Corporate law affects the distribution of powers between directors and shareholders essentially in two ways. On the one hand, it sets the *organizational* rules (how each category of players decides) for implementing both centralized management and the shareholder franchise. On the other hand, it provides for an allocation of tasks (who decides what; that is, *competence*) consistent with the same principles.[21] There is clearly some tension between the two goals of centralized management and shareholder franchise, which is ultimately a major concern for corporate law. Where should centralized management end and shareholder franchise begin?[22] This is the oft-referred to 'discretion-accountability' tradeoff.[23] The combination of organizational and competence rules in corporate law provides a solution to this tradeoff, by setting both legal entitlements to corporate control and the constraints on its exercises.[24]

Although the tradeoff is the same, and the legal instruments by which it is solved (organization and competence rules) may look similar, entitlements and constraints serve completely different purposes. Corporate law's entitlements support the corporate controller's powers, thereby allowing idiosyncratic PBC to keep on motivating business notwithstanding separation of ownership and control.[25] Legal constraints make credible the commitment not to abuse such a power, thereby preventing diversionary PBC from frustrating the provision of external finance by non-controlling shareholders.[26] This distinction is one major result of the analysis carried out in the foregoing Chapters.[27] As I argued, most misunderstandings in the economic and the legal theory of corporate governance arise from confusing the two above problems. As we will discover soon, many regulatory biases also arise from having legal entitlements dealt with as a matter of investor protection instead of as a matter of control support. The reason why I am dealing with only legal enti-

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21 This is a rather traditional way to discuss distribution of powers in a *legal* perspective. See, e.g., in the common law tradition, Hamilton, R.W. [2000], THE LAW OF CORPORATIONS, West Group, 228-253; and Farrar, J.H. and Hannigan, B (with contributions by Furey, N.E. and Wylie, P.) [1998], FARRAR'S COMPANY LAW, Butterworths, (hereinafter Farrar et *al.* [1998], *Company Law*) 301-307 and 363-375; in the civil law tradition, Baums, T. [2000], *op. cit.* I prefer this approach because most of the *economic* analyses of legal distribution of powers are biased by the agency perspective. Nevertheless, for a more articulated framework, see the Kraakman *et al.* [2004], *The Anatomy*, cit., 33-70.

22 Kraakman *et al.* [2004], *The Anatomy*, cit., 1-20.

23 Bainbridge, S.M. [2002b], *op. cit.* (building on Dooley, M.P. [1992], *Two Models of Corporate Governance*, in THE BUSINESS LAWYER, vol. 47, 461-527).

24 Discussion of the constraints is postponed to the next two Chapters.

25 Cools, S. [2005], *op. cit.* (with no explicit consideration for idiosyncratic PBC, though).

26 Kraakman *et al.* [2004], *The Anatomy*, cit., 29-31.

27 See esp. *supra*, Chapter Five, section 5.6.2.

tlements to corporate control here is not mere convenience of exposition. At the end of the day, the matter *should be* dealt with separately from investor protection.

a) Voting at the Director's and the Shareholder's Level

Let us start with organization. Corporate laws provide that directors and shareholders have a typical organizational form: the board structure for directors, and the general meeting for shareholders.[28] In almost any of the countries considered here, a board structure is compulsory at least unless companies are private (but then they cannot be listed on a stock exchange).[29] Italy is the only exception, where single directors are in theory also allowed in publicly held companies[30] – although this happens very seldom in practice. In every system, shareholder action affecting corporate control takes place through the general meeting.[31] Shareholders are also featured with individual and collective rights of action outside the general meeting (for instance, the right to sue directors), but they are established just for investor protection purposes and therefore will only be dealt with in the next Chapters.

Decisions within both the board of directors and the general meeting are normally governed by a majority principle: decisions are upheld when they receive support by the majority of the votes.[32] The matter basically stands as simply, in all of the countries considered here, as far as the board of directors is concerned. Directors must attend board meetings in person and their failure to participate in the board's activity is a typical ground for liability (they must earn their salary!). Anyway, most of them have high-powered incentives to participate in decision-making.[33] They have equal voting rights ('one head-one vote'), even though special rights may be granted to the chairman just to avoid impasse.[34] Majorities do not require additional rules to be either calculated or achieved, even though quorums

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[28] See, for a broad illustration, Hopt, K.J., Kanda, H., Roe, M.J., Wymeersch, E. and Prigge S. (eds.) [1998], COMPARATIVE CORPORATE GOVERNANCE: THE STATE OF THE ART AND EMERGING RESEARCH, Oxford University Press.

[29] Kraakman *et al.* [2004], *The Anatomy*, cit., 13.

[30] Art. 2380-*bis* ICC.

[31] Kraakman *et al.* [2004], *The Anatomy*, cit., 41-49.

[32] Of course, majorities differ across jurisdictions, depending on whether decisions are taken by the board or the shareholders, and on what the decision is about. However, the majority principle is a key feature of corporate law. See, e.g., Hopt, K.J., Kanda, H., Roe, M.J., Wymeersch, E. and Prigge S. (eds.) [1998], *op. cit.*

[33] Kraakman *et al.* [2004], *The Anatomy*, cit., 51-54.

[34] Id., 34-41.

are usually set up to avoid practical circumvention of the board requirement.[35] To cut a long story short, decisions are taken with a certain ease by directors.

The matter gets definitively more complicated when it comes to the general meeting.[36] Shareholders are not required to attend either in person or by proxy (which is generally allowed), and the vast majority of them have no sufficient incentives to participate in the meeting anyhow.[37] Corporate shareholders have unequal voting rights, basically depending on share ownership ('one share-one vote'), but also in excess (multiple voting shares) or in reduction of it (limited voting or non-voting shares) where and to the extent this is allowed.[38] Everywhere the majority at the general meeting means in fact a minority of outstanding shareholders, and having decisions taken by shareholders might be either very easy or relatively difficult, depending on whether quorums are established, how majorities are calculated and voting is implemented.[39] This varies considerably from country to country.[40] To put it briefly, regulation of shareholder voting is more favorable to directors in the US, in the Netherlands and – with qualifications – in the UK; whereas it definitively favors shareholders in Sweden and in Italy. As I have pointed out since the very beginning of this inquiry, the legal discipline of shareholder voting is a key feature of the distribution of corporate powers and it is mainly (albeit not only) an organizational issue.

b) Board Structure

True, at least another set of organizational rules deserves attention. Directors' powers may be scarcely affected by board voting, but they are ostensibly very much by the board structure.[41] Corporate laws know basically two kinds of such a structure.[42] The first is a one-tier board whose members are at least formally elected by the general meeting, in all or in major part. This used to be the only option in Italy

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35 See, e.g., Hamilton, R.W. [2000], *op. cit.*, 306-310. For the notion of quorum, see *supra*, Chapter One, section 1.6.2.

36 Baums, T. [2000], *op. cit.*

37 Easterbrook, F.H. and Fischel, D.R. [1983], *Voting in Corporate Law,* in JOURNAL OF LAW AND ECONOMICS, vol. 26, 395-427.

38 Kraakman *et al.* [2004], *The Anatomy*, cit., 56-61.

39 Cools, S. [2005], *op. cit.*, 738-750; Baums, T. [2000], *op. cit.*

40 Kraakman *et al.* [2004], *The Anatomy*, cit., 54-56.

41 The matter is heavily debated in both the economic and the legal literature. See, respectively: Adams, R.B. and Ferreira, D. [2007], *A Theory of Friendly Boards*, in JOURNAL OF FINANCE, vol. 62, 217-250; Boot, A. and Macey, J.R. [2004], *Monitoring Corporate Performance: The Role of Objectivity, Proximity and Adaptability in Corporate Governance*, in CORNELL LAW REVIEW, vol. 89, 356-393.

42 Kraakman *et al.* [2004], *The Anatomy*, cit., 34-36.

before a recent reform, and still is in Sweden, the US, and the UK.[43] The alternative arrangement is a two-tier board, where only members of one tier are possibly elected by the general meeting, or at least without its opposition,[44] whereas members of the lower tier are always appointed by the upper one. Within our sample of countries, this arrangement is very peculiarly implemented by Dutch corporate law (that makes it compulsory to many and optional to all listed firms) and it is now also an option in Italy;[45] another prominent example of mandatory two-tier structure is offered by German corporate law.[46]

In two-tier board structures, the lower tier is directly in charge of the firm's (top) management ('management board') while the upper one is entrusted the management's supervision ('supervisory board').[47] Indeed, the rationale underlying this board structure is exactly separation of supervisory tasks from active management, given that the two functions are necessarily performed within the same board in a one-tier structure. Most often, two-tier structures are provided for by corporate law in order for supervision to be performed not only on shareholders,' but also on stakeholders' behalf.[48] This is what happens, for instance, in the Netherlands and in Germany.[49] However, two-tier boards are neither a necessary nor a sufficient condition for stakeholder involvement in corporate governance: consideration for stakeholders is implemented within a one-tier board structure under Swedish corporate law.[50] Opting into a two-tier board structure brings about no stakeholder involvement under Italian corporate law.[51] As far as shareholders are concerned, it is theoretically unclear why a separate supervisory board should make directors more accountable to the shareholder interest.[52] In fact, it seems that two-tier structures only take powers *away* from the general meeting of shareholders (like, for instance, that of approving the annual accounts), including a fundamental one: that of appointing

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43 See *infra*, sections 7.3 and 7.4.

44 This qualification implicitly refers to the Netherlands. See *infra*, section 7.3.3.

45 Ventoruzzo, M. [2004], *Experiments in Comparative Corporate Law: the Recent Italian Reform and the Dubious Virtues of a Market for Rules in the Absence of Effective Regulatory Competition*, in TEXAS INTERNATIONAL LAW JOURNAL, vol. 40, 113-156.

46 For a summary illustration of board structure under Dutch and German law, see Kraakman *et al.* [2004], *The Anatomy*, cit., 34-36.

47 Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 94-95.

48 See, e.g., Kemperink, G. [2004], *op. cit.*

49 Kraakman *et al.* [2004], *The Anatomy*, cit., 44-45.

50 Skog, R. [1994a], SETTING UP A BUSINESS IN SWEDEN, FöretagsJuridik, 31-34.

51 Art. 2409-*octies seq.* ICC.

52 Does separation itself involve that supervisors prefer confronting to colluding with the managers which *they* appoint? In other words, who monitors the monitors? For a detailed discussion of this issue, see Boot, A. and Macey, J.R. [2004], *op. cit.*

all directors. Other things being equal, two-tier boards empower directors relative to shareholders, not the other way around.[53]

Other things are never equal, although sometimes economists have to assume they are. To begin with, the above result about board structures has to be coordinated with the organizational rules affecting shareholder voting. A weak general meeting of course complements a two-tier board structure in strengthening directors' power relative to shareholders' – this is certainly the case in the Netherlands.[54] However, director primacy apparently does not require a two-tier board structure – like in the US, where the weakness of the general meeting suffices;[55] and a two-tier structure does not always allow for director primacy – like in Germany, a case I am not considering here, but where the general meeting of shareholders is still too strong for that result to occur.[56] It seems then that, like stakeholder involvement, the importance of board structure in corporate governance has been exaggerated by the literature, and especially so by the economists.[57] Yet other factors appear to make the difference in the distribution of corporate powers. In particular, the legal discipline of shareholder voting – determining the strength or the weakness of the general meeting relative to the board of directors, *whatever* its structure – is one such factor and, contrary to what most economists believe, it allows for a considerable degree of variation between countries.[58]

How shareholders cast their votes is definitely not the only issue. Equally important is how shareholder voting is called for, and the matters upon which it has to be.[59] These are no longer organizational issue. They are in fact a question of competence.

c) Board's Competence vs. the Shareholders General Meeting's

As we already know, the lower bound on directors' competence is their authority over the firm's centralized management: there are a number of matters which do

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53 Cools, S. [2005], *op. cit.*, 750.

54 de Jong, A., Kabir, R., Marra, T. and Röell, A. [2001], *Ownership and Control in the Netherlands*, in F. Barca and M. Becht (eds.), THE CONTROL OF CORPORATE EUROPE, Oxford University Press, 188-206, (hereinafter, de Jong *et al.* [2001], *Ownership and Control in NL*) for a non-technical illustration.

55 Bainbridge, S.M. [2002a], *op. cit*, 191-240.

56 Cools, S. [2005], *op. cit.*, 740-741.

57 See, illustratively, Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*

58 See Kraakman *et al.* [2004], *The Anatomy*, cit., 41-46. See also, in more detail: Baums, T. [2000], *op. cit.*; Wymeersch, E. [2000], *Current Company Law Reform Initiatives in the OECD Countries: Challenges and Opportunities*, Report to the OECD Conference on Company Law Reform in OECD Countries, Stockholm, 7-8 December 2000, available at www.ssrn.com.

59 Cools, S. [2005], *op. cit.*, 741-744.

not bear shareholder interference.[60] The upper bound is directors being replaceable and, anyway, periodically up for election: directors cannot stay in charge forever, unless shareholders (at least formally) consent.[61] Many factors affect the actual width of this range, wherein directors' authority is basically unfettered. Equally importantly, other factors determine the actual degree of shareholder involvement in corporate governance *outside* that range.[62] The fewer matters have to be decided upon shareholder voting, the higher will be the directors' power relative to the shareholders'.[63] The case becomes extreme when even director appointment (and replacement) does not completely depend on shareholder voting (like in the Netherlands).[64]

Directors' powers can be enhanced in a much subtler way, no matter of how many corporate matters ostensibly require that a decision be taken by shareholders. Directors may be in fact the only ones who can bring those matters to shareholder attention.[65] For instance, charter amendments need to be endorsed by shareholders but can only be proposed by directors in the US. Shareholders who want their own amendments to be passed will have no choice but replacing first opposing directors with people they trust. There comes the trick. Directors may also enjoy privileged initiative rights in choosing nominees to the election – as they actually do in the US and, even more so, in the Netherlands.[66] As a result, director replacement through voting may be not an option, unless one shareholder (or a coalition of them) gets strong enough to challenge directors' nominations.[67] Disgruntled shareholders would have then only one way to get rid of incumbent directors: taking the firm over.

d) Takeover Defenses

Once the issues regarding subject-matters and initiative have been set up, takeover resistance becomes the last piece of the competence puzzle. Entitlements to takeover resistance may reside either with shareholders or with directors.[68] The dis-

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60 This varies considerably across jurisdictions. See Kraakman *et al.* [2004], *The Anatomy*, cit., 46-49.

61 Id., at 34-36.

62 Cools, S. [2005], *op. cit.*

63 Rock, E.B. and Wachter, M.L. [2001], *Islands of Conscious Power: Law, Norms and the Self-Governing Corporation*, in UNIVERSITY OF PENNSYLVANIA LAW REVIEW, vol. 149, 1619–1700.

64 See *infra*, section 7.3.3.

65 Bebchuk, L.A. [2005a], *The Case for Increasing Shareholder Power*, in HARVARD LAW REVIEW, vol. 118, 833-914.

66 For the US, see Cools, S. [2005], *op. cit.*, 745-750. For the Netherlands, see *infra*, section 7.3.3.

67 An alternative is making directors' nomination not binding on shareholder vote. See Bebchuk, L.A. [2003b], *The Case for Shareholder Access to the Ballot*, in THE BUSINESS LAWYER, vol. 59, 43-66.

68 See, for the divide, Kraakman *et al.* [2004], *The Anatomy*, cit., 161-173.

tribution of powers between the two categories of players is affected accordingly.[69] When takeover defenses need to be authorized by the general meeting of shareholders (like in Italy and in the UK) directors' position becomes suddenly very weak: unless they enjoy strong support from one or more large shareholders (or they are large shareholders themselves), they will be basically at the insurgents' mercy.[70] As we will see, directors deprived of takeover defenses might be granted nonetheless some unintended 'secret weapons' by takeover regulation, listing rules, or the general corporate law to the extent they can make insurgency costlier or less profitable.[71] But, sure enough, when the board of directors is basically free to decide about the implementation of takeover defenses (like in the Netherlands and in the US) it may become virtually impossible for disgruntled shareholders to have directors replaced against their will.[72]

Takeover defenses have to be put in perspective. Of course, they may dramatically tilt the balance of corporate powers in favor of directors.[73] But – in the economists' jargon – takeover defenses can only empower directors at the margin. That is, directors need to be *already* powerful enough to exert corporate control without much shareholder interference. This is what we observe under both American and Dutch corporate law, where organization and competence rules empower directors also when control is unchallenged, but they have nonetheless to look after the firm management.[74] In such a situation, takeover defenses complement directors' empowerment.[75] Having just a primacy in the ongoing exercise of corporate control would seem to be insufficient when directors are unable to defend their otherwise powerful position from takeovers. This is the apparently puzzling case of the UK. However, the combined effect of mandatory bid, regulatory disfavor towards controlling shareholders, and limited squeeze-out rights available to a successful insurgent shareholder is too often overlooked in interpreting British corporate governance.[76] In fact, all these factors together allow directors in the UK to entrench themselves even in the absence of formal takeover defenses.[77]

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[69] Cools, S. [2005], *op. cit.*, 748-750.

[70] Id., at 755-762.

[71] This is what happens in the UK. See *infra*, section 7.3.2.

[72] Kraakman *et al.* [2004], *The Anatomy*, cit., 168-170.

[73] This is how they are normally understood in both law and economics. See, respectively Kraakman *et al.* [2004], *The Anatomy*, cit.; and Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*

[74] Kraakman *et al.* [2004], *The Anatomy*, cit., 33-70.

[75] Cools, S. [2005], *op. cit.*, 745-750.

[76] For a prominent exception, see Franks, J., Mayer, C. and Renneboog, L. [2001], *Who Disciplines Management in Poorly Performing Companies?*, in JOURNAL OF FINANCIAL INTERMEDIATION, vol. 10, 209-245.

[77] Crespi-Cladera R., Renneboog L. [2003], *Corporate Monitoring by Shareholder Coalitions in the UK*, ECGI Finance Working Paper No. 12/2003, available at www.ssrn.com and www.ecgi.org.

Conversely, the mere ability to resist a takeover becomes useless when directors are not so powerful relative to shareholders, and so both their position and decisions have to be anyway endorsed by outstanding shareholders *on a regular basis*. Unsurprisingly, in the past, the liberal attitude of Swedish corporate law towards takeover defenses did not minimally contribute to directors' empowerment relative to shareholders.[78] Neither are likely to do, in the future, the opportunities for takeover resistance unwittingly introduced in Italian corporate law.[79] Takeover defenses might be indeed fundamental for reinforcing directors' empowerment, but, by themselves, they cannot turn around a balance of powers that is already favorable to shareholders.

7.2.3. Why Economics Is Not Enough to Support Corporate Power

Surprising as it may appear, the distribution of powers in corporate governance is very seldom regarded as a legal problem, but, rather, as an economic one.[80] Since Berle and Means, directors' empowerment within the corporate structure has been always explained as a consequence of ownership dispersion.[81] Shareholders of large

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[78] Agnblad, J., Berglöf, E., Högfeldt, P. and Svancar, H. [2001], *Ownership and Control in Sweden: Strong Owners, Weak Minorities, and Social Control*, in F. Barca and M. Becht (eds.), THE CONTROL OF CORPORATE EUROPE, Oxford University Press, 228-258.

[79] Bianchi *et al.* [2005], *Proprietà*, cit.

[80] Cools, S. [2005], *op. cit.*, 736-738. But there is at least one exception in the analysis of US corporate governance that is worth reporting: Barca, F. [1998], *Some Views on U.S. Corporate Governance*, in COLUMBIA BUSINESS LAW REVIEW, vol. 1998, 1-26. Like the present discussion, also Fabrizio Barca's interpretation of Corporate Law and Economics is based on contractual incompleteness and the need to preserve private benefits of control to some extent. This carries the economic investigation of corporate law one step further compared with Cools – in spite of Barca's paper being almost ten years older. Differently from the present framework, neither an explicit taxonomy of PBC is allowed nor is the issue of legal distribution of governance powers explicitly raised. Nonetheless, the work of Fabrizio Barca is particularly insightful. Unfortunately, most of his publications are in Italian (see, very prominently, Barca, F. [1994], IMPRESE IN CERCA DI PADRONE. PROPRIETÀ E CONTROLLO NEL CAPITALISMO ITALIANO, Laterza), and the few available in English are often overlooked in the international literature.

[81] Berle, A.A. Jr. and Means, G.C. [1932], THE MODERN CORPORATION AND PRIVATE PROPERTY, MacMillan, had two key insights in interpreting separation of ownership and control in the US. The first one is that "if one can determine who does actually have the power to select the directors, one has located the group of individuals who for practical purposes may be regarded as 'the control'." Id., at 70. The second one is that – when "*ownership is so widely distributed* that no individual or small group has even a minority interest large enough to dominate the affairs of the company" (Id., at 84, emphasis added) – "control will tend to be in the hands of those who select the proxy committee by whom, in turn, the election of directors for the ensuing period may be made. Since the proxy committee is appointed by the existing management, the latter can virtually dictate their own suc-

listed companies are too many and too little to bother with interfering with firm management. Economists have formalized this situation as a collective action problem leading individual shareholders to a characteristic state of mind, which is normally referred to as 'rational apathy.' As a result, directors are there only in theory to foster shareholder interest. In practice, they are just 'captured' by the same managers they are intended to supervise, since shareholders are too distant and passive to care about choosing their own representatives.[82] Most legal scholars on both sides of the Atlantic have bought this account at face value.[83] In both law and economics, the basic problem of corporate governance becomes then how to make

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cessors." Id., at 87. On the importance of proxy voting for the distribution of corporate powers, see *infra*, section 7.2.4.

Unfortunately, Berle and Means subtly contradicted themselves in merging these two insights, and the contradiction is exactly what received wisdom has handed down to posterity: "[The foundation of] management control is *extra legal*, resting on a *factual* rather than a legal base." Id., at 70 (emphases added). The factual circumstance in question is that "no stockholder is in the position through his holdings alone to place important pressure upon the management or to use his holdings as a considerable nucleus for the accumulation of the majority of votes necessary to control." Id., at 84. But why is it so? Berle and Means provide themselves the answer, which is worth reporting in its entirety:

> "In such companies where does control lie? To answer this question, it is necessary to examine in greater detail the conditions surrounding the electing of the board of directors. In the election of the board the stockholder ordinarily has three alternatives. He can refrain from voting, he can attend the annual meeting and personally vote his stock, or he can sign a proxy transferring his voting power to certain individuals selected by the management of the corporation, the proxy committee. As his personal vote will count for little or nothing at the meeting unless he has a large block of stock, the stockholder is practically reduced to the alternative of not voting at all or else of *handing over his vote to individuals over whom he has no control and in whose selection he did not participate*. In neither case will he be able to exercise any measure of control."

Id., at 86-87 (emphasis in the original, footnotes omitted).

Berle and Means' analysis was so much embedded in the US experience that they ended up overlooking that the above mechanism rests in fact on a *legal* institution: directors' control over the proxy machinery. Comparative law was not so popular at that time – it did not even exist as an autonomous field of legal studies. If Berle and Means had looked at the other side of the Atlantic, they would have probably reconsidered their factual approach to separation of ownership and control. On the one hand – as others have subsequently pointed out –, managerial control of listed companies hardly existed outside the US. More importantly, on the other hand, most corporate law jurisdictions did not (and still do not) feature management's privileged access to the proxy machinery, at least not in the same way as American law did. Many things have changed in corporate laws since Berle and Means wrote their classic. But the interaction between economic and legal distribution of corporate powers, and the role of proxy voting therein, is still a fundamental feature of separation of ownership and control, which I am going to extensively elaborate upon in the following pages.

82 Hart, O. [1995], FIRM, CONTRACTS, AND FINANCIAL STRUCTURE, Oxford University Press, 128.

83 Kraakman *et al.* [2004], *The Anatomy*, cit., 21-32.

directors less dependent on inside management and more accountable to outside shareholders.[84] As a matter of cold fact, this is the story that we all learned at the university, and that we still teach to our students.

There is, however, too little wonder about the facts of corporate governance that that story leaves unexplained. Crudely speaking, why do some legal systems like the American, the Dutch, and (at least to some extent) the British continue to empower directors relative to shareholders just when the latter are most weak due to ownership dispersion? Even more strangely, why do shareholders seem to be more willing to invest in the stock market just in those countries whose corporate law is most supportive of directors' power? Conversely, why do other systems (like Swedish and Italian corporate laws) that prefer to empower shareholders instead of directors end up with concentrated ownership structures and relatively thinner stock markets? Are we sure that what matters is the economic distribution of power and not, rather, the legal one? In fact, the least that can be said is that the two issues are equally important and closely related.[85] Assessing whether they are determined by one another and the direction of causality is certainly more complicated, but understanding corporate governance leaves us with no alternative.

A few commentators have gained over time some moderate awareness of this problem. On the legal side, Mark Roe suggested already more than a decade ago that some regulatory factors were indeed responsible for shareholder weakness in the US, even though such a weakness was anyway achieved through dispersion of ownership.[86] The point is that ownership dispersion did not arise by chance in the US. Financial regulation preventing both banking and non-banking institutions from holding controlling stakes in non-financial companies, just when financial needs of large business became too high to be sustained by otherwise wealthy families, leaded to the "strong managers-weak owners" situation that still characterize today's corporate America. Bernard Black complemented Roe's analysis with similar arguments.[87] Even though both accounts have more to do with securities regulation than with corporate law, the patterns of corporate governance regulation are 'path-dependent.'[88] At the beginning, political support against powerful financiers (emerging as a backlash to the crisis of the 1930s) only indirectly empowered directors; but then directors became the only interest group able to influence corporate

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[84] See Easterbrook, F.H. and Fischel, D.R. [1991], *op. cit.*; and Shleifer, A. and Vishny, R. [1997], *A Survey of Corporate Governance*, in JOURNAL OF FINANCE, vol. 52, 737-783.

[85] Cools, S. [2005], *op. cit.*, 765-766.

[86] Roe, M.J. [1994], STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE, Princeton University Press.

[87] Black, B.S. [1990a], *Shareholder Passivity Reexamined*, in MICHIGAN LAW REVIEW, vol. 89, 529-591.

[88] Bebchuk, L.A. and Roe, M.J. [1999], *A Theory of Path Dependence in Corporate Ownership and Governance*, in STANFORD LAW REVIEW, vol. 52, 127-170.

legislation and case-law – as they probably did. As a result, the trend in American directors' empowerment is not likely to be reversed until some other backlash occurs.[89]

Mark Roe subsequently extended this approach to the comparative analysis, developing the 'political' theory of corporate governance that was discussed in the Fourth Chapter.[90] Whether directors or shareholders are empowered in corporate governance is ultimately regarded as a political issue, for law (and especially corporate law) can do little in this respect. Politics determines whether ownership dispersion is induced in the first place, thereby empowering directors. But where the political conditions are not such as to make ownership dispersion affordable for shareholders – for instance, because support for stakeholders is too strong – only concentrated ownership structures can emerge and persist over time, that leaving no scope for directors' autonomy. The opportunity to address the question whether directors' empowerment also needs support by legal entitlements was just there, but in the end it was missed.[91]

Mark Roe's conservative position on that account is far from unique. Within the general disagreement upon the determinants of corporate ownership structures, almost nobody dares to question the basic Berle and Means insight that managers be empowered just by ownership dispersion. To my knowledge, there are just two exceptions on the legal side and one on the economic side. Among legal scholars, Lucian Bebchuk has recently made the point that the weakness of American shareholders is not a necessary consequence of dispersion of ownership, but it is "at least in part due to legal rules that insulate management from shareholder intervention."[92] However, he also claims that further empowerment of shareholders relative to directors would not alter the "existing patterns of ownership," and it would be indeed very advisable for the efficiency of US corporate law.[93]

By taking a comparative approach, Sofie Cools has carried the argument even further, with possibly reversing its policy implications.[94] Dispersion of ownership is itself not sufficient to bring about managerial control, for the latter needs *also* to be supported by an appropriate distribution of legal powers between the board of directors and the general meeting of shareholders. This should explain why powerful directors are in charge of American corporate governance, *and then* ownership is

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[89] Roe, M.J. [1998], *Backlash*, in COLUMBIA LAW REVIEW, vol. 98, 217-241.

[90] Roe, M.J. [2003c], *op. cit.* See *supra*, Chapter Four, section 4.4.2, for discussion.

[91] See, however, Barca, F. [1998], *op. cit.*, for an attempt to bring all of these issues together in the analysis of CG in the US.

[92] Bebchuk, L.A. [2005a], *op. cit.*, 842.

[93] *Ibidem.*

[94] Cools, S. [2005], *op. cit.*

dispersed; whereas shareholders have the lion's share of legal powers in most countries of continental Europe, *and then* ownership is concentrated. Ownership structure thus follows the balance of powers established by corporate law, not the other way around. Comparative analysis shows that shareholder empowerment is incompatible with dispersion of ownership, while director empowerment prevents controlling shareholders from taking the lead.

Unfortunately, this account can possibly explain why managerial capitalism has never become ascendant in most countries of continental Europe, but definitely not why controlling shareholders are also present (albeit infrequent) in the US.[95] In addition, the peculiarities of other systems where corporate ownership is most often dispersed (like in the Netherlands and in the UK) are not accounted for.[96] But still, the crucial importance of the legal distribution of corporate powers was finally brought to light.

Neither Lucian Bebchuk nor Sofie Cools realized that a similar point was made contemporaneously by two economists. In their introduction to *The Control of Corporate Europe*, Marco Becht and Colin Mayer plainly asserted, "Regulation visibly affects the relationship between ownership and control."[97] At first glance, this proposition may recall the never-ending debate about whether over- or under-regulation is the problem of corporate governance; but in fact it has very little to do with it.[98] The authors' contention is rather that regulation (whether there is too much or too little of it) anyway creates biases, and the *direction* of such biases is what really matters. Regulatory biases allocate powers between different agents. They can empower dominant shareholders ('private control bias'), or alternatively prevent or discourage them from exerting ongoing corporate control ('market control bias') to such an extent as to practically shield the managers from their interference ('management control bias').[99] Nearly all of those biases arise from corporate law, in that it provides – or does not prohibit – devices for separating voting rights from cash flow rights (which empower shareholders), or control rights from voting rights (which empower the managers).

Although they do not explicitly refer to the legal distribution of powers between shareholders and directors, Becht and Mayer simply look at it from a different angle. In fact, 'private control bias' means nothing but shareholder empowerment (again, what we observe in Italy, Sweden, and in many other countries of continen-

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[95] See *supra*, Chapter Two.

[96] See *infra*, sections 7.3.2 and 7.3.3.

[97] Becht, M. and Mayer, C. [2001], *Introduction*, in F. Barca and M. Becht (eds.), THE CONTROL OF CORPORATE EUROPE, Oxford University Press, 5.

[98] Id., at 4-7.

[99] Id., at 5-15.

tal Europe); whereas a 'management control bias' is achieved by either depriving shareholders of some of their entitlements (like in the UK) or directly providing directors with additional ones (like in the US or in the Netherlands). The 'market control bias' appears to be confined in a theoretical limbo with almost no practical relevance.[100] What comparative empirical evidence displays is shareholder control or management control, none of which is ever contestable on the market, save for exceptional cases. Undeniably, each control pattern is supported by corporate law with a consistent distribution of powers.

7.2.4. How Does Distribution of Powers Affect Corporate Governance?

Having the traditional account of directors' power – dispersion of ownership – dismissed as a matter secondary (and possibly just consequential) to the legal distribution of powers may seem overly exaggerated to many readers. It is. Recent advances in both lawyers' comparative analysis and economists' empirical work have shown something different. Namely, that managerial control and dispersion of ownership do *not simply* arise from one another. For that result to emerge, directors' autonomy from shareholders needs *also* to be supported by a favorable distribution of legal powers. However, managerial control is not just a necessary consequence of directors being favored in the legal balance of corporate powers. Whatever is that balance, directors could not be in charge in the presence of a controlling shareholder. Indeed, even those countries whose corporate law appears to be the most supportive of directors' managing powers (the US, the UK, and the Netherlands) allow for the presence of controlling shareholders – notwithstanding shareholder control being sometimes disfavored.[101] I will further speculate on both causes and consequences of corporate law's non-neutrality between shareholder and managerial control later in this Chapter. But it should be rather clear by now that corporate control patterns are affected by *both* the legal distribution of powers *and* the ownership structure, and so the two issues must be considered together.

A crucial point for any corporate controller is the power to appoint and to remove directors.[102] This clearly holds for a controlling shareholder. A necessary condition for his being in charge of decision-making is that at least the majority of directors owe their position to his good wishes. The achievement of that result is relatively easy for a shareholder featured with a large share of voting rights. He can

[100] Id., at 37.
[101] See *infra*, section 7.3.2.
[102] Berle, A.A. Jr. and Means, G.C. [1932], *op. cit.*, 70.

easily control resolutions of the general meeting, provided that the vast majority of non-controlling shareholder would never show up there (due to rational apathy), and the few that possibly would are not even together large enough to outvote the controlling shareholder. Regulation can indeed make life more complicated for controlling shareholders, by constraining his entitlements to appoint and remove members of the board of directors.[103] However, in none of the country jurisdictions under consideration (nor, I believe, anywhere else in the world) a controlling shareholder is completely unable to have his own representatives appointed to the board. Even under the hurdles of the traditional Dutch 'structured regime,' – which have been somewhat reduced in recent times – a controlling shareholder might have obstructed the process of board members cooptation or anyway threaten disloyal directors to withhold from his support (which they would eventually need) at the general meeting.[104] The dominant position of the controlling shareholders obviously extends to all of the other issues of corporate life (like charter amendments, mergers, and so on) that need to be endorsed by the general meeting.[105]

The managers' position is structurally weaker. Managers do not typically hold large portions of the firm's stock. So let us assume for a moment that they hold none. How can they possibly succeed in having them and the people they trust appointed to the board of directors? One option is obviously placing themselves under the authority of a controlling shareholder. As we have just seen, this is indeed the *only* option when there is a controlling shareholder. But what if there is none? Then Berle and Means had predicted that directors would be automatically in charge, and that they would be *de facto* selected by the inside management.[106] However, Berle and Means were wrong in that they posited managerial control being just the consequence of a shareholder power vacuum.[107] Filling in that vacuum is indeed far from automatic. Managers might be unchallenged by a controlling share-

[103] This is the case of the UK. See *infra*, section 7.3.2.

[104] This process was in fact named '*controlled* co-optation,' and could be challenged in courts. See Kemperink, G. [2004], *op. cit*. See *infra*, section 7.3.3.

[105] Kraakman *et al.* [2004], *The Anatomy*, cit., 131-156.

[106] "In the typical large corporation […] control does not rest upon legal status. In these companies control is more often *factual* […]. Such control […] may be maintained over a long period of years, and as a corporation becomes larger and its ownership more widespread, it tends towards a position of impregnability comparable to that of legal control, a position from which it can be dislodged only by a virtual revolution." Berle, A.A. Jr. and Means, G.C. [1932], *op. cit.*, 79-80.

[107] To be sure, Berle and Means never made any such statement. They just suggested this by *characterizing* managerial control on a factual basis. "Such management control, though resting on no legal foundation, appears to be comparatively secure where the stock is widely distributed." Berle, A.A. Jr. and Means, G.C. [1932], *op. cit.*, 88. But they actually *described* managerial empowerment as a result of ongoing control over the proxy machinery. This is indeed a legal issue. On this fundamental contradiction of Berle and Means' analysis, see *supra*, note 81.

holder, but they still need to find a way for having trusted directors (or even themselves) appointed to the board and making sure that they are not removed the day after. More often than not, this would require that ongoing support by the general meeting be obtained (save when directors are *not* appointed by the general meeting, as it used to be for some Dutch corporations). The same support is anyway needed to exert corporate control in those instances where any decision has to be approved by the general meeting. Curiously enough, very few commentators – on both the economic and the legal side – have ever wondered how this is actually achieved.[108]

At least as far as I understand the comparative picture, proxy voting – which perhaps received too little attention by Berle and Means, but even less so by their readers – is the key word. Proxy voting is a terrific way to exploit shareholders' rational apathy to the managers' advantage, even though this is definitely not the way in which proxy voting is commonly understood. It might seem that proxy voting serves to enhance shareholder democracy, by allowing otherwise rationally apathetic owners to participate in corporate decision-making. Upon this account proxy voting was included in the Anti-director Rights Index of *Law and Finance*.[109] Utopia is always good-looking, but never verified in practice. In real-world corporate governance there is not such thing as a shareholder democracy. Somebody has to be in charge. And, in this case, this is the one who collects the proxies, not those ones who send them in.[110]

In three out of the five countries here considered – the US, the UK, and the Netherlands – managerial control is more frequent than shareholder control. In all of them, corporate law allows directors to collect or otherwise hold proxies from dispersed shareholders *at the company's expenses*. Although this is achieved by different legal arrangements in Anglo-American corporate governance and in the Netherlands (where management control over shareholders' votes does not exactly depend on proxy voting, but rather on stock being placed in a trust), the result is always that shareholder voting is reduced to little more than a formality.[111] It is in fact directors who cast shareholder votes, subject to the very loose condition that – ra-

[108] I have to mention the important exception of an Italian commentator, who – irrespective of the mainstream literature – described the US proxy voting system exactly as a device supporting the exercise of managerial control in dispersed ownership structures. Perna, R. [1998], *Public company e democrazia societaria: voto per delega e governo delle imprese nel capitalismo statunitense*, Il Mulino. While taking full responsibility of any mistake in the following analysis, I have to acknowledge that a significant part of it takes stock of that book.

[109] La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R. [1998], *Law and Finance*, in JOURNAL OF POLITICAL ECONOMY, vol. 106, 1113-1155.

[110] For this interpretation of proxy voting in the US, see, authoritatively, Eisenberg, M.A. [1989a], *The Structure of Corporation Law*, in COLUMBIA LAW REVIEW, vol. 89, 1461-1525.

[111] Hellwig, M. [2000], *op. cit.*

tionally apathetic! – shareholders do not object. Therefore, it is corporate law and not just dispersion of ownership that enables directors to enjoy ongoing support at the general meeting. This explains not only how directors manage to be appointed (and re-appointed) to the board, but also how they have other resolutions passed by the general meeting when they need that.

Both in Italy and in Sweden, proxy voting cannot systematically work to the directors' advantage, nor are there other ways for directors to get support at the general meeting; unless, of course, they are sponsored by a controlling shareholder. To be sure, proxy solicitation has been introduced almost a decade ago in Italian corporate law and it is now available under Swedish legislation too. However, in none of those systems directors (as well as other constituencies) are entitled to collect proxies at the company's expenses.[112] In such a situation, directors would risk being voted out at every general meeting and would have practically no way to implement decisions that require shareholder support. Soliciting proxies at their own expenses would be clearly too a high price to pay for exerting corporate control. And it is in fact no surprise that such a burdensome regulation of proxy voting has proven unfruitful to both directors and shareholders, at least in Italy. As far as directors are concerned, that simply excludes any possible autonomy from the general meeting. The ultimate reason why managerial control has never emerged as a corporate governance pattern in Italy and in Sweden seems to be then one of *technical infeasibility*. There – as in many other countries, I conjecture – corporate law does not allow directors to exert corporate control without the support of a controlling shareholder.

For the sake of brevity and intuitiveness, I have clearly oversimplified the matter. Many more factors are indeed at play in determining the distribution of corporate powers. However, the basic intuition holds. Directors' legal empowerment is a precondition for the emergence of managerial control. Where directors are not entitled to exploit shareholders' rational apathy through a favorable discipline of voting at the general meeting, a controlling shareholder shall be practically the only option for corporate governance. This proposition is only based upon consideration for shareholder voting, thereby including just one part – albeit the fundamental one – of the organizational discipline of the general meeting. It has therefore to be supplemented with other important organization and competence features of corporate law that affect the distribution of power between the board of directors and the general meeting of shareholders. Adequate consideration for all those features re-

[112] To be sure, there is an exception in Sweden. The 2006 reform of the Companies Act has laid down a system of voting by mail, whose burden of expenses may be placed on the company. See OECD [2006], *Database*, cit. However, it is unclear whether, and to what extent, directors can avail themselves of this mechanism in order to solicit suffrages for their own reappointment.

quires a rather in-depth investigation that cannot be performed cross-country. By the country analysis that follows, I shall be able to uncover consistent paths of either director or shareholder empowerment in corporate law.

7.3. Legal Underpinnings of Managerial Control

7.3.1. Directors Autonomy in the US

In the US, directors are quite well-known for being the most powerful category of players in corporate governance, perhaps immediately followed by corporate lawyers.[113] The (intuitively legal) reasons underlying the latter belief will become clear in the next two Chapters. As far as directors are concerned, their power basically depends on the ability of the board to control the outcomes of the general meeting, provided that shareholders remain dispersed, and to entrench its members, should shareholders ever dare to coalesce their power.[114] It is in fact a combination of organizational rules (shareholder voting procedures) and competence rules (initiation rights and takeover defenses) what makes corporate directors so powerful in the US. While the former set of rules allows directors to exert ongoing control over the firm management, the latter makes sure they can keep such a control uncontested.

a) Directors appointment: the US proxy voting system

Once directors are in charge (let us suppose they were appointed before the firm went public), their basic concern is being re-elected. Under US corporate law, directors are elected by a plurality (not by a majority) of the votes cast at the general meeting, provided that a quorum is either present in person or represented by proxy.[115] Directors must be normally up for election *every year*.[116] There is one im-

[113] See, e.g., Paredes, T.A. [2004], *op. cit.*

[114] This has been brilliantly illustrated by Bebchuk in a series of articles, most prominently including: Bebchuk, L.A., Coates, J.C. IV and Subramanian, G. [2002a], *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence & Policy*, in STANFORD LAW REVIEW, vol. 54, 887-951; Bebchuk, L.A. [2003b], *op. cit.*; Bebchuk, L.A. [2005a], *op. cit.* Cools, S. [2005], *op. cit.*, takes stock of Bebchuk's work for analyzing the matter from a different and, in a sense, opposite angle.

[115] Under Delaware law, the default quorum of general meetings is the majority of the shares entitled to vote; it cannot be lower than one-third. DGCL § 216. Other jurisdictions are more flexible (see,

portant exception to this rule, when the board is 'classified' (or 'staggered'); among other things, this implies that each director's term of office is extended up to three years.[117] Staggered boards will be discussed later, though, since in the US they are more of a takeover defense than of a device for facilitating director re-appointment. Proxy solicitation is instead one such device.[118]

Every year directors solicit proxies from dispersed shareholders by sending them a form that carries their own nominations to the board.[119] Individual shareholders may return the proxy form with their signed approval, totally or partially deny their consent, abstain, or they may simply not return the form. What shareholders cannot do is voting for other candidates.[120] This is not possible unless an independent proxy solicitation is promoted *in opposition* to the board or shareholders propose alternative nominees by showing up *in person* at the general meeting – which they will never do until they are dispersed.[121] Opposition would involve a contested vote (i.e., a so-called proxy fight) that, for the reasons the will be clarified shortly, occurs very infrequently in the US – and almost never in the rest of the world.[122] In normal

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e.g., MBCA § 7.25). In the election of directors, the general rule is plurality voting. See DGCL §216 and MBCA §7.28. According to Joseph Grundfest:

> "What is interesting is the way Delaware law works, and every state law of which I'm aware works, is that a director needs to be elected by a plurality. That means that if a million shares count as a quorum, and if 999,999 ballots strike your name out and say no, you, as the director, owning only one share, and you vote for yourself, congratulations, you win. You have the plurality."

Bebchuk, L.A. (ed.) [2003c], *Symposium on Corporate Elections*, Harvard Law School, October 23, 2003 (transcripts), available at www.ssrn.com, 95.

A recent amendment of Delaware law has opened the door to majority voting (which, by the way, has always been an option, at least in theory). Plurality is still the default rule, but this may be changed through a shareholder bylaw that directors cannot repeal. See DGCL § 216 (as amended by the Senate Bill No. 322, passed on June 27, 2006), and the comments by McBride, D.C. and Bissel, R.P. [2006], *Delaware's Flexible Approach to Majority Voting for Directors*, in WALL STREET LAWYER, vol. 10, No. 6.

116 See Hamilton, R.W. [2000], *op. cit.*, 263 and Bainbridge, S.M. [2002a], *op. cit.*, 446 (where reference to the pertinent rules, and exceptions, provided for by DGCL and MBCA)

117 DGCL § 141 and MBCA § 8.06. See Bainbridge, S.M. [2002a], *op. cit.*, 446-448.

118 Most shareholders of a publicly held corporation would not vote if not by proxy. Proxy voting is a distinctive feature of US corporate governance. It is regulated at both the state and the federal level. By and large, state law governs the "substantive aspects" of proxy voting, whereas federal law takes care of the procedure of proxy solicitation under § 14(a) of the Securities Exchange Act of 1934. Bainbridge, S.M. [2002a], *op. cit.*, 439-517.

119 Id., 472-483.

120 Hamilton, R.W. [2000], *op. cit.*, 404-405.

121 Donald, D.C. [2004], *The Nomination of Directors under U.S. and German Law*, Working Paper No. 21, Frankfurt University, Institute for Law and Finance, available at www.ilf-frankfurt.de.

122 Kraakman *et al.* [2004], *The Anatomy*, cit., 41-44.

situations, where voting is uncontested, it suffices that most shareholders return their proxy for having incumbent directors re-appointed.[123] Let us see briefly why.

Since returning the proxy does not cost shareholders more than a signature (postage is also paid for), many individual investors and most institutional ones always return their proxies unless they have something to object to the incumbent management – in which case, they would rather sell their shares.[124] Then the quorum is easily met. Shareholders are not likely to do more than signing the form (thereby conferring a vast amount of discretion upon soliciting directors); for any other course of action would involve additional decision-making costs they are certainly not willing to bear. Paradoxically, however, even shareholder failure to support directors would not change the outcome of the general meeting, provided that alternative candidates cannot be voted for. Directors are elected by a plurality of the votes, meaning that "mere abstention or a vote against a proposed candidate will not be sufficient to prevent her election."[125] To be sure, even each director's bunch of votes for his own (negligible) share ownership would suffice to make a plurality, provided that enough shares are represented by proxy to count as a quorum. Proxy voting is therefore a rather complicated mechanism through which American directors are quite easily re-appointed. It should be noticed that proxy voting also costs nothing to the directors: US corporate law places upon the company the (quite heavy, indeed) burden of expenses of proxy solicitations promoted by the *incumbent* board.[126]

b) Decisions by the General Meeting of Shareholders

Proxy voting is not only a way for directors to be re-appointed to office. It is also a possible way to have resolutions passed by the general meeting when the law or the charter requires that certain decisions be upheld by shareholders. Here the matter is more complicated, for this kind of resolutions must be voted by majority and not by plurality, so that – in a nutshell – the number of 'NO' matters as much as the number of 'YES.'[127] In addition, motions involving charter amendments or other so-called 'fundamental' corporate transactions need to be endorsed by the

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[123] As a matter of fact, US directors are reappointed to office by merely proposing themselves for election. Blair, M.M. and Stout, L.A. [1999], *A Team Production Theory of Corporate Law*, in VIRGINIA LAW REVIEW, vol. 85, 311.

[124] Easterbrook, F.H. and Fischel, D.R. [1991], *op. cit.*, 81-89; Bainbridge, S.M. [2002a], *op. cit.*, 512-517.

[125] Cools, S. [2005], *op. cit.*, 746.

[126] Rosenfeld v. Fairchild Engine & Airplane Corp., 128 N.E.2d 291 (N.Y.1955).

[127] Plurality is only established for election of directors. In general, resolutions are passed by the majority of the votes cast at the meeting, provided that a quorum is present in person or by proxy. Compare DGCL § 216 (abstentions count as NO) with MBCA § 7.25 (abstentions are ignored).

majority of the votes carried by *outstanding* shares, no matter of how many of them are represented at the general meeting.[128] Directors then always run the risk of being unable to summon enough *favorable* votes through proxy solicitation in order to have their decision affirmed by the general meeting. However, they do not also run the risk of being outvoted by a different proposal, for American shareholders practically have no power to place motions on the *agenda* of the general meeting whose endorsement would be binding on directors.[129] This statement suffers just two exceptions: director removal, which will be discussed in the next subsection; and bylaws amendment, whose minor relevance can easily be deduced from the circumstance that bylaws are always subordinated to the corporate charter.[130] As regards the other issues that might be brought to the attention of the general meeting of shareholders, a few qualifications are in order.

Major structural changes like charter amendments, mergers, substantial sale of assets, and dissolution can only be initiated by the board of directors, who therefore enjoy a veto right on such matters.[131] In theory, shareholders can also veto directors' proposals by refusing to return the majority of proxy votes with their ap-

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[128] DGCL §§ 242, 251, 271 (majority of outstanding shares); MBCA §§ 10.03, 11.04, 12.02 (majority of the shares entitled to vote).

[129] Cools, S. [2005], *op. cit.*, 741-742. For the non-binding character of shareholder proposals that the board may be requested, under certain conditions, to include the meeting's agenda, see *infra* in the text.

[130] Bylaws are a very peculiar feature of American corporate law. Bylaws can be adopted unilaterally by either the shareholders or the board of directors; in principle, each player retains authority to amend the other's bylaws. Cools, S. [2005], *op. cit.*, 740. Bylaws are supposed to set the rules governing the internal affairs of the corporation, and in this respect they complement the articles of incorporation (charter). However, on the one hand, a number of statutory defaults can only be opted out by the charter (e.g., DGCL § 141(a)): on the other hand, bylaws cannot be inconsistent with the charter (DGCL § 109(b); MBCA §2.06(b)).
Shareholders may initiate and approve bylaws, but whether this option confers upon them any effective power is debated. Apparently, bylaws amendments are eligible for shareholder proposals under SEC Rule 14a-8 (see *infra* in the text). According to Boot, A. and Macey, J.R. [2004], *op. cit.*, 382-383, shareholder may avail themselves of this technique to constrain directors' power, for instance by requiring the company's poison pills to expire under certain circumstances. Other commentators are far more skeptical. See, e.g., Donald, D.C. [2005], *Shareholder Voice and its Opponents*, Working Paper No. 40, Frankfurt University, Institute for Law and Finance, available at www.ilf-frankfurt.de. Delaware courts have never addressed the issue of how far bylaws can go in constraining the board's authority. See Bebchuk, L.A. [2005a], *op. cit.*, 845. Bainbridge, S.M. [2002a], *op. cit.*, 45-48 contends that this authority cannot be unilaterally constrained by shareholders, at least not in Delaware (a bylaw limiting the board's power to adopt a poison pill was upheld by the Supreme Court of Oklahoma in 1999). The recent evolution of Delaware statutory law has explicitly provided for such a constraint with respect to bylaws introducing majority voting for the election of directors. See *supra*, note115.

[131] Bebchuk, L.A. [2005a], *op. cit.*

proval.[132] In practice, this might possibly depend on rational apathy (when accounting for more than 50% of voting rights), but it is very seldom due to a knowledgeable dissent, at least unless directors' proposal is noticeably outrageous.[133] Only in the last case, the proposal may find such a widespread opposition that it has no chance of being passed. The introduction of classified (staggered) boards by charter amendment is one prominent example in this regard.[134] Dissent could otherwise be summoned by a proxy contest. This option is often mentioned in legal textbooks under the name of 'issue contest' to have it distinguished from the typical instance of proxy fight, the 'control contest', where directors' election is in question.[135] However, since in that case all expenses of proxy solicitations against a board proposal have to be definitively borne by their promoters, issue contests are basically unheard of in American corporate practice. In conclusion, directors have the exclusive right to initiate a structural change, whereas dispersed shareholders have little power to vote it down.[136]

For any other matter, US directors usually do not need shareholder support.[137] Perhaps the most cited provision of Delaware corporate law is that the corporation "shall be managed by or under the direction of a board of directors."[138] By such a statement, shareholder involvement is basically ruled out of corporate governance, to the extent it is not restored by specific statutory or charter provisions. Neither the former nor the latter – whose amendments, as we have just seen, are in the end under directors' control – provide for much further involvement of shareholders in corporate decision-making.[139] Nonetheless, regulation provides shareholders with at least one way to make their voice heard by directors, even though directors are not

[132] Kraakman *et al.* [2004], *The Anatomy*, cit., 131-155.

[133] For empirical evidence that US shareholders routinely vote with the management, see Maug, E. and Rydqvist, K. [2001], *What is the Function of the General Meeting? Evidence from the U.S. Proxy Voting Process*, Working Paper, Humboldt University and Norwegian School of Management, available at www.ssrn.com.

[134] Bebchuk, L.A. [2003a], *Why Firms Adopt Antitakeover Arrangements*, in UNIVERSITY OF PENNSYLVANIA LAW REVIEW, vol. 152, 715.

[135] Bebchuk, L.A. and Kahan, M. [1990], *A Framework for Analyzing Legal Policy towards Proxy Contests*, in CALIFORNIA LAW REVIEW, vol. 78, 1073-1135.

[136] Bebchuk, L.A. [2005a], *op. cit.*

[137] American law differs considerably from European law in this particular respect. See Bainbridge, S.M. [2002c], *Director v. Shareholder Primacy in the Convergence Debate*, in TRANSNATIONAL LAWYER, vol. 62, 48.

[138] DGCL § 141(a). This is formally a default rule, but virtually no corporate charter in Delaware opts out it. For two opposite views on the matter, compare Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, with Hansmann, H. [2006a], *Corporation and Contract*, in AMERICAN LAW AND ECONOMICS REVIEW, vol. 8, 1-19. See also *infra*, Chapter Eight, section 8.1.3.

[139] Bebchuk, L.A. [2005b], *The Myth of the Shareholder Franchise*, Working Paper No. 565, Harvard Law School (Faculty Series), available at www.ssrn.com, forthcoming in VIRGINIA LAW REVIEW, 2007.

compelled to listen. This is the 'shareholder proposal' under Rule 14a-8 of the Federal Proxy Regulations.[140]

Under a number of relatively tolerant eligibility and procedural requirements, shareholders are entitled to place items on the agenda of the general meeting and to have them included, with a brief supporting statement, in the proxy material circulated by the board of directors *at the company's expenses*.[141] Piggybacking is the basic advantage of a shareholder proposal compared to an issue contest.[142] However, while an 'expensive' issue contest might at least lead to a (negative) resolution binding directors against their will, 'cheap' shareholder proposals are never binding regardless of how large is the support that they receive at the general meeting. This is due to one fundamental ground for excluding the proposal: that is, its being 'improper' under state law.[143] Since state corporate laws commit most power of initiating shareholder action to the board of directors, the Securities and Exchange Commission (SEC) has recognized that proposals of a mandatory resolution may be regarded as improper and thus recommended that they be framed in a precatory form.[144] As a result, directors routinely feel free to ignore resolutions arising out of a shareholder proposal, including one of the most popular: removing board classification.[145]

b) Directors Removal: Staggered Boards

Little wonder that such a powerful directorship should be easily brought to an end. In theory, directors can be removed anytime in the US, with or without cause.[146] In practice, however, something like that hardly happens in the US. Midterm removal is constrained by the ability of shareholders to summon a special meeting to this purpose – which is excluded under Delaware law, unless otherwise provided for in the charter.[147] In addition, director removal without cause is just the

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140 SEC Rule 14a-8, promulgated under § 14(a) of the Securities Exchange Act of 1934.

141 Bainbridge, S.M. [2002a], *op. cit.*, 495-505.

142 Kraakman *et al.* [2004], *The Anatomy*, cit., 42-43.

143 Cools, S. [2005], *op. cit.*, 742.

144 Note to SEC Rule 14a-8(i)(1).

145 Black, B.S. [1998], *Shareholder Activism and Corporate Governance in the United States*, in P. Newman (ed.), THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW, vol. 3, Macmillan, 459-465.

146 At common law, directors could only be removed for cause. See Cools, S. [2005], *op. cit.*, 747. However, this has been superseded by statutory law. See Hamilton, R.W. [2000], *op. cit.*, 235-237. DGCL § 141; MBCA § 8.08.

147 DGCL § 211(d) allows for special meetings to be called only by the board and any other person explicitly authorized by the articles or bylaws. MBCA § 7.02(a)(1) also empowers the holders of at least 10% of the voting shares to call a special meeting.

default provision.[148] Yet directors can only be removed *with cause* when a classified board structure is adopted, and this happens to be true for the *majority* of US publicly held corporations.[149] Board classification involves that board members are divided into up to three classes.[150] Every year, only one class of directors is up to election, so that board members' term of office is 'staggered.' Since midterm removal is practically excluded, directors of a typical staggered board stay in charge three years. At first glance, this may seem just a postponement of their destiny – and, after all, not a too bad one. However, staggering also prevents shareholders from replacing *all* board members at once and, as such, it is the ultimate source of board entrenchment against hostile takeovers – which, as it turns out, it is not a bad outcome either.[151]

Incumbency provides US directors with all the advantages that I have just reviewed. Still, apparently, they may lose the annual elections in a contested vote aimed at replacing them. There are two possibilities. One is to have incumbent directors outvoted by a proxy fight. The other one is to have them replaced by a shareholder taking over firm control. Staggered boards involves that an insurgent shareholder has to win two consecutive proxy contests to gain control of the majority of the board; under US corporate law, only after he has succeeded he might have a chance of being reimbursed of the huge proxy solicitation expenses.[152] Takeovers would seem to be a fairly better option, if directors were not entitled to resist hostile bids – which in fact they are.[153] Having either voting power or share ownership (or both) coalesced against directors is then far from easy in the US, and may prove impossible more often than not.

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[148] Options available to the corporate charters slightly differ across US jurisdictions. Compare MBCA § 8.08 with DGCL § 141(k).

[149] Bebchuk, L.A. and Cohen, A. [2005], *The Costs of Entrenched Boards*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 78, 409–433.

[150] Bainbridge, S.M. [2002a], *op. cit.*, 446-448; Hamilton, R.W. [2000], *op. cit.*, 270-272.

[151] There is a considerable controversy on staggered boards going on in the US. For the terms of debate, see the Response Symposium on Bebchuk, L.A., Coates, J.C. IV and Subramanian, G. [2002a], *op. cit.*: Bainbridge, S.M. [2002d], *Director Primacy in Corporate Takeovers: Preliminary Reflections*, in STANFORD LAW REVIEW, vol. 55, 791-817; Gordon, M. [2002], *Takeover Defenses Work. Is That Such a Bad Thing?*, in STANFORD LAW REVIEW, vol. 55, 819-837; Stout, L.A. [2002], *Do Antitakeover Defenses Decrease Shareholder Wealth? The Ex Post/Ex Ante Valuation Problem*, in STANFORD LAW REVIEW, vol. 55, 845-861; Strine, L.E. Jr. [2002], *The Professorial Bear Hug: The ESB Proposal as a Conscious Effort to Make the Delaware Courts Confront the Basic "Just Say No" Question*, in STANFORD LAW REVIEW, vol. 55, 863-883; Bebchuk, L.A., Coates, J.C. IV and Subramanian, G. [2002b], *The Powerful Antitakeover Force of Staggered Boards: Further Findings and a Reply to Symposium Participants,* in STANFORD LAW REVIEW, vol. 55, 885-917.

[152] Bainbridge, S.M. [2002a], *op. cit.*, 484.

[153] See *infra*, next subsection.

Proxy contests used to be very popular among academics in the past, and that contributed to the widespread – but, now we see, mistaken – belief that proxy voting works to the shareholders' advantage. Then Henry Manne famously described proxy fights as "the most expensive, the most uncertain, and the least used of the various techniques" for control acquisition, and apparently – at least according to conventional wisdom – advocated hostile takeovers as the really important tool of both managerial discipline and efficient control allocation in the US.[154] In fact, he only advocated the merits of fully-fledged acquisitions over proxy contests, without making a case for hostile takeovers – which he regarded as inferior to negotiated mergers.[155] But this is not the point. Hostile takeovers were extremely popular in the US during the 1980s, in the face of the economic and legal hurdles that proxy contests were actually confronted with. Afterwards, things changed slightly as far as proxy contests are concerned and most significantly with regard to hostile takeovers.[156] Today, proxy fights seem to have somehow resurrected in connection with initially hostile bids.[157] The liberal attitude of Delaware courts and of many other states' legislation towards takeover defenses has made hostile bids almost impossible to succeed without first taking control of the board and of his exclusive entitlements.[158] However, as we are about to see, even a combination of a hostile bid with a proxy contest would be ultimately frustrated by a staggered board. This is how most hostile bids in the US only manage to go through, ultimately, as friendly deals.

A proxy contest alone is a quite inconvenient option for insurgent shareholders: they risk losing too much when they are unsuccessful and gaining too little when they are successful.[159] In the former case, they will have to bear all the expenses of the proxy solicitation. In the latter, they will be reimbursed if both the (new) board and the general meeting so decide.[160] But, still, what is in for them? Should they manage the firm any better than the earlier directors, all the other shareholders will

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[154] Manne, H.G. [1965], *Mergers and the Market for Corporate Control*, in JOURNAL OF POLITICAL ECONOMY, vol. 76, 110-120.

[155] "[Friendly] mergers seem in many instances to be the most efficient of the three devices for corporate take-overs." Id., at 119.

[156] Hostile takeovers have basically disappeared from US finance since then. See Holmström, B. and Kaplan, S. [2001], *Corporate Governance and Takeovers in the USA: Making Sense of the 80's and 90's*, in JOURNAL OF ECONOMIC PERSPECTIVES, vol. 15, 121-144.

[157] Hamilton, R.W. [2000], *op. cit.*, 404-405.

[158] Bainbridge, S.M. [2002a], *op. cit.*, 485-486 and 652-654.

[159] Bebchuk, L.A. and Kahan, M. [1990], *op. cit.*

[160] Notice that "the U.S. may be the only jurisdiction [in the world] to permit corporations to compensate successful insurgents *ex post* for their campaign costs." Kraakman *et al.* [2004], *The Anatomy*, cit., 43.

free ride.[161] Taking from the firm's profit any larger share than their pro-rata would involve a breach of fiduciary duties. As we will see in the next Chapters, these are quite well enforced in the US.[162] Takeovers work differently. If there is no impediment, a successful insurgent will not only take control of the board, but also become the owner of the company (technically, by having it merged in another one that he owns entirely). By this strategy, a would-be acquirer seeks to appropriate a significant part, if not all, of the takeover gains.[163] Impediments to that strategy are created by making the acquisition of a large stake in the company unsuitable for takeover or just unprofitable to the prospective bidder. Takeover defenses are aimed exactly at that purpose.

d) Takeover Defenses in the US

A comprehensive review of defensive techniques and their statutory and case-law regulation in the US would be too lengthy to be undertaken here.[164] However, one would not exaggerate by saying that in most situations an incumbent board can 'just say no' to any unwanted takeover bid. Even though neither Delaware courts – the most director-friendly and, at any rate, the most important corporate jurisdiction in the US – nor state anti-takeover statutes have ever put it so bluntly, this is how many commentators depict the state of American law regarding takeover defenses.[165]

Let us consider just the most notorious weapon within the wide directors' arsenal: the 'poison pill.' The pill's official name is 'shareholder rights plan.' Basically, the plan entitles *existing shareholders* to purchase stock either of the target or of the bidding company (after a merger has been performed) for a consideration well below market price (say, a half of it), thereby diluting both voting power and cash flow rights of the aggressor.[166] "Boards can adopt this pill without a shareholder vote and at any time, even *after* a hostile bid has been launched (the 'shadow pill' or 'morning after pill') if they do not already have one at that time."[167] Pills can be

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[161] Grossman, S.J. and Hart, O. [1980b], *Takeover Bids, the Free Rider Problem, and the Theory of the Corporation*, in BELL JOURNAL OF ECONOMICS, vol. 11, 42–69. But the point was informally made earlier, by Manne, H.G. [1965], *op. cit.*

[162] See *infra*, Chapter Nine, section 9.2.3. See also Chapter Ten, section 10.3.1, for the implications of dilution of minority shareholders on the takeover mechanism.

[163] See *infra*, Chapter Ten, section 10.3.

[164] See Bainbridge, S.M. [2002a], *op. cit.*, 677-693 ("The Arsenal").

[165] See, e.g., Bebchuk, L.A., Coates, J.C. IV and Subramanian, G. [2002a], *op. cit.*; Gordon, M. [2002], *op. cit.*; Kahan, M. and Rock, E.B. [2002], *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, in UNIVERSITY OF CHICAGO LAW REVIEW, vol. 69, 871-915.

[166] Hamilton, R.W. [2000], *op. cit.*, 438.

[167] Cools, S. [2005], *op. cit.*, 748-749.

more or less poisonous, but takeovers can hardly succeed once the shareholder rights plan has been implemented and until those rights are not redeemed.[168] Only the board of directors has the authority to redeem the pill.[169]

The last generation of pills, unredeemable by anybody but the *incumbent* directors ('dead hand' or 'no hand' pills), has been invalidated by recent case-law.[170] Apart from that, Delaware courts are of the opinion that directors are under no duty to redeem the pill in the face of a hostile bid. In the implementation of defensive tactics, they enjoy the protection of the 'business judgment rule' (that basically shield directors' discretionary authority from judicial review), provided that the presumptive requirements of directors' fiduciary duties are met.[171] In a nutshell, this involves that takeover resistance is allowed under the business judgment rule if, after a reasonable investigation by the board of directors, it proves commensurate to the threat posed to the corporation (the *Unocal* standard).[172] Such a threat may simply consist in shareholders being potentially misled in the decision whether to tender their shares (the *Time* ruling, often referred to as 'just say no' rule).[173] The proportionality test for enjoying protection of the business judgment rule is therefore satisfied within a quite extensive 'range of reasonableness' (the *QVC* ruling).[174] Such a test anyway excludes 'draconian' defensive provisions (those which are 'preclusive' of any change in control - *Unitrin*);[175] and it is replaced by a more stringent standard when the company is *already* put up for sale (in which case the board should behave like a neutral auctioneer – *Revlon*).[176]

What apparently Delaware judges only care of is that shareholders are not deprived forever of a takeover premium: that is, that the market for corporate control

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[168] For illustration of how at least some takeovers can succeed when the poison pill is triggered, see Carney, W.J. and Silverstein, L.A. [2003], *The Illusory Protections of the Poison Pill*, in NOTRE DAME LAW REVIEW, vol. 78, 179-220. This is why poison pills are often supplemented with other anti-takeover mechanisms. See *infra* in the text.

[169] Bainbridge, S.M. [2002a], *op. cit.*, 680-690.

[170] Carmody v. Toll Bros., Inc., 723 A.2d 1180 (Del.Ch.1998); Mentor Graphics Corp. v. Quickturn Design Sys., Inc., 728 A.2d 25 (Del.Ch.1998); Quickturn Design Sys., Inc. v. Shapiro, 721 A.2d 1281 (Del.Sup.1998).

[171] On the business judgment rule, see *infra*, Chapter Eight, section 8.4.2, and Chapter Nine, section 9.2.2. In the takeover context, the operation of the business judgment rule is somewhat 'special.' See Hamilton, R.W. [2000], *op. cit.*, 460-463. For the long-standing view that that this is exactly how it should be, at least from a Law and Economics standpoint, see Carney, W.J. [1988], *Controlling Management Opportunism in the Market for Corporate Control: An Agency Cost Model*, in WISCONSIN LAW REVIEW, vol. 1988, 424-433.

[172] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del.Sup.1985).

[173] Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140 (Del.Sup.1989).

[174] Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34 (Del.Sup.1994).

[175] Unitrin, Inc. v. American General Corp., 651 A.2d 1361 (Del.Sup.1995).

[176] Revlon, Inc. v. MacAndrews and Forbes Holdings, Inc., 506 A.2d 173 (Del.Sup.1986).

is not definitively set aside by board entrenchment.[177] Provided that a control sale is always possible either now or in the future, the courts have shown so far little objection to the board deciding if, when, and on what terms it should be implemented.[178] Takeover defenses have thus to be regarded as a device for having takeovers most often (if not always) negotiated with incumbent directors, who retain a great deal of discretion on redeeming poison pills and similar impediments to a change in control.[179]

A prospective bidder would still be able to bypass directors' resistance by taking control of the board and redeeming the poison pill himself. This could be done by a proxy contest immediately followed by a takeover bid.[180] Staggered boards are there just to make this strategy overly burdensome and, thus, impracticable. An insurgent shareholder would have to win two elections before he can gain the majority of the board seats and redeem the pill. In the meantime, he would have to keep his bid open to outstanding shareholders. Even without considering the risk of losing one or both of the elections – which would involve bearing all the expenses of the procedure – it is quite clear that a staggered board has a 'powerful antitakeover force.'[181] Nor would any insurgent shareholder ever be able to destagger it, since charter amendments can only be initiated by the board itself.

In conclusion, the power of US directors is both unfettered on an ongoing basis and unchallengeable by means of a takeover. And it is corporate law that supports this outcome.

7.3.2. Regulatory Disfavor for Controlling Shareholders in the UK

For quite a long time, both legal and economic commentators have considered the American and the British legal discipline of corporate governance as quite simi-

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177 As Gordon, M. [2002], *op. cit.*, 820 puts it, 'just say no' should be distinguished from 'just say never,' which is not legal in Delaware. 'Just say no' is "perhaps better characterized as 'just say later'."

178 Bainbridge, S.M. [2002a], *op. cit.*, 705-738.

179 See *infra*, Chapter Ten, section 10.3.1, for the discussion of the economic rationale and implications of this bargaining strategy; and Chapter Eleven, section 11.2.1, for its discussion in the US context. It should be already noted, however, that this perspective departs from the mainstream approach on takeover defenses. The propriety of takeover resistance by the board of directors has been a long-standing matter of debate. See, illustratively, Easterbrook, F.H. and Fischel, D.R. [1991], *op. cit.*, 162-211. But see also: Gilson, R.J. [1982], *Seeking Competitive Bids versus Pure Passivity in Tender Offer Defense*, in STANFORD LAW REVIEW, vol. 35, 51-67; Bebchuk, L.A. [1982], *The Case for Facilitating Competing Tender Offers: A Reply and Extension*, in STANFORD LAW REVIEW, vol. 35, 23-50.

180 For the economics of this strategy, see Bebchuk, L.A. and Hart, O. [2001], *Takeover Bids vs. Proxy Fights in Contests for Corporate Control*, NBER Working Paper No. 8633.

181 Bebchuk, L.A., Coates, J.C. IV and Subramanian, G. [2002a], *op. cit.*

lar to each other.[182] Few statements would be farther from the truth. Economists on both sides of the Atlantic have recently started to realize this.[183] Comparative lawyers have finally remedied the misconception by uncovering fundamental differences between corporate law in the US and in the UK.[184] To our purposes, it is sufficient to say that regulation of corporate governance is far more shareholder-friendly in the UK than in the US.[185] However, as far as publicly held companies are

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[182] Originally the British case was little studied. Then the similarity in CG patterns, as opposed to those prevailing in continental Europe, led commentators to the conjecture that the institutional underpinnings were also similar. La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R. [1998], *op. cit.*, turned the conjecture into numbers, and so further nurtured the misunderstanding over the past ten years. This had a considerable influence on the debate about convergence of corporate patterns and laws around the world. See Hansmann, H. and Kraakman, R.H. [2001], *The End of History for Corporate Law*, in GEORGETOWN LAW JOURNAL, vol. 89, 439-468.

[183] Djankov, S., La Porta, R., Lopez-de-Silanes, F. and Shleifer, A. [2006], *op. cit.*; Franks, J. and Mayer, C. [2002], *Corporate Governance in the UK – Contrasted with the US System*, in CESIFO FORUM No. 3/2002, 13-22. It is worth noting that British commentators had always highlighted a number of regulatory differences between CG in the US and in the UK. However, this was confined to takeover regulation. Franks, J. and Harris, R.S. [1989], *Shareholder Wealth Effects of Corporate Take-overs: The UK. Experience 1955-1985*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 23, 225-249; Franks, J., Harris, R.S. and Mayer, C. [1988], *Means of payment in takeovers: results for the United Kingdom and the United States*, in A. Auerbach (ed.), CORPORATE TAKEOVERS, CAUSES AND CONSEQUENCES, University of Chicago Press, 221-58.

[184] The Kraakman *et al.* [2004], *The Anatomy*, cit., provides perhaps the broadest illustration of these differences. For a more detailed analysis, yet confined to takeover regulation, see Armour, J. and Skeel, D.A. [2006], *Who Writes the Rules for Hostile Takeovers, and Why? The Peculiar Divergence of US and UK Takeover Regulation*, ECGI Law Working Paper No. 73/2006, available at www.ssrn.com and www.ecgi.org.

[185] The notion of British law of CG requires some greater precision. Most part of company law in Britain has a statutory source: the Companies Act (CA – currently in transition from the 1985 to the 2006 version). The Financial Services and Markets Act (FSMA) of 2000 is an additional source of regulation for quoted companies, via the Listing Rules (LR) that are nowadays administered by a public body: the Financial Services Authority (FSA), which has replaced the traditional Self-Regulatory Organizations (SROs) of the London Stock Exchange. As it will be clarified in Chapter Nine, case-law plays a minor role in the discipline of British listed companies due to a number of hurdles in private enforcement of shareholder remedies (Davies, P. [2002a], INTRODUCTION TO COMPANY LAW, Oxford University Press, 191-197 and 231-245).

This is not the end of the story. The heritage of the self-regulatory tradition in the financial law of Great Britain has produced two additional bodies of regulations, which can be only formally characterized as 'soft law.' These are the Combined Code on Corporate Governance (Combined Code) and the City Code on Take-overs and Mergers (City Code). In effect, the provisions of both codes are binding on listed firms. On the one hand, the peculiarities of the financial community in the City of London are such that deviations would be punished by reputation sanctions – mainly in the form of exclusion from the community – sufficiently powerful to take the place of legal sanctions (see *infra*, Chapter Eleven, section 11.3.1). On the other hand, the latter have been never completely absent, and have recently acquired more importance. Compliance with the Combined Code is regulated by a comply-or-explain principle (see *infra*, Chapter Nine, section 9.3.2) included in the LR and, therefore, enforced by the FSA. The City Code has been given statutory authority since concerned, this proposition holds rather for non-controlling shareholders than for shareholders 'as a class.'[186] Since both theory and practice show that shareholder interference with firm management can only be an issue when corporate control is at stake (i.e., non-controlling shareholders are rationally apathetic), British law is *not neutral* between shareholder control and managerial control.[187] Regulatory disfavor for controlling shareholders is the ultimate responsible of directors' empowerment in British publicly held firms. Non-controlling shareholders seem to have a great power in the UK, but they have hardly any incentive to exercise it – at least for control purposes. In Britain, directors are still the most favored category of players in corporate governance but, differently from the US, they need also to be 'non-controlling' shareholders to some extent, for otherwise they would have no way to resist an unwanted takeover attempt.[188]

While this dissertation was being finalized, the UK has adopted a new corporate legislation (Companies Act of 2006), whose full implementation is due for October 2008.[189] The new provisions only marginally affect the items that are going to be

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2006. The provisions of the two Codes have thus both binding character and legal support. They will be regarded as pertinent 'law' in the following discussion. For illustration of the legal and reputational underpinnings of the two codes, and of the implications for their enforcement, see Wymeersch, E. [2005], *Implementation of the Corporate Governance Codes*, in K.J. Hopt, E. Wymeersch, H. Kanda, and H. Baum, CORPORATE GOVERNANCE IN CONTEXT: CORPORATIONS, STATES, AND MARKETS IN EUROPE, JAPAN, AND THE US, Oxford University Press, 403-419; and Armour, J. and Skeel, D.A. [2006], *op. cit.*

186 Kraakman *et al.* [2004], *The Anatomy*, cit., 60: "In some respects the protection of minority interests in the corporate governance system is inversely proportional to the power of shareholders as a class."

187 To be sure, this is controversial. Two major comparative studies depict the attitude of British law towards controlling shareholders differently. Compare Kraakman *et al.* [2004], *The Anatomy*, cit., 60 (British law "hardly restricts the discretion of controlling shareholders") with Becht, M. and Mayer, C. [2001], *op. cit.*, 12 (Legal protection of minority shareholders in the UK "prevents large shareholders from monitoring the board and corporate management"). On the basis of the analysis that follows, I subscribe to the latter view.

188 On the importance of insider ownership for management entrenchment, see Franks, J., Mayer, C. and Renneboog, L. [2001], *op. cit.*

189 Companies Act of 2006 – Chapter 46: "An Act to reform company law and restate the greater part of the enactments relating to companies; to make other provision relating to companies and other forms of business organisation; to make provision about directors' disqualification, business names, auditors and actuaries; to amend Part 9 of the Enterprise Act 2002; and for connected purposes." The Act has received Royal Assent on 8 November 2006. All parts of the Act will be commenced by October 2008. The full text of the Act, its explanatory notes, and further information are available at www.dti.gov.uk/bbf/co-act-2006/index.html.

discussed in this and the following Chapters.[190] Reference will be made to both the statutory law currently in force and to the forthcoming rules.[191]

a) *Director Appointment and Removal: The Silent Role of British Institutional Investors*

Like in the US, reappointment of British directors is basically obtained through the proxy voting system. British law allows directors to solicit proxies from outstanding shareholders at the company's expenses.[192] To be sure, they might not even need it. Uncontroversial resolutions can be taken at the general meeting by a show of hands. When proxies are not counted, the majority of the *people* present at the meeting win.[193] Directors voting as shareholders normally count as such a majority, since fewer outside shareholders ever show up at the general meeting and quorum requirements are basically inexistent under company law of the UK.[194] The importance of voting on a show of hands should not be exaggerated, though. Voting in a pool can easily be demanded at the general meeting, and then the weight of both share ownership and proxy votes is restored.[195] Even more importantly, following the auspices of some commentators, voting on a show of hands will be less favorable to directors after the new Companies Act becomes effective.[196] Directors would not mind much in either case, for they still hold on their own shares and on outside shareholders' proxies.

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[190] Although the CA 1985 has been repealed almost entirely, the vast majority of its provisions have been simply restated and coordinated with case-law. All substantial changes pertinent to the discussion will be highlighted in what follows.

[191] All of the available comments and textbooks on British company law refer to the CA 1985, and to its Table A – setting the statutory default model of the articles of incorporation. However, the reform of the Companies Act has been preceded by a long-standing debate, which was normally accounted for by the British commentators even before the adoption of the new Act.

[192] Farrar et *al.* [1998], *Company Law*, 314-316.

[193] The old default rule was that proxies were not counted in voting on a show of hands. § 370 and Table A of CA 1985. This has now been reversed: proxies are counted unless the articles state otherwise. See §§ 284 *seq*. of CA 2006.

[194] Goergen, M. and Renneboog, L. [2001], *Strong Managers and Passive Institutional Investors in the UK*, in F. Barca and M. Becht (eds.), THE CONTROL OF CORPORATE EUROPE, Oxford University Press, 259-284. In the UK the default quorum for the validity of general meetings is ridiculous: two people present either in person or by proxy. Farrar et *al.* [1998], *Company Law*, 317. See also § 318 of CA 2006.

[195] Farrar et *al.* [1998], *Company Law*, 322-323.

[196] The CA 2006 now provides that proxies count also when vote is taken by show of hands and further restricts the ability of companies, through their articles, to exclude the right of members to demand a pool. See Myners, P. [2005], *Review of the impediments to voting UK shares*, Report by Paul Myners to the Shareholder Voting Working Group, available at www.investmentfunds.org.uk.

Proxy voting *normally* confers upon directors enough voting power to count as a majority or even as a super-majority when it is required by the law or the charter to have a resolution passed by the general meeting. However, this does not also involve that directors will *always* manage to pass any resolution they wish. Differently from those of their American colleagues, both the position and propositions of British directors can be contested.[197] In fact, they are very seldom.[198] The credible threat of being outvoted is sufficient for directors to refrain from any action that would not receive support by outside shareholders and (here is the most important difference from the US!) may also lead to their replacement.[199]

Removing directors is much easier in the UK than in the US. This might seem counterintuitive at first glance. British company law does not set any mandatory term of office, even though the Combined Code of Corporate Governance recommends a period no longer than three years and all listed firms seem to comply.[200] British boards may be as staggered as the American ones, and very often they are. Finally, it is unclear whether proxy contestants would be entitled to any reimbursement even in case of success – and, at any rate, proxy contests are unheard of in British corporate governance.[201] A limited bunch of company law's rules apparently suffices to offset all this. One of the few mandatory provisions of the 1985 Companies Act is § 303 (§ 168 of the 2006 Companies Act), which stipulates that directors can be removed *anytime* and *without cause* by an ordinary resolution of the general meeting of shareholders.[202] Under British law, shareholders accounting for at least 10% of voting rights can always summon an extraordinary meeting to this purpose.[203] Alternatively, shareholders accounting for 5% or more of the voting rights may piggyback the circulation of proxy materials for the annual meeting, and no restriction is established as to the contents of the shareholder proposal.[204] How-

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[197] Differently from the US, proxies must be two-way in the UK (i.e., they have to provide shareholders with equal opportunity to vote *for* or *against* proposed resolutions). See Farrar et *al.* [1998], *Company Law*, 316; Goergen, M. and Renneboog, L. [2001], *op. cit.*; and LR 9.3.6 (June 2006).

[198] Black, B.S. and Coffee, J.C. Jr. [1994], *Hail Britannia: Institutional Investor Behavior under Limited Regulation*, in MICHIGAN LAW REVIEW, vol. 92, 1997-2087.

[199] Stapledon, G.P. [1996], INSTITUTIONAL SHAREHOLDERS AND CORPORATE GOVERNANCE, Oxford University Press.

[200] See Combined Code (2006), § A.7, and Davies, P. [2002a], *op. cit.*, 131.

[201] Farrar et *al.* [1998], *Company Law*, 315.

[202] Davies, P. [2002a], *op. cit.*, 129-139. A removal resolution qualifies as 'ordinary,' but it requires a 'special' notice. Id., 139. Special and ordinary resolutions are distinguished from the annual or extraordinary meeting in which they can be adopted. Both distinctions are not particularly important today. Farrar et *al.* [1998], *Company Law*, 320-321.

[203] Id., at 138 (§ 368 CA 1985; § 303 CA 2006).

[204] Farrar et *al.* [1998], *Company Law*, 310-315 (§ 376 CA 1985; § 314 CA 2006). To be sure, under CA 1985, shareholders had still to bear the *additional* expenses of circulation of their statement ("but these should not be large if the resolution goes out with the AGM paper which the company has to

ever, because of mismatch between the special notice requirements of a removal resolution and the timing of piggybacking, this used to be in practice not an option for cheaply replacing directors.[205] This has not changed substantially with the 2006 Companies Act.[206] Provided that the expenses of soliciting suffrages for directors' removal cannot be spared anyhow, it is quite doubtful whether it would be any convenient for disgruntled shareholders to wait for the annual meeting when they can get rid of directors earlier.

Indeed, the crucial question is a different one. Who will do the deed and put together sufficient votes to oust incumbent directors, given the collective action problem faced by shareholders? In practice, it seems that directors are hardly ever removed by a shareholder resolution in the UK. This is consistent with the standard account of rational apathy of non-controlling shareholders. And yet, directors resign. They do it not only after a takeover – a situation that will be considered shortly – but also in case of considerable underperformance or mischief.[207] It is exactly in these rather extreme situations that directors do no longer enjoy the *silent support of institutional investors*. One should recall here that institutional investors are the largest shareholders of the typical British listed company, and that on average they jointly account for more than 20% of each firm's share capital.[208] Together, they are powerful enough to give a hard time to directors. In practice, such a struggle would be in the interest of no one. Institutional investors would lose their time and money, and directors their most valuable asset – reputation.[209] Institutional action therefore takes place behind closed doors. Major investors in the firm talk to its non-executive directors; executives that no longer enjoy institutional support are then induced to resign by the board; and finally, the board itself fills in the vacancies and has the replacements endorsed by the next annual meeting.[210] This mecha-

mail in any event to those entitled to attend." Davies, P. [2002a], *op. cit.*, 137). Under CA 2006, shareholders can request that also these costs be borne by the company, if certain conditions are fulfilled.

[205] Davies, P. [2002a], *op. cit.*, 137.

[206] The mismatch problem has been not entirely fixed. Shareholder can now have their statements circulated at the company's expenses, but only if they file the request before the company's financial year-end. By that time, however, they would have not yet seen the annual accounts and the related company disclosures, which are the typical grounds on which replacement of incumbent directors is advocated. This arrangement differs from what suggested by the Company Law Review (CLR) Report, which ultimately led to the adoption of the CA 2006, and still makes piggybacking the circulation of proxy materials a strategy unsuitable for directors' removal. See Davies, P. [2002a], *op. cit.*, 136-139.

[207] Franks, J., Mayer, C. and Renneboog, L. [2001], *op. cit.*

[208] Goergen, M. and Renneboog, L. [2001], *op. cit.* See also *supra*, Chapter Two.

[209] Black, B.S. and Coffee, J.C. Jr. [1994], *op. cit.*

[210] Stapledon, G.P. [1996], *op. cit.*, 122-134.

nism entirely works through 'moral suasion,' but always 'in the shadow of the law.' It is in fact § 303 (now § 168) of the Companies Act what makes the removal threat so credible that it never needs to be actually implemented.[211]

The reader should be cautioned that the above situation is rather the exception than the rule. Institutional investors do not interfere with how the firm is managed until the value of their investment is seriously endangered. All over the world, institutional investors acknowledge that choosing the management team is beyond their tasks and expertise. Indeed, the market should do the job.[212] This is no different in the UK, where in fact, as we have just seen, it is still the board that replaces the executives whom institutions are dissatisfied with. Normally, British institutions sign in their proxy to the incumbent board and that is sufficient to have its members routinely reelected at the annual meeting. Other shareholders are collectively too dispersed and individually too small to outvote directors; unless, of course, they are or they become controlling shareholders. I shall turn to this in a moment.

b) Passing Shareholder Resolutions at the General Meeting

It is worth nothing that, similarly to the US, the proxy voting system in the UK also allows directors to have resolutions that do not concern their election passed by the general meeting.[213] This is even more important for governing a British listed firm than an American one, since the statutory competences of the general meeting are wider (even though not as much as in most countries of continental Europe), and they can be enlarged at will by the charter and its subsequent amendments.[214] One prominent example in this regard is the approval of significant transactions involving one or more director's conflict of interest – an issue that will be deeply investigated in the next two Chapters.[215] The position of British directors is then apparently weaker than that of their American colleagues, for they risk being unable

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[211] Id., 251-277. Notice that, in the typical ownership structure of a British public company, institutional investors are jointly large enough to outvote any coalition of directors. In addition, the two-way character of the proxies may make unnecessary to mount an independent proxy solicitation in order to neutralize managerial collection of votes from dispersed shareholders. Simply advertising the struggle would be equally effective, but much cheaper. Solving this game by backwards induction shows that actual implementation of the struggle is unnecessary to induce directors to resign.

[212] Compare, on this fundamental account, the different views that have been put forward for the US and the UK: Stapledon, G.P. [1996], *op. cit.*, 283-295; Gilson, R.J. and Kraakman, R.H. [1991], *Reinventing the Outside Director: An Agenda for Institutional Investors*, in STANFORD LAW REVIEW, vol. 43, 863-906; Coffee, J.C. Jr. [1991], *Liquidity versus Control: The Institutional Investor as Corporate Monitor*, in COLUMBIA LAW REVIEW, vol. 91, 1277-1368.

[213] Farrar et *al.* [1998], *Company Law*, 315-316.

[214] Davies, P. [2002a], *op. cit.*,121-127. Farrar et *al.* [1998], *Company Law*, 363-376.

[215] See esp. *infra*, Chapter Nine, section 9.3.2.

to control the firm if they cannot get shareholder support for some matters requiring endorsement by the general meeting. The picture might look even worse if one considers that, under British company law, some of these resolutions also require a three quarters super-majority and directors have by no means exclusive initiation rights.[216]

Difficulties are more apparent than real. Shareholders may indeed initiate any resolution they wish, but when this overrides directors' competence a three quarters majority is *always* required.[217] However, majorities are established with reference to the votes cast;[218] and – as I mentioned – the meetings whereby resolutions are approved have in fact no meaningful quorum whoever initiates them.[219] When ownership is dispersed, the majority of the votes are cast by proxy and only directors are entitled to soliciting proxies cheaply. Unsurprisingly, then, only directors can have a super-majority resolution passed when there is no controlling shareholder and, like in the US, proxy voting is the reason.

On both sides of the Atlantic board-initiated resolutions can be possibly voted down. In the UK, this would require institutional shareholders withdrawing their consent from the board and *voting* against its proposals.[220] As a matter of fact, this only happens in two situations: when institutions realize that they have been cheated;[221] when the outcome of the resolution would be against the policy matters they have agreed upon for protecting their own rights as shareholders.[222] This explains why British boards never manage to have pre-emption rights waived or dual class shares, pyramiding, and pre-bid takeover defenses introduced for enhancing their control power (and, to be sure, they do not even dare to).[223]

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216 Farrar et *al.* [1998], *Company Law*, 320-322.

217 Davies, P. [2002a], *op. cit.*, 139.

218 § 378 of CA 1985; § 283 of CA 2006. The complicated distinction between extraordinary and special resolutions has been abolished by the 2006 Act (which maintained only the latter category). On the futileness of such a distinction, see Farrar et *al.* [1998], *Company Law*, 320-321.

219 § 370 and Table A of CA 1985; § 318 of CA 2006.

220 Compared to the US, the absence of a meaningful quorum is tempered by the requirement that proxies must be two-way (see *supra*, note 197). Institutional investors cannot counter a board resolution by simply not returning the proxy form, but they may easily frustrate the management proposition by mailing in a compulsory proxy to vote against it.

221 In which case, institutional investors will also force disloyal directors to resign. See *infra*, Chapter Nine, section 9.3.2.

222 Stapledon, G.P. [1996], *op. cit.*, 55-78.

223 Id. at 56-67. See also Black, B.S. and Coffee, J.C. Jr. [1994], *op. cit.*, and – for a historical account – Franks, J., Mayer, C. and Rossi, S. [2005a], *Spending Less Time with the Family: The Decline of Family Ownership in the UK*, in R. Morck (ed.), A HISTORY OF CORPORATE GOVERNANCE AROUND THE WORLD: FAMILY BUSINESS GROUPS TO PROFESSIONAL MANAGERS, NBER Conference Volume, University of Chicago Press, 581-607 (also available as NBER Working Paper No. 10628).

c) Takeover Resistance and the Regulatory Burden of Being a Controlling Shareholder

It should be clear by now that directors' empowerment in the UK ultimately depends on the absence of a controlling shareholder. Not only – like in the US and nearly everywhere in the world – this means that when a controlling shareholder is already there they must defer to his authority. Apparently, it also involves that their position is constantly endangered by the risk that a controlling shareholder materializes by taking the firm over.

Differently from their American colleagues, British directors appear to be entitled to no defensive strategy. In essence, pre-bid defenses are ruled out by the opposition of institutional investors.[224] The City Panel on Takeovers and Mergers provides for the rest, by prohibiting directors from engaging in any defensive tactic after a bid has been launched – unless shareholders approve resistance, which they would hardly ever do when they are offered a significant a takeover premium.[225] It might seem that the legal system is very favorable to hostile takeovers in the UK – apparently, the most favorable among OECD countries – and managers can do little to prevent shareholder insurgency.[226] Puzzling enough, though, over 90% of takeovers in the UK are friendly – i.e., they are implemented with the board's consent;[227] and empirical evidence suggests that board members most often manage to entrench themselves by forming informal voting coalitions powerful enough to resist an unwanted takeover.[228]

Then the question is how this is *legally* possible. The answer lies in a very often-overlooked regulatory bias against controlling shareholders.[229] Being unable to resist takeovers on their own, British directors have, in fact, no choice but to exploit such a bias. Regulation of listed companies in the UK exhibits a couple of prominent rules affecting any owner (or a group of owners acting in concert) who either qualifies as 'substantial shareholder' in that he controls the exercise of at least 10% of votes,[230] or else wishes to acquire more than 30% of voting power. On the

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224 Goergen, M. and Renneboog, L. [2001], *op. cit.*

225 Rule 21 of the City Code on Take-overs and Mergers (May 2006).

226 Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 62-63.

227 Weir, C. and Laing, D. [2003], *Ownership Structure, Board Composition and the Market for Corporate Control in the UK: An Empirical Analysis*, in APPLIED ECONOMICS, vol. 35, 1747-1759.

228 Crespi-Cladera R., Renneboog L. [2003], *Corporate Monitoring by Shareholder Coalitions in the UK*, ECGI Finance Working Paper No. 12/2003, available at www.ssrn.com and www.ecgi.org.

229 Becht, M. and Mayer, C. [2001], *op. cit.*, 12.

230 According to the Listing Rules (June 2006), a substantial shareholder is "any person (excluding a bare trustee) who is entitled to exercise or to control the exercise of 10% or more of the votes able to be cast on all or substantially all matters at general meetings of the company (or any other company which is its subsidiary undertaking or parent undertaking or is a fellow subsidiary undertaking of its parent undertaking)." LR, Appendix 1, Relevant definitions.

one hand, a substantial shareholder's relationship with the firm has to be at 'arm's length', meaning that – among other things – he shall be not entitled to appoint more than a *minority* of board members nor shall he be able to remove any other member unless a majority of independent directors consent.[231] On the other hand, any attempt to acquire more than 30% of voting rights triggers a mandatory bid for all outstanding shares at the highest price paid within the twelve-month period before the threshold is surpassed.[232] None of these constraints is established by the Companies Act. They are nonetheless binding on listed firms, via the statutory authority conferred upon a number of regulatory instruments administered by the Financial Services Authority (FSA) and the City Panel.[233]

Being a controlling shareholder turns out then to be quite inconvenient in the UK. In spite of the large stake in the company ownership, a controlling shareholder cannot be in total control of the board decision-making. This used to be a straightforward consequence of holding more than 30% of voting power.[234] That should

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[231] See Wymeersch, E. [2003], *Do we need a law on groups of companies?*, in K. Hopt and E. Wymeersch (eds.), CAPITAL MARKETS AND COMPANY LAW, Oxford University Press, 573-600. Becht, M. and Mayer, C. [2001], *op. cit.*, 12; Goergen, M. and Renneboog, L. [2001], *op. cit.*, 241. All of these authors refer to arm's length requirements which were formerly included in the Listing Rules, but today are established in connection with the Combined Code. See *infra*, notes 234-237 and accompanying text.

[232] Rule 9 of the City Code on Take-overs and Mergers (May 2006).

[233] Under the FSMA 2000, the FSA has both regulatory and enforcement powers over the discipline of listed companies. Its Listing Rules have therefore statutory authority. They provide for the comply-or-explain principle (LR § 9.8.6.) as regards the provisions of the Combined Code on Corporate Governance (which is annexed to the Listing Rules). Although the FSA is not supposed to enforce compliance, it will persecute false or misleading statements of compliance and failure to explain non-compliance. On how this mechanism results in the binding character of self-regulation, see *infra* Chapters Eight, section 8.5.3, and Nine, section 9.3.2. For the first time since the establishment of the City Panel, the Code on Take-overs and Mergers has been also given statutory authority. This was necessitated by the coming into force of the EU Takeover Directive. See The Takeovers Directive's Interim Implementation, Regulations 2006 – S.I. 2006/1183 (transitional provisions, in force since 20 May 2006); Companies Act of 2006, §§ 942-965.

[234] As of 2003, the Listing Rules used to provide the following:

> "Controlling shareholder
>
> § 3.12 A company which has a controlling shareholder must be capable at all times of carrying on its business independently of such controlling shareholder (including any associate thereof as defined in paragraph 3.13) and all transactions and relationships between the company and any controlling shareholder (or associate) must be at arm's length and on a normal commercial basis […].
>
> § 3.13 For the purposes of paragraph 3.12, a controlling shareholder is any person (or persons acting jointly by agreement whether formal or otherwise) who is:
>
> (a) entitled to exercise, or to control the exercise of, 30% or more of the rights to vote at general meetings of the applicant (but the rights to vote attaching to any treasury

explain why holdings larger than 30% are infrequent among British listed firms and, overall, controlling shareholders are even more exceptional in the UK than in the US.[235] The current state of regulation of listed firms in Britain has extended the hurdles to any shareholder accounting for more than 10% of voting rights. On the one hand, the Listing Rules compel this 'substantial' shareholder to seek independent approval of all significant related-party transactions (including a post-takeover merger) by the general meeting.[236] On the other hand, the Combined Code prevents such a shareholder from appointing more than a minority of board members.[237] On top of that, *becoming* a controlling shareholder in the UK is also very burdensome because of the mandatory bid. In combination, these two inconveniencies attached to the would-be controlling position make takeovers unattractive, at least unless the incumbent board cooperates.

In effect, a way out of the above hurdles is taking the company private after a takeover, for the arm's length requirements of board composition would have no reason to apply then. This implies that minority shareholders who do not tender their shares need to be squeezed out.[238] Here, however, the cooperation of the incumbent management is required. The Companies Act provides for two major options as far as going private transactions are concerned. The first option is the so-

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shares held by a company are not to be taken into account when calculating a person's percentage of rights to vote under this paragraph); or

(b) able to control the appointment of directors who are able to exercise a majority of votes at board meetings of the applicant."

The provision was replicated by § 9.34 as a condition for maintaining the status of quoted company. One fundamental implication of these provisions – routinely included in the listing agreements with the London Sock Exchange – was the inability of the controlling shareholder to appoint the majority of board members. Wymeersch, E. [2003], *op. cit.*

These provisions are no longer included in the Listing Rules as of June 2006.

[235] See *supra*, Chapter Two, section 2.4.

[236] Substantial shareholders and their associates qualify as 'related-party,' and trigger the application of LR § 11 (independent shareholder approval of all significant transactions). See *infra*, Chapter Nine, section 9.3.2. For the implications in the takeover context, see *infra*, Chapter Eleven, section 11.3.2.

[237] Detailed arm's length requirements in the composition of the board are no longer contained in the current version of the LR (June 2006). But, if anything, the current regulations are even stricter. The Combined Code provides that the majority of the board (i.e., 50% of its members plus the Chairman) must be composed of independent directors, and one key condition of independence is established with regard to the appointment by 'significant' shareholders. Combined Code § A.3.1. The Code does not specify a percentage of significance, but this can be derived by the definition of 'substantial' shareholder under the Listing Rules, Appendix 1, Relevant definitions (setting the threshold at 10% of voting rights). A controlling shareholder would qualify at any rate, thus being unable to appoint but a minority of board members. Although the Combined Code has formally no force of law, its provisions are nonetheless binding for British listed firms. As I mentioned, the Code is annexed to the Listing Rules and regulated by a comply-or-explain principle, which is toughly enforced by the FSA. Wymeersch, E. [2005], *op. cit.* See *infra* Chapter Nine, section 9.3.2.

[238] On the importance of squeeze-outs in the takeover mechanism, see *infra* Chapter Ten.

called scheme of arrangement, whereby takeovers are followed by a peculiar cash merger transaction upon agreement with the incumbent board and endorsement by a super-majority of minority shareholders.[239] Classical squeeze-outs are far more popular, for they can be implemented unilaterally. However, this option is only available when at least 90% of the firm's stock is put together.[240] Unsurprisingly, nearly all takeover bids in the UK are made conditional on that result being achieved.[241] This also explains how directors manage to frustrate hostile bids, by holding on their shares (that jointly account for an average 11% of the firm's capital) and recommending outside shareholders to do the same.[242] In the vast majority of British listed firms, boards enjoy a *de facto* veto power on minority squeeze-out, which regulation of controlling shareholders makes a necessary condition for the success of *any* takeover.

In conclusion, also British directors are able to exercise ongoing control over the firm management and to entrench themselves in the face of a hostile takeover. This is due to the distribution of power set up by corporate law, but – differently from the US – such a distribution is based on a strong disfavor of controlling shareholdings.

7.3.3. Bypassing Shareholders in the Netherlands

The regulatory structure of Dutch corporate law is completely different from what we have just seen for the US and the UK. Comparative analyses often avoid discussing it, for it is allegedly too complicated.[243] However, the resulting distribution of powers between the board of directors and the general meeting of shareholders in the Netherlands provide for no less empowerment of directors than under Anglo-American law, and to be sure for even more than that. I will therefore

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[239] Farrar et *al.* [1998], *Company Law*, 603-605 (CA 1985 §§ 425-427; CA 2006 §§ 895-899). See *infra*, Chapter Eleven, section 11.3.3.

[240] Farrar et *al.* [1998], *Company Law*, 607-610 (CA 1985 §§ 428-430; CA 2006 §§ 979-982). See *infra*, Chapter Eleven, section 11.3.2.

[241] Goergen, M. and Renneboog, L. [2001], *op. cit.*, 240-241.

[242] This point is suggested in a number of publications co-authored by Luc Renneboog. See Goergen, M. and Renneboog, L. [2001], *op. cit.*; Crespi-Cladera R., Renneboog L. [2003], *op. cit.*; Goergen, M. and Renneboog, L. [2003], *Why Are the Levels of Control (So) Different in German and UK Companies? Evidence from Initial Public Offerings*, in JOURNAL OF LAW, ECONOMICS AND ORGANIZATION, vol. 19, 141-175.

[243] One prominent exception is the Kraakman *et al.* [2004], *The Anatomy*, cit., 33-70, where the special features of Dutch distribution of corporate powers are indeed analyzed as an extreme case of shareholder disempowerment. See also Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, where frequent reference is made to the specificities of Dutch CG.

attempt to portray the Dutch distribution of legal powers skipping all not strictly necessary complications.

a) The Hypocrisy of Stakeholder Protection and the Recent Evolution of Dutch Corporate Law

To begin with, in the Netherlands, the general meeting of shareholders does not have supreme authority over corporate decision-making.[244] Although this is practically true also in Britain and in the US, it has never been put this way by the courts who, if anything, always state the opposite as a matter of principle.[245] In the Netherlands, instead, the very essence of shareholder franchise is bluntly put into question.[246] As we will see, this is quite exceptional for continental Europe where shareholder primacy is both, in principle, the major legal feature of corporate governance and the only way to have firm control implemented in practice.[247] The recurrent explanation of the peculiarities of Dutch corporate law is a high, and possibly extreme, consideration for stakeholders – basically, for one category of them: the employees.[248]

Compared to other stakeholder-oriented corporate societies (most prominently, Germany and Sweden), the Dutch attitude appears to have historically featured the least shareholder-friendly jurisdiction in Europe (and yet – relative to GDP – one of the highest stock market capitalization in the world!).[249] As it often turns out, however, it is highly questionable whether this has led to any actual empowerment of employees in corporate governance.[250] Rather, it seems that stakeholder protection have been just the Trojan horse of *directors'* empowerment. In recent times,

[244] Schuit, S.R., Bier, B., Verburg, L.G. and Ter Wisch, J.A. [2002], CORPORATE LAW AND PRACTICE OF THE NETHERLANDS: LEGAL AND TAXATION, 2nd edn., Kluwer Law Int'l (hereinafter Schuit *et al.* [2002], *Corporate Law*), 7.1.a.

[245] See, illustratively, Bebchuk, L.A. [2005b], *op. cit.*; and Armour, J., Deakin, S. and Konzelmann, S. [2003] *A Post-Stakeholder World? Reflections on the Trajectory of UK Corporate Governance*, in BRITISH JOURNAL OF INDUSTRIAL RELATIONS, vol. 41, 531-555.

[246] This is the long-standing position of the Dutch Supreme Court (*Hoge Raad* – HR). See HR 21 January 1955, NJ 1959, 43.

[247] See *infra*, section 7.4.

[248] This is known as the so-called 'polder model' of CG. See de Jong, A. and Röell, A. [2005], *Financing and Control in The Netherlands: A Historical Perspective*, in R. Morck (ed.), A HISTORY OF CORPORATE GOVERNANCE AROUND THE WORLD: FAMILY BUSINESS GROUPS TO PROFESSIONAL MANAGERS, NBER Conference Volume, University of Chicago Press, 467-506; and, for the legal underpinnings, Kemperink, G. [2004], *op. cit.*

[249] See *supra*, Chapter Two, section 2.5.

[250] Hellwig, M. [2000], *op. cit.*

Dutch scholars and policymakers have started to realize this.[251] As a result, corporate law was changed in 2004 on exactly those points that we have under consideration.[252] Yet distribution of powers is probably the most path-dependent feature of corporate law. Recent changes that allegedly brought to an end most controversial peculiarities of Dutch law are in fact unlikely to reverse the path. This is fortunate, for that path has made the Netherlands perhaps the only country in continental Europe that allows the majority of publicly held companies to be under managerial control. Historically, this might possibly have to do with the Dutch people having 'invented' the corporate enterprise and the stock market in the sixteenth century.[253] In what follows, I will show that, at least nowadays, it mostly depends upon the law.

Three key features determine the basic distribution of power under Dutch corporate law. The first has mainly to do with competence: who is entitled to appoint and remove directors.[254] The second one is a matter of organization: how shareholder votes are cast. The third one is – as usual – takeover resistance. As I mentioned, in many firms listed in the Netherlands shareholders used to have almost no say in directors' appointment (and removal), not even formally.[255] 'Almost no say' turns into a modest 'little say' after the reform.[256] Other traditional peculiarities of Dutch corporate law are the entitlement of directors to have outside shares voted according to their wishes (through the institution of an *administratiekantoor*) and to implement both pre-bid and post-bid takeover defenses that are possibly even stronger that those upheld by US law.[257] In a nutshell, the recent evolution of Dutch corporate law has weakened – but not eliminated! – the former feature,[258]

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[251] See, illustratively, Bratton, W.B. and McCahery, J.A. [2001b], *Restructuring the Relationship between Shareholders and Managers*, in H. Schenk (ed.), PREADVIEZEN VAN DE KONINKLIJKE VERENIGING VOOR STAATHUISHOUDKUNDE, Herpositionering van ondernemingen, 63-85.

[252] Stibbe [2004], *Amendment of the Rules Relating to the Large Company Regime Has Been Adopted by the Upper Chamber of the Dutch Parliament*, 21 July 2004, www.stibbe.com (on file with author); De Brauw Blackstone Westbroek (hereinafter De Brauw) [2004], *Change of 'Structure Regime' – Statutory Basis for Corporate Governance Code*, 7 July 2004, available at www.debrauw.com.

[253] de Jong, A. and Röell, A. [2005], *op. cit.*

[254] See, for economic interpretation, Chirinko, R., van Ees, H., Garretsen, H. and Sterken E. [2004], *Investor Protections and Concentrated Ownership: Assessing Corporate Control Mechanisms in the Netherlands*, in GERMAN ECONOMIC REVIEW, vol. 5, 119–138.

[255] Kraakman *et al.* [2004], *The Anatomy*, cit., 36.

[256] This depends on the asymmetry between (unconstrained) rights of removal and inability to make binding nominations for the election to the supervisory board in the structured regime. See *infra*, next subsection.

[257] See, for illustration in an economic perspective, Kabir, R., Cantrijn, D. and Jeunink, A. [1997], *Takeover Defenses, Ownership Structure and Stock Returns in the Netherlands: An Empirical Analysis*, in STRATEGIC MANAGEMENT JOURNAL, vol. 18, 97–109.

[258] See Stibbe [2004], *op. cit.*

while providing legal support for a proxy voting system that closely resembles that in place in the US.[259] Quite to the contrary, the latter feature – takeover defenses – has been basically unaffected by regulatory changes and it is very unlikely that it will be even after the implementation of the EU Takeover Directive.[260]

b) The Dutch Structured Regime

Issues of competence under Dutch corporate law are deeply embedded within the discipline of the board structure, which is typically two-tier in the Netherlands even though this is not always compulsory.[261] The two-tier structure is made of a

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259 Proxy voting has always been allowed under Dutch corporate law, but this technique is traditionally little used. Baums, T. [1998], *Shareholder Representation and Proxy Voting in the European Union: A Comparative Study*, in K.J. Hopt, H. Kanda, M.J. Roe, E. Wymeersch, S. Prigge (eds.), COMPARATIVE CORPORATE GOVERNANCE: THE STATE OF THE ART AND EMERGING RESEARCH, Oxford University Press, 545-564. Proxy solicitation was practically not an option until corporate law was changed in order to allow (like in the US) for a record date defining the shareholder entitlement to vote without need to have the shares blocked until the meeting takes place. Meinema, M. [2003], *Mandatory and Non-Mandatory Rules in Dutch Corporate Law*, in ELECTRONIC JOURNAL OF COMPARATIVE LAW, vol. 6.4, 169, available at www.ejcl.org/64/art64-10.pdf. This is effective since December 15, 2002. de Jong, A., DeJong, D.V., Mertens, G., Wasleyc, C.E. [2005], *The Role of Self-Regulation in Corporate Governance: Evidence and Implications from the Netherlands*, in JOURNAL OF CORPORATE FINANCE, vol. 11, 497-498. Paralleling the evolution of legal rules, a Shareholder Communication Channel (*Stichting Communicatiekanaal Aandeelhouders*) was established for electronic collection of shareholder proxies. However, very few companies participate in the channel and the channel itself has proven unable so far to produce a system of proxy solicitation. Foundation for Corporate Governance Research for Pension Funds (SCGOP) [2004], *Manual Corporate Governance 2004*, available at www.scgop.nl (SCGOP has turned into Euromedion in 2006). On the other hand, the management is entitled to use the company's funds to collect proxies from outside shareholders. OECD [2006], *Database*, cit. The management is also in control of the record date, which, however, cannot be set any earlier than 7 days before the date of the meeting. Therefore, the current regulation of proxy voting in the Netherlands is functionally very similar to that in US.
To be sure, the Dutch legislator went further. Following the auspices of the Tabaksblat Committee (Corporate Governance Committee [2003], *The Dutch Corporate Governance Code*, available at www.commissiecorporategovernance.nl), the possibility of remote voting through electronic means has been introduced in Dutch corporate law. See the 'Act Amending Book 2 of the Dutch Civil Code to promote the use of electronic means of communication in decision-making within legal entities', which came into force on January 1, 2007. Whether this will actually result in increased shareholder participation *directly* in the meeting is hard to predict, but seems to be very unlikely.

260 Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids (hereinafter Takeover Directive). Art. 9 of the Directive lays down shareholder approval of defensive tactics, unless member states choose to make the provision just optional for individual companies. Apparently, the Dutch legislature is inclined to opt out art. 9. See *infra*, Chapter Eleven, section 11.5.2.

261 The mandatory two-tier board structure applies to both NV (*Naamloze Venootshap* – joint-stock companies) and to BV (*Besloten Vennootschap* – limited liability companies), provided that they qualify as 'large companies.' The large company regime is therefore independent on the status of listed

supervisory board (‘*raad van commissarissen*’) and a management board (‘*raad van bestuur*’). However, contrary to what one would expect, it is competence and not board structure what matters the most. Beyond the board structure, Dutch law provides for a *mandatory* discipline of corporate governance where all key decisions used to be taken by directors, and this still includes those concerning their own appointment. This discipline is called the ‘structured regime’ (*structuurregime*).[262]

The structured regime is: a) *compulsory* when the company is ‘large’ enough to meet some requirements in terms of net assets and number of employees (the latter also triggering a mandatory work council); b) *mitigated* for multinational groups whose parent or operative companies are established outside the Netherlands, provided that the majority of the group work force is also employed outside the Netherlands; c) *optional* for any company, provided that there is a work council.[263] Traditionally, the structured regime involved the transfer of certain decision rights (approval of significant transactions initiated by the management board and adoption of the annual accounts) from the shareholder meeting to the supervisory board. After the reform, most of these rights have been reallocated to the general meeting.[264] More importantly, under the unmitigated structured regime shareholders used to have almost no power in the appointment of directors to either board. Nowadays they can only influence that process to the extent that they are large enough to toughly bargain with the members of the supervisory board. When the structured regime is not adopted, shareholders get back their right to appoint directors.[265] This applies to either board when the structure is two-tier, but the company

company. Meinema, M. [2003], *op. cit*, 157-159. This has changed little after the reform. See De Brauw [2004], *op. cit*.

262 See, for a detailed analysis, Kemperink, G. [2004], *op. cit*. The evolution of the regime is described *de jure condendo*, but the description is consistent with the legislation actually enacted in 2004.

263 See Schuit *et al.* [2002], *Corporate Law*, cit., 8.1.b, for a detail of the requirements of each sub-regime. This has changed little after the reform, the most notable innovation being that family-owned companies now also qualify for the mitigated regime (provided, however, that no stock is placed with the investing public). The reform also stipulates that voluntary adoption of the structured regime has to be endorsed by the general meeting, if any exemption has become applicable after January 1, 1997. Stibbe [2004], *op. cit*.

264 This only applies to NV, where shareholders now have to approve significant corporate transactions and the policy of remuneration of managing directors. De Brauw [2004], *op. cit*. On the contrary, the change concerning the ‘adoption’ of annual accounts is merely cosmetic, since shareholders were already entitled to their ‘approval’ and still cannot make amendments. Stibbe [2004], *op. cit*. A more important change is the introduction of an Anglo-American style shareholder proposal. This does not have the restrictions of US law, so that theoretically it enables shareholder control over the agenda of the meetings. However, as we are about to see, important exceptions are established for the nominations to the supervisory board under the structured regime, as well as in the presence of priority shares whether or not the structured regime applies.

265 Schuit *et al.* [2002], *Corporate Law*, cit., 8.1.a, 8.2.c, and 8.3.c.

is also free to adopt a one-tier structure. Shareholder rights are also restored under the mitigated regime, but the board structure *must* be two-tier. As of 1997, 61% of Dutch listed firm had adopted the structured regime, and almost one quarter of them (16% of listed firms) had done it voluntarily; the mitigated regime accounted for just 3% of listed firms.[266]

In the structured regime, only the supervisory board can appoint directors to the management board. No interference by shareholders is allowed. So the key question is *who appoints the members of the supervisory board*. Before the reform of 2004 the answer was the supervisory board itself, by a system of so-called 'controlled cooptation.'[267] In the international literature, that mechanism used to be compared to the reciprocal appointment of the Pope and the Bishops.[268] To be sure, cooptation was subject to some control by both the work council and the general meeting, which could potentially result in a veto right. On the one hand, both organs were entitled to make non-binding recommendations to the supervisory board. On the other hand, they could object to the people appointed by the supervisory board. However, any objection could be resisted by the supervisory board unless it was upheld by the judiciary – namely, by the Enterprise Chamber of the Amsterdam Court of Appeals.[269] For this reason, veto rights were actually granted to either the shareholders or the work council only on grounds that the supervisory board would have been 'improperly constituted.'[270]

This has changed more formally than substantially after the reform.[271] Today the supervisory board is still entitled to *exclusive* nomination rights at least as far as the majority of its members is concerned (a minority is subject to the *binding* recom-

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[266] de Jong *et al.* [2001], *op. cit.*,

[267] Kemperink, G. [2004], *op. cit.*, 66-72.

[268] Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 83.

[269] The Enterprise Chamber of the Amsterdam Court of Appeals (*OndernemingsKamer* – OK) is a special court in charge of dealing with key corporate matters in the Netherlands. Kroeze, M. [2004], *Theory and practice of specialised courts*, 6th Asian Roundtable on Corporate Governance, OECD, Seoul, 2-3 November 2004, www.oecd.org/dataoecd/42/36 /33962715.pdf. Most importantly, it is in charge of administering the objections of shareholders and employees to the nominations of the supervisory board (after 1987 – Kemperink, G. [2004], *op. cit.*, 72-75) and the inquiry procedure (*Enquêterecht*) into the management of the company (see *infra* Chapter Nine, section 9.3.3). It is worth noting that shareholders and trade unions may also challenge the position of supervisory board members on grounds of mismanagement, to the extent they can activate the inquiry procedure and seek any of the court's remedies thereby (shareholders accounting for at least 10% of share capital always have this right).

[270] SER (Social Economic Council) 27 Sept. 1983, De NV 1983, 233; OK (Enterprise Chamber) 2 February 1989, NJ 1990, 86.

[271] See Bratton, W.B. and McCahery, J.A. [2001b], *op. cit.*, for a similar conclusion on the reform, at the time when it was proposed. The following illustration is based on De Brauw [2004], *op. cit.*, and Stibbe [2004], *op. cit.*

mendations of the work council). However, nominations of the supervisory board have to be *endorsed* by shareholders, and they can be overruled by the majority of the votes cast at the general meeting, even without a quorum. The problem is that shareholders are by no means entitled to present their own candidates for the election. As it turns out, this double-veto regime enables only a controlling shareholder to bargain upon the composition of the supervisory board. When they are dispersed, Dutch shareholders are not less apathetic than Anglo-American ones. Then they are equally likely to rubberstamp the supervisory board's nominations. Different rules apply to midterm removal of members of the supervisory board, who can now be collectively dismissed anytime for reasons of lack of confidence. Removal resolutions need to be upheld by a majority representing at least one third of outstanding shares, but still they bring no nomination right to shareholders. The Enterprise Chamber will take care of the temporary replacements. Provisions concerning both nomination rights and collective dismissal of the supervisory board are mandatory, whereas the article of incorporation may determine a different mechanism of appointment and even reintroduce the controlled cooptation.

As a result, on condition that ownership stays dispersed, members of the supervisory board are still quite easily reappointed and very unlikely to be removed by the general meeting under the structured regime. Even though supervisors cannot directly intervene in the firm management,[272] they retain the exclusive power to appoint directors to the management board and to remove them from office. Plain deference of the management board to the supervisory board cannot but follow.[273] Even though the two boards have to be formally independent of each other,[274] in practice they are both still insulated from shareholder interference. Here lies at least one of the legal roots of managerial capitalism in the Netherlands. As we are going to see, it is not the only one and, nowadays, it is neither necessary nor desirable.

c) Voting Trust Foundations and Priority Shares

The highly peculiar use of voting trusts in Dutch corporate governance is perhaps even more important than the structured regime, although this is sometimes

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[272] Schuit *et al.* [2002], *Corporate Law*, cit., 8.3.

[273] Indeed, this is the natural line of command arising from the appointment rules. It should also be noticed that, in the absence of a controlling shareholder, at least the majority of each board cannot but be captured by the incumbent management. Thus, in a sense, also the members of the supervisory board will ultimately defer to the managing directors. So long as the two boards get along well with each other, directors will be insulated from shareholder interference; whereas, in case of disagreement, directors in both boards run the risk that shareholders coalesce and take over. This situation is not different from the past. See Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 78-83.

[274] Kemperink, G. [2004], *op. cit.*, 75-78.

overlooked in the international comparisons. Shares of a publicly held company can be placed with a foundation (*stichting*) that issues depository receipts (*certificaten*) in exchange. The foundation operates as a trust office (*administratiekantoor*) whose most important task is the exercise of voting rights.[275] Those rights are in fact stripped from the depository receipts held by beneficial owners – the shareholders. Once the shares are transferred to the trust office, shareholders basically lose their voting rights and are left just with their cash flow rights.[276] Depository receipts are traded on the stock market instead of the underlying shares. Even though shareholders are formally the beneficial owners, the foundation is typically formed by the corporation and so the trust office is most often friendly to the management.[277] The *administratiekantoor* then routinely supports directors' decisions at the general meeting, whether or *not* the firm is subject to the structured regime.[278] That explains how directors have managed to gain voting power from dispersed shareholders in the Netherlands, even in the absence of legal support for an Anglo-Saxon style proxy voting system.[279] The reader should recall from the Second Chapter that in 1996 nearly 40% of Dutch listed firms had shares placed with such a trust office and that it held more than a quarter of voting rights in over 35% of the companies. Since few large shareholders seem to stand behind an *administratiekantoor*, this is a remarkable evidence of managerial control in the Netherlands.[280]

It should be noted that the above situation has not been significantly affected by the reform.[281] Receipt holders are now formally entitled to cast their vote without exchanging their certificates for shares (which would be limited by the trust deed, usually to 1% of outstanding share capital),[282] by simply requesting voting proxies from the trust office. The board of the *administratiekantoor* can refuse to issue the proxies when there is a risk of takeover or when this would be otherwise against the company's interest.[283] Clearly, however, dispersed shareholders are not likely to

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[275] Meinema, M. [2003], *op. cit*, 167.

[276] Schuit *et al.* [2002], *Corporate Law*, cit., 5.5.

[277] de Jong *et al.* [2001], *op. cit.*

[278] de Jong, A., Mertens, G. and Roosenboom, P. [2005], *Shareholders' Voting at General Meetings: Evidence from the Netherlands*, Working Paper, Erasmus University (ERIN series), available at www.ssrn.com.

[279] de Jong, A. and Röell, A. [2005], *op. cit.*

[280] See *supra* Chapter Two, section 2.4, and de Jong *et al.* [2001], *op. cit.*, for the data.

[281] See Schuit *et al.* [2002], *Corporate Law*, cit., 7.6, for presentation, and Bratton, W.B. and McCahery, J.A. [2001b], *op. cit.*, for discussion of the new rules as proposed. See Stibbe [2004], *op. cit.*, and De Brauw [2004], *op.* cit, for illustration of the rules as enacted.

[282] This used to be a major problem for the exercise of voting rights by outside shareholders. See de Jong, A., Mertens, G. and Roosenboom, P. [2005], *op. cit.*

[283] During the debate on the implementation of the Takeover Directive, the Dutch Government proposed to eliminate this exception as an application of art. 11 (breakthrough of pre-bid defenses). Like art. 9 (board neutrality pending a takeover bid), art. 11 is optional for member states. On this

make any such request *unless* a takeover is in the making. Even if they absurdly did, Dutch boards may today avail themselves of mass solicitation of proxy votes at the company's expenses – an option that was technically unavailable a few years ago. Whatever attenuation (if any at all) the reform has brought to the management's ability to collect voting power from the *administratiekantoor*, this might be more than offset by the availability of a very board-oriented proxy voting system.[284]

Managerial control of voting rights is of course of fundamental importance *outside* the structured regime, where the general meeting of shareholders retains full power to appoint and to remove directors in either a one-tier or a two-tier structure. However, to be sure, it is also important *within* the structured regime where some, but not all of the general meeting powers are transferred to the supervisory board. Prominent examples include charter amendments, mergers, divisions, and – after the reform – the sale of all or of a substantial part of the company's assets. These decisions need anyway to be endorsed by the general meeting. Voting power held by the trust office might be either unavailable or just insufficient to have those resolutions passed (charters may require a quorum, a qualified majority, or both).[285] And proxy solicitation is just a recently-introduced feature. In fact, Dutch corporate law traditionally provides for another instrument of directors empowerment: the so-called 'priority shares.'

Non-voting shares and customary differentiation of voting rights through dual class shares are, in principle, not featured by Dutch law.[286] Priority shares carry in

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ground, the proposal has been rejected by the Dutch Parliament. See *infra*, Chapter Eleven, section 11.5.2.

[284] See *supra*, note 259. This is only apparently tempered by the introduction of the right of shareholders to place items on the agenda of the meeting (shareholder proposal). In fact, this mechanism is not suitable for activating a proxy contest, since insurgent shareholders would not be entitled to recover the expenses of solicitation even in case they are successful. Only the management is entitled to use the company's funds to collect proxy votes. OECD [2006], *Database*, cit. (see also, indirectly, Kraakman *et al.* [2004], *The Anatomy*, cit., 43).

[285] Schuit *et al.* [2002], *Corporate Law*, cit., 7.2 and 11.2.

[286] Even though the *certificaten* are nothing but non-voting shares, the latter are formally not allowed under Dutch law. Limited and multiple voting shares are legal, but they are subject to a number of regulatory restrictions intended to *formally* preserve the one share–one vote principle. Schuit *et al.* [2002], *Corporate Law*, cit., 7.3. Specifically, multiple votes can only be awarded in proportion to the par value, which then must likewise be a multiple of common stock's par. However, the proportionality is not established with respect to the common stock's market value, and this may be a source of *de facto* deviation from one share–one vote. According to a recent study on a limited sample of Dutch companies, multiple voting shares are very popular among the largest Dutch listed firms. Deminor-rating [2005], *Application of the one share–one vote principle in Europe*, A study commissioned by the Association of British Insurers, available at www.abi.org.uk. The study acknowledges the difficulties in ascertaining the disproportionality effect, provided that multiple voting shares are not traded on the market. Perhaps more importantly, previous studies of larger samples of companies listed in the Netherlands do not report the existence of either dual class security-voting struc-

fact no excess voting rights. They do carry, however, special initiation and veto rights, as well as the entitlement to have resolutions of the general meeting passed with simple majority *and* no quorum. Contrariwise, proposals *not* made by the holder of priority shares can only be endorsed by a two-third majority accounting for at least 50% of outstanding shares.[287] For that reason, priority shares are also called 'oligarchic devices.'[288] Needless to say, they confer an enormous power upon their holder who can thereby easily dominate the general meeting. Notice that this is true for both directors and a controlling shareholder. Directors would count on their indirect voting power (they do not need to hold many shares on their own, especially when *certificaten* are outstanding), on rational apathy of otherwise dispersed shareholders, and on the privileges of the priority for having resolutions passed (and never opposed) by the general meeting. A controlling shareholder would have his own shares on top of that. In addition, special initiation rights of priority shares can be extended to binding nominations of the board members, on condition that the company is not subject to the structured regime. This explains how directors can control also corporations that adopt the 'regular' regime (which accounted for nearly 40% of listed firms in 1996) and, possibly, even a one-tier board structure.

d) Takeover Defenses in the Netherlands

There is some confusion among lawyers and economists about whether all of the above devices serve ongoing control purposes or are, rather, takeover defenses.[289] Surely, both effects are at play, but the former normally outweighs the latter. Structured regime, voting trusts, and priority shares make certainly takeovers more difficult but not always impossible to a rider who manages to acquire more than 50% of outstanding shares. Having those devices labeled as takeover defenses

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tures or pyramidal groups. de Jong *et al.* [2001], *op. cit.*. They contend that disproportional voting power is mainly obtained through arrangements that formally do not deviate from one share–one vote, like the *administratiekantoor* and priority shares. Chirinko, R., van Ees, H., Garretsen, H. and Sterken E. [2004], *op. cit.* Undoubtedly, the role of dual class shares in Dutch CG needs further empirical analysis. In the absence of up-to-date evidence, all that can be said is that multiple voting shares face some regulatory hurdles in the Netherlands, but the peculiarities of Dutch law provide a wide range of equally effective substitutes.

287 Schuit *et al.* [2002], *Corporate Law*, cit., 5.1.

288 de Jong, A. and Röell, A. [2005], *op. cit.* Indeed, a controller would not need many of them to be empowered.

289 Meinema, M. [2003], *op. cit.*; Roosenboom, P. and van der Goot, T. [2003], *Takeover Defences and IPO Firm Value in the Netherlands*, in EUROPEAN FINANCIAL MANAGEMENT, vol. 9, 485–511.

is indeed common practice in both Dutch and international literature,[290] but it is ultimately misleading.

Dutch law in fact allows for *strictu senso* takeover defenses. They might be implemented by the board either before or after a takeover attempt. One rather typical technique is based on so-called 'preference shares', which can be issued at *nominal* value with *only 25%* of the amount being paid up.[291] Like US-style poison pills, Dutch preference shares are therefore a relatively cheap way to dilute any insurgent shareholder's voting power, since they carry the same voting rights as common stock and they are issued to a management-friendly foundation (a *stichting* different from the *administratiekantoor*). Since Dutch law allows the issuance of preference shares to be delegated to the management board for a five-year period, many firms have such a takeover defense constantly in place.[292] For those that have not, the board seems to be nonetheless entitled to post-bid resistance. The legality of takeover resistance, under relatively loose conditions of proportionality of action taken by the board, is a genuine product of judge-made law.[293] The principle was introduced after the famous struggle between the management of Gucci and Louis Vuitton brought the unusual matter of hostile takeovers to the attention of the Dutch judiciary.[294] Takeover resistance is upheld under the general standard of compliance with the "elementary principles of good business judgment" (the Dutch equivalent of the US business judgment rule),[295] anytime the board can "make a good faith argument that the takeover threat was against the best interest of the target and all

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[290] Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*; Kabir, R., Cantrijn, D. and Jeunink, A. [1997], *op. cit.*

[291] Schuit *et al.* [2002], *Corporate Law*, cit., 5.1.

[292] de Jong *et al.* [2001], *op. cit.*

[293] Many see the influence of Delaware courts here. See Finley, J. [2002], *How Gucci Resembles Unocal*, in THE M&A JOURNAL, vol. 3, issue 1, available on www.themandajournal.com. For the discussion of the principle of proportionality, and on how it may be applied differently from the US due to consideration for stakeholders by Dutch law, see Timmerman, L. [2004], *Review of management decisions by the courts, seen partly from a comparative legal perspective*, in THE COMPANIES AND BUSINESS COURT FROM A COMPARATIVE LAW PERSPECTIVE, Kluwer, 55.

[294] This has been depicted as a "legal 'boxing match' with six judgments." Meinema, M. [2003], *op. cit*, 161 – citing OK 27 May 1999, NJ 1999, 487; HR 27 Sept. 2000, NJ 2000, 653; OK 8 March 2001, NJ 2001, 224. In the end Vuitton lost its battle, and Gucci was taken over by the white knight selected by its management (Pinault Printemps Redoute). The parties reached an agreement to terminate litigation in 2001. Pinault had to buy 20% of Vuitton, but was able to take full control of Gucci's board only as of April 2004. Hernández-López, E. [2003], *Bag Wars and Bank Wars, the Gucci and Banque National De Paris Hostile Bids: European Corporate Culture Responds To Active Shareholders*, in FORDHAM JOURNAL OF CORPORATE AND FINANCIAL LAW, vol. 9, 127-190.

[295] See Timmerman, L. and Doorman, A. [2002], *Rights of Minority Shareholders in the Netherlands*, in ELECTRONIC JOURNAL OF COMPARATIVE LAW, vol. 6.4, 201, available at www.ejcl.org/64/art64-12.html. More broadly, on the marginal character of the scrutiny of business judgment by Dutch courts, see Timmerman, L. [2004], *op. cit.*, 59-91.

its constituents (which includes its shareholders, but also its employees, creditors and other relevant parties)."[296]

In conclusion, also Dutch boards are entitled to exert ongoing control over the firm management and to resist a takeover threat, thanks to a favorable distribution of power provided for by corporate law.

7.4. When Shareholder Control Is the Only Option (and Why)

7.4.1. The Legal Distribution of Corporate Powers in Sweden and In Italy

The foregoing discussion of legal institutions supporting managerial control should tell how difficult is providing entitlements to corporate control is when the controller is not a major shareholder. Having a controlling shareholder in charge is much easier. It suffices that he is there and has his rights as the major owner of the company enforced. We are about to see that the reverse is not true. Therefore, the classical Berle and Means argument is likewise turned on its head. Dispersed ownership alone does not bring about managerial control. Rather, dispersed ownership may never arise when corporate law does not also support managerial control. When directors are not entitled to fill in the power vacuum left by the absence of a controlling shareholder, the vacuum will not be created in the first place. This is likely to be the typical situation in most countries of continental Europe. Let us focus on just two of them, which exhibit similar patterns of family capitalism albeit with a very different importance of equity finance.[297] They are Sweden, whose stock market capitalization relative to GDP comes very close to the Anglo-American figures; and Italy, which has one of the least developed stock market among the top economies.

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[296] Simpson, S. [2004], *The Future of Takeover Defenses in Europe*, in Practising Law Institute, FOURTH ANNUAL INSTITUTE ON SECURITIES REGULATION IN EUROPE: A CONTRAST OF EU & US, 832 (819-834). The Dutch Supreme Court has confirmed the proportionality test for the review of takeover resistance in HR 18 April 2003, NJ 2003, 256. Timmerman, L. [2004], *op. cit.*, 55.

[297] Barca, F. and Becht, M. (eds.) [2001], THE CONTROL OF CORPORATE EUROPE, Oxford University Press.

a) Why Directors Need a Controlling Shareholder

The legal distribution of corporate powers in Sweden and Italy is quite similar on most fundamental aspects, which allows treating them jointly.[298] In both countries, board members are elected by the general meeting.[299] Employees are granted board representation in Sweden, but this does not affect the distribution of powers since the majority of the board need always to be appointed by the general meeting.[300] Directors are elected by majority in Italy and by plurality in Sweden, and appointment resolutions can be freed from quorum requirements.[301] The crucial point is, however, that incumbent directors cannot be any sure they will be re-appointed, unless they own themselves a sufficient number of shares to this purpose or they enjoy the protection of a controlling shareholder. Even more importantly, when none of these conditions is fulfilled, they run the risk of being replaced anytime and – at the very latest – on the next annual meeting.[302]

Under both Swedish and Italian law, directors can be removed without cause and a special meeting to this purpose can be summoned by shareholders representing at least 10% of outstanding shares.[303] Therefore, terms of office only matter for liability damages, not for tenure (and they are limited anyway by the law, the charter, and self-regulation). In addition, annual meetings where directors are not up for election are nonetheless very dangerous for them. This is certainly true in Sweden, where individual shareholders have full access to the agenda of the general meet-

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[298] Both Italian and Swedish corporate laws have been reformed very recently. In Sweden, the Companies Act of 1975 has been replaced by the New Companies Act of 2006. The changes have not been substantial, at least as far as the matters dealt with here are concerned, and they are mostly aimed at further empowering shareholders. See the notice by the Swedish Ministry of Justice, *New Companies Act*, May 2005, available at www.sweden.gov.se. As we will see, the balance of corporate powers was already very much in favor of shareholder as a class in the old legislation. The new rules do not affect the primacy of controlling shareholders in Sweden, and still leave no scope for managerial control.
The process of corporate law reform in Italy begun in 1998, and apparently it is not yet concluded. The major reform since then took place in 2004 (when the Legislative Decree No. 6/2003 came into force). The Italian Civil Code (ICC) was substantially amended to introduce a new discipline of joint stock (public or private) companies and limited liability (private) companies. Other reforms were enacted as a reaction to the Parmalat scandal, but – at the time this dissertation is being finalized – the implementing regulations have not yet been adopted by the securities authority (*Consob*).

[299] See Skog, R. [1994a], *op. cit.*, and Ventoruzzo, M. [2004], *op. cit.* (where also the details of the optional two-tier board structure are discussed).

[300] See Kraakman *et al.* [2004], *The Anatomy*, cit., 62; and OECD [2006], *Database*, cit.

[301] Art. 2368(1) ICC (majority voting) and art. 2369(3) ICC (no quorum in second call); Karnell, G. [1981], *op. cit.*, 339.

[302] See Cools, S. [2005], *op. cit.*, for a similar argument in other jurisdictions of Continental Europe.

[303] Art. 2367 ICC; Skog, R. [1994a], *op. cit.*, 30.

ing.[304] But directors can be removed 'anytime' by the general meeting also in Italy, where shareholders' access to the agenda is traditionally more limited.[305]

One may object that the above situation is no different from at least one of the board-oriented jurisdictions that we have just examined, namely from British law.[306] And yet, Italian and Swedish directors are powerless without the support of a controlling shareholder, whereas they would be not in the UK. The underlying reason is very simple. Neither in Italy nor in Sweden proxy voting can be solicited by the board of directors at the company's expenses – whereas it can in the UK. To be sure, nothing today prevents Swedish and Italian directors from soliciting proxies, provided they hold some shares (they have to do it in their capacity as shareholders, at least in Italy) and they are willing to bear all the expenses. Both Italian and Swedish laws provide for proxy solicitation, since 1998 and 2006 respectively, but they do not allow any involvement of the company with the related expenses.[307] Unsurprisingly, such a device has hardly ever been used in Italy either to support the incumbent board or to challenge its position.[308] And it is very doubtful whether it will ever be also in Sweden.

Italian and Swedish boards are therefore unable to exercise control over the firm management on an ongoing basis, for the obvious reason that they cannot make sure they *stay* in charge unless a controlling shareholder supports them. It should be noticed that this has neither to do with takeovers nor with their resistance, which will be dealt with shortly. The problem is rather that the board, in itself, has almost

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304 Karnell, G. [1981], *op. cit.*, 339.

305 Art. 2383 ICC (directors can be removed without cause); art. 2366 ICC (directors are in control of the meetings' agenda) – but, in this regard, see *infra*, next subsection.

306 See *supra*, section 7.3.2.

307 Proxy voting has always been allowed both in Italy and in Sweden. Proxy solicitation is, however, a rather novel issue. See, for Italy, art. 136-144 Legislative Decree No. 58/1998 ("Testo unico delle disposizioni in materia di intermediazione finanziaria"); for Sweden, OECD [2006], *Database*, cit. In Sweden, the problem of remote voting has been a sensitive matter for quite a long time. Skog, R. [2000], *The institution of the general meeting and new communication technology – A few considerations de lege lata and de lege ferenda*, Working Paper, available at www.jura.uni-duesseldorf.de. The 2006 reform explicitly provides for procedures of electronic voting and voting by mail. Apparently, the costs of distant voting are borne by the company, but the management is not entitled to recover the costs of solicitation of shareholders' suffrage. OECD [2006], *Database*, cit. Similarly, in Italy, anybody who wishes to engage in proxy solicitation has to bear his own expenses. Art. 134(11) Consob Reg. No. 11971/1999.

308 To be sure, there is one exception. Two competing proxy solicitations were at least initiated during a takeover battle between two family firms in 2004: Arena and Roncadin. This was just a threat, though, and the solicitation was withdrawn in a few days. In the end, the parties settled for the acquisition of Roncadin by Arena. See, illustratively, Arena Holding [2004], *Documento di Offerta Pubblica di Acquisto Obbligatoria su Azioni Ordinarie Roncadin*, filed with the *Consob*, available at www.consob.it.

no chance to avoid being outvoted at the general meeting. Directors would be in fact at the mercy of whoever can cast the majority of the votes at the general meeting. He (or they) may account for whatever small fraction of outstanding shares, provided that directors account for less and nobody else shows up at the meeting. Why should ever the board be outvoted by an insignificant ownership stake? For a number of both rational and psychological reasons. For instance, envy, greed, blackmail, or even a shareholder willing to be the company's one-day king. Actually, shareholders might even show up at the meeting just for taking a chance on this!

This is of course a parody to describe a nonsensical situation. Corporate control is quite a serious issue that cannot be left to the temper of small, individual shareholders. Sooner or later a controlling shareholder would come out to take care of the matter. But it is exactly for that reason that he will hardly disappear in the first place. When directors are ultimately powerless – as they are under both Italian and Swedish corporate law – managerial control cannot emerge in corporate governance.

b) Shareholder Control over the Agenda of the General Meeting

Further discussion of board freedom from (and influence on) shareholder resolutions may add very little to the above conclusion. To what extent directors can do without the general meeting of shareholders, or have a favorable resolution passed therein, is basically unimportant when the very process of their election and removal is out of their control. Yet, here lies quite a significant difference between Italian and Swedish law that is worth just mentioning.

The general meeting of shareholders retains supreme authority over the firm decision-making under Swedish corporate law. Many board decisions have to be upheld by shareholders; and every year the general meeting has to decide whether directors are individually discharged from liability.[309] Shareholder resolutions can be voted almost on any subject – unless they are explicitly reserved for a decision by the board or the managing director – and they are binding on directors.[310] Finally, individual shareholders can have any matter added to the agenda of the general meeting, provided the request is not too late for being included in the notice.[311] These features have not been changed by the new Companies Act of 2006 whereby, if anything, the position of the general meeting of shareholders has been strengthened even further.[312]

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[309] Karnell, G. [1981], *op. cit.*, and 342-344.
[310] Id., at 338-340.
[311] Skog, R. [1994a], *op. cit.*, 30.
[312] OECD [2006], *Database*, cit.

Italian shareholders are weaker – even though, paradoxically, directors are no more powerful. To begin with, default powers have always resided with the board under Italian corporate law. The board of directors has exclusive competence over the firm management and shareholders are not allowed to interfere.[313] This principle was somewhat controversial before the 2004 reform – and anyway it could be derogated by the charter – but it is now explicitly stated in the law as a mandatory rule.[314] Like in the US, it basically involves that shareholders who wish to have any management strategy, or even a single decision implemented, need to replace the members of an opposing board of directors first. Differently from the US, though, directors are quite easily removed under Italian corporate law. The introduction of three options as regards the board structure does not affect this result to any meaningful extent.[315] Italian boards still cannot do without a controlling shareholder.

Whatever the board structure, directors also enjoy exclusive initiation rights in many matters falling within the competence of the general meeting – like mergers, divisions, waiver of pre-emption rights, and the approval of the annual accounts under one-tier board structures. Yet, in the absence of a workable proxy voting system, there is no chance that directors will ever have any resolution passed without the support of a controlling shareholder.[316] Italian boards have also a very strong competitive advantage in setting the agenda of the general meeting, which used to be their exclusive responsibility.[317] This rule has always had one important exception: when shareholders are entitled to summon a general meeting, they also set its

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[313] Before the reform, this principle was indirectly derived from the discipline of the general meeting. Art. 2364 ICC provided for a limited number of tasks of the general meeting, which, however, could be expanded almost at will by the articles of association. After the reform, this is no longer an option. See the next note.

[314] Art. 2380-*bis* ICC now clearly states that "the management of the firm resides exclusively with directors." This holds irrespective of the board structure. The new version of art. 2364 ICC still allows the articles of association to require shareholder authorization for certain board decisions, but the general meeting is now prevented from withdrawing delegation of any management task from directors.

[315] See Ventoruzzo, M. [2004], *op. cit.*, 146-149, for illustration.

[316] Voting at the general meeting is governed by a complicated set of rules under Italian law. See Ventoruzzo, M. [2004], *op. cit.*, 156, for a clear illustration of quorums and majorities.

[317] Art. 2366 ICC. This has changed very recently with the introduction of a general right to place items on the meetings agenda by shareholders of listed companies who account for at least 2.5% of share capital. Art. 126-*bis* Legislative Decree No. 58/1998 (as amended by art. 5 of the Act No. 262/2005 – so-called 'Savings Act,' whereupon *infra* Chapter Nine, section 9.3.5). However, shareholder proposals are not allowed on any issue upon which the board has exclusive initiation rights (this is consistent with the limitations of shareholders' power to summon a special meeting – art. 2367(3) ICC). In addition, in the absence of the possibility to recover the expenses of a proxy solicitation, shareholder proposals are unlikely to be ever passed by the general meeting, if ever put forward at all.

agenda. In practice, a general meeting is only summoned by minority shareholders in opposition to a controlling shareholder. Whatever hostility there may be in this game, directors are hardly those who play it.

Hostile takeovers are very rare in Italy, and basically unheard of in Sweden. Contrary to the conventional wisdom, this does not just depend on the overwhelming presence of controlling shareholders, but also on the law.

7.4.2. Takeover Resistance by a Controlling Shareholder

In both Italy and Sweden, takeover defenses have to be considered in a different perspective. Since managerial control is technically unfeasible on an ongoing basis, takeover defenses cannot serve the purpose of protecting *directors* from shareholder insurgency. While a controlling shareholder would do a much better job on this account, takeover defenses would not help directors to do without a controlling shareholder. Directors' resisting a takeover makes actually little sense when their position depends anyway on the good wishes of the general meeting of shareholders (i.e., when they cannot exploit ownership dispersion to their advantage). Takeover defenses may instead serve the purpose of protecting a *controlling shareholder* from any insurgency that might turn out in his being outvoted at the general meeting. Needless to say, differently from directors, a controlling shareholder does not *need* takeover defenses to this purpose. Holding 50% (plus one) of outstanding voting shares will always do. But this is quite a burdensome solution, for it limits the firm's access to equity finance to an amount strictly resulting from the corporate controller's wealth constraints, liquidity preferences, and risk aversion; and it likewise limits the firm's growth prospects by the amount of internal cash flow reinvestment. Therefore, even in a corporate governance structure based on shareholder control, takeover defenses are of fundamental importance to ease the above constraints – at least, to some limited extent.[318]

Typology of takeover defenses also changes within this perspective. They no longer need to be based on separation of control rights from voting rights, like in the case of board resistance. On the one hand, in many European jurisdictions such a separation would be ultimately impossible to reconcile with the leading principle

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[318] Coates, J.C. IV [2003], *Ownership, Takeovers and EU Law: How Contestable Should EU Corporations Be?*, ECGI Law Working Paper No. 11/2003, available at www.ssrn.com and www.ecgi.org, as published in E. Wymeersch and G. Ferrarini (eds.) [2004], COMPANY AND TAKEOVER LAW IN EUROPE, Oxford University Press.

of shareholder primacy.[319] On the other hand, featuring board resistance against a takeover is far from necessary when a controlling shareholder is in charge. The battle would be indeed for the control of the general meeting, and not of the board of directors. At the general meeting, it is only voting power that matters. Unsurprisingly, then, the typical way of implementing takeover resistance in continental Europe is having *voting*, and not *control* rights, separated from ownership claims – clearly, to the advantage of the controlling shareholder.[320] The board of directors plays indeed a minor role in this game, if any at all.

Quite surprisingly, it is exactly that role that is most extensively regulated. Regulators seem to care of board passivity in the face of a takeover more than of the controlling shareholder's behavior.[321] This is possibly justified on grounds that the controlling shareholder may be not yet completely entrenched when a takeover bid is made. Still, directors will do what the controlling shareholder compels them to do. Under shareholder control, board resistance is not practically restrained by a simple requirement that any defensive tactic be upheld by the general meeting. Yet, this is the tendency of many European jurisdictions, lately supported by EC law on takeovers.[322]

Under Italian law, for instance, post-bid defenses are only valid if approved by 30% of voting rights at the general meeting.[323] This basically corresponds with the law of those European member states which did not opt out article 9 of the Takeover Directive. One may easily recognize the influence of the London City Panel here.[324] However, such a provision is of very little use in continental Europe, where

[319] One should recall that defensive control rights are not granted to British directors if not indirectly (and anyway by means of their own *voting* rights). Under Swedish law, they would need to be upheld by the general meeting of shareholders. von Haartman, A. [2006], *The regulatory framework for takeover bids changes on 1 July 2006*, Memorandum Finansinspektionen, available at www.fi.se. Italian directors may be granted instead some discretionary entitlements to takeover defenses after the 2004 reform, which may escape the rule of board neutrality in the wake of a takeover (art. 104 Legislative Decree No. 58/1998). See *infra* in the text. However, this is still insufficient to support managerial control in the absence of a consistent distribution of powers between the board and the general meeting.

[320] Becht, M. and Mayer, C. [2001], *op. cit.*

[321] The implementation of the Takeover Directive is illustrative of this point. Apparently, the vast majority of member states have chosen to opt in art. 9 (board neutrality rule) and to opt out art. 11 (breakthrough rule). European Commission [2007], *Report on the implementation of the Directive on Takeover Bids*, SEC(2007)268, available at www.ec.europa.eu.

[322] See art. 9 of the Takeover Directive. It should be noticed that most member states had already in place a board neutrality rule when the Directive came into force. European Commission [2007], *Report*, cit.

[323] Art. 104 Legislative Decree No. 58/1998. The current state of legislation does not take the Takeover Directive into account. As of May 2007, the Directive was not yet implemented in Italy.

[324] Rule 21 of the City Code on Take-overs and Mergers (May 2006).

controlling shareholders usually account for more than 30% of voting rights. To be sure, the Takeover Directive goes also a little further, by attempting to 'break-through' the voting power of controlling shareholders as long as it exceeds his ownership stake.[325] However, since this matter has nothing to do with distribution of power within the corporation, it will be dealt with in the Ninth Chapter where the market for corporate control is discussed.

For the good or the bad, something always escapes regulation. This is what happened in Italy with the corporate law reform of 2004. Even though many legal scholars have not yet realized this, something very similar to US-style takeover defenses has been introduced into Italian corporate law. A new kind of securities, named 'Participative Financial Instruments' (PFI), can be in fact employed in that fashion.[326] Holders of PFI can be granted special appointment rights as to board membership and likewise special veto rights on resolutions by the general meeting.[327] Since, according to the mainstream view, appointment rights cannot extend but to a minority of board members, let us consider briefly just veto rights.[328] Holding just one of those PFIs, a controlling shareholder can for instance block a merger. This would be enough for frustrating a 'classical' takeover attempt. And, of course, this is just one of the possible examples. Upon authorization by the charter or any subsequent amendment thereof, directors are entitled to issue PFIs without significant limitations – they do not even need to be paid up. Post-bid issuance would probably be subject to a special authorization by the general meeting, but pre-bid issuance would not. No doubt that this is not sufficient to tilt the balance of powers in favor of directors – for they could not use PFIs for having all of them appointed to the board. But it is not unlikely that a controlling shareholder may wish to avail himself of PFIs for anti-takeover purposes, when he is not completely entrenched already by means of his voting power. At any rate, Italian corporate law cannot be any longer characterized as a system where takeover defenses are severely regulated.[329]

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[325] See art. 11 of the Takeover Directive.

[326] Enriques, L. [2006a], *EC Company Law Directives and Regulations: How Trivial Are They?*, in UNIVERSITY OF PENNSYLVANIA JOURNAL OF INTERNATIONAL ECONOMIC LAW, vol. 27, 52-53.

[327] Art. 2348(2) and art. 2351(5) ICC.

[328] Pellegrini, C. [2005], *Strumenti finanziari: profili di disciplina e alcune implicazioni per il governo societario*, in DIRITTO DELLA BANCA E DEL MERCATO FINANZIARIO, 4/2005, 547-592.

[329] For the view that courts would probably have a negative attitude towards the issuence of PFIs by the corporate controller, thereby short-circuiting their anti-takeover potential, see Enriques, L. [2005b], *Quartum non datur: appunti in tema di 'strumenti finanziari partecipativi' in Inghilterra, negli Stati Uniti e in Italia*, in BANCA BORSA TITOLI DI CREDITO, vol. 68, 166-183.

7.4.3. Pyramids and Dual Class Shares

A controlling shareholder would not need much of either pre-bid or post-bid takeover defenses if not in case of emergency. Normally, he would be already entrenched by means of devices that *permanently* enhance his voting power relative to his ownership stake – thereby supporting *both* the exercise of ongoing control *and* takeover resistance.[330] As we already know, dual class shares and pyramidal groups are the most typical of such devices.[331] They might be used individually or in combination both with each other and with other ancillary devices that, for the sake of brevity, I am not considering here.

Similarly to other countries of continental Europe, corporate governance in Sweden and Italy features a wide resort to both pyramids and dual class shares. In a nutshell, the former are more characteristic of largest Italian listed firms, while the latter are more popular among all Swedish publicly held companies.[332] As we are about to see, this depends only in part by their direct regulation in corporate law. The amount of voting power that can be leveraged in excess of the corporate controller's ownership stake also depends on outside investors' willingness to uphold such leverage through the stock price.[333] On the one hand, this is inversely related to the likelihood being expropriated by the controlling shareholder – whose legal implications will be considered in the next two Chapters. On the other hand, outside investors' willingness to pay for comparatively weakened voting rights is ultimately dependent on the likelihood of a value-increasing change in control – a matter that will be thoroughly investigated Chapters Ten and Eleven. How and to what extent voting and cash flow rights can be separated *from a strictly legal perspective* will be instead the subject-matter of the following discussion.

a) Multiple and Limited Voting Shares

Under Swedish corporate law (basically unaffected on this point by the 2006 reform), there are little restrictions to the usage of dual class shares.[334] Basic ones are the prohibition of non-voting shares and an upper bound on voting rights that can be granted to super-voting shares: since the mid-forties, multiple voting rights cannot exceed a ratio of ten to one. This still allows a controlling shareholder to achieve an enormous degree of separation of ownership and control: 5% of cash

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[330] Morck, R., Wolfenzon, D. and Yeung, B. [2005], *Corporate Governance, Economic Entrenchment and Growth*, in JOURNAL OF ECONOMIC LITERATURE, vol. 43, 657–722.
[331] See *supra*, Chapters One and Two.
[332] See Barca, F. and Becht, M. (eds.) [2001], *op. cit.*
[333] See *supra*, Chapter Six, section 6.4.
[334] Karnell, G. [1981], *op. cit.*, and OECD [2006], *Database*, cit.

flow rights would be sufficient to control 50% of voting rights. In practice, such an extreme separation is never implemented through dual class shares – although similar results are sometimes achieved through the joint use of dual class shares and pyramidal groups.[335] Empirical analysis shows that over 60% of Swedish listed firms employ dual class shares, and this allows controlling shareholders to exercise on average 1.47 voting rights for any unit of direct ownership (the average figure raises up to about 2 when also the effect of pyramids is considered).[336]

The situation is remarkably different in Italy, where dual class shares have never been very popular among listed firms (they have almost disappeared in recent times) and their effect on leveraging of voting power is negligible both on average and for individual firms.[337] This has certainly to do with regulation. In Italy, multiple voting shares are prohibited. Before the 2004 reform, only two kinds of differentiation were allowed: either non-voting shares ('azioni di risparmio') or preference shares carrying voting rights limited to the extraordinary general meeting ('azioni privilegiate'). In addition, non-voting and limited voting shares could jointly account for no more than 50% of outstanding share capital.[338] A controlling shareholder had therefore limited possibilities for enhancing his voting power through dual class shares. Nor have these possibilities ever been exploited if not to a very limited extent. One might think that there is not much difference between downwards and upwards deviations from the 'one-share, one-vote' rule, but this is not completely true. Compared to a shareholder whose voting rights are indirectly weakened, a shareholder deprived outright of voting rights might have no chance to share in any takeover premium. All the more so as he might face a higher risk of being expropriated of his cash flow rights.[339] This should explain why non-voting or very limited voting shares do not enjoy much popularity among investors, especially where – like in Italy – opportunities for expropriation of minority shareholders are not very effectively constrained by the law.

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[335] Holmén, M. and Högfeldt, P. [2005], *Pyramidal Discounts: Tunneling or Agency Costs?*, ECGI Finance Working Paper No. 73/2005, available at www.ssrn.com and www.ecgi.org.

[336] See *supra*, Chapter Two, section 2.4.3.

[337] Bianchi *et al.* [2005], *Proprietà*, cit.

[338] Art. 2351 ICC and art. 145 Legislative Decree No. 58/1998 (before the reform).

[339] Before the 2004 reform, enhanced cash flow rights was intended to be a compensation for limited voting rights. Ventoruzzo, M. [2004], *op. cit.*, 118-119. Since most of shareholder remedies were available only in connection with voting rights, one problematic implication of this approach was that holders of limited voting rights were particularly exposed to expropriation. Holders of non-voting stock could count on practically no legal venue to make sure that their special cash flow rights were effectively enforced. Thanks to enhanced freedom of contract in the definition of classes of shares, and improved tools for protection of minority shareholders, this should be no longer an issue.

The above situation has changed very little after the 2004 reform.[340] The two major constraints on dual class shares (prohibition of multiple voting shares and the 50% bound on the proportion of limited voting shares) have been maintained. Enhanced possibilities of variation of voting rights and some minor improvements in the protection of cash flow rights might eventually increase the popularity of limited voting shares among investors in Italian companies. But it is quite doubtful that they will ever be used for enhancing the corporate controller's voting power to any significant extent.[341] And yet, such a power is enhanced in Italy too. As of 1996, the average voting leverage of a controlling shareholder was about 1.2 voting rights for each unit of integrated (i.e., direct plus indirect) ownership, and it has not changed considerably in recent times.[342] The figure is significantly lower than the Swedish average, but is still non-negligible. Provided that dual class shares do not play almost any role in this story, and other control enhancement mechanisms are prohibited in Italy, pyramids are basically the only responsible.[343]

b) Pyramidal Groups

Pyramids are tricky. On the one hand, they could be the only option for having ownership separated from control when a controlling shareholder is (or must be) in charge and other devices for leveraging voting power are impractical or unavailable.[344] On the other hand, they might lead (as they often do) to undesirable outcomes for non-controlling shareholder at both the bottom and the intermediate layers of the pyramid.[345] This latter contention requires some greater precision.

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340 Ventoruzzo, M. [2004], *op. cit.*, 119-122.

341 Disproportional control structures in the Italian stock market mostly depend on pyramidal groups and coalitions of large shareholders. Apparently, a trend is in place to switch from pyramids to coalitions. Bianchi, M. and Bianco, M. [2006], *Italian corporate governance in the last 15 years: from pyramids to coalitions?*, ECGI Finance Working Paper No. 144/2006, available at www.ssrn.com and www.ecgi.org

342 Compare Bianchi, M., Bianco, M. and Enriques, L. [2001], *Pyramidal Group and the Separation between Ownership and Control in Italy*, in F. Barca and M. Becht (eds.), THE CONTROL OF CORPORATE EUROPE, Oxford University Press, 154-187, with Bianchi *et al.* [2005], Proprietà, cit. 139-146.

343 The simplified notion of corporate controller adopted in this work does not allow for special treatment of shareholder coalitions, since the latter are considered as one single controlling shareholder in any respect. See *supra*, Chapter One, section 1.1. However, coalitions are also a control enhancement device to the extent that decision-making powers are exercised by the leader, and the other members can or do not participate in the process. Coalitions are very important in the interpretation of Italian CG, and they also pose a number of regulatory issues. See, for a recent analysis, Bianchi, M. and Bianco, M. [2006], *op. cit.*

344 Bebchuk, L.A. [2003a], *op. cit.*

345 Bebchuk, L.A., Kraakman, R.H. and Triantis, G. [2000], *Stock Pyramids, Cross-Ownership, and Dual Class Equity: the Mechanisms and Agency Costs of Separating Control from Cash-flow Rights*, in R. Morck

Pyramidal (voting) power is enhanced by two factors: the number of company's layers and the proportion of minority shareholders at each layer. The ownership stake of the corporate controller is concentrated at the apex of the pyramid, whereas it can be much diluted at its bottom. By definition, he controls every layer. Investors of course care of the ultimate controller's financial commitment in each company, since the less is such a commitment the more his decisions might end up driven by the pursuit of distortionary PBC (say, empire building) and diversionary PBC (say, tunneling).[346] Let us assume for the moment that the latter problem is effectively policed by corporate law. We will see in the next Chapter how this can or should happen. Under a shareholder control structure, distortionary PBC are only policed through share ownership, which also affects the likelihood that an efficient change in control will take place in the future.[347] Consequently, the corporate controller will not be allowed to dilute indefinitely his ownership stake through pyramiding, for investors at each layer will apply a discount on outside stock price until further dilution is no more profitable to the controller than retention of (indirect) cash flow rights.[348] When also the risk of diversionary PBC is accounted for, and it is high enough, the discount might actually get so large that no pyramiding is allowed – no investor would dare to buy stock at the bottom of a pyramid, knowing that nearly all of the profits will be diverted to its apex![349]

Nevertheless, non-controlling shareholders may still be tricked by pyramiding. Outside investors can only constrain the corporate controller's behavior when new stock is first sold to them. But assume that a further layer is added at the *bottom* of the pyramid. Minority shareholders of the newly set company (NewCo) will not be affected – they will buy stock at a discount consistent with the ultimate controller's ownership stake. On the contrary, minority shareholders at *any* intermediate layer of the pyramid will simply see the value of their investment diminished by the potential for empire building added by the NewCo – and they cannot do anything about it.[350]

(ed.), CONCENTRATED CORPORATE OWNERSHIP, NBER Conference Volume, University of Chicago Press, 295-315.

[346] Almeida, H. and Wolfenzon, D. [2006], *A Theory of Pyramidal Ownership and Family Business Groups*, in JOURNAL OF FINANCE, vol. 61, 2637-2681.

[347] See *supra*, Chapter Six, section 6.4.

[348] Holmén M. and Högfeldt P. [2004], *A Law and Finance Analysis of Initial Public Offerings*, in JOURNAL OF FINANCIAL INTERMEDIATION, vol. 13, 324-358.

[349] Puzzling enough, however, very often investors do buy stock in pyramidal groups. Bertrand M., Mullainathan S. [2003], *Pyramids*, in JOURNAL OF THE EUROPEAN ECONOMIC ASSOCIATION, vol. 1, 478-483. See the following discussion in the text.

[350] Almeida, H. and Wolfenzon, D. [2006], *op. cit.* (whose model, however, strictly requires that investor protection be imperfect as to allow for tunneling).

This appears to be today the major problem of Swedish corporate governance.[351] The same strategy would be more difficult to implement in Italy, since investors might refuse to buy stock in the NewCo of an already long control chain for fear of being expropriated. Something even worse can happen in Italy. One or more layers can be added on *top* of the pyramid, thereby diluting the controller's ownership stake in any lower layer. Minority shareholders of existing layers cannot but be harmed by such a strategy; but, again, they are powerless. In contrast, new outside investors are more easily found on top rather than at the bottom of a pyramid. This is therefore a terrific strategy for expanding equity finance in a group enterprise, without risk of losing its control.[352] In fact, it has been implemented for at least one of the largest Italian listed groups: Telecom Italia, the formerly state-owned public utility company.

It should be noted that Italian corporate law basically features no alternative for corporate governance. Like in Sweden, legal entitlements supporting managerial control are not available. Differently from Sweden, however, dual class shares are more severely regulated and practically of no use for significant leveraging of voting power. Italian entrepreneurs have just two options to secure corporate control: either they maintain – by themselves or through a voting coalition – an over 50% direct ownership stake, thereby giving up large-scale equity finance; or they set up a pyramidal group structure. Perhaps surprisingly, only the largest Italian listed firms have chosen the second option while the vast majority of them have a controlling shareholder holding on more than 50% of direct ownership.[353]

This should tell why the Italian stock market is still so underdeveloped. Administrative costs of pyramiding cannot be the only explanation, nor can it be group taxation, which is neutral under Italian law.[354] Pyramiding appears to be only available to the largest and most reputable companies, to the extent that they manage to overcome corporate law's shortcomings regarding investor protection against expropriation. Other firms cannot avail themselves of equally effective, but far less expensive and dangerous devices, like multiple voting shares, since they are prohib-

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351 Holmén, M. and Högfeldt, P. [2005], *op. cit.* (who reach this result also in the absence of cash flow diversion within pyramidal groups).

352 Holmén, M. and Högfeldt, P. [2005], *op. cit.*, derive similar results by studying a different mechanism (the set up of a new wholly-owned subsidiary at the bottom of the pyramid). However, the institutional framework is also different. In Sweden, pyramiding does not appear to be a technique to divert resources from minority shareholders.

353 Bianchi *et al.* [2005], *Proprietà*, cit. A few companies are controlled with a more limited ownership stake, but coalitions always make sure that control is not contestable. Bianchi, M. and Bianco, M. [2006], *op. cit.*

354 See Morck, R., Wolfenzon, D. and Yeung, B. [2005], *op. cit.*, for a summary illustration of these two factors.

ited by Italian corporate law. In Sweden, there is none of the two above problems. Expropriation of minority shareholders has never been a matter of concern there. And, as far as separation of voting from cash flow rights is concerned, at least Swedish controllers may choose between pyramids and multiple voting shares (even though such a choice may be distorted by tax considerations).[355]

c) One Advantage of Dual Class Shares over Pyramids

The problem of successive implementation (or extension) that affects pyramiding does not apply to dual class shares with equal severity. One would just wish that corporate controllers were unable to impose a change in the capital structure to non-controlling shareholders without having to bear the effects of outside investors' discount. This is straightforward in the absence of conversion. New limited voting rights will have to be placed with outside investors, who will only buy them at a discount. When multiple voting shares are issued to ease the controller's financial constraint, they would have ultimately to replace a portfolio of common stock carrying comparatively weakened voting rights; this likewise leads to a discounted sale.

However, midstream implementation of dual class capital structure can also be operated through conversion of existing common stock.[356] These are so-called dual class recapitalizations, which may be unilaterally implemented by coercing non-controlling shareholders.[357] After a long-standing debate, regulation of listed firms in the US has coped with this problem.[358] In Europe, dual class recapitalizations are less of a problem. On the one hand, regulation of share capital prevents corporate controllers from diluting minority shareholders outright. On the other hand, midstream alteration of the security voting structure is financially less attractive for controlling shareholders than for the management – and managerial control is very infrequent in Europe.[359]

In conclusion, dual class shares are preferable to pyramids as far as midstream implementation is concerned. If anything, regulation should address remaining

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[355] Holmén, M. and Högfeldt, P. [2005], *op. cit.*

[356] Bainbridge, S.M. [1991], *The Short Life and Resurrection of SEC Rule 19c-4*, in WASHINGTON UNIVERSITY LAW QUARTERLY, vol. 69, 565-634.

[357] Gilson, R.J. [1987], *Evaluating Dual Class Common Stock: The Relevance of Substitutes*, in VIRGINIA LAW REVIEW, vol. 73, 807-844; Gordon, J.N. [1988], *Ties That Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, in CALIFORNIA LAW REVIEW, vol. 76, 1-85.

[358] See, for a summary illustration, Rock, E.B. [2002], *Securities Regulation as Lobster Trap: A Credible Commitment Theory of Mandatory Disclosure*, in CARDOZO LAW REVIEW, vol. 23, 698-700.

[359] Ferrarini, G. [2006], *One Share – One Vote: A European Rule?*, ECGI Law Working Paper No. 58/2006, available at www.ssrn.com and www.ecgi.org.

problems on this account, instead of biasing the choice of disproportional voting structures in favor of pyramidal groups. As we will see in the last Chapter, the European legislator has taken so far the opposite course of action,[360] in spite of the suggestion by authoritative commentators to take stock of the American experience.[361]

7.5. Are Managerial Control and Shareholder Control Compatible?

7.5.1. Board Empowerment and Controlling Shareholders

The foregoing discussion has uncovered two very important results. On the one hand, some corporate law systems – like the American, the British, and the Dutch – provide for enough empowerment of the board of directors to make managerial control of publicly held corporations viable. On the other hand, other corporate laws – like the Italian and the Swedish – do not provide for entitlements supporting managerial control, and then shareholder control is basically the only option for corporate governance. Whether this also allows ownership to be significantly separated from control depends, in turn, on the availability of legal devices for exercising voting rights in excess of the corporate controller's cash flow rights.

It might seem that some corporate laws favor managerial control over shareholder control, whereas some others display exactly the opposite attitude. This is also suggested by the recent analysis of legal distribution of corporate powers as "the real difference between the US and continental Europe."[362] This conclusion is only partially correct. The analysis performed throughout this Chapter shows that, in fact, managerial control is not feasible in some European jurisdictions – and this may hold for many other countries of continental Europe. But the same analysis does not also show that, where managerial control is feasible, shareholder control is necessarily disfavored by the legal system. Indeed, the fundamental question is whether the availability of legal entitlements to managerial control is compatible with the presence of a controlling shareholder.

[360] See *infra*, Chapter Eleven, section 11.4.2.
[361] Ferrarini, G. [2006], *op. cit.* See also *infra*, section 7.6.2.
[362] Cools, S. [2005], *op. cit.*

The answer is a qualified yes. To my knowledge, there is no corporate governance system in the entire world where shareholder control has been completely displaced by managerial capitalism. On that account, the famous Berle and Means prophecy was most visibly wrong.[363] There is a considerable number of controlling shareholder even in the US.[364] Controlling shareholders have not disappeared also in the UK and, even more so, in the Netherlands. From a legal point of view, this is not surprising. A controlling shareholder is always in the position to hold board members (and thereby the firm management) strictly accountable to himself. Whatever the power they are entitled to, a controlling shareholder will ultimately be able to allow only directors he trusts to sit in the board. This is basically the reason why directors are so afraid of hostile takeovers when they are in charge, since a controlling shareholder would emerge thereby. Legally speaking, allowing directors to resist takeovers – a precondition for managerial control – does not necessarily implies that the powers of an *existing* controlling shareholder also be weakened, but only that his unwelcome *emergence* could be frustrated. Normally, jurisdictions that feature managerial control follow this second path.[365] But sometimes – like in the UK – they rather follow the first one, and then the entitlements to managerial control ultimately depend on shareholder control being disfavored.

7.5.2. How Easily a Controlling Shareholder Can Be in Charge in the US

There is not such thing as a regulatory disfavor for controlling shareholders in the US.[366] Once he holds a large enough voting block, an American controlling

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[363] Berle, A.A. Jr. and Means, G.C. [1932], *op. cit.*, 352-357.

[364] Holderness, C.G. [2006], *A Contrarian View of Ownership Concentration in the United States and around the World*, AFA 2006 Boston Meetings Paper, available at www.ssrn.com.

[365] See *supra*, sections 7.3.1 and 7.3.3.

[366] This proposition is extremely controversial. Authoritative commentators (Roe, M.J. [1994], *op. cit.*, and Black, B.S. [1990a], *op. cit.*) have argued exactly the opposite in explaining the high dispersion of ownership in the US. Their point is that securities regulation has traditionally prevented institutions from acquiring large stakes in their portfolio companies, and that both the SEC and US courts have placed a heavy regulatory burden on controlling shareholders. The first part of the argument is more concerned with monitoring than with the exercise of corporate control; however, monitoring by large, non-controlling shareholders plays a minor role in the framework of the present inquiry. See *supra* Chapter Four, section 4.2.2., and Chapter Five, section 5.5. The second part is likewise misguided. Neither securities regulation nor corporate law is biased against the powers of controlling shareholders in the US. The legal rules are just tailored to presence of controlling shareholders when it comes to constraining expropriation of outside investors, but do not allow minority shareholders to interfere with decision-making. Regulation of related-party transactions is essentially "transaction based" in the US, whereas it is more "governance based" in the UK. See Kraakman *et al.* [2004], *The Anatomy*, cit., 68, and *infra*, Chapter Nine, sections 9.2 and 9.3.2. Roe's

shareholder will have no problem at governing any corporation. He would only need to show up at the general meeting and to vote his shares – which he will always do. One should notice that showing up in person is sufficient to break the board's monopoly over directors' nominations and, normally, to win the elections by plurality.[367] Then any autonomy of the board would be ended.[368] Directors alone cannot challenge the controlling shareholder's voting power, when this is significant enough to have all board members elected (and replaced) at his will. If necessary, it would be the controlling shareholder to solicit proxies from outside investors, not directors against him – for they would have no chance to win. This explains how a controlling shareholder has nearly always himself, or a puppet of his, appointed to the board.[369] In addition, his voting power can be enhanced almost without limits through the use of dual class shares.

In the US, dual class shares used to be restricted by the listing rules of the major stock exchanges, but the restriction was removed in the late 80s.[370] Today, about 8% of US publicly held companies (meaning a few hundreds) employ dual class shares, and this may account for between one half and one third of family controlled firms, depending on how shareholder control is inferred.[371] When a controlling shareholder avails himself of multiple voting shares he will hardly need any other takeover defense. In the absence, the wide array of takeover defenses available under US law anyway allows a controlling shareholder to make his position unchallenged with a relatively tiny share ownership (provided, of course, that it is sufficient to control the board). This should also explain why pyramids are basically unheard of in American corporate governance. Although the mainstream explanation lies in both fiscal and regulatory disfavor of pyramidal groups in the US,[372] it should be clear by now that pyramids have never been much needed in the first place. In fact, American corporate law provides controlling shareholders with several other means of empowerment.

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and Black's view that US law is biased against controlling shareholders has been recently challenged, also on empirical grounds, by Holderness, C.G. [2006], *op. cit.*

367 Donald, D.C. [2004], *op. cit.*

368 It might be nonetheless necessary to preserve some board independence to have conflicted interest transactions insulated from litigation. But this is a matter that will be dealt with in the next Chapter.

369 Gadhoum, Y., Lang, L.H.P. and Young, L. [2005], *Who Controls US?*, in EUROPEAN FINANCIAL MANAGEMENT, vol. 11, 339-363.

370 Bainbridge, S.M. [2002a], *op. cit.*, 450-461.

371 See *supra*, Chapter Two, sections 2.3.1 and 2.3.3.

372 Morck, R. and Yeung, B. [2005], *Dividend Taxation and Corporate Governance*, in JOURNAL OF ECONOMIC PERSPECTIVES, vol. 19, 163-180.

7.5.3. Imperfect Neutrality of Legal Distribution of Corporate Powers in the Netherlands

Dutch law is not exactly as neutral to corporate control structure as US law. Before the reform, the structured regime undoubtedly favored directors over a controlling shareholder. Yet, a significant proportion of the companies subject to the structured regime were controlled by a shareholder. This probably required the corporate controller being *de facto* in control of one or more positions on the supervisory board. Anyway, even a 'structured' Dutch company should have been very difficult to govern with the opposition of a controlling shareholder – that is, in the end, some harmony between the management and the general meeting of shareholders should have been the only possible equilibrium.[373] After the reform, the regulatory bias against controlling shareholders is much attenuated in the Netherlands and it might have possibly disappeared at all. Today, a controlling shareholder may veto any nomination to the supervisory board and can dismiss all of its members at will. It is therefore quite difficult to imagine that, in the long run, either the management board or the supervisory board can be constituted of members who do not enjoy the trust of an existing controlling shareholder. This would not hold as simply also when a controlling shareholder suddenly materialize after a takeover; but that is another story, and it will be told in the Eleventh Chapter.

Other 'oligarchic devices' that characterize corporate law in the Netherlands are perfectly neutral between shareholder control and managerial control. A voting trust foundation (*administratiekantoor*) can also be set up by a shareholder, and priority shares can be held by a controlling shareholder as well as by the company's directors. Similarly, Dutch-style 'poison pills' (i.e., preference shares) can be also employed to defend the position of a controlling shareholder, anytime he is in control of the management board. Even more importantly, none of the above devices is compulsory. Yet, when a controlling shareholder is present, they might work as a good substitute for dual class shares – whose issuance is confronted with a number of hurdles under Dutch law – or pyramids – which are extremely rare in Dutch corporate governance. For instance, a controlling shareholder would not need to retain a large ownership stake when he has priority shares that allow him to have the general meeting passing *favorable* resolutions by simple majority of the votes cast and endorsing no *unfavorable* resolution without a two-thirds majority and a quorum of 50% of share capital. Similar results can be possibly obtained by stripping voting

[373] A controlling shareholder had always the opportunity to challenge nominations by the supervisory board on grounds of improper constitutions, and could at least threaten to have its members removed by the court upon allegation of mismanagement. See *supra*, section 7.3.3.

rights from outside shareholders and placing them with an *administratiekantoor* deferring to the controlling shareholder instead of to the company management.

In conclusion, it seems that a controlling shareholder would have few difficulties in governing a Dutch corporation on an ongoing basis. Indeed, in 1996, shareholder control accounted for no less than 43% of publicly held firms in the Netherlands.[374]

7.5.4. Impediments to Shareholder Control in the UK

Controlling shareholders have a much harder life in the UK. 'Substantial' shareholders (i.e., those who hold, either alone or as a coalition, more than 10% of voting rights) are basically prevented from controlling the majority of the board through a particularly unfavorable combination of rules disciplining the governance of listed companies. The Listing Rules used to presume the status of controlling shareholder in the presence of a concentration of voting rights exceeding 30%, which likewise triggered a number of restrictions in the exercise of governance rights. It is therefore unsurprising that, as of 1992, only about 9% of British listed firms had a shareholder accounting for more than 30% of voting rights, and the percentage goes down to 2.4% for firms controlled by an absolute majority shareholder.[375] These figures are lower than in the US and possibly the lowest in the world. Regulation is most likely to be the responsible.

The British discipline of listed companies is far more shareholder-friendly than US law. However, differently from most jurisdictions of continental Europe, shareholders in the UK are not simply protected *as a class* – which would ultimately empower controlling shareholders.[376] British shareholders can in fact exercise their extensive governance rights as against the directors' on condition that they hold *non-controlling* positions. Since minority shareholders do not actively exercise any control rights they might be entitled to, such a special protection indirectly empowers management-controlled boards (whose directors are entitled to fill in the power's vacuum through the proxy voting system). The only losers in this game appear to be both existing and would-be controlling shareholders.[377]

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[374] See *supra*, Chapter Two, section 2.4.3.

[375] Goergen, M. and Renneboog, L. [2001], *op. cit.*, 268-270.

[376] Kraakman *et al.* [2004], *The Anatomy*, cit., 60-61 and 67-70.

[377] As I mentioned (*supra*, section 7.3.2.), the conclusion that controlling shareholders face a regulatory disfavor in Britain is somewhat controversial (like the claim that securities regulation creates a bias against controlling shareholders in the US – see *supra*, section 7.5.2). However, I hope to have demonstrated that regulation of listed companies in Britain effectively disfavors the holding of voting power exceeding 10% (and it used to definitely obstruct both the acquisition and the mainte-

Regulatory disfavor for controlling shareholders in listed companies clearly does not involve that they are completely ruled out of corporate governance. However, publicly held companies under shareholder control might be less than they should be in the UK. A British entrepreneur basically faces the following alternative: either he takes his firm public, and then he must be ready to have firm control handed over to professional management or anyway exerted with a very limited ownership stake; or he keeps it private, but then he has to give up the opportunity of both liquidating his investment and raising equity funds on a large scale. The first alternative would be only profitable for the entrepreneur on condition that idiosyncratic PBC are not too high. In other words, the corporate governance system in the UK does not allow for highly innovative and uncertain business to be financed through the stock market, for that kind of business would require a rather concentrated ownership structure whose control is very difficult (if not impossible) to implement under the regulation of listed firms in the UK. British economists seem to be well-aware of this problem. As Colin Mayer very efficaciously put it:

> "The UK […] goes further than virtually any other system in restricting private benefits. The advantage is that we live in a society in which there is less concentration of power, more protection of minorities and small investors, and less risk of banking failure. The drawback is that there is less incentive to invest in activities that markets are inadequate to sustain."[378]

The high peculiarity of legal distribution of corporate powers in Britain seems to be also responsible of the limited (and practically inexistent) use of devices for separating voting rights from cash flow rights. On the one hand, they would not help to circumvent the threshold that triggers the status of 'substantial shareholder,' for it is established in terms of voting rights. On the other hand, institutional investors have always been in the position to oppose them, in their capacity as the most important financiers of British public companies and as the holders of the last word over charter amendments and directors' tenure.

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nance of holdings larger than 30%): substantial shareholders are ultimately prevented from controlling the majority of the board. On the contrary, US regulation creates no impediment to the ability of controlling shareholders to hold the board of directors to account. Although this has repercussions on a tighter scrutiny of related-party transactions, their discipline in the US does not allow minority shareholders to interfere with the controller's decision-making provided that conflicts of interest are neutralized by an appropriate procedure. See *infra*, Chapter Nine, section 9.2.2.

[378] Mayer, C. [1999], *Firm Control*, Inaugural Lecture at the University of Oxford (February 18, 1999), available at www.finance.ox.ac.uk, as published in J. Schwalbach (ed.) [2001], CORPORATE GOVERNANCE: ESSAYS IN HONOR OF HORST ALBACH, Springer-Verlag.

In conclusion, the ownership structure of publicly held firms in the UK may be more dispersed than desirable due to a strong regulatory bias against controlling shareholders. Related inefficiencies might be corrected dynamically, by the market of corporate control. In the Eleventh Chapter, I shall discuss how takeover regulation may prevent also that goal from being achieved.

7.6. Policy Implications

Normative implications are implicit in the above discussion, if only the reader recalls how prescriptions about the 'optimal' corporate governance regulation were derived from Prediction 2 in the previous Chapter. Therefore, it will not take me long to sum them up.

7.6.1. Providing Entitlements to Support Managerial Control

Legal distributions of corporate power affect the range of ownership structures that can be implemented under a certain corporate law. Since we do not know what the efficient ownership structure is, and this is likely to vary from business to business under the endogeneity assumption that rules the present work, that range should be as wide as possible.[379] However – as we have just seen – *regulation very often creates biases that may distort the firm's choice of ownership structure.* In particular, a dispersed ownership structure may fail to be implemented in the absence of legal entitlements to managerial control. An entrepreneur will have to stop diluting his ownership stake as soon as he risks not being able to exercise and defend firm control just holding on one or more positions in the board of directors. For similar reasons, firm control will be never handed over to professional management where managers are not able to run the firm without the support of a controlling shareholder. No entrepreneur would ever leave firm control up for grabs. When he cannot 'sell' it to professional management, he will have no choice but keeping it for himself of for another controlling shareholder willing to pay him enough for taking over. This might be unfortunate, since the business may be ripe for a more dispersed ownership structure if only the founder could cash in his idiosyncratic PBC, by selling his ownership stake to the market and corporate control to the management.

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[379] See *supra*, Chapter Six, section 6.6.

The above situation characterizes most countries of continental Europe and, arguably, of the entire world. There, publicly held firms are likely to be often stuck in ownership structures that are more concentrated than desirable. That ultimately means a shortage of equity finance that negatively affects the pursuit of growth opportunities, and might turn out in few firms actually going public when the benefits of listing are so tiny to be systematically outweighed by its costs.[380] The importance of the foregoing analysis is in that it uncovers one *legal* reason that may underlie such a situation, which does not depend on *insufficient* investor *protection* (a matter that will be dealt with in the next two Chapters) but, rather, on *insufficient empowerment* of corporate controllers. I conjecture that, in many corporate law systems, managers simply cannot be in charge and, as a result, ownership must be concentrated to feature the power of a controlling shareholder even when such a concentration is inefficient. The previous discussion has shown that this is certainly true for Sweden and for Italy.

In Italy something else should also be at play. The standard explanation of the very high ownership concentration that features Italian corporate governance lies in weak investor protection.[381] The following analysis will confirm that account. Yet I suspect that, even if the investor protection problem were suddenly fixed, ownership structure would not change much. Under Italian corporate law, managerial control is technically unfeasible since the board members have no entitlement to influence the outcomes of the general meeting of shareholders as regards their own appointment and removal. What is lacking is basically a board-controlled proxy voting system, since – especially after the 2004 reform – Italian directors could be otherwise very powerful relative to both dispersed shareholders and to the insurgency of a controlling one.

On this account, the situation is much worse in Sweden, where directors can be completely deprived of authority and placed – as they normally are – at the mercy of the general meeting of shareholders. That should explain why, in a country where weak investor protection has never been an issue, ownership is still very concentrated (especially in the hands of a few wealthy families) and managerial capitalism have been always unheard of. Allowing for a change in that corporate governance path would require much more than the mere introduction of a rule entitling

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[380] Others have reached this conclusion. See, e.g., on the legal side, Coates, J.C. IV [2003], *op. cit.* (also based on legal support for PBC); on the economic side, Boot, A., Gopalan, R. and Thakor, A. [2006], *The Entrepreneur's Choice between Private and Public Ownership*, in JOURNAL OF FINANCE, vol. 61, 803-836 (based on a different framework).

[381] See Gilson, R.J. [2006], *Controlling Shareholders and Corporate Governance: Complicating the Taxonomy*, in HARVARD LAW REVIEW, vol. 119, 1641-1679: and, for a more spectacular illustration, Johnson, S., La Porta, R., Lopez-de-Silanes, F., and Shleifer, A. [2000], *Tunneling*, in AMERICAN ECONOMIC REVIEW, vol. 90, 22–27.

the board to solicit voting proxies at the company's expenses. In fact, the entire system of competence rules should also be adapted to director control, and ultimately include the possibility of board-initiated takeover defenses.[382]

7.6.2. Pyramids and Dual Class Shares: Should They Be Regulated?

To be sure, in Swedish corporate governance, it is not exactly corporate ownership to be concentrated but, rather, voting power. Sweden exhibits one of the highest rates of divergence between voting rights and cash flow rights in worldwide corporate governance. This probably explains how the Swedish stock market manages to be among the most developed in the world. Good investor protection has allowed Swedish controlling shareholders to dilute widely their ownership stake by raising considerable amounts of equity finance from the stock market. Corporate law has allowed them to do it without losing the majority of voting rights. The permissive regulation of dual class shares in Swedish law seems to be then a key factor that leaded to the stock market development. Pyramids have certainly also contributed to that result, even though – as we know – their effects on the efficiency of corporate governance are at best ambiguous and at worst counterproductive.

As it is often the case for extremely complex phenomena, the welfare analysis of pyramids is still very much underdeveloped.[383] Nevertheless, most commentators argue that they should be regulated, if not even prohibited.[384] No doubt, they are very dangerous in those legal systems where the risk of expropriation of minority shareholders is substantial.[385] Even in that case, having pyramids prohibited out-

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[382] Just incidentally, it is worth noting that this is not the direction that EU legislation has taken. Not only the Takeover Directive displays a negative attitude towards both pre-bid and post-bid takeover defenses (although it failed to impose their definitive prohibition on member states – see *infra*, Chapter Eleven, section 11.4), but a number of initiatives included in the so-called 'Company Law Action Plan' (European Commission [2003a], *Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward*, COM(2003)284, available at www.ec.europa.eu) clearly go in the direction of enhancing the governance rights of non-controlling shareholders. See, illustratively, European Commission [2005], *Proposal for a Directive on the Exercise of Shareholders' Voting Rights*, COM(2005)685, available at www.ec.europa.eu, which has been endorsed by the European Parliament in first reading on February 15, 2007.

[383] See *supra*, section 7.4.3.

[384] Bebchuk, L.A., Kraakman, R.H. and Triantis, G. [2000], *op. cit.* However, the authors acknowledge that prohibition of pyramids and/or dual class shares, short of fixing the problem, may just undermine separation of ownership and control.

[385] Bertrand, M., Mehta, P. and Mullainathan, S. [2002], *Ferreting out Tunneling: An Application to Indian Business Groups*, in QUARTERLY JOURNAL OF ECONOMICS, vol. 117, 121-48.

right seems to be a much too coarse solution compared to a comprehensive policing of conflicted interest transactions.[386]

Anyway, minority shareholder expropriation is apparently not a problem in Sweden. Still, pyramids seem to be a vehicle for misuse of free cash (in the form of empire building) at the expenses of non-controlling shareholders.[387] I believe that this problem would be better policed by the market for corporate control, on condition that cashing in the control premium is a more profitable alternative to playing with the firm's assets for a controlling shareholder. Unfortunately, this condition is not always satisfied in Sweden. The ultimate reason is that managerial control, which could bring about further equity finance without need of pyramidal structures, is not supported by corporate law.

Then we are in a bind. Short of promoting a more efficient dispersion of ownership, a restrictive regulation of pyramids (for instance, through an appropriate fiscal policy) might just undermine separation of ownership and control when legal entitlements to managerial control are unavailable. The reason why this did not happen in the US (where pyramids have always been disfavored) is that managers and controlling shareholders hardly *need* pyramidal groups to control American listed companies and to shield them from hostile takeovers. This suggests that, at least in other countries, the case against pyramids is not yet strong enough to yield to a draconian prohibition. On the one hand, contestability of corporate control cannot be imposed by regulation. Many entrenchment devices are difficult to regulate, and some may turn out to be definitely "unregulable."[388] On the other hand, although control tends to be naturally uncontested, entrenchment devices may not be equally efficient under different circumstances. Regulation undoubtedly distorts their choice, but it is not unlikely that the market itself would select the most efficient arrangement if freed of unwarranted legal constraints. Specifically, pyramids may be spontaneously superseded as soon as more efficient alternatives as to separation of ownership and control become available.

The above reasoning applies even more forcefully to Italy, where multiple voting shares are not allowed and pyramids are currently the only way to have ownership substantially separated from control. Italian law performs comparatively worse than Swedish law on the dual class shares account. Allowing multiple voting shares should not worry policymakers too much, when this is supplemented by a substantial improvement in how non-controlling shareholders are protected from expropriation and by some minor changes in corporate law that would make managerial

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[386] Any such policy obviously includes intra-group transactions. See *infra*, Chapter Eight.

[387] Holmén, M. and Högfeldt, P. [2005], *op. cit.*

[388] Arlen, J. and Talley, E. [2003], *Unregulable Defenses and the Perils of Shareholder Choice*, in UNIVERSITY OF PENNSYLVANIA LAW REVIEW, vol. 152, 577–666.

control also an option for Italian corporate governance. As the US experience testifies, the market would ultimately make sure that dual class shares are not overused when alternatives as to both shareholder control and managerial control are present. In addition, even where managerial control is not an option (like in Sweden), multiple voting shares present fewer problems than pyramids. Both can feature shareholder control with a higher degree of separation from ownership, thereby nurturing large-scale equity finance and the firm's growth, but dual class shares can hardly result in unfair surprises for minority shareholders.[389]

7.6.3. No Bias Is Good: Corporate Law's Neutrality as to the Ownership Structure

From a purely theoretical perspective, ownership can be either more or less concentrated than desirable. The first situation tends to prevail around the world, and it characterizes, allegedly, corporate governance in continental Europe as opposed to the UK and the US. This stylized picture is, at best, imprecise. Public companies having no controlling shareholder are in fact rare on a worldwide basis, but they are by no means confined to Anglo-Saxon countries. As far as Europe is concerned, managerial control seems to account for the majority of listed firms also in the Netherlands. The foregoing analysis has shown how this depends on the legal distribution of corporate powers more than upon any influence of the common law tradition. Normally, in Europe, this distribution is so biased towards shareholders as a class that it fails to support directors' autonomy from the general meeting. This provides no legal grounds for transition from controlling shareholdings to managerial control. In that respect, Italy and Sweden should be regarded as illustrative of a

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[389] See *supra*, section 7.4.3. It is worth noting that the European Commission has instead taken a very negative attitude towards dual class shares. The Company Law Action Plan (European Commission [2003a], *Modernising*, cit.) explicitly endorses shareholder democracy as fundamental principle of CG regulation. On this basis, Commissioner McCreevy has engaged a political battle against disproportional voting structures ("It is my goal to get the one share–one-vote principle accepted across the 25 member states", Financial Times, October 17, 2005). The Action Plan was slightly more cautious, and therefore an expert-study was commissioned by the Internal Market Directorate to form the basis of regulatory action. The tender of the Commission (Call for tender MARKT 2006/15/F) was won by a consortium of institutions, including the European Corporate Governance Institute (ECGI). As of May 2007, the final report is just about to be released; but rumors say that the report will definitely not support Commissioner McCreevy's stance against disproportional security-voting structures. The solution of a mandatory one share–one-vote rule has been traditionally opposed by academics. See, e.g., Bebchuk, L.A. and Hart, O. [2002], *A Threat to Dual Class Shares,* in FINANCIAL TIMES, May 31, 2002.

more general problem; but the US and the UK are definitely not the only legal models supporting dispersed ownership.

The foregoing analysis also shows that the distribution of powers can be biased in the opposite direction, in that it fails to support shareholder control. If there is a country where this is likely to happen, that is the UK. Under British law, directors' empowerment supporting managerial control ultimately comes at the expenses of controlling shareholders. There is therefore a fair chance that, in the UK, ownership could be in the end more dispersed than desirable, due to non-neutrality of the legal distribution of corporate powers. As the US experience testifies, disfavoring shareholder control is not necessary for the emergence of managerial capitalism. British law should be then more neutral between shareholder control and managerial control.

At first glance, the first candidate for reform would seem to be the arm's length requirements jointly established by the Listing Rules and the Combined Code, in the presence of substantial shareholders. However, on the one hand, this would expose management of British listed companies – who are otherwise defenseless in the face of a hostile takeover – to the insurgency of controlling shareholders; on the other hand, this might have adverse effects on protection of minority shareholders. Like in other European countries, this solution will probably result in too little scope for managerial control. Thus, the matter is far more complicated and it cannot be addressed piecemeal. At the end of the day, it has to do with the confusion between issues of (minority) investor protection and those concerning the empowerment of corporate controllers. As I hope to have demonstrated in the foregoing Chapters, such confusion is responsible of most misunderstandings in the standard interpretation of corporate governance. The British regulation of listed firms is the living proof of how those misunderstandings can translate into regulatory biases that possibly undermine the efficiency of corporate governance.

It might seem – as Colin Mayer apparently suggests – that British investors enjoy 'excessive' legal protection. I find also this interpretation not entirely convincing. Rather, it seems to me that strong investor protection – which is not necessarily too bad – is implemented in the wrong fashion in the UK. Outside shareholders are not just *protected*; they are *empowered* by British regulation. Yet, in corporate governance, shareholder protection should be dealt with separately from distribution of powers. As we will see in the following Chapters, this is actually possible. It requires that the role of the judiciary be directed, and that of institutional investors be limited, to constraining expropriation. In the same vein, the optimal regulation of corporate control transactions should rely on neither a mandatory bid nor a prohibition of takeover resistance in order to protect non-controlling shareholders. The law of the UK has none of these features, and – as I will show – this makes British corporate governance suboptimal in spite of its performance being among the highest in the world.

At least as far as distribution of powers is concerned, the Netherlands and the US appear to be the winners of our five-country tournament. In these countries, the legal distribution of corporate powers is basically *neutral* between shareholder control and managerial control. In other words, American and Dutch corporate laws allow for a wide range of entitlements to corporate control. In either country, this range is large enough to support both directors' autonomy from the general meeting and a controlling shareholder being in charge with as much ownership dispersion as the market can bear.

Dutch law is not perfectly neutral though. The structured regime cannot be opted out by a considerable number (about one third) of companies listed in the Netherlands. Although the structured regime is not sufficient to rule out shareholder control, especially after the 2004 reform have partly restored shareholder powers in directors' appointment, it is nonetheless not very suitable for a controlling shareholder. It could be easily repealed, since also directors do not strictly need it for their empowerment and – as it is often the case – stakeholder protection is little more than an excuse for vested interests that could be satisfied otherwise. At any rate, the Dutch structured regime does not much distort the initial choice of the ownership structure as it affects its subsequent evolution. Indeed, the rigidities of the structured regime are very likely to make changes in control more difficult. I shall discuss this particular problem in the last Chapter of this inquiry.

CHAPTER EIGHT – **Law of Conflicted Interest Transactions (I): Functional Analysis**

8.1. Investor Protection: Stealing and Shirking Compared

8.1.1. Policing Investor Protection

Separation of ownership and control requires both willing sellers and willing buyers of the company's stock.[1] In the previous Chapter, the supply side (the sellers' point of view) has been analyzed. It has been shown how the corporate controller should be willing to dilute his ownership stake, provided that his position and idiosyncratic private benefits of control (PBC) are not endangered. The range of legal entitlements available to this purpose determines how far ownership *can* be separated from control. However, the demand side (the buyers' point of view) is crucial for the *actual* choice of the ownership structure within that range. On condition that the corporate controller retains residual control rights, how much stock he is willing to sell to the investing public will depend on the price he can get for the shares sold. Outside shareholders' willingness to pay isaffected, in turn, by two major concerns: their not being expropriated of the investment and their expected return on the same investment being maximized.

In other words, what worries outside shareholders is both 'stealing' and 'shirking' by the corporate controller, interpreted in their broadest significance.[2] The next

[1] Paredes, T.A. [2004], *A Systems Approach to Corporate Governance Reform: Why Importing U.S. Corporate Law Isn't The Answer*, in WILLIAM AND MARY LAW REVIEW, vol. 45, 1061.

[2] So far these two problems have been respectively characterized in terms of diversionary and distortionary PBC. In a publicly held company, outside shareholders apparently do not bother much either of interfering with corporate control or of grabbing the controller's idiosyncratic PBC, provided that the two other kinds of PBC are adequately policed by corporate governance (hereinafter CG). See *supra*, Chapter Five.

question is how stealing and shirking can be policed in such a way as to make shareholders willing to invest. In principle, this should be primarily the corporate controller's concern, for it ultimately affects the price he can get for the shares sold to the investing public. However – as we know – contractual incompleteness undermines his ability to *commit credibly* to a 'no-stealing, no-shirking' policy.[3] Neither can he give up residual control rights to this purpose, for he would be no longer able to protect his (idiosyncratic) control rents then.[4] Another solution needs to be worked out in order to exploit the gains from trade arising from efficient policing of both diversionary and distortionary PBC.[5] Intuitively, such a solution cannot be left to private ordering, or at least not entirely. This is basically *why* institutions, and the law, matter for investor protection.[6]

Which institutions matter, and *how*, is another question. On the one hand, institutions have to make sure that the corporate controller will not misuse his power to divert cash flow from outside shareholders ('stealing') when he has the opportunity to do that. Law is the best candidate for this job: the legal discipline of conflicted interest transactions is a major device for curbing *diversionary* PBC.[7] But, on the other hand, institutions need also to support investors' expectations that the value of their investment will be ultimately maximized by the corporate controller (i.e., that he will not 'shirk'). Economic analysis suggests that law can do little to obtain this result directly.[8] However, it can contribute to its achievement indirectly, by promoting an efficient market for corporate control. Another area in which law matters is thus regulation of corporate control transactions, whereby private benefits can be profitably exchanged for enhanced security benefits and this should lead to dynamic minimization of *distortionary* PBC.[9]

This Chapter will show how legal regulation of corporate governance should be mostly concerned with the stealing problem, but very little with shirking – as, in fact, corporate law seem to be in most jurisdictions. The next Chapter will analyze the five jurisdictions of our sample in this perspective. It will be shown that this

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3 See *supra*, Chapter Three.
4 See *supra*, Chapter Five.
5 See *supra*, Chapter Five, section 5.6.2.
6 See *supra*, Chapter Four.
7 See *supra*, Chapter Five, section 5.3.2.
8 Roe, M.J. [2002], *Corporate Law's Limits*, in JOURNAL OF LEGAL STUDIES, vol. 31, 233-271; Klausner, M. [2004], *The limits of Corporate Law in Promoting Good Corporate Governance*, Working Paper No. 300, Stanford Law School, available at www.ssrn.com, as published in J.W. Lorsch, L. Berlowitz, and A. Zelleke (eds.) [2005], RESTORING TRUST IN AMERICAN BUSINESS, MIT Press. See *supra*, Chapter Five, section 5.4.2.
9 This is a major result of the theoretical analysis developed so far. See *supra*, Chapter Six, sections 6.4 and 6.7.3.

provides the basis of a positive theory of corporate law and fruitful guidelines on how to improve its efficiency. The impact of regulation of corporate control transactions on the dynamic efficiency of corporate governance will be analyzed in the last two Chapters.

8.1.2. Separating Stealing from Shirking

Treating stealing separately from shirking yields two important implications for the legal policing of investor protection. The first one is a different approach to the discretion-accountability tradeoff – our ultimate yardstick for evaluating regulation of corporate governance.[10] In this respect, discretion in the exercise of corporate control and the problem of managerial shirking are two sides of the same coin. Easing the entrepreneur's financial constraints entails a reduction of the relative weight of his financial commitment, and then requires more accountability to the financiers.[11] Parties should be free to work out by themselves the solution to this discretion-accountability tradeoff, choosing the pattern of separation of ownership and control that maximize the joint value of cash flow rights sold to the market and of control rights retained by the corporate controller. The market for corporate control will correct for inefficiencies arising over time due to contractual incompleteness, by providing incentives to sell control to a more efficient manager instead of expanding the inefficient consumption of distortionary PBC – i.e., shirking.[12] Both mechanisms are based on *carrot* rather than on stick:[13] in the first situation, the entrepreneur's desire to cash out his holdings or to expand his business without having to surrender control and its rents; in the second one, the corporate controller's opportunity to cash in his idiosyncratic PBC when a more efficient manager takes over. Law should just provide the right entitlements for corporate control to be exercised and transferred in such a way.

Stealing is a completely different story.[14] *Ex post*, stealing is worth to the thief almost as much as it costs to the victim. Intuitively, then, the only 'carrot-deal'

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[10] See *supra*, Chapter Six, section 6.6.

[11] Roe, M.J. [2004b], *The Institutions of Corporate Governance*, Working Paper No. 488, Harvard Law School (Faculty Series), available at www.ssrn.com, as published in C. Menard and M.M. Shirley (eds.) [2005], HANDBOOK OF NEW INSTITUTIONAL ECONOMICS, Springer, 371-399.

[12] The opportunity cost of shirking increases in the amount of free cash available for mismanagement. Jensen, M.C. [1986], *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, in AMERICAN ECONOMIC REVIEW, vol. 76, 323-329. This is the reason why the problem of shirking is ideally dealt with by the market for corporate control. See *supra*, Chapter Five, section 5.5.

[13] See Roe, M.J. [2004b], *op. cit.*, for a similar view.

[14] See *supra*, Chapter five, section 5.3.

shareholders could ever offer to the corporate controller is the following: 'Please, do not steal: we will give you as much as you want.' *Stick* is therefore the only option for curbing diversionary PBC *ex ante*. Differently from shirking, stealing cannot be dealt with as a matter of choice between alternative ownership structures. Whatever that structure, stealing has to be prevented *ex ante* and severely punished *ex post*. Law cannot protect investors from expropriation by simply allowing them to *choose* how much stock they are willing to buy from an entrenched controller. They might end up buying none.[15] Law has rather to provide investors with *reliable constraints* on the corporate controller's ability to steal from their pockets, *whatever his ownership stake*. The corporate controller's discretion needs be constrained to this purpose. How and to what extent this should be done are the key policy issues. This is also a discretion-accountability tradeoff whose solution, however, is not implemented by different patterns of separation of ownership and control, but is a *precondition* for the latter to occur at any rate.[16]

The second implication of separating shirking from stealing in corporate governance is that the anti-expropriation policy needs ultimately to be implemented by means of mandatory rules.[17] The reason why parties cannot be expected to 'work it out themselves' when it comes to stealing is that commitments not to steal the residual claim on the firm's assets are not credible when they are taken by who retains residual rights of control over the same assets. Since corporate contracts are incomplete, in those contingencies which have not been contracted upon, who controls the assets has the power to appropriate them and basically no incentive to refrain from doing it.[18] Within our framework, this situation always characterizes the corporate controller.

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[15] One should recall that ownership concentration alone cannot solve the problem, in the absence of an upper bound on opportunities for stealing. See *supra*, Chapter Four, section 4.4.4.

[16] Black, B.S. [2001], *The Legal and Institutional Preconditions for Strong Securities Markets*, in UCLA LAW REVIEW, vol. 48, 781-855. Compared to Black's, the present work straightly departs from the standard 'law matters' argument. See La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R. [1998], *Law and Finance*, in JOURNAL OF POLITICAL ECONOMY, vol. 106, 1113-1155. In a sense, it takes stock of Roe, M.J. [2003c], POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE, Oxford University Press. However, in a similar vein as Gilson, R.J. [2006], *Controlling Shareholders and Corporate Governance: Complicating the Taxonomy*, in HARVARD LAW REVIEW, vol. 119, 1641-1679, it relies on the market for corporate control, instead of on politics, as the ultimate determinant of efficient separation of ownership and control in the absence of value diversion from minority shareholders. Differently from Gilson, I argue that the market for corporate control can be efficiently operated through friendly takeovers, whatever the ownership concentration. See *supra* Chapter Five, sections 5.1 and 5.5.

[17] See, e.g., Eisenberg, M.A. [1989a], *The Structure of Corporation Law*, in COLUMBIA LAW REVIEW, vol. 89, 1461-1525; and, in a similar vein, Roe, M.J. [2004b], *op. cit.*

[18] Rock, E.B. and Wachter, M.L. [2001], *Islands of Conscious Power: Law, Norms and the Self-Governing Corporation*, in UNIVERSITY OF PENNSYLVANIA LAW REVIEW, vol. 149, 1619–1700.

In more practical terms, contractual safeguards against stealing can never be detailed enough to rule out opportunities of expropriation. This is not simply a matter of including an inflexible 'no-stealing' provision in the corporate charter – anybody would agree on that. The problem is rather how having such a provision implemented within an open mandate to discretionary management.[19] In the absence of external constraints, the corporate controller is easily entitled to abuse his discretion for stealing purposes. This could only be constrained contractually by means of very *detailed* and *unchangeable* charter provisions, limiting the corporate controller's discretion as to day-to-day control over the firm's assets. Provisions of such a kind should be based on actual or virtual unanimity rules, which would need to be extended broadly across the charter to avoid circumvention. Unsurprisingly, provisions like unanimity or high super-majority requirements are practically unheard of in the charters of publicly held corporations. Companies going public do not seem willing to give up flexibility in prospective charter amendments in order to deter opportunistic latecomer terms.[20] For the good or the bad, the corporate controller's discretion typically includes the entitlement to have the charter amended (most clearly so when he is a controlling shareholder), and this is the ultimate reason why contractual commitment not to steal are not credible in corporate governance.[21]

8.1.3. The Debate on Mandatory Rules in Corporate Law

In advocating the case for mandatory regulation of 'stealing' in corporate governance, I am taking a narrower approach to the more general debate about whether corporate law should be mandatory or enabling – perhaps the most con-

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19 Rock, E.B. and Wachter, M.L. [2000], *Corporate Law as a Facilitator of Self Governance*, in GEORGIA LAW REVIEW, vol. 34, 529-545.

20 Easterbrook, F.H. and Fischel, D.R. [1991], THE ECONOMIC STRUCTURE OF CORPORATE LAW, Harvard University Press, 32-35. This circumstance has been recently interpreted by Hansmann, H. [2006a], *Corporation and Contract*, in AMERICAN LAW AND ECONOMICS REVIEW, vol. 8, 1-19, as a prominent difference between the corporation and commercial contract. See *infra*, section 8.1.3, for discussion.

21 As I have shown in Chapter Six, sections 6.3 and 6.4, contractual commitments not to shirk fare much better, at least from an economic point of view. On condition that no stealing is allowed, both the profit sharing rule originally contracted for with outside shareholders (whose successive alteration would amount to stealing, and then is barred by assumption) and the perspective of cashing the idiosyncratic value of control as soon as private benefits are ready to be compensated with enhanced security benefits (namely, in a negotiated control sale), provide the corporate controller with the incentive to create shareholder value out of his discretion, with no need of further constraints. For this reason, regulation of corporate control and of its transfers should be enabling, but a sine qua non of CG efficiency is mandatory regulation of stealing.

troversial issue in Corporate Law and Economics.[22] As I am going to show, this approach provides more fruitful grounds for answering the question. The question about the mandatory/enabling balance in corporate law is misguided when one insists on bundling problems of shareholder expropriation with those of incentive alignment in the exercise of corporate control (i.e., 'stealing' with 'shirking'). No surprise, then, that Law and Economics scholars have not yet found an agreement on such a matter.

In the standard debate, the rationale for mandatory rules in corporate law is twofold.[23] On the one hand, charter terms might be *ex ante* inefficiently priced by investors. On the other hand, the same terms might be modified *ex post* without the investors' knowledgeable consent. Regulators argue that freedom of contract would not be sufficient to protect shareholders from both one-sided charter provisions and opportunistic amendments, provided that (non-controlling) shareholders are ill-informed and rationally apathetic.[24] Deregulators contend that shareholders also include market professionals, or are at least assisted by them, and this should ultimately make sure that charter provisions are adequately priced by the stock market, and that opportunistic amendments are ultimately voted down by shareholders.[25] However, it is better to analyze separately the two problems of efficient pricing of the corporate contract and of its midstream amendments, since only the latter seems to provide a rationale for mandatory regulation of the corporate charter; and this rationale is limited to the stealing case.

a) Pricing of Contract Terms

The problem of efficient pricing of contract terms that are not bargained for is not peculiar to corporate law. This is germane to the more general debate on standard form contracts entered into by consumers on a take-it-or-leave-it basis.[26] Like

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22 See, illustratively, Symposium [1989], *Contractual Freedom in Corporate Law*, in COLUMBIA LAW REVIEW, vol. 89, 1395-1774 (November 1989).

23 See Gordon, J.N. [1989], *The Mandatory Structure of Corporate Law*, in COLUMBIA LAW REVIEW, vol. 89, 1549-1598, and Hansmann, H. [2006a], *op. cit.*, for a more detailed illustration.

24 Bebchuk, L.A. [2002b], *Asymmetric Information and the Choice of Corporate Governance Arrangements*, Working Paper No. 398, Harvard Law School (Faculty Series), available at www.ssrn.com; Bebchuk, L.A. [1989b], *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, in HARVARD LAW REVIEW, vol. 102, 1820–1860.

25 Romano, R. [1989], *Answering the Wrong Question: The Tenuous Case for Mandatory Corporate Laws*, in COLUMBIA LAW REVIEW, vol. 89, 1599-1617.

26 See Kraakman, R.H., Davies, P., Hansmann, H., Hertig, G., Hopt, K.J., Kanda, H. and Rock, E.B. [2004], THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH, Oxford University Press (hereinafter Kraakman *et al.* [2004], *The Anatomy*), 193. I have analyzed the Law and Economics of standard form contracts elsewhere: Pacces, A.M. [1995], *The problem of standard form contracts and its new legal discipline in Italy after the E.C. directive on unfair terms in consumer con-*

consumers, investors are not expected to screen the quality of the standardized contract they enter into when they buy corporate stock. To be sure, individual investors do not even *feel* they sign any contract with the issuer of the securities in their portfolio, whereas, for instance, no consumer would deny having signed a contract with his Internet Services Provider – even though he hardly know what is written in it.[27] Yet, paradoxical as it may appear, investors in financial markets are in a better position relative to consumers of goods or services.

Individual investors do not deal directly with securities issuers but, rather, with market professionals acting as intermediaries.[28] The latter have high-powered incentives to get stock prices right. Individual investors certainly do not go through corporate charters and corporate governance arrangements, but they buy and sell stock through securities firms that must do it at their own risk when they 'make the price.' Securities dealers, underwriters, and financial institutions provide investors with a professional pricing of contract terms that is normally unavailable to consumers of other goods and services.[29] Investors' being unaware of the quality of charter terms is, therefore, not a good rationale for mandatory rules in corporate law, which ultimately disciplines contractual arrangements between relatively sophisticated players (like, for instance, the promoters and the underwriters of an IPO).[30] This is not to say that investors do not need protection, but only that unfair charter terms is the wrong problem for investor protection. Investors might indeed be duped by the corporate disclosures and the securities professionals they must rely upon for participating in the financial market.[31] However, this has little to do with exploitation of unfair charter terms, and then with corporate law. It is in fact a matter of securities regulation. In many respects, the actual degree of shareholder protection from extraction of diversionary PBC also depends on securities regula-

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tracts: a Law and Economics approach, Erasmus Programme in Law and Economics, Master Thesis (First Prize 1994/1995), mimeo (on file with author). That paper was subsequently published, with substantial modifications, as Pacces, A.M. and Pardolesi, R. [1996], *Clausole vessatorie e analisi economica del diritto: note in margine alle ragioni (e alle incongruenze) della nuova disciplina*, in DIRITTO PRIVATO, vol. 1996, 377-426.

27 Pacces, A.M. [2003a], *La disciplina europea dei servizi finanziari al dettaglio: prospettive di armonizzazione e di concorrenza tra ordinamenti nella tutela del* consumatore, in TOWARDS AN EUROPEAN BANKING AND FINANCIAL SYSTEM?, Research Paper No. 47, Ente L. Einaudi, available at www.enteluigieinaudi.it.

28 Pacces, A.M. [2000], *Financial Intermediation in the Securities Markets: Law and Economics of Conduct of Business Regulation*, in INTERNATIONAL REVIEW OF LAW AND ECONOMICS, vol. 20, 479-510.

29 Gilson, R.J. and Kraakman, R.H. [1984], *The Mechanisms of Market Efficiency*, in VIRGINIA LAW REVIEW, vol. 70, 549-644.

30 Gordon, J.N. [1989], *op. cit.*, 1556-1564.

31 For two complementary views of the problem, see Pacces, A.M. [2000], *op. cit.*; Rock, E.B. [2002], *Securities Regulation as Lobster Trap: A Credible Commitment Theory of Mandatory Disclosure*, in CARDOZO LAW REVIEW, vol. 23, 675-704.

tion. But its connection with the protective stance of corporate law has to be put in the right perspective. This connection will be clarified throughout this Chapter.[32]

b) Opportunistic Amendments

The argument concerning opportunistic amendments has more virtue. We know from the foregoing Chapter that, under both managerial and shareholder control, the corporate controller is typically featured with the power to significantly influence, if not to determine, the process of charter amendment.[33] Shareholder weakness in this regard does not simply arise out of their being ill informed, and thus cannot be cured just by the intervention of market professionals. Non-controlling shareholders simply lack the *power* to constrain the corporate controller's opportunistic behavior, since they are not vested with residual rights of control.[34] Apparently, then, both stealing and shirking are good candidates for mandatory regulation when the risk of opportunistic amendments of the corporate contract is being considered.

In practice, however, the two problems appear to be dealt with differently by corporate laws. Take takeover resistance as an example of potential shirking. Although, especially in legal terms, the problem of entrenchment is considered different from plain shirking,[35] entrenchment may be as well motivated by the corporate controller's desire to maintain on-the-job consumption of perquisites – and, to be sure, this is just how entrenchment is explained by the agency theory.[36] It is worth noting that the corporate controller's ability to have the charter amended is not as much legally constrained by his being interested in defending his controlling position as it would be by his interest in diverting shareholder money. Charter amendments formally upheld by a shareholder vote can be nullified by courts on grounds they are motivated by diversionary purposes, whereas they have little chances to be overridden based on allegation that they serve entrenchment purposes.[37] Even in those jurisdictions where takeover resistance is severely regulated (like, as we saw, in Italy and the UK), corporate controllers may always retain enough voting power to be either already entrenched or to legitimately amend the charter to this purpose; as it turns out, most often they do.[38] Whereas, in those jurisdictions with a more

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32 See *infra*, section 8.3.1.

33 See *supra*, Chapter Seven, section 7.2.

34 See *supra*, Chapter Six, section 6.2, for discussion of the economic rationale of this arrangement.

35 See Eisenberg, M.A. [1989a], *op. cit.*, 1473-1474.

36 See Bebchuk, L.A. [2003a], *Why Firms Adopt Antitakeover Arrangements*, in UNIVERSITY OF PENNSYLVANIA LAW REVIEW, vol. 152, 713-753.

37 Kraakman *et al.* [2004], *The Anatomy*, cit., 131-155.

38 See, e.g., Bianchi, M., Bianco, M., Giacomelli, S., Pacces, A.M. and Trento, S. [2005], PROPRIETÀ E CONTROLLO DELLE IMPRESE IN ITALIA*,* Il Mulino; Crespi-Cladera R., Renneboog L. [2003], *Corpo-*

liberal attitude towards takeover defenses (like, e.g., in the US), corporate charters could always be drafted in such a way to rule out anti-takeover devices unless they are approved by outside shareholders; and yet, most often they do not.[39] Only apparently, then, the ease with witch takeover resistance can be implemented by the corporate controller depends on the law; in the end, it is a matter of choice.

Deregulators might be right, thus, when they claim that little involvement of outside shareholders in both the exercise and the allocation of corporate control is not the unintended consequence of the corporate structure, but the desired outcome of the contracting process.[40] The reason why outside shareholders have almost no say in the firm governance – and yet they still invest – is not that they like to be fooled by managerial consumption of perquisites. They know from the very beginning that some shirking is to be expected, but nonetheless they have *chosen* not to interfere with how and to what extent profits will be made by corporate management. This explains, in turn, why corporate law also does not *force* non-controlling shareholders to interfere.[41] That is, there are no mandatory rules requiring that shareholders actually participate in decision-making for the corporate enterprise to be managed and its charter to be adapted to changed circumstances. As we know from the previous Chapter, the requirement of shareholder voting can be – and most often is – reduced to little more than a formality in the practice of publicly held companies. Indeed, corporate charters can be made more or less easy to amend without the involvement of non-controlling shareholders, but this will depend on the amount of discretion that outside shareholders are willing to provide the corporate controller with at the outset.[42] That choice being ultimately made by sophisticated players, interested in maximizing the revenues of placing the company's stock with the market, there appears to be little reason to have the same choice overridden by mandatory rules.

c) The Rubberstamp Problem

The above reasoning fits very well the shirking problem, but is inapplicable to the stealing case. Shareholders may be willing to buy stock at a discount accounting for a moderate risk of shirking (given the ownership structure and the controller's incentive scheme set up *ex ante*), knowing that at some point the corporate control-

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rate Monitoring by Shareholder Coalitions in the UK, ECGI Finance Working Paper No. 12/2003, available at www.ssrn.com and www.ecgi.org.

39 Daines, R. and Klausner, M. [2001], *Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs*, in JOURNAL OF LAW ECONOMICS AND ORGANIZATION, vol. 17, 83–120.

40 Romano, R. [1989], *op. cit.*

41 Rock, E.B. and Wachter, M.L. [2001], *op. cit.*

42 Dooley, M.P. [1992], *Two Models of Corporate Governance*, in THE BUSINESS LAWYER, vol. 47, 461-527.

ler will prefer to sell control to a more efficient manager rather than to expand his shirking.[43] But the same discount would erode the entire value of the firm's stock, should stealing be also allowed. In other words, unconstrained stealing opportunities make financial exchange impracticable.[44] Since no corporate controller would refrain from a 'take the money and run' strategy when this involves no penalty, no money would be provided by shareholders in the first place.

It is illusory to believe that the corporate controller would be able to commit *anyway* to a no-stealing policy, simply by means of the corporate contract, should any legal system ever make optional the anti-expropriation rules of corporate law.[45] Here lies the major weakness of deregulators' position. This position has been authoritatively articulated by Roberta Romano:

> "Critics of the enabling regimes suppose that shareholders would vote to permit managers to steal corporate assets by rescinding the duty of loyalty. This is said to demonstrate a need for mandatory rules. But the hypothetical, eliminating the duty of loyalty, is too incredible to be seriously entertained: what sane shareholders would agree to license theft? […] If investors are so poorly informed or foolish to vote to transfer their wealth to managers without compensation, we have far deeper problems than refining corporation codes. How can we have confidence that investors will make the fundamental allocative investment decisions required in a capitalist economy? Or better yet, to participate in a democracy?"[46]

The above reasoning has one important flaw: it assumes actual participation of outside shareholders to corporate decision-making, through their voting at the general meeting. On that basis, mandatory rules in corporate law would be a trivial issue, for they would do no more than mimicking the standard outcome of a market bargain: 'I provide you with the money you need on condition that you are bound not to steal any of them'.[47] Permissible deviations from such a scheme are unimportant, for they would never be implemented with the shareholder consent. However, we know from the previous Chapter that charter amendments do not always re-

43 This summarizes the view of the CG problem detailed in Chapter Six, above.

44 This is the unquestionable virtue of the 'law matters' argument. See Shleifer, A. and Vishny, R. [1997], *A Survey of Corporate Governance*, in JOURNAL OF FINANCE, vol. 52, 737-783.

45 For the interpretation of the US system of fiduciary duties in this perspective, see Coffee, J.C. Jr. [1989], *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, in COLUMBIA LAW REVIEW, vol. 89, 1618-1691.

46 Romano, R. [1989], *op. cit.*, 1601-1602.

47 Easterbrook, F.H. and Fischel, D.R. [1991], *op. cit.,* 90-108.

quire the *actual* consent of non-controlling shareholders.[48] When a controlling shareholder is in charge with a substantial share of voting rights, not even their *formal* consent might be necessary.[49] Anyway, also when ultimate control powers reside with the management (or likewise when a controlling shareholder has not enough voting power to have the charter amended at his own will) outside shareholder consent does not provide enough guarantees against opportunistic amendments put forward by the corporate controller.[50]

Of course, no single shareholder would ever support, either in person or by proxy, any explicit 'license to steal'.[51] But there are one million ways to induce outside shareholders to rubberstamp management proposals having equivalent purposes.[52] Think, for instance, to a proposal of lowering the fiduciary standards of certain intra-group transactions, on grounds that this is needed to catch up with competitors. The alleged motivation might be truthful, and that could justify widening managerial *discretion*. Nevertheless, reduced *accountability* in transactions involving potential conflicts of interest may easily lead to outrageous instances of tunneling.[53] How can we expect investors to evaluate how changed circumstances affect the discretion-accountability tradeoff, and to cast their vote accordingly? This would be far more ambitious than claiming that shareholders are not foolish. In fact, such an expectation would contradict the terms of the original agreement between shareholders and the corporate controller. The latter is vested with the authority to manage the firm and to adapt its governance to changed circumstances, possibly also by amending the corporate charter. Shareholders will not interfere, and will vote with the management when required.

Even though – according to Professor Romano – the rubberstamp strategy is suboptimal in the presence of uncertainty as to whether management resolutions are beneficial or detrimental to shareholder value,[54] this is the outcome supported by empirical evidence. With absolutely negligible exceptions, shareholders always vote with the firm management.[55] However, if shareholders are not impertinent,

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48 See *supra*, Chapter Seven, section 7.3.

49 See *supra*, Chapter Seven, section 7.4.

50 See Eisenberg, M.A. [1989a], *op. cit.*, 1474-1480, for a detailed presentation of "the limits of shareholder consent."

51 This is actually the most powerful argument in favor of contractual freedom in corporate law. Romano, R. [1989], *op. cit.*, 1601-1602.

52 Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1654-1663.

53 See, for illustration, Johnson, S., La Porta, R., Lopez-de-Silanes, F., and Shleifer, A. [2000], *Tunneling*, in AMERICAN ECONOMIC REVIEW, vol. 90, 22–27.

54 Romano, R. [1989], *op. cit.*, 1606-1613.

55 See, for authoritative illustration of how this obtains in the US, Eisenberg, M.A. [1989a], *op. cit.*, 1474-1480. Unfortunately, there are not many empirical studies on corporate voting. The only two I am aware of definitely support the conclusion that the general meeting normally rubberstamps

they are not stupid either.[56] Not only they will never vote in favor of a resolution *unambiguously* detrimental of their own interest (which is then very unlikely to be ever put forward), but they will have never invested their money in the absence of a meaningful guarantee that the corporate controller cannot misuse his discretion (which they normally support with their vote) for stealing purposes. Such a guarantee cannot but come from institutions that are out of the corporate controller's reach.[57]

d) *Mandatory Rules as a Credible Commitment*

That corporate law should feature mandatory rules to that purpose may seem straightforward. However, Henry Hansmann has recently advocated a different solution.[58] First, he contends that, at least in the US, corporate laws only consist of default rules that, in theory, could be derogated by the corporate charter. Then he argues that, in practice, corporate charters are less flexible than is commonly understood, and therefore adaptation of the corporate contract to new circumstances is realized by modification of corporate law's default rules. In his view, this explains why US companies hardly depart from default arrangements, which thus become both a source of commitment and a device for delegating to the state the process of charter amendment.

I disagree with both contentions. On the one hand, even in the US corporate laws have a mandatory core.[59] Hansmann's argument is that they could be always opted-out, by either the choice of a more flexible statutory form or reincorporation in a more liberal jurisdiction. Although American companies theoretically have this freedom, the fact is that they almost never exercise it in practice.[60] Virtually all of the companies listed in the US are subject to the few, but fundamental, mandatory rules of the statutory form of business corporations, which is most often the Delaware General Corporation Law. On the other hand, the distinction between default/enabling rules and mandatory ones is still a meaningful one in corporate law.

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the corporate controller's proposals. See De Jong, A., Mertens, G. and Roosenboom, P. [2005], *Shareholders' Voting at General Meetings: Evidence from the Netherlands*, Working Paper, Erasmus University (ERIN series), available at www.ssrn.com; Maug, E. and Rydqvist, K. [2001], *What is the Function of the General Meeting? Evidence from the U.S. Proxy Voting Process*, Working paper, Humboldt University and Norwegian School of Management, available at www.ssrn.com

56 See *supra*, Chapter Six, section 6.1.2.

57 Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1654-1660.

58 Hansmann, H. [2006a], *op. cit.*

59 See, e.g., Eisenberg, M.A. [1989a], *op. cit.*, 1480-1485. The presence of mandatory rules is basically unquestioned in corporate jurisdictions other than those of the US. See the Kraakman *et al.* [2004], *The Anatomy*, cit., 29-31.

60 This is acknowledged by Hansmann himself. Hansmann, H. [2006a], *op. cit.*, 2-5.

The majority of US listed firms are incorporated in Delaware.[61] By so doing, companies do not simply 'buy' a package of default rules. As I have shown in the foregoing Chapter, rules on director removal and the security-voting structure often depart from statutory defaults.[62] Rather, American companies seem to 'buy' the mandatory rules included with the package of Delaware law, which most prominently include the administration of fiduciary duties by the sophisticated judiciary of the Chancery Court.[63]

I do not think that professor Hansmann would disagree with the basic idea that corporate controllers are willing to subject themselves to mandatory rules in order to take a credible commitment that they will not expropriate non-controlling shareholders. After all, he made himself this point with Reiner Kraakman.[64] However, for the reasons sketched out above, neither default rules nor the corporate charter can be regarded as an equally reliable commitment device. Therefore, when the risk of stealing is involved, the solution of the discretion-accountability tradeoff cannot be left to private ordering, but must rely upon a set of mandatory rules.[65] Needless to say, the impact of such rules on the efficiency of corporate governance is far from trivial.[66]

8.1.4. Conflicts of Interest in a Theory of Private Benefits of Control

The important achievement of the foregoing discussion is that 'stealing' by the corporate controller has to be policed by means of a set of mandatory rules. The notion of stealing not only underlies the economic rationale of this proposition, but also defines the boundaries of its validity. The reason why one cannot entirely rely

61 See *supra*, Chapter Seven, section 7.1 (note 7).

62 See *supra*, Chapter Seven, section 7.3.1.

63 In spite of the extensive debate on the normative implications of regulatory competition in US corporate law, this positive interpretation is hardly questionable. See Coffee, J.C. Jr. [1989], *op. cit.*; Rock, E.B. [1997], *Saints and Sinners: How Does Delaware Corporate Law Work?*, in UCLA Law Review, vol. 44, 1009-1107; Fisch, J.E. [2000], *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, in UNIVERSITY OF CINCINNATI LAW REVIEW, vol. 68, 1061-1100.

64 "Each [standard form legal entity] exhibits some rigidity, by virtue of mandatory rules. […] The result is to enhance the entrepreneur's ability to signal, via her choice of form, the terms that the firm offers to other contracting parties, and to make credible the entrepreneur's commitment not to change those terms." Kraakman *et al.* [2004], *The Anatomy*, cit., 31.

65 See *infra*, section 8.5.3, for an important qualification of this statement concerning self-regulation which is both economically binding and legally enforced.

66 Compare with Black, B.S. [1990b], *Is Corporate Law Trivial? A Political and Economic Analysis*, in NORTHWESTERN UNIVERSITY LAW REVIEW, vol. 84, 542-597. But see also Black, B.S. [2001], *op. cit.*, 783 (note 3).

on private ordering when it comes to corporate governance is that the corporate controller is vested with enormous discretion in managing the firm's assets, which allows for exquisite opportunities for stealing. Apparently, however, shareholders of a publicly held corporation do not want this discretion to be undermined by contract or, even worse, by the law. They simply want it not to be abused to their own disadvantage. This is more easily said than done. The practical problem is that both 'stealing' and 'abuse of discretion' are very vague concepts, and they are almost of no use to operationalize a legal strategy against the extraction of diversionary PBC in corporate governance.

Perhaps a more fruitful way to look at the matter, which is much more conventional at least from a legal perspective, is through the notion of *conflict of interest*.[67] After all, what non-controlling shareholders are afraid of is the corporate controller's managing the firm in his exclusive interest rather than with the purpose of maximizing shareholder value.[68] The problem is that the potential conflicts of interest of a corporate controller include *more* than just stealing. As we already know, once the corporate controller is in charge, he may not only wish to appropriate that part of the firm's residual shareholders are entitled to (e.g., by siphoning some of the firm's assets off). He may also wish to derive non-monetary personal benefits (such as leisure) from the management of the firm's assets at the expenses of their productivity, and to keep on enjoying those benefits in the face of more efficient controllers available in the managerial labor market.[69] Legally speaking, these are all equally relevant categories of conflict of interest between a corporate controller and non-controlling shareholders. Also from an economic standpoint, all the above-mentioned behaviors are a matter of concern for non-controlling shareholders. The crucial difference is that they are not necessarily to be dealt with by means of legal rules, let alone by means of mandatory ones.[70]

The reader may recall from the critical discussion of the agency approach to separation of ownership and control that conflicts of interest are another way to look at the discrepancy between private benefits and securities benefits in corporate governance – that is, the problem of PBC. Our framework of analysis of corporate governance, based on a qualitative distinction between different categories of PBC, turns out to be very helpful in identifying the instances of conflict of interest that are eligible for mandatory regulation, and those that are not.

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67 See, e.g., Davies, P. [2002a], INTRODUCTION TO COMPANY LAW, Oxford University Press, 170-191.

68 Fox, M.B. and Heller, M.A. [2006], *What Is Good Corporate Governance?*, in M.B. Fox and M.A. Heller (eds.), CORPORATE GOVERNANCE LESSONS FROM TRANSITION ECONOMY REFORMS, Princeton University Press, 3-31.

69 See *supra*, Chapter Three.

70 See, in this regard, Black, B.S. [1990b], *op. cit.*, and Black, B.S. [2001], *op. cit.*

Like PBC, conflicts of interest come in three basic kinds.[71] One is outright shirking or, broadly speaking, misdirection of managerial effort – what has been termed so far as distortionary PBC. It is the most dangerous conflict of interest, for it costs to shareholders far more than it benefits the corporate controller. And yet, just because of this reason, it is the one more easily policed by means of non-legal *incentives*, both static (profit sharing) and dynamic (market for corporate control), which are supposed to align the corporate controller's interest with that of shareholders. So far this has been argued mostly on economic grounds. The following discussion will show that corporate laws are actually ill equipped for dealing with the corporate controllers' failure to maximize shareholder value. Functionally, corporate law copes much better with stealing than with shirking.[72] In the next Chapter, it will be shown that the absence of overreaching regulation of shirking in corporate governance is not just desirable from a normative perspective; it is also part of a positive theory of corporate law.

Another conflict of interest is due to the corporate controller's concern with staying in charge. Under standard agency theory, this is just a byproduct of managerial on-the-job consumption (i.e., shirking).[73] However, legal scholarship prefers to treat this as a separate instance of conflict of interest, which becomes relevant in actual or potential takeover situations: the so-called 'positional' conflict of interest.[74] The corporate controller's concern with his own position (entrenchment of corporate control) is a key feature of our framework based on a tripartite account of PBC.[75] However, based on the same framework, this is just *potentially* dangerous. When only idiosyncratic PBC motivate entrenchment, and they are still too high to be compensated through the proceeds of a control sale, the existing allocation of corporate control will be efficient. On the contrary, inefficiency arises when the prospective securities benefits of a control transfer are higher than the idiosyncratic value of control, and yet the former are foregone due to *shirking*, *stealing*, or both. The question of whether the positional conflict of interest should be regulated by corporate law, and to what extent this regulation should be mandatory, is therefore more complicated. The answer provided so far, on economic grounds, is that this has little to do with regulation of the corporate contract, which is left intentionally incomplete in this respect, and rather concerns the provision of the right entitlements to both the incumbent and the insurgent controllers.[76] Not differently from

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71 See *supra*, Chapter Five.
72 Roe, M.J [2004], *op. cit.*, 3-4; Black, B.S. [2001], *op. cit.*, 784.
73 Jensen, M.C. [1986], *op. cit.*
74 Eisenberg, M.A. [1989a], *op. cit.*, 1473.
75 See *supra*, Chapter Six.
76 See *supra*, Chapter Six, section 6.7.3.

the case of shirking in a static setting, there is no compelling reason to constrain the parties' freedom to exchange those entitlements in a takeover context, on condition that the exchange does not lead to stealing corporate assets from non-controlling shareholders. The theoretical underpinning of this proposition, and how it matches the regulation of corporate control transactions in Europe and in the US, will be the subject-matter of the last two Chapters.

This leaves us with just one subset of conflicts of interest between the corporate controller and non-controlling shareholders. In the wordings of an authoritative commentator, "all agents have a potential interest in diverting the principal's assets to their own use through unfair self-dealing. This is the problem of *traditional conflicts of interest*."[77] Although, according to the view presented here, corporate controllers are more of entrepreneurs than of just shareholders' agents, the problem of diversion of assets is, if anything, even more severe under separation between corporate ownership and its control than in a standard principal-agent setting. The reason is that virtually no agent is ever vested with the same discretion in managing 'other people's money' as a controller of a publicly held company. This results in unique opportunities for diverting profits, if not property, from the owners.[78]

Once the notion of conflict of interest in corporate governance is narrowed down to the diversion of corporate assets, the problem of diversionary PBC can be framed in more precise legal terms than just 'stealing'. The problem arises anytime the corporate controller has the opportunity to use his discretionary powers over the corporate assets for having the firm's cash flow diverted to his own pockets.[79] Compared to the shirking and the positional conflicts that I have just reviewed, this traditional conflict is perhaps not the worst kind of conflict of interest (shareholders cannot lose more than the controller gains), but it is certainly the sharpest (the controller gets as much as he manages to steal from shareholders). *Ex post*, stealing is simply a matter of distribution, which may thus seem to be neutral to the aggregate wealth of controllers and shareholders. Not only is such a view incorrect (any resource devoted to stealing or to its prevention is a pure waste), but redistribution is exactly what makes stealing so worrisome to shareholders *ex ante*. Opportunities for stealing may undermine any *incentive compatibility* of the corporate structure. Unconstrained opportunities of such a kind would make shareholders unwilling to place their money under the corporate controller's management at the outset, since

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77 Eisenberg, M.A. [1989a], *op. cit.*, 1471.

78 This departs from the traditional view that corporate managers are like "like the stewards of a rich man." Smith, A. [1776], THE WEALTH OF NATIONS, Cannan Edition (Modern Library, New York, 1937), 700.

79 Black, B.S. [2001], *op. cit.*, 804-806.

they would know they are not going to get anything back.[80] That explains, in turn, the urge to have this, and just this, traditional conflict of interest policed by legal constraints on the controller's ability to divert resources from shareholders' pockets. For this reason, I shall consider only opportunities for diverting corporate assets and cash flow as relevant sources of conflict of interest in the remainder of this Chapter.

8.2. Efficient Regulation of 'Diversionary' Conflicts of Interest

8.2.1. Non-pro-rata Distributions and Conflicted Interest Transactions

a) Related-Party Transactions

The prototypical instance of 'diversionary' conflict of interest is the so-called 'self-dealing' by the corporate controller. Self-dealing means that the corporate controller's is transacting with himself in the company's name. The risk involved by such a kind of transaction is very intuitive: a corporate controller vested with discretionary powers will naturally tend to set the transaction terms in such a way as to foster his own interest at the expenses of that of the company (and thus, of non-controlling shareholders). Self-dealing transactions may easily result in diversion of corporate asset, anytime the consideration of the exchange departs from market prices. By and large, either a below-market prices sale or an above-market prices purchase may amount to outright stealing from the shareholders' to the corporate controller's pockets.

Unfortunately, this very basic case of self-dealing is not the only possible instance of conflicted interest transaction that may result in stealing by the corporate controller. To be sure, it is not even the most important one. Managers or controlling shareholders being explicitly on both sides of a corporate transaction is no longer as common as it used to be in the nineteenth century, at least in most developed countries.[81] However, the same danger is involved by a much broader set of transactions, which are formally third-party transactions, but where the corporate controller is *personally* interested in the welfare of the third party.[82] The third party in

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[80] Shleifer, A. and Vishny, R. [1997], *op. cit.*
[81] Kraakman *et al.* [2004], *The Anatomy*, cit., 101-103.
[82] Clark, R.C. [1986], CORPORATE LAW, Little, Brown and Company, 147.

question may be a family member of the corporate controller, an affiliate (if not a puppet) of his, or an entity (e.g., a corporation, or a partnership) in which he has a larger financial stake than in the company he controls. Clearly, as far as the interest in diverting corporate assets is concerned, it makes little difference whether the beneficiary is the corporate controller himself or any of the persons mentioned above, who are all 'related' to the personal interests of the corporate controller. As a matter of fact, this kind of third-party transactions shares the key features of traditional self-dealing. The corporate controller is free to set the terms of the transaction and he is interested in favoring the related party over the corporation that he controls (but that he does not own entirely), inasmuch as the interest in the wealth of the related party exceeds his stake in the company.[83] For this reason, self-dealing is nowadays more broadly characterized as related-party transactions.

Related-party transactions need to involve neither the corporate controller nor the corporation he controls directly. A transaction between two differently related parties may be indeed characterized by the same traditional conflict of interest on the corporate controller's side, provided that one is related to the company's interest and the other to the corporate controller's one. The case in point is a transaction between one of the company's subsidiary and another company or a partnership wherein the corporate controller of the former has a significant financial interest.[84] The picture could be complicated much further. This is not our goal, though. What is worth noting is that diversion of corporate assets can be implemented through a very broad range of transactional techniques, provided that just two conditions are fulfilled. The first is that the corporate controller has unfettered discretion over the transaction and its financial terms. The second is that the transaction isaffecting, at least potentially, the welfare of the corporation and of his corporate controller in two opposite ways: whatever the parties formally involved, the transaction is such that it may ultimately impoverish the corporation while enriching, at the end of the day, its controller.

The reader may recall from the introduction to the basic features of the corporate structure, which was presented at the very beginning of this inquiry, that the legal notion of *shareholder ownership* defines the entitlement of the company owners to share in the residual claim on the corporate assets.[85] In functional terms, the prominent consequence of this principle is that all distributions of the firm's surplus (i.e., what is left after all the inputs of production are rewarded according to

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83 Enriques, L. [2000], *The Law on Company Directors' Self-Dealing: A Comparative Analysis*, in INTERNATIONAL AND COMPARATIVE CORPORATE LAW JOURNAL, vol. 2, 297-333.

84 Wymeersch, E. [2003], *Do we need a law on groups of companies?*, in K. Hopt and E. Wymeersch (eds.), CAPITAL MARKETS AND COMPANY LAW, Oxford University Press, 573-600.

85 See *supra*, Chapter One, section 1.4.4.

the contracts entered into by the company) must be made pro-rata, either in the form of midstream dividends or of final liquidation of assets upon the company's dissolution.[86] Related-party transactions are perhaps the most dangerous challenge to this pro-rata rule, since they may easily feature 'tunneling' of the company's funds (which are subject to the pro-rata rule) to the corporate controller's individual property (which of course is not).[87]

Easily does not mean certainly.[88] I have defined related-party transactions in such broad terms that it would be foolish to believe that they are necessarily characterized by cash flow diversion. In fact, they are a significant part of every company's operation. The problem is not related-party transactions themselves, but rather the non-pro-rata distributions that they may, as may not, involve. Focusing on related-party transactions is just a way to operationalize a meaningful ban of non-pro-rata distributions. While avoiding non-pro-rata distributions is a fundamental task of corporate law, and – as I argue – the only task that should be implemented by means of mandatory rules, unfortunately this goal cannot be simply achieved by prohibiting related-party transactions altogether. The important consequences of this hurdle will be clarified shortly.

b) Other Conflicted Interest Transactions

The domain of potentially non-pro-rata behaviors includes more than just related-party transactions. As far as outright diversion of assets and cash flow is concerned, at least three more categories of transactions are to be considered.[89] One is *managerial compensation*. In the absence of a controlling shareholder, this is a very peculiar kind of self-dealing. Directors normally set their own compensation on behalf of the company. The situation is equally dangerous when there is a controlling shareholder, and he sits in the board of the company or of any of its subsidiary. The problem of the corporate controller's compensation is, however, even more complicated than that of related-party transactions, for it overlaps with the question of rewarding managerial effort.[90] Since one major focus of this inquiry, if not the most important one, is concerned with non-contractibility of managerial compensation under separation of ownership and control, the potential distortions in contracting over the corporate controller's reward (e.g., salary, stock option plans, and the like) are not dealt with here. To avoid confusion between the problems of en-

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86 Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1654-1660.
87 Johnson, S., La Porta, R., Lopez-de-Silanes, F., and Shleifer, A. [2000], *op. cit.*
88 On this point, see especially Enriques, L. [2000], *op. cit.*
89 Kraakman *et al.* [2004], *The Anatomy*, cit., 102.
90 See *supra*, Chapter Six, sections 6.2 and 6.3.

trepreneurial reward and non-pro-rata distributions in corporate governance, I simply assume that the contractible part of managerial compensation is always determined by an incentive-compatible mechanism set up in the corporate charter.[91] What the features of this mechanism are or should be, and whether they would need any support by corporate law in order to avoid the risk of non-pro-rata distributions, is a matter for separate inquiry.[92]

For similar reason, this discussion does not deal with two other instances of generic misappropriation, which do not result in the corporation directly or indirectly transacting with a corporate controller's related party, but rather depend on the corporation or its shareholders being *excluded* from transacting with unrelated third parties.[93] The first is the appropriation by the corporate controller, typically through a related entity that he may own entirely, of investment opportunities that may be as profitably exploited by the corporation. Even though this misbehavior does not exactly consist of diversion of corporate assets, it would ultimately result in diversion of cash flow potential from the company. As a result, the problem can be handled within a framework not very different from that which I am going to present for the discipline of related-party transactions. However, in many legal systems, this problem is dealt with by a separate doctrine: that of so-called '*corporate opportunities*.'[94] Reviewing the doctrine of corporate opportunities in a comparative fashion would lead us away from the focus of this investigation: that is, how diversionary PBC are most typically extracted by corporate controllers, and what corporate law should do about it.

The second instance of exclusionary misappropriation by the corporate controllers is the so-called '*insider trading*.'[95] As a matter of fact, by virtue of his being in charge of ultimate decision-making about the company management, the corporate controller has access to privileged information ahead of actual and potential non-

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91 Other commentators in Law and Economics analyze CG under this assumption. See, e.g., Klausner, M. [2004], *op. cit.*; and Kahan, M. and Rock, E.B. [2002], *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, in UNIVERSITY OF CHICAGO LAW REVIEW, vol. 69, 871-915. For earlier, but extremely topical, elaborations on this assumption, see Carney, W.J. [1988], *Controlling Management Opportunism in the Market for Corporate Control: An Agency Cost Model*, in WISCONSIN LAW REVIEW, vol. 1988, 385-433.

92 For a comprehensive analysis of this problem in the US, see Bebchuk, L.A. and Fried, J.M. [2004], PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION, Harvard University Press.

93 See Davies, P. [2002a], *op. cit.*, 183, for this distinction.

94 See, e.g., Bainbridge, S.M. [2002a], CORPORATION LAW AND ECONOMICS, Foundation Press, 321-334 (for the US); and Davies, P. [2002a], *op. cit.*, 183-191, (for the UK). But functionally equivalent doctrines are established in other legal systems. Kraakman *et al.* [2004], *The Anatomy*, cit., 116.

95 Bainbridge, S.M. [2000], *Insider Trading*, in B. Bouckaert and G. De Geest (eds.), ENCYCLOPEDIA OF LAW AND ECONOMICS, vol. V, No. 5650, 772-812.

controlling shareholders. Trading the company's stock on the basis of this information may lead to easy profits at the expenses of outside shareholders. However, whether this trading actually amounts to non-pro-rata distribution of the company's residual is debatable. After all, differently from other conflicted interested transactions, the aggregate amount of this residual (the shareholder value) is unaffected by insider trading – the corporate controller's profits are just determined by a timely exchange of the company's stock. According to traditional Corporate Law and Economics, this is sufficient to conclude that insider trading is just a matter of distribution of the firm value, having no efficiency consequences.[96] This view is apparently contradicted by subsequent theoretical analyses, and – in positive terms – by the fact that insider trading is prohibited in virtually any jurisdiction.[97] The matter is still very much debated, but the traditional argument against the prohibition of insider trading at least gives us a good reason to avoid embarking on such a debate here. Insider trading is neutral to the corporate wealth, even though it might be not neutral to the aggregated wealth of the company's investors. The two issues are of course related, but, in principle, the efficiency of the placement of company's stock with the investing public, and of its exchange thereafter, is dealt with by a different set of legal rules, namely securities regulation. Here I do not deal with non-pro-rata distributions affecting shareholder's wealth directly, but only with those which result in cash flow diversion from the company, *and then* from outside shareholders – which is mostly, albeit not only, a matter of corporate law.

In addition, non-pro-rata distributions may be implemented even more subtly by the corporate controller, without diverting any asset or cash flow from the company's property. What may suffice to achieve the same purpose is – in the recent wording of two commentators – "*diversion of claims*."[98] This diversion is typically implemented through some form of corporate restructuring: share issues, mergers or divisions, spin-offs, winding-up, and the like. The result is that the original ownership claim of non-controlling shareholder may be diluted through these restructurings, in favor of the corporate controller or of one related party of his, with nothing being formally diverted from the corporate assets, investment opportunities, or cash flow potential. At first glance, it might then seem wise to dismiss this problem from our inquiry based on the same argument that has been just made with reference to insider trading – claim diversion affects shareholders individually, not the company as a whole. But that would be a mistake. Virtually everywhere in the

96 Manne, H.G. [1966], INSIDER TRADING AND THE STOCK MARKET, Free Press.
97 See, e.g., Macey, J.R. [1991], INSIDER TRADING: ECONOMICS, POLITICS, AND POLICY, AEI Press.
98 Fox, M.B. and Heller, M.A. [2006], *op. cit.*, 16-18.

world, corporate restructuring is in fact a key part of corporate law, not of securities regulation. This is with good reason.

Corporate restructuring (or – in the typical Corporate Law and Economics terminology – "significant corporate actions") is first a matter of distribution of corporate powers.[99] Normally (albeit not always) it involves some modification of the corporate contract, if not its termination. We have just seen in the previous Chapter that, at least formally, corporate laws give shareholders much more authority in the field of charter amendments than in the ordinary management of the company's affairs; even though, in practice, the corporate controllers end up being vested with significant discretion also when it comes to these, so to say, 'extraordinary' affairs. That being said, conflicts of interests in this field must be put in context. On the one hand, they are comparable to those affecting related-party transactions in the ordinary course of business; the basic difference being that stealing may arise indirectly, from diversion of ownership claims instead of the assets over which ownership is established.[100] On the other hand, the conflicts of interest involved by corporate restructuring are much broader, and their exploitation by the corporate controller (i.e., actual diversion of claims) does not necessarily lead to stealing (i.e., actual diversion of assets).

One may recall from the foregoing illustration of the theory of corporate governance that differential treatment of controlling and non-controlling shareholders is a crucial issue for interpreting the role of PBC when ownership is separated from control.[101] Dilution is but a way to discriminate between the two categories of shareholders. As PBC can be either good or bad, also dilution may be not just a way to expropriate outside shareholder of the value of their investment (diversionary PBC), but also a way for the corporate controller to cash in the value of the idiosyncratic PBC that motivated his entrepreneurial investment at the outset. Takeovers are customarily implemented through some form of corporate restructuring. This may or may not involve looting through dilution of minority shareholders, which is equivalent to asset diversion and should therefore be policed not differently from self-dealing. But takeovers may also need to involve some dilution of the interest of non-controlling shareholders, in order to feature the adequate rewards for both the insurgent and (in the normal case of friendly takeovers) the

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[99] Kraakman *et al.* [2004], *The Anatomy*, cit., 131-133.

[100] Id., at 132.

[101] See Zingales, L. [2000], *In Search of New Foundations*, in JOURNAL OF FINANCE, vol. 55, 1640 (discussed *supra*, Chapter Five, sections 5.2.4 and 5.2.5).

incumbent controller.[102] It would make no sense to consider these two aspects of dilution separately. Their discussion is therefore postponed to the last two Chapters, where corporate control transactions will be analyzed. Corporate restructurings taking place in the absence of changes in control would deserve a special investigation and, therefore, they are left out of this discussion.[103]

8.2.2. False Positives and False Negatives in the Discipline of Related-Party Transactions

In order to protect shareholder ownership in the absence of control rights, corporate law should ideally feature a ban on non-pro-rata distributions. In practical terms, such a general prohibition – which, by the way, is present in every jurisdiction – would be useless in the absence of more detailed constraints on the corporate controller's discretion.[104] By reviewing the transactions involving the most severe conflicts of interest when it comes to non-pro-rata distributions I have identified the domain of these constraints, and chosen to focus on the most paradigmatic – and dangerous – example of transaction which may lead to expropriation of non-controlling shareholders: self-dealing or, more precisely, related-party transactions. In order to avoid circumvention, the definition of related-party transactions has to be as broad as possible. However, the broader the definition of potentially conflicted interested transactions, the higher the risk that the same transactions do not actually involve any non-pro-rata distribution, and constitute, rather, legitimate exercise of the managerial discretion which outside shareholders are willing to entrust to the corporate controller. Therefore, after having identified the operational domain of a legal policy against the extraction of diversionary PBC, one has to be extremely careful in setting the appropriate constraints on the corporate controller's behavior.

The Law and Economics approach features a standard paradigm for assessing the efficiency of constraints on human behavior, which may result in a socially undesirable outcome, but whose connection with the same outcome is ambiguous

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[102] For the most famous illustration of this mechanism, see Grossman, S.J. and Hart, O. [1980b], *Takeover Bids, the Free Rider Problem, and the Theory of the Corporation*, in BELL JOURNAL OF ECONOMICS, vol. 11, 42–69

[103] For a detailed analysis, in a comparative Law and Economics perspective, see Kraakman *et al.* [2004], *The Anatomy*, cit., 131-155.

[104] Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1661-1663; Kraakman *et al.* [2004], *The Anatomy*, cit., 101-130.

either *ex ante*, *ex post*, or – very often – in both situations.[105] Murder is a case in point. *Ex ante*, we may for instance observe that John, a policeman, carries a gun when he is off and goes to visit his friend Bob. *Ex post*, we will know that Bob was shot and he died. Let us assume that society wants murderers to be severely punished in order for murder to be deterred. We might be tempted to achieve this result by convicting John for a lifetime sentence, after having inferred from the above information that he intentionally murdered Bob. And it could seem even better to punish John *ex ante*, for carrying a gun when he is off duty, thinking that this would prevent the murder from occurring. However, any of the above solution would be regarded as a stretch, if not completely mistaken, in the light of the following, additional information, which for the moment we assume is real, but was not proven at the trial. Bob managed to call John during a fight with a thief who had broken into his house. Then John rushed to Bob's place to help, but he arrived just too late – Bob had been already killed and the thief had disappeared forever.

This very stylized example shows how ambiguous the behavior of people under suspicion can be with regard to the conduct that society wants to be banned. In the light of the last-mentioned circumstances, convicting John would amount to finding an innocent person guilty. This is conventionally known as 'Type I error' or 'false positive' – the proposition 'John is a murderer' is considered true while it is actually false. Of course, depending on how the ambiguity of John's behavior is dealt with, the reverse kind of error is also possible. In fact, nobody knows the real circumstances in which Bob was killed and, short of being 'real,' the above story about Bob's phone call might have been just invented by John to escape conviction. If courts believe any of John's stories at face value, the risk will be high that he is found innocent while being guilty. This would be a 'Type II error', or a 'false negative' – the proposition 'John is *not* a murderer' is considered true while it is actually false.[106]

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[105] The paradigm is known as Type I/Type II errors (or false positives/false negatives), and it is normally employed for the study of adjudication of the law (with special reference to the burden of proof). Cooter, R.D. and Ulen, T.S. [2004], LAW AND ECONOMICS, 4th edn., Addison-Wesley, 449-450; Posner, R.A. [2003], ECONOMIC ANALYSIS OF LAW, 6th edn., Aspen Publishers, 617-622. This is going to be illustrated with a standard example in the text.

[106] The Type I/Type II errors paradigm is derived from statistical inference. Assume that the goal is to test a certain hypothesis (e.g., that the accused is guilty). This implies rejecting the opposite hypothesis (that the accused is innocent), considered as the default state of nature, which is conventionally referred to as the 'null hypothesis.' A Type I error occurs when the null hypothesis is rejected when it is actually true – the test of the hypothesis of interest is falsely positive: an innocent person is convicted. A Type II error occurs when the null hypothesis is accepted when it is actually false – the test of the hypothesis of interest is falsely negative: a guilty person is acquitted. This treatment of errors was imported in Law and Economics for the analysis of mistaken adjudication of the law. See Pindyck, R.S. and Rubinfeld, D.L. [1976], ECONOMETRIC MODELS AND ECONOMIC

The Type I/Type II errors paradigm is perfectly suitable to the assessment of legal policing of related-party transactions. When the legal discipline of self-dealing is very strict, it will be relatively easy to infer non-pro-rata distribution (the socially undesirable outcome) from a related-party transaction (the ambiguous behavior). As a result, few non-pro-rata distributions may escape the legal policy against shareholder expropriation – i.e., there is a limited risk of false negatives – and it is fair to conclude that extraction of diversionary PBC would be highly deterred. The flip side of the coin is that corporate controllers might have to forego profitable investment opportunities featured by related-party transactions, for fear that he will be held liable for these transactions notwithstanding that they have neither diversionary purpose nor do they involve any non-pro-rata distribution.[107] In other words, a very strict policy against self-dealing leads to a high risk of false positives. Managerial discretion may be 'over-killed' and the maximization of overall shareholder value would be undermined consequently.[108] It goes without saying that a very lax policy against self-dealing would lead to just the opposite result. The corporate controller's ability to make profits through the exercise of managerial discretion would not suffer many restrictions in the face of conflicts of interest (little risk of false positives), but the risk will be high that he would divert those profit to himself instead of dividing them pro-rata with non-controlling shareholders (false negatives problem).

In policing self-dealing, there is no way to avoid the tradeoff between Type I and Type II errors. From an economic perspective, it is just possible to optimize this tradeoff.[109] Given the foregoing discussion of the theory of corporate governance, the optimization criterion should be shareholder value. It makes little sense to constrain the corporate controller's ability to enter into related-party transactions, when the potential gains of these transactions to shareholders as a group exceed the expected value of diversion. But it would be equally inefficient to allow related-party transactions when the potential benefits to the corporation are more than offset by the non-pro-rata distributions involved. Finding the right balance between managerial discretion and the constraints against non-pro-rata distribution is the crucial question of a legal discipline of self-dealing.

FORECASTS, McGraw-Hill. It was subsequently extended to the study of fiduciary duties by Cooter, R.D. and Freedman, B.J. [1991], *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, in NEW YORK UNIVERSITY LAW REVIEW, vol. 66, 1045-1075. For the application of the same paradigm to self-dealing by corporate directors see Enriques, L. [2000], *op. cit.*

107 Kraakman *et al.* [2004], *The Anatomy*, cit., 101-102.

108 Enriques, L. [2000], *op. cit.*

109 Easterbrook, F.H. and Fischel, D.R. [1991], *op. cit.,* 103-105.

In a broader perspective, this is a part of the more general *discretion-accountability tradeoff* that characterizes the problem of corporate governance, and probably the part where legal rules and their enforcement are mostly relevant.[110] However, the advantage of the approach being followed here is that the issue of shareholder expropriation isseparated, at least conceptually, from that of the firm governance. On the one hand, this allows decision-making powers to be allocated independently of the protection of non-controlling shareholders, in such a way as to feature both entrepreneurial discretion and its prospective reward notwithstanding separation of ownership and control. On the other hand, a precondition for control rights to be allocated to an entrepreneur in the absence of full ownership is that these rights do not include the power to expropriate non-non-controlling shareholder of their part of the residual claim on the corporate assets and cash flow. The problem of Type I and Type II errors in policing self-dealing should be then managed in such a way by corporate law as to make credible the corporate controller's commitment that he will not abuse his powers to violate the pro-rata principle of distribution to shareholders. However, this policy should also be devised in such a way as to minimize interference with the exercise of the corporate controller's discretion.[111]

8.2.3. Three Elements of a Legal Strategy towards Related-Party Transactions

There are several possible techniques to discipline related-party transactions. Perhaps the most intuitive one is to prohibit them outright. It should be evident from the foregoing discussion that this is not a practicable solution. Related-party transactions are not just evil. Their prohibition would lead to an enormous risk of false positives in the policing of non-pro-rata distributions. To be sure, this would not even suffice to avoid the risk of false negatives.[112] One should neither underestimate the fantasy of corporate controllers (and of their legal counsels) in devising related-party transactions in the face of their formal prohibition, nor overestimate the limited amount of resources that both shareholders and public authorities may efficiently commit to the enforcement of this prohibition. Therefore, modern corporate laws do no longer include sweeping prohibitions of related-party transactions and contain, at the very most, just selective prohibitions.[113] Normally, the transactions at issue tend to be both relatively easy to detect and to feature little risk of profitable business being foregone because of their prohibition. The typical ex-

[110] Bainbridge, S.M. [2002a], *op. cit.*, 306-308.
[111] Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1653-1663.
[112] Kraakman *et al.* [2004], *The Anatomy*, cit., 102; Enriques, L. [2000], *op. cit.*
[113] Enriques, L. [2000], *op. cit.*

ample is credit transactions between the company and one or more of its directors, which are prohibited *per se* in a number of jurisdictions.[114] Indeed, even in that restricted domain, whether outright prohibition of self-dealing is an efficient solution may be questioned.[115] It is probably for this reason that the relevance of prohibitions of such a kind in positive corporate law is absolutely negligible.

Regulation of related-party transactions in corporate governance is simply a more complicated matter. In the next few pages, I am going to describe in purely functional terms the solutions that may be featured by corporate law to cope with it. In the next Chapter, the options of legal intervention will be compared with the policies actually implemented in the five jurisdictions of our sample: the US, the UK, Sweden, Italy, and the Netherlands. In the end, we will be able to assess the efficiency of each policy based on the theoretical framework developed thus far.

The reader may recall from Chapter Four that the functional terms of a legal policy against diversionary PBC have been nicely illustrated by Ronald Gilson.[116] Basically, three requirements must be fulfilled for the same policy to have some bite. First, a *substantive standard* must be specified in order to assess whether conflicted interest transactions actually feature non-pro-rata distributions. Even if that standard were set in such a way as to catch all transactions involving non-pro-rata distributions, and only those ones, effectiveness of legal constraints on expropriation of non-controlling shareholders would still require two additional features. On the one hand, "those with the power to enforce the standards [need to] know of violations."[117] This implies that also *disclosure* of conflicted interest transactions, which are subject to the substantive standard, should be featured. On the other hand, both the disclosure requirements and the substantive standard should be enforced. An effective *enforcement process* is then another essential requirement of a discipline of related-party transactions.

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[114] See Kraakman *et al.* [2004], *The Anatomy*, cit., 111-114. After the Enron debacle, US securities law also features such a prohibition (§ 402 of the Sarbanes-Oxley Act of 2002). So do all the other jurisdictions in our five-country sample, with the exception of Italy. See Organization for Economic Cooperation and Development [2006], *Corporate Governance and Company Law Database*, The OECD's Directorate for Financial and Enterprise Affairs and The Stockholm Centre of Commercial Law (hereinafter OECD [2006], *Database*), available at http://oecd.eddy.se – restricted access, on file with author (last accessed May 1, 2007). The Italian Civil Code (ICC) used to prohibit company loans to directors before the 2004 reform of corporate law (art. 2624 ICC), but now this transaction is subject to the general discipline of self-dealing (the prohibition only remains in place for banks, per art. 136 Legislative Decree No. 385/1993).

[115] Enriques, L. [2000], *op. cit.*

[116] Gilson, R.J. [2006], *op. cit.*, 1653.

[117] *Ibidem.*

A rather common mistake in the analysis of the legal discipline of self-dealing is to consider just the strength of the above factors as the end of story.[118] However, this would tell us, at most, about the *effectiveness* of legal constraints against non-pro-rata distributions.[119] Even though we all would like corporate governance not to feature any kind of asset or cash flow diversion, this should not come at the expenses of *efficiency* of constraints on self-dealing. Therefore, the quality of each requirement of an effective regulation of conflicted interest transactions must be ultimately assessed on the basis of the Type I and Type II errors which they may lead to, depending on how they are implemented by the legal system.[120] Efficiency requires that, at the margin, expected harm to shareholder depending on profitable business being foregone (false positive) be equal to the expected harm depending on additional diversion being allowed (false negative). In this perspective, I am going to analyze each of the three functional requirements of a legal discipline of conflicted interest transaction. One should bear in mind that all these requirements in fact form a system within each jurisdictional and institutional context, and therefore it is quite a stretch to consider them separately. However, the comparative-functional approach being followed in this inquiry leaves us with no alternative. The important synergies between the three requirements in question will come to light in the country-by-country analysis of the next Chapter.

That being said, I shall start from disclosure. An optimal substantive standard, even when it is backed by an efficient enforcement process, would have no possibility of being implemented in the absence of "knowledge of violations."[121]

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[118] See, most prominently, Djankov, S., La Porta, R., Lopez-de-Silanes, F. and Shleifer, A. [2006], *The Law and Economics of Self-Dealing* (November 13, 2006), Working Paper, Harvard School of Economics, available at www.economics.harvard.edu /faculty/shleifer/papers, forthcoming in JOURNAL OF FINANCIAL ECONOMICS, 2008 (discussed *infra*, Chapter Nine, section 9.4.1).

[119] Legal commentators sometimes focus of this aspect of law enforcement, as opposed to the efficiency criterion in Law and Economics. See van Boom, W.H. [2006], *Efficacious enforcement in contract and tort*, Inaugural Lecture, Erasmus University Rotterdam, available at www.eur.nl.

[120] This is exactly how comparative legal inquiries are undertaken by Law and Economics scholars, as opposed to the narrower attitude of economists. See, e.g., Kraakman *et al.* [2004], *The Anatomy*, cit., 109; Enriques, L. [2000], *op. cit.*

[121] Gilson, R.J. [2006], *op. cit.*, 1653

8.3. Showing Conflicts of Interest: Disclosure

8.3.1. Corporate Law and Securities Regulation at a Meeting Point

The debate in the aftermath of the Great Depression in the US made famous Justice Brandeis' advocacy of the disclosure strategy: "Sunlight is the best disinfectant; electric light is the best policeman."[122] To be sure, both the importance and the regulatory implications of disclosure by publicly held companies are not confined in the domain of conflicted interest transactions. This is just too a big issue to be discussed here. Apparently, it mostly concerns the placement of securities – including stock – with the investors, and their trading afterwards. Both require information about the company management to be disclosed before that stock can be knowledgeably purchased on either the primary or the secondary market.[123] On that basis, disclosure is arguably a matter of securities regulation and not of corporate law.[124]

However, when it comes to disclosure of conflicts of interest, the distinction between securities regulation and corporate law is not as clear-cut as in other fields of the legal discipline of corporate governance.[125] From a Law and Economics perspective, the main goal of securities regulation is having stock (and other corporate securities) priced efficiently. Intuitively, this requires that reliable information about the corporate assets, their management, and related profit opportunities be adequately disseminated in the market, for it to be impounded in stock prices.[126] What mechanism of dissemination should be considered 'adequate' for purposes of either efficiency, fairness, or both, is perhaps the most debated issue between financial economists and legal scholars, very often even within their own group. This is exactly the kind of debate that I am not going to address here.[127]

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[122] Brandeis, L.D. [1914], OTHER PEOPLE'S MONEY, AND HOW THE BANKERS USE IT, Stokes, 92.

[123] For a very interesting discussion of the economic rationale of the disclosure strategy in securities regulation, see Paredes, T.A. [2003], *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, in WASHINGTON UNIVERSITY LAW QUARTERLY, vol. 81, 421-431.

[124] For a summary of the mandatory disclosure regime that forms the core of US securities regulation, see Loss, L. and Seligman, J. [2000], FUNDAMENTALS OF SECURITIES REGULATION, 4th edn., Aspen Publishers, 25-37.

[125] Kraakman *et al.* [2004], *The Anatomy*, cit., 193-194.

[126] Still, the best illustration of this mechanism is in Gilson, R.J. and Kraakman, R.H. [1984], *The Mechanisms of Market Efficiency*, in VIRGINIA LAW REVIEW, vol. 70, 549-644.

[127] This parallels the long-standing debate on mandatory disclosure, which is not yet settled in Law and Economics, although it appears to be no longer an issue for policymakers. Kraakman *et al.* [2004], *The Anatomy*, cit., 207 ("Indeed, investor protection is the area of corporate law with the greatest division of opinion among legal scholars, even though, paradoxically, it is also an area with

Corporate law has in fact a different set of goals. The one we are considering here is setting efficient constraints to the corporate controller's ability to expropriate non-controlling shareholders. Disclosure of conflicts of interest, which is required to this purpose, is also necessary for stock prices to be determined accurately.[128] It is for that reason that such a disclosure is relevant in both corporate law and securities regulation.[129] However, the kind of reaction that corporate law expects from outside investors, when they are confronted with disclosure of conflicted interest transactions, is significantly different from that expected by securities regulation. From a corporate law perspective, non-controlling shareholders are expected to check, directly or indirectly, conflicted transactions in order to prevent or punish non-pro-rata distributions.[130] From the perspective of securities regulation, investors are expected to decide whether to buy or sell corporate stock depending on the risk that they will be expropriated by the corporate controller.[131] In terms of business organization theory, the latter reaction can be characterized as an 'exit' strategy, whereas the former involves a more proactive role, and then the exercise of 'voice.'[132]

Especially in the field of related-party transactions, these two strategies are clearly complementary. Investors' willingness to pay for corporate stock will not just depend on their knowledge of conflicted interest transactions (a matter for securities regulation), but even more so on the likelihood that they do not result in non-pro-rata distributions (a question of corporate law). Shareholders' ability to deter non-pro-rata distributions will in turn depend not just on the mechanisms (including disclosure), which are formally in place for the scrutiny of conflicted interest transactions (corporate law), but also on a broader knowledge of how these mechanisms are implemented in the actual governance of the company (securities

great similarity of legal regimes across jurisdictions"). See, in particular: Romano, R. [1998], *Empowering Investors: A Market Approach to Securities Regulation*, in YALE LAW JOURNAL, vol. 107, 2359-2430; Fox, M.B. [1999], *Retaining Mandatory Securities Disclosure: Why Issuer Choice is not Investor Empowerment*, in VIRGINIA LAW REVIEW, vol. 85, 1335-1419; Romano, R. [2001b], *The Need for Competition in International Securities Regulation*, in THEORETICAL INQUIRIES IN LAW, vol. 2, n. 2, *Protecting Investors in a Global Economy*; Fox, M.B. [2001], *The Issuer Choice Debate*, in THEORETICAL INQUIRIES IN LAW, vol. 2, n. 2, *Protecting Investors in a Global Economy.*

128 Mahoney, P.G. [1995], *Mandatory Disclosure as a Solution to Agency Problems*, in UNIVERSITY OF CHICAGO LAW REVIEW, vol. 62, 1047-1112.

129 Apparently, however, the materiality requirements seem to give more importance to "deterring illicit self-dealing" than to "informing securities prices". Kraakman *et al.* [2004], *The Anatomy*, cit., 195-196.

130 Id., at 101-130.

131 Id., at 193-214.

132 Hirschman, A.O. [1970], EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES, Harvard University Press.

regulation). Therefore, in order for a policy against non-pro-rata distributions to be effective, corporate law and securities regulation need to rely upon each other.[133] This would achieve simultaneously the goal of efficient pricing of corporate stock and of efficient raising of equity funds from non-controlling shareholders, provided that efficient constraints are set forth on the corporate controller's ability to divert resources from the company and that outside investors are timely and reliably informed about the quality of these constraints.[134] In the light of the previous discussion of distribution of powers, and of the consequent ability of the corporate controllers to opportunistically alter the terms of the corporate contract, it goes almost without saying that both corporate law and securities regulation should be mandatory as to the disclosure and discipline of related-party transactions.

8.3.2. *Ex Ante* and *Ex Post* Disclosure

Mandatory disclosure of conflicts of interest can be established both before and after related-party transactions are entered into. In both cases, the precise nature and the extent of the conflicts should be disclosed, together with how the conflicts are being handled, in order for the diversionary potential of the transaction to be knowledgeably assessed. It could seem then that this disclosure is only useful when it takes place *ex ante*.[135] After all, non-controlling shareholders may be regarded as helpless when they know of the risk of asset diversion only after the suspected transaction has been concluded – which could imply that their money are already gone. This is not entirely true.

To start with, *ex post* disclosure is always useful as a complement of *ex ante* disclosure. As we are about to see, some non-pro-rata distributions will always escape the substantive discipline of conflicted interest transaction or its enforcement.[136] Then there are two possibilities. If the terms of the transaction are fully disclosed *ex post*, shareholders as a group may have the chance to have it scrutinized later and, should any non-pro-rata distribution be uncovered, this would be offset by damage compensation to the company.[137] If, as it is more likely to be the case, disclosure is either incomplete or misleading, shareholders as individual investors may have the chance to recover damages when it turns out that they bought the stock at inflated

[133] Black, B.S. [2001], *op. cit.*
[134] See, respectively, Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, and Rock, E.B. [2002], *op. cit.*
[135] Djankov, S., La Porta, R., Lopez-de-Silanes, F. and Shleifer, A. [2006], *op. cit.*
[136] See *infra*, sections 8.4 and 8.5.
[137] For how this applies to *corporate* litigation, see Kraakman *et al.* [2004], *The Anatomy*, cit., 114-118.

prices.[138] Of course, the likelihood of each of these scenarios depends on how shareholders' rights can be enforced under both corporate law and securities regulation.[139] But, provided that an efficient enforcement process is in place, *ex post* disclosure of conflicts of interest will increase deterrence of non-pro-rata distributions.

The above argument can be easily extended to the case in which only *ex post* disclosure is available. Under certain conditions, *ex post* disclosure can even work as a substitute of *ex ante* disclosure. The conditions under which *ex post* disclosure can suffice for an efficient policing of non-pro-rata distributions are determined by the corporate jurisdiction's choices as to the enforcement process. Relying just on *ex post* disclosure basically implies that extraction of diversionary PBC by the corporate controller must be policed just by means of deterrence of harmful behavior, with little – if any – prevention of the wrongful conduct.[140] The implications of this choice will be discussed in more detail with other issues regarding enforcement. But it is important to bear in mind that also *ex post* disclosure of conflicted interest transactions may fulfill the requirements of an effective policing of self-dealing.

8.3.3. False Positives and False Negatives of Mandatory Disclosure

It could seem that mandatory disclosure of conflicts of interests and of how they are handled by the corporate controller involves little risk of false positives, whereas it is normally the case that too lax disclosure requirements would lead to high frequency of false negatives. This kind of reasoning underlies the view that more disclosure is always better for society. Such a view is generally incorrect,[141] and it turns out to be even more misguided in the case of conflicted interested transactions. Disclosure is in fact costly for both the originator and the recipient of information.[142] To be sure, the costs to the originator (the company) may seem little thing compared to the risk of asset diversion. But this overlooks a number of important factors.

On the one hand, too burdensome disclosure requirements may prevent the corporate controller from entering related-party transactions also in the absence of

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[138] For how this applies to *securities* litigation, see Id., at 210-212.

[139] This is exactly the point where jurisdictions apparently exhibit most important differences. See Kraakman *et al.* [2004], *The Anatomy*, cit., 128-130; 212-214. For a brilliant comparison of Germany with the US, see Baums, T. and Scott, K.E. [2005], *Taking Shareholder Protection Seriously? Corporate Governance in the U.S. and Germany*, in AMERICAN JOURNAL OF COMPARATIVE LAW, vol. 53, 31-76.

[140] Shavell, S. [1993], *The Optimal Structure of Law Enforcement*, in JOURNAL OF LAW AND ECONOMICS, vol. 36, 255-287.

[141] Easterbrook, F.H. and Fischel, D.R. [1991], *op. cit.,* 276-314.

[142] Romano R. [1998], *op. cit.*

non-pro-rata implications. For instance, having to notify outside shareholders individually of any conflict of interest may undermine the exploitation of synergies through intra-group transactions, at least to the extent that the costs of disclosure exceeds the gains at stake.[143] On the other hand, depending on how the related issues of standard setting and enforcement are dealt with by the legal system, corporate disclosures may increase as such the exposure of the corporate controller, and of the company management, to the risk of legal liability, market sanctions, and shaming.[144] This is apparently desirable for enhancing deterrence of tunneling. This perspective, however, overlooks the tendency of the investing public, and of market players acting on its behalf, to infer non-pro-rata distributions from the knowledge of just a potential conflict of interest.[145] Not differently from the example of Bob's murder, this may be too a hasty conclusion, which may suffice nonetheless to deter related-party transactions that would ultimately benefit non-controlling shareholders. This is enough to conclude that disclosure requirements may also lead to Type I errors.

One final reason why more disclosure is not always better disclosure is that its recipients need to understand it properly.[146] More information about the corporate controller's conflict of interest does not necessarily imply a closer scrutiny of conflicted interest transactions. Investors are rationally apathetic not only as far as participating in the company management is concerned, but also when it comes to self-help. The difference from the management of corporate affairs is that investors seem to be as reluctant to interfere with the judgment of business strategies, as eager to prevent corporate controllers from absconding with their money. However, it is not worthwhile to process a huge load of information about the corporate controller's conflicts of interest, and to acquire the expertise to do it knowledgeably, in order to protect a few thousand Euros of investment. For disclosure to be of any use, it has to be tailored to the needs, skills, and incentives of those who are supposed to scrutinize conflicted interested transactions on the basis of the disclosed information. Then individual, non-controlling shareholders cannot be reasonably expected to perform any thorough scrutiny on their own. Information is quite likely

143 Notice, however, that this argument only applies at the margin (i.e., it does not hold when a comprehensive system of mandatory disclosure is already in place for different purposes). Kraakman *et al.* [2004], *The Anatomy*, cit., 105.

144 See, e.g., Romano, R. [1991], *The Shareholder Suit: Litigation without Foundation?*, in JOURNAL OF LAW, ECONOMICS, AND ORGANIZATION, vol. 7, 55-87; Langevoort, D.C. [2001], *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, in GEORGETOWN LAW JOURNAL, vol. 89, 797-832.

145 Zingales, L. [2005], *The Importance of Bad News*, in G. Owen, T. Kirchmaier and J. Grant (eds.), CORPORATE GOVERNANCE IN THE US AND EUROPE, Macmillan, 96-100.

146 Paredes, T.A. [2003], *op. cit.*

to be both too much and too little to this purpose. The amount of information *disclosed* may be too much, compared to what the typical investor can and will rationally handle. The amount of information actually *processed* may be too little, compared to what is needed to ascertain the diversionary potential of suspected transactions.

Disclosure requirements should be then more concerned with the recipients of information than with its overall amount. Knowledgeable assessment of conflicted interest transactions requires a professional expertise which individual investors cannot be given credit for. In order for disclosure to achieve the goal that "those with the power to enforce the standards know of violations,"[147] some form of professional intermediation is required. That is to say, monitoring of the corporate controller's conflicts of interest cannot be undertaken by non-controlling shareholders individually, but must be in fact *delegated monitoring*.[148]

On the one hand, this implies that information required by disclosure regulation has to be selected to fit the delegated monitors' needs, and not shareholders'. On the other hand, this brings into the framework a specific agency problem: who monitors the monitor? Differently from the corporate controllers, delegated monitors (like, e.g., institutional investors, independent directors, and – under certain circumstances – corporate lawyers) can be plainly considered as shareholder agents, since they are not supposed to play any entrepreneurial role in corporate governance.[149] The welfare assessment of disclosure requirements must then be confronted with a further complication. Provided that information formally addressed to shareholders is ultimately filtered by delegated monitors, misalignment of their incentives with the shareholder interest may lead either to false positives or to false negatives in the policing of related-party transactions. Whether Type I or Type II errors are more likely to occur will not just depend on what information the corporate controller is compelled to disclose, and to whom, but also on the contents of delegated monitoring and the set of incentives underlying its implementation. The former is defined by the substantive standard for reviewing conflicted interest transactions, whereas the latter depends on the enforcement process.

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[147] Gilson, R.J. [2006], *op. cit.*, 1653.

[148] Paredes, T.A. [2004], *op. cit.*, 1085-1101.

[149] See, for a similar approach, Zingales, L. [2006], *The Costs and Benefits of Financial Market Regulation*, ECGI Law Working Paper No. 21/2004, available at www.ssrn.com and www.ecgi.org.

8.4. Taming Conflicts of Interest: Standards

8.4.1. Why Related-Party Transactions Cannot Be Simply 'At Arm's Length'

At first glance, setting a standard for the assessment of the diversionary potential of self-dealing may seem as easy as prohibiting non-pro-rata distributions. In order for conflicted interest transactions to respect the Eight Commandment ("Thou shalt not steal"), it would be sufficient that they are entered into in terms which are comparable to those of an ordinary market transaction with a third party, unrelated to the interests of the corporate controller. This benchmark is customarily referred to as "arm's length transaction" – a typical English expression to depict a transaction between perfect strangers. The arm's length requirement is often invoked for assessing the merits of a conflicted interest transaction by students of corporate governance, on both the economic and the legal side.[150] It might be unfortunate, but the fact is that determining whether a conflicted interested transaction is (or was) in fact concluded at arm's length is virtually impossible. Our reconstruction of the theory of corporate governance helps to explain why.

The difficulty with related-party transactions is that allegedly they may have plenty of business purpose, other than the extraction of diversionary PBC.[151] But what may the business purpose be of transactions with, say, a subsidiary, a special purpose entity, a partnership, or simply a natural person in whose wealth the corporate controller happens to be significantly interested?[152] In the neoclassical theory of perfect competition, all markets are characterized by homogeneous goods, so that there is apparently no reason why any corporate transaction should not be concluded at arm's length. Basically, the model of perfect competition also does not feature entrepreneurship for this reason – entrepreneurs are supposed to be also homogeneous! However, there is no more homogeneity than perfect competition in the real world. The reason why, so often, neither the model of perfect competition nor the assumption upon which it is built hold is that we live in a world of uncertainty. In modern economic theory, uncertainty brings two fundamental challenges to the neoclassical model. The first is that the identity of entrepreneurs matters, in

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[150] See, respectively, Djankov, S., La Porta, R., Lopez-de-Silanes, F. and Shleifer, A. [2006], *op. cit.*; and Kraakman *et al.* [2004], *The Anatomy*, cit., 102.

[151] McCahery, J.A. and Vermueulen, P.M. [2005], *Corporate Governance Crises and Related Party Transactions: A Post-Parmalat Agenda*, in K.J. Hopt, E. Wymeersch, H. Kanda, and H. Baum, CORPORATE GOVERNANCE IN CONTEXT: CORPORATIONS, STATES, AND MARKETS IN EUROPE, JAPAN, AND THE US, Oxford University Press, 228-230.

[152] Fox, M.B. and Heller, M.A. [2006], *op. cit.*, 16-20.

that each of them is willing to establish and manage a certain firm just in order to tackle uncertainty.[153] The second is that the firm itself is not to be regarded as a standard profit-maximizing 'black box,' but rather as a rather unique web of relationships designed in such a way as to cope with uncertainty.[154] These two insights are very seldom brought together, but the reader may recall that one of the goals of the present inquiry is exactly to merge them with each other in a more comprehensive theory of corporate governance.[155]

The bottom line is that non-homogeneous entrepreneurs are also the designers of a web of non-homogeneous relationships, and such a design lies at the core of their making decisions under conditions of uncertainty – that is, of entrepreneurial discretion. Relationships differ from arm's length transactions in that they involve some degree of idiosyncrasy (i.e., the parties' identity is not a matter of indifference). Idiosyncrasy of transactions inside the firm is of course higher than that of transactions outside the firm. However, the underlying rationale is the same in both cases: relationships may reduce exposure of the parties' investments to uncertainty.[156] The consequence is twofold. On the one hand, the merits of idiosyncrasy in market relationships bear no more second-guessing than the basic choice as to 'make-or-buy.'[157] On the other hand, the terms of transaction within idiosyncratic relationships cannot be possibly compared with those of any transaction between perfect strangers, since arm's length is by definition incompatible with idiosyncrasy.[158] There is no reason to consider related-party transactions as separated from the idiosyncratic relationship they may be part of, for there lays the only legitimate business purpose that they may have in corporate governance.[159]

In this perspective, any attempt to determine whether a related-party transaction was actually concluded at arm's length would be quite a stretch. But it would be even worse to allow for a judgment whether it was worthwhile for the company to enter into a certain transaction with a corporate controller's related party *instead* of at arm's length.[160] In fact, both kinds of assessments are made *ex post*, when most consequences of the transaction are known, and they amount to a review of a decision that was taken *ex ante*, when the same consequences were uncertain. In other

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153 Knight, F.H. [1921], RISK, UNCERTAINTY, AND PROFIT, Houghton Mifflin.

154 Coase, R.H. [1937], *The Nature of the Firm*, in ECONOMICA, vol. 4 (New Series), 386-405.

155 See *supra*, Chapter One, section 1.4.5.

156 Klein, B., Crawford, R.G. and Alchian, A.A. [1978], *Vertical Integration, Appropriable Rents and the Competitive Contracting Process*, in JOURNAL OF LAW AND ECONOMICS, vol. 21, 297–326.

157 Williamson, O.E. [1991], *Comparative Economic Organization: The Analysis of Discrete Structural Alternatives*, in ADMINISTRATIVE SCIENCE QUARTERLY, vol. 36, 269-296.

158 See, at least suggestively, Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1647-1653.

159 Bainbridge, S.M. [2002a], *op. cit.*, 315-320.

160 Easterbrook, F.H. and Fischel, D.R. [1991], *op. cit.*, 103-105.

words, both judgments are made with hindsight bias, which deny any virtue to idiosyncrasy as long as it turns out to underperform ordinary market transactions. It goes without saying that, if such a review were allowed, no corporate controller would dare to take decisions under uncertainty, provided that he would have to share their profits with outside shareholders while bearing all of the losses they may involve.[161] The presence of a conflict of interest is no sufficient reason to dismiss this argument. It only suggests that it should be handled with particular care.[162]

Entering into a related-party transaction is a part of the managerial discretion the corporate controller is featured with. In principle, this implies that the merits of the transaction cannot be reviewed under any substantive standard – there is no benchmark that qualifies. However, we definitely want the diversionary potential of the transaction to be assessed under a substantive standard – where the benchmark does exist, and it is respect of the Eight Commandment. The only possible way out of this bind is to set prohibition of non-pro-rata distributions as a substantive standard governing the corporate controller's *conduct*, but to have related-party transactions *reviewed* under a non-substantive standard. Given that these transactions are challenged only when they turn out to be unprofitable, a substantive review of the underlying conflict of interest would allow for a very high risk of Type I errors due to unavoidable second-guessing of entrepreneurial judgment with hindsight bias.[163] This is the reason why the standard of review of related-party transactions should disregard the merits of the decision, and just have regard to its process.

8.4.2 Fiduciary Duties and Judicial Abstention from Business Judgment

a) Standards of Conduct and Standards of Review

The distinction between standards of conduct and standards of review has a long-standing tradition in the legal studies of corporate governance. A standard of conduct "states how an actor should conduct a given activity or play a given role."[164] A standard of review "states the test a court should apply when it reviews an actor's conduct" to determine whether he complied with the standard of conduct.[165] According to Professor Eisenberg, one fundamental feature of corporate

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[161] Eisenberg, M.A. [1989b], *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, in FORDHAM LAW REVIEW, vol. 62, 437-468.
[162] Bainbridge, S.M. [2002a], *op. cit.*, 306-307.
[163] Unfortunately, the flip side of the coin is that the absence of judicial review of situations involving a conflict of interest may easily lead to Type II errors. See Paredes, T.A. [2004], *op. cit.*, 1083-1085.
[164] Eisenberg, M.A. [1989b], *op. cit.*, 437.
[165] *Ibidem.*

law is that "standards of conduct pervasively diverge from standards of review."[166] The reason – as he also argues – is uncertainty, and its consequences in terms of institutional design, which may involve deference to a corporate organ inasmuch as it is in charge of deciding in conditions of uncertainty. As a result, the standards on whose basis liability is imposed on corporate directors differ from those upon which, for instance, doctors or lawyers are held liable of malpractice or, more generally, an agent is considered to have breached the fiduciary duties he owes to his principal.[167]

Apparently, the standards of conduct governing all of these actors' behaviors look very similar. In fact they are all categorized under the same heading: *fiduciary duties*. Both corporate and non-corporate actors are basically expected to abide by a duty of loyalty and a duty of care in conducting business with their counterparties. In the general case, which may be characterized as a principal-agent relationship, the standard of review is whether actors were actually disloyal or negligent. Corporate directors, however, are held liable on a different basis. What matters is not whether their conduct was *actually* negligent or disloyal, but whether a breach of duties of care or loyalty can be *inferred* from non-compliance with different standards of review.[168] The standards in question mostly concern the very process of decision-making, and not its contents or the actions they result in.

Many students of legal theory are puzzled by this peculiarity of corporate law.[169] From a Law and Economics perspective, or at least from that being followed in this work, this may seem somewhat less puzzling, provided that corporate controllers (and so directors, whenever they act in this capacity) are not considered to be agents, either of shareholders or of anybody else. Although in corporate law the divergence of standard of conduct and standard of review has a much broader scope of application than just related-party transactions,[170] it is worth discussing it in some detail, for it explains how the problem of false positives and false negatives is dealt with in the scrutiny of the corporate controller's decision-making.

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166 Id., at 438.

167 Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1665-1666.

168 Eisenberg, M.A. [1989b], *op. cit.*, 439-445.

169 See, e.g., Eisenberg, M.A. [1997], *The Director's Duty of Care in Negotiated Dispositions*, 51 in UNIVERSITY OF MIAMI LAW REVIEW, vol. 51, 579-604; Manning, B. [1984], *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, in BUSINESS LAWYER, vol. 39, 1477-1501; Gevurtz, F.A. [1994], *The Business Judgment Rule: Meaningless Verbiage or Misguided Notion?*, in SOUTHERN CALIFORNIA LAW REVIEW, vol. 67, 287–337; Arkes, H.R. and Schipani, C.A. [1994], *Medical Malpractice v. the Business Judgment Rule: Differences in Hindsight Bias*, in OREGON LAW REVIEW, vol. 73, 587-638.

170 Eisenberg, M.A. [1989b], *op. cit.*

b) The Business Judgment Rule

Let us start from the risk of false positives. Although the problem is similar when the duty of loyalty is in question, this is best understood with reference to the duty of care. Non-controlling shareholders of course want the corporate controllers to take care in managing the corporate affairs. In the economist's jargon, they want him to put effort in it, and not to shirk.[171] Yet, at the same time, non-controlling shareholders – no matter of how large and committed they are – are unable not only to observe managerial effort, but also to infer effort from the quality of management.[172] On the one hand, shareholders are not entrepreneurs; neither do they wish to act as they were. On the other hand, every business decision is rather unique. At the end of the day, what determines one entrepreneur's success is his ability to identify business opportunities which no other entrepreneur would have bet a dime on. This is indeed a crucial point, which makes the difference from a standard principal-agent setting.[173] People can hardly observe their lawyers' or doctors' effort, but that can be verified *ex post* with reference to an objective standard of conduct. The ultimate reason why it makes sense to put lawyers or doctors under a duty of care is that negligence may be assessed with reference to how another lawyer or doctor would have acted under a similar set of circumstances. This is also the reason why it makes almost no sense to review the entrepreneur's behavior in the same fashion.[174] Other entrepreneurs' behaving differently in similar circumstances tells us very little about one entrepreneur's diligence. In fact, this is in the very nature of entrepreneurship.

Nearly every business decision may look negligent, or incompetent, in hindsight when it turns out badly.[175] Other entrepreneurs will easily claim that they would have never gone for it. Yet, in a different state of the world, they would as easily regret they did not have that idea first. The same decision would have been regarded as very clever if it turned out to be profitable. One might claim that negligence must not be assessed *ex post*, but *ex ante*, on the basis of probability calculus; and this is actually how fault liability is analyzed in Law and Economics.[176] How-

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[171] Roe, M.J. [2004b], *op. cit.*

[172] Black, B.S. [2001], *op. cit.*, 784. Judges are even more ill-equipped. Roe, M.J. [2002], *op. cit.*, 242-243.

[173] Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1653-1660.

[174] See Barca, F. [1998], *Some Views on U.S. Corporate Governance*, in COLUMBIA BUSINESS LAW REVIEW, vol. 1998, 4-13, for a similar approach.

[175] This problem is known as hindsight bias. Eisenberg, M.A. [1997], *op. cit.*, 585. Hindsight bias equally affects the review of other professional decision-making. Gevurtz, F.A. [1994], *op. cit.*, 287–337; Arkes, H.R. and Schipani, C.A. [1994], *op. cit.,* 601. For the key difference between entrepreneurial and other professional judgments, see *infra* in the text.

[176] Cooter, R.D. and Ulen, T.S. [2004], *op. cit.*, 307-347.

ever, entrepreneurs do not deal with risk, but with uncertainty, whose outcomes can hardly be predicted – let alone assigned a probability – before they materialize.[177] In essence, reviewing entrepreneur's choice under a negligence standard is a category mistake that tends to generate false positives. Unsuccessful entrepreneurs may be too easily considered as negligent, no matter of how much effort they put in the management of the company.[178]

Intelligent judges understand pretty well this story.[179] They know that shareholders will only complain about business judgment in hindsight, while being unwilling to interfere with it at the outset. Giving them an easy case in finding the corporate controller liable would result in the following game: Heads – we all win; nails – the corporate controller loses. That is why judges tend to show so much deference to decisions taken by the company management. It is not just – as it is argued sometimes – that they acknowledge their being incompetent in second-guessing business judgment.[180] After all, judges cannot be expected to be any more competent in reviewing a doctor's practice.[181] The reason is rather that, differently from the case of the doctor's or of any other agent's judgment, business judgment allows for no *ex post* revision that would make sense also *ex ante*.[182] While both doctors and patients would agree on doctor's care being reviewed under some negligence standard, there is no such revision that shareholders and a corporate controller would ever settle for at the outset.[183] In corporate law, this results in a principle of judicial abstention from reviewing managerial decisions, which is often referred to as 'business judgment rule.' Although this is a doctrine of American judge-made law, similar principles are present under different headings and with different modes of implementation in virtually every jurisdiction. This is unsurprising, given that the underlying rationale is purely functional.[184]

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[177] Knight, F.H. [1921], *op. cit.*

[178] Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1647-1653 (discussing this point in terms of protection of firm-specific investments).

[179] It is not by chance that the principle of judicial restraint from second-guessing business judgment was first explained, on a Law and Economics basis, with the key contribution of a law professor who was also acting as a judge: Frank Easterbrook (today Chief Judge of the United States Court of Appeals for the Seventh Circuit). See Easterbrook, F.H. and Fischel, D.R. [1991], *op. cit.,* 90-108. More recent analyses of the Law and Economics of self-dealing by equally prestigious economists have not yet reached the same degree of sophistication. Djankov, S., La Porta, R., Lopez-de-Silanes, F. and Shleifer, A. [2006], *op. cit.* See *infra*, Chapter Nine, section 9.4.1.

[180] The doctrine of judicial abstention from reviewing business judgment was established on these grounds in American case-law. See Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich.1919).

[181] Bainbridge, S.M. [2002a], *op. cit.*, 254-257.

[182] Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1649-1652.

[183] Bainbridge, S.M. [2002a], *op. cit.*, 259-269.

[184] Kraakman *et al.* [2004], *The Anatomy*, cit., 108-109 and 114-118.

But why then directors are, at least formally, always subject to a duty of care by corporate laws?[185] If the corporate controller's diligence in managing the corporate assets is a real standard of conduct, what is the corresponding standard of review? Should the business judgment rule be just the end of story, it would make little sense, if any, to speak about any judicial review of director's conduct. The problem is that absolute judicial abstention from reviewing managerial choices would result in an extraordinary risk of false negatives. Apparently, this could still be regarded as a matter of inefficient effort – in legal terms, negligence.[186] Albeit popular, this view is mostly incorrect. If the business judgment rule involves any problem of false negatives in reviewing the corporate controller's conduct, this does not concern compliance with the duty of care, but with the duty of loyalty.[187]

c) The Extreme Case of Waste

It is often argued that, in the absence of a duty of care, managing directors could simply *waste* shareholder's money. In fact, there is little evidence that they ever do, at least unless they have some other secret purpose.[188] We know that managers having a limited ownership stake will naturally tend to shirk. But they can be reasonably expected to do it in a smarter way than just wasting corporate assets (i.e., with a reward somewhat higher than the mere pleasure of wasting other people's money). On-the-job consumption of managerial perquisites and empire-building are just two prominent examples.[189] I have just explained why corporate laws cannot but abstain from policing these subtler forms of shirking, inasmuch as they have a potential business purpose. However, plain instances of waste are usually granted no protection by the business judgment rule.[190] Why? The answer might seem pretty obvious to a lawyer, who would then probably disagree on the contention (which has been repeatedly argued throughout this inquiry) that law can and should do little about managerial shirking. On the contrary, an economist would be just puzzled by knowing that law worries more about waste, having apparently so little individual motivation, than about misdirection of managerial effort, which has instead plenty of it.

Waste *must* have a reason, and this has probably very little to do with laziness, or even recklessness. If a professional manager allows that some of the assets under

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185 Id., at 51 ("the duty of care […] sets the minimum quality threshold for managerial decisions, [but it] is not [enforced] rigorously anywhere for good reason").

186 Hamilton, R.W. [2000], THE LAW OF CORPORATIONS, West Group, 447-460.

187 Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1661-1670.

188 Id., at 1652-1653.

189 Jensen, M.C. [1986], *op. cit.*

190 See, for the US, Bainbridge, S.M. [2002a], *op. cit.*, 314-315. More in general, see Kraakman *et al.* [2004], *The Anatomy*, cit., 51.

his management are wasted with no apparent purpose, something else must be at play.[191] Judges are then worried with good reason. However, they can only argue that waste and similarly grossly negligent behaviors are incompatible with any rational exercise of business judgment, and are therefore to be regarded as a breach of the duty of care.[192] Most likely, judges will suspect that apparently inexplicable waste actually conceals some form of siphoning-off of corporate assets. Suspicions are no sufficient grounds for adjudicating a case. Imposing liability on the basis of waste, instead of fraud, is thus a practical way to cope with the false negatives involved by the business judgment rule, whenever none of the corporate controller's conflicts of interest came to light at trial, and yet conflict of interest is basically the only possible explanation of why shareholder wealth was dissipated.[193] At the end of the day, the false negatives problem does not actually concern violation of the duty of care, but of the duty of loyalty. This brings us back to the very core of our discussion: the standard of review of conflicted interest transactions.

8.4.3. Review of Related-Party Transactions under the Duty of Loyalty

Legally speaking, conflicted interest transactions are regarded as a potential breach of the duty of loyalty.[194] Most legal textbooks, in both the civil and the common law tradition, claim that the business judgment rule or equivalent doctrines do not apply in these cases. Judges seem to be willing to review business judgment in the presence of a conflict of interest of the decision-maker.[195] While formally correct, such a perspective may be misleading. I have already argued, on economic grounds, that conflict of interest is not a sufficient reason for considering related-party transactions as outside the scope of managerial discretion. The basic standard of conduct – discretion in business judgment – is therefore not in question, but it must be coordinated with another equally important one: '*Thou shalt not steal*.' Accordingly, when it comes to the duty of loyalty, the standard of review of the corporate controller's decision-making should not be truly different, but simply

[191] Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1663.
[192] Id., at 1663-1681, for interpretation of US case-law in this perspective.
[193] "[R]arest of all – and indeed, like Nessie, possibly non-existent – would be the case of disinterested business people making non-fraudulent deals (non-negligently) that meet the legal standard of waste!" Steiner v. Meyerson, 1995 WL 441999 at *5 (Del.Ch.1995).
[194] Hamilton, R.W. [2000], *op. cit.*, 467-473
[195] Notice, however, that the attitude of the judiciary towards the review of business judgment tainted by conflicts of interest varies considerably across jurisdiction; contrary to what is often reported in the international literature, Delaware courts are perhaps the most interventionist. Kraakman *et al.* [2004], *The Anatomy*, cit., 114-118. See *infra*, Chapter Nine, section 9.2.2.

more elaborated than a plain business judgment rule. The principle of judicial abstention from second-guessing business judgment should still apply to related-party transaction, but only on condition that the decision-making process has been emancipated from conflicts of interest.[196] In this perspective, the duty of loyalty is no exception to the business judgment rule. However, while the business judgment rule protects the integrity of entrepreneur's decision-making, it should "create no license to steal."[197]

International corporate practice shows that related-party transactions are hardly reviewed by courts, so long as an independent assessment has been made that they do not involve diversion of assets or cash flow to either the corporate controller or one affiliate of his.[198] However, courts do not abstain from reviewing related-party transactions when this independent assessment is lacking, or is unreliable. This is basically the choice corporate controllers are confronted with when they decide to enter into a related-party transaction: either the decision is meaningfully freed from the underlying conflict of interest, or the consequences of this conflict of interest may have to be scrutinized in courts. Thus, another way to look at the matter is that conflicted interest transactions just require an additional, independent assessment in order to enjoy the protection of the business judgment rule.[199] In theory, this assessment is limited to the diversionary potential of the transaction, and therefore – not differently from the operation of the duty of care – it should involve no interference with business judgment.

This is more easily said than done.[200] One the one hand, the requirement of independent assessment has a number of qualifications, which are very difficult to fulfill in practice.[201] On the other hand, whenever the assessment cannot be considered as actually independent, judges will have to take up the role of independent reviewers. However unwilling they are to second-guess business judgment, they will have to review the transaction under an objective, substantive standard. The balance between Type I and Type II errors in the regulation of related-party transactions ultimately depends on this apparently easy, but practically very complicated, interaction of judicial abstention and judicial intervention in the review of corporate decision-making.

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196 Bainbridge, S.M. [2002a], *op. cit.*, 310-314.
197 Coffee, J.C. Jr. [1989], *op. cit.*, 1650 – citing Irwin v. West End Development Company, 342 F.Supp. 687 (D.C.Colo.1972).
198 Kraakman *et al.* [2004], *The Anatomy*, cit., 105-109.
199 Bainbridge, S.M. [2002a], *op. cit.*, 307-314.
200 Kraakman *et al.* [2004], *The Anatomy*, cit., 108-109.
201 See *infra*, section 8.5.3.

In conclusion, efficient policing of non-pro-rata distributions requires that related-party transactions be reviewed under a standard of either procedural or substantive fairness.[202] The requirement of procedural fairness is met by virtue of independent assessment of the diversionary potential of the transaction. The requirement of substantive fairness has to be checked instead by the court, on the basis of the evidence provided by the plaintiff and the defendant at trial. In theory, the two requirements should be mutually exclusive. Substantive fairness should be presumed in the presence of procedural fairness; and procedural fairness should be unnecessary once the substantive fairness has been ascertained. The imperfections of the real world make this division merely suggestive.[203] Based on the previous discussion, one may prefer the procedural standard in that it apparently minimizes the risk of false positives;[204] but one may still wish that a residual check on substantive fairness is performed by courts in order to cope with the problem of false negatives.[205] In any case, the bearing of each standard on Type I and Type II errors cannot be predicted across the board, for it depends on how procedural and substantive fairness are actually enforced.

8.5. Conflicts of Interest in Action: Enforcement

The general theory of enforcement in Law and Economics is simply too broad to be comprehensively reviewed here.[206] Therefore, the following discussion will be limited to just two prominent aspects of enforcement of a discipline of related-party transactions. They are: i) whether this discipline should be enforced *before*, or *after* related-party transactions are entered into (*ex ante* vs. *ex post* enforcement); ii)

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[202] Enriques, L. [2000], *op. cit.*

[203] Cooter, R.D. and Freedman, B.J. [1990], *An Economic Model of the Fiduciary's Duty of Loyalty*, in TEL AVIV UNIVERSITY STUDIES IN LAW, vol. 10, 297-313 (suggesting, at 312, that there are economic reasons for holding corporate directors to more relaxed liability standards than trustees).

[204] This is indeed the traditional approach to self-dealing in Corporate Law and Economics. Easterbrook, F.H. and Fischel, D.R. [1991], *op. cit.,* 104-105.

[205] This has been suggested only recently, based on comparative analysis of corporate law. Kraakman *et al.* [2004], *The Anatomy*, cit., 109.

[206] For an overview, see Shavell, S. [2004], FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW, Harvard University Press (Belknap), 569-592 (Chapter 25 – *The General Structure of the Law and Its Optimality*). See also Garoupa, N. [1997], *The Theory of Optimal Law Enforcement*, in JOURNAL OF ECONOMIC SURVEYS, vol. 11, 267-295; Polinsky, A.M. and Shavell, S. [2000], *The Economic Theory of Public Enforcement of Law*, in JOURNAL OF ECONOMIC LITERATURE, vol. 38, 45-76; Shavell, S. [1993], *op. cit.*

who should take the initiative of activating the enforcement process (institutional competence, including the choice between private and public enforcement).[207]

8.5.1 Deterrence and the Basic Mechanisms of Enforcement

a) Enforcing Disclosure

The first step of the enforcement process is about disclosure.[208] Extensive, but ineffective, disclosure requirements would be of no use and this would compromise the enforcement of the entire discipline of conflicted interested transactions. It would seem pretty obvious to conclude that under-enforcement of disclosure just leads to Type II errors. However, the problem is different depending on whether it is *ex ante* or *ex post* disclosure. The purpose of *ex ante* disclosure is to enable a thorough scrutiny of related-party transactions. Insufficient disclosure *ex ante* will undermine the procedural fairness of the transactions, and therefore it is best analyzed together with the enforcement of the standard of review.[209] *Ex post* disclosure works differently. Its purpose is rather to inform non-controlling shareholders that a number of conflicted interest transactions were entered into, and of how the conflicts of interest were managed by the corporate controller.[210] Perfect enforcement of *ex post* disclosure would enable outside investors to withdraw from their investment (or to refrain from entering it) anytime they are dissatisfied about how conflicts of interest are handled by the corporate controller.

Perfect enforcement is just a myth, or – in more technical terms – a purely theoretical reference point for the analysis of substantive rules.[211] The reason why *ex post* disclosure requirements may have a bite on non-pro-rata distributions is that failure to comply enables investors, or some other player on their behalf, to take some

[207] The important question of whether the substantive standard of review of related-party transactions should be enforced by a specialized judiciary is postponed to the country-by-country analysis, for its answer depends on the interaction between the other variables characterizing the national discipline and its enforcement. Conversely, given the boundaries of this inquiry, I am giving limited consideration to the standard issue of whether non-pro-rata distributions should be also deterred by means criminal, non-monetary sanctions, and to what extent. For a general theory of criminal law enforcement, see Garoupa, N. [2007], *The Economics of Codified Law: Criminal Law*, in Hatzis, A. (ed.), ECONOMIC ANALYSIS OF LAW: A EUROPEAN PERSPECTIVE, Elgar.

[208] Kraakman *et al.* [2004], *The Anatomy*, cit., 103-105.

[209] Enriques, L. [2000], *op. cit.*

[210] Kraakman *et al.* [2004], *The Anatomy*, cit., 195-196.

[211] The majority of handbooks of Law and Economics take this approach. See, e.g., Polinsky, A.M. [2003], AN INTRODUCTION TO LAW AND ECONOMICS, 3rd edn., Aspen Publishers; Cooter, R.D. and Ulen, T.S. [2004], *op. cit.*

action that results in punishment of non-transparent corporate controllers. Expected punishment – the argument runs – will deter corporate controllers from untruthful or misleading disclosures, and this will result, in turn, in deterrence of non-pro-rata distributions: nobody is going to steal when he is actually forced to disclose his stealing *ex post*.[212] However, implementing punishment is costly to both individuals and society. For this reason, short of being perfect, enforcement is just carried out up to the optimal level – i.e., where the expected reward of punishment is equal to the expected costs at the margin.[213] There are basically three kinds of punishment that may be triggered by violation of *ex post* disclosure requirements.[214] The first is legal liability; the second is ouster; the third is shaming. Liability and ouster directly depend on legal rules; shaming apparently does not, but there is reason to believe that it may only work – so to say – 'in the shadow of the law.'[215]

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212 "People who are forced to undress in public will presumably pay some attention to their figures." Loss, L. [1983], FUNDAMENTALS OF SECURITIES REGULATION, Little, Brown and Company, 36.

213 Becker, G.S. [1968], *Crime and Punishment: An Economic Approach*, in JOURNAL OF POLITICAL ECONOMY, vol. 76, 169-217.

214 The problem of law enforcement in CG is very often regarded as the crucial issue in the policing of non-pro-rata distributions (see, e.g., Kraakman *et al.* [2004], *The Anatomy*, cit., 128-130 and 212-214; McCahery, J.A. and Vermueulen, P.M. [2005], *op. cit.*, 231-236), but it has been little studied so far. Berglöf, E. and Claessens, S. [2004], *Enforcement and Corporate Governance*, World Bank Policy Research Working Paper No. 3409, available at www.ssrn.com. One important exception is the work by Katarina Pistor and her co-authors, which, however, is mostly related to transition economies. Pistor, K., Raiser, M. and Gelfer, S. [2000], *Law and Finance in Transition Economies*, in ECONOMICS OF TRANSITION, vol. 8, 325-368; Xu, C. and Pistor, K. [2004], *Incomplete Law*, in N.Y.U. JOURNAL OF INTERNATIONAL LAW AND POLITICS, vol. 35, 931-1013. Here I am not attempting to develop a comprehensive theory of enforcement of constraints on expropriation of non-controlling shareholders. Rather, I am trying to set up a *minimal* framework for analyzing the reaction of the five sample jurisdictions to the problem of self-dealing. This is based on a mix of different sources. See, for the US, Paredes, T.A. [2004], *op. cit.*; for the UK, Stapledon, G.P. [1996], INSTITUTIONAL SHAREHOLDERS AND CORPORATE GOVERNANCE, Oxford University Press; for the Netherlands, Timmerman, L. and Doorman, A. [2002], *Rights of Minority Shareholders in the Netherlands*, in ELECTRONIC JOURNAL OF COMPARATIVE LAW, vol. 6.4, 181-211, available at www.ejcl.org/64/art64-12.html; for Sweden, Coffee, J.C. Jr. [2001a], *Do Norms Matter? A Cross-Country Evaluation*, in UNIVERSITY OF PENNSYLVANIA LAW REVIEW, vol. 149, 2151–2178; for Italy, Enriques, L. [2002a], *Do Corporate Law Judges Matter? Some Evidence from Milan*, in EUROPEAN BUSINESS ORGANIZATION LAW REVIEW, 756-821.

215 There is a considerable debate on the role of social norms in the mechanisms of enforcement pertaining to CG. See, for a broad illustration, Symposium [2001], *Norms & Corporate Law*, in UNIVERSITY OF PENNSYLVANIA LAW REVIEW, vol. 149, 1607-2191 (June 2001). One milestone publication in the study of social norms in Law and Economics is Ellickson, R. [1991], ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES, Harvard University Press. For a critical review, see Conley, J.M. [1994], *The Sacred Cows Of Shasta County: An Anthropologist's View Of Ellickson's Order Without Law*, in SOCIAL JUSTICE RESEARCH, vol. 7, 423 ("Every day in Shasta County, California, just as in Greenhouse's "Hopewell, Georgia," people marry, buy and sell houses, divide property among their

b) Optimal Deterrence: Liability, Ouster, Shaming

Liability – which, for simplicity, I assume can just result in monetary sanctions – is imposed by initiative of private parties or of public agencies. In the field of corporate disclosure there is apparently little reason to rely on private initiative. Because of collective action problems and the investor's rational ignorance (the typical investor has little knowledge of disclosure requirements, not to speak about information about their infringements), the cost to an individual of bringing a civil suit far exceeds the expected benefit of damage compensation (which would be just commensurate to the size of his investment).[216] The case for publicly enforced civil liability and/or administrative fines would seem then to be very strong. Although a public agency has low-powered incentives and high administrative costs borne by taxpayers who may, or may not, participate in the stock market, it is a way to overcome shareholders' collective action problem that undermines deterrence of private enforcement.[217] This is only partly correct, for there are other ways to cope with shareholders collective action problem when it comes to constraining the corporate controller's ability to extract diversionary PBC. In light of these alternatives, public enforcement may turn out to be not necessarily the most efficient solution.[218]

Outside shareholders may have in fact a civil suit brought by one representative of theirs. This might solve the collective action problem in a cheaper and possibly even more effective fashion than public enforcement, at least to the extent that the representative's incentives are aligned with the interest of outside shareholder.[219] The case for public enforcement of disclosure requirements would no longer look as strong, once a private litigator – acting on behalf of non-controlling shareholders – has sufficient incentive to know about disclosure regulation and the way in which the company management have dealt with it. The merits of this solution in terms of Type I and Type II errors depend on the principal-agent problem underlying dele-

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relatives, perform their contracts, and stop at red lights, all without dispute. Surely the law is not irrelevant to these events; on the contrary, they must be seen to occur *in its shadow*").

[216] Kraakman *et al.* [2004], *The Anatomy*, cit., 210-212.

[217] See Polinsky, A.M. and Shavell, S. [2000], *op. cit.*

[218] For a summary of arguments why private enforcement should be preferred, Shleifer, A. [2005], *Is There a Major Problem with Corporate Governance in the United States?* in G. Owen, T. Kirchmaier and J. Grant (eds.), CORPORATE GOVERNANCE IN THE US AND EUROPE, Macmillan, 91-95. For empirical evidence, see most prominently La Porta, R., Lopez-de-Silanes, F. and Shleifer, A. [2006], *What Works in Securities Laws?*, in JOURNAL OF FINANCE, vol. 61, 1-32; and Djankov, S., La Porta, R., Lopez-de-Silanes, F. and Shleifer, A. [2006], *op. cit.*

[219] Coffee, J.C. Jr. [1985], *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, in LAW AND CONTEMPORARY PROBLEMS, vol. 48, 5-81.

gated enforcement.[220] Delegated enforcement is in fact one particular aspect of delegated monitoring. I shall come to this shortly.

The framework for analyzing (threat of) ouster as a mechanism for policing insufficient disclosure is quite similar. However, the case for public enforcement is somewhat weaker here, provided that ouster by a public authority involves overreaching of private mechanisms of appointment and dismissal of the company management.[221] In addition, in most situations, the deterrent effect of ouster is higher than that of mere liability.[222] This reduces *ceteris paribus* the risk of false negatives. However, it also determines a more serious problem of false positives. Private enforcement of ouster would only apparently fare better. The problem is that it is practically impossible to empower shareholders to oust the management just when the latter is not transparent, or is dishonest. On the one hand, the threat would hardly be credible when it is limited to situations where ouster provides shareholders with little reward. On the other hand, normally, either shareholders have the power to oust the management or they do not have it. As we know from the foregoing Chapters, it might not be entirely desirable that non-controlling shareholders have this power, for they might be induced to use it for extracting quasi-rents from corporate controllers (hold-up is a high-reward strategy).[223] The bottom line is that, when a large enough non-controlling shareholder has both the power and the incentive to oust management at his will, disclosure of conflicts of interest may be not much of a problem. However, the exercise of managerial control would be indeed problematic – at least to the extent that delegated monitoring by large, non-controlling shareholders extends beyond constraining the extraction of diversionary

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220 Miller, G.P. [1998], *Class Actions*, in P. Newman (ed.), THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW, vol. 1, Macmillan, 257-262.

221 Compared to liability, ouster is not meant to be (just) a remedy for malfeasance, but more broadly for underperformance. There is no reason to believe that any public body has more information than market participants in this last respect. Therefore, the case for public enforcement of ouster is weaker than in the case of mere liability. See Shavell, S. [1993], *op. cit.*

222 It is a quite settled point in Law and Economics that – in the absence of errors in adjudication – liability under-deters. Cooter, R.D. and Ulen, T.S. [2004], *op. cit.*, 307-387. When errors are introduced, this may both worsen the under-deterrence problem (due to false negatives) and lead to over-deterrence (due to false positives). Enriques, L. [2000], *op. cit.* Ouster usually does not spare liability, unless it is implemented before the harm materializes. However, ouster always disrupts the value of specific investments made by the ousted. When this value is substantial – like it is assumed to be in the present work – the threat of ouster considerably increases deterrence. Cooter, R.D. and Freedman, B.J. [1991], *op. cit.*, 1073. Notice, however, that the argument does not hold in so-called 'endgame' situations (i.e., when the controller's rents are exhausted and he no longer expects to be on the job market). See Gulati, M. [1999], *When Corporate Managers Fear a Good Thing Is Coming to an End: The Case of Interim Nondisclosure*, in UCLA LAW REVIEW, vol. 46, 675-756.

223 For discussion of this hold-up strategy through the opportunistic exercise of minority rights, see Kraakman *et al.* [2004], *The Anatomy*, cit., 128.

PBC.[224] If the goal is just that of policing non-pro-rata distributions, this is a clear example of how private enforcement can boost the risk of false positives.

Shaming is a non-legal mechanism of enforcement.[225] It works by complementing – if not even substituting – deterrence of legal sanctions with that of social sanctions. By virtue of shaming, the author of misconduct may end up being excluded from the social circle he belongs to. The economic implications of this mechanism are not always clear-cut.[226] However, as far as corporate managers are concerned, there is little doubt that shaming is an issue of high economic importance.[227] The manager's reputation is in fact his most valuable asset on the labor market. Losing that reputation would ultimately imply that he has to change his job. To be sure, the deterrent effect of shaming depends on two crucial factors. On the one hand, social norms in the institutional context have to be such that the expected social sanction of misbehavior is credible.[228] It is illusory to take this for granted, even in the restricted sample of developed economies we are considering, provided that one is not speaking about ferocious criminals but, rather, about somebody who ultimately turns out to be 'smart' enough to take the money and run.[229] On the other hand, shaming in modern societies has most often to be backed by some form of legal sanction. In corporate governance, shaming will induce compliance with an established set of norms only when their violation produces some manifest consequence (like, e.g., ouster or liability), which would in turn trigger the social sanction.[230] Like investors, the management society need to know of violations – and the problem of keeping managers up to their professional standards cannot be equated to that of policing littering in a close neighborhood.[231] This has both positive and negative consequences. Shaming is a relatively inexpensive way to increase deterrence, thereby reducing the risk of false negatives. How-

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[224] In a sense, this is germane to the over-monitoring problem highlighted in the literature. Burkart, M., Gromb, D. and Panunzi, F. [1997], *Large Shareholders, Monitoring, and the Value of the Firm*, in QUARTERLY JOURNAL OF ECONOMICS, vol. 112, 693-728 (discussed *supra*, Chapter Five, section 5.6.1).

[225] Skeel, D.A. [2001], *Shaming in Corporate Law*, in UNIVERSITY OF PENNSYLVANIA LAW REVIEW, vol. 149, 1811-1868.

[226] Kahan, M. [2001], *The Limited Significance of Norms for Corporate Governance*, in UNIVERSITY OF PENNSYLVANIA LAW REVIEW, vol. 149, 1869-1900.

[227] Paredes, T.A. [2004], *op. cit.*, 1086-1094. See also Blair, M.M. and Stout, L.A. [2001], *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, in UNIVERSITY OF PENNSYLVANIA LAW REVIEW, vol. 149, 1735-1810.

[228] Coffee, J.C. Jr. [2001a], *op. cit.*

[229] Enriques, L. [2003], *Bad Apples, Bad Oranges: A Comment from Old Europe on Post-Enron Corporate Governance Reforms*, in WAKE FOREST LAW REVIEW, vol. 38, 911-934

[230] Barca, F. [1998], *op. cit.*

[231] This is one major objection to the Ellickson's reliance on private ordering. Ellickson, R. [1991], *op. cit.*

ever, it can also turn out to be a multiplier of false positives, depending on how the matter is dealt with at the legal level.

c) The Gatekeepers' Contribution

It is worth noting that the enforcement of disclosure regulation in the securities market features a much broader range of techniques than the three that have been just reviewed.[232] One of them is especially relevant as far as conflicted interest transactions are concerned. This is the so-called 'gatekeeper strategy.'[233] Gatekeepers – like accountants, securities analysts, rating agencies, and underwriters – enjoy a special position in policing some instances of corporate misbehavior. By virtue of either regulation or financial economics, they control access of the corporation to the securities market. Therefore, they can enforce securities regulation by withdrawing support from the companies that fail to comply with it. The requirement of this "third-party enforcement strategy" is that gatekeepers face a sanction when they fail to prevent violators from entering, or staying on, the market. The sanction is either loss of reputation, legal liability, or both.

Efficient gatekeeping is indeed a crucial issue of securities regulation.[234] It is not by chance that 'gatekeeper failure' is often invoked as one major explanation of the corporate scandals of the last few years.[235] The matter is very much related to the enforcement of the legal discipline of related-party transactions, but in just one respect: disclosure. Gatekeepers' failing to check the quality of disclosure as to both the corporate controller's conflicts of interest and the way in which they have been handled may have – as we experienced in the past few years – disastrous consequences. However, disclosure is just one element of a legal policy towards self-dealing. Disclosure would be of no help in the absence of professional assessment of the diversionary potential of the transaction. In theory, this assessment may also

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[232] As I mentioned, criminal law also plays an important role. However, in order to keep the discussion as simple as possible, I am not considering deterrence by criminal sanctions here. The matter will be only marginally touched upon in the next Chapter.

[233] Kraakman, R.H. [1986], *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, in JOURNAL OF LAW, ECONOMICS, AND ORGANIZATION, vol. 2, 53-104.

[234] Coffee, J.C. Jr. [2006a], GATEKEEPERS: THE ROLE OF THE PROFESSIONS IN CORPORATE GOVERNANCE, Oxford University Press.

[235] See the remarkable series of Jack Coffee's publications in this field and, in particular: Coffee, J.C. Jr. [2002], *Understanding Enron: It's About the Gatekeepers, Stupid*, BUSINESS LAWYER, vol. 57, 1403-1420; Coffee, J.C. Jr. [2004a], *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, in BOSTON UNIVERSITY LAW REVIEW, vol. 84, 301-364; Coffee, J.C. Jr. [2005], *A Theory Of Corporate Scandals: Why the USA and Europe Differ*, in OXFORD REVIEW OF ECONOMIC POLICY, vol. 21, 198-211. See also, for a more European approach, Ferrarini, G. and Giudici, P. [2005], *Financial Scandals and the Role of Private Enforcement: The Parmalat Case*, ECGI Law Working Paper No. 40/2005, available at www.ssrn.com and www.ecgi.org.

be enforced through a gatekeeper strategy. In practice, however, normally it is not.[236] Neither would it be desirable to have the merits of related-party transactions reviewed by, say, an accounting firm as a precondition for their viability. As a result, third-party enforcement of the discipline of conflicted interested transactions is only relevant as far as their disclosure to investors is concerned.[237] This being only tangentially related to corporate law, I shall put aside gatekeepers in the following discussion. Contrariwise, both the *ex ante* and the *ex post* review of related-party transactions is strictly a matter of corporate law. While gate-keeping affects the preconditions of this review (namely, "knowledge of violations"), third-party enforcement does (and should) play no role in this field.

d) Enforcing the Standard of Review

The liability-ouster-shaming paradigm can be easily extended to the enforcement of the standard of review of related-party transactions. We know that, in functional terms, this standard has both a procedural and a substantive fairness component. Violation of either component should result in liability, ouster, or shaming of the corporate controllers for the latter to be deterred from non-pro-rata distributions. However, like in the case of disclosure, activation of each of these remedies requires that the shareholders' collective action problem be overcome. The case for public enforcement appears to be much weaker here, at least from the point of view of society. While opacity of a corporate controller produces significant exter-

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236 This requires a little bit of explanation. In the wake of the financial scandals of the beginning of this century, most jurisdictions have enhanced the role and responsibilities of gatekeepers, also with respect to the discipline of related-party transactions. Specifically, auditing firms have to review (normally *ex post*, but sometimes also *ex ante*) disclosure of conflicted interest transactions and of the internal procedures for managing the underlying conflicts. See Thompson, R.B. [2003], *Corporate Governance after Enron: The First Year*, in HOUSTON LAW REVIEW, vol. 40, 99-117; Enriques, L. and Gatti, M. [2006a], *EC Reforms of Corporate Governance and Capital Markets Law: Do They Tackle Insiders' Opportunism?*, Working Paper, available at www.ssrn.com; Davies, P. [2005], *Enron and Corporate Law Reform in the UK and the European Community*, in K.J. Hopt, E. Wymeersch, H. Kanda, and H. Baum, CORPORATE GOVERNANCE IN CONTEXT: CORPORATIONS, STATES, AND MARKETS IN EUROPE, JAPAN, AND THE US, Oxford University Press, 163-190. Auditing firms may prevent companies from circulating misleading statements about related-party transactions, but not from entering them into. As a result, related-party transactions are not policed by a gatekeeper strategy, but only their disclosure is.

237 A hot issue in this field is how liability exposure of gatekeepers contributes to deterrence of securities fraud. For illustration of the debate, compare: Partnoy, F. [2001], *Barbarians at the Gatekeepers? A Proposal for a Modified Strict Liability Regime*, WASHINGTON UNIVERSITY LAW QUARTERLY, vol. 79, 491–547; Hamdani, A. [2004], *Gatekeeper Liability*, in SOUTHERN CALIFORNIA LAW REVIEW, vol. 77, 53-122; Coffee, J.C. Jr. [2004b], *Partnoy's Complaint: A Response*, in BOSTON UNIVERSITY LAW REVIEW, vol. 84, 377-382; Partnoy, F. [2004], *Strict Liability for Gatekeepers: A Reply to Professor Coffee*, in BOSTON UNIVERSITY LAW REVIEW, vol. 84, 365-375.

nalities on the well-functioning of the stock market, non-pro-rata distributions affect shareholders of one single company or of a group of them at most. It is probably for this reason that corporate law is typically enforced by private parties, whereas normally securities regulation is enforced both privately and publicly.[238]

That being said, private enforcement of related-party transactions' standard of review requires some special mechanism for aggregating shareholders' common interest in the operation of an exponential entity, to which I shall refer as shareholder representative, or agent, for expositional convenience. The remainder of the discussion will be concerned just with this mechanism of delegated enforcement of the legal discipline of conflicted interest transactions.

8.5.2 Delegation of *Ex Post* Enforcement: Shareholder Litigation

a) The collective action problem

No individual shareholder would ever sue the corporate controller, unless he expects the reward from such an action at least to offset the costs of litigation.[239] None of the three remedies under consideration is likely to bring him such a reward. To be sure, liability may look like a good candidate for the individual investor's reward, since he will be granted damage compensation anytime the corporate controller is found liable. But there are two problems with this approach. The first is that non-pro-rata distributions do not harm outside shareholders directly, provided that resources are diverted from the company's assets, not from shareholders' pockets. This argument may seem of no use to an economist, but the fact is that this distinction is so important at law that individual shareholders do not even have standing to sue in some jurisdictions; and, where they do, they anyway cannot claim damages if not on behalf of the corporation.[240] The second problem is more important, and applies as well to claims brought on the individual investor's account under securities regulation (like, e.g., in case of insufficient disclosure, which determined the purchase of overvalued stock). Whatever is the damage determined by the corporate controller's misbehavior, individual shareholders would be only entitled to recover a part of it, depending on their stake in the company's value. This leads to the well-known free rider problem.[241] The best strategy for the individual

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[238] See, e.g., Kraakman *et al.* [2004], *The Anatomy*, cit., 114-118 and 210-212.

[239] For the Law and Economics of litigation, see Cooter, R.D. and Ulen, T.S. [2004], *op. cit.*, 388-444.

[240] Kraakman *et al.* [2004], *The Anatomy*, cit., 116-117.

[241] See Baums, T. and Scott, K.E. [2005], *op. cit.*, for the implications on enforcement of shareholder protection.

shareholder is to wait for other investors bearing the costs of litigation, which in the end would benefit non-controlling shareholders as a group. Since any rational shareholder would go for this strategy, this is the best guarantee of impunity that a fraudulent corporate controller could ever strive for.

The problem would be solved if shareholders managed to coordinate in such a way that both costs and reward of litigation are divided pro-rata. Coordination is also costly, and it is not likely to take place spontaneously in a group of thousands investors. It is for this reasons that the mechanisms of aggregation of both shareholder interests and shareholder action require some institutional background. There are basically two kinds of institutions supporting shareholder litigation: one is shareholder associations, the other is corporate lawyers. Both institutions feature aggregation of shareholder interest, and action that is supposed to represent the interest of shareholders as a group. Therefore, both involve a principal-agent problem whose characteristics, however, are significantly different.

b) Shareholder Associations vs. Corporate Lawyers

Shareholder associations are nowadays a very popular way to aggregate investors' claims in liability suits brought under corporate law or securities regulation.[242] Yet, they suffer from one major inconvenience as regards the exercise of decision-making: accountability to the shareholder interest. Like consumer associations, shareholder associations may possibly form a powerful interest group.[243] However, whether they actually represent the interest of the underlying constituency is doubtful, provided that the same constituency is featured by an extremely large number of members. In appointing the association's representatives and monitoring their performance, shareholders face the same collective action problem that prevents them from challenging in court non-pro-rata distributions by the corporate controller. Apparently, there is little reason why shareholder association should fare any better in this respect.

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[242] Curiously enough, the topic is as popular in the policy debates in Europe as little studied in the academic literature. One important exception is Schaefer, H.-B. [2000], *The Bundling of Similar Interests in Litigation. The Incentives for Class Action and Legal Actions Taken by Associations*, in EUROPEAN JOURNAL OF LAW AND ECONOMICS, vol. 9, 183-213. In corporate governance, Law and Economics of mass litigation is almost exclusively focused on the study of American class actions. See, e.g., Kraakman *et al.* [2004], *The Anatomy*, cit., 116-118 and 210-212.

[243] As Kraakman *et al.* [2004], *The Anatomy*, cit., 193, nicely suggest, the problem of investor protection from unscrupulous issuers is a "close cousin" of consumer protection in other areas of law. *Mutatis mutandis*, shareholder associations can also be analyzed as a variant of consumer associations. On the general problem of interest group from a public choice perspective, see Den Hertog, J. [2000], *General Theories of Regulation*, in ENCYCLOPEDIA OF LAW AND ECONOMICS, vol. V, No. 5000, 223-270.

Under certain conditions, however, shareholder associations may reduce the risk of false negatives in reviewing related-party transactions without correspondingly increasing the risk of false positives. These conditions require that shareholder representatives have a personal gain from bringing a successful case to trial, but that they also get a penalty when the case brought turns out to be not meritorious. In the absence of regulation of shareholder associations, the fulfillment of the above conditions depends on the importance of concern for reputation in the institutional environment.

Differently from shareholder associations, corporate lawyers have no mission to bring legal suits on behalf of a vast group of shareholder. However, they can be given a specific incentive to do so.[244] This can be achieved by a two-sided strategy. On the one hand, their remuneration should be set on a contingent basis, so that lawyers get a percentage of damage compensation awarded to disgruntled shareholders in case they are successful, and nothing otherwise. On the other hand, lawyers should be entitled to represent the entire class of investors that claim damage compensation, so that in case of success their reward will be commensurate to the damages awarded to shareholders as a group, not as individuals. Such an incentive scheme may allow for enormously generous lawyer's compensation, thereby inducing law firms not only to prosecute non-pro-rata distributions with much more determination than any disgruntled (non-controlling) shareholder, but also to screen the entire stock market in search of substantive or procedural violations of the rules that may result in a successful case.[245]

The combination of contingent fees and class action suits creates what has been defined as an "entrepreneurial system of private enforcement."[246] This does not come without drawbacks. Compared with shareholder associations, class action lawyers have much higher-powered incentives. However, these incentives are imperfectly aligned with the shareholder interest.[247] The incentive scheme in question

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[244] See Coffee, J.C. Jr. [1985], *op. cit.*

[245] Romano, R. [1991], *op. cit.*

[246] To be sure, these two elements are complemented by other peculiarities of American civil procedure: these are, most prominently, an expensive discovery process and the so-called 'American rule' on fee shifting (plaintiffs and defendants bear their own expenses, no matter of the outcome). See Coffee, J.C. Jr. [1987], *The Regulation of Entrepreneurial Litigation: Balancing Fairness and Efficiency in the Large Class Action*, in UNIVERSITY OF CHICAGO LAW REVIEW, vol. 54, 877-937. On discovery, see Rubinfeld, D.L. [1998], *Discovery*, in P. Newman (ed.), THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW, Macmillan, vol. 1, 609-614. On fee shifting: Hughes, J.W. and Snyder, E.A. [1998], *Allocation of Litigation Costs: American and English Rules*, in P. Newman (ed.), THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW, Macmillan, vol. 1, 51-56.

[247] Macey, J.R. and Miller, G.P. [1991], *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, in UNIVERSITY OF CHICAGO LAW REVIEW, vol. 58, 1-118.

features high reward for meritorious cases, but almost no penalty for non-meritorious ones. The only penalty that lawyers may face is their bearing the litigation costs when the case is lost. The company and its controller risk losing much more, in both financial and reputational terms, from the very moment in which the case is brought to trial. Therefore, parties will tend to settle when there is any uncertainty about the outcome of the case, no matter of whether the latter is founded or unfounded.[248] Lawyers – who get a substantial part of the money settled for – will be the only winners in this game.[249] In the absence of further regulation, the risk of false positives brought about by class action lawyers is likely to be huge, and this would be definitely too a high price to pay for minimizing the false negatives problem.[250]

c) Institutional Investors

Compared to liability, ouster allows for no mechanism of incentive manipulation. The ousting shareholder must be simply large enough to benefit more from ouster than from any other strategy, of course net of related costs. In principle, there seems to be little reason why a non-controlling shareholder should prefer ousting a dishonest corporate controller to withdrawing from his investment in the company.[251] However, this view overlooks an important problem.[252] When a non-controlling shareholder like an institutional investor has a significant stake in the company, it might end up being locked-in in his own investment. Assume that one institutional investor becomes aware of non-pro-rata distributions before any other market participant. Selling, say, 10% of the company's stock straight away would not save any losses, but just anticipate their realization – the stock price would fall at any rate. Filing a legal suit against the company or its director is also no option, for it would add to the stock devaluation the expected costs of both litigation and

[248] Garry, P.M., Spurlin, C.J., Owen, D.A., Williams, W.A., Efting, L.J. [2004], *The Irrationality of Class Action Lawsuits: A Proposal for Reform*, in SOUTH DAKOTA LAW REVIEW, vol. 49, 275-312.

[249] Although this may seem unfair at first glance, the outcome could be perfectly consistent with the goal of enhancing deterrence – the only thing that matters from an efficiency standpoint. However, empirical studies have been so far unable to tell whether class actions are beneficial or detrimental even in this narrower perspective. See Choi, S.J. [2004], *The Evidence on Securities Class Actions*, in VANDERBILT LAW REVIEW, vol. 57, 1465-1528.

[250] See Coffee, J.C. Jr. [2006b], *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, in COLUMBIA LAW REVIEW, vol. 106, 1534-1586, for an up-to-date review of the regulatory issue pertaining to securities class action, and discussion of desirable reform from a Law and Economics perspective.

[251] Rock, E.B. [1991], *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, in GEORGETOWN LAW JOURNAL, vol.79, 445-506.

[252] Coffee, J.C. Jr. [1991], *Liquidity versus Control: The Institutional Investor as Corporate Monitor*, in COLUMBIA LAW REVIEW, vol. 91, 1277-1368.

loss of reputation: whatever the outcome of the case is, these costs would be a deadweight loss to the investor's portfolio.

In this perspective, ouster of dishonest controllers turns out to be the only possible strategy for institutional investors with a large financial commitment to the company.[253] In order to minimize its costs, it ought to be implemented as silently and quickly as possible. Under these conditions, the threat of ouster is credible and may suffice to deter corporate controllers from non-pro-rata distributions at the outset. However, as I mentioned earlier, threat of ouster may also lead to false positives to the extent it is not (and cannot be) confined to the policing of self-dealing. Shareholders may also use their power to hold up the corporate controller. Perhaps one way to avoid this outcome is having ouster implemented by an agent who is not directly concerned about profitability of the company management, but who would ultimately lose his job when he fails to prevent or to punish non-pro-rata distributions.[254] Here is how delegated enforcement *ex post* merges with delegated monitoring *ex ante*.

8.5.3. Delegated Monitoring *Ex Ante*: Independent Directors

a) Shareholders as Independent Reviewers?

Ex ante enforcement of a discipline of related-party transactions aims at preventing non-pro-rata distributions, rather than deterring them through the threat of liability, ouster, or shaming. Compared to *ex post* punishment, preventing extraction of diversionary PBC requires a tighter monitoring of related-party transactions. In order for non-pro-rata distributions to be effectively prevented, conflicts of interest must both be disclosed at the outset, in their full scope and implications, and systematically reviewed by means of a procedure that guarantees independent assessment of the diversionary potential of the transaction. Whether this enforcement methodology is efficient ultimately depends on its bearing on the balance between false positives and false negatives in policing non-pro-rata distributions.[255] The argument that enforcement is normally more expensive *ex ante* than *ex post* has instead no much relevance here, provided that disclosure and independent monitoring are required not only for preventing non-pro-rata distributions *ex ante*, but also for hav-

[253] Stapledon, G.P. [1996], *op. cit.*, 251-277.
[254] Gilson, R.J. and Kraakman, R. [1991], *Reinventing the Outside Director: An Agenda for Institutional Investors*, in STANFORD LAW REVIEW, vol. 43, 863-906. But see Stapledon, G.P. [1996], *op. cit.*, 293-295, for a skeptical position on institutional involvement in the election of outside directors.
[255] Kraakman *et al.* [2004], *The Anatomy*, cit.,

ing related-party transactions reviewed *ex post* on the basis of just procedural fairness.[256] Whether one likes it or not, these two requirements have proven so far necessary to combine a discipline of conflicted interest transactions with protection of integrity of business judgment.[257]

There are several ways to implement independent assessment of related-party transactions. Perhaps the most intuitive is having the transaction previously approved by shareholders. But this is tricky. The illusion of shareholder sovereignty over the management of the company may easily lead to the conclusion that conflicted transactions may enjoy full protection of the business judgment rule once they have been approved by a majority of shareholders. In at least two situations this conclusion would turn out to be a terrible mistake.[258] First, shareholders approving the transaction may not be independent from the corporate controller – even worse, a controlling shareholder may hold a sufficient majority to have any related-party transaction approved. Second, shareholders may be not adequately informed to assess the diversionary potential of the transaction. In both situations, shareholder approval would lead to false negatives. Ideally, the problem would be solved when shareholders qualify for transaction approval only inasmuch they are insulated from the sphere of influence of the corporate controller, and they are provided with the optimal amount of information to assess its diversionary potential.[259] In practice, however, the requirements for a truly independent shareholder approval are so burdensome that a corporate controller would rather refrain from entering a related-party transaction, unless there is a very big deal at stake. Even in the latter case, there would be the risk that non-controlling shareholder will attempt to hold him up. This may lead to a serious false positives problem. There is hardly a way out of this bind. From a normative perspective, independent shareholder review of the corporate controller's conflicts of interest should be just limited to most significant related-party transactions – i.e. those that may result in either outrageous tunneling, or in terrific profit opportunities.[260]

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[256] For a general discussion of the efficient stage of intervention in enforcement, see Shavell, S. [1993], *op. cit.*

[257] See Enriques, L. [2000], *op. cit.*, for illustration.

[258] See Kraakman *et al.* [2004], *The Anatomy*, cit., 109-111 and 121-123.

[259] Id., at 123.

[260] Enriques, L. [2000], *op. cit.*

b) Proximity vs. Objectivity in Corporate Boards

Independent assessment of related-party transactions would apparently fare much better at the board level.[261] It is perhaps for this reason that the issue of independent directors is so popular in both theory and policy of corporate governance around the world. However, as I mentioned earlier in this dissertation, there is much confusion about the role that board of directors should play in corporate governance, and this leads, in turn, to disagreements as to both the meaning of independent directorships and their overall desirability.[262] Independent directors are normally characterized as general monitors of the corporate controller's performance in managing the firm. In this perspective, they are supposed to care about a much broader range of conflicts of interest than just diversion of corporate assets or cash flow. According to the standard view, independent directors should police not only stealing, but also shirking and the corporate controller's tendency to entrench himself (the so-called 'positional' conflict of interest).[263] Most recent developments in the literature cast a number of doubts on the ability of independent directors to do all these things together.[264] Also the empirical literature has been so far unable to deliver clear-cut results as to the overall effects of board independence on firm performance: it seems that the number of independent directors in the board improves firm performance in some situations, whereas it has no significant effect in some others.[265] All in all, there seem to be a structural tradeoff between a director's independence and his sharing information with the corporate controller.[266] A director can either participate in managerial decision-making (thereby con-

[261] Notice, however, that this may require additional checks on directors' independence. Specifically, this solution appears to work properly only where judicial standards of review are credibly enforced in the background. See Kraakman *et al.* [2004], *The Anatomy*, cit., 105-109.

[262] For a recent survey of the debate, see Hertig, G. [2005], *On-Going Board Reforms: One Size Fits All and Regulatory Capture*, in OXFORD REVIEW OF ECONOMIC POLICY, vol. 21, 269-282.

[263] For a critical discussion, see Becht, M., Bolton, P. and Röell, A. [2002], *Corporate Governance and Control*, ECGI Finance Working Paper No. 02/2002, available at www.ssrn.com and www.ecgi.org, as published in G. Constantinides, M. Harris, and R. Stulz (eds.) [2003], HANDBOOK OF ECONOMICS AND FINANCE, North-Holland, 41-45. On the legal notion of 'positional' conflict of interest, see instead Eisenberg, M.A. [1989a], *op. cit.*, 1472-1474.

[264] Hermalin, B.E. and Weisbach, M.S. [2003], *Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature*, in FEDERAL RESERVE BANK NY – ECONOMIC POLICY REVIEW, April 2003, 7-26.

[265] Romano, R. [2001a], *Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, in YALE JOURNAL ON REGULATION, vol. 18, 174-251; Bhagat, S. and Black, B.S. [1999], *The Uncertain Relationship between Board Composition and Firm Performance*, in BUSINESS LAWYER, vol. 54, 921-63; Bhagat, S. and Black, B.S. [2002], *Board Independence and Long-Term Firm Performance*, in JOURNAL OF CORPORATION LAW, vol. 27, 231-273.

[266] Adams, R.B. and Ferreira, D. [2007], *A Theory of Friendly Boards*, in JOURNAL OF FINANCE, vol. 62, 217-250.

tributing to its quality) or be a tough monitor of the underlying conflicts of interest; but he cannot be expected to perform both tasks at the same time.

The narrower approach being taken here to the problem of conflicts of interest may help to identify the proper role for independent directors. Directors that are supposed to contribute to shareholder wealth maximization – thereby policing shirking and entrenchment by the corporate controller – would not stay independent for long, even under the heroic assumption that they were at some point of their appointment process. *Proximity* is required for a knowledgeable participation in business judgment, but it is ultimately irreconcilable with *independence*.[267] However, there is little need of proximity for a knowledgeable policing of stealing. Directors being comprehensively informed about the corporate controller's conflicts of interest may simply be required by regulation for the procedural fairness of related-party transactions. This information flow would not compromise director's independence to the extent that it does not allow interference with the decisions on how the company should be managed, and by whom. Independent directors turn out to be very useful for corporate governance, but only on condition that their role is limited to the assessment of the diversionary potential of conflicted interest transactions.

In this perspective, it is also easier to set forth the requirements for a truly independent assessment. Literal 'independence' of directors from the corporate controller will not automatically result in independence of judgment, when it comes to the diversionary potential of conflicted interest transactions. A director may be independent in that he has neither direct nor indirect financial involvement with the corporate controller or with any of his natural or corporate affiliates. This is just a necessary condition for an independent scrutiny of related-party transactions, but is far from sufficient.[268] The director in question will be still under the influence of the corporate controller in one major respect: his reappointment, and to some extent also his staying in office, basically depend on the corporate controller's will.[269] The reader may recall from the previous Chapter that a prominent feature of corporate control is the ability to appoint (and dismiss) at least the majority of directors. In the absence of mandatory employee representation, it is the corporate controller that ultimately determines who will sit on the board, with what responsibilities, and for how long. This holds regardless of the board structure and of whether the company is governed by a controlling shareholder or by its management.[270] It

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[267] Boot, A. and Macey, J.R. [2004], *Monitoring Corporate Performance: The Role of Objectivity, Proximity and Adaptability in Corporate Governance*, in CORNELL LAW REVIEW, vol. 89, 356-393.

[268] McCahery, J.A. and Vermueulen, P.M. [2005], *op. cit.*, 235-242.

[269] Coffee, J.C. Jr. [2005], *op. cit.*, 207-209.

[270] More legally-oriented comparative analyses often miss this point, and consider this to be a problem just in controlling shareholder systems. See McCahery, J.A. and Vermueulen, P.M. [2005], *op. cit.*,

turns out that, at least in those jurisdictions that require employee representatives to sit in the board, the only directors who are actually independent of the corporate controller are those appointed by a non-shareholder constituency. However, they are not eligible for policing the extraction of diversionary PBC, provided that, by definition, the latter come at the expenses of shareholders and not of other stakeholders.[271]

If we want independent directors to carefully scrutinize the diversionary potential of conflicted interest transactions, they must be both *accountable* to shareholders and appointed *independently* of the corporate controller. Formally independent directors, who are appointed by the board itself or, even worse, by a controlling shareholder, cannot be entirely relied upon.[272] True, they must have some concern for their own reputation of both honesty and professionalism, for nobody would take them seriously otherwise. But they must have also some deference to the corporate controller, for nobody would take the risk of appointing them otherwise. For independent directors, a strategy balanced between these two concerns might be to *quietly* resign as soon as they realize that some diversion of assets is going on.[273] We would definitely expect more. We would expect that asset diversion be *loudly* stopped by independent directors, in such a way as to activate also shaming, if not ouster, of dishonest corporate controllers. So long as independent directors are appointed with the corporate controller's consent, this is very unlikely to happen. Independent directors should be then appointed by somebody else, equally interested in maximization of shareholder value but with exactly the opposite interest in diversion of the same value. Non-controlling shareholders seem to be the only possible option.[274] However, the appointment of minority representatives to the board, in the function of independent directors, raises different problems depending on the prevailing ownership structure. They will be discussed in the country-by-country analysis.

236; Coffee, J.C. Jr. [2005], *op. cit.*, 208; Kraakman *et al.* [2004], *The Anatomy*, cit., 128-130. But see also Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 42.

271 See *supra*, Chapters Three and Five.

272 Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 41-42.

273 See, illustratively, Langevoort, D.C. [2001], *op. cit.*

274 Pardolesi R., A.M.P. (alias Alessio M. Pacces), Portolano A. [2004], *Latte, lacrime (da coccodrillo) e sangue (dei risparmiatori). Note minime sul caso Parmalat*, in MERCATO, CONCORRENZA, REGOLE, vol. 1/04, 193-216.

c) Credible Commitments: Legally Enforceable Self-Regulation

One last point about independent directors is that they are a creation of self-regulation.[275] Corporate laws only knew of 'disinterested' directors in the discipline of conflicted interest transactions, and in most jurisdictions – with the noticeable exception of the US – any director with no conflict of interest in the specific transaction qualified for the 'disinterested' label.[276] The spontaneous emergence of directorships supposed to be independent to a broader extent makes this institution a promising venue for the economic analysis of regulation of related-party transactions.[277] But one crucial point must be clarified at the outset. Corporate controllers can only take a credible commitment that non-controlling shareholders will be dealt with fairly by placing themselves under some binding constraints. So far, it has been argued that this can only be achieved by means of mandatory rules.[278] Even more than charter provisions, self-regulation itself is no sufficient source of credible commitment. Not only may a corporate controller unilaterally renegotiate compliance at a later stage; he may also pretend that he complies when he actually does not.[279]

Most recent evolutions in self-regulation of corporate governance have tried to cope with these problems.[280] On the one hand, once a code of corporate governance has been voluntarily adhered to, the implementation of its provisions is most often regulated by the so-called 'comply-or-explain' principle – which makes straight departures from the code provisions unlikely and at least *formal* compliance somewhat binding. On the other hand, in some jurisdictions, untruthful or misleading statements as to the compliance with the code being adhered to are regarded as infringements of securities regulation – which makes *actual* compliance with the code legally enforceable. In the following discussion, the provisions of corporate governance codes concerning independence of directors will be regarded as sources of credible commitment for the corporate controller only to the extent that – not

[275] Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 65-67.

[276] Kraakman *et al.* [2004], *The Anatomy*, cit., 105-107.

[277] McCahery, J.A. and Vermueulen, P.M. [2005], *op. cit.*, 235-236.

[278] See *supra*, section 8.1.3.

[279] For how this applied to Italian corporate scandals, see Ferrarini, G. and Giudici, P. [2005], *op. cit.*, and Pardolesi R., A.M.P. (alias Alessio M. Pacces), Portolano A. [2004], *op. cit.*

[280] Wymeersch, E. [2005], *Implementation of the Corporate Governance Codes*, in K.J. Hopt, E. Wymeersch, H. Kanda, and H. Baum, CORPORATE GOVERNANCE IN CONTEXT: CORPORATIONS, STATES, AND MARKETS IN EUROPE, JAPAN, AND THE US, Oxford University Press, 403-419.

differently from mandatory rules of law – the same provisions are both *binding* and *enforced*.[281]

[281] See, for a similar approach, de Jong, A., DeJong, D.V., Mertens, G., Wasleyc, C.E. [2005], *The Role of Self-Regulation in Corporate Governance: Evidence and Implications from the Netherlands*, in JOURNAL OF CORPORATE FINANCE, vol. 11, 473-503.

CHAPTER NINE – Law of Conflicted Interest Transactions (II): Comparative Legal Analysis

9.1. Introduction

This Chapter discusses the functional framework of regulation of related-party transactions as applied to the five jurisdictions of our sample. This implies that the analysis will be structured according to the disclosure-standard-enforcement paradigm developed in the previous Chapter, regardless of how the discipline of related-party transactions is described in the legal literature on corporate law and securities regulation of each country. However, differently from the previous Chapter, the country-by-country approach will now enable us to take into account institutional complementarities between the three fundamental aspects of the discipline.

The quality of legal rules and of their enforcement is going to be assessed on the basis of the false positives/false negatives criterion. The goal of this assessment is twofold. On the one hand, I will attempt to put the problem of protection of non-controlling shareholders in the right perspective. The legal analysis will confirm that ownership concentration and stock market underdevelopment obtains when the discipline of related-party transactions does not have enough 'bite' (false negatives problem). But it will also show that this is just a part of the story. The standard 'law matters' argument is still partly consistent with Italian law (whose investor protection features have significantly improved in the past years), but have very limited explanatory power as far as the other jurisdictions of the sample are concerned. For instance, controlling shareholders prevail in Sweden in spite of an optimal balance between false positives and false negatives in the policing of minority shareholders expropriation. British law of related-party transactions is based on rebalancing the distribution of powers in favor of non-controlling shareholders, and the resulting false positives problem ultimately leads to controlling shareholders being disallowed.

On the other hand, the following discussion will demonstrate that the framework developed in the foregoing Chapter provides a sounder basis for both a positive and a normative legal analysis. For instance – contrary to the received wisdom – Dutch law turns out to feature quite high standards of shareholder protection from expropriation, whereas the excellent shareholder protection in Sweden has an important, but too often neglected, legal background. On the normative side, the Type I/Type II errors paradigm suggests that all of the discipline of related-party transactions considered here could be improved by separating the scrutiny of conflicts of interest from interference with business judgment. The functional question of whether the discipline is better enforced *ex ante* or *ex post* makes independent directorship a promising venue for inquiry in this regard, provided that their role is coordinated with the institutional peculiarities of each jurisdiction. This casts some doubts on the prospects for convergence in the discipline of related-party transactions. More importantly, the present approach highlights the structural weakness of a much too coarse "numerical comparative law," as well as of clumsy harmonization attempts at the EU level, at least when it comes to shareholder protection.

9.2. Regulation of Related-Party Transactions in the US

The United States are considered as one of the countries providing outside shareholders with a very high level of protection from the corporate controller's misbehavior – if not the highest level in the world. This perception is based on a rather unique combination of rules and enforcement, of federal (securities) regulation and state (corporate) laws, and of institutional factors that are both legal and non-legal.[1] Whatever the relative importance of each of these determinants is, the fact is that US firms have access to vibrant stock markets, which apparently provide them with the equity finance necessary to exploit opportunities for growth. We know that outside shareholder protection is not a sufficient condition for this result to hold; but we also know that it is absolutely necessary. How the corporate America has achieved such high standards in policing non-pro-rata distributions, and at what price in terms of overall efficiency of corporate governance, is now going to be discussed. This is nicely illustrated by the discipline of related-party transactions and the problem of false positives and false negatives that it may involve.

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1 For a very nice illustration of how these factors interact with each other, see Paredes, T.A. [2004], *A Systems Approach to Corporate Governance Reform: Why Importing U.S. Corporate Law Isn't The Answer*, in WILLIAM AND MARY LAW REVIEW, vol. 45, 1055-1157.

In the US, this discipline has a number of special players: the Securities and Exchange Commission (SEC) – the oldest, and perhaps still the most aggressive, securities regulator in the world;[2] Delaware courts – the leading jurisdiction in American corporate law;[3] corporate lawyers – after executive directors, perhaps the second most important player in US corporate governance;[4] and the financial press – the ultimate activator of reputational constraints in the corporate America.[5] How each of them fits our functional framework will be clarified in the following discussion.

9.2.1. *Ex post* Disclosure: Federal Securities Regulation

Investor protection in the US relies heavily on disclosure.[6] When it comes to related-party transactions, conflicts of interest must be disclosed both *ex ante* and *ex post*. Disclosure *ex ante* is relevant for the application of the standard of review under the corporate law of the state of incorporation; I shall come to this in a moment. *Ex post* disclosure is mandated by securities regulation at the federal level.[7] Traditionally, in the US, related-party transactions had to be disclosed *individually*, in the periodic disclosures filed with the SEC, provided that they satisfied the requirement of materiality.[8] The same transactions had also to be reported in the annual accounts, following the strict requirements of the Generally Accepted Accounting Principles (GAAP).[9] In the aftermath of Enron and of the other financial scandals of the beginning of this century, these requirements have been supple-

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[2] Rock, E.B. [2002], *Securities Regulation as Lobster Trap: A Credible Commitment Theory of Mandatory Disclosure*, in CARDOZO LAW REVIEW, vol. 23, 675-704.

[3] Fisch, J.E. [2000], *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, in UNIVERSITY OF CINCINNATI LAW REVIEW, vol. 68, 1061-1100.

[4] Coffee, J.C. Jr. [2001a], *Do Norms Matter? A Cross-Country Evaluation*, in UNIVERSITY OF PENNSYLVANIA LAW REVIEW, vol. 149, 2164-2165.

[5] See, e.g., Zingales, L. [2005], *The Importance of Bad News*, in G. Owen, T. Kirchmaier and J. Grant (eds.), CORPORATE GOVERNANCE IN THE US AND EUROPE, Macmillan, 96-100. But on how this interacts with the role played by the Delaware's judiciary, see Rock, E.B. [1997], *Saints and Sinners: How Does Delaware Corporate Law Work?*, in UCLA Law Review, vol. 44, 1009-1107.

[6] Kraakman, R.H., Davies, P., Hansmann, H., Hertig, G., Hopt, K.J., Kanda, H. and Rock, E.B. [2004], THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH, Oxford University Press (hereinafter Kraakman *et al.* [2004], *The Anatomy*), 103 and 195-203.

[7] This is based on two fundamental Securities Acts (Securities Act of 1933 and Securities Exchange Act of 1934) and on the SEC Regulations enacted thereupon.

[8] SEC Regulation S-K, Item 404 (disclosure in the annual filings of all company transactions directly or indirectly concluded with the management or their related parties, provided that they exceed $ 60,000 in value).

[9] Statement of Financial Accounting Standards (SFAS) 57 – Related Party Disclosure.

mented with the obligation of real-time disclosure: material conflicted interest transactions must now be reported within two days.[10]

Disclosure of related-party transactions in the US is demanding, and therefore burdensome – not differently from the rest of information regulation in the securities field.[11] However, on the one hand, the requirement of materiality is established just to cope with the risk of false positives – which would be high when direct and indirect costs of disclosure exceed the value of the transaction.[12] On the other hand, mandatory disclosure activates a number of mechanisms to cope with the risk of false negatives.[13] This has not much to do with individual investors negatively reacting to information about the corporate controller's conflicts of interest. In spite of extensive disclosure (or maybe just because of that), most investors do not even know of them; and those who do would hardly care.[14] Much more important is that a dishonest corporate controller will never disclose non-pro-rata distributions involved by related-party transactions.[15] Extraction of diversionary private benefits of control (PBC) is therefore deterred more by the consequences of *violation* of mandatory disclosure (that is, false/misleading information, or omission of material facts), than by its *compliance*.[16] These consequences are criminal and civil liability of either executive directors or controlling shareholders (depending on who is *actually* in charge), which in turn activates shaming in the managerial profession much before a verdict is delivered and a sentence pronounced.[17]

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10 § 16(a) of the Securities and Exchange Act of 1934, as amended by § 403 of the Sarbanes-Oxley Act of 2002. As a result, related-party transactions must be not only reported in the annual Form 10-K, but also filed in real time with a Form 8-K (provided, of course, that they are material).

11 Kraakman *et al.* [2004], *The Anatomy*, cit., 197-201.

12 Id., at 195-196.

13 This is the "enforcement function of mandatory disclosure." Id., at 195.

14 Paredes, T.A. [2003], *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, in WASHINGTON UNIVERSITY LAW QUARTERLY, vol. 81, 417-485.

15 See Mahoney, P.G. [1995], *Mandatory Disclosure as a Solution to Agency Problems*, in UNIVERSITY OF CHICAGO LAW REVIEW, vol. 62, 1047-1112. Indeed, "[p]eople who are forced to undress in public will presumably pay some attention to their figures." Loss, L. [1983], FUNDAMENTALS OF SECURITIES REGULATION, Little, Brown and Company, 36.

16 "There are a number of reasons why firms might disclose too little or lie outright if allowed to do so, some of which are subtle and some not. The first – and possibly the most important – is the very unsubtle agency problem between public shareholders and corporate insiders. […] Mandating disclosure of news, whether good or bad, minimizes this agency problem for public investors – providing, of course, that the law's mandate is enforced." Kraakman *et al.* [2004], *The Anatomy*, cit., 204. On how violations are credibly enforced in the US, see Id., at 210-212, and *infra* section 9.2.3.

17 US Securities regulation is very detailed when it comes to identifying the controlling person upon witch liability is imposed. See Lowenfels, L.D. and Bromberg, A.R. [1997], *Controlling Person Liability Under Section 20(a) of the Securities Exchange Act and Section 15 of the Securities Act*, in THE BUSINESS LAWYER, vol. 53, 1-33. On how the threat of legal suit interacts with 'shame and embarrassment' of corporate controllers in the US, see Paredes, T.A. [2004], *op. cit.*, 1085-1101.

This is basically how deterrence of non-pro-rata distributions is obtained by US securities regulation. Whether this is more likely to be over-deterrence or under-deterrence depends on interaction with enforcement and the other substantive rules. The crucial point is that, not only in the discipline of related-party transactions, US securities regulation works as a "lobster trap."[18] Corporate controllers of companies placing stock with American investors are thereby committed to high-quality disclosure, which in turn implies abiding by the restrictions on transactions suspected of diversionary implications, under the penalty of severe monetary and non-monetary sanctions.

While mandating disclosure of conflicted interest transactions, securities regulation does not set the criteria for assessing their diversionary potential or implications. That is the domain of corporate law. As I mentioned earlier in this work, corporate law in the US is basically the law of Delaware.[19] This is the outcome of US states competition for corporate charters. Like in the past Chapters, I shall refrain from entering the debate about the determinants and the implications of regulatory competition in American corporate law. Nevertheless, Delaware's primacy in the production of corporate law will be a matter of speculation, since at least one major reason of this primacy seems to be the superior ability of Delaware's judiciary to cope with the problem of Type I and Type II errors in policing non-pro-rata distributions and, more in general, with the discretion-accountability tradeoff in corporate governance. The design of the standard of review of related-party transactions is an exemplary illustration of this point.

9.2.2. Substantive Standards: Corporate Law and Its Refinements by Delaware Courts

a) Fiduciary Duties of the Board of Directors

At early common law, corporate directors were subject to the agent's fiduciary duties.[20] This implied that they faced liability in case of negligent behavior, and that director's conflicted interest transactions were per se voidable by the corporation as

[18] Rock, E.B. [2002], *op. cit.*

[19] See *supra*, Chapter Seven, note 7.

[20] This is the typical starting point of both American and British treaties on corporate law. Yet, to be sure, the point is not entirely clear. It might well be that the two major common law jurisdictions have never really subjected corporate directors to the duties of the agent. See Enriques, L. [2000], *The Law on Company Directors' Self-Dealing: A Comparative Analysis*, in INTERNATIONAL AND COMPARATIVE CORPORATE LAW JOURNAL, vol. 2, 297-333, for a historical illustration.

breach of the duty of loyalty.[21] At the same time, controlling shareholders owed no fiduciary duties to non-controlling shareholders – so that, basically, no discipline of conflicts of interest was applicable to the former.[22] This is history, and none of the above-mentioned rules applies any longer.[23] The evolution of judge-made corporate law introduced the business judgment rule as a general standard of review of director's conduct, thereby short-circuiting – in the corporate field – the interpretation of the equitable principle of the fiduciary's due care as a substantive negligence standard.[24] The standard became, at most, that of so-called 'process due care,' which basically requires that a decision is taken by the board on the basis of information reasonably available under the circumstances – no matter of the consequences of the decision in hindsight.[25]

The requirement of process due care is the essence of perhaps still the most debated ruling of the Supreme Court of Delaware: *Smith v. Van Gorkom*.[26] Even this very mild requirement was subsequently short-circuited by the adoption of statutory provisions (so-called 'D&O' statutes) that allowed the corporation to indemnify directors and officers in case of fault liability, or to provide them with insurance for the same event.[27] This is how the business judgment rule has become *de facto* a principle of judicial abstention from reviewing director's diligence in decision-making.[28] Board decisions can only be challenged in court by claiming that the

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21 Bainbridge, S.M. [2002a], CORPORATION LAW AND ECONOMICS, Foundation Press, 308.

22 Id., at 335-336.

23 For the fiduciary duties of controlling shareholders see *infra*, next subsection.

24 The principle itself is a very old one. See, e.g., Dodge v. Ford Motor, 170 N.W. 668 (Mich.1919); Leslie v. Lorillard, 18 N.E. 363 (N.Y.1888). The leading cases in modern corporate law are: Shlensky v. Wrigley, 237 N.E.2d 776 (Ill.App.1968); Kamin v. American Express, 383 N.Y.S.2d 807 (Sup.Ct.1976), aff'd, 387 N.Y.S.2d 993 (App.Div.1976). In Delaware, see Aronson v. Lewis, 473 A.2d 805 (Del.Sup.1984). However, "Delaware courts often have not been as clear as they might be about the effect of the business judgment rule." Bainbridge, S.M. [2002a], *op. cit.*, 249. "About all one can say with confidence, therefore, is that we probably have not heard the last word on the subject." Id., at 251. The business judgment rule has been 'codified' in the last version of the Model Business Corporation Act (hereinafter MBCA), in § 8.30; whereas the Delaware General Corporation Law (hereinafter DGCL) is absolutely silent on the matter.

25 The requirement of process due care is a peculiar feature of Delaware case-law. See Brehm v. Eisner, 746 A.2d 244 (Del.Sup.2000). In other jurisdictions, directors are subject to much less stringent standards. See, e.g., MBCA § 8.30(c) – as commented by Bainbridge, S.M. [2002a], *op. cit.*, 297-299 and Hamilton, R.W. [2000], THE LAW OF CORPORATIONS, West Group, 447-453.

26 Smith v. Van Gorkom, 488 A.2d 858 (Del.Sup.1985).

27 See, most prominently, DGCL §102(b)(7) and DGCL § 145. Bainbridge, S.M. [2002a], *op. cit.*, 299-304.

28 Easterbrook, F.H. and Fischel, D.R. [1991], THE ECONOMIC STRUCTURE OF CORPORATE LAW, Harvard University Press, 90-108.

business judgment rule is inapplicable to the particular case. On top of that, they will never result in out-of-pocket liability for director's failure to exercise due care.[29]

It may seem then quite difficult for a plaintiff to hold a director liable. However, to start with, the business judgment rule is not an irrefutable presumption of correctness of board decisions. A plaintiff could always demonstrate that the decision was irrational, or that there was none.[30] Delaware courts would never uphold a non-decision, nor one "that cannot be attributed to a rational business purpose."[31] Albeit very important, for the reasons that will be clarified in a moment, the irrationality exception to the business judgment rule still gives the plaintiff a hard life. Much more importantly, the protection of the business judgment rule cannot be invoked in case of illegality and fraud.[32] This implies that, in the presence of conflicts of interest, such a protection is available just on condition that the decision is 'procedurally fair.'[33]

Procedural fairness requires full and frank disclosure of the director's conflict of interest and the approval of the conflicted decision by an informed and disinterested body: either a majority of independent directors, or a majority of independent shareholders.[34] Therefore, what is left of the old prohibition of self-dealing is that related-party transactions are allowed to the extent they are fair. They may be procedurally fair, and then they will enjoy the protection of the business judgment rule. Alternatively, they may fail to meet the conditions of procedural fairness, and then courts will uphold them only to the extent they are substantively fair.[35]

A crucial issue is who has to prove what at trial. Once the plaintiff has demonstrated that the decision was not procedurally fair (i.e., that it was not reviewed and approved independently), it will be up to the defendant to show that the terms of the transaction were substantively fair (i.e., that the transaction did not involve di-

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29 Black, B.S., Cheffins, B.R., Klausner, M. [2006], *Outside Director Liability: A Policy Analysis*, in JOURNAL OF INSTITUTIONAL AND THEORETICAL ECONOMICS, vol. 162, 5-20.

30 Aronson v. Lewis, 473 A.2d 805, 813 (Del.Sup.1984) (requirement of exercise of judgment); Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del.Sup.1971) (requirement of a rational business purpose).

31 Brehm v. Eisner, 746 A.2d 244, 264 n. 66 (Del.Sup.2000).

32 This holds in virtually all of US state jurisdictions. See Bainbridge, S.M. [2002a], *op. cit.*, 272-274.

33 Enriques, L. [2000], *op. cit.*; Bainbridge, S.M. [2002a], *op. cit.*, 310-314.

34 See DGCL §144 and MBCA Subchapter F (§§ 8.60-8.63), which superseded the former § 8.31 of the Model Act 1984. Former MBCA § 8.31 was based on DGCL §144, and many states have kept the old model provisions in their corporate statutes. Subchapter F is much more complicated, and it is intended to preempt common law by setting forward binding statutory definitions and safe harbors. For illustration of former MBCA § 8.31 and Subchapter F, see Hamilton, R.W. [2000], *op. cit.*, 467-472; for discussion of the differences from Delaware law and the solution proposed by the Principles of Corporate Governance of the American Law Institute (ALI Principles), see Bainbridge, S.M. [2002a], *op. cit.*, 310-320.

35 Enriques, L. [2000], *op. cit.*

version of assets or cash flow).[36] This is going to be as hard as demonstrating the adequacy of consideration in the absence of an objective benchmark – a rather typical situation when transactions are concluded with related parties instead of at arm's length.[37] As a result, liability is normally imposed on corporate controllers who fail to meet the standard of procedural fairness in conflicted interest transactions.

Under the business judgment rule, the reverse test is in principle not allowed. When the requirements of procedural fairness are fulfilled, the plaintiff should be prevented from any allegation that the transaction was not substantively fair, however difficult proving this is.[38] While this is the law of some states, Delaware courts went further.[39] Not only the immunization effect of the business judgment rule is anyway overcome upon a showing of waste – and here comes the importance of the irrationality exception.[40] Also, procedural fairness itself does not prevent Delaware courts from exercising a 'smell test' on the substantive fairness of the transactions.[41] As a result, if the plaintiff manages to demonstrate that the transaction, albeit meeting the standard of procedural fairness, is highly suspected of being fraudulent, it will be subject to judicial review.[42] This is no repudiation of the business judgment doctrine, but only a refinement. Delaware judges still defer to busi-

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36 Marciano v. Nakash, 535 A.2d 400 (Del.Sup.1987). See also Bainbridge, S.M. [2002a], *op. cit.*, 315-316.

37 See *supra*, Chapter Eight, section 8.4.1.

38 See Hamilton, R.W. [2000], *op. cit.*, 467-472 (discussing "sanitization" of conflicted interest transactions under former § 8.31 and current Subchapter F of the MBCA).

39 As I mentioned, Subchapter F of the MBCA preempts common law with immunizing safe harbors, whereas DGCL § 144 does not. Therefore, under Delaware jurisdiction (and, to be sure, in a number of other American states as well), approval of related-party transactions by disinterested directors or shareholders have no immunization effect and only shifts to the plaintiff the burden of proving that the business judgment rule is inapplicable.

40 Rock, E.B. and Wachter, M.L. [2001], *Islands of Conscious Power: Law, Norms and the Self-Governing Corporation*, in UNIVERSITY OF PENNSYLVANIA LAW REVIEW, vol. 149, 1663. On the importance of the waste exception, see *supra*, Chapter Eight, section 8.4.2.

41 This is the high peculiarity of Delaware courts' attitude when reviewing related-party transactions. See Enriques, L. [2000], *op. cit.*, and Kraakman *et al.* [2004], *The Anatomy*, cit., 108-109 and 114-118.

42 This is well illustrated by Fliegler v. Lawrence, 361 A.2d 218, 222 (Del.Sup.1976):

> DGCL § 144 does not provide a "broad immunity." "It merely removes an 'interested director' cloud when its terms are met and provides against invalidation of an agreement 'solely' because such a director or officer is involved. Nothing in the statute sanctions unfairness [to the plaintiff] or removes the transaction from judicial scrutiny."

In Kahn v. Lynch Communication Systems, 638 A.2d 1110 (Del.Sup.1994), the Supreme Court explicitly stated that ratification by disinterested shareholders or directors only has "the effect of shifting the burden of proof of unfairness to the plaintiff." Notice, however, that to our purposes this is a mere *dictum*: *Kahn* was about a freeze-out merger, to which the business judgment rule is not applicable – see *infra*, Chapter Eleven, section 11.2).

ness judgment in the presence of disinterested approval of related-party transactions, but do not want this to generate any 'license to steal.'[43] As we are about to see, this has important effects on the balance between false positives and false negatives in the discipline of related-party transactions.

b) Fiduciary Duties of the Controlling Shareholder

The practical approach of American case-law to the policing of non-pro-rata distributions is even better illustrated by how the problem is dealt with in the presence of a controlling shareholder. The extension of fiduciary duties to controlling shareholders is a rather unique feature of US law,[44] which took place already in the first half of the twentieth century.[45] Courts were prompt in recognizing the obvious circumstance that a controlling shareholder has the power to elect the entire board of directors, and therefore that the latter lacked any possible independence absent proof to the contrary.[46] This involves the presence of an inherent conflict of interest anytime a board decision may adversely affect minority shareholders. On this basis, the courts of Massachusetts refused to grant this kind of decisions the protection of the business judgment rule, and imposed upon both directors and controlling shareholders a general duty of equal treatment of minority shareholders.[47] The negative consequences of such a principle on the corporate controller's discretion (especially in the takeover context) are quite intuitive, and will be discussed in more detail in the next two Chapters.[48] Luckily, this ruling has never been applied outside

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[43] This expression is normally referred to 'exculpatory provisions' of the articles of incorporation. Irwin v. West End Development Company, 342 F.Supp. 687 (D.C.Colo.1972). Delaware judges are inclined to extend this attitude to the interpretation of statutory law. To summarize, approval of an interested transaction by either a fully-informed disinterested board of directors or the disinterested shareholders provides the protection of the business judgment rule, *unless* the plaintiff shareholders "demonstrate that the terms of the transaction are so unequal as to amount to a gift or waste of corporate assets." In re Wheelabrator Tech., Inc. Shareholder Litigation, 663 A.22d 1194 (Del.Ch.1995).

[44] See Kraakman *et al.* [2004], *The Anatomy*, cit., 123-131 (with special reference to the 'majority of minority' rule, discussed *infra* in the text).

[45] See, e.g., Southern Pac. Co. v. Bogert, 250 U.S. 483, 39 S.Ct. 533, 63 L.Ed. 1099 (1919); Pepper v. Litton, 308 U.S. 295, 60 S.Ct. 238, 84 L.Ed. 281 (1939).

[46] Bainbridge, S.M. [2002a], *op. cit.*, 336.

[47] Donaue v. Rodd Electrotype Co., 367 Mass. 578, 328 N.E.2d 505 (Mass.1975).

[48] See *infra*, Chapter Ten, section 10.3.2., and Chapter Eleven, section 11.2.2.

closely held corporations.[49] More importantly, it has never become the law of Delaware.[50]

Delaware courts have taken a more focused approach to the matter, which is essentially limited to self-dealing.[51] Controlling shareholding is itself no exception to the business judgment rule, but only a reason to be more careful about related-party transactions.[52] A controlling shareholder will have to show the substantive fairness of transactions concluded with him or any related party of his, unless he can prove that the same transactions received truly independent (i.e. both informed and disinterested) approval.[53] The only corporate bodies that qualify for such an approval are either directors appointed without the votes of the controlling shareholders (a very unlikely occurrence, at least unless cumulative voting is provided for by the corporate charter) or – more generally – a 'majority of the minority shareholders.'[54] It is finally worth noting that Delaware courts take a case-by-case approach to the identification of controlling shareholders (at the end of the day, what matters is his ability to control the board of directors), differently from other bodies of law or recommendations which rely instead on presumptive threshold of voting control.[55]

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49 Bainbridge, S.M. [2002a], *op. cit.*, 797-831; Easterbrook, F.H. and Fischel, D.R. [1991], *op. cit.*, 228-252.

50 *Donaue* was explicitly rejected by the Supreme Court of Delaware in Nixon v. Blackwell, 626 A.2d 1366 (Del.Sup.1993). See Hamilton, R.W. [2000], *op. cit.*, 373-375.

51 For an excellent overview of fiduciary duties of controlling shareholders in the US see Bainbridge, S.M. [2002a], *op. cit.*, 335-360.

52 The typical conflict of interest of a controlling shareholder takes place in parent-subsidiary transactions. The Supreme Court of Delaware identified two standards potentially applicable to such transactions: the business judgment rule (a rebuttable presumption of good faith) and the intrinsic fairness test (which places on the controlling person the burden of proving objective fairness of the transaction to minority shareholders). Under Delaware law, the intrinsic fairness test is applicable *only* when the controlling shareholder is in the position to extract non-pro-rata benefits, namely benefits "to the exclusion and at the expenses of the subsidiary." Sinclair Oil Co. v. Levien, 280 A.2d 717, 720 (Del.Sup.1971).

53 Bainbridge, S.M. [2002a], *op. cit.*, 338; Hamilton, R.W. [2000], *op. cit.*, 488.

54 "A party alleging domination and control of a majority of a company's board of directors, and thus the company itself, bears the burden of proving such control by showing a *lack of independence on the part of a majority of the directors*." Odyssey Partners, L.P. v. Fleming Companies, Inc., 735 A.2d 386, 487 (Del.Ch.1999) – emphasis added. "Approval of the transaction by an independent committee of directors or an *informed majority of minority shareholders* shifts the burden of proof on the issue of fairness from the controlling or dominating shareholder to the challenging shareholder-plaintiff. Nevertheless, even when an interested *cash-out merger* transaction receives the informed approval of a majority of minority stockholders or an independent committee of disinterested directors, an entire fairness analysis is the only proper standard of review." Kahn v. Lynch Communication Systems, 638 A.2d 1110, 1117 (Del.Sup.1994) – emphases added. The latter qualification is a peculiarity of freeze-out transactions, which will be discussed in Chapter Eleven, section 11.2.

55 Under Delaware law, a shareholder (or a coalition of them) is (are) considered to be in control if he (they) either own(s) a majority of voting stock or exercise(s) *de facto* control over corporate deci-

This is apparently an ideal system of substantive regulation of related-party transactions. However, any judgment upon the US discipline would be premature until its enforcement is considered. As we know, enforcement can take place at either the *ex post* or the *ex ante* stage. Perhaps differently from anywhere else in the world, one major driver of *ex post* enforcement in the US is an "entrepreneurial system" of private litigation dominated by corporate lawyers.[56] At least when it comes to violations of securities regulation, this is coupled with the action of one of the most aggressive public enforcers in the world: the Securities and Exchange Commission.[57] Finally, the combination of public and private law enforcement activates shaming through the forceful action of the American financial press.[58] From the very first moment a public investigation and/or a private suit are initiated, the corporate controller's reputation is seriously endangered. This may suggest two conclusions. On the one hand, enforcement of the discipline of related-party transactions makes constraints on non-pro-rata distributions very effective in US corporate governance. On the other hand, the same enforcement is highly exposed to the risk of false positives, which may undermine the overall efficiency of the US discipline. As it turns out, both conclusions are correct, albeit with some qualifications.

9.2.3. Enforcement of Shareholder Protection against Self-Dealing

a) *Securities Litigation: Class Action Suits*

It is relatively easy for a company whose stock is traded in the US to end up being involved in securities litigation.[59] The wide reach of the major antifraud provi-

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sion-making. See Bainbridge, S.M. [2002a], *op. cit.*, 337 (where reference to the pertinent authorities). The SEC instead presumes control in the presence of ownership of 10% or more of the voting stock, especially when this is coupled with membership on the board and other circumstances, and apparently considers stock ownership as sufficient when the 20% threshold is surpassed. Black, B.S. [1990a], *Shareholder Passivity Reexamined*, in MICHIGAN LAW REVIEW, vol. 89, 549. These presumptions are relevant in the enforcement of controlling person liability under the two Securities Acts of 1933 and 1934, but they are not binding on the federal courts. See Lowenfels, L.D. and Bromberg, A.R. [1997], *op. cit.* The ALI Principles § 1.10(b) presumes control at the 25% threshold.

56 Coffee, J.C. Jr. [1987], *The Regulation of Entrepreneurial Litigation: Balancing Fairness and Efficiency in the Large Class Action*, in UNIVERSITY OF CHICAGO LAW REVIEW, vol. 54, 877-937.

57 Rock, E.B. [2002], *op. cit.*

58 Zingales, L. [2005], *op. cit.*

59 This is how securities regulation performs an 'enforcement function' in US corporate governance (hereinafter CG). Kraakman *et al.* [2004], *The Anatomy*, cit., 195. Despite of formal division of competence between the federal and the state level, class actions brought under securities law subject managerial behavior to additional scrutiny. Thompson, R.B. and Sale, H.A. [2003], *Securities Fraud as Corporate Governance: Reflections upon Federalism*, in VANDERBILT LAW REVIEW vol. 56, 859-910. On

sion under US securities law – the infamous Rule 10b-5 promulgated under the Securities Exchange Act of 1934 – is as well known by corporate lawyers as heavily criticized by academics, especially in the Law and Economics field.[60] A detailed analysis of anti-fraud provisions under US securities law is outside the scope of the present inquiry.[61] Here it is sufficient to point out that Rule 10b-5 provides individual investors with private standing to sue triggered by reliance on misleading, material information in the purchase or sale of securities.[62] Inadequate disclosures of

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this basis, it has been authoritatively suggested that regulatory competition in US corporate governance is not really at the state level, but rather between Delaware and the federal government. Roe, M.J. [2003a], *Delaware's Competition*, in HARVARD LAW REVIEW, vol. 117, 588-646. When it comes to anti-fraud provisions (our focus in the study of regulatory constraints on self-dealing), enforcement of securities law in the US is to be understood as a peculiar combination of private and public enforcement. Kraakman *et al.* [2004], *The Anatomy*, cit., 221. Indeed, class actions are most likely to succeed (i.e., to be settled for spectacular amounts of money) in combination with a SEC investigation. Cox, J.D. and Thomas, R.S. [2003], *SEC Enforcement Heuristics: An Empirical Inquiry*, in DUKE LAW JOURNAL, vol. 53, 737-779. This makes an allegation of securities fraud the most powerful deterrent against the corporate controller's misbehavior in the US.

60 SEC Rule 10b-5 was promulgated under § 10(b) of the Securities and Exchange Act 1934, and is the most famous of "a dozen antifraud provisions under the federal securities acts." Kraakman *et al.* [2004], *The Anatomy*, cit., 211. What makes Rule 10b-5 a nightmare for corporate managers (and the heaven of securities lawyers) is the so-called 'fraud-on-the-market' doctrine elaborated by the federal courts. See Basic Inc. v. Levinson, 485 U.S. 224, 108 S.Ct. 978, 99 L.Ed.2d 194 (1988). By and large, this exposes wrongdoers not only to the tough enforcement by the SEC, but also to private legal suits for massive damage compensation. Civil actions for breach of Rule 10b-5 are typically brought as class actions wherein any investor who traded in the presence of false or misleading information is considered as injured, independently of actual reliance on information in the decision of whether to trade or not the affected securities. The fraud-on-the-market doctrine has been heavily criticized in Law and Economics. See, e.g., Macey, J.R. and Miller, G.P. [1990], *Good Finance, Bad Economics: An Analysis of the Fraud-on-the-Market Theory*, in STANFORD LAW REVIEW, vol. 42, 1059-1092. The debate is not yet terminated. For a recent discussion of how both case-law and the literature have evolved (especially by taking the insights of behavioral finance into account), see Ribstein, L.E. [2006], *Fraud on a Noisy Market*, in LEWIS & CLARK LAW REVIEW, vol. 10, 137-168.

61 For a summary illustration of the topic, as related to securities litigation, see Hamilton, R.W. [2000], *op. cit.*, 556-574. An important issue concerns the liability of so-called 'secondary defendants,' namely those who did not operate the alleged fraud, but failed to exercise their duties to prevent it. See, in this regard, Partnoy, F. [2001], *Barbarians at the Gatekeepers? A Proposal for a Modified Strict Liability Regime*, in WASHINGTON UNIVERSITY LAW QUARTERLY, vol. 79, 491–547.

62 Rule 10b-5 provides grounds for civil liability in the presence of the following elements (Hamilton, R.W. [2000], *op. cit.*, 559): (1) a *misstatements* or an *omission* of facts; (2) *materiality* of information as to the decision whether to make or dispose of an investment; (3) *scienter* (i.e., knowledge of wrongness or illegality of the conduct – but the courts normally consider recklessness or an extreme departure from the applicable standard of care as sufficient); (4) *injury* of the plaintiff due to *reliance* on the misstatement or omission. The fraud-on-the-market theory is based on the assumption that market prices are informationally efficient (see Gilson, R.J. and Kraakman, R.H. [1984], *The Mechanisms of Market Efficiency*, in VIRGINIA LAW REVIEW, vol. 70, 549-644). The underlying information is therefore presumed to be relied upon by rational investors. As a result, the proximate cause test for im-

related-party transactions clearly qualify, but indeed even the most honest statement concerning the corporate controller's conflicts of interest may be charged of being misleading until a federal court dismisses the petition as unfounded. Very often, such a petition will be filed as soon as anything goes wrong with the company's stock price for whatever reason.[63] Why? Because corporate lawyers will take over, being motivated by their own financial interest rather than by maximization of shareholder value.

The perverse combination of class action and contingent fees makes this result hold. In the US, a legal suit can be brought on behalf of the entire class of investors without need of an explicit mandate by all of them. As a result, a few disgruntled shareholders may suffice for the initiative.[64] The contingent fee arrangement gives

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position of liability (see Cooter, R.D. and Ulen, T.S. [2004], LAW AND ECONOMICS, 4th edn., Addison-Wesley, 315) is trivialized.

63 Garry, P.M., Spurlin, C.J., Owen, D.A., Williams, W.A., Efting, L.J. [2004], *The Irrationality of Class Action Lawsuits: A Proposal for Reform*, in SOUTH DAKOTA LAW REVIEW, vol. 49, 275-312. This has mostly to do with the fraud-on-the-market-theory, whereby the burden of proof of causation in securities lawsuits for damages is significantly relaxed. The perverse outcome described in the text was the major argument that led the Congress to pass the Private Securities Litigation Reform Act (PSLRA) of 1995, in spite of the veto by President Clinton. The Committee Report proposing the legislation explicitly stated the purpose to end the "routine filing of lawsuits against issuers of securities and others whenever there is a significant change in an issuer's stock price, without regard to any underlying culpability of the issuer, and with only faint hope that the discovery process might lead eventually to some plausible cause of action." H.R. Rep. No. 104-369, at 31 (1995). The picture presented to the Congress is very efficaciously described in Hamilton, R.W. [2000], *op. cit.*, 560-561. While the picture "may be overdrawn" (Id., at 561), it is quite doubtful that the PSLRA effectively brought the above situation to an end. See Perino, M.A. [2002], *Did the Private Securities Litigation Reform Act Work?*, in UNIVERSITY OF ILLINOIS LAW REVIEW, vol. 2003, 913-977.

64 In corporate governance, a class action is a direct suit brought by one or more shareholders as a representative of a larger class of shareholders for injuries pertaining to the interests of the class. Once the class action is 'certified' by the court, the plaintiff will represent the entire group of the company's stockholders. The requirements for valid representation have been sharpened by the PSLRA 1995, but this has not altered the basic functioning of the mechanism. In the typical situation, the plaintiff will claim that disclosures by the corporation were false and/or misleading, and thus had adverse effects on the price of the company's stock. Both the alleged wrongdoers and the corporation are named as primary defendants, and the plaintiff will also seek to involve as many secondary defendants as possible. The latter and the company are in fact the 'deep pockets.' Both case-law (Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 114 S.Ct. 1439, 128 L.Ed.2d 119 (1994)) and the PSLRA 1995 have limited the scope of joint and several liability of secondary defendants. However, this mostly concerns gatekeepers – an issue which is not dealt with here. To our purposes, it is worth noting that the expectations of a successful class actions are that the company will pay a huge amount of money for damage compensation commensurate to the (presumptive) size of the class; however, for the reason that we are about to see, it is the plaintiff's lawyers, and not the individual class members, that get the lion's share of it. After the class action has been certified, chances are very high that the suit is settled before the trial begins. The aim is that of sparing the company a burdensome discovery process. Settlement of a class action is sub-

lawyers the incentive to actually *solicit* class actions whenever there are the slightest grounds for that, and provides shareholders with the incentive to yield to solicitation.[65] Shareholders will apparently risk nothing but being awarded damage compensation, and also lawyers can only profit from this strategy. This last point is tricky, since in theory American lawyers anyway bear the litigation expenses under a contingent fee scheme, and will get nothing when the case is lost.[66] In practice, however, securities class actions are normally settled before going to trial, and almost none of them are concluded with a court judgment. Regardless of the merits of the suit, the company will always prefer an early settlement to an expensive discovery procedure and – even more so – to the adverse consequences of a jury trial on its reputation in both the financial and the products market.[67] As a result, lawyers being awarded extremely generous fees – as a part of the settlement – are the only winners of this game. A few shareholders, if any of them, do realize that this money is ultimately coming out of their pockets, and that they are getting just a part of it back in the form of damage compensation.[68]

This is of course an oversimplification. In fact, there are a number of safeguards against frivolous suits in American civil procedure – even though it is doubtful that they are sufficient to prevent the outcome sketched out above – and they are even stricter in securities law.[69] In addition, the company is not the only defendant in a securities class action. Also directors and controlling shareholders are, even though

ject to a number of procedural requirements and has to be approved by the court. See, illustratively, Hamilton, R.W. [2000], *op. cit.*, 556-574.

65 The contingent fee arrangement makes the plaintiff's lawyers the key decision-makers in a class action. Under this arrangement, the lawyers get a percentage of the entire damage compensation to be awarded to the class in case of success, and nothing otherwise. See Rubinfeld, D.L. and Scotchmer, S. [1998], *Contingent Fees*, in P. Newman (ed.), THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW, Macmillan, vol. 1, 415-420. It should be noticed that the lawyers' compensation largely exceeds the damage compensation to individual class members. It is for this reason that class action litigation is driven by the lawyers. Few plaintiff shareholders are actually involved and their stake in the suit is negligible compared to the expected awards to the class – and yet, the vast majority of its members are not involved in the suit! When it comes to bargaining for a settlement, it will be ultimately the lawyers' interest as opposed to that of the company. As a result, the plaintiff's lawyers always get the lion's share of the money settled for, whereas the company will pay most of it. A part, but only a part, of the money paid by the company will go back to shareholders in the form of damage compensation. But the company's money is ultimately shareholders' money, isn't it? See Romano, R. [1991], *The Shareholder Suit: Litigation without Foundation?*, in JOURNAL OF LAW, ECONOMICS, AND ORGANIZATION, vol. 7, 55-87.

66 Hughes, J.W. and Snyder, E.A. [1998], *Allocation of Litigation Costs: American and English Rules*, in P. Newman (ed.), THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW, Macmillan, vol. 1, 51-56.

67 See Hamilton, R.W. [2000], *op. cit.*, 559-561; and Paredes, T.A. [2004], *op. cit.*, 1086-1103.

68 Garry, P.M., Spurlin, C.J., Owen, D.A., Williams, W.A., Efting, L.J. [2004], *op. cit.*

69 Hamilton, R.W. [2000], *op. cit.*, 562-572.

they cannot be reasonably expected to be the 'deep pocket' where the money of the settlement will ultimately come from. Finally, and most importantly, the question of who gets compensation and who pays for it is the wrong one from an economic standpoint.[70] *Ex post*, compensation is just a matter of distribution, although it affects incentives *ex ante*. At the end of the day, what matters for efficiency is whether liability optimally deters misbehavior *ex ante*. In this perspective, high reward of the lawyer's effort is in itself not a bad thing, provided that it is necessary to achieve deterrence of non-pro-rata distributions by corporate controllers.[71]

In the US, deterrence is most likely to obtain from the threat of securities litigation and, if anything, one may predict that there will be too much of it.[72] This holds irrespective of the limited personal wealth of wrongdoers (who would be ruined anyway by a class action suit), and rather depends on the circumstance that civil liability is just one part of the expected sanction.[73] Securities fraud is also a federal criminal offence, and it is regarded as a serious malfeasance by the American society. Traditionally, Americans do not want to 'mess with the feds,' and the news of a SEC investigation – which is expected to follow the filing of a class action suit, if it was not already initiated – would suffice for the manager's reputation to be compromised by the national press, even in case of subsequent acquittal in both administrative and criminal proceedings.[74] It is because of a so powerful combination of enforcement mechanisms that US securities regulation may easily lead to over-deterrence of related-party transactions.[75] Given the high exposure to the risk of false positives, honest corporate controllers may choose to forego efficient business opportunities anytime a potential conflict of interest could result in grounds for

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[70] Coffee, J.C. Jr. [2006b], *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, in COLUMBIA LAW REVIEW, vol. 106, 1534-1586.

[71] For how contingent fees are actually desirable in that they align the lawyer's incentives to the interest of plaintiffs with a strong case, and allow meritorious suits to be selected thereby, see the classic Rubinfeld, D.L. and Scotchmer, S. [1993], *Contingent Fees for Attorneys: An Economic Analysis*, in RAND JOURNAL OF ECONOMICS, vol. 24, 343-356. See also Rubinfeld, D.L. and Scotchmer, S. [1998], *op. cit.*, for a broader overview of the literature.

[72] The reader should be warned that this result is far from uncontroversial. So far, the empirical evidence has not borne out the theoretical hypothesis that securities class actions lead to over-deterrence, but has not rejected it either. See Choi, S.J. [2004], *The Evidence on Securities Class Actions*, in VANDERBILT LAW REVIEW, vol. 57, 1465-1528.

[73] For the combination of legal and non-legal sanctions faced by potential wrongdoers in US corporate governance, see Paredes, T.A. [2004], *op. cit.*, 1075-1103.

[74] See Hazard, G.C. and Rock, E.B. [2004], *A New Player in the Boardroom: The Emergence of the Independent Directors' Counsel*, in THE BUSINESS LAWYER, vol. 59, 1389-1412 (making this argument for outside directors).

[75] Owen, G., Kirchmaier, T. and Grant, J. [2005], *Corporate Governance in the US and Europe: Where are We Now?*, in G. Owen, T. Kirchmaier and J. Grant (eds.), CORPORATE GOVERNANCE IN THE US AND EUROPE, Macmillan, 12.

litigation – with the unavoidable follow-up of a public inquiry. Still, even this powerful enforcement machinery cannot entirely deter "spectacular, one-shot appropriations, of the 'take the money and run' sort."[76] This machinery did not prevent Enron, nor – arguably – could anything else have prevented it.

b) Corporate Litigation: Derivative Suits

The balance between false positives and false negatives is somewhat more even in corporate litigation. Although the lawyers' incentive scheme is very similar to securities litigation, there are important differences.[77] To start with, a shareholder suit is not formally a class action. It is more precisely a 'derivative' suit that the individual shareholder may bring on behalf of the corporation against its directors or controlling shareholder.[78] The prominent consequence of the derivative character of the suit is that only the corporation, and not the plaintiff shareholder, is entitled to damage compensation. This makes little difference for the corporate lawyer working on a contingent basis, provided that his expected reward is still commensurate to the damages indirectly suffered by shareholders as a group.[79]

A more important difference is that a derivative suit has to be brought in the courts of the company's state of incorporation. For the vast majority of listed companies this means Delaware courts.[80] Whatever the merits of state competition for corporate charters in the US are, one rather uncontroversial point is that a highly specialized judiciary emerged as a result.[81] On the one hand, this has lead to the development of the very sophisticated standards of review of related-party transactions, which we have just discussed. On the other hand, the technical skills of Delaware judges make frivolous suits very unlikely to go to trial. Indeed, both class actions and derivative suits may be dismissed by the court upon a summary judgment of the claim being not meritorious.[82] However, this assessment can be reasonably expected to be much more accurate when it is made by a very specialized judiciary, whose prestige (perhaps the strongest motivation of judges) ultimately

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76 Easterbrook, F.H. and Fischel, D.R. [1991], *op. cit.*, 103.

77 Hamilton, R.W. [2000], *op. cit.*, 535-543.

78 A class action is instead a 'direct' suit. On this important distinction, see Hamilton, R.W. [2000], *op. cit.*, 536-538.

79 See Bainbridge, S.M. [2002a], *op. cit.*, 361-368.

80 Bebchuk, L.A. and Cohen, A. [2003], *Firms' Decisions Where to Incorporate*, in JOURNAL OF LAW AND ECONOMICS, vol. 46, 389.

81 Fisch, J.E. [2000], *op. cit.*

82 Hamilton, R.W. [2000], *op. cit.*, 542-544 and 548.

depends on its ability to adjudicate just corporate law's cases.[83] On top of that, derivative litigation has a further procedural hurdle: the 'demand requirement.'[84]

Since the cause of action of corporate lawsuits ultimately belongs to the corporation, shareholders may not bring derivative suit unless they first make demand on the board or demand is 'excused.'[85] Although this is often overlooked in the international literature, in practice the demand requirement makes derivative suits relatively rare in the US.[86] Since directors are naturally reluctant to sue their colleagues (and even more so the controlling shareholder who appointed them), corporate lawsuits most often take place after a change in control or in bankruptcy proceedings. This result parallels what we observe in European jurisdictions.[87] Therefore, contrary to what one would expect, even in the US derivative suits raise little concern of false positives – at least, not as much as securities class actions. However, differently from other jurisdictions, they also contribute to minimizing the risk of false negatives. The ultimate reason of this very special balance between Type I and Type II errors when it comes to the controller's exposure to liability under corporate law is, once again, the proficiency of Delaware courts.

A well-counseled shareholder will *not* make demand on the board knowing that chances are high that it will be refused.[88] Then the crucial issue is when demand is excused.[89] Under Delaware law, futility of demand is based on a bifurcated test: *either* directors are tainted by a conflict of interest (in that they are not *independent* of the corporate controller) *or* they failed to exercise 'process due care' in deciding the

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83 Bainbridge, S.M. [2002a], *op. cit.*, 254-257.

84 See Rule 23.1 of the Federal Rules of Civil Procedure: "The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he or she desires from the directors or comparable authority and the reasons for his or failure to obtain the action or for not making the effort."

85 Bainbridge, S.M. [2002a], *op. cit.*, 385-386.

86 Paredes, T.A. [2004], *op. cit.*, 1083-1085.

87 Kraakman *et al.* [2004], *The Anatomy*, cit., 114-118.

88 Bainbridge, S.M. [2002a], *op. cit.*, 393-395. "At least in Delaware, a plaintiff who makes demand is deemed to concede that demand was required." Id., at 393. This has important implications on judicial review of decisions of the Special Litigation Committee (SLC – see *infra* in the text): basically, a demand refusal by such a committee will enjoy full protection by the business judgment rule. See Hamilton, R.W. [2000], *op. cit.*, 549-552.

89 Demand is excused when its is 'futile,' and so it is when directors: (1) have a conflict of interest in the challenged transaction; (2) were not reasonably informed when they approved it; or (3) the transaction was so egregious that it could not possibly have any rational business purpose. Marx v. Akers, 644 N.Y.S.2d 121, 666 N.E.2d 1034 (N.Y.1996). See Hamilton, R.W. [2000], *op. cit.*, 544-546 for a broader overview.

challenged transactions.[90] The reader can easily realize that these are basically the conditions under which the business judgment rule is set aside. What suffices for demand to be excused is that a 'reasonable doubt' exists that one of these conditions holds.[91] Once the plaintiff's petition passes this test, chances will be high that the case is settled – and, again, lawyers will get the most out of the settlement. But the corporate controller has another option. He can set up a Special Litigation Committee in the board, which will decide whether continuing the lawsuit is in the best interest of the corporation. When the members of the committee are independent and disinterested, their decision will be protected by the business judgment rule.[92]

In many American states, a negative decision by the committee would just bring litigation to an end.[93] Not in Delaware, or at least not necessarily.[94] Delaware judges are in fact rather skeptical about 'independent' directors. Not only they are willing to review conflicted interest transactions that – notwithstanding formally independent approval – "stink bad enough,"[95] but they will also not uphold decisions of the Special Litigation Committee just because its members have no apparent conflict of interest. They have in fact a *structural* one, in that they are appointed by the defendants to derivative litigation – like, in general, independent directors are appointed by the corporate controller.[96] Therefore, in both litigation and substantive review of

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90 Aronson v. Lewis, 473 A.2d 805, 814 (Del.Sup.1984). In Levine v. Smith, 591 A.2d 194, 205 (Del.Sup.1991), the court made clear that the test is a bifurcated one, so that satisfying either prong is sufficient for demand to be excused on grounds of futility.

91 Bainbridge, S.M. [2002a], *op. cit.*, 388-393.

92 Id. 395-404. When demand is excused, Delaware courts are much more parsimonious in awarding decisions by the SLC the protection of the business judgment rule. See also Hamilton, R.W. [2000], *op. cit.*, 548-552.

93 See, e.g., Auerbach v. Bennett, 419 N.Y.S.2d 920 (N.Y.1979) (decision by the SLC to terminate litigation is protected by the business judgment rule, unless it is tainted by conflict of interest or inappropriateness of procedure).

94 This depends on whether demand on the board was required or excused in the first place. Hamilton, R.W. [2000], *op. cit.*, 548-552. When demand is required, Delaware courts will grant decisions of the SLC the protection of the business judgment rule. Conversely, when demand is excused (which means that it was properly brought without making demand on the board), the court will be more skeptical about the judgment by the SLC. See Zapata Corp. v. Macdonaldo, 430 A.2d 779 (Del.Sup.1981) (the court will review both the *procedure* and the *merits* of the decision by the SLC to terminate litigation, in order to check whether termination can be deemed to be in the best interest of the company).

95 Enriques, L. [2000], *op. cit.*

96 Bainbridge, S.M. [2002a], *op. cit.*, 399-400. "The question naturally arises whether a 'there but for the grace of God I' empathy might not play a role." Zapata Corp. v. Macdonaldo, 430 A.2d 779, 787 (Del.Sup.1981). This line of reasoning was endorsed by the federal Circuit Judge Ralph Winter in Joy v. North, 692 F.2d 880, 888 (2d Cir.1982), cert. denied, 460 U.S. 1051 (1983):

self-dealing, Delaware courts do take a 'hands-in' approach whenever the board judgment does not provide sufficient guarantees of being actually independent. This is how also derivative litigation ends up being a serious threat to the corporate controller's misbehavior; and – after securities litigation – the most serious one in US corporate governance.

c) Monitoring Conflicts of Interest: Independent Directors

Delaware law's attitude towards independent directors highlights perhaps the major weakness of US corporate governance, when it comes to the legal policy against non-pro-rata distributions. This policy is highly, if not exclusively, based on the deterrent effect of securities and corporate litigation, which in turn creates an almost unavoidable false positives problem.[97] The problem would be much less severe if independent directors were any more reliable. Ideally, independent directors should enforce the discipline of related-party transactions *ex ante* rather than *ex post*, by preventing more than deterring non-pro-rata distributions based on their professional judgment and the information they must be provided with by the corporate controller.

The above mechanism would confine both securities and corporate litigation to a residual role.[98] On the one hand, independent directors' review of disclosures concerning conflicted interest transactions could provide a safe harbor for class action suits, or just make them harder to file. On the other hand, Delaware courts would easily stop being skeptical about the exercise of business judgment by independent directors, if only judges could trust their not being deferent to the corporate controller who appointed them. Even such an ideal system will never work in the absence of an institutional background. Corporate and securities law will have still to feature credible and severe punishment of misconduct, but the focus of substantive regulation should switch to 'real' independence of director's oversight.

After Enron, this is apparently the direction that US law has taken. The Sarbanes-Oxley Act of 2002, which would be impossible to discuss here in any detail, has undoubtedly intended to strengthen the role of independent directors in

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> "It is not cynical to expect that such committees will tend to view derivative actions against the other directors with skepticism. Indeed, if the involved directors expected any result other than recommendation of termination at least as to them, they would probably never establish the committee."

97 Kraakman *et al.* [2004], *The Anatomy*, cit., 114-118.

98 The line of reasoning being suggested in the text is significantly different from the proposals, which have a long-standing tradition in the American Law and Economics literature, to place significant constraints on shareholder litigation, if not to eliminate it outright. See, e.g., Bainbridge, S.M. [2002a], *op. cit.*, 400-404 (discussing policy issues in derivative litigation).

American corporate governance.[99] However, this effort and the others which followed or are in the making are still very much misdirected. To put it very shortly, the reason is twofold. On the one hand, regulators seem to insist more on the quantity of independent directors in the board than on the quality of their independence. On the other hand, the current legal policy towards independent directors seems aimed at increasing rather their exposure to legal liability more than their accountability to non-controlling shareholders.

The Sarbanes-Oxley Act has notoriously compelled listed firms to set up an audit committee composed solely of independent directors, and the SEC – to say it with an understatement – 'encouraged' the Stock Exchanges to carry the matter of independent directorships further.[100] So the New York Stock Exchange (NYSE) did, and now American listed companies must have a 'majority of independent directors' in their boards.[101] Listing rules are formally binding on the companies that wish to be listed on the NYSE, although the enforcement powers of the Stock Exchange are not comparable to those of the SEC.[102] But the crucial point is that neither in securities law nor in the Stock Exchange regulations is the independence requirement established with reference to appointment by the corporate controller, but only in terms of lack of financial or family involvement with the latter.[103]

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99 For a summary illustration of the Sarbanes-Oxley Act, see Thompson, R.B. [2003], *Corporate Governance After Enron: The First Year*, in HOUSTON LAW REVIEW, vol. 40, 99-117. The post-Enron federal legislation has been heavily criticized from the very beginning. See Ribstein, L.E. [2002], *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, in JOURNAL OF CORPORATION LAW, vol. 28, 1-67. Apparently, the Sarbanes-Oxley Act is not a good example of a sound law-making process, and the empirical evidence since its enactment does not seem to support its merits. See Romano, R. [2005], *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, in YALE LAW JOURNAL, vol. 114, 1521-1611. For a more balanced discussion of the Sarbanes-Oxley Act, see Langevoort, D.C. [2007], *The Social Construction of Sarbanes-Oxley*, in MICHIGAN LAW REVIEW, vol. 105, 1817-1856.

100 Hazard, G.C. and Rock, E.B. [2004], *op. cit.*, 1393.

101 See § 303A.1 of the new Listed Company Manual of the NYSE (2004), approved by the SEC on November 4, 2003.

102 The limited enforceability of Stock Exchange regulations in the US is an old story. See, for an illustration, Rock, E.B. [2002], *op. cit.*, 697-701. The new Listed Company Manual of the NYSE compels the CEOs of listed companies to file an annual statement of compliance and to promptly notify in writing any material non-compliance with § 303A (NYSE Company Manual 2004 § 303A.12). In addition to the traditional sanction of delisting (which is hardly considered as a credible threat), the NYSE can now issue a public reprimand letter in case of violation (NYSE Company Manual 2004 § 303A.13). This is significantly different from the 'comply-or-explain' approach adopted by the European Corporate Governance Codes. Ironically, however, foreign issuer listed on the NYSE are subject to a 'comply-or-explain' rule (NYSE Company Manual 2004 § 303A.11). See Rickford, J. [2005], *Corporate Governance Systems – How Much Convergence?*, in G. Owen, T. Kirchmaier and J. Grant (eds.), CORPORATE GOVERNANCE IN THE US AND EUROPE, Macmillan, 25-30.

103 See § 301 of the Sarbanes-Oxley Act of 2002; § 303A.2 of NYSE Company Manual 2004.

One equally important point is that the Sarbanes-Oxley Act has overburdened independent directors of legal responsibilities, with the clear intention of making them an easy target of litigation.[104] While this would work not differently than in the past in the presence of conflicts of interest, it is very doubtful that it will result in outside, formally 'independent,' directors being subject to any stricter duty of care then their executive colleagues.[105] Many legal and economic commentators agree that this would be neither feasible nor desirable.[106] Companies will have just to pay more expensive D&O insurance policies, if they do not want good candidates to be strongly discouraged from serving as independent directors.[107]

Independent directorship most probably requires a totally different legal policy, based on accountability rather than liability.[108] To be sure, this kind of approach has been suggested in the US, at both the academic and the policy level. Professor Bebchuk has authoritatively advocated to "empower shareholders" by giving them "access to the ballot" in corporate elections.[109] This position was partly endorsed by the SEC in a proposal to amend regulation of the proxy machinery so as to take control of nominations away from the board of directors.[110] In light of the discussion of the Seventh Chapter, the adoption of such a rule could be unfortunate, for

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104 Ribstein, L.E. [2005], *Sarbanes-Oxley after Three Years*, in NEW ZEALAND LAW REVIEW, vol. 2005, 365-382. Perhaps the most controversial provision of Sarbanes-Oxley in this respect is § 404, requiring annual disclosures about the adequacy of internal control structures, attested by the firm's auditor. Per § 404 significant liability risks are imposed, "since a clever trial lawyer might be able to trace virtually any business problem, in hindsight, to a failure to implement some internal control." Id., at 371.

105 Black, B.S., Cheffins, B.R., Klausner, M. [2006], *op. cit.*

106 See e.g., Hertig, G. [2005], *On-Going Board Reforms: One Size Fits All and Regulatory Capture*, in OXFORD REVIEW OF ECONOMIC POLICY, vol. 21, 269-282; Shleifer, A. [2005], *Is There a Major Problem with Corporate Governance in the United States?* in G. Owen, T. Kirchmaier and J. Grant (eds.), CORPORATE GOVERNANCE IN THE US AND EUROPE, Macmillan, 91-95.

107 Black, B.S., Cheffins, B.R., Klausner, M. [2006], *op. cit.* See also Wambach, A. [2006], *Comment on 'Outside Director Liability: A Policy Analysis,'* in JOURNAL OF INSTITUTIONAL AND THEORETICAL ECONOMICS, vol. 162, 26-31 (discussing in more detail the role of the insurance matter in outside director's liability); and Schmies, c. [2006], *Comment on 'Outside Director Liability: A Policy Analysis,'* in JOURNAL OF INSTITUTIONAL AND THEORETICAL ECONOMICS, vol. 162, 21-25 (analyzing the problem of outside director's liability from the perspective of German law).

108 For this kind of framework, see Boot, A. and Macey, J.R. [2004], *Monitoring Corporate Performance: The Role of Objectivity, Proximity and Adaptability in Corporate Governance*, in CORNELL LAW REVIEW, vol. 89, 356-393.

109 Bebchuk, L.A. [2005a], *The Case for Increasing Shareholder Power*, in HARVARD LAW REVIEW, vol. 118, 833-914; Bebchuk, L.A. [2003b], *The Case for Shareholder Access to the Ballot*, in THE BUSINESS LAWYER, vol. 59, 43-66. Both proposals need to be understood in light of the specificities of American law when it comes to election of directors and agenda-setting powers. See *supra*, Chapter Seven, section 7.3.1.

110 See SEC Release No. 34-48626 (Oct. 14, 2003), *Proposed Rule: Security Holder Director Nominations*, available at www.sec.gov.

it may destroy one major legal underpinning of managerial control of US corporations.[111] However, while the academic debate is still very heated in this regard, the SEC proposal has not yet been adopted (and it is unlikely that it will ever be) because of the strong opposition of the managers' profession – an interesting example of how path-dependence may not just prevent efficient institutional change, but also inefficient ones.[112]

I shall discuss Bebchuk's position in more detail with regard to the Italian case, where the appointment of independent directors seems to be a major issue for preventing non-pro-rata distributions.[113] As far as the US is concerned, the last news is that state law took over the matter. In June 2006, the Delaware's General Assembly passed a minor amendment of corporation law.[114] As a result, the board may still be in control of corporate elections but, on the one hand, it will be easier for shareholders to opt-in majority instead of plurality voting and, on the other hand, they will be able to *force* a director to resign also in an uncontested election by simply withholding their vote.[115]

Although, at the present stage, US corporate law is still very far away from providing for independent appointment of outside directors, the newest Delaware's legislation can be considered as a first step towards a non-revolutionary rebalancing of the discretion-accountability tradeoff, in the direction of enhanced accountability of *a part* of the board to non-controlling shareholders. Independent director appointment should be handled very carefully, in such a way as to preserve the corporate controller's managerial powers while constraining their abuse. It is for this reason that non-controlling shareholders should only be able to elect non-executive directors, who account for a minority of the board and whose tasks are strictly lim-

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[111] See *supra*, Chapter Seven, section 7.6.1. This point is also made by Cools, S. [2005], *The Real Difference in Corporate Law between the United States and Continental Europe: Distribution of Powers*, in DELAWARE JOURNAL OF CORPORATE LAW, vol. 30, 697-766.

[112] The SEC Proposal has faced utmost strong opposition by the Business Roundtable, an association including the CEOs of the largest US companies. See Bebchuk, L.A. [2005c], *The Business Roundtable's Untenable Case against Shareholder Access*, Working Paper No. 516, Harvard Law School (Faculty Series), available at www.ssrn.com. Chances are high that the proposed rule will not be adopted, at least not in the near future. The academic debate on empowerment of US shareholders is still very heated. See, e.g., the *Responses to 'Increasing Shareholder Power'* in the April 2006 issue of the Harvard Law Review: Bainbridge, S.M. [2006], *Director Primacy and Shareholder Disempowerment*, in HARVARD LAW REVIEW, vol. 119, 1735-1758; Strine, L.E. Jr. [2006], *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America*, in HARVARD LAW REVIEW, vol. 119, 1759-1783; Bebchuk, L.A. [2006], *Reply: Letting Shareholders Set the Rules*, in HARVARD LAW REVIEW, vol. 119, 1784-1813.

[113] See *infra*, section 9.3.5.

[114] Senate Bill No. 322, passed on June 27, 2006.

[115] See, for a more detailed comment, McBride, D.C. and Bissel, R.P. [2006], *Delaware's Flexible Approach to Majority Voting for Directors*, in WALL STREET LAWYER, vol. 10, No. 6.

ited to oversight of non-pro-rata distributions. While in the US this is just a question of fine-tuning the legal policy against diversionary PBC, independent directorship is a much more urgent matter in the other countries in our sample. None of them, and – arguably – no other corporate jurisdiction in the world, can rely on an "entrepreneurial system of private enforcement" of shareholder protection comparable to that of the US.[116]

9.3 The Legal Discipline of Conflicts of Interest in Europe

9.3.1. A European Problem?

There are at least two good reasons to treat shareholder protection in the European countries of our sample under the same heading, but separately from the US. The first is that corporate law and securities regulation in European countries are not as elaborated as in the US in dealing with related-party transactions, and – even more importantly – exposure to the risk of legal liability is not the reason why European corporate controllers should refrain from non-pro-rata distributions.[117] In fact, this exposure is negligible, if not nil, in both continental Europe and – maybe surprisingly – in the UK. The second reason is that the establishment of an effective legal policy against diversionary PBC has become more and more a European problem; or, at least, it is perceived as such.[118]

After the Ahold and Parmalat debacles – just to mention the most famous – demonstrated that corporate scandals were definitely not just an 'American thing,' the legal policy towards self-dealing has taken highest priority in the European regulators' agenda, at both the national and the EU level.[119] Virtually every country

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[116] Coffee, J.C. Jr. [2001a], *op. cit.*, 2164-2165.

[117] Kraakman *et al.* [2004], *The Anatomy*, cit., 116-118.

[118] See, e.g., McCahery, J.A. and Vermueulen, P.M. [2005], *Corporate Governance Crises and Related Party Transactions: A Post-Parmalat Agenda*, in K.J. Hopt, E. Wymeersch, H. Kanda, and H. Baum, CORPORATE GOVERNANCE IN CONTEXT: CORPORATIONS, STATES, AND MARKETS IN EUROPE, JAPAN, AND THE US, Oxford University Press, 228-230; Davies, P. [2005], *Enron and Corporate Law Reform in the UK and the European Community*, in K.J. Hopt, E. Wymeersch, H. Kanda, and H. Baum, CORPORATE GOVERNANCE IN CONTEXT: CORPORATIONS, STATES, AND MARKETS IN EUROPE, JAPAN, AND THE US, Oxford University Press, 163-190.

[119] Hopt, K.J. [2005], *European Company Law and Corporate Governance: Where Does the Action Plan of the European Commission Lead?*, in K.J. Hopt, E. Wymeersch, H. Kanda, and H. Baum, CORPORATE GOVERNANCE IN CONTEXT: CORPORATIONS, STATES, AND MARKETS IN EUROPE, JAPAN, AND THE US, Oxford University Press, 119-214.

has taken some legislative or regulatory measure in this field.[120] Even more importantly, the European legislator suddenly awoke from years and years of silence, and it has embarked on the very ambitious project of setting Pan-European rules for both securities regulation and corporate law. A European "Action Plan" of both 'hard' and 'soft' legislation has been approved by the Commission in either field, and their implementation is either completed or just about to be so.[121]

So far, however, the outcome of this extensive legislative activity has not been very much up to the expectations.[122] At the national level, the legislature's activism seems to have just followed the wake of 'me too' reforms, which – as it turns out – mostly led to cosmetic changes.[123] One major exception is perhaps Italy, whose regulation of related-party transactions lagged far behind both European and non-European developed countries. Anyway, it is at least controversial that the three major reforms of Italian corporate and securities law, which occurred in the past decade, determined any substantial improvement of corporate governance – Parmalat, perhaps the worst of European scandals, just occurred in between the second and the third one.[124] The picture is no rosier at the European level. As it turns out, the only substantial changes that the European Commission managed to get through were already decided, or in the making, at the national level. While this was useful to overcome the moderate resistance of national vested interests, the European legislator has achieved little more. The adoption of the Takeover Directive is one major failure of European harmonization that I will discuss in the next Chapters, but it is not the only one. In the wording of a Law and Economics commenta-

[120] For an excellent overview of most representative CG reforms in Continental Europe, in a Law and Economics perspective, see Enriques, L. and Volpin, P.F. [2007], *Corporate Governance Reforms in Continental Europe*, in JOURNAL OF ECONOMIC PERSPECTIVES, vol. 21, 117-140.

[121] European Commission [1999], *Implementing the Framework for Financial Markets: Action Plan*, COM(1999)232, available at www.ec.europa.eu (hereinafter European Commission [1999], *Financial Services Action Plan*); European Commission [2003a], *Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward*, COM(2003)284, available at www.ec.europa.eu (hereinafter European Commission [2003a], *Company Law Action Plan*). The Financial Services Action Plan was completed in most part in 2004; reports on implementation at the member state level and economic impact analysis are regularly filed at www.ec.europa.eu/internal_market/finances/actionplan/. The Company Law Action Plan is on its way to completion; see www.ec.europa.eu/internal_market/company/modern/.

[122] Enriques, L. and Gatti, M. [2006a], *EC Reforms of Corporate Governance and Capital Markets Law: Do They Tackle Insiders' Opportunism?*, Working Paper, available at www.ssrn.com.

[123] Hertig, G. [2005], *op. cit.*, 270.

[124] Enriques, L. [2005a], *Scelte pubbliche e interessi particolari nella riforma delle società di capitali* (*Public Choices and Special Interests in the Italian Corporate Law Reform*), in MERCATO, CONCORRENZA, REGOLE, vol. 1/05, 145-192.

tor, the effect of European legislation on national company laws seems to be just "trivial."[125]

This is not unfortunate. The following discussion will briefly illustrate how Member States have found over time their own way to police non-pro-rata distribution, or – like Italy – are in the process of finding it. Anything of course can (and sometimes must) be improved, but legal and non-legal institutions need to evolve on their own path.[126] As regards the discipline of related-party transactions, there is perhaps one issue on which the attention of national regulators converges. This is independent directors. The reason why European harmonization seems to have failed also in this respect is that the matter has to be put in perspective; and every legal system turns out to have its own.

9.3.2. Institutional Monitoring in the UK

a) A Peculiar Approach to Conflicts of Interest

It took quite a long time, but it is now generally acknowledged that the British discipline of related-party transactions is significantly different from the American one.[127] On the one hand, the substantive rules are somewhat stricter than in the US. On the other hand, and more importantly, their enforcement is not based on private litigation but, rather, on a combination of public enforcement and (threat of) ouster by institutional investors. As a result, the balance between false positives and false negatives is ultimately determined by the bite of these enforcement mechanisms more than by the strictness of substantive standards. Overall, this bite is quite high, and the consequent risk of false positives is just mitigated by the peculiar forms and the limited extent of institutional investor's activism in the UK.[128]

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[125] Enriques, L. [2006a], *EC Company Law Directives and Regulations: How Trivial Are They?*, in UNIVERSITY OF PENNSYLVANIA JOURNAL OF INTERNATIONAL ECONOMIC LAW, vol. 27, 1-78.

[126] See the discussion of arguments against and in favor of European harmonization of company law in Enriques, L. and Gatti, M. [2006b], *The Uneasy Case for Top-Down Corporate Law Harmonization in the European Union*, in UNIVERSITY OF PENNSYLVANIA JOURNAL OF INTERNATIONAL ECONOMIC LAW, vol. 27, 939-998.

[127] Kraakman *et al.* [2004], *The Anatomy*, cit., 101-130; Djankov, S., La Porta, R., Lopez-de-Silanes, F. and Shleifer, A. [2006], *The Law and Economics of Self-Dealing* (November 13, 2006), Working Paper, Harvard School of Economics, available at www.economics.harvard.edu/faculty/shleifer/papers, forthcoming in JOURNAL OF FINANCIAL ECONOMICS, 2008 (hereinafter Djankov *et al.* [2006], *Self-Dealing*)

[128] Stapledon, G.P. [1996], INSTITUTIONAL SHAREHOLDERS AND CORPORATE GOVERNANCE, Oxford University Press.

As it was illustrated in the Seventh Chapter, institutional activism in the UK takes place 'behind closed doors,' and it is basically limited to situations of director's severe underperformance or mischief.[129] It is not in the institutional investors' interest to do more than inducing directors to resign in these situations. At the same time, it is shareholder legal empowerment under British company law that makes the threat of ouster so credible that it hardly needs to be implemented.[130] This has more to do with distribution of legal powers than with the discipline of related-party transactions. To be sure, there is some evidence that this may be changing. On the one hand, British institutions appear to be willing to take a more proactive role.[131] On the other hand, the recent company law's reform clearly goes in the direction of enhancing shareholder's ability to hold directors liable.[132] Provided that the corporate controller's discretion suffers already a number of constraints in the UK, this trend is likely to increase the risk of false positives in policing non-pro-rata distributions.

b) Board and Shareholder Approval

Like their American colleagues, British judges have traditionally refused to second-guess business judgment.[133] However, since no distinction between standards of conduct and standard of review has ever been elaborated in the British jurisprudence, the courts of the UK always risk reviewing the merits of director's conduct when they are requested to enforce the far-reaching number of duties that directors owe to the company.[134] Apparently, they have hardly done this in the past. Director's duty of care used to be considered a subjective standard of diligence (whose assessment was based on director's *actual* skill), which added little to the director's duty to act in (likewise subjective) good faith – i.e. in what *he* considered to be the best interests of the company.[135] This has changed over time. In the recent codifica-

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[129] See *supra*, Chapter Seven, section 7.3.2.
[130] Davies, P. [2002a], INTRODUCTION TO COMPANY LAW, Oxford University Press, 127-144.
[131] Becht, M., Franks, J., Mayer, C. and Rossi, S. [2006], *Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes U.K. Focus Fund*, ECGI Finance Working Paper No. 138/2006, available at www.ssrn.com and www.ecgi.org.
[132] See, illustratively Freshfields [2006a], *Companies Act 2006*, 8 November 2006, available at www.freshfields.com.
[133] Farrar, J.H. and Hannigan, B (with contributions by Furey, N.E. and Wylie, P.) [1998], FARRAR'S COMPANY LAW, Butterworths, (hereinafter Farrar et *al.* [1998], *Company Law*) 429, citing: Carlen v. Drury [1812] 1 Ves & B 154 ("the court could not undertake the management of every brewhouse and playhouse in the kingdom"); Burland v. Earle [1902] 3 All ER 420; Hogg v. Cramphorn Ltd. [1967] Ch 254.
[134] Davies, P. [2002a], *op. cit.*, 151-167.
[135] Id., 154-160.

tion of director's equitable duties in the Companies Act of 2006, a number of objective elements have been injected into both duties, thereby allowing, at least in theory, judicial review of director's skill and diligence.[136]

Related-party transactions are a completely different story. In principle, directors – like any fiduciary – are not entitled to profit from any transaction in which they have a conflict of interest ('no-conflict rule').[137] Transactions violating the no-conflict rule are not binding on the company, and director's profits must be disgorged.[138] This could sound like a ban on conflicted interest transactions, but it is not. When the conflict of interest is disclosed and shareholders nonetheless approve or subsequently ratify the transaction, neither nullification nor disgorgement applies.[139] As we know, this is still quite a burdensome discipline of conflicted transactions. But, at least to some extent, it is possible to opt it out – as most British companies do. Most conflicted interest transactions can be just approved by the board of directors provided that full disclosure of the conflict of interest is made.[140] Before the Companies Act of 2006, there was no need of disinterested approval and the interested director was entitled to vote. In the presence of full disclosure, it was only possible to attack the transaction on the basis of the duty of good faith. As of now, votes of interested directors do no longer count for a valid board approval.[141]

Shareholder approval is still pivotal in the British discipline of conflicted interest transactions. To begin with, it cannot be entirely opted out. Company law makes it compulsory for certain transactions, most notably substantial property transactions and payments for loss of office – an issue I shall return to in the last Chapter of this book.[142] Secondly, significant related-party transactions entered into by quoted

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136 See §§ 170-181 of the Companies Act of 2006 (CA 2006). On the coming into force of the new Companies Act in the UK, which will replace the Companies Act of 1985 (CA 1985) by October 2008, see *supra* Chapter Seven, section 7.3.2. On the meaning of 'codification' of common law rules and equitable principles pertaining to director's duties, see the Explanatory Notes to the Companies Act 2006, §§ 305-306, available at www.dti.gov.uk/bbf/co-act-2006/index.html.

137 Farrar et *al.* [1998], *Company Law*, cit., 396-397.

138 Enriques, L. [2000], *op. cit.*

139 Davies, P. [2002a], *op. cit.*, 172-174.

140 Id., at 174-176. Under the current legislation, this outcome is the result of there tiers of rules: (1) the equitable no-conflict rule; (2) art. 85 of Table A of CA 1985, which contains the default waiver of the equitable rule (on condition that the conflict of interest is disclosed); (3) § 317 of the CA 1985, which mandates disclosure of conflicts of interest to the board, but not also abstention of the interested director from voting. See Farrar et *al.* [1998], *Company* Law, cit., 396-409, for a comprehensive discussion of statutory and judge-made law. CA 2006 have simplified the matter, by explicitly allowing board authorization of most conflicted interest transactions.

141 See § 175 of CA 2006.

142 See §§ 320-322 of CA 1985 and §§ 190-196 of CA 2006 ('substantial property transactions'). Notice that shareholder approval complements, and does not substitute, the director's duties in order to

companies are anyway subject to the different, and in a sense stricter, procedure of shareholder approval prescribed by the Listing Rules of the Financial Services Authority (FSA).[143] Thirdly, only shareholder approval (or ratification) can safely relieve directors from liability, at least in those circumstances in which ratification is allowed.[144] This may suggest that the British approach to non-pro-rata distributions leaves little margins for false negatives, but possibly allows for high risk of false positives. This conclusion is essentially correct, but requires two major qualifications. One is about controlling shareholders, and how their behavior is policed in spite of their being in control of the general meeting. The other one concerns the limited standing to sue derivatively of non-controlling shareholders, and how directors are nonetheless prevented from engaging in diversionary conduct.[145]

c) Limited Scope for Shareholder Litigation in the UK

Surprising as it may appear, British company law seems to worry very little about the controlling shareholder's conflicts of interest. Differently from the US, controlling shareholders owe no fiduciary duty to minority shareholders in the UK.[146] As a result, they are always entitled to vote in their own interest. In theory, this should allow for exquisite opportunities for non-pro-rata distributions, given the ease with which controlling shareholders can have related-party transactions approved by the general meeting. However, this has never been a real problem in British corporate governance. To be sure, even though both interested directors and interested controlling shareholders used to face no limitation in casting their vote at the general meeting, courts have always maintained that breach of the duty of loyalty was not ratifiable.[147] In addition, in the presence of non-ratifiable breaches, the procedural

avoid the effects of the no-conflict rule. About payments for loss of office (severance payments, or so-called 'golden parachutes') see *infra*, Chapter Eleven, section 11.3.2.

143 See Listing Rules (LR) § 11 (Related Party Transactions).

144 Davies, P. [2002a], *op. cit.*, 191-196.

145 The following picture may seem incomplete. Indeed, minority shareholders in the UK can avail themselves of an additional, and very powerful, statutory remedy against oppression by the majority shareholder: the 'unfair prejudice' remedy. See §§ 459-461 of CA 1985 (restated in §§ 994-998 of CA 2006), illustrated and discussed in Farrar et *al.* [1998], *Company Law*, cit., 448-462. However, for a number of reasons that cannot be discussed here, the standard interpretation is that this remedy is only available for closely held companies. See Davies, P. [2002a], *op. cit.*, 240-243. The following discussion only deals with the remedies available to shareholders of public companies.

146 Davies, P. [2002a], *op. cit.*, 220-221.

147 Cook v. Deeks [1916] 1 AC 554, PC (shareholders cannot ratify fraud or illegality). See also Smith v. Croft (No 2) [1988] Ch 114 (individual shareholders may not sue for breaches that can be ratified by a majority of shareholder independent of the wrongdoer), discussed in Davies, P. [2002a], *op. cit.*, 219, 225-226. British common law has not otherwise attempted to constrain decision-making pow-

hurdles of derivative litigation in the UK – which are going to be touched upon shortly – are not applicable provided that the wrongdoer is in control of the company.[148] Finally, the Listing Rules – which are strictly enforced by both the FSA and institutional investors – do not allow either directors or 'substantial' shareholders (i.e., those who control 10% or more of the voting rights) to vote on significant transactions with their related parties.[149]

And yet, none of these rules provide the ultimate explanation of why controlling shareholders do not only refrain from 'stealing,' but are also very rare among British listed companies. The real explanation is that the Listing Rules (today in combination with the Corporate Governance Code annexed to them) provide that these companies must be anyway capable of carrying on business independently of a controlling shareholder,[150] which – according to the standard interpretation – means that the latter cannot be in control of the board of directors.[151] Therefore, not differently from where managers are in control, non-pro-rata distributions by controlling shareholders are ultimately policed by institutional investors through their influence on board members. The new provisions of the Companies Act of 2006 seem to add little to this result, in that they require that votes of interested directors or controlling shareholders be disregarded on both ratification decisions and decisions whether to sue directors for breach of duty.[152]

In the normal situation, where executive directors are in charge and there is no controlling shareholder, board and/or shareholder approval raise little concern of false negatives. Entering into related-party transactions requires that extensive disclosures be made to the competent body, before it approves them, and in the annual accounts, after they have been approved.[153] Failure to disclose may trigger either criminal liability, a proceeding by the FSA, or both. Indeed, a feature of British law when it comes to self-dealing is the availability of a number of venues for public enforcement. A certain proportion of shareholders may request, for instance, the Secretary of State to institute a proceeding of investigation of the company's docu-

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ers of controlling shareholders, if not in just one long-standing exception (Allen v. Gold Reefs of West Africa Ltd. [1900] 1 Ch 656), discussed in Davies, P. [2002a], *op. cit.*, 234-236.

[148] Farrar et *al.* [1998], *Company* Law, cit., 435-441. See *infra*, the discussion of *Foss v. Harbottle*.

[149] Based on LR § 11.1.7, related parties and their associates cannot vote on the shareholder resolution approving the transaction. According to LR § 11.1.4 a substantial shareholder qualifies as related party. 'Substantial shareholder' is defined in LR, Appendix 1, Relevant definitions.

[150] Davies, P. [2002a], *op. cit.*, 246.

[151] See, in much detail, *supra* Chapter Seven, section 7.3.2.

[152] See § 239(4) and §§ 261-263 of CA 2006.

[153] See Kraakman *et al.* [2004], *The Anatomy*, cit., 104-111, for illustration.

ments, or to appoint an inspector for reviewing the company's affairs, when they suspect of director's misconduct.[154]

Even more importantly, non-transparent directors would never be forgiven by institutional investors, and likewise by the business community at the London Stock Exchange.[155] More than any form of legal liability, directors fear ouster from that community. While the former would be forthcoming, and it is uncertain at any rate, the latter is immediate and not appealable. As a result, transactions featuring non-pro-rata distributions are very unlikely to be put forward, for they will never pass the direct or indirect scrutiny of institutional investors.[156] On the contrary, institutions will not exercise their *de facto* veto power on related-party transactions that potentially have business purpose: *ex ante*, it is in their interest to defer to business judgment. Neither would they challenge these transactions *ex post*, when they turn out badly. In the UK, shareholder ability to sue derivatively has been limited for over a century by the *Foss v. Harbottle* ruling, which gives standing against directors only to the company and its competent bodies, unless a fraud on the minority has been committed *and* the wrongdoer is in control of the company.[157] This principle has been heavily debated but never overruled, until the Companies Act of 2006 took it over. Derivative suits are now allowed when there is a *prima facie* case of breach of *any* of the director's duties (including an *objective* duty of care!), subject to permission by the court and unless the transaction has been ratified by disinterested shareholders.[158]

Strengthening shareholder's ability to hold directors liable is unlikely to alter the very peculiar equilibrium of distribution of powers in British corporate governance.

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[154] See, especially, the powers conferred upon the Secretary of State by § 432 (appointment of inspectors) and § 447 (investigation of company documents) of CA 1985. This part of the Companies Act has not been repealed by the CA 2006, which only amended the discipline of company investigations by enhancing the powers the Secretary of State of moderately changing the investigation procedure. See CA 2006, Part 32, §§ 1035-1039.

[155] On the reputational constraints faced by the business community of the City of London, see, e.g., Armour, J. and Skeel, D.A. [2006], *Who Writes the Rules for Hostile Takeovers, and Why? The Peculiar Divergence of US and UK Takeover Regulation*, ECGI Law Working Paper No. 73/2006, available at www.ssrn.com and www.ecgi.org.

[156] See, e.g., Black, B.S. and Coffee, J.C. Jr. [1994], *Hail Britannia: Institutional Investor Behavior under Limited Regulation*, in MICHIGAN LAW REVIEW, vol. 92, 1997-2087.

[157] Foss v. Harbottle [1843] 2 Hare 461. The functioning of the '*Foss v. Harbottle* Rule' is detailed in Farrar et *al.* [1998], *Company* Law, cit., 435-441. This has to be understood in combination with ratification of director's breach of fiduciary duties. At common law, ratifiable breaches provide no grounds for derivative suit. See *supra*, in the text.

[158] See §§ 260-264 of CA 2006. Formally, this is not intended to overrule *Foss v. Harbottle*, but only to provide a statutory basis for derivative suits. See the Explanatory Notes to the Companies Act 2006, §§ 483-492, available at www.dti.gov.uk/bbf/co-act-2006/index.html.

Institutional investors do not like to sue.[159] When they are too much committed to the company for a plain 'exit' strategy, they would prefer having directors they are dissatisfied of ousted from the board.[160] Other non-controlling shareholders may behave worse. However, the absence of an expert judiciary and, above all, of contingent fees (of which the British 'conditional fee' arrangement is not a substitute) makes it unlikely that director's liability will ever become a major driver of corporate governance in the UK.[161] This is fortunate, for director's liability would probably lead to an explosion of false positives otherwise. In the words of authoritative commentators, the policy of non-pro-rata distributions in the UK is "governance based," as opposed to the "transaction based" approach of the US.[162] As I mentioned, there is a strong case for institutions to evolve towards a more efficient equilibrium along their own path instead of by legal transplant. This makes monitoring by independent directors, rather than director's liability, a most promising venue for improving the discipline of related-party transactions in the UK.

d) Institutional Monitoring and Independent Directors

Independent directors as an instrument for governance (as opposed to a safe harbor for the corporate controller's liability) are a British, not an American invention. British law keeps on maintaining the self-regulatory character of this institution, but there is no reason to doubt that it is a source of credible commitment for corporate controllers.[163] Provisions of the British Combined Code are both binding and enforced according to our earlier classification. They are subject to the 'comply-or-explain' principle – which makes explicit departures very unlikely to be accepted by institutional investors; and they are attached to the Listing Rules – which makes effective compliance subject to oversight by the FSA.[164]

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[159] Stapledon, G.P. [1996], *op. cit.*, 131-133.

[160] Id., at 111-131.

[161] Davies, P. [2002a], *op. cit.*, 249-251. The conditional fee arrangement is basically a 'success fee' awarded on top on of the regular attorney's remuneration. See Gravelle, H. [1998], *Conditional Fees in Britain*, in P. Newman (ed.), THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW, Macmillan, vol. 1, 382-386. The underlying incentive structure is completely different from the contingent fee (which features *both* a 'no win–no fee' deal with the attorney and proportionality of the award with the value of the claim). For an economic comparison of contingent and conditional fees, see Emons, W. and Garoupa, N. [2006], *US-style Contingent Fees and UK-style Conditional Fees: Agency Problems and the Supply of Legal Services*, in MANAGERIAL AND DECISION ECONOMICS, vol. 27, 379-385.

[162] Kraakman *et al.* [2004], *The Anatomy*, cit., 68.

[163] For a history of Non-Executive Directors (NEDs) in the development of the British Corporate Governance Codes, see Davies, P. [2002a], *op. cit.*, 200-206.

[164] See *supra*, Chapter Seven, section 7.3.2.

Among other things, the Code requires that at least a half of the board members – plus the chairman – be non-executive directors (NEDs) "determined by the board to be independent."[165] Independence requirements plainly *exclude* representation of significant shareholders, so that controlling shareholders are effectively unable to appoint the majority of board members unless the company is characterized as being small.[166] This contributes to the bias against shareholder control in the UK, which has been criticized in the Seventh Chapter. On the other hand, the notion of independence does not exclude non-executives who are *de facto* appointed by directors in control of the proxy machinery.[167] Although institutional investors must not object for insider's nominations to be any viable, this – as we know – is no guarantee of 'real' independence from managerial control.[168]

Would such independence be any desirable, or just feasible, given the tradeoff between proximity and monitoring in the boardroom?[169] Certainly, it would not, at least with reference to the majority of the entire board. But the answer may change when a minority partition of the board, featured with specific monitoring tasks and no possible interference with business judgment, is considered. In the British tradition of unitary board, this solution may be only implemented through a special committee composed exclusively of directors appointed by non-controlling shareholders. The next step would be placing institutional investors on the driver seat.[170] This may be problematic, provided that they seem to be quite reluctant to take any explicit involvement in the appointment of NEDs – while they usually monitor their nomination in the background.[171]

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[165] Combined Code on Corporate Governance, June 2006 (Combined Code), § A.3.2. The underlying general principle is that "[t]he board should include a balance of executive and non-executive directors (and in particular independent non-executive directors) such that no individual or small group of individuals can dominate the board's decision taking." Combined Code § A.3.

[166] Combined Code § A.3.1.

[167] The minimal requirements of independence are basically established on the basis of the absence of family ties with executives and of financial involvements with the latter or the company. The only 'representation' explicitly excluded is that of a 'significant shareholder.' As a general matter, "[t]he board should determine whether the director is independent in character and judgement and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director's judgement." Combined Code § A.3.1.

[168] See *supra*, Chapter Seven.

[169] See Boot, A. and Macey, J.R. [2004], *op. cit.*

[170] This proposal has been authoritatively advanced, in the US, by Gilson, R.J. and Kraakman, R.H. [1991], *Reinventing the Outside Director: An Agenda for Institutional Investors*, in STANFORD LAW REVIEW, vol. 43, 863-906. However, this might suit British CG better, given the prominent role of institutional investors in the ownership structure. Rickford, J. [2005], *op. cit.* On ownership and control structure of British listed firms, see *supra*, Chapter Two.

[171] Stapledon, G.P. [1996], *op. cit.*, 293-295.

Reserving a number of separate director's seats for election by non-controlling shareholders would not be then a dramatic change, whereas – on condition that their role is limited to policing the controller's conflicts of interest – it would probably improve accountability without undermining discretion in corporate control. This provision would have to be supplemented either by a special indemnification of the costs incurred for soliciting shareholder's suffrages for the independent partition of the board, or by allowing institutional investors to piggyback the circulation of proxy materials not only for director's removal, but also for their appointment. It goes without saying that – differently from the current state of British law in this respect – both appointment and removal powers of non-controlling shareholders should be mandatory, and strictly limited to the committee that we want to be actually independent of either executive management or controlling shareholders.[172]

9.3.3. Shareholder Protection in the Netherlands: A Neglected Story of Judicial Oversight

a) *The Source of Misunderstanding of the Dutch Case*

The Dutch case is a most interesting one. The received wisdom about corporate law in the Netherlands is that it protects non-controlling shareholders very little. Accordingly, when it comes to investor protection, the standard characterization of the Dutch jurisdiction in the international comparisons is 'low quality.'[173] As I mentioned, this characterization is at odds with the high degree of stock market development in the Netherlands, and is in fact completely misguided. Economists dominating the field of 'numerical comparative law' are easily mislead in their analyses, at both the national and the international level; whereas Dutch law is much neglected by comparative lawyers, who prefer to focus on jurisdictions considered as being more representative of the civil law tradition (like, e.g., France and Germany).[174]

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[172] Compare with the current rules for director appointment and removal, discussed *supra*, Chapter Seven, section 7.3.2. On why regulation of appointment and removal of minority representatives to the board should be mandatory (or at least subject to a binding form of self-regulation), see *supra*, Chapter Eight, sections 8.1.3 and 8.5.3.

[173] La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R. [1998], *Law and Finance*, in JOURNAL OF POLITICAL ECONOMY, vol. 106, 1113-1155 (hereinafter La Porta *et al.* [1998], *Law and Finance*). This negative judgment is reflected in the national literature. See, e.g., Roosenboom, P. and van der Goot, T. [2003], *Takeover Defences and IPO Firm Value in the Netherlands*, in EUROPEAN FINANCIAL MANAGEMENT, vol. 9, 485–511.

[174] See, e.g., the Kraakman *et al.* [2004], *The Anatomy*, cit., 1-19 and 33-70 (where Dutch law is not part of the sample, although it is sporadically mentioned). But a change is in the making: corporate law

The reason of misinterpretation of the Dutch case is twofold. On the one hand, shareholder protection from non-pro-rata distributions is normally confused with shareholder empowerment in corporate governance.[175] In the Seventh Chapter, we discussed how the legal distribution of governance powers in the Netherlands does not actually favor shareholders, thereby allowing public companies to be under managerial control.[176] But this has not necessarily to do with whether and how non-controlling shareholders are protected from expropriation. In fact, the only jurisdiction of our sample in which these two issues are connected with each other is the UK, with the implications that we have just seen. On the other hand, Dutch 'law on the books' seems not only to give shareholders little powers, but also to insufficiently protect them from the corporate controller's misbehavior.[177] Apparently, both directors and controlling shareholders face little risk of liability for non-pro-rata distributions; neither judicial nor independent review of conflicted interest transactions is provided for; and disclosure of conflicts of interest is as little required *ex ante* as poorly enforced *ex post*. Upon a more careful investigation, however, none of the above statements proves being true.

One fundamental tenet of legal comparison is that the analysis must be freed from reliance on *any* national legal category, and performed just in functional terms.[178] True, Dutch corporate law does not allow shareholders to sue derivatively, thereby confining the enforcement of director's duties to situations where a change in control, or bankruptcy, has occurred. Standing to sue for directors liability resides essentially with the supervisory board,[179] whose members – despite formal requirements of independence – naturally defer to the corporate controller who has

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of the Netherlands is becoming increasingly studied by comparative lawyers. See McCahery, J.A. and Vermueulen, P.M. [2005], *op. cit*; and Hopt, K.J. [2006], *Modern Company and Capital Market Problems: Improving European Corporate Governance after Enron*, in J. Armour and J.A. McCahery (eds.), AFTER ENRON, IMPROVING CORPORATE LAW AND MODERNISING SECURITIES REGULATION IN EUROPE AND THE US, Hart Publishing, 445-496.

175 See, e.g., Chirinko, R., van Ees, H., Garretsen, H. and Sterken E. [2004], *Investor Protections and Concentrated Ownership: Assessing Corporate Control Mechanisms in the Netherlands*, in GERMAN ECONOMIC REVIEW, vol. 5, 119–138.

176 See *supra*, Chapter Seven, section 7.3.3.

177 See Djankov *et al.* [2006], *Self-Dealing*, cit.

178 Zweigert, K. and Kötz, H. [1998], INTRODUCTION TO COMPARATIVE LAW, 3rd edn. (translated from German by T. Weir), Oxford University Press.

179 Schuit, S.R., Bier, B., Verburg, L.G. and Ter Wisch, J.A. [2002], CORPORATE LAW AND PRACTICE OF THE NETHERLANDS: LEGAL AND TAXATION, 2nd edn., Kluwer Law Int'l (hereinafter Schuit *et al.* [2002], *Corporate Law*), 9.1 and 9.2.

de facto the last word on their appointment. In addition, controlling shareholders owe no fiduciary duties to non-controlling shareholders.[180]

To be sure, most of the above categories have little meaning in the formal structure of Dutch corporate law, which – as we know – does not acknowledge the primacy of shareholder interest in corporate governance and, consequently, does not distinguish between controlling and non-controlling shareholder. In principle, shareholder control should not be admitted for firms incorporated in the Netherlands.[181] Economists are nowadays inclined to believe that the prevalence of substance over form is a feature of the common law tradition,[182] but this is wrong: it is in fact a (functional) feature of case-law.[183] As it turns out, in a civil law jurisdiction like the Netherlands, protection of non-controlling shareholders have been mostly elaborated by judge-made law, on the basis of the interpretation of corporate law's general clauses, of a dedicated procedure for enforcing legality in corporate governance, and of a specialized jurisdiction in charge of administering this procedure.

b) The Role of the Judiciary and the Mechanisms of Private Enforcement

The so-called 'inquiry procedure' (*Enquêterecht*) is the most important tool of shareholder protection under Dutch corporate law.[184] To be sure, its formal scope of application is both wider and narrower: wider, because the instrument is also available for stakeholders' and public enforcement; narrower, because most part of corporate litigation must follow the standard civil procedure. The aim of the inquiry procedure is to restore legality in the relationship between corporate stakeholders, which implies a judgment as to whether legality has been breached in the first place. For this reason, the most important limitation of this procedure is that it cannot lead to imposition of liability, but only to implementation of injunctions, corrective remedies, and pronunciation of declaratory judgment – on whose basis liability can subsequently be sought for in a separate trial.[185]

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180 Timmerman, L. and Doorman, A. [2002], *Rights of Minority Shareholders in the Netherlands*, in ELECTRONIC JOURNAL OF COMPARATIVE LAW, vol. 6.4, 201, available at www.ejcl.org/64/art64-12.html,181-183.

181 See *supra*, Chapter Seven, section 7.3.3.

182 Glaeser, E.L. and Shleifer, A. [2002], *Legal Origins*, in QUARTERLY JOURNAL OF ECONOMICS, vol. 117, 1193-1230.

183 Merryman, J.H. [1969], THE CIVIL LAW TRADITION, Stanford University Press.

184 Timmerman, L. and Doorman, A. [2002], *op. cit.*, 195-204.

185 Schuit *et al.* [2002], *Corporate Law*, cit., 10.2.b. The Dutch Supreme Court (*Hoge Raad* – HR) has ruled that a mere declaratory judgment may be sought for under the inquiry procedure. HR 10 January 1990, NJ 1990, 466. This is the typical basis for a follow-on suit for damages to be brought individually against the company. Timmerman, L. and Doorman, A. [2002], *op. cit.*, 184. On how this may gain a class dimension from the very first moment the petition for inquiry is filed with the

In practice, the scope of application of the *enquêterecht* is very broad, and almost every situation that may be characterized as corporate mismanagement qualifies.[186] We know that this is potentially dangerous, for it can lead to courts second-guessing the exercise of managerial discretion. According to Dutch law, mismanagement is to be assessed on the basis of a general criterion of reasonableness and fairness.[187] Although Dutch law has not formally elaborated any business judgment rule, the Enterprise Chamber of the Amsterdam Court of Appeals has developed a similar standard of review. Compliance with the "elementary principle of responsible entrepreneurship" is sufficient for courts to abstain from reviewing of business judgment.[188]

The Enterprise Chamber has exclusive jurisdiction on the *enquêterecht* and a number of other corporate matters, and it is a judiciary highly specialized in corporate affairs.[189] Its judgments are subject to review by the Dutch Supreme Court, which apparently has played an important role in correcting the Enterprise Chamber's tendency to step too much into the corporate controller's shoes. It is now quite settled that corporate management is subject to "limited assessment" by the courts, having regard more to the process of decision-making than to the merits of

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trial court (Enterprise Chamber of the Amsterdam Court of Appeals – *OndernemingsKamer*), see *infra* in the text. The list of remedies available to the Enterprise Chamber under the inquiry procedure is a *numerus clausus*, and it ranges from suspension or nullification of resolutions endorsed by any corporate body to winding up of the company. See section 2:356 of the Dutch Civil Code.

186 Timmerman, L. and Doorman, A. [2002], *op. cit.*, 199-202.

187 Schuit *et al.* [2002], *Corporate Law*, cit., 9.1. A number of key corporate law provisions are interpreted under this general clause. In particular, the principle of equal treatment of shareholder (section 2:201(92) of the Dutch Civil Code) is interpreted flexibly by the Dutch Supreme Court: departure from this principle is admitted when there are objective reasons that makes departure 'fair' and 'reasonable.' Undoubtedly this means that non-pro-rata distributions are illegal at any rate. Timmerman, L. and Doorman, A. [2002], *op. cit.*, 191-195. But the standard is vague enough to allow virtually anything else to be included. The danger of second-guessing the exercise of management discretion is avoided by the elaboration of a functional equivalent of the business judgment rule by the Dutch courts. See *infra* in the text. The Supreme Court has applied this principle more strictly than the Enterprise Chamber of the Amsterdam Court of Appeals (*OndernemingsKamer* – OK). Timmerman, L. [2004], *Review of management decisions by the courts, seen partly from a comparative legal perspective*, in THE COMPANIES AND BUSINESS COURT FROM A COMPARATIVE LAW PERSPECTIVE, Kluwer, 59-91. As a result, also the management decision to implement takeover resistance enjoys the protection of the business judgment rule. See *supra*, Chapter Seven, section 7.3.3.

188 Timmerman, L. and Doorman, A. [2002], *op. cit.*, 201, report that this principle was first formulated by the Enterprise Chamber in OK 21 June 1979, NJ 1980, 71. According to Schuit *et al.* [2002], *Corporate Law*, cit., 9.2, the principle of judicial abstention from reviewing business judgment was upheld by the Supreme Court in HR 6 June 1996, NJ 1996, 695.

189 See Schuit *et al.* [2002], *Corporate Law*, cit., 10.1; and Kroeze, M. [2004], *Theory and practice of specialised courts*, 6th Asian Roundtable on Corporate Governance, OECD, Seoul, 2-3 November 2004, www.oecd.org/dataoecd/42/36/ 33962715.pdf.

decisions.[190] Conversely, conflicted interest transactions allow for almost no excuse in the absence of independent approval. Courts will check whether the statutory principle of equal treatment of shareholders is respected on a substantive basis, unless non-controlling shareholders have approved the transaction knowing of the conflict of interest, or alternatively the transaction has been decided by the supervisory board independently of the corporate controller.[191] The notion of corporate control is likewise assessed on a substantive basis, so that the conflict of interest is identified upon the members of the managing/supervisory board or upon a controlling shareholder, depending on who is ultimately in charge.[192] None of these judicial standards is written down in the Dutch civil code.[193]

A detailed discussion of the inquiry procedure is outside the scope of this brief discussion.[194] However, it is important to point out that only shareholders who account for at least 10% of share capital (also in the form of depository receipts) have standing to request an *enquêterecht*, and that damage compensation is not included in the remedies that can be granted by the Enterprise Chamber. In principle, although all expenses of the procedure are borne by the corporation,[195] there is little reason why any non-controlling shareholder should ever go for it. This is particularly problematic if we consider that institutional investors – which are otherwise reluctant to litigation – have been traditionally very passive in Dutch corporate governance.[196]

However, two fundamental ingredients of Dutch corporate law's enforcement must be added to the picture. First, a declaratory judgment of mismanagement by the Enterprise Chamber can form the basis for a successful suit for damages before the competent district court, which may be brought either by the company for breach of director's duties (after a new management constituency has been appointed following the *enquêterecht*), or by individual shareholders under the general

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[190] Timmerman, L. [2004], *op. cit.*, 45-49.

[191] See, e.g., OK 1 March 2001, JOR 2001, 131 (special information rights for minority shareholders in the presence of conflicts of interest); and HR 10 January 1990, NJ 1990, 466 (procedural obligations of the management and the supervisory board).

[192] See, e.g., OK 8 October 1998, NJ 1999, 348 (conflicts of interest of the majority shareholder).

[193] Apparently, in the international CG literature, only Dutch commentators are aware of them. See McCahery, J.A. and Vermueulen, P.M. [2005], *op. cit.*, 241.

[194] See broadly, in this regard, Jitta, M.J. [2004], *Procedural aspects of the right of inquiry*, in THE COMPANIES AND BUSINESS COURT FROM A COMPARATIVE LAW PERSPECTIVE, Kluwer, 1-42.

[195] Timmerman, L. and Doorman, A. [2002], *op. cit.*, 196.

[196] See de Jong, A. and Röell, A. [2005], *Financing and Control in The Netherlands: A Historical Perspective*, in R. Morck (ed.), A HISTORY OF CORPORATE GOVERNANCE AROUND THE WORLD: FAMILY BUSINESS GROUPS TO PROFESSIONAL MANAGERS, NBER Conference Volume, University of Chicago Press, 467-506; and Högfeldt, P. [2005], *Financing and Corporate Control in The Netherlands: Extreme Exception to the Rule?*, in R. Morck (ed.), A HISTORY OF CORPORATE GOVERNANCE AROUND THE WORLD: FAMILY BUSINESS GROUPS TO PROFESSIONAL MANAGERS, NBER Conference Volume, University of Chicago Press, 507-515.

law of torts (e.g., for inadequate disclosure of conflicted interest transactions in the company's financial accounts).[197] Secondly, both the application for the inquiry procedure and a subsequent suit for damages can be filed in the form of shareholder's representative action, where standing or representative powers are conferred upon associations whose constitution is intended to protect a collective interest suitable for bundling.[198] Shareholder associations are the case in point.

Dutch representative actions are not to be confused with class actions in the US. It is exactly for this reason that they provide similar incentives to private enforcement. Contingent fees are not allowed in the Netherlands, so it is up to shareholder associations, not to corporate lawyers, to aggregate the interest of non-controlling shareholders. Shareholder associations have just standing for requesting a declaratory judgment, after which, in theory, shareholders must proceed individually with their liability claims.[199] In practice, shareholder associations are also granted by disgruntled investors the power of attorney for the second stage, in which they are usually allowed to collect some additional fees *conditional* – but like in the UK, not contingent – on success.[200] As a result, most claims brought by shareholder associations in the Netherlands are settled for generous shareholder compensations before going to trial. Since mid-2005, the Amsterdam Court of Appeals may declare, under a number of conditions, the settlement as binding also on shareholders not participating in the representative action.[201]

This procedure is little known outside the Netherlands,[202] but is becoming more and more popular. The main Dutch shareholder association (*Vereniging van Effectenbezitters* – VEB) has already established a remarkable record of accomplishment in securities litigation. For instance, the suit against Ahold N.V. and its former man-

[197] Schuit *et al.* [2002], *Corporate Law*, cit., 10.2.

[198] 'Class actions' in the Netherlands (which are more accurately described as 'representative actions') are regulated by section 3:305 of the Dutch Civil Code, whose subsections a) and b) were introduced in 1994 by the act on 'Regulation of the competence of certain legal persons to bring a legal action for the protection of other persons interests.' See Blenheim [2007], *Collective action in private law in the Netherlands: Possibilities and limitations*, available at www.blenheim.nl.

[199] Timmerman, L. and Doorman, A. [2002], *op. cit.*, 184.

[200] See Clifford Chance [2006], *Are "class actions" on the way to Europe?*, available at www.cliffordchance.com, 13-14, for a summary description of the mechanism. "'No win no fee' agreements are not allowed but a success fee may be agreed for successful claims (including a percentage of the damages or settlement sum, unless this would be excessive)" Id., at 14.

[201] See the 'Act on Collective Settlement of Mass Damages,' which came into force on 27 July 2005. Disgruntled shareholders have limited possibilities to opt out. See Clifford Chance [2006], *op. cit.*, 13.

[202] One important exception is Hopt, K.J. [2006], *op. cit.*

agement was settled for sizeable compensation already before the latest rules came into force.[203]

c) Independent Directors and the Corporate Governance Code

Based on the foregoing discussion, it can no longer be denied that investor protection has a considerable bite in the Netherlands. Whether this also results in efficient policing of non-pro-rata distributions is, however, an open question. The inquiry procedure is very burdensome for the company, and its increasing popularity may lead to false positives. At the same time, deterrence by *ex post* enforcement of liability and/or ouster – especially when the initiative is entrusted to shareholder associations – does not always provide sufficient guarantees against the risk of false negatives. In the wake of the Ahold scandal, the Dutch government decided therefore to follow a different path in order to strengthen the policing of non-pro-rata distributions.[204]

In 2004 a new Corporate Governance Code (the so-called 'Tabaksblat Code') came into force, which mostly relies on independence the supervisory board for monitoring corporate management and disciplining related-party transactions.[205] Similarly to the UK, the Dutch code has now a statutory basis. While adhesion to the previous edition (based on the so-called 'Peters Report') was just voluntary,[206] the Dutch civil code now requires that a statement about compliance with the code is published together with the company's annual accounts – explaining the reasons of non-compliance.[207] Dutch legislation is less insistent than the British one on the

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[203] See the last two annual reports (2005 and 2006) of the Dutch Shareholder Association (*Vereniging van Effectenbezitters* – VEB), available at www.veb.net.

[204] McCahery, J.A. and Vermueulen, P.M. [2005], *op. cit.*, 240-241. For a detailed illustration of the Ahold scandal, see de Jong, A., DeJong, D.V., Mertens, G. and Roosenboom, P. [2005], *Royal Ahold: A Failure of Corporate Governance*, Working Paper, Erasmus University (ERIM series), available at http://hdl.handle.net/1765/1863.

[205] The Corporate Governance Committee (so-called 'Tabaksblat Committee') was established upon invitation by the Dutch Ministries of Finance and of Economic Affairs, and published the Dutch Corporate Governance Code on 9 December 2003. The Code was given a statutory basis by the Dutch Parliament on 30 December 2004. In 2005 a Monitoring Committee on the Corporate Governance Code was established with the task of reporting on implementation of the Code, as well as on national and international developments in CG. The Tabaksblat Code replaced the Forty Recommendations issued by the so-called 'Peters Report' in 1997. Both the current Dutch Corporate governance Code and the former Forty Recommendations are available at www.commissie-corporategovernance.nl.

[206] See de Jong, A., DeJong, D.V., Mertens, G., Wasleyc, C.E. [2005], *The Role of Self-Regulation in Corporate Governance: Evidence and Implications from the Netherlands*, in JOURNAL OF CORPORATE FINANCE, vol. 11, 473-503.

[207] See section 2:391(4)(5) of the Dutch Civil Code, discussed in Wymeersch, E. [2005], *Implementation of the Corporate Governance Codes*, in K.J. Hopt, E. Wymeersch, H. Kanda, and H. Baum, CORPORATE

enforcement of the 'comply-or-explain' principle by the securities regulator.[208] However, according to the latest report of the Monitoring Commission on Corporate Governance, 92% of listed firms were applying the code in 2006, complying on average with 96% of its provisions.[209]

As far as the contents of the code are concerned, most of the remarks made with reference to the British Combined Code are applicable. The Dutch Code requires independence of *all* the members of the supervisory board.[210] Independence is determined with regard to financial and family involvement with members of the managing board, and with respect to shareholders accounting for more than 10% of share capital.[211] The peculiar rules governing appointment to either board in the Netherlands are not given proper account. As a result, such independence is going to be either a 'mission impossible' or – more probably – just hypocrisy. The supervisory board cannot be reasonably expected to be independent of the corporate controller, inasmuch as it is in charge of electing the managing board.[212] It is therefore illusory to believe that shareholders representatives in the supervisory board will not be *de facto* selected by either the management or a controlling shareholder, depending on the ownership structure. As a result, monitoring of conflicted interest transaction by the supervisory board – specifically disciplined by the Tabaksblat Code – cannot be entirely relied upon.[213] The code's inconsistency with economic analysis is testified by its assigning the supervisory board two contradictory tasks: monitoring and advice – which, as we know, are ultimately irreconcilable.[214] The

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GOVERNANCE IN CONTEXT: CORPORATIONS, STATES, AND MARKETS IN EUROPE, JAPAN, AND THE US, Oxford University Press, 415.

[208] Wymeersch, E. [2005], *op. cit.*, 414-417.

[209] See Corporate Governance Code Monitoring Committee [2006], *Second Report on Compliance with the Dutch Corporate Governance Code*, December 2006, available at www.commissiecorporategovernance.nl.

[210] See Corporate Governance Code § III.2.1 (allowing exceptions for just up to one member).

[211] See Corporate Governance Code § III.2.2. Notice that the provision concerning significant shareholders is not as far-reaching as that contained in the British Combined Code. Under § III.2.2(e), significant shareholders are prevented from directly sitting in the supervisory board, but not also from appointing their own representatives. In addition, § III.2.2(f) provides for a derogation in case of groups of companies.

[212] This certainly holds for the companies subject to the 'structured regime.' See *supra*, Chapter Seven, section 7.3.3. See also, in the economic literature, Maassen, G. and van den Bosch, F. [1999], *On the Supposed Independence of Two-Tier Boards: Formal Structure and Reality in the Netherlands*, in CORPORATE GOVERNANCE: AN INTERNATIONAL REVIEW, vol. 7, 31–37; Hooghiemstra, R. and van Manen, J. [2004], *The Independence Paradox: (Im)possibilities Facing Non-Executive Directors in the Netherlands*, in CORPORATE GOVERNANCE: AN INTERNATIONAL REVIEW, vol. 12, 314-324.

[213] Corporate Governance Code § II.3. See McCahery, J.A. and Vermueulen, P.M. [2005], *op. cit.*, 241-242, and *supra*, Chapter Eight, section 8.5.3.

[214] Corporate Governance Code § III.1: 'The role of the supervisory board is to *supervise* the policies of the management board and the general affairs of the company and its affiliated enterprise, as well

direction of a desirable reform of Dutch corporate governance is thus twofold. On the one hand, the supervisory board should be just concerned with monitoring non-pro-rata distributions. On the other hand, its members should be elected by non-controlling shareholders. A necessary condition for this to work is that the supervisory board is no longer in charge of appointing executive directors to the managing board.

9.3.4. Legal Underpinnings of Shareholder Protection in Sweden

a) Legal Rules, Social Norms, or Just Both of Them?

The Swedish case is also very interesting in comparative corporate governance, but for a different and, in a sense, opposite reason compared to the Netherlands: while the Dutch case has been little studied, the Swedish case seems to be overstated.

Apparently, Sweden poses a big challenge to the 'law matters' thesis: both stock market development and separation of ownership and control are very high in Sweden, in the face of shareholder protection appearing to be just average in legal terms. Comparative economists tend nowadays to consider Sweden as the exception that confirms the rule: common law jurisdictions still outperform civil law ones in investor protection, with the exception of Scandinavian countries where some other extralegal factor seem to contribute to investor's confidence.[215] Swedish financial economists tend to subscribe to this position, and have tried to demonstrate it on empirical grounds.[216] Comparative lawyers have been more speculative. On the one hand, they have suggested that social norms, more than corporate law and its enforcement, may be the driver of investor protection in Sweden.[217] On the other hand, they have tried to explain the persistence of shareholder control in spite

as to assist the management board by providing *advice*." (Emphases added). Compare with Boot, A. and Macey, J.R. [2004], *op. cit.* (discussed *supra*, Chapter Eight, section 8.5.3). On the tradeoff between monitoring and advice in company's boards, see also Adams, R.B. and Ferreira, D. [2007], *A Theory of Friendly Boards*, in JOURNAL OF FINANCE, vol. 62, 217-250.

[215] See, e.g., Djankov *et al.* [2006], *Self-Dealing*, cit.; Dyck, A. and Zingales, L. [2004], *Private Benefits of Control: An International Comparison*, in JOURNAL OF FINANCE, vol. 59, 537-600 (finding, however, no empirical support for the primacy of the common law tradition in constraining the extraction of PBC).

[216] See e.g. Cronqvist, H. and Nilsson, M. [2003], *Agency Costs of Controlling Minority Shareholders*, in JOURNAL OF FINANCIAL AND QUANTITATIVE ANALYSIS, vol. 38, 695-719; Holmén M. and Högfeldt P. [2004], *A Law and Finance Analysis of Initial Public Offerings*, in JOURNAL OF FINANCIAL INTERMEDIATION, vol. 13, 324-358.

[217] Coffee, J.C. Jr. [2001a], *op. cit.*

of good investor protection by introducing – as I am doing – a qualitative distinction of private benefits of control.[218]

Unfortunately, Swedish corporate lawyers have never joined this debate. Had they done that, they would have probably told the following facts about Swedish corporate law. First, that distribution of powers is based on shareholder supremacy, which – as we saw in Chapter Seven – implies that corporate management cannot do without a controlling shareholder. Second, that minority shareholders are as weakly involved in decision-making as strongly protected from non-pro-rata distributions. Third, that legal enforcement and the power of social norms work in tandem to achieve this result.

The argument that social norms may substitute for low quality of law and its enforcement has two major weaknesses. The first and obvious one is that, as such, social norms are beyond control by policymakers: there is little one can do with them, unless there is some way to shape their contents through the legal system. This leads to the second and subtler criticism: in the absence of legal support, the norms of a society may be disrupted by exposure to a different set of norms. Globalization and competition, which are otherwise beneficial for the efficiency of corporate governance, may be responsible of this disruption. Sweden used to be very concerned about this risk, and traditionally limited the ability of foreigners to acquire a significant stake in national companies.[219] These constrains were against European law, and today they are history. Yet, as of now, not even a single instance of shareholder expropriation has ever been reported in Sweden.[220] Swedish social norms have turned out to be strong enough to prevent also outsiders – who supposedly do not share the same social concerns as Swedish people – from engaging in extraction of diversionary PBC. The only possible explanation for this is that in Sweden – like probably anywhere else – social norms provide a source of credible commitment inasmuch as they are operated 'in the shadow of the law.'[221]

b) *Public and Private Enforcement of Legal Rules in the Background*

The legal policing of non-pro-rata distribution in Sweden relies extensively upon disclosure of conflicts of interest by both directors and controlling shareholders.

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[218] Gilson, R.J. [2006], *Controlling Shareholders and Corporate Governance: Complicating the Taxonomy*, in HARVARD LAW REVIEW, vol. 119, 1641-1679.

[219] Skog, R. [1994b], *Corporate Law in Transition – The Swedish Harmonization to the EU*, in M. Isaksson and R. Skog (eds.), ASPECTS OF CORPORATE GOVERNANCE, Juristförlaget, 117-126.

[220] Agnblad, J., Berglöf, E., Högfeldt, P. and Svancar, H. [2001], *Ownership and Control in Sweden: Strong Owners, Weak Minorities, and Social Control*, in F. Barca and M. Becht (eds.), THE CONTROL OF CORPORATE EUROPE, Oxford University Press, 228-258.

[221] See *supra*, Chapter eight, section 8.5.1.

Conflicted interest transaction must be reported in detail in the company's periodic disclosures. On the contrary, there is no requirement to disclose conflicts of interest *ex ante*; neither is any procedure established for management of these conflicts by the company's organs.[222] Basically, the entire discipline of related-party transactions in Sweden is based on *ex post* enforcement.

Swedish people hardly consider the hypothesis that a corporate controller may violate this discipline, or fail to disclose his interest in the transaction.[223] Sweden has a close-knit business community, made of people who have built their reputation over a number of family generations. These families still control most of Swedish corporations and have much to lose from violating the rules of the game.[224] The power of social norms is that they may provide an ideal balance between false positives and false negatives in enforcement. If they are relied upon by the community, there will be no risk of false positives on the assumption that everybody sticks to them. But this equilibrium depends on false negatives being likewise ruled out. Here is where, for the reasons I have just mentioned, the law must step in. The ultimate reason why shareholders can be confident about compliance with the norms of fair dealing is that they expect virtually *any* wrongdoing to be deterred. While the threat of social sanctions would suffice in most cases, law has to take care of residual risk of misbehavior to preserve the same threat's credibility.

The efficacy of corporate law and its enforcement in Sweden is such that hardly any punishment has to be implemented. As far as substantive law is concerned, conflicts of interest need not only be disclosed *ex post*, but they cannot result in non-pro-rata distributions at any rate. Both directors and the CEO (the 'managing director') cannot deal with any matter where they, or their related parties, have a considerable interest that may be in conflict with that of the company.[225] As a rule, shareholders can instead vote on any resolution even when they have a material interest; but they cannot vote on related-party transactions and on their discharge from liability as directors.[226] More important is, however, the general principle that

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[222] See Organization for Economic Cooperation and Development [2006], *Corporate Governance and Company Law Database*, The OECD's Directorate for Financial and Enterprise Affairs and The Stockholm Centre of Commercial Law (hereinafter OECD [2006], *Database*), available at http://oecd.eddy.se – restricted access, on file with author (last accessed May 1, 2007). For details about the OECD Database, see *supra*, Chapter Seven, section 7.1.

[223] Berg, A. [2002], *Corporate Governance in Sweden*, in CORPORATE GOVERNANCE SYSTEMS AND THE NATURE OF INDUSTRIAL RESTRUCTURING, European Industrial Relations Observatory (EIRO), available at www.eurofound.europa.eu/eiro/.

[224] Holmén, M. and Högfeldt, P. [2005], *Pyramidal Discounts: Tunneling or Agency Costs?*, ECGI Finance Working Paper No. 73/2005, available at www.ssrn.com and www.ecgi.org.

[225] Skog, R. [1994a], SETTING UP A BUSINESS IN SWEDEN, FöretagsJuridik, 31-36.

[226] Id., at 29-31.

all distributions to shareholder must be made pro-rata, and that any act violating this principle is voidable.[227] Neither the board nor a controlling shareholder may pass a resolution giving 'undue advantage' to one or more shareholders to the detriment of the company or of other shareholder.[228] On top of nullification, violation of this general clause may trigger both criminal and civil liability.

As far as private enforcement is concerned, minority shareholders have both an individual and a derivative cause of action, depending on whether the company or individual shareholders have been harmed.[229] By and large, director's liability is to be sought for through a derivative suit, which requires at least 10% of share capital to be initiated and pursued in spite of opposition by the shareholder meeting. A claim for shareholder's liability for discriminatory treatment is instead, normally, an individual action.[230] In fact, both actions are hardly ever brought in Sweden. Nevertheless, there is little doubt they could be quite easily. Maybe that derivative suits were not so much of a threat before civil procedure was amended to account for aggregation of collective claims; but individual actions have always been. On the one hand, Swedish shareholders are entitled to piggyback a criminal proceeding against the wrongdoer. On the other hand, legal costs of private litigation are traditionally very low in Sweden, and every natural person used to be entitled to public legal aid. This has changed, but the overwhelming majority of the population is nonetheless covered by private insurance of legal costs.[231]

In 2003, Sweden was the first European country to introduce class actions.[232] In corporate/securities law, both derivative and individual shareholder litigation qualifies. The action – which is more precisely a 'representative' action, for it requires actual opt-in by the class members – may be brought by an individual shareholder, a governmental authority, or a shareholder association. Opting-in individuals do not bear any expenses, and lawyer's contingent fee arrangement may be allowed upon the plaintiff's special request to the court. *Aktiespararna*, the main shareholder association in Sweden, may count on over 40 years of tradition and about 100.000

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[227] Fyman, B. [1996], *Unlawful Distributions under the Swedish Companies Act*, in JOURNAL OF BUSINESS LAW, vol. 1996, 526-538.

[228] Indeed, the very core of legal protection of minority shareholders in Sweden lies in this rule (formerly based on sections 8:13 and 9:17 of the Companies Act 1975). See Karnell, G. [1981], *The Law of Associations, with Special Regard to Company Law*, in S. Strömhold (ed.), AN INTRODUCTION TO SWEDISH LAW, vol. 2, Kluwer, 342-344; Skog, R. [1994a], *op. cit.*, 31 and 33; and OECD [2006], *Database* , cit. (where updated information on the Companies act 2006).

[229] Karnell, G. [1981], *op. cit.*, 344-350.

[230] Dotevall, R. [2003], *Liability of Members of the Board of Directors and the Managing Director – A Scandinavian Perspective*, in INTERNATIONAL LAWYER, vol. 37, 7-22.

[231] See, on all these matters, Broman, C. and Granström [2003], *Sweden*, in S. Grubbs (ed.), INTERNATIONAL CIVIL PROCEDURE, Kluwer Law Int'l, 705-729.

[232] Id., at 721.

members (out of a few millions people population) to make this as a credible threat for prospective wrongdoers.[233] To date, no class action has been ever brought in Sweden in either corporate or any other substantive law's field.[234]

c) The Swedish Code of Corporate Governance

Being aware that non-pro-rata distributions were not a problem in Sweden, the national legislature took a very mild approach to legal reform in the wake of the financial scandals on both sides of the Atlantic. A Commission on Business Confidence (*Förtroendekommissionen*) was established in 2002, but just minor modifications of company law were advocated.[235] Most of them were already decided and came into force with the new Companies Act of 2006, in which regulation of conflicts of interest is basically unchanged.[236] The Swedish legislature rather went for promoting self-regulation. A Swedish Code of Corporate Governance was approved in 2005.[237] Its adherence is required by the listing rules of the Stockholm stock exchange for companies whose market capitalization exceeds 3 billion SEK, and is based on a 'comply-or-explain' principle. Listing rules have no statutory authority in Sweden. However, the listing authority has a number of enforcement powers, ranging from fines to delisting.[238] In the Swedish institutional environment, this means that the code is both binding and enforced.

In practice, the code's provisions amount to little more than fine-tuning of Swedish corporate governance. The major innovation is independent directors. Independence is required on both a financial and a family-ties basis with respect to the company management, and applies to the majority of directors elected by shareholders excluding the CEO.[239] More importantly, two of these independent directors must be also independent of the controlling shareholder, and cannot be

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233 See the information about the Swedish Shareholder Association on www.aktiespararna.se.

234 For a detailed analysis of class actions in Sweden, see European Commission [2004], *Report from Sweden*, in STUDY ON THE CONDITIONS OF CLAIMS FOR DAMAGES IN CASE OF INFRINGEMENT OF EC COMPETITION RULES, available at www.ec.europa.eu.

235 Förtroendekommissionen [2004], *Final Report*, Summary in English, SOU 2004:47, 43-74 (on file with author). The report used to be available at www.sou.gov.se, but it has been removed.

236 See Swedish Ministry of Justice, *New Companies Act*, May 2005, available at www.sweden.gov.se; and OECD [2006], *Database*, cit.

237 Paralleling the investigation by the *Förtroendekommissionen*, a Code Group was established to issue a Swedish Corporate Governance Code. The first proposal was issued in 2004 (SOU 2004:46), and the final version was presented to the government at the end of the same year: Code Group [2005], *Swedish Code of Corporate Governance*, Report from the Code Group, SOU 2004:130. The code is available, with a short introduction to the Swedish CG model, at www.bolagsstyrning.se.

238 OECD [2006], *Database*, cit.

239 Swedish Code of Corporate Governance § 3.2.4.

selected by him.[240] Under these rules, the controlling shareholder can still arrange the board size and composition in such a way as to control decision-making. Still, the two independent directors will be in the position to provide a reliable check on conflicts of interests.[241] This is probably the most balanced solution of the discretion-accountability tradeoff that we have reviewed so far.

9.3.5. Shareholder Protection in Italy: A Tortuous and Slow Path toward Improvement

a) *A Tradition of Weak Protection of Minority Shareholders*

For an Italian, it is embarrassing to write about the national corporate law's discipline of conflicted interest transactions.[242] Short of being neglected or overstated, the Italian case is notorious, and with good reason. The story is almost as old as comparative corporate governance and, over the past ten years, it has been told by economists and lawyers on the two sides of the Atlantic in nearly the same terms.[243] Both rules and enforcement of corporate law in Italy do not supply minority shareholders with sufficient protection from expropriation, and this is the reason why ownership is so little separated from control and the Italian stock market is significantly underdeveloped compared to the other countries of the developed world.

Since then, the problem has been addressed by an outstanding number of legal reforms at the national level. Apparently, however, none of them has brought about any significant change in Italian corporate governance.[244] As a result, Italy is still the

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240 Swedish Code of Corporate Governance § 3.2.5.

241 Given the traditional activism of the Swedish Shareholder Association, also in the field of exercise of voting rights by dispersed shareholders, it is not unlikely that *Aktiespararna* will play an important role in the appointment of independent directors. See www.aktiespararna.se. Swedish company law does not provide for minority representation on the board, but this can be arranged by the articles of association. See OECD [2006], *Database*, cit.

242 Enriques, L. [2003], *Bad Apples, Bad Oranges: A Comment from Old Europe on Post-Enron Corporate Governance Reforms*, in WAKE FOREST LAW REVIEW, vol. 38, 915.

243 See, e.g.: Johnson, S., La Porta, R., Lopez-de-Silanes, F., and Shleifer, A. [2000], *Tunneling*, in AMERICAN ECONOMIC REVIEW, vol. 90, 22–27; Roe, M.J. [2003c], POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE, Oxford University Press; Ferrarini, G. and Giudici, P. [2005], *Financial Scandals and the Role of Private Enforcement: The Parmalat Case*, ECGI Law Working Paper No. 40/2005, available at www.ssrn.com and www.ecgi.org; Bianchi, M., Bianco, M. and Enriques, L. [2001], *Pyramidal Group and the Separation between Ownership and Control in Italy*, in F. Barca and M. Becht (eds.), THE CONTROL OF CORPORATE EUROPE, Oxford University Press, 154-187.

244 Bianchi, M., Bianco, M., Giacomelli, S., Pacces, A.M. and Trento, S. [2005], PROPRIETÀ E CONTROLLO DELLE IMPRESE IN ITALIA, Il Mulino.

case in point of 'bad law' when it comes to shareholder protection.[245] It is fair to say that, among most developed countries' jurisdictions, Italian law still provides the weakest safeguards against the extraction of diversionary PBC by corporate controllers.[246] However, it would be unfair to conclude that process of corporate law's reform in Italy was just cosmetic, driven by the national vested interests, and essentially misguided. All of this has been authoritatively argued by Professor Enriques, and can be agreed upon with respect to a number of specific issues.[247] Yet it is undeniable that, overall, Italian corporate law is now on the right track as far as the substantive discipline of conflicted interest transactions is concerned. Even though, perhaps the most important ingredient of an efficient policy against non-pro-rata distributions is still missing from the Italian system. In the words of Ronald Gilson, this is "an effective enforcement process."[248]

Traditionally, Italian minority shareholders used to be both powerless as to corporate decision-making and helpless in protecting themselves from expropriation. This situation leaded to the award of one of the lowest scores on the Anti-director rights index of *Law and Finance*, which bundled governance rights with protection against self-dealing.[249] In the light of our more sophisticated framework, the case was even worse, for it determined a perverse combination of false positives and false negatives in the discipline of corporate transactions. Minority shareholders had very few judicial venues for challenging decisions taken or upheld by the controlling shareholder. They could either individually attack resolutions of the general meeting on grounds that they violated the law or the articles of association,[250] or put together at least 10% of share capital and file with the court a petition for investigation on allegedly "serious" mismanagement.[251] In practice, both venues used to be pursued with reference to the approval of annual accounts. This had as little bearing on the policing of self-dealing (of which non-controlling shareholders had no chance of being informed), as much the effect of resulting in blackmail for different purposes. None of these actions was obviously appealing for small investors in listed firms, whereas they could amount to a serious nuisance in the presence of non-controlling blockholders.

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[245] Gilson, R.J. [2006], *op. cit.*

[246] See Dyck, A. and Zingales, L. [2004], *op. cit.*

[247] Enriques L. [2005a], *Scelte pubbliche e interessi particolari nella riforma delle società di capitali* (*Public Choices and Special Interests in the Italian Corporate Law Reform*), in MERCATO, CONCORRENZA, REGOLE, vol. 1/05, 145-192.

[248] Gilson, R.J. [2006], *op. cit.*, 1653.

[249] La Porta *et al.* [1998], *Law and Finance*, cit.

[250] See art. 2377 of the Italian Civil Code (hereinafter ICC) before the Corporate Law Reform of 2004.

[251] See art. 2409 ICC before the Legislative Decree No. 58/1998 and the Corporate Law Reform of 2004.

With the clear intention of bringing Italian law up to the international standards set – for the good or the bad – by *Law and Finance*, the law of listed corporations was changed in 1998.[252] Among others, most remarkable innovations were the introduction of a derivative suit for director's liability, mandatory minority representation on the board of auditors, and a lower threshold for requesting a court investigation on serious irregularities.[253] The goal was that of making the board of directors accountable also to minority shareholders, at least as far as its members' legal obligations of due care and loyalty were concerned.

This did not succeed. Despite of the broad definition of director's duties in the Italian civil code, judges have traditionally shown a deferential attitude to the board decisions.[254] Most surprisingly, this deference is not just concerned with exercise of business judgment, but extends also to situations in which directors and, even more so, the controlling shareholder has a conflict of interest. Judges were just content with *formal* compliance with the rules disciplining conflicts of interest on both sides. In practice, they would only check whether conflicted interest transactions were passed by the board or the general meeting with the determinant vote of either the interested director or the interested shareholder.[255] In addition, the requirement for shareholder's standing to sue (5% of share capital) was much too strict to determine a serious threat of litigation, and this was coupled with the absence of contingent fees or equivalent devices for aggregating shareholder claims in any incentive-compatible manner.[256] On top of this, derivative litigation is unsuitable for challenging the controlling shareholder's conflicts of interest at the general meeting; investors had basically no way to recover damages from controlling shareholders in the face of most outrageous instances of tunneling. As a result, both directors and controlling shareholder continued to face a real threat of being sued for damages just in case of bankruptcy.[257] It is worth noting that also litigation for the Parmalat debacle has been handled in this way.

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[252] See Legislative Decree No. 58/1998 ("Testo unico delle disposizioni in materia di intermediazione finanziaria").

[253] See, respectively, art 129, art. 148(2), and art. 128(2) of Legislative Decree No. 58/1998 (original formulations). Artt. 128 and 129 are now replaced by artt. 2408, 2409, and 2393-bis ICC. Art. 149(2) has been redrafted, with substantial modifications, by the Act No. 262/2005 and the Legislative Decree No. 303/2006.

[254] Enriques, L. [2002a], *Do Corporate Law Judges Matter? Some Evidence from Milan*, in EUROPEAN BUSINESS ORGANIZATION LAW REVIEW, 756-821.

[255] See art. 2391 and art. 2373 ICC (before the 2004 reform).

[256] Enriques, L. [2002a], *op. cit.*, 786.

[257] Stanghellini, L. [1995], *Corporate Governance in Italy: Strong Owners, Faithful Managers. An Assessment and a Proposal for Reform*, INDIANA INTERNATIONAL AND COMPARATIVE LAW REVIEW, vol. 6, 91-185.

b) Corporate Law Reforms in Italy: Catching up Slowly?

That was just the start of the reform process in Italy. The Italian Securities Authority (*Consob*) continued by recommending a comprehensive *ex post* disclosure of conflicts of interest as well as of the procedure by which they are handled. This remained a dead letter, so since 2003 ongoing disclosure of related-party transactions is mandatory in nearly the same terms as under US law.[258] Failure to disclose triggers both director's and the company's liability under securities regulation.

In 2004, a general reform of Italian corporate law came into force.[259] As far as self-dealing is concerned, two major innovations are worth noting. On the one hand, the discipline of director's conflicts of interest has been changed.[260] Formal abstention from approving the conflicted transaction is no longer required, and it is not sufficient for the validity of the transaction. The transaction must be approved by a majority of disinterested directors on an informed basis. Directors – and, depending on the board structure, members of the board of auditors, of the audit committee, or of the supervisory board – face liability for failure both to disclose their own conflicts and to monitor those of their colleagues.[261] At the same time, the normative criterion for assessing both the director's and the monitor's liability have been changed from the diligence standard of the agent (the reasonable care of the *bonus pater familias*) to a more even standard of professional competence, which is more consistent with the tenets of the business judgment rule.[262]

On the other hand, a completely new discipline has been introduced for intra-group transactions.[263] In controlling shareholding systems, these transactions are perhaps the most dangerous source of tunneling, and the traditional approach of Italian law to the shareholder's conflicts of interest was ill equipped in coping with them.[264] That far, case-law had just managed to stop most outrageous instances of abuse by controlling shareholders, because of the narrow interpretation of both the

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[258] Art. 71-bis Consob Reg. No. 11971/1999.

[259] The general discipline of joint-stock companies contained in Book 5 of the Italian Civil Code was entirely replaced by the Legislative Decree No. 6/2003. References to the ICC are made to the legislation currently in force, unless otherwise indicated.

[260] Enriques, L. [2003], *op. cit.*, 924-925.

[261] Art. 2391 ICC.

[262] Compare the current formulation of art. 2392 ICC (due diligence is determined on the basis of director's specific tasks and competences) with that of former art. 2392 (director's diligence is tested against the general standard applicable to the agent).

[263] See art. 2497 *seq.* ICC ('*Direzione e coordinamento di società*'), discussed by Ventoruzzo, M. [2004], *Experiments in Comparative Corporate Law: the Recent Italian Reform and the Dubious Virtues of a Market for Rules in the Absence of Effective Regulatory Competition*, in TEXAS INTERNATIONAL LAW JOURNAL, vol. 40, 143-145.

[264] See, for illustration, Johnson, S., La Porta, R., Lopez-de-Silanes, F., and Shleifer, A. [2000], *op. cit.*; and Enriques, L. [2002a], *op. cit.*, 792-809.

relevance of conflicts of interest at the general meeting and of individual shareholder's right to claim individual damages from directors.[265] After the reform, shareholders can individually sue both the subsidiary and the parent company when their stock has been devalued by intra-group transactions, unless the damage is compensated by the overall results of the group management.[266] Directors and controlling shareholders are jointly and severally liable to the extent that either they participated in the decision, violating the principles of 'fair business judgment,' or they anyway benefited from it. Apart from the obvious risk of false positives involved by the notion of 'fair business judgment,'[267] this is anyway the first step of Italian corporate law towards preventing controlling shareholders from non-pro-rata distributions. However, the actual deterrence of both this provision and the new regime of director's liability for related-party transactions depends on the enforcement mechanisms – which, as we are about to see, are still very weak under Italian corporate law.

The Parmalat scandal exploded just in the eve of the corporate law reform coming into force.[268] Obviously, it was impossible to draw any conclusion about the new rules. Yet, the facts of the Parmalat case highlighted a number of weaknesses of the legal and institutional framework that were still to be addressed in Italy. Some of them were concerned with regulation of the securities industry and gatekeeper failure – two universal problems of the financial scandals at the turn of the century, which however are not dealt with here. Surprisingly enough, the attention

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[265] See art. 2373 (conflicts of interest at the general meeting) and art. 2395 (directors liability towards individual shareholders and third parties) ICC before the reform. For the standard interpretation of these provisions, see Enriques, L. [2002a], *op. cit.*, 721-722 and 786-787. Although the two articles have been redrafted, the Corporate Law Reform has not affected the issue of shareholders' individual rights in case of egregious mismanagement and abuse of powers by controlling shareholders. This issue is overly technical to be comprehensively reviewed here. It is just worth mentioning that the loophole has been addressed by the case-law: in the 1990s the Italian Supreme Court (*Corte di Cassazione*) has granted shareholders most outrageously deprived of their individual rights a different cause of action based on the general clauses of fairness and good faith. See Enriques, L. [2002a], *op. cit.*, 722, for a summary description; and Preite, D. [1993], *Abuso della maggioranza e conflitto di interessi del socio nelle società per azioni*, in G.E. Colombo e G.B. Portale (eds.), TRATTATO DELLE SOCIETÀ PER AZIONI, UTET, vol. 3, part II, for a detailed discussion of the problem.

[266] Art. 2497 ICC.

[267] Italian judges have never elaborated a doctrine comparable to the business judgment rule. Their traditional deference to the decisions of corporate controllers appears to be rather the result of a formalistic application of statutory law. This is particularly evident from how trial courts have handled so far the cases of self-interested transactions and conflicted resolutions of the general meeting brought to their attention. See Enriques, L. [2002a], *op. cit.*, 794-801.

[268] The Parmalat scandal is illustrated by a number of international publications. See, e.g., Coffee, J.C. Jr. [2005], *A Theory Of Corporate Scandals: Why the USA and Europe Differ*, in OXFORD REVIEW OF ECONOMIC POLICY, vol. 21, 198-211; McCahery, J.A. and Vermueulen, P.M. [2005], *op. cit.*, 225-228; Ferrarini, G. and Giudici, P. [2005], *op. cit.*, 5-18.

of the public opinion and the political debate were concentrated on the alleged responsibilities of the Central Bank and of its Governor.[269] But, in the end, it was clear in both the national and the international scientific debate that the problem was different, and – in a sense – very 'Italian.'

As two commentators and I argued elsewhere, one – if not *the* – major failure of Parmalat's governance was in the internal monitoring.[270] Parmalat was one of the largest 'family firms' in Europe, and all the corporate organs were under control of the management, which in turn was controlled by the major shareholder – Mr. Calisto Tanzi. External monitoring could fare no better in this situation, for it was likewise dependent – for both business and information – on Parmalat's controlling shareholder. As a result – differently from the financial scandals of other countries – Parmalat was not a sophisticated case of earnings manipulation, but after all a rather naïve story of long-standing, but ongoing, diversion of both shareholders' and bondholders' money, which came to light when it was just too late.[271] The problem with Parmalat is that the controlling shareholder exaggerated. In the words of Luca Enriques, diversion by controlling shareholders is sort of 'tolerated' in Italian corporate governance, inasmuch as it is 'moderate.'[272] The ultimate reason why Parmalat deserves some more attention than the other scandals is that, while the latter can be at most characterized as an epidemic consequence of the international stock market's bubble burst in 2000, Parmalat is a paradigmatic example of an endemic problem in Italy: that of systematic extraction of diversionary PBC by controlling shareholders.[273]

The Italian government was distracted for a long time by misdirection of the political debate, and managed to come up with a rigorous legislation (a so-called 'Savings Act') only two years later.[274] One crucial point was minority representation on the board of auditors, a rule that turned out to be systematically circumvented by listed firms (including Parmalat). The new legislation requires that the votes of shareholders, which determined the majority representation on the board of audi-

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[269] See, in both respects, Ferrarini, G. and Giudici, P. [2005], *op. cit.*

[270] Pardolesi R., A.M.P. (alias Alessio M. Pacces), Portolano, A. [2004], *Latte, lacrime (da coccodrillo) e sangue (dei risparmiatori). Note minime sul caso Parmalat*, in MERCATO, CONCORRENZA, REGOLE, vol. 1/04, 193-216.

[271] See, for a similar reconstruction, Coffee, J.C. Jr. [2005], *op. cit.*, 204-207.

[272] See Enriques, L. [2006b], *How it works in the EU*, briefing on Comparative Regulation, TRANSATLANTIC CORPORATE GOVERNANCE DIALOGUE, Meeting of 27 June 2006 ('Controlling Shareholders and Corporate Governance'), transcripts (slides) available at www.ecgi.org.

[273] Pardolesi, R. and Portolano, A. [2001], *All'ombra delle piramidi: Appunti su OPA, governo societario e concorrenza tra ordinamenti*, in MERCATO, CONCORRENZA, REGOLE, vol. 1/2001, 67-110.

[274] Act No. 262/2005 (so-called 'Savings Act'), subsequently amended by Legislative Decree No. 303/2006.

tors, be excluded from the election of minority representatives, based on a regulation to be enacted by the *Consob*.[275] This rule applies not only to the board of auditors (which, as we are about to see, can be now opted out), but likewise to any monitoring body in the company's governance structure. Here is how, finally, minority shareholders are put on the driver seat as far as the election of truly independent internal monitors is concerned. Unfortunately, the new rules are both undershooting and overshooting the target of an efficient balance between false positives and false negatives in the discipline of related-party transactions.

Since 2004, Italian joint stock companies may choose among three alternative board structures: the traditional unitary structure with a board of auditors basically in charge of monitoring legality of management; a two-tier structure with a supervisory board in charge of a broader monitoring of the management board, and of the appointment of its members; and a new one-tier structure wherein a sort of Anglo-Saxon style audit committee is established to provide the monitoring.[276] The members of each monitoring body must comply with statutory requirements of independence, none of which, however, is established with respect to the controlling shareholder. To be sure, independence of directors (let alone of the members of the board of auditors) from controlling shareholders has been required for a long time by the Corporate Governance Code, on a 'comply-or-explain' basis.[277] However, since the code used to have no statutory authority, this provision was not legally enforceable and could be *de facto* unapplied. Parmalat formally complied with the code while having its CFO as one 'independent' director.[278]

The Savings Act took care of all of these problems. On the one hand, it moved the issue of independent monitoring at the statutory level, and it solved it by mandating *actual* minority appointment of at least one member of the monitoring body,

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[275] Art. 148(2) of Legislative Decree No. 58/1998, as amended by art. 2(1) of the Act No. 262/2005 and art. 3(14) of the Legislative Decree No. 303/2006. As of May 2007, the Consob Regulations have not been issued yet.

[276] See *supra*, Chapter Seven, section 7.4.1. The three options are illustrated in more detail by Ventoruzzo, M. [2004], *op. cit.*, 146-149.

[277] The first edition of the Italian Code of Corporate Governance was issued by a committee leaded by Stefano Preda in October 1999. The requirements of directors' independence were strengthened in the revised edition of July 2002. The last edition of the Code was issued in March 2006. The 'comply-or-explain' principle is established by the Listing Rules of the Italian Stock Exchange. This principle has been given statutory authority only after the Savings Act came into force. But see *infra* in the text, for how this does not currently provide sufficient guarantee of enforcement. Both the Corporate Governance Code (from the first to the last edition) and the Listing Rules are available in English at www.borsaitaliana.it.

[278] Pardolesi R., A.M.P. (alias Alessio M. Pacces), Portolano, A. [2004], *op. cit.*

whatever the board structure.[279] On the other hand, it supplied enforcement of the 'comply-or-explain' principle of the Code with two statutory safeguards: one is the company's obligation to publish a yearly statement about compliance, coupled with the monitoring body's responsibility as to its correspondence with the company's practice;[280] the other was oversight by the *Consob*, which could impose fines in case of untruthful statements.[281] The latter provision was repealed in early 2007, thereby casting serious doubts as to what extent the Italian Code can yet be considered as actually enforced.[282]

A more serious problem is that Italian legislation went much beyond the policing of conflicts of interest in regulating corporate governance. In order to promote a more effective independent monitoring, it required the same mechanism of minority representation (based on the exclusion of the controlling shareholder's votes) not only for the monitoring body in each governance structure, but also for up to two members of the board of directors in the traditional structure.[283] This is unfortunate for at least two reasons. First, it creates scope for regulatory arbitrage between the three alternative structures. Secondly, and more importantly, it worsens the balance between discretion and accountability in the traditional structure, while its definitive improvement was just round the corner.

The advantage of the traditional Italian model, which provides a rather unique board structure, is that monitoring of conflicts of interest can be naturally separated from involvement in discretionary management. In fact, the two matters are ideally dealt with by separate organs – the board of auditors and the board of directors,

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279 Compare the current and former art. 148 of Legislative Decree No. 58/1998. The crucial difference is that, while minority representation on the board of auditors was originally to be dealt with by the charter, it is now to be directly regulated by the *Consob*, under explicit constraint of exclusion of the corporate controller's votes and with the aim of having minorities *effectively* represented. The same provision is applicable to the other board structures (per art. 148(4-*bis*) in the two-tier structure and per art. 147-*ter*(3) in the one-tier structure).

280 Art. 124-*bis* of Legislative Decree No. 58/1998, as introduced by art. 14(2) of the Act No. 262/2005.

281 Art. 124-*ter* of Legislative Decree No. 58/1998, as introduced by art. 14(2) of the Act No. 262/2005.

282 Art. 124-*ter* of Legislative Decree No. 58/1998, as amended by art. 3(11) of the Legislative Decree No. 303/2006 (the *Consob* is no longer in charge of monitoring truthfulness of company's statements of compliance with the code).

283 Art. 147-*ter* of Legislative Decree No. 58/1998, as amended by art. 1 of the Act No. 262/2005 and art. 3(13) of the Legislative Decree No. 303/2006. Notice that the combined provisions of art. 147-*ter* and art. 148 apply differently to different board structures. In the traditional one, minority representation is required in *both* the board of directors and the board of auditors. In the new one-tier structure, the potential overlap between art 147-*ter* and art. 148 is solved by having minority representation just in the audit committee (art. 147-*ter*(3) and art. 148(4-*ter*)). In the two-tier structure, minority representation just applies to the supervisory board (art. 148(4-*bis*)).

respectively. This separation is exactly what I have been advocating throughout this discussion in order to achieve the right balance between false negatives and false positives. To be effective against non-pro-rata distributions, this solution just requires that the board of auditors be in charge of approving related-party transactions on the basis of a mandatory flow of information about the corporate controller's conflicts of interest;[284] and that its members are entirely elected by non-controlling shareholders.[285] Minority representation on the board of directors would not add anything to this result, whereas it may just spoil it with the risk of false positives involved by outsiders' interference with discretionary management. Worse enough, the current state of Italian law falls still short of coping with the problem of false negatives.

c) Two Venues for Fine-Tuning: Independent Directors and Private Enforcement

There are two fundamental requirements for independent director's appointment, to whatever board, by non-controlling shareholders. One is – in Bebchuk's wording – 'shareholder access to the ballot.'[286] As we know, this is more of a problem in the US than in Italy, where – especially after the recent reforms – shareholders face little difficulties in proposing their own nominees at the elections. The important difference is the role of proxy voting, which is necessary for the exercise of managerial control whereas it is hardly of any use to controlling shareholders.[287] In the US, access to the ballot essentially means shareholder access to the proxy machinery controlled by the incumbent board. That is the proposal that the SEC has not yet managed to push through,[288] but – as Bebchuk pointed out – it is far from sufficient for independent nominee prevailing over the incumbent board. "To have

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284 A similar rule was suggested, indeed, during the long-standing debate that preceded the final enactment of the Savings Act. It was proposed to require approval of related-party transactions not only by a majority of disinterested directors, but also by *all* members of the monitoring body (thereby including the minority representative). See the Government Bill No. 3328, approved by the lower Chamber of the Parliament (*Camera dei deputati*) on 3 March 2005 (art. 7, proposing the introduction of art. 2391-*ter* in the civil code). This proposal has never become law. Rather, listed companies are now compelled by a separate amendment of the civil code (art. 2391-*bis* ICC, as introduced by Legislative Decree No. 310/2004) to adopt a charter discipline of related-party transactions based on both procedural and substantive fairness, according to the principles which – as of May 2007 – are yet to be established by the *Consob*.

285 Other commentators and I have argued in favor of this solution elsewhere: see Pardolesi R., A.M.P. (alias Alessio M. Pacces), Portolano, A. [2004], *op. cit.*

286 Bebchuk, L.A. [2003b], *op. cit.*

287 I have discussed this difference elsewhere: see Pacces, A.M. [2003b], *La sollecitazione delle deleghe di voto: spunti di analisi comparata in una prospettiva di riforma*, Working Paper, Bank of Italy (on file with author).

288 See *supra*, section 9.2.3.

a meaningful chance of success, nominees will have to incur expenses to make their case effective to shareholders. […] A group of shareholders holding, say, five percent of the shares might be unwilling to bear significant costs even if they believe that election of their nominee would enhance shareholder value."[289]

This is then the second requirement for the election of minority representatives: reimbursement of campaign expenses. In Italy, this is even more important than in the US, where a proxy campaign is launched every year by the board at the company's expenses, and shareholders might be entitled to piggyback it – even though they currently face a number of restrictions in this respect.[290] Facing a controlling shareholders, Italian investors may have to launch *their own* campaign to win the elections. As we know, Italian law currently allows for no reimbursement of expenses incurred by proxy solicitation, not even in case of success.[291] It is therefore insufficient to require – as the Savings Act did – that minority representatives be elected through cumulative voting, and that 2% of share capital be sufficient to present a candidate, unless good candidates are given a chance to prevail over nuisance nominee.[292] If we want institutional investors to lead selection and promotion of good candidates for monitoring the corporate controller's conflicts of interest, non-controlling shareholders should be entitled to indemnification of the expenses incurred for a successful proxy solicitation.

The solution I am advocating is different from Bebchuk's. First, success and not just "substantial shareholder support" should trigger reimbursement – although I understand that a different approach may be necessary for appointing independent directors in the US.[293] Secondly, and more importantly, I am not advocating this solution across the board – and definitely not for overreaching the board's control over the agenda of the shareholder meeting.[294] The reimbursement policy should be limited to corporate elections, and specifically just to the appointment of the monitoring body's members under each board structure. In Italy, the number of slates reserved to minority appointment should be inversely related to the degree of interference allowed with the managing body – which is the highest in the two-tier structure. Reservation of slates to non-controlling shareholders may finally make proxy solicitation just a threat by institutional investors, credible inasmuch as its

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289 Bebchuk, L.A. [2003b], *op. cit.*, 64.

290 See *supra*, Chapter Seven, section 7.3.1.

291 See *supra*, Chapter Seven, section 7.4.2.

292 Art. 147-*ter*(1) of Legislative Decree No. 58/1998, as amended by art. 1 of the Act No. 262/2005 and art. 3(13) of the Legislative Decree No. 303/2006.

293 Compare with Bebchuk, L.A. [2003b], *op. cit.*, 64. See also Bebchuk, L.A. and Kahan, M. [1990], *A Framework for Analyzing Legal Policy towards Proxy Contests*, in CALIFORNIA LAW REVIEW, vol. 78, 1073-1135.

294 See instead Bebchuk, L.A. [2005a], *op. cit.*

expenses would be reimbursed in case of success, but basically inexpensive for the company to the extent that other shareholders would spontaneously refrain from putting would-be losers up to election.[295]

That being said, Italian law has another major weakness, which is judicial enforcement. In a famous study, Professor Enriques showed how corporate law's adjudication by Italian judges is so much tainted by formalism that it normally results in deference to the controller's decision-making, even in the presence of conflicts of interest.[296] Although this is too often regarded as a typical problem of civil law jurisdictions, especially by comparative economists,[297] we learned from the foregoing review of both Dutch and Swedish law that this is not necessarily the case. The different outcome in Italy is most probably determined by the weakness of social norms – recent experience tells that little shaming is still attached to 'take the money and run' behaviors in financial markets – and the absence of a specialized judiciary.[298]

To be sure, a specialized corporate jurisdiction may not only cope with the problem of formalism in adjudication, but also with the promotion of social concern for fairness in corporate governance. On the one hand, reputation and prestige of a specialized judiciary depends much more on the ability to cope with exercise of corporate control and its abuses than on the judge's general skill in jurisprudence.[299] On the other hand, corporate law's judges are natural entrepreneurs of social norm.[300] It is, for instance, quite a settled point that in the US – one environment otherwise characterized by relatively weak social norms – Delaware judges play a fundamental role in shaping the norms of corporate governance, by drafting their opinions more in the form of "corporate law sermons" than just like plain adjudication of rights and responsibilities.[301] Of course, such a role can only be played in combination with other institutional factors – like, most prominently, an independent financial press. As it turns out, all of this is lacking in Italian corporate governance. Even worse, the institution of a specialized judiciary for corporate and securities law seems to be a lost case as of now. This was initially a part of the Italian cor-

[295] Other commentators and I have suggested this outcome elsewhere: Bianchi, M., Bianco, M., Giacomelli, S., Pacces, A.M. and Trento, S. [2005], *op. cit.*, 172.
[296] Enriques, L. [2002a], *op. cit.*
[297] Djankov *et al.* [2006], *Self-Dealing*, cit.
[298] See, very effectively, Enriques, L. [2003], *op. cit.*
[299] See, e.g., Bainbridge, S.M. [2002a], *op. cit.*, 254-257.
[300] Paredes, T.A. [2004], *op. cit.*, 1089-1194.
[301] Rock, E.B. [1997], *op. cit.*, 1016.

porate law's reform, but the proposal miserably failed under the opposition of both the judges' and the attorneys' constituencies.[302]

The outlook of private litigation as a deterrent against non-pro-rata distributions may be just slightly rosier.[303] The current state of Italian law does not provide incentive-compatible mechanisms for aggregating disgruntled shareholder's claims. The 5% threshold for activating derivative suits in listed companies is much too high to make this an effective tool for counteracting the corporate controller's opportunism; even though a lower threshold would probably not address the right problem (free riding), but just raise a different one (nuisance suits). Individual causes of action, which have been increased under both corporate and securities law, do not fare much better because of similar shareholder collective action problems.

However, a change is in the making. On the one hand, a battle over contingent fees has just started between the government and the lawyers' vested interests: contingent fee arrangements are now legal since mid-2006, and the opposition of the Bar Association is not going to last for long.[304] On the other hand, the debate over the introduction of class actions in Italy is about to reach its prime. A government bill has been presented to the Parliament, providing both investors and consumer associations with standing to sue on behalf of their associates.[305] The bill is currently dormant and open to discussion in a number of crucial points (e.g., whether only injunction or also damages may be sought for, and under what conditions judgments and settlements are binding on the class members).[306] What the conse-

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[302] The Reform of Corporate Law was preceded by a committee study, which explicitly advocated the institution of specialized jurisdictions for corporate law in each regional district. The Reform Committee, leaded by Professor Mirone, released its final proposal of legislative delegation ('*Schema di legge delegata*') in February 2000. The proposal included the statutory basis for the institution of specialized jurisdictions. The legislative delegation subsequently adopted by the following legislature (Act No. 366/2001) did not include these provisions. As a result, the Legislative Decree No. 5/2003 had no authority to amend the rules on jurisdiction, and only supplied minor changes to the procedural rules of corporate and securities litigation.

[303] For a more skeptical position, see Ferrarini, G. and Giudici, P. [2005], *op. cit.*

[304] The government repealed the long-standing prohibition of attorneys' contingent fees in the civil code (art. 2233(3) ICC) with the Decree No. 233/2006 (converted into law by Act No. 248/2006). The Italian Bar reacted by holding on its Code of Best Practices (whose art. 45 likewise prohibited contingent fees). The latest news is that the Bar finally repealed the provisions of the Code of Best Practice which were not consistent with the new legislation. However, the Bar continues to recommend to its associates avoidance of contingent fee arrangements.

[305] See the Government Bill No. 1495, under examination by the lower Chamber of the Parliament (*Camera dei deputati*). There are, however, as many as 7 more competing bills. The committee in charge of discussing the legislative proposal is currently engaged in a series of auditions of the affected constituencies. See www.camera.it.

[306] For a summary illustration in English, see Clifford Chance [2006], *op. cit.*, 11-12.

quences of this combination will be for Italian corporate governance is hard to predict. The problem is that litigation is ultimately policed by rational expectations about judicial outcomes.[307] In the absence of a specialized and skillful judiciary, the enhanced bite of shareholder litigation may result so much in higher risk of false positives as in false negatives remaining essentially unaffected. As other commentators and I argued elsewhere, the problem of Italian institutions with the extraction of diversionary PBC by corporate controllers is manifold, and cannot be addressed piecemeal.[308] A tighter independent monitoring, a better skilled judiciary, more room for private enforcement, and the development of a social concern for corporate governance are all equally urgent ingredients of an efficient policing of self-dealing in Italy.

9.4. Two Final Notes on the Discipline of Self-Dealing

The patient reader will have noticed that the analysis of related-party transactions has taken two large chapters of an otherwise extensive dissertation. The reason is twofold. The first is that I maintain that efficient legal constraints on the extraction of diversionary PBC are a necessary, but not sufficient condition for efficient regulation of corporate governance. Compared to the standard account of how law matters for corporate governance, this claim is quite unconventional in Corporate Law and Economics. Most part of the present book is dedicated to demonstrating that investor protection and diversionary PBC are not all that matters in the legal discipline of corporate governance, and to developing the regulatory implications of this contention as to both the exercise and the transfer of corporate control. Conversely, the discussion of non-pro-rata distributions, as a key problem in the legal discipline of corporate governance, is concentrated in this and the previous Chapter. The second reason why the discussion of legal policies against shareholder expropriation has taken that long is that this problem is so complicated that it cannot be dismissed in a few pages. Even confining the analysis to the most paradigmatic instance of diversion (i.e., self-dealing), we have just seen that the problem of non-pro-rata distributions can be addressed through a large number of legal techniques, whose operation can only be compared between different jurisdictions on the basis of a functional paradigm allowing for an equally wide range of choices.

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[307] For the Law and Economics of litigation, see Cooter, R.D. and Ulen, T.S. [2004], *op. cit.*, 388-444.
[308] Bianchi, M., Bianco, M., Giacomelli, S., Pacces, A.M. and Trento, S. [2005], *op. cit.*, 173-174.

The relative efficiency of these choices bears no ranking across the board, and then assessing the ability of each legal system to cope with diversionary PBC requires a deep investigation of institutional complementarities. But instead of bothering the reader any further, I wish to briefly elaborate on this complexity to address two very fashionable approaches to legal comparison in the current debate over the 'most efficient' policing of self-dealing, and to show how these approaches differ form the one developed here. One is – once again – 'numerical comparative law,' which is being increasingly patronized by the World Bank with special regard to the problem of self-dealing.[309] The other is the 'one-size-fits-all' approach taken by the European Commission in the attempt to 'modernize' European company law.[310]

9.4.1. An Alternative Approach to the Law and Economics of Self-Dealing

a) *The Very Last Shot of Numerical Reductionism*

In late 2005, the latest product of 'numerical comparative law' appeared with a very ambitious title: "The Law and Economics of Self-Dealing."[311] The paper follows the tradition inaugurated nearly ten years before by *Law and Finance*, with a number of methodological refinements intended to tackle the criticisms on both the economists' and the lawyers' side. However, it is quite doubtful that even this last experiment by Andrei Shleifer and his co-authors has managed to hit the target. As it was discussed in Chapter Four, the numerical methodology is very hard – and possibly impossible – to reconcile with functional legal comparison.[312] Therefore, although the paper at issue is an invaluable source of information about certain, specific rules governing related-party transactions in 72 countries, the picture that it provides about the legal policing of non-pro-rata distributions across jurisdictions is at best incomplete, and sometimes even distorted. Normative implications are likewise misguided, even though they are apparently supported by the force of econometric analysis. The paper has undergone a number of revisions and, at the time the present work is being finalized, has not yet been published.[313] Nonetheless, the

[309] See *supra*, Chapter Four, section 4.3.
[310] See *supra*, section 9.3.1.
[311] Djankov *et al.* [2006], *Self-Dealing*, cit. The following references are made to the last version of the manuscript.
[312] See *supra*, Chapter Four, section 4.3.
[313] The first version, Djankov, S., La Porta, R., Lopez-de-Silanes, F. and Shleifer, A. [2005], *The Law and Economics of Self-Dealing* (November 4, 2005), mimeo, was circulated informally in Autumn 2005. The final version of the paper is forthcoming in the Journal of Financial Economics in 2008.

main indexes of regulation of self-dealing have been already included by the World Bank in the worldwide estimates of investor protection provided within the *Doing Business* project.[314] Without repeating myself, I just wish to highlight the major inconsistencies of this approach in dealing with the problem of shareholder expropriation, and how its results and policy implications differ from those that have been just discussed.

Compared to previous work in the same line, *Law and Economics of Self-Dealing* apparently tries to take functional comparison seriously. The study is based on a stylized case of conflicted interest transaction concluded between two companies where the controlling shareholder has two different stakes – and is obviously interested in tunneling resources from the low-stake company to the high-stake one.[315] Then a relative broad range of legal strategies to counteract tunneling is considered, and they are divided into three major functional categories: *ex ante* private enforcement, *ex post* private enforcement, and public enforcement.[316] Finally, information about the national disciplines is not just limited to the 'law on the books' – like it was in *Law and Finance*: legal information is gathered from different law firms involved in the national practice, and subsequently cross-checked by individual discussion with the authors.[317] From this description, the framework may look hardly different from ours. However, the reason why the foregoing discussion was not just a waste of time is that the difference in approach is, indeed, substantial.

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314 World Bank [2007], *Doing Business in 2007 – How to Reform (Overview)*, The World Bank (also available at www.worldbank.org), and the comprehensive information on the Doing Business Project regularly posted on www.doingbusiness.org. For further details see *supra*, Chapter Four, section 4.3.1.

315 The stylized case is described in Djankov *et al.* [2006], *Self-Dealing*, cit., 5-6 and Figure 1.

316 Id., at 7-11 ('The Regulation of 'Self-Dealing').

317 Id., at 4-7 ('Methodology'). The authors have constructed a database on the basis of a questionnaire sent out to the law firms participating in the *Lex Mundi* project (see *supra*, Chapter Four, section 4.3.2). The questionnaire deals with how each legal system disciplines the stylized self-dealing transaction, as regards disclosure of conflicts of interest, private enforcement of remedies by minority shareholders, and public enforcement of monetary and non-monetary sanctions. The answers have been double-checked through follow-up conference calls. The authors included case-law and judicial precedents as relevant sources of legal rules, and excluded all not formally biding sources of discipline (like CG codes). However, curiously enough, they admit that one possible limitation of this approach is that only law on the books is measured, while the practice of enforcement may possibly "matter as much or more." They contend that controlling for the "general quality of enforcement" in the regressions (however this 'general quality' is measured) is enough. On top of this, they claim that "a decade of research in this area suggests that, while the quality of enforcement surely matters, so do the legal rules themselves." Id., at 5. Needless to say, the 'decade of research' in question has been performed (with some turnover in co-authorship) by the authors themselves.

b) 'The Stricter, the Better:' Is This the Right Economics?

To start with, non-pro-rata distributions are a *general* problem of abuse of control power, and its relevance cannot be limited to the case in which a controlling shareholder is in charge. The prejudice underlying the structure of the paper is that managerial control cannot emerge unless the ability of controlling shareholders to extract private benefits is constrained by the legal system – and, once again, this is how the primacy of Anglo-Saxon jurisdictions is derived.[318] We know that this is just a part of the story. But, in any case, failure to constrain director's ability to divert resources from shareholder's pockets would likewise result in managerial control being not viable. The previous discussion showed how both the US and the UK – albeit in different manners – care about policing not only the controlling shareholder's conflicts of interest, but even more so the director's ones. Whether other jurisdictions fare any better or any worse in promoting separation of ownership and control likewise depends on their ability to cope with both problems, and not just with one of them. However, surprising as it may appear to a lawyer, the issue of director's conflicts of interest is completely neglected by Shleifer and his co-authors.[319]

A more important point is that the problem of self-dealing is mischaracterized, and so are its legal remedies. Most part of the foregoing discussion was devoted to the problem of Type I/Type II errors in enforcing the legal discipline of the corporate controller's conflicts of interest. This issue is not considered in the paper, for the simple reason that it implicitly assumes that the stylized transaction – where the controlling shareholder is on both sides of the purchase of standardized trucks –

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[318] Compare with La Porta *et al.* [1998], *Law and Finance*, cit., 1145-1151.

[319] In Djankov *et al.* [2006], *Self-Dealing*, cit., only the conflict of interest on the controlling shareholder's side is considered. The authors assume that the controlling shareholder is a director himself, that he has appointed the majority of board members, and that the CEO of the company is the controlling shareholder's son. As a result, board approval of conflicted interest transactions is dismissed as a trivial issue. "An important assumption in our case facts is that all related parties (i.e., controlling shareholder, CEO, and interested directors) vote in favor of the transaction whenever legally possible even when doing so may expose them to greater litigation risk. Prudence might require greater caution, but we focus on the letter of the law. For this reason, we separate disinterested shareholder approval as the purest case of arms-length endorsement of the transaction." Id., at 8. These assumptions make perfect sense, but also preclude extension of the analysis to those situations where there is no controlling shareholder and the executive members of the board are ultimately in charge. In the last scenario, approval by disinterested directors would be no longer a trivial issue. Neglecting this mechanism of private enforcement may appear consistent with the authors' focus on controlling shareholders. Yet a further consequence of this omission is that the option of delegated monitoring by independently appointed outside directors is neglected across the board. In fact, we know that this option is equally suitable, *mutatis mutandis*, to managerial and shareholder control systems. See *supra*, Chapter Eight, section 8.5.3, and above in this Chapter.

may only be entered into for diversionary purposes.[320] This is wrong. Either the authors made the wrong assumption or they simply chose the wrong example for describing the prototypical related-party transaction. In principle, the latter may have indeed business purpose, and limiting the analysis to an imaginary transaction, which hardly can have any, is just nonsense.

The consequences of this approach on legal analysis are unacceptable. Some of the variables are defined as "ease" of holding either the controlling shareholder or the directors under his control liable, or "ease of proving wrongdoing:" the easier these things are, the better a jurisdiction scores on quality of law.[321] More in general, the easier the enforcement of *ex ante* restrictions or *ex post* sanctions on related-party transactions, the better. That related-party transactions may involve no non-pro-rata distributions is not even considered as a remote possibility. For instance, mandatory approval of these transactions by disinterested shareholders is definitely considered as a feature of 'good law,' regardless of the risk of false positives that this may involve.[322]

c) Incomplete Legal Information

Putting efficiency aside, information about the *strength* of legal constraints on self-dealing is only apparently more reliable. Undoubtedly, the authors put much effort in understanding legal technicalities. But they have not managed yet to get rid of the prejudices arising from the legal categories they are most acquainted with – or that they simply like the most. Their otherwise broad framework, short of being purely functional, is restricted to the tools that are most typically available in Anglo-Saxon jurisdictions. Compared to the analysis of the foregoing pages, this kind of investigation is seriously incomplete and sometimes even wrong.

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[320] To be sure, the authors do not make this point explicitly. Quite to the contrary, they explain that the reason why self-dealing transactions are not banned outright by societies is "perhaps because in many instances related-party transactions actually make economic sense." In addition, they conclude the description of the stylized case of self-dealing specifying that "[a]lthough the proposed transaction has a possible business purpose, it involves an obvious conflict of interest." Unfortunately, the authors just pay lip service to the potential virtues of related-party transactions, and this is evident from how they construct the Anti Self-Dealing Index. "[W]e start with a fixed self-dealing transaction, and then measure the *hurdles* that the controlling shareholder must jump in order to get away with this transaction. *The higher the hurdles, the higher the anti-self-dealing index is.*" Djankov *et al.* [2006], *Self-Dealing*, cit., 5 (emphases added).

[321] See Djankov *et al.* [2006], *Self-Dealing*, cit., Table III – 'Ex-post private control of self-dealing and anti-self-dealing index'.

[322] Id., Table I – 'Description of the Variables' ("Approval by disinterested shareholders: Equals 1 if the transaction must be approved by disinterested shareholders, and zero otherwise"). Notice again that approval by disinterested, and independently appointed, directors is not even considered as an option, let alone as a functional substitute.

For instance, one major improvement in the analysis is that the American approach to protection of minority shareholders is no longer considered as similar, if not identical, to the British one.[323] The curious thing is that the authors do not point to the right differences. The figures show that the UK scores much higher than the US on *ex ante* enforcement and nearly as high on *ex post* enforcement.[324] However, as the authors otherwise recognize in the text, private litigation has never been a prominent feature of corporate governance in the UK, whereas it certainly is in the US.[325] On the other hand, informed approval by a disinterested body is traditionally much more of a concern in the US, where – as we know – courts do require that self-dealing by a controlling shareholder be approved by 'a majority of minority shareholders' upon full disclosure of the conflict of interest.[326] In reality,

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323 Compare La Porta *et al.* [1998], *Law and Finance*, cit., 1130-1131, with the description of the diverging British and American approaches to the discipline of related-party transactions in Djankov *et al.* [2006], *Self-Dealing*, cit., 13-20.

324 On "Ex-ante private control of self-dealing" the UK scores 100% and the US just 33%; on "Ex-post private control of self-dealing" the UK scores 90% and the US 98%. Since the Anti Self-Dealing Index is obtained as the simple average of these two components, the UK ultimately outperforms the US in "private control of self-dealing" (95% as opposed to 65%). Djankov *et al.* [2006], *Self-Dealing*, cit., Tables II and III.

325 "The strength of the regulation of self-dealing in the UK lies in the heightened scrutiny of transactions involving related parties before they may be approved rather than in favoring litigation by minority shareholders." Djankov *et al.* [2006], *Self-Dealing*, cit., 16. On the contrary, "the US does not require shareholder approval for related-party transactions and instead emphasizes litigation to protect minority shareholders against self-dealing." Id., at 19. In spite of that, the authors award to the US and the UK the same score on the ability of shareholders to sue derivatively. They argue that changing coding for the UK would not affect their results. That might be true, but the coding remains descriptively incorrect – at least, as of May 2003 (the paper's reference date). See *supra*, section 9.3.2 (discussing the *Foss v. Harbottle* rule and how it might have been superseded by the Companies Act of 2006). On top of this, information about shareholder approval of conflicted interest transactions entered into by controlling shareholders in the US is also incorrect. See the next note.

326 Otherwise the transaction is voidable and both the controlling shareholder and the directors who approved it would be held liable inasmuch as they are unable to prove that the transaction at issue was fair to the corporation. See *supra*, section 9.2.2. The mistake made by Djankov *et al.* is well illustrated by Kraakman *et al.* [2004], *The Anatomy*, cit., 121:

> "[Delaware law] – in theory, at least – vests disinterested directors with as much power to insulate deals with controlling shareholders as to protect deals with company managers [citing *Kahn v. Lynch Communication Systems*, discussed *supra*, section 9.2.2]. But this doctrine should not be taken too literally. In practice, the 'disinterestedness' of controlled company's directors may be vulnerable to attack, which makes the informed approval of minority shareholders the safest method of insulating a conflicted transaction with a controller [citing *In re Wheelabrator Technologies, Inc. Shareholder Litigation*, discussed *supra*, section 9.2.2]."

Djankov *et al.* [2006], *Self-Dealing*, cit., 19-20, cite a different precedent to support their contention that board approval suffices, although it does not shield the controlling shareholder from litigation: Weinberger v. OUP, Inc., 457 A.2d 701 (Del.Sup.1983). They report, correctly, that approval by a special committee of independent directors or disinterested shareholders would shift the burden of the US and the UK should score nearly the same on *ex ante* enforcement, whereas the US should definitely prevail on the second prong.

None of this information would account for the real difference between the two jurisdictions, though, let alone for their relative ranking as to efficiency. The British system relies on the governance powers of institutional investors as a credible threat against non-pro-rata distributions, whereas the American one is mostly based on the threat of disruptive litigation on suspected transactions.[327] Both systems are exposed to the risk of false positives, but for different reasons. The policy implication suggested by the analysis by Shleifer and his co-authors (i.e., let us have *both* minority shareholders more involved *and* litigation easier to bring in the presence of conflicts of interest) would ultimately amount to combining the worst, rather than the best, of the two systems.[328]

The problem with *Law and Economics of Self-Dealing* is actually much broader, and for reason of space, I cannot go much further in detail. However, the following shortcomings of such a limited framework are worth a brief remark: i) the authors fail to account for the ability of the Dutch system to cope with non-pro-rata distributions by either directors or controlling shareholders, based on the case-law developed by a specialized judiciary, legislation expanding the scope of private litigation even in the absence of a derivative cause of action, and self-regulation which is both binding and enforced;[329] ii) the quality of the Swedish system, which is based

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proof to the plaintiff challenging the transaction, but would not change the standard of review ('entire fairness' of the transaction). However, they make two additional mistakes. First, *Weinberger* applies to freeze-out mergers, which trigger a tighter scrutiny by Delaware courts (see the Kraakman *et al.* [2004], *The Anatomy*, cit., 143, and *infra*, Chapter Eleven, section 11.2); whereas the case in point is just an intra-group purchase of assets. Second, the purpose of *Weinberger* was not just that of recommending independent board approval. As the Supreme Court of Delaware clarified in *Kahn*, the courts would expect that the controlling shareholder is not in the position to impose the terms of the transaction to minority shareholders; in most situations (where all of the board members are appointed by the controlling shareholder) only approval by a majority of minority shareholders would satisfy this test. See *supra*, section 9.2.2. Then, also in the US, conflicted interest transactions entered into by controlling shareholders require approval by minority shareholders. Only in case of a freeze-out merger this will not be enough to spare the transaction a scrutiny of entire fairness; still, it will be up to the plaintiff to prove unfairness.

[327] See *supra*, sections 9.2.3 and 9.3.2. This is well illustrated in comparative Law and Economics. See Kraakman *et al.* [2004], *The Anatomy*, cit., 67-70.

[328] See Djankov *et al.* [2006], *Self-Dealing*, cit., 39-43 ('Summary and Implications').

[329] The Netherlands score 20% on the Anti Self-Dealing index (word average: 44%). This is due to the very low scores on the two principal components of the index. As far as *ex ante* disclosure is concerned, the authors neglect that case-law has imposed on the controlling shareholder comprehensive 'disclosure' duties to minority shareholders; likewise, 'independent review' is mandated by the Corporate Governance Code, which is binding, enforced, and complied with by the near totality of Dutch listed firms. The Netherlands should therefore get a full mark on at least these two prongs. As far as the *ex post* remedies are concerned, the authors only award the Netherlands a positive (but

on a unique combination of social norms and legal rules in the background, is likewise underestimated – related-party transactions being little monitored *ex ante* is not so important when non-pro-rata distributions are almost perfectly deterred by *ex post* enforcement of civil, criminal, and social sanctions;[330] iii) the Italian system – one favorite target of numerical comparative law since *Law and Finance* – is nearly as well described by words as badly interpreted by figures (by the way, it ranks much higher than both Sweden and the Netherlands).[331] The problem of Italian law is neither insufficient checks nor insufficient liability in the presence of conflicts of interest, but rather a weak enforcement of both by non-independent directors, a formalistic judiciary, and hurdles to private litigation. None of these factors is ac-

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not full) score on 'access to evidence.' I suspect that this is supposed to account for the inquiry procedure. As we have seen, however, the inquiry procedure is more far-reaching. It can be definitely interpreted as a functional substitute of derivative suits (liability suits are a typical follow-up of the procedure, and individual claims can be aggregated by shareholder associations) and undoubtedly it can lead to 'rescission' of the transaction (the list of remedies available to the Enterprise Chamber includes setting aside the transaction); however, the Netherlands score 0 on both accounts. In addition, if we put the inquiry procedure in perspective, liability will be imposed almost with certainty (albeit in separate proceedings) after a declaratory judgment of mismanagement has been pronounced. This makes holding both the controlling shareholder and the members of the approving boards liable quite 'easy' when conflicts of interest are not appropriately handled, in spite of the Netherlands scoring 0 on these accounts. See *supra*, section 9.3.3.

330 Sweden scores really bad on the *ex ante* disclosure component of the Anti Self-Dealing Index (17%), significantly better on the *ex post* remedies component (50%), and very high on the public enforcement index (100%). However, as we have seen, it is the system that matters. Overall, the combination of legal and extralegal institutions in Sweden provides excellent safeguards against non-pro-rata distributions by controlling shareholder, and this is not reflected in the Anti Self-Dealing Index (only 33%, well below the world average 44%). See *supra*, section 9.3.4.

331 Italy has one of the highest scores on the Anti Self-Dealing Index among civil law jurisdictions (42% as opposed to the 35% average), and that is slightly below the world average (44%). In the article, however, the authors contrast the description of how self-dealing is handled under Italian law with the British discipline: the former is supposed to be the characteristic example of how badly civil law countries tackle the controller's conflicts of interest, whereas the latter is presented as evidence of the primacy of common law in protecting investors. The description of Italian law is fairly accurate as of May 2003, although it wound be completely different as of 2007: some of the improvements brought about by the recent reforms would qualify for upgrade of the Anti Self-Dealing Index (e.g., enhanced liability of directors in case of conflicts of interest and of controlling companies in intra-group transactions), while some others would not (e.g., independent appointment of minority representatives to the board). Regardless of the limitations of the index, these improvements would certainly bring Italian ranking closer to the high British standards. But this is not the point. Actually, as we have seen, the bite of British law when it comes to litigating related-party transactions is overestimated. Even more so is the quality of Italian law, and this holds in spite of the recent improvements: independent directorships are not yet entirely reliable, and shareholder litigation cannot be considered as a serious threat against the corporate controller's misbehavior due to the hurdles of civil procedure and formalistic adjudication of corporate law. See *supra*, section 9.3.5. The Anti Self-Dealing Index is simply too parsimonious to account for these problems.

counted for by Shleifer and his co-authors, but this is exactly what is changing (or should change) in Italian legislation.

In conclusion, the legal information provided by *Law and Economics of Self-Dealing* is both incomplete and misleading in many respects. This is already a sufficient reason to be skeptical about its ability to deliver policy implications of any sort. On top of this, the economic framework of the analysis is questionable on both positive and normative grounds. First, constraining self-dealing cannot be regarded as a normative goal in itself. Second, shareholder approval and shareholder derivative suit are definitely not the only incentive-compatible mechanisms for policing non-pro-rata distributions: on the one hand, they may be both over-inclusive and under-inclusive; on the other hand, different checks (like independent director approval), legal remedies (like injunction), or mixed sanctions (like ouster and/or shaming) may fare even better under certain circumstances. Thirdly, and relatedly, comparative Law and Economics is not about cherry picking: in corporate governance, like in any other field, institutional complementarities must always be taken into account in the quest of efficiency. Simply put, one size does not fill all.

9.4.2. 'Modernization' of European Company Law: Where Do We Go from Here?

a) *The 'Children of a Lesser God' Syndrome*

The impact of numerical comparative law was not limited to academics. Since the appearance of *Law and Finance* this methodology, let alone the results it delivered, had an unparalleled influence on policy-making. Europe was far more exposed to this influence than the US, where Corporate Law and Economics had already reached its prime.[332] European commentators had no counterarguments to explain limited separation of ownership and control outside the Anglo-Saxon world, and could at most express some shy skepticism towards the claim that the common law tradition is best suited to investor protection and efficient corporate finance.[333] What they could do better was showing that Europe had is own way to catch up. Here is *how* (but, as we are about to see, not necessarily *why*) European institutions got involved, with the support of at least one part of European academics. Allegedly, the European Commission's goal was that of "ensur[ing] sustainable

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[332] See *supra*, Chapter Four, section 4.5.
[333] See *supra*, Chapter Four, section 4.6.

public confidence in financial markets," also on this side of the Atlantic.[334] To many, this appeared as the best of all possible worlds. According to Klaus Hopt – an authoritative supporter of involvement of European institutions:

> "Whatever position one takes on [the debate about the empirical work by La Porta *et al.*], a replication of these American studies in Europe would be welcome, though certainly with more neutral criteria and better knowledge of the European and factual situation. Until then, the Commission was right to proceed and act as it did, even in the face of uncertainty and based on mere plausibilities."[335]

While hoping that the present work will fall under his auspices, it is probably just because this is intended to be a critical alternative to, more than a replication of, those empirical studies that I must disagree on Professor Hopt's conclusion. I am in fact more sympathetic with another side of European Law and Economics scholarship, according to which: i) improvement of corporate governance regulation does not necessarily mean convergence to a set of legal rules regarded as being the 'best ones' across the board;[336] ii) the drawbacks of a uniform European legislation are likely to exceed its advantages in most fields of company law – and certainly in the three key areas being analyzed in the present dissertation;[337] iii) short of being an efficient synthesis of national preferences, company law at the EU level seems to be rather the result of workable compromises between national legislators, and anyway prone to both interest groups' pressure for maintaining the status quo and EU bureaucrats' motivation to enhance their power and prestige.[338] As a result, the prospect of European harmonization of company law seems to be neither attainable nor desirable, maybe with only minor exceptions. The first argument of this contention is self-explanatory, in the light of previous discussion. The other two will be briefly elaborated upon with reference to a few examples from the discipline of related-party transactions.

b) Why Shareholder Protection Is Not a Good Matter for Harmonization

Activism of the European Commission grew significantly in the wake of Enron. The *Financial Services Action Plan* was still on its way to completion, when the Com-

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[334] See European Commission [2003b], *Company Law and Corporate Governance: Commission Presents Action Plan*, Press Release IP/03/716, available at www.europa.eu.
[335] Hopt, K.J. [2005], *op. cit.*, 122.
[336] Hertig, G. [2005], *op. cit.*
[337] See Enriques, L. and Gatti, M. [2006b], *op. cit.*
[338] Enriques, L. [2006a], *op. cit.*

mission came up, in 2003, with a *Company Law Action Plan* ("Modernizing Company Law and enhancing Corporate Governance in the EU") as a follow-up of the second report by the High Level Group of Company Law Experts.[339] Both the flavor of the report and the previous interest of European institutions for corporate governance were initially concerned with recommendations of best practices – as opposed to financial regulation, mostly characterized by binding legislation.[340] However, the explosion of financial scandals gave the European bureaucrats a wonderful opportunity to take the lead. So did they, and the highly regulatory stance of the Action Plan was undoubtedly reinforced after Ahold, Parmalat, and similar European debacles demonstrated that 'it can also happen here.'[341] Based on this escalation of events, and considering the far-reaching scope of legal intervention planned by the Commission, one would expect that regulation of related-party transactions were a primary concern of the Action Plan. However, short of being a priority in the regulatory agenda, the matter is hardly dealt with.[342] This case is very much illustrative of motivation, constraints, and expected outcome of European harmonization of company law.

Throughout this Chapter, we have seen how setting a substantive discipline of conflicted interest transactions requires tackling the delicate balance between discretion and accountability in the exercise of corporate control. After the financial scandals of the beginning of this century, virtually every jurisdiction has tried to improve that balance.[343] While this process has been clearly influenced by inter-jurisdictional imitation, none of the reforms we have reviewed has taken any straight departure from the national tradition. Rather than transplanting new rules or doctrines from foreign legislation, each legal system has attempted to cope with the loopholes of its own.

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339 See European Commission [2003a], *Company Law Action Plan*, cit. The background is provided by High Level Group of Company Law Experts [2002b], *A Modern Regulatory Framework for Company Law in Europe*, Final Report, 4 November 2002, available at www.ec.europa.eu.int. The High Level Group of Company Law Experts was set up by the European Commission in September 2001, after the European Parliament failed to pass the first proposal of a Takeover Directive in second reading. The Group was assigned two tasks. The first was to report on a number of issues concerning a new proposal of a Takeover Directive, based on previous experience of failed negotiations with member states. The second was to issue recommendations for a modern regulatory framework for European company law. As a result, the Group issued two reports, respectively in January and in November 2002. The above-cited report deals with the second assignment. On the first report see *infra*, Chapters Ten and Eleven.

340 Compare European Commission [1999], *Financial Services Action Plan*, cit., with the High Level Group of Company Law Experts [2002b], *Final Report*, cit.

341 Davies, P. [2005], *op. cit.*, 163-165.

342 Enriques, L. and Gatti, M. [2006a], *op. cit.*

343 Hopt, K.J. [2006], *op. cit.*, 448.

The European legislator could fare no better. On the one hand, while setting efficient constraints on the extraction of diversionary PBC can be considered as a general goal of corporate law, there is no unique set of rules to achieve this goal.[344] The legal discipline of non-pro-rata distributions is just a part of a broader discretion-accountability tradeoff, whose efficient solution also depends on how corporate governance reacts to distribution of powers and the dynamics of changes in control: these two aspects are both country-specific and firm-specific.[345] On the other hand, a crucial determinant of efficient regulation of related-party transactions is far beyond the European institutions' reach: this is enforcement. As Enriques and Gatti have efficaciously summarized, any involvement of the European legislature in the discipline of corporate self-dealing would risk being not only "inefficient" (i.e., "both overinclusive and underinclusive"), but also "ineffective" exactly for this reason.[346] However, this just explains why European harmonization would not be desirable, at least in this respect, not also why it has been left out of an otherwise comprehensive agenda.

c) Harmonization and Convergence in the Discipline of Self-Dealing: Are They Really Separate Issues?

Other aspects of the legal discipline of non-pro-rata distributions can better explain the limits of harmonization. Putting aside the substantive discipline of self-dealing, the European legislature seems to have achieved at least one success and one failure in regulation of related-party transactions. On the one hand, it has managed to compel adoption of *International Accounting Standards* (IAS) in the European companies' annual and interim accounts, thereby making disclosure of related-party transactions subject to the stringent requirements of the IAS Principle No. 24 – in line with the mandatory character of the GAAP under US securities regulation.[347] On the other hand, it has failed to deliver any binding piece of legislation regarding structure, composition, and remuneration of board of directors. In any of these fields, the Commission has only managed to issue, at most, recommendations, whose "main impact is in the national policy discussions: if their contents fits the policy agenda of policymakers (or lobbying groups) at the national level, they lend

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344 Compare the functional framework set up in Chapter Eight with the previous discussion of how investor protection is implemented, and could be improved, in each jurisdiction of our sample.

345 See *supra*, Chapter Six.

346 Enriques, L. and Gatti, M. [2006a], *op. cit.*, 41.

347 Regulation 1606/2002/EC of the European Parliament and of the Council of 19 July 2002 – On the application of international accounting standards, discussed in Enriques, L. and Gatti, M. [2006a], *op. cit.*, 7-9. See also Kraakman *et al.* [2004], *The Anatomy*, cit., 103-105.

force to it increasing to a varying degree the chances that the desired policy measures will be adopted. Otherwise, they will easily be ignored."[348]

From a public choice perspective, the bottom line is straightforward.[349] It is not in the interest of European bureaucrats to engage in a struggle in any controversial field of corporate governance, let alone in areas which – for the good or the bad – exhibit strong path-dependency at the national level. They have indeed a much better option: taking up the legal changes, which are already in the making, but still suffer of moderate opposition by vested interests at some (but not all) national levels. This brings prestige and power to the European bureaucrats, without undermining their popularity with either national governments or most powerful interest groups active in lobbying at the level of European institutions.

In the aftermath of Enron, and of the European scandals that followed, it is not unlikely that spontaneous convergence to the IAS principles would have been just a matter of time. On the contrary, insisting on pushing through, on any binding basis, board reforms, substantive regulation of self-dealing, and – more in general – any other matter having a significant bearing on the fundamental discretion-accountability tradeoff of corporate governance, would have probably costed European bureaucrats their job without resulting in anything but cosmetic changes. The reasons are manifold, and I cannot but sketch out some of them here.

First, resistance by interest groups is overcome only after events have unambiguously proved the weakness of certain institutions.[350] Backlash is then the major driver of institutional reform, but it differs from revolution in that confidence in the overall strength of the institutional system is preserved.[351] None of the above-mentioned corporate scandals provided sufficient grounds for revolutions in corporate governance, thereby saving most vested interests from disruption. This prevented, in turn, both European and national legislators from dismantling the evolutionary path of corporate laws.

This is less unfortunate than it may appear. A second reason for 'triviality' of European company law is in fact that in most areas of corporate governance – with the noticeable exclusion of disclosure and accounting practices – there is no 'focal

[348] Enriques, L. and Gatti, M. [2006a], *op. cit.*, 24. See Commission Recommendation 2004/913/EC of 14 December 2004 – Fostering an appropriate regime for the remuneration of directors of listed companies; Commission Recommendation 2005/162/EC of 15 February 2005 – On the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board.

[349] See, for a similar approach, Enriques, L. [2006a], *op. cit.*

[350] See, for historical illustration, Rajan, R.G. and Zingales, L. [2003], *The Great Reversals: The Politics of Financial Development in the Twentieth Century*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 69, 5–50.

[351] Compare with Roe, M.J. [1998], *Backlash*, in COLUMBIA LAW REVIEW, vol. 98, 217-241.

point' of convergence other than those established by short-lived vogues.[352] This holds at both the academic and the public policy levels. Academics on both the economic and the legal side exhibit, for instance, a long-standing disagreement on what is, at least in my view, a much exaggerated subject: the optimal board structure.[353] Policy-makers are likewise stuck in a never-ending debate upon whether the more stakeholder-oriented model of corporate governance in the continental tradition is any better than the Anglo-Saxon exclusive concern for shareholder interest.[354] For the most part this kind of debates is just ideological, and their fluctuation over time provides perhaps the most compelling evidence of futileness.

It is therefore unsurprising that very little convergence has occurred on this basis, and that clumsy attempts of harmonization have been regularly short-circuited at the national level. One illustrative example in this regard is the recent creation, in Britain, of a safe-harbor for director's liability in the face of the increased exposure to damage compensation of both executive and non-executive directors, which would follow the implementation of a number of EC Directives.[355] So far, Law and

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[352] Enriques, L. and Gatti, M. [2006b], *op. cit.*, 962-965.

[353] See, e.g., Hertig, G. [2005], *op. cit.*; and Becht, M., Bolton, P. and Röell, A. [2002], *Corporate Governance and Control*, ECGI Finance Working Paper No. 02/2002, available at www.ssrn.com and www.ecgi.org, as published in G. Constantinides, M. Harris, and R. Stulz (eds.) [2003], HANDBOOK OF ECONOMICS AND FINANCE, North-Holland.

[354] For how this can be interpreted as a problem of different preferences between member states, which also weakens the case for corporate law harmonization, see Enriques, L. and Gatti, M. [2006b], *op. cit.*, 974.

[355] See the 'Transparency Directive' (Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 – On the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC Directive 109/2004/EC), establishing liability for certification of annual and interim financial reports (in line with § 302 of the Sarbanes-Oxley Act); the 'Statutory Audit Directive' (Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 – On statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC), requiring companies to establish within their boards an audit committee entirely composed of independent directors (in line with § 301 of the Sarbanes-Oxley Act); and the 'Revised Accounting Directive' (Directive 2006/46/EC of the European Parliament and of the Council of 14 June 2006 – Amending Council Directives 78/660/EEC on the annual accounts of certain types of companies, 83/349/EEC on consolidated accounts, 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions and 91/674/EEC on the annual accounts and consolidated accounts of insurance undertakings), requiring companies to issue a corporate governance statement in their annual reports and establishing collective responsibility of board members for the annual accounts (a milder version of the controversial § 404 of the Sarbanes-Oxley Act). All of these initiatives are discussed, in more detail, by Enriques, L. and Gatti, M. [2006a], *op. cit*. Here is just worth noting that the British Companies Act of 2006 has established a safe harbor for director's liability in connection with the company's annual and interim disclosures: directors are only liable to the company in case of reckless or deliberate misstatements, or dishonest con-

Economics research has demonstrated that the incentives of board members matter much more than the formal board structure. On the one hand, there is a tradeoff between the managing and the monitoring function of directors, which makes not only proximity and monitoring ultimately irreconcilable with each other, but also 'one-size-fits-all' solutions undesirable at both the country and the firm level.[356] On the other hand, it seems that increasing directors' exposure to liability in their capacity as monitor would just result in "shrinkage of the pool of potential outside directors," rather than in tighter monitoring of the corporate controller's conflicts of interest;[357] and that in fact Anglo-Saxon jurisdictions are not paying more than lip service to such a policy.[358]

At the end of the day, we owe both persistence of a flexible approach to the discretion-accountability tradeoff and avoidance of hasty legal transplants to the interdiction by interest groups at the national level, rather than to the action of policymakers at the European level. The outlook of European harmonization of company law is therefore quite gloomy. After all, one can but be happy about that.

cealment of facts (§ 463 of CA 2006). Liability of the company to the investors may be established in a broader set of circumstances. See Freshfields [2006a], *op. cit.*, 3-4.

356 See, respectively, Adams, R.B. and Ferreira, D. [2007], *op. cit.*; Boot, A. and Macey, J.R. [2004], *op. cit.*; Hertig, G. [2005], *op. cit.*

357 Black, B.S., Cheffins, B.R., Klausner, M. [2006], *op. cit.*, 18-19.

358 See *supra*, sections 9.2.3 and 9.3.2.

CHAPTER TEN – Regulation of Control Transactions (I): Legal and Economic Framework

10.1. Introduction

10.1.1. The Importance of Takeovers and of Their Regulation in Corporate Governance

The subject-matter of this and the following Chapter is the final and crucial issue of the present inquiry: the market for corporate control and the regulation of the paradigmatic transactions whereby it is operated – takeovers. In the foregoing Chapters, two necessary legal conditions for separation of ownership and control have been discussed: i) the availability of legal entitlements to idiosyncratic private benefits of control (PBC) for the corporate controller, which makes entrepreneurs willing sellers of corporate stock;[1] ii) legal constraints on the extraction of diversionary PBC by the corporate controller, which makes non-controlling shareholders willing buyers.[2] We have seen how incentive compatibility requires that entrepreneurs be in control of corporate assets that they do not own entirely, while taking a credible commitment that the proceeds of corporate management will be shared pro-rata with non-controlling shareholders. Failure of corporate law to provide both a sufficiently broad range of entitlements to corporate control and an efficient set of constraints on non-pro-rata distributions may result in either too much or too little separation of ownership and control.[3]

The conditions above are just for static efficiency. In the presence of uncertainty, not only contracts are necessarily incomplete – which determines the impor-

[1] See *supra*, Chapter Seven.
[2] See *supra*, Chapter Eight and Nine.
[3] See *supra*, Chapter Six, sections 6.7.1 and 6.7.2.

tance of power and of legal constraints on its exercise. Also, the allocation of control powers that is efficient today may no longer be efficient tomorrow.[4] The players of our game have no choice but postponing all decisions about control reallocation to the moment when unforeseen contingencies will materialize. This does not mean that they dismiss the matter as unimportant. Quite to the contrary, their very decision to enter the game at the outset depends on their expectations on whether, how, and in what terms control reallocations will take place eventually. Given that the two conditions for static efficiency are satisfied, the ultimate efficiency of corporate governance still depends on a third condition: an efficient dynamics of control allocation.[5] Hereby the importance of control transactions and of their legal discipline enters the picture.

This may look somewhat obscure. So, even at risk of repeating myself, let me recall a few key points about how corporate governance works – at least, according to the framework presented here.[6]

Suppose that corporate law features both an ideal system of corporate powers and a perfect ban on non-pro-rata distributions. Diversionary PBC ('stealing') will be disallowed and parties to the corporate contract will choose the form and degree of separation of ownership and control that maximize the joint value of quasi-rents on both the entrepreneur's and shareholders' investments: these are idiosyncratic PBC (profits 'in the entrepreneur's head') and shareholder value (expected earnings on corporate stock), respectively. In the absence of constraints on the exercise and maintenance of control powers, separation of ownership and control is determined by the weight of idiosyncratic PBC relative to the expected stream of verifiable profits. The latter – which may be considered as stock demand – is decreasing in the amount of separation, due to the problem traditionally characterized as agency cost (distortionary PBC). The former set a lower bound on the entrepreneur's willingness to sell – stock supply –, since the discount on outside stock cannot be lower than idiosyncratic PBC. This is the static equilibrium.[7]

The efficiency of this equilibrium depends on the two PBC parameters, whose value may change over time.[8] Distortionary PBC are an opportunity cost to outside shareholders. This cost will rise as soon as either a more diligent or a more competent manager appears on the market, thereby making the current allocation of corporate control and ownership structure inefficient. In such situation, control should

[4] See *supra*, Chapter Five, section 5.5.

[5] See *supra*, Chapter Six, section 6.7.3.

[6] The following summarized the theoretical framework upon which this inquiry is built. See *supra*, Chapter Six, for further details.

[7] See *supra*, Chapter Six, section 6.4.2.

[8] For taxonomy of PBC and their role in corporate governance (CG) see *supra*, Chapter Five.

definitely change hands for corporate governance to be efficient *ex post*. Unfortunately, the presence of idiosyncratic PBC determines a tradeoff between *ex ante* and *ex post* efficiency. Protection of the incumbent's control rents is necessary for the entrepreneur to establish the firm and take it public at the outset. However, one would wish to disregard this protection *ex post*, as soon as a slightly better corporate controller shows up. Here comes the fatal attraction of hostile takeovers. Yet they are not an option if one wants entrepreneurship to be featured by corporate governance. The alternative solution is having takeovers agreed upon (i.e., friendly takeovers), so that the incumbent's control rents can be compensated by the insurgent. This implies that the higher the incumbent's idiosyncratic PBC, the higher discontinuity in the controllers' efficiency will be required for a value-increasing change in control to be feasible. Departure from the conditions of first best is the highest in the absence of idiosyncratic PBC on the insurgent's side. However, while this might possibly be the case for highly mature businesses (which, allegedly, can be managed as a matter of "routine"),[9] the absence of control rents in corporate governance seems to be too exceptional to assume that the role of entrepreneurship can be exhausted in just one takeover stage – if ever. Rather, this result seems to be the asymptotical tendency of a multiple-stage takeover process over the indefinite time horizon of the firm's lifecycle. This makes decreasing idiosyncratic PBC a condition for dynamic efficiency.[10]

It is fair to assume that insurgent controllers will be normally also featured with idiosyncratic PBC. Idiosyncrasy of entrepreneurial talent makes it impossible to simply assume control rents of equal size as the incumbent, which would eliminate the above-mentioned discontinuity in efficient changes in control. In theory, the insurgent's control rents could be higher than the incumbent's, and this may result in changes in control being driven by entrepreneur's subjective expectations rather than by objective increases of shareholder value. In practice, this is unlikely to occur, provided that such expectations need to be mostly (if not entirely) self-financed,[11] and the financial needs of taking over a publicly held company are incomparable with those of a starting up an entrepreneurial firm. Positive, but decreasing, idiosyncratic PBC as the 'entrepreneurial' motivation of takeovers is, therefore, the most reasonable assumption. As a result, idiosyncratic PBC are insufficient to determine a change in control regardless of its efficiency in terms of shareholder value. Takeovers will occur when the insurgent can enhance firm value

[9] Hart, O. [1995], FIRM, CONTRACTS, AND FINANCIAL STRUCTURE, Oxford University Press, 126.

[10] See *supra*, Chapter Six, section 6.4.3.

[11] Mayer, C. [1999], *Firm Control*, Inaugural Lecture at the University of Oxford (February 18, 1999), available at www.finance.ox.ac.uk, as published in J. Schwalbach (ed.) [2001], CORPORATE GOVERNANCE: ESSAYS IN HONOR OF HORST ALBACH, Springer-Verlag, 15.

in the form of verifiable stock earnings *and* bring some further profit opportunities in the form of residual idiosyncratic PBC. The two components must generate sufficient surplus to compensate the incumbent's rents while leaving some reward for insurgency.

The above condition results in a constrained-efficient equilibrium in between each takeover stage, where the constraint is always compensation of the incumbent's idiosyncratic PBC.[12] In a comparative statics perspective, this preserves *ex ante* efficiency at the cost of *ex post* inefficiency. However, in a dynamic perspective, the evolution of equilibria determined by shrinking of control rents at every stage is simply efficient, even though there is no guarantee that it will ever lead to Pareto optimality. Indeed, the latter would require no control rents at all, and therefore it is most probably unattainable in a world of uncertainty. In other words, the envisaged dynamics of control allocation can lead at most to a second best. The achievement of this second best outcome should be the ultimate goal of corporate governance.[13]

Both controllers and non-controlling shareholders rely as much on the condition for dynamic efficiency as on those for static efficiency when they decide whether to separate ownership from control at the outset. The former will not just be content with securing control power and its rents, but also wish to have those rents cashed in eventually. The latter will indeed require protection from expropriation before they buy non-controlling stock, but also wish that the prospective value of their investment is maximized. These two expectations are based on a smooth process of changes in control, wherein cashing in idiosyncratic PBC goes hand in hand with reduction of distortionary PBC. An efficient market for corporate control will make shareholder value progressively increasing its weight relative to control rents, thereby allowing for separation of ownership and control to be more attractive *ex ante* as it is bound to increase efficiently over time. On the contrary, impediments to the takeover process will make corporate control easily stuck in suboptimal allocations, inefficient consumption of progressively costlier distortionary PBC the only way to extract control rents, and separation of ownership and control either too high or too low compared to what would be efficient from both an *ex ante* and an *ex post* perspective.[14]

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12 See *supra*, Chapter Six, section 6.5.3.

13 See *supra*, Chapter Six, section 6.6.

14 See *supra*, Chapter Six, section 6.7. In general, corporate ownership will be stuck in either over-concentrated or under-concentrated structures when the takeover process does not function efficiently. What may seem counterintuitive is that an inefficient market for corporate control can also lead to *excessive* separation of ownership and control. However, the outcome depends, on the one hand, on how separation is established in the first place and, on the other hand, on how it is bound to evolve. Suppose that controlling shareholding is discouraged by regulation. Such an institutional environment would not feature high idiosyncratic PBC in listed firms. This does not need to lead

Impediments to efficient reallocations of corporate control may arise from different sources. The first one is the incentive-compatibility constraint of the takeover process that we have just reviewed: in order to preserve the entrepreneur's incentive to go public *ex ante*, some efficient changes in control need to be foregone *ex post* to allow compensation of the incumbent's control rents.[15] The second source is the distribution of takeover gains. Due to contractual incompleteness, this distribution depends on the bargaining power of the parties involved.[16] However, the same distribution also affects the incentive to undertake a takeover. The introduction of a third player in the game – the acquirer – is therefore problematic. On the one hand, the prospective acquirer's incentive is a key determinant of the takeover process. On the other hand, the acquirer seems to have little chance to participate in the takeover gains, for at the outset he is featured with neither residual rights of control nor with any significant share of the residual claim on the firm's assets.

The third source of impediments is regulation.[17] The problem is two-sided. As I am going to show, distribution of takeover gains is a matter that cannot be entirely solved by private ordering, for this would undermine the efficient dynamics of control allocation and, in turn, efficient separation of ownership and control. Thus, takeover regulation is necessary. However, regulation may – on the one hand – violate the above-mentioned incentive-compatibility constraint (for instance, by forcing exposure to hostile takeovers), thereby reducing the range of choices available for separation of ownership and control. On the other hand, regulation may just fail to define the right boundaries of bargaining in the takeover game, thereby frustrating either the insurgent's incentives to initiate a takeover, the incumbent's incentives to part with control, or both. The typical reason of this failure is inefficient legal protection of the third category of players – outside shareholders. Contrary to conventional wisdom, *excessive* shareholder protection is most often the cause of distortion, although a similar problem may arise when protection is insufficient.

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to fewer firms going public, but clearly reduces the role of entrepreneurship in the governance of listed firms. Separation of ownership and control would be then 'excessive' in that businesses with highly uncertain prospects are denied access to the stock market. Given the initial conditions, the problem of excessive separation may get even worse over time if taking a public company private is made too difficult by takeover regulation. When the latter makes corporate acquisitions more expensive or otherwise constraints the incumbent managers' ability to cash in their control rents, inefficient consumption of distortionary PBC will obtain in overly dispersed ownership structures. As it turns out, this appears to be the outcome of corporate law's distortions in the UK.

15 See *supra*, Chapter Six, section 6.2.3.

16 See *supra*, Chapter Six, section 6.3.2.

17 See *supra*, Chapter Six, section 6.7.3.

The crucial point is that shareholder protection in takeovers is important, indeed; but it must be put in the right perspective.

This Chapter will attempt to identify the right perspective for a functional Law and Economics analysis of takeover regulation. Unfortunately, as it will be shown in the next Chapter, the solutions adopted in the majority of the jurisdictions in our sample are not based on the same perspective. Efficiency of the European markets for corporate control may just be undermined for this reason.

10.1.2. The Novelty of the Analysis

The economics of takeovers is a heavily debated topic in Corporate Law and Economics.[18] However, both the theory and its regulatory implications are extremely controversial – probably the most controversial issue in the analysis of corporate governance. The problem of distribution of takeover gains and the need for some regulatory intervention are both generally acknowledged.[19] Little emphasis, however, has been put so far on the divergence between *ex ante* and *ex post* efficiency. This is mostly the result of neglecting the problem of entrepreneur's incentives to go public and its implications on the takeover mechanism.[20] By considering the controller's idiosyncratic PBC, I am going to present a different approach to the problems analyzed in both the economic and the legal literature. Intuitively, the conclusions will differ from the mainstream. However, the approach I am advocating is consistent with the empirical evidence on both the structure of corporate governance and the takeover process.

As far as the first point is concerned (governance structure), the scenario which is going to be analyzed is that of friendly takeovers. While this rules out any 'disciplinary' function attributed to takeover threat by the agency theory,[21] the empirical evidence questions, in this respect, the very essence of the agency approach to cor-

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18 See, for a comprehensive survey of the state of the art, Burkart, M. and Panunzi, F. [2006b], *Takeovers*, ECGI Finance Working Paper No. 118/2006, available at www.ssrn.com and www.ecgi.org (hereinafter Burkart, M. and Panunzi, F. [2006b], *Takeovers*).

19 Kraakman, R.H., Davies, P., Hansmann, H., Hertig, G., Hopt, K.J., Kanda, H. and Rock, E.B. [2004], THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH, Oxford University Press (hereinafter Kraakman *et al.* [2004], *The Anatomy*), 162-163.

20 Coates, J.C. IV [2003], *Ownership, Takeovers and EU Law: How Contestable Should EU Corporations Be?*, ECGI Law Working Paper No. 11/2003, available at www.ssrn.com and www.ecgi.org, as published in E. Wymeersch and G. Ferrarini (eds.) [2004], COMPANY AND TAKEOVER LAW IN EUROPE, Oxford University Press.

21 Jensen, M.C. [1986], *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, in AMERICAN ECONOMIC REVIEW, vol. 76, 323-329.

porate governance. Changes in control only exceptionally can and do take place through hostile takeovers;[22] and little discipline, if any at all, is involved by their threat even when they are abstractly possible.[23] As regards the second point (takeover process), the ability of corporate controllers to block a takeover and the significant wealth effects of successful takeovers on shareholders – both testified by the empirical evidence[24] – suggest that takeovers are best analyzed as the outcome of a Coasian bargain for the division of transaction surplus. However, the involvement of a third party (the acquirer) and the presence of high transaction costs (due to both uncertainty and asymmetric information) make the outcome of private contracting on the division of transaction surplus unreliable in terms of allocative efficiency. Legal entitlements should therefore be allocated between the parties involved in such a way as to guarantee that control transactions take place if and only if they are efficient.[25]

While nobody would question that this should be the ultimate goal of takeover regulation, the legal and economic research in this field has apparently reached the conclusion that the above result is not attainable if not at the cost (or the risk) of making outside shareholders worse off.[26] That is to say, there is a tradeoff between an efficient market for corporate control and shareholder protection. By approach-

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[22] Becht, M., Bolton, P. and Röell, A. [2002], *Corporate Governance and Control*, ECGI Finance Working Paper No. 02/2002, available at www.ssrn.com and www.ecgi.org, as published in G. Constantinides, M. Harris, and R. Stulz (eds.) [2003], HANDBOOK OF ECONOMICS AND FINANCE, North-Holland, 68-78; Schwert, G.W. [2000], *Hostility in Takeovers: In the Eyes of the Beholder?*, in JOURNAL OF FINANCE, vol. 55, 2599-2640; Weir, C. and Laing, D. [2003], *Ownership Structure, Board Composition and the Market for Corporate Control in the UK: An Empirical Analysis*, in APPLIED ECONOMICS, vol. 35, 1747-1759.

[23] Comment, R. and Schwert, G.W. [1995], *Poison or Placebo? Evidence on the Deterrence and Wealth Effects of Modern Antitakeover Measures*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 39, 3-43; Franks, J., Mayer, C. and Renneboog, L. [2001], *Who Disciplines Management in Poorly Performing Companies?*, in JOURNAL OF FINANCIAL INTERMEDIATION, vol. 10, 209-245.

[24] See Burkart, M. and Panunzi, F. [2006b], *op. cit.,* for a comprehensive review of the empirical evidence about wealth effects of takeovers.

[25] This is one of the normative implications of the Coase Theorem in the presence of transaction costs. The reader should be aware that it differs from the standard version of the normative Coase Theorem, which would just imply removing obstacles to private agreements. Sometimes, "lubricating private exchange" may be not sufficient to achieve allocative efficiency, and a specific allocation of entitlements may be called for. Authoritative commentators have characterized this approach to legal intervention as "Hobbes Theorem." See Cooter, R.D. and Ulen, T.S. [2004], LAW AND ECONOMICS, 4th edn., Addison-Wesley, 96-99.

[26] Burkart, M. and Panunzi, F. [2003], *Mandatory Bids, Squeeze-out, Sell-out and the Dynamics of the Tender Offer Process*, ECGI Law Working Paper No. 10/2003, available at www.ssrn.com and www.ecgi.org, as published in G. Ferrarini, K.J. Hopt, J. Winter, and E. Wymeersch (eds.) [2004], REFORMING COMPANY AND TAKEOVER LAW IN EUROPE, Oxford University Press (hereinafter Burkart, M. and Panunzi, F. [2003], *Mandatory Bids*).

ing the matter in terms of Coasian bargain, I claim that the tradeoff is different and it depends on the necessity to allow a control premium to reward the incumbent controller's investments *ex ante* (idiosyncratic PBC).[27] Given that part of the takeover gains is allocated to that purpose, the remainder should just serve the function of allowing efficient changes in control. As a result, the two goals of promoting an active takeover market and protecting investors can be pursued independently by corporate law. On the one hand, takeover decreasing shareholder value should be disallowed. On the other hand, the acquirer should be entitled to reap all the gains necessary to allow for value-increasing takeovers.

As I am going to show, when changes in control are correctly bargained for, there is no need to sacrifice the acquirer's gains to shareholder protection. Although this is nowadays the prevailing position among European policy-makers, it is misguided, as many commentators also argue, at least from an economic standpoint.[28] What mainstream economic theory concedes to this position is that reducing the likelihood of efficient takeovers is the price to pay for protecting shareholders from inefficient control transactions. I will show that this claim is also unwarranted, at least to the extent that diversionary PBC are efficiently policed by corporate law and complementary institutions. The latter claim is based on confusion between different categories of PBC. According to the framework presented here, they have different nature, and therefore deserve different treatment. Before revisiting the economic theory of takeovers in this perspective, a brief introduction to the players' incentives in bargaining for a change in control is in order.

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27 See *supra*, Chapter Six, section 6.4.3.

28 For an economic analysis of the proposed EC Takeover Directive see, in the context of the European market for corporate control, McCahery, J.A., Renneboog, L. (with P. Ritter and S. Haller) [2003], *The Economics of the Proposed European Takeover Directive*, CEPS Research Report in Finance and Banking No. 32, available at www.ceps.be. For a comparative, functional discussion of the issues dealt with by the Directive, see Kraakman *et al.* [2004], *The Anatomy*, cit., 157-191. For a critical analysis of the Takeover Directive, as finally adopted (Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids), see *infra* Chapter Eleven, section 11.4.

10.2. The Basic Structure of the Takeover Game

10.2.1. Sale of Office vs. Sale of Corporate Control

It is customarily believed that corporate controllers do not fancy the idea of being taken over.[29] However, this just depends on their being removed from office without consideration. Corporate controllers have nothing to fear about takeovers when they are tenured. Given the importance of idiosyncratic PBC in corporate governance, we can live with the fact that normally they are. Yet, the empirical evidence does not only show that corporate controllers are effectively tenured, but also that they part with control every now and then. The reason why they do is exactly the opposite of conventional wisdom: under certain conditions, it is in fact in *their own interest* to have the firm they control taken over.[30] For this to hold they just need to be compensated for their controlling position. As I mentioned throughout this work, this compensation takes the form of either a severance payment or a control premium, depending on whether the company is under managerial or shareholder control.[31] Compensation of the incumbent's rents may be regarded as a first application of Coasian bargaining to corporate control transactions.

Whether the Coase Theorem holds with respect to the efficiency of bargaining is another question.[32] The answer depends on what kind of PBC the incumbent's compensation accounts for. Let us maintain that diversionary PBC are ruled out by means of the various legal techniques that have been discussed in the past two Chapters; since we know that efficient regulation of non-pro-rata distributions is unable to achieve this ideal result, this assumption will be removed at a later stage.[33] Idiosyncratic PBC deserve full compensation because of their role of promoting entrepreneurship at the outset. Then we are left with distortionary PBC, which have potentially adverse effects on the efficiency of control transactions, and therefore call for some legal constraints on private contracting.

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[29] This idea has a long-standing tradition among both economic and legal commentators. See, e.g., Shleifer, A. and Vishny, R. [1989a], *Management Entrenchment: The Case of Manager-Specific Investments*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 25, 123–139; Easterbrook, F.H. and Fischel, D.R. [1981], *The Proper Role of a Target's Management in Responding to a Tender Offer*, in HARVARD LAW REVIEW, vol. 94, 1661-1204.

[30] See, e.g., Schnitzer, M. [1995], *'Breach of Trust' in Takeovers and the Optimal Corporate Charter*, in JOURNAL OF INDUSTRIAL ECONOMICS, vol. 43, 229-259.

[31] For illustration, see Coates, J.C. IV [2003], *op. cit.*

[32] See *supra*, Chapter Six, section 6.5.2.

[33] See *infra*, section 10.4.

In Chapter Six, optimality of allocation of residual rights of control to a non-owner entrepreneur has been derived on the basis of efficient rent protection.[34] This has an important drawback. If the corporate controller faced no restriction on the identity of the transferee, he would have all the bargaining power in control transactions. Then, his best strategy would be to put his office up for auction. Control would be allocated to the highest bid for the company management, and not for the company's shares. Whatever the resulting distribution of the transaction surplus (an issue which we are not considering yet), the crucial problem is that this surplus may be extracted at the expenses of powerless shareholders. Indeed, the change in control may be determined not just by prospective increases in the firm value, but also by the insurgent's higher willingness to pay for on-the-job consumption of managerial perquisites (distortionary PBC).[35] It is for this reason that 'passing over shareholder's heads' was disallowed by assumption in our previous discussion of the optimal allocation of residual rights of control.[36] The corporate controller is free to decide whether and in what terms to part with control, but he can only transfer the latter to a shareholder. This assumption is reflected in the paramount prohibition of sale of manager's office in virtually any corporate jurisdiction; and in the fact that control cannot but be transferred with a block of shares in the presence of a controlling shareholder. Control can only change hand by means of a transfer of corporate ownership; and that above is the economic rationale.[37]

Having this fundamental principle functionally upheld by corporate law determines two important consequences: on the one hand, it brings non-controlling shareholders back into the play; on the other hand, it provides the basis for having inefficient takeovers ruled out.

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[34] See *supra*, Chapter Six, section 6.1.3.

[35] Easterbrook, F.H. and Fischel, D.R. [1991], THE ECONOMIC STRUCTURE OF CORPORATE LAW, Harvard University Press, (hereinafter Easterbrook, F.H. and Fischel, D.R. [1991], *Economic Structure*), 133

[36] See *supra*, Chapter Six, section 6.1.2. Notice that, differently from Easterbrook, F.H. and Fischel, D.R. [1991], *Economic Structure*, cit., 171-174, also "Going over Manager's Heads" is disallowed in this framework.

[37] Easterbrook, F.H. and Fischel, D.R. [1991], *Economic Structure*, cit., 132-134. But see, for a critical view, Zingales, L. [2006], *The Costs and Benefits of Financial Market Regulation*, ECGI Law Working Paper No. 21/2004, available at www.ssrn.com and www.ecgi.org (paralleling Hart's contention that, if votes can be completely unbounded from shares, the security-voting structure is irrelevant – Hart, O. [1995], *op. cit.*, 205-205).

10.2.2. Value-Increasing Takeovers and Free Riding by Shareholders

Takeovers are a terrific source of empowerment for shareholders.[38] Once it is established that takeovers must be implemented through stock acquisition, shareholders stand to gain either directly (because they have to sell the stock) or indirectly (because –diversionary PBC being ruled out – they will benefit pro-rata from the increased market value of the controlling block). This result is far from intuitive, but it is strongly supported by the empirical evidence: the wealth effect of takeovers is unambiguously and substantially positive for non-controlling shareholders of both free-standing firms and companies with a controlling shareholder.[39] Therefore, to illustrate how this outcome can occur, we proceed as follows. First, let us assume for the moment that takeovers can only increase firm value; how value-decreasing takeovers are effectively ruled out will be explained shortly. This allows us to focus just on the problem of distribution of a positive transaction surplus. Secondly, the problem of surplus distribution is handled differently under managerial and shareholder control, so we describe the two scenarios separately. Non-controlling shareholders stand to gain in both cases, and the following discussion will show how this may be due to the same reason: free riding on the acquirer's skill and effort.

Under managerial control, both the incumbent management and shareholders have veto power on the acquisition; the first because he is tenured, the second because they have to tender a sufficient number of shares to the acquirer for the takeover to succeed.[40] In a completely dispersed ownership structure, a tender offer is the cheapest way to purchase a controlling stake. However, let us postpone the discussion of the economics of tender offers to the next pages. What is important to highlight here is how this situation allows bargaining power to be transferred from the management to non-controlling shareholders. Ultimately, this may lead to takeover gains being not appropriable by the prospective acquirer, who will in turn refrain from initiating a takeover in the first place. This outcome, which is in the interest of neither of the parties involved, is determined by high transaction costs faced by dispersed shareholders. The following discussion will show that the Coase Theorem does not hold for this reason, and that efficient bargaining for corporate control just requires further legal intervention.

38 Easterbrook, F.H. and Fischel, D.R. [1991], *Economic Structure*, cit., 162-163.
39 Burkart, M. and Panunzi, F. [2006b], *Takeovers*, cit., 5-9.
40 Kraakman *et al.* [2004], *The Anatomy*, cit., 164.

Managers are just committed to be tough negotiators up to the point in which their control rents are rewarded.[41] Skilled managers will indeed go for renegotiation of their golden parachutes, provided that this leaves the acquirer with sufficient gains to have the takeover initiated in the first place; they know that they will simply get nothing otherwise.[42] The agreement between the incumbent and the insurgent on how to split the surplus is potentially endangered by the need to involve outside shareholders, which places them in the position to claim a premium for tendering their shares.[43] However, this would be not much of a problem if there was just one single non-controlling shareholder: he would simply tender his shares for any price above his outside option – the current market value. This means that, in equilibrium, our hypothetical shareholder makes (almost) no profit and all efficient takeovers succeed provided that their gains are sufficient to compensate the incumbent's rents and the insurgent's costs of engineering the acquisition: the players will let the latter appropriate the residual surplus, for they would get nothing otherwise.

Such a shareholder cannot exist in a publicly held company. In the face of a takeover bid, a myriad of dispersed shareholders is confronted with two strategies. The first is tendering at any bid price above market value. The second is holding on their shares. What makes the latter strategy attractive is that non-controlling shareholders who do not tender will free ride on the higher firm value brought about by the insurgent management, provided that the takeover succeeds – i.e., that other shareholders will tender.[44] The source of shareholders' bargaining power is therefore not their veto power, but their ability to free ride. Notice that free riding may obtain in *every* situation in which there is more than one non-controlling shareholder. However, for this to result in bargaining power, a further condition is required: shareholders must be committed to stand firm for a share of the transaction surplus – that is, they must be in the position to holdout.

Hold-out and free riding are often confused in the literature, but indeed the two situations stand in a cause-effect relationship.[45] A free rider's strategy is just to sit and wait that others do the job. A free rider will only turn into a holdout when this strategy makes the production of transaction surplus impossible or unprofitable: then the producer – in our case, the insurgent controller – will have to buy him out. This is exactly what happens in the acquisition of a free-standing firm. A sufficient

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41 This holds in every situation in which management is entrenched. See, e.g., Schnitzer, M. [1995], *op. cit.*; Almazan, A. and Suarez, J. [2003], *Entrenchment and Severance Pay in Optimal Governance Structures,* in JOURNAL OF FINANCE, vol. 58, n. 2, 519-47.

42 See *supra*, Chapter Six, section 6.3.3.

43 Easterbrook, F.H. and Fischel, D.R. [1991], *Economic Structure*, cit., 110-126.

44 Burkart, M. and Panunzi, F. [2006b], *Takeovers*, cit., 12-14.

45 Cohen, L. [1998], *Holdouts*, in P. Newman (ed.), THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW, vol. 2, Macmillan, 236-240.

number of shares must be tendered for the takeover to succeed and its gains to be generated. However, any shareholder would like to holdout, hoping that others will tender and let them free ride on these gains. When there are many, atomistic shareholders, they will all think the same, so that none of them will tender for less than the entire bargaining surplus. As a result, the only takeover bids that can succeed in theory are those depriving the acquirer of all gains in favor of target shareholders.[46] While this outcome is consistent with the empirical evidence on wealth effects of actual takeovers, it still cannot explain why would-be acquirers initiate takeovers in the first place. There must be some mechanism for preserving the acquirer's gains in spite of shareholder holdout. The problem will be addressed in the discussion of economics of tender offers.

The source of shareholders' commitment to holdout is their inability to coordinate due to transaction costs.[47] If they managed to coordinate in a hypothetical bargaining table with the acquirer, they would settle for some split of the takeover gains. A similar result obtains in the presence of moderately large shareholders, to the extent that they are, and perceive themselves as being, pivotal for the success of the acquisition. Shareholders' holdout potential is instead eliminated in the presence of a controlling shareholder. The reason is twofold. On the one hand, since control is transferred between controlling shareholders without necessity of a tender offer, control transactions need not involve minority shareholders – unless takeover regulation gives them a special entitlement to participate.[48] On the other hand, the controlling shareholder is not committed to holdout, so long as his control rents are compensated: he will accept any division of the residual surplus that makes the takeover viable.[49]

What is often overlooked by the literature is that, when control transactions are concluded between controlling shareholders, minority shareholders will still free ride on the acquirer's gains.[50] This is of course much less of a problem compared to the acquisition of a free-standing firm, since the acquirer will still be able to make

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[46] Grossman, S.J. and Hart, O. [1980b], *Takeover Bids, the Free Rider Problem, and the Theory of the Corporation*, in BELL JOURNAL OF ECONOMICS, vol. 11, 42–69 (hereinafter Grossman, S.J. and Hart, O. [1980b], *Free Rider*). This result may be not as famous as other fundamental paradoxes in economic analysis (like the Coase Theorem and the Modigliani and Miller Theorem). Nevertheless, it is the starting point of every discussion of takeover bids in an economic perspective.

[47] See Burkart, M. and Panunzi, F. [2003], *Mandatory Bids*, cit.

[48] Kraakman *et al.* [2004], *The Anatomy*, cit., 184-187.

[49] Bebchuk, L.A. [1994], *Efficient and Inefficient Sales of Corporate Control*, in QUARTERLY JOURNAL OF ECONOMICS, vol. 109, 957-993 (hereinafter Bebchuk, L.A. [1994], *Sales of Control*).

[50] "Neither of these problems [the free rider and the pressure to tender problems] impairs the (in)efficiency of a control transfer involving firms with controlling shareholders." Burkart, M. and Panunzi, F. [2003], *Mandatory Bids*, cit., 22. On pressure to tender (the reverse problem of free riding) see *infra*, section 10.3.1.

profits on the control block.[51] Yet, free riding by minority shareholders (which explains how they do gain also in this scenario) is certainly unpleasant for the acquirer. The latter would indeed wish to buy out minority shareholders after gaining firm control, but a tender offer is not an option for it would place shareholder again in a holdout position.[52] One may think that, compared to the previous scenario, this is just a problem of distribution with no efficiency consequence – after all, changes in control take place independently of minority shareholders. However, if we reason by backwards induction, the free riding problem may lead to a situation in which takeover gains would be sufficient to compensate the incumbent, but the acquirer's share of them would not; such transactions will not be entered into in the first place, in spite of their efficiency.[53]

In conclusion, the problem of the acquirer's gains differs in degree, not in kind, between managerial and shareholder control structures. In both situations, non-controlling shareholders can free ride on value-increasing takeovers. Therefore, the problem must be addressed also in the analysis of control transactions that apparently only involve controlling shareholders. Once again, the Coase Theorem does not hold because of transaction costs faced by outside shareholders: while it would be efficient to split takeover gains with the acquirer, minority shareholders are unable to coordinate and are just committed to rule out a number of value-increasing takeovers by their free riding.

10.2.3. A Narrow Set of Conditions for Value-Decreasing Takeovers

Takeovers need not be value-increasing.[54] Indeed, control could be transferred to a less diligent and skillful manager or, even worse, to a looter. This would be

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51 Bebchuk, L.A. [1994], *Sales of Control*, cit., 958-959, puts it in the right way: "In such transactions, the *seller's decision* about whether to sell does not involve the free rider or pressure-to-tender problems that characterize the tender decision of dispersed shareholders. [H]owever, the lack of [these problems] on the seller side does not imply that there are no efficiency problems with sale-of-control transactions." (Emphasis added).

52 Id., at 966-967.

53 For a broader set of arguments, see Easterbrook, F.H. and Fischel, D.R. [1982a], *Corporate Control Transactions*, in YALE LAW JOURNAL, vol. 91, 708-711.

54 Here I am not considering the issue of whether stakeholders should also enter the definition of efficiency. I have already discussed this problem in Chapter Three, section 3.5, where I concluded that stakeholder protection should not interfere with the normative goals of CG. Mainstream Law and Economic literature mostly analyzes takeovers from the perspective of shareholder value. See, e.g., Kraakman *et al.* [2004], *The Anatomy*, cit., 157-191; Easterbrook, F.H. and Fischel, D.R. [1991], *Economic Structure*, cit., 109-144 and 162-211. For an overview of the problems of stakeholder protection in takeovers, see Becht, M., Bolton, P. and Röell, A. [2002], *op. cit.*, 48-57.

clearly inefficient.[55] It might seem somewhat counterintuitive, but this is more of a problem in hostile takeovers than in friendly ones. As I showed in Chapter Six, the character of takeovers bears no consequence on the risk of looting. I shall then keep on assuming, for the moment, that diversionary PBC are ruled out. The friendly character of the takeover process, which is being analyzed here, provides instead an important advantage as far as distortionary PBC are concerned. This is due to the circumstance that execution of a friendly takeover requires the incumbent's idiosyncratic rents to be compensated and a significant ownership stake to be acquired.

The first source of restriction on inefficient sales of corporate control is the principle that takeovers require acquisition of an ownership stake sufficient to grant control. The significance of corporate ownership acquired to this purpose makes changes in control unlikely to be motivated just by increase in distortionary PBC. The reason is that, no matter of how much these PBC are worth to the corporate controller, they have by definition a larger opportunity cost in terms of shareholder value. Let us consider managerial control first. The insurgent will have to acquire a controlling stake in a company where there is none. As a result, he will bear the opportunity costs of distorted managerial choices to a much greater extent than the incumbent. The amenity of managerial perquisites to the insurgent should be very large for further extraction of distortionary PBC to be worthwhile. It is therefore fair to assume that distortionary PBC will hardly increase in this scenario, and that they are more probably bound to decrease. The situation is different when control is transferred between controlling shareholders. On the one hand, the problem of distortionary PBC is less severe in such ownership structures.[56] On the other hand, the insurgent needs to acquire no larger ownership stake than the incumbent. Distortionary PBC can therefore increase if they are worth more to the former than to the latter. In both kinds of takeover, the acquisition of a significant ownership stake limits the scope for increase in distortionary PBC, but provides no definitive guarantee against inefficient changes of control.

An additional restriction on takeover bargaining provides this guarantee: the need to negotiate changes in control with the incumbent. The reason is that takeovers do not only require the acquisition of a controlling stake, but also that the current value of corporate control (idiosyncratic PBC) be paid upfront. The last circumstance narrows the scope of the acquirer's gains further. In order for him to gain by increasing consumption of distortionary PBC, both the opportunity costs

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55 Easterbrook, F.H. and Fischel, D.R. [1991], *Economic Structure*, cit., 129-131.

56 Roe, M.J. [2004b], *The Institutions of Corporate Governance*, Working Paper No. 488, Harvard Law School (Faculty Series), available at www.ssrn.com, as published in C. Menard and M.M. Shirley (eds.) [2005], HANDBOOK OF NEW INSTITUTIONAL ECONOMICS, Springer, 371-399.

on the controlling stake and the price paid for the incumbent's idiosyncratic PBC must be offset. If one recalls that distortionary and idiosyncratic PBC are equal in the sale of non-controlling stock equilibrium,[57] and that idiosyncratic PBC are assumed to decrease in every change in control,[58] the above condition never holds. It will be always more profitable for the acquirer to go for increase in the value of corporate stock after completion of a takeover, rather than for increase in consumption of managerial perquisites.[59] This is straightforward when control of a free-standing firm is acquired: little compensation of the incumbent's control rents will be sufficient to induce the emerging controlling shareholder to sell back to the market his ownership stake, at a premium – which can only be possible to the extent that distortionary PBC are not expected to increase. A similar outcome can be expected under shareholder control. Here the rent compensation will be much higher (the size of control premia is incomparable to the otherwise substantial severance payments that managers receive when they leave), and therefore dilution of the controlling stake is not a necessary condition to rule out increase in distortionary PBC. However, further separation of ownership and control will still dominate the strategy of expanding consumption of distortionary PBC so long as – as I assume – idiosyncratic PBC are decreasing.

The above conclusion requires a number of qualifications. The first is about takeover practice.[60] The acquisition of a controlling stake is normally just an intermediate step, whereas: i) the funds for financing the takeover are raised *before* the acquisition; ii) the ultimate changes in the ownership structure are implemented through mergers, stock issue or repurchase, and other securities transactions *after* the acquisition. Although the sequence of events may vary depending on the transaction (and the ownership) structure, the above scheme of concentration/deconcentration of ownership is an intrinsic feature of the takeover process, which affects the underlying incentives regardless of the technicalities of control transactions.

The second qualification is the objection that 'the acquirer' is normally not a (natural) person, but another listed company. Therefore, takeovers may not harm shareholders of the target firm, but still be against the interest of the acquirer's minority shareholder – for instance, because of empire building by the acquirer's controller.[61] This is essentially correct, but given the limited scope of this inquiry, we

[57] See *supra*, Chapter Six, section 6.4.2.
[58] See *supra*, Chapter Six, section 6.4.3.
[59] See *supra*, Chapter Six, section 6.3.2.
[60] For a comprehensive illustration of the transactional techniques, see Black, B.S. and Gilson, R.J. [1995], THE LAW AND FINANCE OF CORPORATE ACQUISITIONS, 2nd edn., Foundation Press.
[61] Jensen, M.C. [1986], *op. cit.*

just consider the governance of one company at once. I am then going to keep the assumption that the acquirer is either a person or, even if it is a company, its entering a takeover is not tainted by the problem of distortionary PBC; after all, an acquiring company misusing its free cash flow will eventually be acquired in its turn.[62]

The third qualification is that I am implicitly assuming that the acquirer makes some profit from taking over, so that reaping these gains in the form of increased shareholder value (either of the control block or of a stock sale on the market) is always preferable than extracting them in the form of distortionary PBC. Given the problem of free riding by shareholders, this cannot be taken for granted, and the acquirer's reward is actually the fundamental problem of takeovers that we are going to discuss in the following pages.[63] However, it is worth noting that inability to reap this kind of gains do not affect the probability of inefficient transactions, but only lowers (and possibly brings to zero) the probability of efficient ones.[64] When value-increasing takeovers are not an option for this reason, distortionary PBC will increase not because the firm is acquired, but just because it cannot – and the incumbent has no alternative to enjoying private benefits at the non-controlling shareholder's expenses.

The fourth qualification is the fundamental assumption of the entire reasoning: the absence of shareholder value diversion of any kind. In the presence of diversionary PBC, there is no guarantee that control transactions are efficient.[65] On the one hand, they may be simply motivated by the insurgent's higher ability to implement non-pro-rata distributions than the incumbent's.[66] On the other hand, the incentive-compatibility constraint on extraction of distortionary PBC does not hold any longer: their opportunity cost to the new controller could be just compensated by increased diversion. As two commentators have recently pointed out, "there is a

62 Hellwig, M. [2000], *On the Economics and Politics of Corporate Finance and Corporate Control*, in X. Vives (ed.), CORPORATE GOVERNANCE: THEORETICAL AND EMPIRICAL PERSPECTIVES, Cambridge University Press, 118-121.

63 This is a central issue in both theoretical and legal analyses. See Burkart, M. and Panunzi, F. [2006b], *Takeovers*, cit., 14-17; and Kraakman *et al.* [2004], *The Anatomy*, cit., 173-183.

64 Burkart, M. and Panunzi, F. [2003], *Mandatory Bids*, cit., 12-17.

65 See, e.g., Bebchuk, L.A. [1999], *A Rent-Protection Theory of Corporate Ownership and Control*, NBER Working Paper No. 7203; Bebchuk, L.A., Kraakman, R.H. and Triantis, G. [2000], *Stock Pyramids, Cross-Ownership, and Dual Class Equity: the Mechanisms and Agency Costs of Separating Control from Cash-flow Rights*, in R. Morck (ed.), CONCENTRATED CORPORATE OWNERSHIP, NBER Conference Volume, University of Chicago Press, 295-315; Burkart, M, Gromb, D. and Panunzi, F. [2000], *Agency Conflicts in Public and Negotiated Transfers of Corporate Control*, in JOURNAL OF FINANCE, vol. 55, 647-677.

66 Bebchuk, L.A. [1987], *The Pressure to Tender: An Analysis and a Proposed Remedy*, in DELAWARE JOURNAL OF CORPORATE LAW, vol. 12, 911-949 (hereinafter Bebchuk, L.A. [1987], *Pressure to Tender*).

potential interaction between the failure to make pro-rata distributions and the failure to maximize residuals."[67] This is just one of them.

The flip side of the coin is that the presence of diversionary PBC may also ease the occurrence of efficient changes in control. When diversion is allowed, it is no longer necessary to assume that the acquirer makes profits through the acquisition (and the potential resale) of the company's stock for efficient takeovers to be viable. Actually, when the prospective increase in the firm value cannot be appropriated through capital gains in stock trading, an appropriate increase in the level of diversion would still provide the acquirer with sufficient incentives to perform the acquisition. This may provide a solution to the free riding problem.[68]

The next question is, then: is shareholder value diversion that bad, after all? From an *ex post* perspective, diversion is just a matter of redistribution, which, however, provides the advantage of easing the achievement of allocative efficiency. This may legitimate the view that diversionary PBC are a good way to promote an active market for corporate control. Hence the tradeoff with shareholder protection obtains, perhaps in the most extreme – but, as we are about to see, also in the most famous – formulation.[69] Unbounded diversion from minority shareholders is efficient only on the condition that overall value-decreasing takeovers are disallowed. A milder version of this statement is that – provided that value-decreasing takeovers may be not disallowed – some 'optimal' amount of diversion maximizes the probability of efficient takeovers while minimizing the probability of inefficient ones.[70]

Neither statement is correct. To start with, diversion – or, more precisely, allowing diversion to increase in takeovers – is not necessary for promoting an active market for corporate control. There are in fact other ways to cope with the problem of the acquirer's gains (shareholders' free riding) when diversionary PBC are ruled out.[71] More importantly, unconstrained extraction of diversionary PBC is disruptive *ex ante*. Being unable to distinguish thieves and looters from honest actual or would-be controllers, investor will regard both the stock market (where ownership is supposed to be first separated from control) and the market for corporate

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[67] Fox, M.B. and Heller, M.A. [2006], *What Is Good Corporate Governance?*, in M.B. Fox and M.A. Heller (eds.), CORPORATE GOVERNANCE LESSONS FROM TRANSITION ECONOMY REFORMS, Princeton University Press, 19.

[68] This is undoubtedly the best known solution to the free rider problem in the economic analysis of takeovers, although it is clearly unacceptable as such by legal commentators. See Grossman, S.J. and Hart, O. [1980b], *Free Rider*, cit.

[69] Burkart, M. and Panunzi, F. [2006b], *Takeovers*, cit., 14.

[70] Burkart, M. and Panunzi, F. [2003], *Mandatory Bids*, cit., 10.

[71] See Burkart, M. and Panunzi, F. [2006b], *Takeovers*, cit., 15-16. However, they can only partly solve the problem. See Burkart, M. and Panunzi, F. [2003], *Mandatory Bids*, cit., 11-12. See *infra*, section 10.3.1.

control (where incoming inefficiencies should be corrected for) as 'markets for lemons,' which the best controllers will either exit or refrain from entering in the first place.[72] Therefore, an upper bound on the extraction of diversionary PBC must be set in any case. If incremental diversion is necessary for takeovers to succeed, this implies that eventually there will be none. From the perspective of overall efficiency of corporate governance, such a solution is thus unnecessary, undesirable, and ultimately ineffective.

The above result obtains because two different problems are inappropriately bundled together: one is shareholder protection from expropriation, and its intrinsic limitations; the other is shareholder's free riding on takeover gains. As we are going to see, the two problems should be treated separately. One would actually wish that diversionary PBC could be brought to zero in corporate governance. The reason why this is in fact not an option has nothing to do with the efficiency of takeovers, but rather depends on the problem of Type I/Type II errors in policing non-pro-rata distributions.[73] This, and nothing else, is what forces us to live with just an upper bound on value diversion. However, this should be low enough to exclude any possible increase in diversion following a takeover.[74] When this condition holds, the basic mechanism of friendly takeover that I have just described cannot result in inefficient changes in control due to increase in either diversionary or distortionary PBC. Intuitively, law plays a crucial role in this respect, on the basis of mechanisms similar to those reviewed in the past two Chapters. But law plays an even more important role in allowing efficient takeovers to succeed.

10.3. Law and Economics of (Friendly) Takeovers

The economic theory of takeovers is one of the most fascinating parts of modern microeconomics, and it would be nice to review it comprehensively. This would take us away from the focus of the present inquiry. Rather, what I am going to do is taking stock of most important insights of this theory for delivering a paradigm of legal analysis consistent with the framework developed so far. This implies, first, that efficiency of corporate controller's resistance to hostile takeovers will be never put in question;[75] nor would be his ability to implement such a resistance via the

[72] See *supra*, Chapter Six, section 6.4.4.
[73] See *supra*, Chapter Eight, section 8.2.
[74] See *supra*, Chapter Six, section 6.7.3.
[75] See *supra*, Chapter Six, sections 6.2-6.4.

legal tools available in the pertinent jurisdiction.[76] Secondly, I will not discuss any further shareholder protection from *ongoing* expropriation by the corporate controller. The rationale and conditions under which such protection is efficient have been already illustrated, and so have the legal instruments for its implementation.[77]

Since this necessarily leaves some scope for shareholder expropriation, I shall discuss at the very end of this Chapter how legal constraints should prevent takeovers from allowing *further* non-pro-rata distributions.[78] In the meantime, I am going to assume that an upper bound is set by the legal system on the ongoing extraction of diversionary PBC so as to make it invariant with the controller's identity. This involves that takeovers can only be value-increasing under a relatively small set of conditions, and that diversionary PBC do not affect their probability but only the degree of separation of ownership and control that is allowed in corporate governance.[79] To our purposes, this is equivalent to maintaining the assumption that diversionary PBC are ruled out.

10.3.1. Changes in Control in Dispersed Ownership Structures

The vast majority of the literature on takeovers analyzes the case of listed companies where no controlling shareholder exists.[80] While this analysis is applicable to just a minority of real-world situations, it captures nonetheless the most important problems underlying the takeover process. I am now going to illustrate how the assumptions of efficient entrenchment by the corporate controller and of absence of diversion of shareholder value changes the predictions of this analysis and delivers somewhat different normative implications as to takeover regulation.

a) Two Dramatic Scenarios: Free Riding and Pressure to Tender

At first glance, the theory of takeovers seems unable but to deliver two opposite, and equally dramatic, scenarios. The first is based on the free riding problem. Sanford Grossman and Oliver Hart have famously demonstrated that, when there are an infinite number of dispersed shareholders, no takeover bid can succeed for less than the post-acquisition stock price.[81] Since in this situation no prospective ac-

76 See *supra*, Chapter Seven.
77 See *supra*, Chapter Eight and Nine.
78 See *infra*, section 10.4.5.
79 This depends on how low the upper bound on shareholder protection is set by legal and non-legal institutions. See *supra*, Chapter Six, section 6.4.4.
80 Burkart, M. and Panunzi, F. [2003], *Mandatory Bids*, cit., 4.
81 Grossman, S.J. and Hart, O. [1980b], *Free Rider*, cit.

quirer can make any profit, or even recover the costs of engineering a takeover, there is no reason why takeover bids should be made in the first place. All the economic theory of takeover starts from this paradox, and studies the ways to get around it.

For a Law and Economics student, it is most tempting to approach the matter like in the paradigmatic case of holdout: that is, what lawyers usually refer to as 'eminent domain', 'compulsory purchase,' or simply 'expropriation.'[82] This is basically what the state does when the presence of several potential holdouts may undermine the conclusion of wealth-increasing transactions: the typical example is the sale of multiple parcels of lands for the construction of a highway – perhaps one of the best illustrations of how the Coase Theorem may fail to hold.[83] The only drawback of the compulsory acquisition approach is that, compared to voluntary exchange, overreaching property rights provides no guarantee of efficiency. This may be even more dangerous in the context of private contracting. If we apply this approach to takeovers, the free riding paradox is easily turned on its head. In order to avoid holdout, shareholders may be simply compelled to sell. However, this may lead to a situation in which they sell at any price. Intuitively, this situation would remove any constraint about the takeover's efficiency – which, in our previous discussion, depended on the insurgent's inability to acquire the firm below its current value. The reason why this second, and no less dramatic, result may occur is the so-called "pressure to tender."[84]

I have assumed so far that acquisition of corporate control when there is no controlling shareholder requires that a tender offer be made to outside shareholders.[85] This is just because, under the standard assumption of atomistic shareholders, transaction costs of the acquisition would be infinite otherwise (and they would be anyway much higher when shareholders are in a finite number of a sufficiently large magnitude). But tender offers are not alike, and – once we introduce compulsory acquisition – they may be structured in such a way as to force any shareholder to sell. Specifically, the bidder may just make a take-it-or-leave-it offer for a number of shares sufficient to gain control (say, 50% of the voting shares) and be committed to buy out non-tendering shareholders only at a lower price.[86] Tendering becomes then "individually rational as a hedge against the unfavorable minority position,

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[82] For a similar approach, see Bainbridge, S.M. [2002a], CORPORATION LAW AND ECONOMICS, Foundation Press, 351-354.
[83] Cooter, R.D. and Ulen, T.S. [2004], *op. cit.*, 174-182.
[84] Bebchuk, L.A. [1987], *Pressure to Tender*, cit.
[85] See Cohen, L. [1998b], *Tender Offers*, in P. Newman (ed.), THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW, vol. 3, Macmillan, 580-583.
[86] Kraakman *et al.* [2004], *The Anatomy*, cit., 178-179.

even though each shareholder prefers the bid to fail."[87] Such a bid – known as 'two-tier bid' – is inherently coercive. Competition among bidders may force the bid to be no lower than the market price: a negative takeover premium is ruled out, as a risk-free profit opportunity cannot occur in equilibrium under the 'no arbitrage' condition of market efficiency in weak form.[88] However, an inefficient bidder will still be able to acquire the firm below its value by rationing shareholders who tender and buying out the remainder at a lower price.

Although the example of two-tier bids is not very realistic, for they are ruled out by a number of legal mechanisms that will be reviewed later,[89] this is useful to show how easily the free riding problem can be turned on its head through compulsory acquisition. The reason is always the same: shareholders are unable to coordinate for the common good.[90] Atomistic shareholders know that they are not pivotal for the success of the acquisition, and then they behave opportunistically in any case. When they can free ride, for they stand to gain from the acquisition, they want to be those who *do not tender* despite of takeover's efficiency. When their free riding would be just ironic, for they stand to lose from the acquisition, shareholders want to be those who *do tender* in spite of takeover's inefficiency.

As Lucian Bebchuk has notably illustrated, the problem of pressure to tender is not confined to two-tier bids.[91] The source of pressure to tender is not just the structure of the bid, but more in general the bidder's ability to impose a loss on minority shareholders after he gains control.[92] Even in the previous scenario, it was the right of a successful acquirer to compel shareholders to sell that generated pressure to tender at any higher price. This entitlement is known as 'freeze-out' or 'squeeze-out' right, and its regulation varies very much across jurisdictions.[93] Let us assume, from now on, that this right is triggered by the mere acquisition of control; we will compare this assumption with the actual state of freeze-out regulation at a later stage. Then, pressure to tender may all the same obtain when tender offers are unrestricted. These are the most common takeover bids (so-called 'any-or-all'), where the bidder is committed to purchase – at equal price – all shares tendered, provided that he gets control. Intuitively, all shares will be tendered and purchased

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87 Burkart, M. and Panunzi, F. [2003], *Mandatory Bids*, cit., 14.

88 Id., at 14. For the definitions of stock market efficiency, see Gilson, R.J. and Kraakman, R.H. [1984], *The Mechanisms of Market Efficiency*, in VIRGINIA LAW REVIEW, vol. 70, 549-644.

89 See *infra*, sections 10.4.3 and 10.4.4. See also Chapter Eleven, sections 11.2.1 and 11.4.2.

90 Bebchuk, L.A. and Hart, O. [2001], *Takeover Bids vs. Proxy Fights in Contests for Corporate Control*, NBER Working Paper No. 8633.

91 Bebchuk, L.A. [1987], *Pressure to Tender*, cit., 925-927.

92 For a more detailed discussion, see Bebchuk, L.A. [1985], *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, in HARVARD LAW REVIEW, vol. 98, 1708-1735.

93 Kraakman *et al.* [2004], *The Anatomy*, cit., 141-144.

at the bid price so long as minority shareholders can be squeezed out at a lower price. In equilibrium, none of them actually would, and therefore the unrestricted character of the bid makes it impossible for the acquirer to buy shares below the bid price.[94] If we maintain the condition that takeover premium be non-negative, no acquirer may profit from destroying (verifiable) firm value in spite of the coercive character of the bid so long as shareholder cannot be rationed.

However, coercion still has a potential drawback: it may allow inefficient acquisition of firms whose stock is undervalued.[95] When the stock price underestimates firm value, a bid equal to, or slightly above, the market price may be value-decreasing but nonetheless succeed due to pressure to tender.[96] One solution may be to allow incumbent management to frustrate the bid. Apart from the alleged shortcomings of this solution (which will be dismissed later), the problem is that it may be insufficient since the management and the bidder can collude.[97] Then we need to exclude coercion without placing shareholders back in the position to hold out. In a recent contribution to the takeover literature, a combination of law and finance professors has demonstrated that this is possible. Amihud, Kahan, and Sundaram have shown that when regulation requires that the squeeze-out price be equal to the bid price all value-increasing takeovers occur, since shareholders can no longer free ride.[98] On the other hand, to the extent that *neither* the bid *nor* the freeze-out can take place below the current market price, coercion is disallowed and no value-decreasing takeover can occur. This important result has one only shortcoming: it allows for no positive takeover premium – a circumstance contradicted by the empirical evidence.

b) Is Squeeze-Out the Optimal Exclusionary Mechanism?

I am going to further elaborate on the squeeze-out rule advocated by Amihud and his co-authors in the next subsection, where how to get around its apparent contradictions will be also illustrated. In the meantime, it is worth noting that other strands of literature do not consider squeeze-out at the bid price as either sufficient

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94 Burkart, M. and Panunzi, F. [2003], *Mandatory Bids*, cit., 17-19.

95 The difference between the firm's 'intrinsic' value and stock market capitalization is tricky in Law and Economics. See Easterbrook, F.H. and Fischel, D.R. [1991], *Economic Structure*, cit., 136-137. However, the purchase of undervalued stock is actually an issue in corporate acquisitions. The only problem is that the firm value cannot be ascertained by any third party – like a judge. Whatever 'intrinsic value' means, this value is inherently unverifiable.

96 Bebchuk, L.A. [1989c], *Takeover Bids below the Expected Value of Minority Shares*, in JOURNAL OF FINANCIAL AND QUANTITATIVE ANALYSIS, vol. 24, 171-184.

97 Bebchuk, L.A. [1987], *Pressure to Tender*, 947-948.

98 Amihud, Y., Kahan, M. and Sundaram, R.K. [2004], *The Foundations of Freezeout Laws in Takeovers*, in JOURNAL OF FINANCE, vol. 59, 1325-1344 (hereinafter Amihud *et al.* [2004], *Freezeout*).

to avoid pressure to tender or necessary to overcome the free rider problem. According to Bebchuk, dispersed shareholders are *structurally* under pressure to tender regardless of whether compulsory acquisition of non-tendering shareholders makes the bid coercive or not.[99] The reason is that shareholder will anyway fear that the emerging controlling shareholders may engage in non-pro-rata distributions at a later stage. Therefore, when there is a positive probability that the bidder is a looter, shareholders may be under pressure to tender even when the squeeze out price is set equal to the bid price, or squeeze out is simply not allowed.

Looting is ruled out by our assumption of zero diversionary PBC. But is interesting to notice how compulsory acquisition of minority shareholder is no longer necessary to overcome the free riding problem once diversion of shareholder value is allowed.[100] Diversion is just an alternative way to generate pressure to tender. This is indeed the second paradoxical result of the celebrated model by Grossman and Hart.[101] In order to allow value-increasing takeovers, shareholders should let prospective acquirers dilute their property rights, so that they will no longer be able to free ride on the acquirer's gains. One way to do it is to write in the corporate contract that a successful acquirer may divert the post-takeover value from minority shareholders – i.e., loot the company. Under this condition, shareholders are committed not to free ride and they will always tender their shares. One important constraint for the efficiency of this mechanism is that takeover bids cannot be lower than the *value* of the firm under the current management, and not just than the current market *price*.[102] Since value-decreasing takeovers are ruled out by definition, Grossman and Hart demonstrate that the maximum level of value diversion (theoretically infinite) is optimal. As a result, shareholders anyway tender at a price equal to the current firm value, the acquirer reaps takeover gains entirely, and all efficient changes in control are operated without need to squeeze out minority shareholder at any rate.

There are a number of objections to this solution.[103] To start with, it is unlawful, and we know that this is with good reason. Although actual diversion is unnecessary for takeovers to work in the framework of Grossman and Hart (diversion never occurs in equilibrium), the possibility of diversion generates a severe externality on corporate governance: should efficient takeovers fail to occur for any reason, the incentive-compatibility of separation of ownership and control would be un-

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[99] Bebchuk, L.A. [1987], *Pressure to Tender*, cit. 942-944.
[100] Burkart, M. and Panunzi, F. [2003], *Mandatory Bids*, cit., 12-17.
[101] In the following, I describe informally the main results of Grossman and Hart model of takeovers. For a formal treatment see the original Grossman, S.J. and Hart, O. [1980b], *Free Rider*, cit.
[102] Id., at 47.
[103] See, e.g., Amihud *et al.* [2004], *Freezeout*, 1335-1338.

dermined.[104] Secondly, under the more realistic assumption that diversion may take place to a limited extent due to imperfections of legal rules and their enforcement, both efficient and inefficient takeovers might get out of control. On the one hand, some efficient transactions will be foregone due to residual shareholders' ability to free ride. On the other hand, the straight condition that takeovers cannot be value-decreasing becomes impossible to enforce with certainty.[105] The latter is indeed a general problem with the attempt to regulate pressure to tender at its core,[106] and it depends on both the pre-takeover and post-takeover value of the firm being unverifiable by courts.[107] Thirdly, the model of Grossman and Hart shares the same contradiction of the alternative exclusionary mechanism based on freeze-out of minority shareholders: neither of them allows for a positive takeover premium in equilibrium, whereas the latter is always substantial in the real world.

It seems then that the two fundamental problems of the takeover process place us in a theoretical bind. Free riding may actually explain why shareholders get positive takeover premia by holding out, but this is ultimately irreconcilable with the fact that takeovers are initiated by a third player – the acquirer – who needs to gain something. Turning, by regulation, free riding into pressure to tender may allow the acquirer to reap his gains, but it cannot explain how shareholders manage to get positive takeover premia. The problem with pressure to tender is that it may result in value-decreasing changes in control. However, compared to dilution (diversion) of shareholder value, the squeeze-out mechanism provides the important advantage of being legally feasible and manageable by courts in such a way as to promote efficient takeovers, while avoiding inefficient ones, simply by setting constraints on the combination of verifiable variables: that is, the bid, the squeeze-out, and the market price. In addition, as we are about to see, our framework allows squeeze-out to generate a positive takeover premium in a dynamic setting.

The reader should be alerted that this places the following analysis out of the mainstream approach to takeovers.[108] As I mentioned, the state of the art in the

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[104] See *supra*, Chapter Six, section 6.4.4.

[105] Burkart, M. and Panunzi, F. [2003], *Mandatory Bids*, cit. 13-16.

[106] Bebchuk, L.A. [1987], *Pressure to Tender*, 922-928.

[107] Amihud *et al.* [2004], *Freezeout*, 1337.

[108] There are important exceptions. In their classic, Easterbrook and Fischel also advocated minimal regulation of corporate control transactions. See Easterbrook, F.H. and Fischel, D.R. [1991], *Economic Structure*, cit., 109-144; and Easterbrook, F.H. and Fischel, D.R. [1982a], *op. cit.* Like Easterbrook and Fischel, I contend that corporate law should be mainly concerned with preventing looting, and this goal should be achieved by *ex post* enforcement of fiduciary duties rather than by placing regulatory constraints on the structure and operation of control transactions. However, the economic framework from which this conclusion is derived is more articulated than Easterbrook and Fishel's. As a result, I am arguing in favor of board involvement in negotiations with the bidder, instead of absolute board passivity in the wake of a takeover bid. This comes somewhat closer

legal and economic analysis is that there is a tradeoff between takeover efficiency and shareholder protection.[109] This is solved by different combinations of free riding and pressure to tender in both economic models and regulatory policy.[110] The latter will be addressed after the presentation of a different theoretical approach. As to the former, the most popular modifications of the Grossman-Hart framework are worth mentioning to conclude this selective survey, for they at least partially solve the free riding problem without exclusion or dilution of minority shareholders.

First, free riding is imperfect in the real world, where the number of outside shareholders is large but finite, and this allow for some gains to be captured by the acquirer.[111] Secondly, the acquirer may get around the free rider problem by capturing some gains *before* making a takeover bid. There are several ways to pursue this strategy, and they are all based on asymmetric information – a problem that was not relevant so far, since shareholders can free ride or may be under pressure to tender independently of asymmetric information. One is to finance the takeover with debt backed by the assets of the target firm (so-called 'leveraged buyout'), thereby forcing a discount on the bid price higher than the risk premium paid by the bidder.[112] Another is to acquire secretly a stake (so-called 'toehold') in the target firm before the tender offer, thereby allowing the bidder to profit from the capital gain.[113] However, the extent to which both strategies are feasible is usually constrained by takeover regulation.[114] Without going into detail, this may be justified by further

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to a perhaps less known, but certainly no less authoritative position in Corporate Law and Economics (which supports *both* minority squeeze-out *and* management involvement in takeover bargaining. See Carney, W.J. [1983], *Shareholder Coordination Costs, Shark Repellents, and Takeout Mergers: The Case against Fiduciary Duties*, in AMERICAN BAR FOUNDATION RESEARCH JOURNAL, vol. 1983, 341-392. If anything, Carney's approach is even more liberal than the one which is being advocated here. While he argues – within a more traditional principal-agent framework – that shareholders are perfectly able to protect themselves from opportunistic squeeze-out via the corporate contract, the following analysis will still rely on fiduciary duties as a response to the problem of contractual incompleteness.

109 Kraakman *et al.* [2004], *The Anatomy*, cit., 189-191.

110 Burkart, M. and Panunzi, F. [2003], *Mandatory Bids*, cit.

111 Bagnoli, M. and Lipman, B.L. [1988], *Successful Takeovers without Exclusion*, in REVIEW OF FINANCIAL STUDIES, vol. 1, 89-110; Holmström, B. and Nalebuff, B. [1992], *To the Raider Goes the Surplus? A Reexamination of the Free Rider Problem*, in JOURNAL OF ECONOMICS AND MANAGEMENT STRATEGIES, vol. 1, 37-62.

112 Mueller, H. and Panunzi, F. [2004], *Tender Offers and Leverage*, in QUARTERLY JOURNAL OF ECONOMICS, vol. 119, 1217-1248.

113 Shleifer, A. and Vishny, R. [1986a], *Large Shareholders and Corporate Control*, in JOURNAL OF POLITICAL ECONOMY, vol. 94, 461-488.

114 Burkart, M. and Panunzi, F. [2006b], *Takeovers*, cit., 15-16.

inefficiency in the takeover outcomes brought about by asymmetric information.[115] In any case, none of these mechanisms allows but for a partial solution of the free riding problem and, under certain conditions, they may generate inefficient pressure to tender.[116]

Building on their respective earlier work, Bebchuk and Hart have lately suggested an elegant solution of both problems simultaneously, through an appropriate combination of a proxy contest with a takeover bid.[117] Shareholders should be entitled to vote on the acquisition proposal before deciding whether to tender their shares. When approval of the offer by a majority of shareholders is both a necessary and sufficient condition for the bid to succeed, both the free riding and pressure to tender problems are eliminated and all gains accrue to the acquirer. It is also possible to make this approval just a necessary condition for the bid's success, thereby allowing for shareholders to profit from the option to tender or free ride. The authors show that, under asymmetric information, all value-decreasing takeovers are anyway ruled out by this mechanism, and that efficient takeovers occur with a very high probability even when shareholders are able to capture a takeover premium.

Nevertheless, I still maintain with Yarrow that minority's squeeze-out is "a simple and elegant solution of the free rider problem."[118] The solution advocated by Bebchuk and Hart may be equally elegant, but is not as simple: indeed, it is extremely difficult, if not impossible, to have it implemented by takeover regulation without fundamentally altering the distribution of powers in corporate law.[119] A related, but more important point of criticism is that this solution relies on shareholders' ability to take an efficient decision in spite of information asymmetry. This reflects professor Bebchuk's more general contention that non-controlling shareholders should be credited with sufficient information to participate in corporate decision-making.[120] What this work attempts to demonstrate is that neither this information, nor shareholder involvement in decision-making which it may result in, are necessary or just desirable for the efficiency of corporate governance.[121] Takeovers are no exception to this claim.

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[115] Amihud *et al.* [2004], *Freezeout*, cit., 1335.
[116] Burkart, M. and Panunzi, F. [2003], *Mandatory Bids*, cit., 11.
[117] Bebchuk, L.A. and Hart, O. [2001], *op. cit.*
[118] Yarrow, G.K. [1985], *Shareholder Protection, Compulsory Acquisition and the Efficiency of the Takeover Process*, in JOURNAL OF INDUSTRIAL ECONOMICS, vol. 34, 4.
[119] Compare with Chapter Seven, above.
[120] See, illustratively, Bebchuk, L.A. [2005b], *The Myth of the Shareholder Franchise*, Working Paper No. 565, Harvard Law School (Faculty Series), available at www.ssrn.com, forthcoming in VIRGINIA LAW REVIEW, 2007.
[121] See *supra*, Chapter Six.

c) A Change in Perspective

One important feature of the takeover mechanism has been neglected so far. That is actual and potential competition among bidders. Several empirical studies show that bidders' competition result in higher takeover premia.[122] Of course, free riding must be excluded for this result to hold. Let us assume, for the moment, that this is achieved by the squeeze-out rule described in the previous subsection, since it outperforms alternative solutions in a static setting. It will be shown that the same rule is utmost efficient in a dynamic setting.

Even in the absence of free riding, bidders' competition reduces the likelihood of efficient takeovers in that it erodes the acquirer's gains in favor of target shareholders. Competition is in fact not in the bidder's interest, for it naturally drives up the price of the acquisition. Worse enough, it may result in overbidding.[123] This is known as the 'winner's course' problem. By and large, since the costs of screening the market in search of takeover targets are sunk, competition at the bidding stage may just force the first bidder to acquire the company at an inflated price. To the extent that this results in inability to recover the initial investment in screening, prospective acquirers will refrain from entering the takeover market.[124]

To be sure, there are a number of strategies to get around this problem. One of them is pre-empting competitive bidding by offering target shareholders a substantial premium at the outset.[125] This strategy is supported by empirical evidence, which shows that takeover bids are either uncontested or, alternatively, competition proceeds by sizeable increases over the last preceding bid.[126] Under the reasonable assumptions of costly bid revision and/or costly investigation of potential targets, this proves to be an optimal bidding strategy that allows takeover premium to be limited to the acquirer's advantage and for some, but not all, efficient takeovers to

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122 Bradley, M., Desai, A. and Kim, E.H., [1988], *Synergistic Gains from Corporate Acquisitions and their Division between the Shareholders of Target and Acquiring Firms*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 21, 3-40; Franks, J. and Harris, R.S. [1989], *Shareholder Wealth Effects of Corporate Take-overs: The UK. Experience 1955-1985*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 23, 225-249; Stulz, R., Walkling, R.A. and Song, M.H. [1990], *The Distribution of Target Ownership and the Division of Gains in Successful Takeovers*, in JOURNAL OF FINANCE, vol. 45, 817-833.

123 Burkart, M. and Panunzi, F. [2006b], *Takeovers*, cit., 21.

124 Easterbrook, F.H. and Fischel, D.R. [1982b], *Auctions and Sunk Costs in Tender Offers*, in STANFORD LAW REVIEW, vol. 35, 1-21.

125 Fishman, M.J. [1988], *A Theory of Preemptive Takeover Bidding*, in RAND JOURNAL OF ECONOMICS, vol. 19, 88-101.

126 See Burkart, M. and Panunzi, F. [2006b], *Takeovers*, cit., 20-22; and Gomes, A. [2001], *Takeovers, Freezeouts, and Risk Arbitrage*, Working Paper, University of Pennsylvania, available at www.ssrn.com.

take place thereby. In this scenario, a positive takeover premium arises out of potential, more than of actual, competition.

This perspective neglects the role of the incumbent controller in takeovers. To be sure, in Corporate Law and Economics, bidding competition has been related to the problem of managerial entrenchment but mostly to argue that this is a pernicious combination.[127] Apparently, promoting competition among bidders is a wonderful strategy for managers to frustrate any takeover attempt. All they need to do is to be sufficiently committed to takeover resistance, allegedly for the sake of securing the highest possible takeover premium for shareholders, as to make winner's curse the most likely (or just the only possible) scenario. It is on this basis that Easterbrook and Fishel have famously argued in favor of *absolute* board passivity in the face of a takeover bid.[128]

This position has never been either upheld by US case-law or agreed upon by the rest of Law and Economics commentators.[129] Some of them have recently argued that concern for managerial entrenchment is unwarranted, given that nowadays the anticipated vesting of stock option plans and otherwise conspicuous golden parachutes align managers' incentives with shareholder interest in value-increasing acquisitions.[130] I am going to carry this fundamental intuition further, by reversing the traditional perspective. Short of being a matter of concern, managerial entrenchment is both supported by empirical evidence and theoretically efficient.[131] If we add to this the possibility of severance payments, the incumbent management is not interested in having takeover attempts frustrated by disruptive bidding competition. Rather, it is interested in having this competition under control, in order to maximize the chances that value-increasing takeovers allow for their rents to be cashed in. Coupled with the appropriate freeze-out rule, this incentive scheme is

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127 Easterbrook, F.H. and Fischel, D.R. [1991], *Economic Structure*, cit., 185-190.

128 Easterbrook, F.H. and Fischel, D.R. [1981], *op. cit.*

129 "It has been suggested that a board's response to a takeover threat should be a passive one. […]. However, that clearly is not the law of Delaware, and as the proponents of this rule of passivity readily concede, it has not been adopted either by courts or state legislatures [citing Easterbrook, F.H. and Fischel, D.R. [1981], *op. cit.*, 1194]. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 949 (note 10) (Del.Sup.1985). In the literature, see most prominently Gilson, R.J. [1982], *Seeking Competitive Bids versus Pure Passivity in Tender Offer Defense*, in STANFORD LAW REVIEW, vol. 35, 51-67 (hereinafter, Gilson, R.J. [1982], *Seeking Competitive Bids*); Bebchuk, L.A. [1982], *The Case for Facilitating Competing Tender Offers: A Reply and Extension*, in STANFORD LAW REVIEW, vol. 35, 23-50.

130 Kahan, M. and Rock, E.B. [2002], *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, in UNIVERSITY OF CHICAGO LAW REVIEW, vol. 69, 871-915. To be sure, this remark was made much earlier in Corporate Law and economics. See, e.g., Carney, W.J. [1983], *op. cit.*, 388-392; and, more broadly, Carney, W.J. [1988], *Controlling Management Opportunism in the Market for Corporate Control: An Agency Cost Model*, in WISCONSIN LAW REVIEW, vol. 1988, 385-433.

131 See *supra*, Chapters Two and Six.

consistent with both positive takeover premia and changes in control taking place if, and only if, they are efficient.

Some legal constraints must be set on managerial entrenchment as a precondition for this result to hold. The Coase Theorem does not hold in its strongest version in the takeover context, so the bargaining game must be somewhat regulated.[132] A rather obvious corollary of the prohibition of sale of manager's office is that the incumbent management cannot profit from bidding competition in its exclusive interest. If that was allowed, the management could simply induce bidders to compete on the severance payments instead of on the bid price. Since this may result in value-decreasing takeovers, both this pattern of competition and collusion between management and the bidder must be prevented by the legal system. This basically implies that managers can renegotiate their golden parachutes just once and for all. Thus, bidding competition cannot be restricted by the incumbent, and may only result in a higher takeover premium.

Let us assume that the incumbent's control rents are fully compensated anyway: this is in fact a precondition for any takeover to occur on friendly terms. Then the management faces some weak incentive to foster competition among bidders. On the one hand, higher takeover premia will result in higher value of manager's share of the residual claim; on the other hand, managers may gain a reputation of tough negotiators in the shareholders' interest. This is, however, little thing compared to the interest that managers have in avoiding takeover's failure because of excessive competition. The problem is that they do not have this competition completely under control, nor is it desirable that they do for the reason that has been just mentioned.

The mere rumor that a takeover is in the making is good news for the target's stock. Especially if we take for granted that takeovers cannot be value-decreasing (and one will shortly go back to the conditions for this to hold), the market infers from the willingness to bid for firm control that some gains are to be captured.[133] Professionally informed traders – the real drivers of stock market prices – will easily bet on a successful takeover by taking a long position (i.e., buying on cash, margins, or options) on the potential target's stock. According to a recent paper – currently under revision – this provides a sufficient condition for arbitrage to generate a posi-

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[132] See, for a comprehensive illustration, Bebchuk, L.A. [2002a], *The Case against Board Veto in Corporate Takeovers*, in UNIVERSITY OF CHICAGO LAW REVIEW, vol. 69, 973-1035 (hereinafter, Bebchuk, L.A. [2002a], *Board Veto*). In what follows, I am taking a much narrower perspective to the problem of managerial conflicts of interest in the wake of a takeover bid.

[133] For a detailed discussion of this mechanism, see Gilson, R.J. and Kraakman, R.H. [1984], *op. cit.*, 569-572.

tive takeover premium.[134] The argument is that arbitrageurs may get in the position to holdout by acquiring sufficient stock to prevent the prospective acquirer from squeezing out non-tendering shareholders; the bid would thus fail unless arbitrageurs are offered a significant takeover premium. The presence of noise trading (both before and, even more so, after the bid is announced) should allow this strategy to be profitable. Since we are still assuming that the threshold for operating a freeze-out is equal to that necessary to gain control, this mechanism is unlikely to fulfill the conditions for a holdout strategy unless ownership is particularly concentrated. Still, the same mechanism allows professionally informed traders to drive up profitably the market price thanks to the presence of noise, and this implies that also the bid price is bound to increase.

This scenario is extremely dangerous for the success of a takeover. Until market professionals believe that the stock price is underestimating the post-takeover value, no takeover bid can possibly succeed unless the freeze-out price makes the offer coercive. As we know, a rule setting the freeze-out price equal to the bid does not allow for coercion (it just eliminates free riding), but it is necessary to rule out value-decreasing takeovers. In this situation, market professionals may also engage in competitive bidding, just with the purpose of capturing as much as possible of the would-be acquirer's gains. This process may just end in the winner's curse, in which either the market or the bid price do not allow the acquirer to reap any gains from the acquisition and force him to make a loss from having initiated it. The only alternative to prospective acquirers refraining from entering such a game in the first place is the expectation that the above process is not endless, but may be terminated with the incumbent management's cooperation. In a friendly takeover, managers have an important advantage over market participants: they have inside information about the deal. Prohibition of insider trading does not allow them to participate directly in the formation of the stock price. However, they may influence it indirectly by disseminating new information to market participants.[135]

One is assuming that control rents are fully compensated at this stage and that the management cannot extract further compensation from bidders' competition. The management has then no interest in allowing redistribution of takeover gains from the bidder to shareholders, and it just would like the bid to go through. Managers may prevent disruptive competition from exhausting the acquirer's gains by injecting new information in the form of bid recommendation. However, this recommendation needs to be credible to hit the target. The insider's information ad-

[134] Gomes, A. [2001], *Takeovers, Freezeouts, and Risk Arbitrage*, Working Paper, University of Pennsylvania, available at www.ssrn.com.

[135] See, for a similar approach, Gilson, R.J. [1982], *Seeking Competitive Bids*, cit.

vantage is substantial, but limited due to information spillovers about the deal.[136] Recommending any bid would be of no use, to the extent that the underlying information is already used up. Market professionals would still profit by buying against noise traders. Management recommendations can only stop the price increase when they provide truly new information that reduces, and possibly eliminates, the noise. In other words, management can only exploit the information gap with professionally informed traders. The gap is sufficiently large to keep the stock price below the post-takeover value, thereby allowing the bidder to gain from the acquisition. But it is also sufficiently small to allow shareholders to get a positive takeover premium. The latter is not due either to free riding or to actual competition among bidders, but simply to information spillovers in the dynamics of the market mechanism.

This interpretation is consistent with a number of empirical observations. First, management recommendations have an impact on the outcome of takeovers.[137] Recommended bids most often succeed, even though they still attract competing bids sometimes. This illustrates the management's power to influence the takeover process, but also its limits. It is for this reason that bidders often choose to pre-empt potential competition by offering a takeover premium at the outset, or have otherwise to revise substantially their bid upwards to win actual competition.[138] This second observation may lead to many efficient takeovers being foregone, in the absence of incumbent management's participation in the process. A third observation is indeed decisive to support our interpretation: the vast majority of takeovers that are initially characterized as hostile are concluded as negotiated deals.[139] Compared to plainly friendly deals, they exhibit lower rates of success but higher bidding competition and takeover premia. To be sure, direction of causality is uncertain. Takeover resistance may be either the cause or the effect of these facts. If it were the cause, this would support the hypothesis of self-interested management entrenchment. But this is contradicted by the evidence about the bidder's stock returns, which are unaffected by the perceived hostility of the takeover. Management involvement in negotiations must be then the *effect* of a tough acquisition process, which is intended to keep both competition and takeover premia sufficiently *low* to preserve the acquirer's gains.

Professor Schwert concludes upon this evidence that "hostility seem[s] to reflect strategic choices made by the bidder or the target firm to maximize their respective

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[136] Gilson, R.J. and Kraakman, R.H. [1984], *op. cit.*, 572-579.
[137] See, e.g., Burkart, M. and Panunzi, F. [2006b], *Takeovers*, cit.
[138] See Gomes, A. [2001], *op. cit.*, and references cited therein.
[139] Schwert, G.W. [2000], *Hostility in Takeovers: In the Eyes of the Beholder?*, in JOURNAL OF FINANCE, vol. 55, 2599-2640.

gains from a potential transaction."[140] I only add to this conclusion that the target management's and the bidder's interest converge on allowing mutually profitable transactions to succeed in spite of adverse fluctuations in stock price and/or bidding competition. This result is derived from the unparalleled illustration of "the mechanisms of market efficiency" by Gilson and Kraakman of nearly three decades ago.[141] It is therefore unsurprising that also Ronald Gilson advocates a proactive role for target management in governing the information flow of the takeover process.[142] His residual preoccupation about conflicts of interest between managers and shareholders is unwarranted in our framework, provided that control rents must be compensated upfront and further rent extraction by restricting bidders' competition is disallowed. Still, incumbent managers may make profits at the shareholders' expenses when they can disseminate false information about the merits of a takeover attempt. However, this behavior has little to do with takeover regulation, and I assume that it is prevented by the anti-fraud provisions of general securities regulation.[143]

The final question about this mechanism is whether it is efficient. To answer, we need to go back to the exclusionary mechanism of minority shareholders after a successful takeover. A rule setting the squeeze-out price equal to the bid price would make sure that non-tendering shareholders cannot free ride (and so all of them will tender in a rational-expectations equilibrium), and that they are not under pressure to tender to a value-decreasing bidder. To be sure, this also requires that the bid price be not lower than the current market price, for the firm could be acquired for less than its verifiable value otherwise. Imposing this condition in a static setting does no harm (and it is actually unnecessary), given that the same result obtains from the 'no arbitrage' condition of stock market efficiency in the weak form.[144] However, once the target's stock price is allowed to fluctuate in a dynamic setting, the necessity to disallow negative takeover premia to prevent value-decreasing takeovers also results in some efficient transactions being ruled out. The reason is that the stock price will always be slightly higher than the pre-takeover value of the company, since takeover bids cannot be coercive and, therefore, they are bound to be value-increasing. As Amihud and his co-authors show, this is the reason why the squeeze-out rule that they advocate (and which I subscribe to) is constrained-efficient: the constraint is not due to the possibility of a positive take-

[140] Id., at 2639.
[141] Gilson, R.J. and Kraakman, R.H. [1984], *op. cit.*
[142] Gilson, R.J. [1982], *Seeking Competitive Bids*, cit.
[143] For illustration of the major antifraud provision under US securities law, see *supra*, Chapter Nine, section 9.2.1.
[144] Burkart, M. and Panunzi, F. [2003], *Mandatory Bids*, cit., 19.

over premium (which arises independently), but to the impossibility of a negative one.[145] The last circumstance imply that a bid below market price is bound to fail, in spite of the insurgent being a better manager then the incumbent. This result is basically unavoidable by takeover regulation, since the pre-takeover value is not verifiable.

This is not the only constraint on the efficiency of takeovers under this mechanism. Another one depends on the necessity for the insurgent to compensate the incumbent's rents; this is also unavoidable for *ex ante* efficiency.[146] Positive takeover premia are apparently a source of further constraint, since they reduce the gains available to prospective acquirers. But it should be noticed that this would not be a problem if only takeover gains were perfectly divisible: management involvement in the takeover process would always split the pie in such a way as to allow otherwise efficient takeovers to succeed, no matter of how little the pie is. That moderately efficient takeovers do not occur in the real world depends not on inefficiency of the takeover process (or of its regulation), but on the functioning of stock markets. Luckily, the latter are characterized by "an equilibrium degree of disequilibrium," for no takeover could ever succeed otherwise.[147] On the other hand, information spillovers and imperfect divisibility of financial assets constrain incumbent manager's ability to preserve the acquirer's gains, and result in the sizeable takeover premia that we all observe. That being said, a rule setting the squeeze-out price equal to the higher between the bid and the market price is the most efficient regulatory solution given all the above constraints. I supplement this important finding by Amihud, Kahan, and Sundaram by incorporating – as they suggest – "an active role for management in the takeover process" and providing an explanation of takeover premia that is broader than just bidding competition.[148] The other lines of inquiry identified by the authors are open questions for future research.

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[145] Amihud *et al.* [2004], *Freezeout*, cit., 1338-1339.

[146] See *supra*, section 10.1.1.

[147] This is one major achievement in the economic theory of financial markets: prices immediately impounding all available information is a non-starter, since this would wipe out any individual's incentive to seek for new information (i.e., making profits against less informed traders). See Grossman, S.J. and Stiglitz, J.E. [1980], *On the Impossibility of Informationally Efficient Markets*, in AMERICAN ECONOMIC REVIEW, vol. 70, 393-408.

[148] Amihud *et al.* [2004], *Freezeout*, cit., 1343.

10.3.2. Changes in Control in the Presence of a Controlling Shareholder

a) Efficient and Inefficient Sales of Corporate Control

The economic analysis of changes in control in the presence of controlling shareholders is quite different, and significantly less developed, compared to that of takeovers of free-standing firms.[149] In a sense, this scenario is much less interesting for an economist, provided that a sale of corporate control between controlling shareholders does not require, by definition, that a tender offer be made to non-controlling shareholders facing collective action problems. This perspective, however, neglects that such tender offer might be in the interest of the acquirer not because it is strictly necessary for the takeover's success, but because it allows further gains to be captured. If we follow this line of reasoning, the possibility to buy out minority shareholders at a convenient price may not just increase takeover's profitability for prospective acquirers, but also allow for a larger number of value-increasing takeovers to be viable. As I mentioned, this is a matter of efficiency and not just of distribution.[150]

What prevents acquirers from making a tender offer for non-controlling shares is not that this is unnecessary, but that this would not allow them to make any further profits. In both dispersed and concentrated ownership structures, non-controlling shareholders know that they can free ride on the acquirer's improvement in firm value. Therefore, they will holdout anyway when confronted with a tender offer, unless some compulsory acquisition mechanism is in place. The observation that, in the presence of a controlling shareholder, changes in control can and do occur in spite of this holdout potential very often overlooks that more changes in control would take place if this potential were excluded; and that this would be efficient.[151]

One fundamental contribution to the analysis of the control transactions at issue is provided by Bebchuk. In a milestone publication, the author makes a number of key points.[152] First, sales of control are decided between the incumbent and the insurgent controlling shareholder based on their own interest in the control block, which may differ from overall maximization of shareholder value. The reason is twofold: on the one hand, their participation in security benefits (the residual claim on the firm's assets) is limited to the cash flow rights attached to the control block; on the other hand, the control block allows them to fully enjoy private benefits of

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[149] Burkart, M. and Panunzi, F. [2003], *Mandatory Bids*, cit., 22.
[150] See *supra*, section 10.2.2.
[151] See, for exemplification of the standard view, Kraakman *et al.* [2004], *The Anatomy*, cit., 161.
[152] Bebchuk, L.A. [1994], *Sales of Control*, cit.

control. The second point is that the transaction surplus is determined by the difference in the sum of private benefits and security benefits between the insurgent and the incumbent controller: a change in control will occur if and only if this difference is positive and sufficient to offset the cost of the acquisition. The third point is that the existence of such a surplus does not imply efficiency nor does efficiency imply a surplus. A change in control may occur when the acquirer's incremental private benefits are large enough to offset a decrease in the security benefits of control (positive transaction surplus), but the increase in private benefits is smaller than the overall decrease in firm value (inefficient takeover). Conversely, a change in control may fail to occur when the acquirer's private benefits are so lower than the incumbent's that they cannot be compensated by the increase in security benefits (negative transaction surplus), although the overall firm value would increase thereby (efficient takeover). As a result, in the absence of regulatory intervention, both value-decreasing takeovers may be imposed on minority shareholders and value-increasing takeover may fail to take place.

None of the above conclusions is questionable. But this is definitively not the only possible approach to sales of control by controlling shareholders and, I believe, it is at least partly misguided. To be sure, professor Bebchuk does not make any assumption about the (in)efficiency of PBC.[153] The problem is that he does not make any distinction among them either, so that private benefits are alike in his framework.[154] I maintain that this treatment of private benefits is incorrect. Indeed, once private benefits are allowed different consideration depending on their nature, the analysis of sales of control blocks yields significantly different results.

To start with, as I have already shown, value-decreasing takeovers may occur only under a very narrow set of conditions when the control block is transferred for a consideration above the stock's market price. The existence of a control premium in block transactions is unambiguously supported by the empirical evidence, and I posit that idiosyncratic PBC – which *do not* affect shareholder value – are a sufficient condition for this.[155] I have also assumed that idiosyncratic PBC decrease at every change in control because of their nature of reward of unverifiable entrepreneurial talent – whose relevance is asymptotically decreasing along the firm's lifecycle. Under this reasonable set of assumptions, the necessity of having the incumbent's control rents compensated by the insurgent makes sure that also distortion-

[153] Id., at 963.

[154] This is illustrative of a more general problem in the analysis of PBC in Corporate Law and Economics. See the discussion of Bebchuk, L.A. [1999], *op. cit*, in Chapter Six, section 6.5.2, above.

[155] Notice, however, that the average control premium varies considerably across jurisdictions, and this is evidence that also other kinds of PBC are at play. See Dyck, A. and Zingales, L. [2004], *Private Benefits of Control: An International Comparison*, in JOURNAL OF FINANCE, vol. 59, 537-600.

ary PBC cannot increase (firm value cannot decrease). This holds as long as at least as much as the control block is purchased for a price above the non-controlling stock's current value, and shareholder value diversion is disallowed (or has already reached the upper bound set by the legal system). Therefore, not differently from takeovers in dispersed ownership structures, a necessary condition for value-decreasing sales of control block being ruled out is the absence of diversionary PBC (or an appropriate upper bound on their extraction). This is also a sufficient condition to the extent that the company's stock cannot be otherwise purchased below its current value. This holds by definition when minority shareholders are not involved in the transaction, for they stand to free ride; but it may require further regulatory constraints once it is established that – as I am going to argue – compelling them to sell is efficient.

That sales of control blocks are very seldom, if ever, value-decreasing when diversionary PBC are sufficiently low is confirmed by the empirical evidence.[156] In the US, block trades are on average associated with abnormal price increases, thereby suggesting that gains are generated through improved security benefits rather than further extraction of private benefits.[157] However, the other side of Bebchuk's argument remains. Unregulated sales of control blocks may result in many value-increasing transactions being foregone. Here the reason is different, and in a sense opposite, to that determining the risk of inefficient transactions: short of being determinant for the change in control, the insurgent's private benefits are insufficient to generate a transaction surplus in spite of the takeover's efficiency. As professor Bebchuk acknowledges, this is due to minority shareholders' ability to free ride on future management improvements, which in turn makes it impossible for the controller to buy their shares at the current market value and sell them at a premium to the acquirer (who would then fully enjoy the residual security benefits).[158] It is worth noting that, in this situation, any regulatory arrangement that would strengthen shareholder protection cannot but make efficient takeovers even *more unlikely* to succeed;[159] we will come back to this important remark later.[160] According to Bebchuk, however, the opposite solution of weakening minority shareholders' position by allowing the controlling shareholder to freeze them out would be no improvement, due to courts' inability to set the freeze-out compensation equal to the pre-takeover value. By erring in either direction – the argument runs – courts

[156] Burkart, M. and Panunzi, F. [2006b], *Takeovers*, cit. 17-24.

[157] See, illustratively, Holderness, C.G. [2003], *A Survey of Blockholders and Corporate Control*, in FEDERAL RESERVE BANK NY – ECONOMIC POLICY REVIEW, April 2003, 51-64.

[158] Bebchuk, L.A. [1994], *Sales of Control*, cit., 966-967.

[159] Id., at 971-972.

[160] See *infra*, section 10.4.4.

would both allow inefficient takeovers to succeed and prevent efficient ones from taking place.[161]

b) Optimal Squeeze-Out after the Sale of Control Blocks

Bebchuk's argument proves too much. Although the pre-takeover value is actually unverifiable, an efficient freeze-out of minority shareholders does not require it to be ascertained. Under certain conditions, reliance on market prices is enough.[162] The first of these conditions is that the freeze-out may be only operated in conjunction with a tender offer and that both of them take place after, and not before, the sale of control block is decided – that is, the operation is performed by the acquirer and not by the seller of corporate control.[163] On the one hand, this makes an otherwise unnecessary tender offer for non-controlling shares an attractive option for the acquirer, provided that it is backed by compulsory acquisition of non-tendering shareholders. On the other hand, this arrangement generates two new pieces of information, which provide the basis for setting the 'right' squeeze-out price. The first is the bid price, which reflects the buyer's willingness to pay for non-controlling shares. Notice that this differs from the price paid for controlling shares, which also includes the control premium, but cannot be lower than the pre-takeover value when diversionary PBC are disallowed and the company's stock is not undervalued by market price. Actually, if minority shareholders can free ride, the opposite is true and the market price would be equal to the post-takeover value. However, when non-tendering shareholders can just be squeezed-out at the bid price, and this is unconstrained, we have to cope with the possibility of negative takeover premia, which may lead to both acquisition of non-controlling stock below its value and, in turn, to inefficient changes in control.[164] Here comes the importance of the second piece of information: the stock's market price *after* the sale of control block is announced.

The post-announcement stock price has important properties, which, however, require that a preliminary constraint is set with reference to the pre-takeover price. The reader should recall that any constraint on the squeeze-out price results in a lower bound to the bid price. Not differently from the case of acquisition of free-standing firms, we need to impose the pre-takeover price as a lower bound to the squeeze-out (and, therefore, to the bid) price to prevent inefficient outcomes. This

[161] Bebchuk, L.A. [1994], *Sales of Control*, cit., 983-984.

[162] For broader reliance on market prices as a benchmark, see the long-standing position of Easterbrook, F.H. and Fischel, D.R. [1991], *Economic Structure*, cit., 124-126.

[163] Contrast this solution with Bebchuk, L.A. [1994], *Sales of Control*, cit., 983-984.

[164] Amihud *et al.* [2004], *Freezeout*, cit., 1335.

is just necessary to avoid that value-decreasing sales of control block are subsidized by a coercive bid for the rest of the company's stock, which would enable its acquisition below market price.[165] However, this is not sufficient to rule out value-decreasing acquisitions. They may still be possible when the non-controlling stock is undervalued, and may be nonetheless acquired at the pre-takeover price through a tender offer backed by compulsory purchase of non-tendered shares. Here the problem is different from the case of free-standing firms, given that the bidder has no incentive to offer a takeover premium; he does not need to make the bid sufficiently attractive to gain control, for he has got it already. But the solution, if anything, is even simpler if we set the post-announcement price as a further constraint on the squeeze-out price. This would just involve that the bid for non-controlling shares also cannot be lower than the post-takeover price, anytime this exceeds the pre-takeover price.[166] This requirement is only binding on condition that market price rises after the sale of control block is announced; but then, it is sufficient to rule out value-decreasing takeovers. In fact, it implies that a tender offer for non-controlling shares may only succeed for a price equal to (or slightly above) the post-announcement price. Making such tender offer is profitable for the acquirer if and only if he can further increase the firm value.[167]

It may seem that minority shareholders can still free ride under this squeeze-out arrangement. Apparently, the post-announcement price is determined by them, and not by the acquirer. This is not correct. After gaining control, the acquirer is confronted with two options. One is making a tender offer to minority shareholders, which would enable him to buy them out at the higher between the pre-takeover and the post-takeover market price. But he has also the option to sell part of his control block so long as this does not imply losing control of the company. I have contended throughout this work that the latter is indeed a (legal) condition for efficient separation of ownership and control.[168] The necessity to give the acquirer the above two options explains why the entitlement to squeeze-out minority sharehold-

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[165] See Easterbrook, F.H. and Fischel, D.R. [1991], *Economic Structure*, cit., 124-126.

[166] Obviously, another way to impose this restriction is to require the consideration for squeeze-out to be no lower than the bid price (i.e., a prohibition of two-tier bids). As it will be illustrated in the next Chapter, this is how the rule that I am advocating can be effectively operationalized in the legal discipline of takeovers. Notice that this rule differs from that advocated by Amihud *et al.* in the acquisition of free-standing firms as far as the *second* lower bound on the squeeze-out (and the bid) price is concerned: when control has been already acquired from a controlling shareholder, this lower bound is set with reference to the market price *before the announcement* of the block transaction, and not just to the pre-bid price.

[167] Compare this solution with discussion of the problem of undervalued equity in Bebchuk, L.A. [1987], *Pressure to Tender*, cit., 928-931.

[168] See most prominently *supra*, Chapter Seven.

ers should be conditional on the making of a tender offer, and the latter should be voluntary. Indeed, this arrangement forces both categories of players to reveal their preferences. The acquirer must immediately decide whether it is more profitable for him to sell or to buy non-controlling shares, and trade accordingly – whereas he would always first go for the squeeze-out solution otherwise. By virtue of the same arrangement, minority shareholders are protected from pressure to tender, but they can no longer free ride. The ability of professionally informed traders to drive up the market price is constrained by prospective acquirers' willingness to award minority shareholders a takeover premium.[169] For the same reason, a takeover premium is allowed just to the extent that it is no impediment to a value-increasing acquisition.[170]

The reader may easily recognize that this solution is in fact an adaptation of the freeze-out rule advocated by Amihud and his co-authors with reference to takeovers of free-standing firms.[171] In the context of companies with a controlling shareholder, the efficiency of squeeze-out is not constrained by the necessity to rule out negative takeover premia. The reason is simply that control is transferred independently in this situation, and this allows for the problem of overestimation of pre-takeover value to be corrected by stock trading after the change in control has occurred. Indeed, this same mechanism keeps *positive* takeover premia sufficiently low as to make all efficient takeovers viable. All of the other constraints stay. That restricting the scope of feasible efficient transactions to those whose gains are sufficient to compensate the incumbent's idiosyncratic PBC is intuitively more severe in the presence of controlling shareholders, given the larger size of the control premium.[172] Furthermore, not differently from free-standing firms, a consistent upper bound on diversionary PBC is required to avoid that squeeze-out of minority shareholders results in value-decreasing takeovers. Given these constraints, *I claim that a rule that allows the acquirer of a control block to squeeze-out minority shareholders at the*

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[169] Compare with Gilson, R.J. and Kraakman, R.H. [1984], *op. cit.*, 622-626.

[170] This result obtains by backwards induction. Suppose that a prospective acquirer is just slightly more efficient than the incumbent. Since his idiosyncratic PBC are lower than the incumbent by assumption, he can only purchase the control block by making a loss. However, the squeeze-out rule I am advocating enables him to recoup his loss (and to make further gains) from subsequently trading non-controlling stock. If the stock price does not increase after the announcement of the takeover, the acquirer will just gain by buying out minority shareholders at the pre-takeover price. If the stock price goes up, or it is otherwise inflated, the acquirer will profit from selling at a premium part of his control block. In equilibrium, there is no scope for a takeover premium to prevent any better manager from initiating the acquisition – i.e., the acquirer can always extract the necessary surplus out of a value-increasing takeover. In conclusion, takeover premia are allowed by bargaining (stock trade) just to the extent that they do not hinder efficient changes in control. Q.E.D.

[171] Amihud *et al.* [2004], *Freezeout*, cit., 1331-1334.

[172] See *supra*, Chapter Six, section 6.4.

higher between the pre-takeover and the post-takeover price, conditional on a tender offer being made, is the most efficient regulation of such control transactions. Being the first to make this claim, I will explore in what follows some of its legal implications while leaving further questions open to future research.

10.4. Regulation of Control Transactions: A Functional Analysis

10.4.1. The Key Issues

The legal regulation of control transactions is a very complicated matter. In virtually every jurisdiction, it is determined by a complex interaction of securities regulation and corporate law. On the first prong, the goal is to make sure that, in the wake of a takeover, investors receive a sufficient amount of information to make the 'right choice:' whether this choice is defined in terms of efficiency or fairness is another question.[173] On the second, corporate law has the difficult task of making sure that control transactions can be operated in spite of objective difficulties in decision-making, but that they not result in 'unfair' consequences for non-controlling shareholders.[174] Again, what are to be considered as fair terms of the transaction, and the relationship between fairness and efficiency in this context, are a matter of extensive debate.[175]

The above distinction is just an ideal one. In practice, in each jurisdiction, the legal discipline of control transactions arises as a particular combination of securities regulation and corporate law.[176] By taking a functional approach, we can disregard this distinction. But we have to tackle a more important problem: the apparent conflict between operability of changes in control and shareholder protection in takeover regulation. It can be argued that takeover law supports control transactions inasmuch as they are fair to minority shareholders. This is not irrelevant in a Law and Economics analysis of corporate governance, for the same statement can be

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[173] See, broadly, Bebchuk, L.A. [1985], *op. cit.*

[174] See Coates, J.C. IV [1999], *Fair Value as an Avoidable Rule of Corporate Law: Minority Discounts in Conflict Transactions*, in UNIVERSITY OF PENNSYLVANIA LAW REVIEW, vol. 147, 1251-1359.

[175] As a prominent illustration of the conflict between efficiency and 'fairness' in the analysis of corporate control transactions, see Easterbrook, F.H. and Fischel, D.R. [1991], *Economic Structure*, 109-144 and 162-211.

[176] Kraakman *et al.* [2004], *The Anatomy*, cit., 162-163.

rephrased in terms of efficiency. In this perspective, the prominent goal of takeover regulation would be the optimal solution of the tradeoff between efficient allocation of corporate control and shareholder protection.[177] This is how mainstream economics approaches the matter, and I have just shown that, at least partly, it is misguided. It is now time to explore in more detail the legal implications of these two different approaches.

The analysis will be then concentrated on a relatively narrow set of subjects. Only the rules having a bearing on the supposed tradeoff between the ease of the takeover process and shareholder protection will be discussed, and the discussion will be highly selective. Indeed, I am going to focus on just the key elements of the theoretical framework discussed so far. These elements carry positive predictions and normative implications for the legal analysis, which are both very strong. First, they confirm some of the criticisms of mainstream economic theory toward excessive shareholder protection by takeover law.[178] Second, they show that the market for corporate control is best supported by legal rules just concerned with efficiency of changes in control, and that this should be the main goal of takeover regulation. Third, they set shareholder protection from expropriation by the corporate controller as a precondition of an efficient takeover process, so that takeover regulation should pursue this goal independently of promoting a smooth market for corporate control.

The above statements translate into the following areas of functional legal analysis. They concern the regulation of each category of players in the takeover game. The first area is about the incumbent controller. Since we consider only friendly takeovers, an entrenched controller should be given the possibility to cash in his private benefits for him to part with control.[179] Regulation affects the ease with which both a controlling shareholder can cash in his control premium and the incumbent management can renegotiate their severance payments. Normally, this goes hand in hand with the legal discipline of entrenchment devices. The second area is perhaps the crucial one: the regulation of the acquirer's gains. This is obtained by placing legal constraints on how the company's stock can be acquired, which affect both the distribution of profits and losses between shareholders and the acquirer and the probability that a change in control occurs whether it is efficient or not. The third area is shareholder protection from value-decreasing takeovers. As we know, this involves first the prohibition of sale of manager's office

[177] Burkart, M. and Panunzi, F. [2006b], *Takeovers*, cit., 14.
[178] See, e.g., Burkart, M. and Panunzi, F. [2003], *Mandatory Bids*, cit., 6-8.
[179] Coates, J.C. IV [2003], *op. cit.*

and of acquisition of corporate stock below its current value. More importantly, however, an effective ban on looting is required to this purpose.[180]

The above essential functions of takeover regulation are not necessarily in a logical order. For instance, shareholder protection from expropriation is a prior for both positive and normative analysis. The areas of takeover law are sorted in this way just for illustrative purposes. I am now going to present the typology of legal rules that belong to each area. The next Chapter will discuss how these rules are actually combined in the five jurisdictions of our sample. The implications of their interaction will be then analyzed in both a positive and a normative perspective.

10.4.2. Regulation of Control Rents

a) Severance Payments

So far we have always assumed that the corporate controller could ask whatever he wanted in exchange of his parting with control. He only faced a market constraint in his ability to cash in control rents: somebody in the market for corporate control had to find it profitable to take over firm control under these conditions.[181] I maintain that this mechanism is the optimal compromise between *ex ante* and *ex post* efficiency of corporate governance, subject to the only constraint that it may not result in value-decreasing takeovers – which is a matter of shareholder protection. However, the ability of incumbent controllers to cash in their rents in a takeover is not unconstrained by corporate law. Indeed, corporate law may make this kind of payments extremely difficult, if not prohibit them outright.[182]

The reason why law may be skeptical about upfront compensation of control rents is twofold. On the one hand, it may regard it as nothing but a 'bribe', which – despite of Coase's famous illustration of how side payments may improve the welfare of society, at least under certain conditions – lawyers tend to consider as immoral *per se*.[183] On the other hand, even apart from value judgments, compensation of control rents may be regarded as shareholder expropriation, since it undoubtedly reduces their share of the takeover gains.[184] We know that none of these arguments is correct: compensation of control rents does not need to be just a bribe, but it is

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[180] Easterbrook, F.H. and Fischel, D.R. [1982], *op. cit.*, 715-719.
[181] See *supra*, Chapter Six, section 6.3.2.
[182] Kraakman *et al.* [2004], *The Anatomy*, cit., 168.
[183] Cf. Coase, R.H. [1960], *The Problem of Social Costs*, in JOURNAL OF LAW AND ECONOMICS, vol. 3, 1-44.
[184] For a more sophisticated articulation of this point, see Bebchuk, L.A. [2002a], *Board Veto*, 1013-1016.

necessary to reward the investment of unverifiable entrepreneurial talent;[185] and it may only results in shareholder expropriation when stealing is already a problem in corporate governance.[186] However, that such compensation is treated with suspicion in many corporate jurisdictions is a matter of fact, and it cannot be neglected.

Regulation may absolutely prohibit severance payments to managers, and that happens most often when they act in their capacity as directors. A milder version of this prohibition is preventing the controlling management from renegotiating their golden parachutes. This is no less worrisome, since we know that a significant part of the manager's incentive to put effort in the ongoing management of the company depends just on his ability to claim a larger severance payment in the face of a takeover.[187] Regulatory restrictions on severance payments then undermine both incentive alignment and the ease of takeovers under managerial control. But this is just a part of the story. Normally, these restrictions are associated with prohibition of management from taking any action that may frustrate the success of a takeover bid, unless it is authorized by shareholders to do so.[188] Apparently, the combination of these two restrictions should result in the incumbent management's inability to influence the outcome of takeovers through negotiations with the bidder.[189] While this was probably the intention of rule-makers, this result is short-circuited by the power of economic incentives. We know that, despite of any legal restriction, the corporate controller's entrenchment must obtain anyway in corporate governance. The only consequence of these restrictions is then that they narrow the scope of feasible corporate governance arrangements, and possibly compromise their efficiency.[190]

Having to reckon a rule of board passivity (or neutrality) in the wake of a takeover, managers will just have to find a different way to entrench themselves. An apparently obvious solution is to become controlling shareholders, but this has a number of shortcomings that makes it unattractive if not as a last resort. The first is the financial commitment, and the resulting opportunity costs in terms of liquidity and risk diversification – not to speak about wealth constraints. This problem could be partly overcome by separating voting rights from cash flow rights, but – as we know – this solution is not always available because of either unfavorable regulation or the veto powers granted to large investors by corporate law. Finally, the same

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185 For a formal demonstration of how this works in a multiple-stage analysis of corporate governance and takeovers, see Schnitzer, M. [1985], *op. cit.*

186 See *supra*, Chapter Six, section 6.5.2.

187 See Almazan, A. and Suarez, J. [2003], *op. cit.* (discussed *supra*, Chapter Six, section 6.5.3).

188 Kraakman *et al.* [2004], *The Anatomy*, cit., 168-170.

189 Id., at 171-172.

190 See *supra*, Chapter Seven, section 7.6.

regulation that makes it difficult for managers to entrench themselves may also make it costly to be a controlling shareholder of a listed firm. The careful reader will have recognized that all of these conditions hold under the British regulation of corporate governance, which force listed companies to be under managerial control and managers to entrench themselves by forming coalitions powerful enough to resist an unwelcome takeover in spite of all formal prohibitions.[191] When it is added to this picture that British managers are also prevented by company law from renegotiating their severance payments, one can easily predict that both managerial incentives to perform are weakened and efficient takeovers are less likely to occur;[192] and, on top of this, controlling shareholders are normally no feasible alternative.[193] These predictions will be confirmed and elaborated upon in the country-by-country analysis.

The British case is a rather peculiar one. Normally, one would expect that regulatory constraints on managerial entrenchment are a sufficient condition for shareholder control to emerge as the only possible outcome.[194] Then, any legal restriction on severance payments would be irrelevant for the market of corporate control, provided that the latter is only operated by controlling shareholders. This is certainly correct, but it is worth noting that the reverse is not necessarily true. In many jurisdictions, managers are entitled to both protect themselves from hostile takeovers and to renegotiate their severance payments at the time of the acquisition.[195] However, in some countries (like the US), this allows both managerial control to be workable and corporate governance to evolve from concentrated to dispersed ownership structures and vice versa. In some others (like the Netherlands), this allows for managerial control, but does not guarantee an equally smooth transition between dispersed and concentrated ownership structures. In others again (like Italy), this is not even sufficient to support managerial control. To put it simply, the absence of restrictions on the managers' taking an active role in takeover bargaining is neither a necessary nor a sufficient condition for managerial control and an active takeover market to be featured in corporate governance. On the one hand, managerial control needs also to be supported by a consistent legal distribution of corporate powers. On the other hand, an efficient dynamics in the allocation of corporate control also depends on how the sale of *controlling blocks* is regulated in the two aspects of transfer of ownership and control power.

[191] See *supra*, Chapter Seven, section 7.3.2.
[192] See *infra*, Chapter Eleven, section 11.3.2.
[193] See *infra*, Chapter Eleven, section 11.3.4.
[194] See *supra*, Chapter Seven, section 7.6.1.
[195] See *supra*, Chapter Seven. For more details about regulation of severance payments, see *infra*, Chapter Eleven.

Normally, the sale of a control block involves both kinds of transfers by definition.[196] However, this can be problematic in those jurisdictions that deny shareholder primacy in the distribution of corporate powers. In our sample, this is applicable just to the Netherlands, and therefore the discussion of this problem is postponed to the specific analysis of that country.[197] A more general problem is that corporate law very often regulates the terms in which the sale of a control block can be operated.[198] This affects the ability for the controlling shareholder to claim a control premium in return for his rents, and thereby the ease with which takeovers may occur.

b) The Control Premium: 'Market Rule' vs. 'Equal Opportunity Rule'

There are mainly two possible regulations of the control premium. One is to allow the controlling shareholder to trade freely his block with no obligation to share the control premium with minority shareholders.[199] This means that controlling and non-controlling shares are exchanged on different terms, and that the former are traded at a premium compared to the latter for they carry the entitlement to corporate control. This is known as the 'market rule' in the sale of corporate control. It has been demonstrated that this rule maximize the probability that efficient takeovers occur, since the incumbent faces no difficulty in having his private benefits compensated other than the acquirer's ability to reap takeover gains in the form of security benefits – a problem that must be coped with anyway.[200] Apparently, however, this rule makes also possible that takeovers are operated to extract further private benefits at the expenses of security benefits, or that extraction of private benefits is otherwise self-perpetuating with shareholder control structures. We know that this is a false problem, and that it may result in value-decreasing takeovers only on condition that value diversion from non-controlling shareholders is not adequately policed otherwise by corporate law. Nevertheless, this problem is considered as a good rationale for the opposite regulation of the takeover premium: the so-called 'equal opportunity rule.'

The equal opportunity rule denies the controlling shareholder the entitlement to cash in a control premium with the exclusion of minority shareholders. The control block may indeed be sold at a premium over market price, but the same premium must be shared with non-controlling shareholders on equal terms. In theory, there

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[196] Easterbrook, F.H. and Fischel, D.R. [1982], *op. cit.*

[197] See *infra*, Chapter Eleven, section 11.5.2. But see also *supra*, Chapter Seven, section 7.3.3.

[198] See, for a critical discussion, Berglöf, E. and Burkart, M. [2003], *European Takeover Regulation*, in ECONOMIC POLICY, vol. 18 171-213.

[199] See, for terminology and economic analysis, Bebchuk, L.A. [1994], *Sales of Control*, cit.

[200] Id., at 964-968.

are different ways to operationalize such a rule. In practice, it is normally implemented through the obligation for the acquirer of a control block to make a tender offer to minority shareholders for the same consideration.[201] This is a mandatory bid with equal treatment of shareholders, whether they are controlling or not. A mandatory bid does not need to feature the obligation to share the control premium, nor does the equal opportunity rule require a mandatory bid. But the two circumstances are normally bundled together in corporate law, so the mandatory bid is – somewhat inappropriately – considered as a synonymous of the equal opportunity rule.[202] I shall further speculate on the specific characteristics of the mandatory bid in the next section. What is important to notice here is that, in this configuration, the mandatory bid amounts to an effective prohibition of the controlling shareholder from getting anything more than minority shareholders get in a takeover.

What are the consequences of equal opportunities being granted to minority shareholders through a mandatory bid? The first and most unfortunate one is that it restricts the scope of feasible control transactions, in spite of their efficiency.[203] Indeed, the size of the incumbent's control rents is given and unaffected by the rule. The latter just makes their compensation more difficult, since the same premium over market price must be paid also to non-controlling shareholders. As a result, the vast majority of efficient takeovers will have to be foregone due to the acquirer's inability to pay such an inflated control premium, and possibly none of them will occur when the controlling shareholder's private benefits are high enough.[204]

It must be acknowledged that the severity of this rule is sometimes tempered by national corporate laws, especially where the presence of controlling shareholders is largely predominant (if not exclusive) in corporate governance.[205] This is obtained

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[201] Burkart, M. and Panunzi, F. [2003], *Mandatory Bids*, cit., 22-26.

[202] Kraakman *et al.* [2004], *The Anatomy*, cit., 184-187.

[203] Bebchuk, L.A. [1994], *Sales of Control*, cit., 971-972.

[204] See, in much milder terms, Berglöf, E. and Burkart, M. [2003], *op. cit.*, 196-198.

> "The mandatory bid rule forces the rival to internalize any negative externality that a control transfer may have on the shares owned by the small shareholders. […] On the other hand, [h]aving also to pay the control premium to the small shareholders can inflate the total purchase price beyond the rival's willingness-to-pay, even though a control transfer would add value. […] Which of the effects dominates is an empirical question."

However, the authors cite Holderness, C.G. [2003], *op. cit.*, as evidence that, at least in the US, "improved management is the primary source of gains in block transactions" that are not followed by a full acquisition; "[t]hus, large as well as small shareholders benefit from the absence of a mandatory bid rule."

[205] Kraakman *et al.* [2004], *The Anatomy*, cit., 180-181.

by allowing for partial bids, a discount on the bid price, or simply by having the mandatory bid triggered by a threshold of stock acquisition sufficiently high to let control transactions occur without the need to share the control premium with minority shareholders. We will discuss this sort of 'waivers' in the next Chapter, since they are not allowed in many jurisdictions and some of them risk disappearing in Europe. It is much more important to wonder why this regulation is so popular even in its strictest formulation, in spite of its disruptive effects on the market for corporate control. The reason is shareholder protection.

Although the desirability of such a protection is often argued on the basis of fairness reasons, there is also an efficiency explanation. Indeed, a mandatory bid with equal treatment of shareholders makes value-decreasing takeovers impossible to succeed.[206] The reason is straightforward: there is in fact no way for the acquirer to extract private benefits of any kind from non-controlling shareholders once he is obliged to offer them the same price that he pays for controlling shares. However, this result is as unquestionable as unnecessary. On the one hand, efficiency of all feasible takeovers obtains as well under the market rule when private benefits of the insurgent and the incumbent are of the same order of magnitude (a condition that typically holds for diversionary PBC, which depend on the legal environment rather than on the identity of controllers). However, the equal opportunity rule discourages a much greater number of value-increasing transactions.[207] On the other hand, ruling out PBC extraction is neither necessary nor desirable for the efficiency of takeovers, so long as (incremental) value diversion from minority shareholders is otherwise excluded.

10.4.3. Regulation of the Acquisition in Dispersed Ownership Structures

a) *Does the Mandatory Bid Matter?*

When the mandatory bid carries no obligation to share the control premium, for instance because there is none in the absence of a controlling shareholder, it only affects the acquirer's gains relative to the shareholders'.[208] In the takeover of a free-standing firm, the mandatory bid simply means that a would-be acquirer *must* make an *unrestricted* tender offer to non-controlling shareholders in order to gain control. It is quite intuitive that the first obligation is irrelevant to the extent that a tender offer is anyway the insurgent's best strategy to acquire a control block – which, for

[206] Bebchuk, L.A. [1994], *Sales of Control*, cit., 968-970.
[207] Burkart, M. and Panunzi, F. [2003], *Mandatory Bids*, cit., 25.
[208] Id., at 12-17.

simplicity, we assume equal to 50% of voting shares. However, the mandatory character of the bid usually comes with regulation of the bid price, so that this cannot be lower than the price paid for previous stock purchases on the market.[209] Assuming that shareholders cannot free ride (an assumption that we are going to discuss momentarily), this may undermine the acquirer's ability to profit from the acquisition of a toehold below the bid price and may, in addition, expose him to adverse fluctuations in the stock price between market purchases and the making of the bid.[210] This solution of course benefits target shareholders conditional on a tender offer being made, but it reduces the probability that a takeover bid occurs.

The second requirement that the bid be 'any-or-all' has different implications on the takeover process depending on how the free riding problem is coped with. When the exclusionary mechanism is based on post-takeover value diversion (like in the model of Grossman and Hart), the prohibition of unrestricted offers is irrelevant provided that diversion is unconstrained.[211] However, it prevents some value-increasing takeovers under the more reasonable assumption that the legal system constrains the acquirer's ability to divert shareholder value, thereby making restricted offers an attractive option.[212] Prohibiting the latter may be nonetheless desirable in this situation, in order to prevent value-decreasing takeovers.

When free riding is instead excluded by the entitlement to squeeze-out non-tendering shareholders, the mandatory bid plays a different role.[213] At first glance, prohibition of restricted offers may seem necessary to avoid pressure to tender, and it would be also sufficient to this purpose inasmuch as the role of diversionary PBC is disallowed in takeovers – as I continue to assume it can. Yet, although coercive offers are undesirable for the efficiency of the takeover process, the mandatory bid is not necessary to avoid coercion. When the squeeze-out price is set equal to the higher between the bid and the market price, shareholders cannot be forced into value-decreasing acquisitions by a two-tier bid.[214] Neither can they free ride whether they tender or not. However, it will be always in the acquirer's interest to squeeze-out shareholders who not tender, either because they do not have rational expectations or because they are rationed: a different strategy would place them backing the position to free ride.

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[209] Kraakman *et al.* [2004], *The Anatomy*, 178-181.
[210] Id., at 180.
[211] Burkart, M., Gromb, D., Panunzi, F. [1998], *Why Higher Takeover Premia Protect Minority Shareholders*, in JOURNAL OF POLITICAL ECONOMY, vol. 106, 187.
[212] Burkart, M. and Panunzi, F. [2003], *Mandatory Bids*, cit., 15-16.
[213] Burkart, M., Gromb, D., Panunzi, F. [1998], *op. cit.*, 187-188.
[214] Amihud *et al.* [2004], *Freezeout*, cit., 1338.

As a result, a restricted bid makes no sense from the acquirer's standpoint, when it is associated with optimal squeeze-out, and its prohibition under a mandatory bid rule is irrelevant. A partial bid may only be in the interest of the acquirer when the above squeeze-out rule is implemented imperfectly, or he is allowed to extract higher private benefits than the incumbent does by looting the company.[215] In each case, the advantage of a prohibition on restricted bids – avoidance of value-decreasing takeovers – must be balanced against its adverse consequences on the probability of efficient changes in control.[216] Needless to say, I regard this approach as inherently flawed, in spite of its being the standard framework for analyzing the problem of mandatory bid.

b) Sell-Out and Squeeze-Out

A topic closely related to the mandatory bid is shareholder's sell-out right. This right enables minority shareholders to have their shares acquired for a fair consideration when their position has become inconvenient because of reduced liquidity of their investment or a change in control, and – most often – because of both reasons.[217] This situation typically occurs in the aftermath of a takeover bid, and – for simplicity – this is the only case considered here. In such a case, the problem of 'fairness' of consideration is easily solved by setting the price equal to that offered in the bid. It is often believed that the sell-out right is just the opposite of the squeeze-out right, and therefore must be granted in equal terms to minority shareholders to compensate for the entitlement given to the acquirer. This perspective, however, is misleading. Although the rules effectively mirror each other, "functionally the two are very different."[218] The illiquidity argument is just a partial argument in favor of the sell-out right, but under certain conditions, it turns out to be the only possible one. A much stronger argument, which enjoys the support of both academics and policymakers, is that the sell-out right may be desirable to counter pressure to tender. In this respect, the function of the sell-out right is apparently similar to that of the mandatory bid.

However, there are important differences. When the squeeze-out rule departs from the optimal arrangement that we have previously described, the sell-out right is only relevant when it is triggered by a no higher percentage of stock acquisition than that sufficient to determine a change in control (which we assume to be

[215] Id., at 1335 and 1338.
[216] Burkart, M. and Panunzi, F. [2003], *Mandatory Bids*, cit., 15.
[217] Id., at 20.
[218] Kraakman *et al.* [2004], *The Anatomy*, cit., 184.

50%).[219] This is both a necessary and a sufficient condition for the sell-out right to remove pressure to tender, whereas the mandatory bid also requires that negative takeover premia be ruled out.[220] To this extent, the sell-out right is preferable to the mandatory bid. Nevertheless, both rules raise the cost of value-increasing acquisitions in order to prevent value-decreasing ones. This is not necessary when the squeeze-out rule is drafted in optimal terms.[221] When this happens, a sell-out right is irrelevant to both the functioning and the efficiency of the takeover process, whatever the triggering threshold. The reason is threefold: i) pressure to tender is already eliminated; ii) neither squeeze-out nor sell-out rights are exercised in a rational expectations equilibrium; iii) in the real-world presence of noise or irrationality, it will always be squeeze-out to be exercised.

So far we have made a strong assumption: that the acquirer's right to squeeze-out non-tendering shareholder is triggered by the mere acquisition of control – which we still assume to be conditional on the transfer of at least 50% of the voting shares. This solution has the important advantage to let the acquirer appropriate as much as possible of the takeover gains, but not all of them, since it still allows for a positive takeover premium to be determined – in a dynamic setting – by the interaction of management's recommendations with information spillovers (traded upon by market professionals) and bidding competition.[222] Apparently, a squeeze-out threshold any higher than the control acquisition threshold would result in a further increase in the takeover premium, due to shareholder's ability to free ride when the latter threshold is met but the former is not.[223] However, this argument has been shown to be incorrect: the only effect of a higher squeeze-out threshold is that of making takeover bids conditional on that threshold being reached, rather than on the mere acquisition of control.[224]

Although this result does not affect the efficiency of takeovers under the assumption of rational expectations, the freeze-out threshold is not irrelevant in the real world. If we take the presence of noise and/or irrationality into account, too high a threshold actually lowers the chances of success of takeover bids. When, for instance, the squeeze-out threshold is set at 90% or more of the voting capital – as it is in Europe –, this enables a number of players (large shareholders, arbitrageurs, and, under certain conditions, the incumbent management) to holdout for a larger premium. This is not because they can free ride, but because they may more easily

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219 Burkart, M. and Panunzi, F. [2003], *Mandatory Bids*, cit., 21.
220 Id., at 15.
221 Amihud *et al.* [2004], *Freezeout*, cit., 1334-1335.
222 See *supra*, section 10.3.1.
223 Burkart, M., Gromb, D., Panunzi, F. [1998], *op. cit.*, 185-186.
224 Amihud *et al.* [2004], *Freezeout*, cit., 1339-1340.

either make profits against noise traders or find it otherwise profitable not to trade.[225] Whatever the reasons of this behavior, it is allowed by a more stringent condition for takeover's success, and it results in more (efficient) takeovers being foregone. Therefore, differently from Amihud and his co-authors, a sufficiently low threshold (possibly, as low as the control acquisition threshold) is a key component of our optimal squeeze-out rule.[226] The inefficiency of a different arrangement will be shown with reference to the British case.

It might still be argued that a higher squeeze-out threshold protects non-controlling shareholders from value-decreasing acquisitions.[227] However, since the latter are already prevented by the regulation of the freeze-out price, this argument is misguided.[228] This is just a part of a broader argument that letting non-controlling shareholders participate in the takeover gains is neither a necessary nor a sufficient condition for having inefficient changes in control ruled out, whereas it certainly undermines the occurrence of efficient takeovers.

10.4.4. Regulation of the Acquisition in Concentrated Ownership Structures

Is the impact of regulation of the acquisition different when control is bound to be transferred from a controlling shareholder? The answer is a qualified yes. On the one hand, it should be recalled that acquisition of non-controlling stock is not strictly necessary for a change in control to take place in this scenario. On the other hand, whether such acquisition is made a real option or an obligation by takeover regulation still affects the prospective acquirer's incentives to initiate a takeover, and that is not much different from the case of a free-standing firm. The legal solution that I advocate for this problem is also not much different, since it is based – in both situations – on the *option*, and not on the *obligation*, for the acquirer to buy out minority shareholders, conditional on shareholder protection being just sufficient to rule out value-decreasing takeovers.[229]

When takeovers are implemented through the sale of control blocks, two problems arise.[230] On the one hand, non-controlling shareholders have no say on the control transaction; on the other hand, they bear a significant part of its wealth effects, whether they are positive or negative. Lawyers and regulators, more than

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[225] See Gomes, A. [2001], *op. cit.*
[226] Compare with Amihud *et al.* [2004], *Freezeout*, cit., 1340.
[227] Burkart, M. and Panunzi, F. [2003], *Mandatory Bids*, cit., 19.
[228] See *supra*, section 10.3.1.
[229] See *supra*, section 10.3.2.
[230] Kraakman *et al.* [2004], *The Anatomy*, cit. 184-185.

economists, are mostly concerned about negative effects, which they often regard as 'unfair.'[231] To be sure, they may also be regarded as inefficient: the new controller may loot the company, either directly or by diverting profit opportunities to other group member companies; or alternatively, he may be unable or unwilling to keep shareholder value at least as high as under the previous management, for instance because he just strives for empire building.[232] In each situation, minority shareholders would be worse off after the control shift, and the outcome would be inefficient too, since – in our framework – it is determined by increase in diversionary or distortionary PBC, respectively. It is on this basis that both fairness and efficiency of granting minority shareholders a right of exit upon a change in control is argued. This right of exit is implemented by a mandatory bid rule.[233]

a) Potential and Limitations of the Mandatory Bid

Compared to the case of acquisition of a free-standing firm, the mandatory bid has a structural difference and a theoretically optional one. The structural difference is that the obligation to make a tender offer is no longer irrelevant, even in the absence of regulation of the bid price, for in a number of situations a would-be acquirer would not make any and just go for the acquisition of the control block.[234] This is already a source of distortion, which I am going to elaborate upon shortly. However, the mandatory bid is intended to protect minority shareholders, and the right of exit is definitely not sufficient to this purpose: shareholders would simply have no bargaining power in a value-decreasing transaction. One option could be to set the bid price equal to the pre-takeover market price: but – as we know – this would still allow for value-decreasing takeovers to the extent that the stock is undervalued. Surely, the best solution would be compelling the bid to be equal to the pre-takeover *value*, instead of the *price*; but this is not an option, since the pre-takeover value is not verifiable. Therefore, the bid price must be regulated with reference to the only alternative to the market price: the price paid for the control block.[235] It is in this way that the mandatory bid becomes more than just a right of exit for minority shareholders, for it also supplies them with the entitlement to

[231] See, e.g., Davies, P. [2002b], *The Notion of Equality in European Takeover Regulation*, in J. Payne (ed.), TAKEOVERS IN ENGLISH AND GERMAN LAW, Hart Publishing, 9-32 (discussing efficiency and fairness of the principle of equal treatment of minority shareholders).

[232] Bebchuk, L.A. [1994], *Sales of Control*, cit., 976-980.

[233] Kraakman *et al.* [2004], *The Anatomy*, cit., 178.

[234] Id., at 184.

[235] Bebchuk, L.A. [1994], *Sales of Control*, cit., 968 and 982-983.

share the control premium (or a part of it, depending on whether a discount is provided for by regulation of the bid price) with the controlling shareholder.[236]

As we have already seen, this configuration of the mandatory bid is most unfortunate for it leads to a vast numbers of efficient transactions (and possibly to all of them) being foregone.[237] Notice that the problem concerns the insurgent more than the incumbent. The latter does not really care about what is given to minority shareholders, provided that his rents are compensated. The former, however, may be unable to bring about enough security benefits to allow for private benefits' compensation to be extended to minority shareholders, in spite of (increases in) the first kind of benefits being sufficiently large to offset (decreases in) the second one.[238] With respect to the goal of preventing value-decreasing takeovers, this solution is therefore, at best, an overshooting. Indeed, as I have shown, payment of the control premium just to the controlling shareholder is already sufficient to prevent value-decreasing takeovers, on condition that at least as much as the control block is transferred and the acquirer is not allowed to divert shareholder value further.[239] While corporate law must provide for the last condition to hold, the first is intrinsic to the takeover process in the presence of a controlling shareholder. As a result, in spite of the mandatory bid with equal treatment of shareholders being also sufficient to rule-out value-decreasing takeovers, it is not necessary to this purpose. In addition, the adverse consequences of this mandatory bid on value-increasing takeovers make it suboptimal compared to other solutions, which likewise exclude inefficient control transactions while placing fewer restraints on efficient ones.[240] In the absence of tender offers for non-controlling shares, having the market rule for block transactions coupled with an effective ban on incremental diversionary PBC is always one such solution.

Could alternative regulations of the mandatory bid fare any better? I believe not. When it does not carry the entitlement for minority shareholders to share in the control premium, the mandatory bid cannot prevent all value-decreasing takeovers while being still counterproductive for value-increasing ones.[241] The only condition

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236 Kraakman *et al.* [2004], *The Anatomy*, cit., 184-187.

237 "Both effects [shareholder protection and frustration of efficient control transfers] are diluted by less stringent versions of the mandatory bid rule. If some discrimination between the per-share price in the block trade and the subsequent tender offer is allowed, fewer efficient control transfers are frustrated and some inefficient transfers are not prevented." Burkart, M. and Panunzi, F. [2006b], *Takeovers*, cit., 19.

238 Bebchuk, L.A. [1994], *Sales of Control*, cit., 971-972.

239 See *supra*, section 10.2.3.

240 For a similar argument, albeit limited to a particular set of circumstances, see Burkart, M. and Panunzi, F. [2003], *Mandatory Bids*, cit., 25-26.

241 Id., at 14.

under which this result does not obtain is an unfeasible one: the bid price set equal to the pre-takeover value. It is nonetheless interesting to study this condition, not because economists typically assume to have a can opener when they obviously cannot have any, but because this is illustrative of the properties that the mandatory bid may have and, even more so, of those that it may *never* have.[242] Simply put, the mandatory bid can do nothing about free riding by minority shareholders. The best that it can do, but only in an ideal world where the pre-takeover value is ascertainable, is to make sure that minority shareholders cannot suffer any loss from a change in control while they can still free ride on its benefits.[243] As a result, non-controlling shares will never be tendered in spite of the mandatory character of the

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[242] I have learned from my teachers that the diverging approaches of economists and lawyers to social science are best illustrated through exaggerations – i.e., by making fun out of them. The well-known metaphor of the can opener provides me with a good opportunity for such illustration. The standard textbook for introductory courses in Law and Economics (Polinsky, A.M. [2003], AN INTRODUCTION TO LAW AND ECONOMICS, 3rd edn., Aspen Publishers) begins with a famous joke, which I loosely report below:

> A shipwreck has left a physicist, a chemist, and an economist without food on a deserted island. A few days later a can of beans is washed up on the shore. The physicist proposes the following method of opening the can:
> "I've calculated that the terminal velocity of a one-pound object – the weight of the can – thrown to a height of twenty feet is 183 feet per second. If we place a rock under the can the impact should just burst the seams without spilling the beans."
>
> The chemist's response is:
> "That's risky since we can't be sure we will throw it to the correct height. I've got a better idea. Let's start a fire and heat the can on the coals for one minute, thirty-seven seconds. I've calculated that this should just burst the seams. This method is less risky since we can always push the can off the fire if it starts to burst sooner (plus we get hot beans)."
>
> The economist's reaction is:
> "Both of your methods may work, but they are too complicated. My approach is much simpler: Assume a can opener."

Law and Economics is definitely not biased against economists. Another story typically told to students in their first class on economic analysis of law is the following:

> Two men on a balloon expedition got hopelessly lost in a storm. When the storm cleared, they found themselves floating above a desolated land, with nobody in sight but a woman. Suddenly, they cried: "Hey! W-h-e-r-e a-r-e w-e?!" To which the woman answered: "You're in a balloon about twenty-five feet off the ground." "She must be a lawyer," commented one passenger to the other. "How can you tell?" his companion asked. "Well – he responded – that's easy: what she said was absolutely accurate and totally useless."

Lawyers and economists who didn't know their own story will easily recognize what is funny on their side, and probably wonder why they should laugh on the other side. Those who are already into Law and Economics will have already paid their ticket, and will know by now that the bottom line is more serious than each story apparently suggests.

[243] See the discussion of the Grossman-Hart dilution mechanism in Amihud *et al.* [2004], *Freezeout*, cit., 1335-1338.

bid. A value-decreasing acquirer would simply refrain from purchasing the control block in the first place, since the tender offer would force him to make a loss; whereas no shares would be tendered at the pre-takeover value by shareholders who know that they can free ride on a higher post-takeover value. Ironically, the only reason why this does not result in any takeovers at all (like in the Grossman-Hart framework) is that changes in control are operated by sales of controlling blocks.[244] Still, a number of efficient takeovers are foregone due to minority shareholders' ability to free ride and the mandatory bid, even in its ideal configuration, can simply do nothing about it.

The above result cannot be improved by any alternative configuration of the mandatory bid that we may observe in the real world, unless pressure to tender is otherwise generated. This automatically means that the mandatory bid must allow for inefficient takeovers, by waving the requirement that non-controlling shares cannot be acquired below their pre-takeover value.[245] There are two necessary conditions for this to hold in the real world. On the one hand, the bidder must be enabled either to offer a lower price for non-controlling stock than that paid for the control block, to bid for less than all outstanding shares, or to combine the two strategies; we know that no value-decreasing takeover would be allowed otherwise. On the other hand, this would still be not enough to create scope for value-decreasing takeovers, and likewise it would not generate any pressure to tender, if the acquirer is not allowed to divert more value than the incumbent does from shareholders who do not tender. Whether the two conditions are also sufficient to result in a larger number of efficient takeovers than in the ideal situation, where no value-decreasing takeovers are possible and value-increasing ones are just prevented by shareholders' free riding, depends on the legal parameters of this complicated arrangement. These are, basically, the discount on the bid price or quantity and the amount of diversionary PBC allowed by the legal system.

Without carrying these complications any further, a few points are worth making. First, the chance of this mechanism to be any beneficial does not depend on the mandatory bid, but on its waivers of the obligation to share the *entire* control premium with *all* minority shareholders. Second, this arrangement is the more likely to improve efficiency the stricter the mandatory bid rule is (i.e., the arrangement exhibits diminishing returns to scale with respect to the parameters determining pressure to tender).[246] Third, an alternative arrangement may replicate the outcome of the least distortive mandatory bid without necessity to generate any pressure to

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[244] Bagnoli, M. and Lipman, B.L. [1988], *op. cit.*
[245] Kraakman *et al.* [2004], *The Anatomy*, cit., 186.
[246] For a similar conclusion, see Berglöf, E. and Burkart, M. [2003], *op. cit.*, 196-198.

tender. When the threshold triggering the obligation is high enough, no tender offer need be made in spite of control effectively changing hand: the outcome in which the mandatory bid is circumvented is actually equivalent to that of a mandatory bid setting the price equal to the pre-takeover value, on condition that diversionary PBC are disallowed.[247] Fourth, under the same condition, it is not necessary to hypothesize any tradeoff between shareholder protection from value-decreasing takeovers and promotion of value-increasing ones. As I have shown, the tradeoff hypothesis is unwarranted, and so is the attempt to cope with it through the mandatory bid. On the one hand, the mandatory bid could at best protect shareholders to the extent it allows them to free ride, and can effectively do it only at the cost of further reducing the probability of efficient takeovers. On the other hand, it can only promote efficient takeovers to the extent that it protects shareholders imperfectly, by exposing them to the risk of value-decreasing changes in control. An optimal squeeze-out rule can promote efficient takeovers and protect shareholders from inefficient ones simultaneously; and, in this context, the mandatory bid is just a nuisance.

b) Optimal Squeeze-Out and Its Regulatory Impediments

In the presence of a controlling shareholder, regulation should make squeeze-out of minority shareholders attractive enough for value-increasing acquirers without allowing also value-decreasing acquirers to profit from this option. We know that this is achieved by allowing squeeze-out to be exercised conditional upon the making of a tender offer for non-controlling shares, and by setting the squeeze-out consideration equal to the higher market price before and after the announcement of the acquisition of the control block.[248] From the economic standpoint, this is both necessary and sufficient to prevent all value-decreasing takeovers from being subsidized through acquisition of non-controlling stock below its current value, and to allow value-increasing acquirers to overcome free riding by minority shareholders. From the legal point of view, it is also necessary that disclosure of control block transactions is provided for and stock price manipulation is prevented.[249] As it turns out, all modern systems of securities regulation provide sufficient guarantees that these minimal conditions for stock market efficiency are fulfilled. As far as corporate law is concerned, the rule at issue is also extremely easy to enforce. Both

[247] For the view that member states should enjoy freedom to set the mandatory bid threshold (as they actually do – see *infra* Chapter Eleven, section 11.4.2.), see McCahery, J.A., Renneboog, L. (with P. Ritter and S. Haller) [2003], *op. cit.*, 53-55.
[248] See *supra*, section 10.3.2.
[249] Kraakman *et al.* [2004], *The Anatomy*, cit., 174-176.

constraints on the squeeze-out price are set with reference to objective market prices.[250] Therefore, from a straight perspective of legal policy, this arrangement is very attractive, at least in the absence of interference with other rules.

Unfortunately, this interference exists in many respects. The first source of interference is the mandatory bid rule. Even if we abstract from the price constraints – which, in practice, significantly depart from the arrangement that we are considering – the mandatory character of the tender offer for non-controlling shares is problematic. We know that the bid should be voluntary to allow for the takeover premium adjusting to the efficient level. If the bid is mandatory, and the price is just constrained by the squeeze-out rule, the bidder will still lose the option to sell part of his control block when the price increase is high enough; worse enough, he will have to make a tender offer for an inflated price. It can be easily demonstrated that this restores shareholders' ability to holdout for any lower price than the post-takeover value.[251] Therefore, the mandatory bid simply short-circuits the squeeze-out's advantage in coping with the free riding problem.

A similar problem may arise from the sell-out right. In the case of a free-standing firm, sell-out is irrelevant in the presence of an optimal squeeze-out rule, for it is always the latter to be exercised when shareholders do not tender. However, when control is acquired from a controlling shareholder, the acquirer may not wish to make any tender offer for non-controlling shares, which should also prevent him from squeezing them out; this is both rational and efficient when the post-announcement price is inflated.[252] If shareholders were granted a sell-out right at the post-takeover price, triggered by the mere change in control, this would be equivalent to the mandatory bid case analyzed above. Luckily, this solution is uncommon, and those commonly practiced by corporate law jurisdictions do not allow minority shareholders to free ride.[253] In some cases, the sell-out price is set at a lower level than the post-takeover value: in the US, for instance, the appraisal right is triggered by the operation of a post-takeover merger, but it just entitles dissenting shareholder to having their shares acquired at the pre-merger price.[254] In other cases, like in Europe, the sell-out right is triggered by a threshold of stock acquisition that is much higher than that necessary for gaining control (between 90% and 95%). Then the acquirer may either avoid reaching that threshold or alternatively

[250] Amihud *et al.* [2004], *Freezeout*, cit., 1340-1342.
[251] Compare with Bebchuk, L.A. [1994], *Sales of Control*, cit., 966-967 and 972 (where the sequence of events is inverted).
[252] See *supra*, section 10.3.2.
[253] See Kraakman *et al.* [2004], *The Anatomy*, cit., 178.
[254] See *infra*, Chapter Eleven, section 11.2.1.

exercise the squeeze-out right when it is reached; in fact, squeeze-out and sell-out rights are normally triggered by the same threshold.[255]

The threshold is, indeed, the third problem with our optimal squeeze-out rule. Like in the case of free-standing firms, the efficient functioning of the rule always obtains when the squeeze-out right is triggered just by acquisition of control. The only reason why I also impose the requirement that a tender offer be made is that otherwise any acquirer would always go for the squeeze-out solution to counter adverse movements in the stock price, even when it is more efficient to sell rather than to purchase stock on the market. However, the point is that when a tender offer is made, and it cannot be value-decreasing due to the regulation of the squeeze-out price, it must succeed with certainty. When this is not true, the beneficial effects of the squeeze-out rule on efficient control transactions are diminished.

Any higher threshold than 50% of the voting capital may potentially determine this result. Whether it does it or not depends on the effective ability of market players to holdout for a higher takeover premium, which would make a number of efficient transactions unprofitable for the prospective acquirer. This ability depends, in turn, on several factors, most prominently including the degree of (non-controlling) ownership concentration and the noisiness of stock prices.[256] A solution cannot be therefore identified with precision across the board. In any case, in this setting, reaching the squeeze-out threshold is a binding condition of a successful tender offer for non-controlling shares, so the latter is expected to be conditional upon that threshold.[257] By and large, a threshold between 60 and 70 percent of the voting stock may still affect little the probability of success. Not quite so, however, a threshold of 90 or 95 percent.[258] This is likely to create enough scope for holdout by minority shareholders, thereby leading to at least some efficient control transactions being foregone.

A fourth source of interference with optimal squeeze-out is courts' natural skepticism towards 'an offer that shareholders can't refuse.' Two fundamental points are worth making in this respect. The first is that the courts' suspicious attitude is not without reason. We know that coercive bids can easily result in inefficient takeovers to the non-controlling shareholders' detriment.[259] However, under the proposed squeeze-out rule, a tender offer for non-controlling shares may look like it is coercive (shareholders who do not tender will be anyway squeezed out at the same price), but in fact it is not. We rule out coercion by disallowing value-decreasing

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[255] See *infra*, Chapter Eleven, section 11.4.2.
[256] Gomes, A. [2001], *op. cit.*
[257] Amihud *et al.* [2004], *Freezeout*, cit., 1339-1340.
[258] Burkart, M. and Panunzi, F. [2003], *Mandatory Bids*, cit., 19.
[259] See *supra*, section 10.3.1.

bids through appropriate lower bounds on the squeeze-out price.[260] As Bebchuk has shown, coercion does not depend on the structure of the offer, but on pressure to tender generated by the fear that a successful bid may make non-tendering shareholder worse-off.[261] Pressure to tender cannot be generated by a bid that is bound not to be value-decreasing, although it may be generated at an earlier stage by an inefficient sale of the control block.

This leads us to the second key point. A sufficient condition for a sale of corporate control to be inefficient is that the acquirer is able to extract a larger fraction of diversionary PBC from non-controlling shareholders; in our framework, based on a tripartite account of PBC, this condition is also necessary for the transfer of control blocks to be value-decreasing. When this happens, it is the change in control and not the squeeze-out right that undermines both the efficiency of the takeover and the wealth of non-controlling shareholders, whether a bid is made or it is not. This is looting and, in theory, courts should just prevent that from occurring in takeovers.[262] In practice, however, distinguishing between efficient and inefficient sales of control requires a high degree of sophistication. The problem is germane to that of Type I/Type II errors in policing non-pro-rata distributions, with the peculiarity that false positives result in impediments to efficient takeovers.[263] This is one way to look at the tendency of unsophisticated courts and legislators to tilt the balance of takeover regulation too much in favor of shareholder protection, thereby awarding minority shareholders the largest possible share of the takeover gains in order to prevent them from being exploited.[264]

c) The Breakthrough Rule

In the next section, we will see how the problem of value-decreasing takeovers is efficiently tackled by a more focused approach to shareholder protection. But, before concluding about the distribution of the acquirer's gains, it is worth discussing a recent invention by policymakers to counter the drawbacks of the mandatory bid in controlling shareholder systems. Everybody recognizes that the obligation to share the control premium, in all or in part, normally carried by the standard configuration of the mandatory bid, significantly reduces the probability that efficient takeovers occur.[265] The problem is how to improve the position of prospective ac-

[260] This is based on Amihud *et al.* [2004], *Freezeout*, cit., 1331-1335.
[261] Bebchuk, L.A. [1987], *Pressure to Tender*, cit., 925-927.
[262] Easterbrook, F.H. and Fischel, D.R. [1991], *Economic Structure*, cit., 129-131.
[263] See *supra*, Chapter Eight, section 8.2.2.
[264] Compare with Kraakman *et al.* [2004], *The Anatomy*, cit., 128-130 and 189-191.
[265] See, for a selective survey of the literature, McCahery, J.A., Renneboog, L. (with P. Ritter and S. Haller) [2003], *op. cit.*, 51-55.

quirers, in order to make them more willing to embark on an efficient takeover, if we want that minority shareholders still get the lion's share of the takeover gains to avoid expropriation. The solution is to allow acquirers to extract takeover gains from the incumbent controller rather than from non-controlling shareholders. This solution is the basic idea underlying the so-called 'breakthrough' rule.[266]

So far, we have implicitly assumed that shareholder control is held with the absolute majority of the share capital, but we know that this is neither necessary nor very common.[267] Shareholder control is normally exercised through devices – like dual class shares, voting pacts, or pyramidal structures – which allow corporate controllers to be in charge of decision-making with an ownership stake lower than 50%. Deviations from the 'one share–one vote' arrangement affect none of the results of the previous discussion, to the extent that the controlling shareholder's entrenchment was always assumed to obtain in equal terms for the incumbent and the insurgent – i.e., a sale of control can only be operated by a transfer of controlling ownership, no matter of the voting leverage, provided that it stays unchanged. These deviations, however, are exactly the target of the breakthrough rule.

Ideally, this rule provides that the 'one share–one vote' principle be restored in the wake of a takeover. This has two major consequences. The first is that control needs no longer to be acquired from the controlling shareholder, for a change in control may be operated through a successful bid for previously non-controlling shares.[268] The second consequence is that the controlling shareholder is no longer able to protect his control rents to the extent that his entrenchment can be effectively broken through: since rent compensation is no longer a condition for taking over, a prospective acquirer is enabled to make larger profits in spite of a burdensome mandatory bid. Both consequences arise from the introduction of hostility in

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[266] Id., at 55-56. The breakthrough rule is an invention of the High Level Group of Company Experts, appointed by the European Commission after the European Parliament failed to pass the first proposal of Takeover Directive in 2001. The basic idea of the breakthrough rule was to 'level the playing field' in European takeover regulation, complementing the board neutrality rule (suitable for contestability of managerial control structures) with equivalent regulations exposing also controlling shareholders to hostile takeovers. See High Level Group of Company Law Experts [2002a], *Issues Related to Takeover Bids*, Final Report, 10 January 2002, available at www.ec.europa.eu.int. In the following, the breakthrough rule will be analyzed in purely functional terms. I will not go into the details of the rule as proposed by the Report of the High Level Group. This rule was adopted in much less stringent terms by the European Takeover Directive (Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids). This is going to be discussed in Chapter Eleven, section 11.4.2, below. For an economic analysis of the breakthrough rule as proposed by the High Level Group, see Berglöf, E. and Burkart, M. [2003], *op. cit.*, 198-202.

[267] See *supra*, Chapter Two.

[268] Ferrarini, G. [2006], *One Share – One Vote: A European Rule?*, ECGI Law Working Paper No. 58/2006, available at www.ssrn.com and www.ecgi.org.

the takeover process, and therefore require that the controlling shareholder is not otherwise allowed to frustrate a takeover bid – a result easily obtained by associating the breakthrough rule with a passivity rule. In addition, deviations from 'one share–one vote' should be in place for the breakthrough rule to have any impact.[269]

The breakthrough rule is both non-sensical and impractical.[270] From an economic standpoint, it could only be interpreted as a way to trade off *ex post* for *ex ante* efficiency. As we know, idiosyncratic control rents draw a wedge between the two. They are needed to feature corporate control with adequate incentives at the outset, but they turn out to be a nuisance for efficient changes in control to be operated at a later stage. In the Seventh Chapter, I argued in favor of contractual freedom for the solution of this tradeoff, in order to allow for efficient modes and degrees of separation between ownership and control to be determined by stock placement with the investing public.[271] This basically means that both separation of control rights from ownership (managerial entrenchment devices) and separation of voting rights from cash flow rights (deviations from 'one share–one vote') should be freely established in connection of stock sale on the market, but should not allow for subsequent modifications being unilaterally implemented in *either* direction.

When no role is acknowledged to idiosyncratic control rents (and entrepreneurship) in corporate governance, the proposition that corporate law should not be any mandatory with respect to the security-voting structure established at the outset becomes questionable.[272] However, the prohibition of unilateral renegotiations in the same respect is out of question, for it is bound to be opportunistic.[273] Allowing shareholders to turn down existing deviations from 'one share–one vote' would exactly amount to such an opportunistic renegotiation, aimed at expropriating the controlling shareholder of the rents that were promised to him in the first place. It is for this reason that the breakthrough rule makes no economic sense.

This also explains why the breakthrough rule is not practical: indeed, it cannot achieve its purpose, if not in the very short run, and only creates distortions in the long run.[274] When a breakthrough rule is first introduced, it may disrupt the vast majority of existing control structures. This result, however, depends on the rule being effectively able to impose a 'one share–one vote' security-voting structure

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[269] Coates, J.C. IV [2003], *op. cit.*

[270] Indeed, it has been heavily criticized in the academic literature. See, illustratively, McCahery, J.A., Renneboog, L. (with P. Ritter and S. Haller) [2003], *op. cit.*, 55-64.

[271] See *supra*, Chapter Seven, section 7.6.2.

[272] See, authoritatively, Grossman, S.J. and Hart, O. [1988], *One Share–One Vote and the Market for Corporate Control*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 20, 175-202.

[273] Ferrarini, G. [2006], *op. cit.*

[274] Bebchuk, L.A. and Hart, O. [2002], *A Threat to Dual-Class Shares*, in FINANCIAL TIMES, May 31, 2002.

when a takeover bid is made. The rule obviously loses its bite when at least one device for leveraging voting power is left out, since controlling shareholders will be expected to turn exactly to that device. Pyramidal structures are the case in point. One the one hand, they are hardly affected by any breakthrough rule, unless it is allowed to be as powerful as to compel dissolution of corporate groups – which is clearly out of question. On the other hand, pyramidal structures may be easily created (or expanded) at the corporate controller's initiative. Indeed, this is the reason why pyramids were characterized as perhaps the most dangerous among the instruments for leveraging voting power in Chapter Seven.[275] Ironically, the introduction of a breakthrough rule may just determine the proliferation of pyramidal structures, instead of easing the takeover process.

Even abstracting from the pyramids problem, and assuming that regulation outperform controlling shareholders' ability to suddenly switch to alternative techniques for leveraging voting or control power, entrenchment is unlikely to be eliminated on a structural basis by the breakthrough rule.[276] On the one hand, controlling shareholders can always entrench themselves by holding 50% of the company's stock. This solution is certainly costly, but may be regarded as preferable to the exposure to hostile takeover in the presence of high control rents. On the other hand, whatever the degree of contestability of corporate control determined by the breakthrough rule in spite of its deficiencies, this will be just temporary. After the first impact of the rule, the expectations of the players will adjust to its existence. All deviations from 'one share–one vote' that can be effectively reneged *ex post* will be regarded as insufficient basis for a credible commitment *ex ante*: this is equivalent to their prohibition at the outset. When deciding whether and in what terms to take their company public, controlling shareholders will therefore resort just to arrangements that make the desired distribution of corporate powers resistant to any break-through rule. If there is none, they will just hold on 50% of ownership or refrain from going public.

In conclusion, the breakthrough rule confirms that contestability of corporate control cannot be imposed by regulation: the only effect of regulatory restrictions on the corporate controller's entrenchment, either *ex ante* or *ex post*, is a lower degree of separation of ownership and control.

[275] See *supra*, Chapter Seven, section 7.4.3.

[276] Neither, apparently, can any other rule do. Arlen, J. and Talley, E. [2003], *Unregulable Defenses and the Perils of Shareholder Choice*, in UNIVERSITY OF PENNSYLVANIA LAW REVIEW, vol. 152, 577–666.

10.4.5. Shareholder Protection

a) Looting As a Determinant of Inefficient Takeovers

Shareholder protection does not need to be distortive of either separation of ownership control or the efficiency of the takeover process. Indeed, it can be made compatible with both entrenchment of corporate control and the absence of restraints on value-increasing takeovers. This compatibility is a fundamental underpinning of an efficient takeover regulation. Throughout the foregoing discussion, I have already mentioned what the functional elements of shareholder protection should be in this framework. Let us now put them in a bit of a structure, by highlighting most prominent legal instruments by which they are implemented in the discipline of control transactions. These instruments will be discussed in more detail in the following country-by-country analysis.

The first problem to be coped with is diversionary PBC. As I have shown, in an ideal system of corporate governance there would be none.[277] However, there is no set of institutional and legal constraints in which non-pro-rata distributions can be ruled out. The tradeoff between Type I and Type II errors in policing stealing by the corporate controller can only be optimized, but never eliminated.[278] In addition, as we have also seen, some legal systems perform better than others do on this account.[279] Let us take both these results, which are respectively normative and positive in character, as a constraint in the analysis of the takeover process. On the one hand, allowing takeovers to function on the basis of value diversion is neither entirely feasible *ex post* nor desirable *ex ante*. On the other hand, takeovers are not the right tool to address imperfections in the legal policing of non-pro-rata distributions; I will further elaborate on this statement shortly.

If the amount of diversionary PBC in the ongoing management of listed companies is given, one should just be concerned that takeovers do not result in their increase.[280] Constant diversion of shareholder value affects neither the probability of takeovers nor their efficiency, whereas its increase may determine their inefficiency. Of course, this scenario is the more unlikely the better diversionary PBC are policed by corporate law and related institutions (the lower the bound set on their extraction). However, upon a more careful investigation, the problem of shareholder value extraction through inefficient takeovers has a more general purport.

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[277] See *supra*, the theoretical discussion in Chapter Six.
[278] See *supra*, Chapter Eight, section 8.2.2.
[279] See *supra*, Chapter Nine.
[280] Bebchuk, L.A. [1994], *Sales of Control*, cit., 964-968.

Assume for one moment that the incumbent controller is utmost honest (i.e., diversionary PBC are nil). By definition, this cannot depend on the legal system, which can at most set an upper bound on non-pro-rata distributions. Faced with a takeover proposal, our controller may find the temptation to cheat on shareholders irresistible. On the one hand, he may face no reputation constraint inasmuch as this is his last corporate transaction before his retirement (a so-called 'endgame problem').[281] On the other hand, the insurgent will have enough scope left by the legal system for featuring the transaction with shareholder expropriation. Therefore, incumbent and insurgent can always be expected to reach an agreement on how to split the gains arising out of the diversionary features of the control transaction, no matter of how tightly ongoing diversion of shareholder value is constrained by corporate law. Notice that such a takeover may be inefficient both *ex post* and *ex ante*. *Ex post*, because the insurgent may end up decreasing the overall firm value, and nonetheless find the takeover profitable to the extent that opportunity costs on *his* security benefits are more than compensated by higher diversion. *Ex ante*, because even if the transaction is merely redistributive of firm value, shareholders will be less willing to buy corporate stock under these conditions.

This extreme example is illustrative of the more general problem with diversionary PBC in the takeover process. First, the problem does not depend on the amount of diversion, but on its increase. Second, in the context of friendly takeovers, it requires collusion between the incumbent and the insurgent. Third, incremental diversion is constrained by the scope for non-pro-rata distributions, but is ultimately determined by the terms of the control transaction. Let us define 'looting' as broadly as to include any instance of incremental diversion of shareholder value that may be involved by a control transaction. Let us also assume, for the moment, that the looter is as a good manager as the previous controller. The former may nonetheless purchase control from the latter to the extent that he bribes him high enough. However, for this strategy to be profitable, the cost of the bribe must be offset by incremental diversion involved by the control transaction.

b) The Role of Fiduciary Duties in Control Transactions

Consider first takeover of a free-standing firm, and recall that regulation of post-takeover squeeze-out does not allow for purchase of non-controlling shares on any more favorable terms than those of the acquisition of controlling ownership.[282] Our looter will have still two options for making profits at the expenses of non-

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[281] Rock, E.B. and Wachter, M.L. [2001], *Islands of Conscious Power: Law, Norms and the Self-Governing Corporation*, in UNIVERSITY OF PENNSYLVANIA LAW REVIEW, vol. 149, 1686-1689.

[282] See *supra*, section 10.3.1.

controlling shareholders. The first is to bid for the company's stock less than it is worth, squeeze-out non-tendering shareholders at the same price, and loot the rest of firm value.[283] The success of this strategy requires collusion with incumbent management, which is supposed to have inside information about the company's stock being undervalued. The only reason why insiders should do this is that they trade a lower bid price for a higher severance payment; the only way in which they can do it is by restricting actual or potential competition among bidders. The second option does not require collusion with the incumbent management (although this might be useful for the looter). The looter may simply acquire, at a no undervalued price, just enough shares to become the controlling shareholder, and refrain from purchasing non-controlling stock.[284] He may subsequently force minority shareholders into a merger with a fully-owned subsidiary, in which either they have the value of their stock diluted or they are otherwise frozen out for a lower consideration than the pre-takeover stock price.[285] When the incumbent management colludes, the terms of this strategy may be even pre-arranged at the takeover stage.

Both looting strategies can be prevented by an appropriate configuration of fiduciary duties.[286] As far as the first one is concerned, courts should just check whether the incumbent management is restricting competition for corporate control just to the size of severance payments. This behavior (playing favorites with the bidder that offers the most for the controlling position, but the least for the controlling stock) would amount to outright breach of the duty of loyalty, and it is quite easily challenged on grounds of procedural fairness. Notice, however, that the definition of procedural unfairness should be broad enough as to include collusion also in the absence of competing bids – to the extent that this is sufficient to determine the acquisition of the company below its value. The second strategy is instead policed by the fiduciary duties of the controlling shareholder.[287] The latter will have quite a hard time in forcing minority shareholders into an unfavorable merger, when his position on both sides of the transaction requires that 'entire fairness' of its substantive terms be proven in courts. This might be somewhat easier when the terms are pre-arranged at the takeover stage, and look more like the outcome of an arm's length transaction. However, courts may be either inclined to review the sub-

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[283] Bebchuk, L.A. [1987], *Pressure to Tender*, cit., 942-944.

[284] Kraakman *et al.* [2004], *The Anatomy*, cit., 178-179.

[285] Bebchuk, L.A. [1987], *Pressure to Tender*, cit., 925-927.

[286] For how the same conclusion can be drawn on different grounds, see Easterbrook, F.H. and Fischel, D.R. [1991], *Economic Structure*, cit., 126-139 (fiduciary duties protect minority shareholders' entitlement to the current stock price in a takeout) and 177-183 (acquisition of undervalued stock is ruled out by unbridled bidding competition – supported by a strict regulation of board passivity in the wake of a takeover bid).

[287] Kraakman *et al.* [2004], *The Anatomy*, cit., 141-144.

stantive terms of the transaction when they suspect collusion (like, e.g., in the US);[288] or require anyway that the transaction be approved by would-be minority shareholders (like, e.g., in the UK).[289]

Looting may seem an easier job when control is transferred by a controlling shareholder, but in fact, it is not if only fiduciary duties are enforced as strictly. To start with, acquisition of undervalued stock is no option, at least to the extent that this is also prevented with reference to non-controlling shares. As we know, the last condition is satisfied by an appropriate configuration of the squeeze-out right.[290] Then, both the seller and the acquirer should be subject to the fiduciary duties of the controlling shareholder. If this were true, the conscious sale of corporate control to a looter would not escape a judgment of procedural unfairness, whereas any looting attempt by the purchasing controlling shareholder would be carefully scrutinized under a strict standard of substantive fairness.[291] Assume that the sale of the control block is regulated by the market rule, so that any premium over the stock market price would be legitimate. What would not be legitimate is that this premium incorporates compensation for allowing the acquirer to loot the company. This needs not (and would hardly) be explicit in the terms of the transaction.[292] The latter, however, should be regarded as procedurally unfair so long as it has no business purpose other than collusion on minority shareholders expropriation. The standards regulating the acquirer's behavior should be stricter, not differently from the case of acquisition of a free-standing firm. Any subsequent organic change in the corporate structure, or even worse a minority's takeout, should be possible only on condition that non-controlling shareholders are no worse-off: either they knowledgeably approve the transaction, or the controlling shareholder has to prove its substantive fairness.[293]

c) Can Takeovers Simply Lead to Worse Management?

The conditions for looting to be profitable become stricter when – as it is normally the case – the looter is not featured with managerial skills and he can only worsen the firm management. Fiduciary duties cannot perform any worse in preventing inefficient takeover under this more realistic assumption. However, the scenario changes when no looting is involved, and the prospective acquirer is just a

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[288] See *infra*, Chapter Eleven, section 11.2.1.
[289] See *infra*, Chapter Eleven, section 11.3.3.
[290] See *supra*, section 10.3.2.
[291] See *supra*, Chapter Eight, sections 8.4.2 and 8.4.3. For how these principles are effectively implemented, at least by the US judiciary, see Chapter Nine, section 9.2.2.
[292] Bainbridge, S.M. [2002a], *op. cit.*, 344-346.
[293] Id., at 351 and 360.

no better manager. Fiduciary duties are ill equipped to tackle lack of skill or diligence – what we termed as distortionary PBC.[294] But can any such acquisition succeed? I believe it cannot, if only corporate law prohibits sale of office – which it normally does. I have already shown that, unless looting is at play, no acquirer may profit from a value-decreasing takeover to the extent that, to gain control, he has to acquire a no lower ownership stake than the incumbent and to compensate his control rents upfront.[295] These conditions are always met when takeovers are friendly and the acquirer cannot just purchase the controller's office.

A necessary corollary of the sale of office prohibition, in the acquisition of a free-standing firm, is that the incumbent management cannot play favorites with bidders concerning the size of severance payments, for this may allow the firm's stock to be acquired below its value; we know that policing this kind of collusion is also necessary to prevent looting.[296] Finally, the acquirer must not be allowed to subsidize a value-decreasing takeover through either compulsory acquisition of non-controlling shares or outright diversion of their value. Therefore, when sale of office is prohibited, a ban on looting is both a necessary and a sufficient condition for value-decreasing takeovers to be ruled out; post-takeover squeeze-out does not affect this result, and just maximizes the probability of value-increasing takeovers, when it is regulated efficiently.

d) Can Takeover Regulation Substitute for Weak Fiduciary Duties?

Two potential objections to this reasoning are worth briefly commenting upon. The first is that legal systems that perform poorly in policing ongoing extraction of diversionary PBC cannot be reasonably expected to provide an effective ban on looting in takeovers. This makes sense, and indeed represents the strongest argument in favor of the mandatory bid rule, in spite of its many drawbacks.[297] To start with, if we assume that corporate law is just unable to set a sufficiently low upper bound on the controller's ability to implement non-pro-rata distributions, only controlling shareholder systems are feasible in corporate governance.[298] Then the risk is

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[294] See *supra*, Chapter Eight, section 8.1.

[295] See *supra*, section 10.2.3.

[296] For the contrarian view that allowing management to play favorites with shareholders at the takeover stage would be efficient, in that favoritism better aligns managerial incentives with shareholder interest *ex ante*, see Choi, S.J. and Talley, E.L. [2002], *Playing Favorites with Shareholders*, in SOUTHERN CALIFORNIA LAW REVIEW, vol. 75, 271-374.

[297] See Enriques, L. and Gatti, M. [2006a], *EC Reforms of Corporate Governance and Capital Markets Law: Do They Tackle Insiders' Opportunism?*, Working Paper, available at www.ssrn.com, 14-15. More broadly on this point, see Enriques, L. [2002b], MERCATO DEL CONTROLLO SOCIETARIO E TUTELA DEGLI INVESTITORI. LA DISCIPLINA DELL'OPA OBBLIGATORIA, 15-39, Il Mulino.

[298] Bebchuk, L.A. [1999], *op. cit.*

high that takeovers result in further inefficiency, both *ex ante* and *ex post*, due to looting. In order to ensure some investor's confidence, it might be preferable to prevent this result from occurring by compelling the control premium to be shared with minority shareholders in the event of a takeover. This rule is easy to enforce in spite of corporate law's deficiencies in coping with stealing by controlling shareholders.[299]

However, there are both practical and logical counterarguments. The practical ones are that the rule has a very high cost in terms of efficiency of the takeover process, and that a more efficient dynamics of control allocation can only be allowed to the extent that the mandatory bid is either circumvented or made less burdensome: either solution cannot avoid the risk of value-decreasing takeovers. The logical counterargument is that policing diversionary PBC through takeover regulation is inappropriate: the problem of non-pro-rata distributions is both broader and different from efficiency of changes in control, upon which it has just side-effects. Stealing in corporate governance should be just addressed by different legal tools. In conclusion, what can be only conceded to this position is that improvement of these tools is a precondition for a more liberal approach to takeover regulation.[300]

This leads me to the second potential objection: the approach to shareholder protection that I am advocating is based on incremental diversion being ruled out of takeovers, but can do nothing to decrease the amount of diversionary PBC in the system. Apparently, an alternative regulation may also achieve this result. According to professor Gilson, the combination of the mandatory bid with the breakthrough rule may allow cross-border acquisitions to eliminate progressively diversionary PBC.[301] This result is obtained by combining two constrains: that on the incumbent's ability to protect his private benefits (breakthrough) and that on the insurgent's ability to extract his own (mandatory bid). Under these conditions, takeovers are efficient when the acquirer is committed, by the legal system he is subject to, to transform previous diversion in future firm residual; and they are profitable to the extent he can share with tendering shareholders the expected benefits from doing so.

However, there are a number of problems with this mechanism, which make it unlikely to produce the desired outcome. First, there is no legal system that can possibly guarantee an absolute commitment to no diversion of shareholder value; this turns the goal of elimination of diversionary PBC into, at best, their reduction.

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[299] Gilson, R.J. [2006], *Controlling Shareholders and Corporate Governance: Complicating the Taxonomy*, in HARVARD LAW REVIEW, vol. 119, 1675-1677.

[300] See *infra*, Chapter Eleven, section 11.5.3.

[301] Gilson, R.J. [2006], *op. cit.*, 1676-1678.

Secondly, as we have seen, the breakthrough rule can never be completely effective in disrupting rent protection, whether this would be efficient (like in the case of diversionary PBC) or not (like in the case of idiosyncratic PBC).[302] Thirdly, and most importantly, Ronald Gilson does not consider the possibility that idiosyncratic control rents are *also* involved on both the incumbent and the insurgent's side.[303] As he recognizes, hostile acquisitions are both undesirable and most likely to be short-circuited when the 'good kind' of PBC determines the presence of controlling shareholders.[304] What he overlooks is that the same holds when the two kinds of private benefits are simultaneously at play. That control may feature just diversionary PBC is just an unrealistic scenario. Seeking reduction of diversionary PBC through artificial injection of hostility in the takeover process cannot but interfere with otherwise efficient protection of control rents, and is therefore irreconcilable with incentive-compatibility of corporate governance.

[302] See *supra*, section 10.4.4.

[303] See instead Coates, J.C. IV [2003], *op. cit.*, for discussion of this scenario.

[304] "In contrast, the breakthrough rule's threat to control in efficient controlling shareholder systems would be substantially more muted. Because of the low level of pecuniary private benefits of control in an efficient controlling shareholder system, there would be no easy source of premiums for would-be bidders." Gilson, R.J. [2006], *op. cit.*, 1677.

CHAPTER ELEVEN – Regulation of Control Transactions (II): How It Is, How It Should Be

11.1. The Emergence of Two Opposite Models of Takeover Regulation

After the extensive discussion of the functional elements of takeover regulation in the past Chapter, the analysis of the actual discipline in corporate laws is going to be relatively straightforward from both a positive and a normative standpoint. Yet one point is worth making beforehand: takeover regulation is a relatively recent phenomenon. It has been generated by the need to cope with new problems arising from the increase in the frequency of changes in control brought about by likewise increasing separation of ownership and control. The two are in fact related, and the relationship is supported by stock market development that nurtures both firm's access to equity finance and a vibrant market for corporate control.[1] The characteristics of this relationship, and its bearing on the patterns of economic growth, are far beyond the scope of this inquiry.[2] However, it is not by chance that takeover regulation was first established in those countries that experienced, before others, extensive separation of ownership and control, and still lead the rest of the world in this particular respect. These countries are Great Britain and the United States.

In the second half of the twentieth century, it became evident in both countries that separation of ownership and control was creating a market for corporate control on the side of the stock market.[3] Paralleling the shrinkage of controlling ownership, hostile takeovers became not just a matter of academic debate, but also a real

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1 Mayer, C. and Sussman, O. [2001], *The Assessment: Finance, Law, and Growth*, in OXFORD REVIEW OF ECONOMIC POLICY, vol. 17, 457-466.

2 See *supra*, Chapter Four, section 4.2.2, for a selective list of references.

3 See, illustratively, Coffee, J.C. Jr. [2001b], *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, in YALE LAW JOURNAL, vol. 111, 1-82.

option for making profits that were unimaginable in connection with more traditional patterns of stock trading.[4] This created two separate, and in a sense opposite, concerns: that of corporate control being unstable, thereby forcing managers to forego long-term investments for short-term stock returns;[5] and that of corporate ownership being under-protected, thereby exposing shareholders to the risk of being not dealt with fairly by a rider.[6] What is often neglected in the current debate about takeover regulation is that the latter was established exactly to address these concerns, by narrowing the scope for hostile acquisitions accordingly.[7] In the US, securities regulation placed a number of constraints on the rider's ability to profit from pre-bid purchases and from any discriminatory structure of the tender offer.[8] In the UK, the rider was even obliged to make an 'any or all' bid for outstanding shares in order to take over – a solution which has never been upheld by American law.[9] Then, American state laws enabled the board of directors to provide further safeguards against hostile acquisitions, and so did Delaware courts; whereas the British regulation preferred having the hurdles of the mandatory bid tempered by the prohibition of directors from frustrating a takeover attempt.[10]

Nowadays, American and British law provide two opposite models of takeover regulation.[11] The historical roots of this divergence have been very nicely illustrated

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4 See Hamilton, R.W. [2000], THE LAW OF CORPORATIONS, West Group, 417-418 and 433-436, for an introduction to the legal background.

5 Shleifer, A. and Vishny, R. [1989b], *Equilibrium Short Horizons of Investors and Firms*, in AMERICAN ECONOMIC REVIEW, vol. 80, 148-153.

6 Franks, J., Mayer, C. and Rossi, S. [2005b], *Ownership: Evolution and Regulation* (March 25, 2005), Working Paper, available at www.ssrn.com (earlier versions: ECGI Finance Working Paper No. 09/2003; EFA 2004 Maastricht Meetings Paper No. 3205; AFA 2003 Washington, DC Meetings).

7 Armour, J. and Skeel, D.A. [2006], *Who Writes the Rules for Hostile Takeovers, and Why? The Peculiar Divergence of US and UK Takeover Regulation*, ECGI Law Working Paper No. 73/2006, available at www.ssrn.com and www.ecgi.org (hereinafter Armour, J. and Skeel, D.A. [2006], *Takeover Rules*).

8 The Williams Act was passed in 1968, introducing a federal discipline of tender offers. The Securities Act of 1934 was amended accordingly. See Easterbrook, F.H. and Fischel, D.R. [1991], THE ECONOMIC STRUCTURE OF CORPORATE LAW, Harvard University Press, 163-166, for a summary illustration of the Williams Act in the context of US takeover regulation.

9 See the City Code on Take-overs and Mergers – hereinafter the City Code (providing that takeover bids must be unrestricted, save for exceptional circumstances, and that they are mandatory when the 30% threshold of share ownership is surpassed by a person or a group of shareholders acting in concert).

10 For a comprehensive historical *excursus*, see Armour, J. and Skeel, D.A. [2006], *Takeover Rules*, cit., 29-45.

11 Kraakman, R.H., Davies, P., Hansmann, H., Hertig, G., Hopt, K.J., Kanda, H. and Rock, E.B. [2004], THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH, Oxford University Press (hereinafter Kraakman *et al.* [2004], *The Anatomy*), 164.

in both the economic and the legal literature of the past few years.[12] Here we just want to avoid one typical misunderstanding arising from the recent comparisons of Anglo-American takeover regulation: that regulation in the US is just management-oriented (or captured), since it allows contestability of corporate control to be restricted; whereas the British regulation is just more shareholder-oriented, for it has been influenced by the long-standing power of institutional investors, and then it promotes contestability.[13] This would be a superficial account of two models of takeover regulation that have proven, at least so far, to be the best in the world. Corporate governance in both the US and the UK is characterized by vibrant markets for corporate control. However, none of them is actually driven by hostile takeovers, which – despite of any appearance to the contrary – are bound to be very exceptional events in both countries.[14] Therefore, the performance of takeover regulation does not depend on whether, and to what extent, it promotes contestability. Rather, it depends on how well regulation allows takeovers to be operated on a negotiated basis, given that corporate controllers cannot be prevented from entrenching themselves if they so wish, but can only be induced to part with control when this is efficient.

I have already suggested that the American regulation may perform somewhat better in this respect, and I shall elaborate upon this shortly. But the reader should be warned that, in both the US and the UK, takeover regulation forms a system with the rest of the institutional and legal discipline of corporate governance. In Britain, the mandatory bid and the requirement that takeovers cannot be explicitly frustrated by the incumbent management may be regarded as distortions of a more efficient market mechanism. However, neither they inhibit the incumbent management's actual involvement in the takeover process nor do they prevent the most part of efficient control transactions from taking place. None of this result would probably hold if British regulation of listed companies were not also very unfavorable to controlling shareholdings. After all, the bias against controlling shareholders may be regarded as the main source of inefficiency of the British discipline of cor-

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12 See, on the one side, Franks, J., Mayer, C. and Rossi, S. [2005a], *Spending Less Time with the Family: The Decline of Family Ownership in the UK*, in R. Morck (ed.), A HISTORY OF CORPORATE GOVERNANCE AROUND THE WORLD: FAMILY BUSINESS GROUPS TO PROFESSIONAL MANAGERS, NBER Conference Volume, University of Chicago Press, 581-607 (also available as NBER Working Paper No. 10628); on the other side, Armour, J. and Skeel, D.A. [2006], *Takeover Rules*, cit.

13 By and large, this is the bottom line suggested by both the studies cited in the previous note.

14 See, respectively, Schwert, G.W. [2000], *Hostility in Takeovers: In the Eyes of the Beholder?*, in JOURNAL OF FINANCE, vol. 55, 2599-2640; and Weir, C. and Laing, D. [2003], *Ownership Structure, Board Composition and the Market for Corporate Control in the UK: An Empirical Analysis*, in APPLIED ECONOMICS, vol. 35, 1747-1759.

porate governance, and it is perhaps the only one.[15] The British takeover regulation fits pretty well this system, although it may be improved; but the same takeover regulation may have disruptive effects on the dynamics of control allocation when it is applied to corporate governance otherwise characterized by the dominant presence of controlling shareholders. This is, in essence, the mistake of having emulated the British model in the European regulation of takeovers. We will come to this after a more detailed comparison of takeover regulation in the US and the UK.

11.2. The Discipline of Control Transactions in the US

We have seen in the foregoing Chapters that one point of strength of the American discipline of corporate governance lies in its being equally suitable to managerial and shareholder control, when both distribution of control powers and prevention of their abuse are considered.[16] The same basically holds for the discipline of control transactions. But, this time, let us consider managerial control and shareholder control separately. It will be shown, nonetheless, that US takeover regulation performs equally well in preventing value-decreasing changes in control and promoting value-increasing ones when a controlling shareholder or professional managers are in charge.

11.2.1. Takeover of Free-Standing Firms

a) The Management's Bargaining Power

American managers face very little constraints on their ability to cash in control rents through a takeover.[17] Golden parachutes are customarily a part of the manager's compensation package, and they are quite often renegotiated in the event of an acquisition.[18] The empirical evidence shows that these renegotiations are a part of the takeover bargaining strategy, and that they systematically determine a lower

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15 See *supra*, Chapter Seven, section 7.3.2.

16 See *supra*, Chapter Seven, section 7.5.2; Chapter Nine, section 9.2.2.

17 Kraakman *et al.* [2004], *The Anatomy*, cit., 168.

18 See Almazan, A. and Suarez, J. [2003], *Entrenchment and Severance Pay in Optimal Governance Structures,* in JOURNAL OF FINANCE, vol. 58, n. 2, 583-540. Similar results are obtained by accelerated vesting of stock options plans upon a change in control. See Kahan, M. and Rock, E.B. [2002], *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, in UNIVERSITY OF CHICAGO LAW REVIEW, vol. 69, 896-897.

takeover premium for outside shareholders.[19] However, it is unclear from regression analysis whether severance payments and other benefits from the incumbent management's exit come at the expenses of target shareholders. It actually seems that renegotiation of severance payments is more than offset by reduction of the takeover premium. On the one hand, this means that "acquirer-paid sweeteners" reduce the overall cost of acquisitions; on the other hand, this may involve that target shareholders are being exploited by trading higher severance payments for lower takeover premia.[20]

However, corporate law in the US prevents managers, at least in their capacity as directors, from playing this kind of tricks with shareholders. There are several elements of Delaware case-law which make sure that directors cannot trade higher severance payments for a lower takeover bid, even though they otherwise enjoy a considerable degree of freedom in bargaining over both their golden parachutes and shareholders' takeover premium *separately*. Simply put, they can do anything but colluding with the bidder on severance payments, since they are strictly prevented from restricting both potential and actual bidding competition in such a fashion. In negotiating an acquisition, there are a number of legal constraints on the management's ability to collude with the acquirer.

A first constraint is that a reasonable investigation has to be made on possible alternatives for a plainly negotiated deal to go through safely.[21] This is especially required by Delaware courts when the reputational incentives of the CEO – who gives the green light to the acquisition and is also supposed to exert a considerable influence over the other board members – are weakened by his being at the end of his career (a typical endgame problem which makes hidden conflict of interest the most worrisome).[22] Although the failure to conduct this investigation on potential bidders is regarded as a breach of the duty of care, and not of the duty of loyalty, the result is unchanged. The only positive significance attached by Law and Economics commentators to the infamous *Smith v. Van Gorkom* decision, in spite of its contradictions with the business judgment rule, is that it counters the tendency of incumbent managers to conceal a sale of office under the appearance of an arm's length control transaction, which may be especially problematic when they are in their last period of play.[23]

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19 Hartzell, J., Ofek, E. and Yermack, D. [2004], *What's In It for Me? CEOs Whose Firms Are Acquired*, in REVIEW OF FINANCIAL STUDIES, vol. 17, 37-61.

20 Bebchuk, L.A. and Fried, J.M. [2004], PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION, Harvard University Press, 87-94.

21 Bainbridge, S.M. [2002a], CORPORATION LAW AND ECONOMICS, Foundation Press, 648-651.

22 Smith v. Van Gorkom, 488 A.2d 858 (Del.Sup.1985), discussed *supra*, Chapter Nine, section 9.2.2.

23 Rock, E.B. and Wachter, M.L. [2001], *Islands of Conscious Power: Law, Norms and the Self-Governing Corporation*, in UNIVERSITY OF PENNSYLVANIA LAW REVIEW, vol. 149, 1686-1689.

Even in the absence of the *Van Gorkom* ruling, the management should be very careful in negotiating side payments in exchange for low bids. "Where side payments persuade the target's board to accept a low initial offer, a second bidder may – and often does – succeed by offering shareholders a higher-priced alternative."[24] Then the game would be over, since Delaware law compels directors to just accept the highest bid in this case. Actual bidding competition triggers the *Revlon* standard, according to which the board should behave like a neutral auctioneer.[25] Does this mean that directors have *always* to seek for the highest takeover premium for shareholders? I believe not, and this is indeed the peculiarity of Delaware law when it comes to takeover regulation.[26] Facing an unwanted takeover bid, directors may 'just say no.' On condition that this does not absolutely prevent the firm from being acquired either now or in the future, this decision will be upheld by Delaware courts under the business judgment rule.[27]

This is how American directors come to enjoy so much bargaining power in corporate acquisitions. Actually, when the time to sell has come, 'saying no' is anyway the best strategy for initiating negotiations.[28] Then the bargaining starts and it may initially concern also the severance payment. When a competing bid materializes, the bargaining power of incumbent management would be lost. However, competition would be also against the interest of the first bidder.[29] Therefore, the insurgent and the incumbent are most likely to settle for a severance payment high enough to induce management to part with control, and a takeover premium attractive enough to allow the bid to be both uncontested and successful.[30] This strategy is compatible with a number of complications that we observe in the takeover practice, like for instance the attraction by the management of a favored bid (so-called 'white knight'). Short of promoting real competition, white knights, greenmail, and similar tactics just serve the purpose of raising the incumbent management's outside option, and are therefore to be regarded as a part of the bargaining strategy.[31]

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24 Bainbridge, S.M. [2002a], *op. cit.*, 650

25 Revlon, Inc. v. MacAndrews and Forbes Holdings, Inc., 506 A.2d 173 (Del.Sup.1986), discussed *supra*, Chapter Seven, section 7.3.1.

26 Bainbridge, S.M. [2002a], *op. cit.*, 705-718.

27 See *supra*, Chapter Seven, section 7.3.1.

28 See, for theoretical and empirical discussion of this strategy, Schwert, G.W. [2000], *op. cit.* On the legal side, see Bainbridge, S.M. [2002a], *op. cit.*, 648-651.

29 Burkart, M. and Panunzi, F. [2006b], *Takeovers*, ECGI Finance Working Paper No. 118/2006, available at www.ssrn.com and www.ecgi.org, 20-22.

30 See *supra*, Chapter Ten, section 10.3.1.

31 Shleifer, A. and Vishny, R. [1986b], *Greenmail, White Knights, and Shareholders' Interest*, in RAND JOURNAL OF ECONOMICS, vol. 17, 293-309.

b) *Freeze-Outs and Shareholder Protection*

The American discipline of the incumbent's behavior conforms to the key functional elements of an efficient takeover regulation. Management entrenchment is coupled with the possibility to renegotiate severance payments, whereas opportunistic renegotiation at the shareholders' expenses is constrained by a meaningful prohibition of sale of office. But what about the acquirer's gains? In the US, this problem is tackled by a complicated body of rules, which results in a rather unique discipline of freeze-outs. This discipline makes sure that non-controlling shareholder cannot be made any worse-off by a takeover, whereas the acquirer is entitled to reap all the gains necessary to motivate an efficient change in control. Takeover premia are determined independently, by the pattern of negotiations between the bidder and the incumbent board described above. As a result, this legal arrangement maximizes the chances that value-increasing acquisitions go through, while ensuring that value-decreasing takeovers cannot be subsidized by inefficient freeze-out of non-tendering shareholders. The residual possibility that takeovers feature higher diversionary private benefits of control (PBC) is also excluded by a strict enforcement of the controlling shareholder's fiduciary duties, which result in an effective ban on post-takeover looting that will be discussed later.

A major source of uniqueness of the American discipline of freeze-out is the traditional absence of a discipline of legal capital.[32] This involves that shareholders can easily exit the company by receiving cash out of the corporate treasury.[33] One typical way to do this is the so-called cash-out merger, by which minority shareholders receive cash as consideration while the controlling shareholder gets all the shares of the surviving company (which is normally a wholly own subsidiary).[34] The transactional technique may vary, but the problem is always the same: the adequacy of consideration received by minority shareholders. It is for this reason that, originally, corporate law used to require unanimous shareholder approval of mergers. Given the evident hold-up potential of this rule, it was rapidly substituted with majority approval. Most American states – including Delaware – today require only

[32] This is a major difference from European jurisdictions. However, the issue of legal capital is outside the scope of the present inquiry. See Enriques, L. and Macey, J.R. [2001], *Creditors versus Capital Formation: The Case against the European Legal Capital Rules*, in CORNELL LAW REVIEW, vol. 86, 1165-1204.

[33] There are subtle distinctions between organic changes having the purpose of cashing out minority shareholders. Especially in the context of close corporations, squeeze-outs, freeze-outs, and cash-out mergers have (slightly) different meanings. See Hamilton, R.W. [2000], *op. cit.*, 365-366. Since I am focusing only on publicly held corporations here, I shall use the three expressions interchangeably.

[34] Hamilton, R.W. [2000], *op. cit.*, 621-622.

50% of outstanding shares to approve a merger, although a few states still require a 2/3 majority.[35] In exchange for that, the possibility for dissenting shareholders to have their share judicially appraised was introduced in statutory law.[36] The bottom line is that the ability to operate a cash-out merger is now generally conditional on the acquisition of just the absolute majority of outstanding shares. As it has been efficaciously pointed out, this is a form of "private eminent domain", which is only apparently tempered by the statutory appraisal right.[37] Indeed, this right provides minority shareholders with a very weak protection from receiving an inadequate consideration for their shares.

A thorough illustration of the appraisal right would lead us far away from the focus of this discussion.[38] In general, exercise of the appraisal right confronts individual shareholders with both high costs – they are not entitled to a class proceeding – and a number of 'traps for the unwary' – they may only seek appraisal between *refusing* to tender and voting *against* the merger.[39] More importantly, in takeovers, the appraisal remedy does not entitle shareholders to participate in *any* of the gains at stake. "In practice, shareholders have no reason to expect that the court's appraisal will be larger than an offer price which exceeds the pre-offer share price."[40] This means that, in spite of the appraisal right, freeze-out is a credible threat that shareholders may be exploited by a takeover. That is, freeze-outs backed by an appraisal remedy still generate pressure to tender.[41] The only possible constraint arising out of the appraisal right is that negative takeover premia are disallowed. In terms of our functional framework, this is equivalent to a sell-out right setting the pre-takeover price as a lower bound on the bid price. The hurdles of individual enforcement of this right make it quite a shaky necessary condition for takeovers to be only value-increasing; in any case, it is not sufficient. However, the statutory appraisal is neither the end of the freeze-out story in the US, nor the most important part of it.

The core of freeze-out law in the US lies in the fiduciary duties judicially imposed on both the target's board and the acquirer, as soon as he becomes a controlling shareholder.[42] In the leading case *Weinberger v. UOP*, the Supreme Court of

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35 Bainbridge, S.M. [2002a], *op. cit.*, 351-352; Hamilton, R.W. [2000], *op. cit.*, 627-629.

36 Easterbrook, F.H. and Fischel, D.R. [1991], *op. cit.*, 145-161.

37 Bainbridge, S.M. [2002a], *op. cit.*, 352.

38 See, for a detailed discussion, Id., at 632-645.

39 Hamilton, R.W. [2000], *op. cit.*, 628; Bainbridge, S.M. [2002a], *op. cit.*, 352.

40 Amihud, Y., Kahan, M. and Sundaram, R.K. [2004], *The Foundations of Freezeout Laws in Takeovers*, in JOURNAL OF FINANCE, vol. 59, 1341 (hereinafter Amihud *et al.* [2004], *Freezeout*)

41 Bebchuk, L.A. [1987], *The Pressure to Tender: An Analysis and a Proposed Remedy*, in DELAWARE JOURNAL OF CORPORATE LAW, vol. 12, 911-949.

42 Kraakman *et al.* [2004], *The Anatomy*, cit., 143 and 183-184.

Delaware ruled that a freeze-out merger must satisfy an 'entire fairness' standard, including both 'fair price' and 'fair dealing' *simultaneously*.[43] On the one hand, this makes effective the lower bound on the squeeze-out consideration set by the appraisal right equal to the pre-takeover price; despite of *Weinberger*'s opining to the contrary – which was subsequently overruled – a freeze-out merger does not preclude enforcement of fiduciary duties through derivative litigation.[44] On the other hand, "the test is not a bifurcated one," so that once fair dealing is in question also the requirement of fair price must be satisfied in order for a freeze-out to be legal.[45] An acquirer will have little chance to meet these requirements after he becomes a controlling shareholder. He would be on both sides of the freeze-out transaction then, and this would automatically exclude fair dealing in the absence of independent approval.[46] If we reason by backwards induction, this is extremely risky for a would-be acquirer, since failure to obtain approval by the majority of (remaining) minority shareholders will compromise legality of the cash-out merger and, in turn, profitability of the takeover. However, the acquirer has also the option of negotiating the freeze-out merger as a follow-up of the takeover bid, when he is not yet a controlling shareholder and fiduciary duties rests on the target's board.[47] This solution requires cooperation of the target's board and that the squeeze-out price is set somewhat higher than the pre-takeover price, and in any case equal to the bid price.

Board cooperation is no problem in our framework, since it is bound to obtain anyway for the takeover to be operated, at the end of the day, as a friendly deal. To

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43 Weinberger v. OUP, Inc., 457 A.2d 701 (Del.Sup.1983).

44 Bainbridge, S.M. [2002a], *op. cit.*, 358-360. Technically, *Weinberger* is a complicated opinion to handle. It overruled a number of precedents, but only did so prospectively. Under *Singer*, the statutory appraisal was not the sole remedy available to disgruntled shareholders in a cash-out merger. Singer v. Magnavox Co., 380 A.2d 969 (Del.Sup.1977). *Weinberger* still granted shareholders a cause of action on equitable grounds, but ruled that, for the future, shareholder remedies should have been confined to those available under the statutory appraisal procedure (which, as we know, does not allows for a class action). The Supreme Court of Delaware did not hold on this position for long. In *Rabkin*, it ruled that *Weinberger* only precluded class (derivative) actions challenging fairness of the price. Rabkin v. Philip A. Hunt Chemical Corp., 498 A.2d 1099 (Del.Sup.1985). At least in Delaware, fair dealing can still be questioned at common law. In contrast, § 13.02 of the Revised Model Business Corporation Act (MBCA) makes the appraisal remedy exclusive "unless the action is unlawful or fraudulent with respect to the shareholders or the corporation."

45 Weinberger v. OUP, Inc., 457 A.2d 701, 713 (Del.Sup.1983). See Enriques, L. [2000], *The Law on Company Directors' Self-Dealing: A Comparative Analysis*, in INTERNATIONAL AND COMPARATIVE CORPORATE LAW JOURNAL, vol. 2, 297-333, for discussion.

46 When there is a controlling shareholder the requirement of independent approval of conflicted transactions is met when a majority of minority shareholders (hereinafter MOM) approve the deal on the basis of adequate information about its terms. To this purpose, an opinion should be issued by a special-purpose committee (SC) of independent directors. See Bainbridge, S.M. [2002a], *op. cit.*, 357, and *supra*, Chapter Nine, section 9.2.2.

47 Amihud *et al.* [2004], *Freezeout*, cit., 1342.

understand why the squeeze-out price must rise up to the level of the bid price, consider instead the following circumstances. First, Delaware (but, to be sure, also non-Delaware) judges consider freeze-out as too a dangerous transaction to be protected by the business judgment rule at any rate: this means that fair dealing may only result in a shift of the burden of proof – i.e., disgruntled shareholders may still prove that the freeze-out consideration was unfair.[48] Second, the target board can satisfy the fair dealing requirement by negotiating with the bidder the terms of the post-takeover merger, submitting the agreement to an independent special-purpose committee, and, on condition that the special committee endorses it (which it will normally do), have the merger approved by shareholders.[49] This last requirement is considered as implicitly satisfied when the majority of shareholders of a free-standing firm tender their shares, provided that there is no coercion.[50] Third, shareholders may still challenge the transaction on grounds that freeze-out consideration is unfair, when the latter is any lower than the bid price. However, when the two are equal, neither coercion in the bid nor unfairness of the freeze-out price can be invoked to question the validity of the deal – provided that none of them is lower than the current stock price.[51] This is how freeze-out law in the US is interpreted as requiring that the squeeze-out price be equal to the highest between the bid and the market price.[52]

It is important to highlight that such an arrangement would not be equally available to the acquirer at a later stage, namely when he has become a controlling shareholder: normally, he will have either to prove 'entire fairness' of freeze-out or to seek approval by a majority of *remaining* minority shareholders in order to shift the burden of proof.[53] The importance of this remark will get clearer in the analysis of sales of control blocks. Conversely, recent developments in Delaware case-law have made somewhat easier to implement the above mechanism of pre-arranged freeze-out. The issue is known under the heading of *Siliconix* and its progeny, and it

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48 Kraakman *et al.* [2004], *The Anatomy*, cit., 143. See also *supra*, Chapter Nine, section 9.2.2.

49 Kahn v. Lynch Communication Systems, 638 A.2d 1110, 1117 (Del.Sup.1994).

50 Amihud *et al.* [2004], *Freezeout*, cit. 1342.

51 This issue is quite technical as a matter of civil procedure, and it is not really necessary to discuss it in much detail. It is just worth noting that coercion impinges on fair dealing, which is easier to challenge in courts. On the contrary, fairness of price can only be challenged in a statutory appraisal proceeding when fair dealing is not in question. When the squeeze-out price is equal to the bid, the transaction can hardly be attacked on either ground.

52 See, for an amazing example of integration of legal and economic analysis, Amihud *et al.* [2004], *Freezeout*, cit.

53 Bainbridge, S.M. [2002a], *op. cit.*, 355-357. The reader should recall that, in this kind of transactions, independent advice by a SC and informed approval by a MOM only shifts the burden of proof. See Id., at 360, and compare with *supra*, Chapter Nine, section 9.2.2.

is currently very much debated in the American legal literature.[54] Basically, after the Chancery Court's ruling in *Siliconix* (confirmed, just one month later, by the Supreme Court in *Glassman*), Delaware courts do no longer apply the entire fairness test for reviewing freeze-outs, so long as they are implemented through a short-form merger follow-up to a tender offer and the consideration is equal to the bid price.[55] The advantage of a short-form merger is that it does not require approval by either the target's board or its shareholder.[56] The disadvantage is that at least 90% of outstanding shares are needed to operate it.[57] All in all, the creation of this new safe harbor adds little to the ability of the acquirer of a free-standing firm to efficiently squeeze-out minority shareholders, save that making the bid conditional on 90% of the shares being tendered might be desirable for the deal to be absolutely insulated from shareholder litigation. However, this ruling may have important implications in acquisitions from controlling shareholders, which – at least to my knowledge – have not yet been completely explored.[58]

c) Are Shareholders Protected Any Further?

To conclude about the acquirer's gains, it should be noticed that American law does not otherwise feature distortions of the takeover process. To start with, there is no general requirement of a mandatory bid. Federal regulation does not even prevent restricted bids, so long as shareholder rationing is executed pro-rata and not on a 'first-come, first-served' basis.[59] The federal requirement that all tendering shareholders shall be granted equal treatment does not alter the overall picture anyhow. The substantial disclosure obligations imposed on both the bidder and the target's board by securities regulation indeed affect the overall cost of takeovers, but we do not consider this problem here. Still, some constraints on the structure of the bid do arise under state law, and at first glance, they may seem to be equiva-

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[54] See Subramanian, G. [2007], *Post-Siliconix Freeze-Outs: Theory and Evidence*, in JOURNAL OF LEGAL STUDIES, vol. 36, 1-26.

[55] In re Siliconix, Inc. Shareholders Litigation, 2001 WL 716787 (Del.Ch.2001); Glassman v. Unocal Exploration Corp., 777 A.2d 242 (Del.Sup.2001).

[56] In a short-form merger, minority shareholders are only entitled to appraisal of their shares. Hamilton, R.W. [2000], *op. cit.*, 623-624.

[57] See Delaware General Corporation Law (DGCL) § 253(a) and MBCA § 11.05.

[58] See *infra*, section 11.2.2.

[59] Armour, J. and Skeel, D.A. [2006], *Takeover Rules*, cit., 29-35 (noticing, at 33, that "the mantra of the legislative debates [which ultimately led to the enactment of the Williams Act] was "neutrality"). For a more detailed illustration of the federal regulation of tender offers, see Bainbridge, S.M. [2002a], *op. cit.*, 654-677.

lent to a mandatory bid.[60] Upon a more careful investigation, however, they turn out to be irrelevant so long as the bid is operated as a part of a negotiated deal with the target's board.

Many states feature anti-takeover statutes in their corporate law.[61] So-called 'fair price' provisions are an illustrative example. By and large, these provisions – which may alternatively be included in the company's articles of incorporation – confers upon shareholders the right to be bought out at the highest price paid by a rider in the acquisition of corporate control. Apparently, this amounts to a sell-out right in the worst possible configuration for the acquirer, since it may force him to give up most part of the takeover gains, and possibly all of them. In addition, fair price provisions exclude the possibility of two-tier offers since the squeeze-out option is superseded by a more favorable sell-out right. However, this right is only triggered by unwanted acquisitions and has therefore the same practical effect of a poison pill. That is, it forces would-be acquirers to come to terms with the target's board. As a result, two-tier bids are of no use in any case: they cannot be used to overcome the board's resistance (which is always allowed, if not required, by Delaware courts in the presence of a coercive bid);[62] they cannot be featured by a negotiated deal, for it needs to involve no coercion to be legal.[63] It is thus unsurprising that two-tier bids have disappeared from the takeover practice in the US.[64] Apart from

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60 Berglöf, E. and Burkart, M. [2003], *European Takeover Regulation*, in ECONOMIC POLICY, vol. 18, 188, report that the mandatory bid rule only exists in Pennsylvania and Maine. However, they most probably refer to state anti-takeover laws (see Armour, J. and Skeel, D.A. [2006], *Takeover Rules*, cit., 10), briefly discussed *infra* in the text.

61 Historically, anti-takeover statutes intervened to support the implementation of so-called 'shark-repellents' in the corporate charters. For the view that shark repellents are an economically sound response to the problem of shareholder coordination in takeovers, see Carney, W.J. [1983], *Shareholder Coordination Costs, Shark Repellents, and Takeout Mergers: The Case against Fiduciary Duties*, in AMERICAN BAR FOUNDATION RESEARCH JOURNAL, vol. 1983, 341-392.
State anti-takeover legislation is a big issue in American corporate law. It actually involves a number of legal technicalities which are not even touched upon here. There are at least three generations of anti-takeover statutes. The first one – giving state officers veto power over the acquisition of any company doing business in the state – was declared unconstitutional by the US Supreme Court. Edgar v. MITE Corp., 457 U.S. 624, 102 S.Ct. 2629, 73 L.Ed.2d 269 (1982). The second generation – including 'fair price' statutes – was upheld by the Supreme Court in CTS Corp. v. Dynamics Corp., 481 U.S. 69, 107 S.Ct. 1637, 95 L.Ed.2d 67 (1987). The third-generation statutes – so-called 'business combination statutes' – have considerably more bite on unwanted takeovers, since they prevent the acquirer from operating a merger in the absence of approval by either the board (before the acquisition) or a super-majority of minority shareholder (after the acquisition). Delaware has enacted a statute of this type. See *infra* in the text. See also Bainbridge, S.M. [2002a], *op. cit.*, 747-767, for more details.

62 Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del.Sup.1985).

63 See *supra*, text accompanying notes 48-51.

64 Amihud *et al.* [2004], *Freezeout*, cit. 1335.

that, fair price statutes or charter provisions have no effect on the structure of a takeover bid, provided that it is negotiated with the incumbent board. Indeed, in other states (like in Delaware), these provisions are replicated by statutes that more explicitly prevent raiders from operating 'business combinations' (including a freeze-out merger) for some time, in the absence of previous agreement with the target board or subsequent approval by a super-majority of minority shareholders.[65]

Finally, sophistication of Delaware courts in enforcing fiduciary duties prevents takeovers from being driven by diversion of shareholder value. To start with, the acquirer cannot collude with the target's board for looting the company, since – as we have seen – the fiduciary obligations of the board exclude any form of collusion with bidders. More importantly, however, the acquirer is effectively prevented from looting the company on his own. On the one hand, when he acts in his capacity as controlling shareholder, the acquirer is prevented from entering into any transaction that may deprive minority shareholders of anything belonging to them. Whenever a potential conflict of interest is involved, the transaction must be approved by a majority of the minority or, alternatively, it requires that entire fairness be proved by the controlling shareholder.[66] On the other hand, exploiting minority shareholders through unfavorable freeze-out terms is also not an option, for this kind of transaction is likewise subject to the entire fairness standard of review.[67] This point is better illustrated with reference to the sale of control blocks.

11.2.2. Taking Over from a Controlling Shareholder

a) Regulation of Control Sales

In the US, the sale of control blocks is regulated by the market rule.[68] Acquirers have neither to make a tender offer for non-controlling stock nor to provide minority shareholders with equal opportunities as to the control transaction. On the one hand, this imply that the incumbent may cash in his control rents through bargaining with the insurgent, which will actually result in a change in control inas-

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[65] DGCL § 203. Notice that § 203 may be opted out by the articles of incorporation. In addition, the restrictions on business combinations are waived conditional upon acquisition of 85% of the stock which is not under the insiders' control.

[66] See *supra*, Chapter Nine, section 9.2.2.

[67] Weinberger v. OUP, Inc., 457 A.2d 701 (Del.Sup.1983).

[68] Kraakman *et al.* [2004], *The Anatomy*, cit., 176-178. for the distinction between 'market rule' and 'equal opportunity rule' see Bebchuk, L.A. [1994], *Efficient and Inefficient Sales of Corporate Control*, in QUARTERLY JOURNAL OF ECONOMICS, vol. 109, 957-993, discussed *supra*, Chapter Ten, section 10.4.2.

much as it leaves the latter with a sufficient share of the takeover gains. On the other hand, minority shareholders have no right of exit, nor are they entitled to share in the control premium at any rate. The question that naturally arises is how shareholders are otherwise protected from value-decreasing changes in control that, apparently, could just be imposed upon them. This question has not been neglected by American courts, which occasionally 'flirted' with the equal opportunity rule.[69] However, the latter rule has never become a part of the US states common law.[70]

Both courts and commentators tend to regard sales of control blocks on the free market as transactions that are normally beneficial to minority shareholders, in that they essentially feature an efficient dynamics of control allocation.[71] This view – which I definitely subscribe to – is supported by the empirical evidence, at least that regarding block trades in the US.[72] As a result, one fundamental principle of American corporate law is that controlling shareholders are free to dispose of their stock as they wish, and they may decide to sell or not to sell corporate control without consulting the minority. This principle is rather unique in the discipline of listed firms by most developed countries, but – even in the US – it is not without exceptions.

To start with, a controlling shareholder is not entitled to sell to a looter. This may seem rather obvious in case of outright fraud, but the transaction may be also challenged on grounds of gross negligence or misrepresentation of material facts.[73] By and large, a *Van Gorkom*-type suit might be brought on the first prong, not because the controlling shareholder has a positive duty to investigate, but because courts would hold him liable when it was apparent from the transaction terms that it had hardly any business purpose other than looting.[74] A class action might be brought on the second prong, when the sale is operated in connection with trading on the market and it is not timely and properly disclosed.[75]

Second, a controlling shareholder is prohibited (like the management) from sale of office. However, the prohibition has little bite given the acquirer's ability to take

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69 Perlman v. Feldmann, 219 F.2d 173 (2nd Cir.1955), discussed in Easterbrook, F.H. and Fischel, D.R. [1991], *op. cit.*, 126-129. on the major inconsistencies of Delaware case-law when it comes to control premia, see instead Carney, W.J. and Heimendinger, M. [2003], *Appraising the Nonexistent: The Delaware Courts' Struggle with Control Premiums*, in UNIVERSITY OF PENNSYLVANIA LAW REVIEW, vol. 152, 845-880.

70 Hamilton, R.W. [2000], *op. cit.*, 518-519.

71 Bainbridge, S.M. [2002a], *op. cit.*, 348-349.

72 Holderness, C.G. [2003], *A Survey of Blockholders and Corporate Control*, in FEDERAL RESERVE BANK NY – ECONOMIC POLICY REVIEW, April 2003, 51-64.

73 Hamilton, R.W. [2000], *op. cit.*, 519-521.

74 Rock, E.B. and Wachter, M.L. [2001], *op. cit.*, 1680-1686.

75 Hamilton, R.W. [2000], *op. cit.*, 522.

control of the board without cooperation by the seller, as soon has he purchases the majority of voting stock.[76] The prohibition is only useful to guarantee that no change in control can take place without transfer of controlling ownership.[77]

Third, most recent developments in Delaware case-law apparently suggest that a stricter approach to the payment of the control premium is in the making.[78] In late 2005, the Chancery Court held that entire fairness of a merger granting a 10% premium on high-voting shares was a triable issue, at least in the absence of properly independent approval by a special-purpose committee.[79] Since the case never went to trial, it is currently uncertain whether, and on what conditions, controlling shareholder are entitled to extract a control premium through a dual class security-voting structure, when the sale of control is implemented by a merger with a third party.[80]

b) Protection of Minority Shareholders

Much more important is that, however control is transferred, the acquirer is prevented from abusing on minority shareholders. As I mentioned before, the strictness of fiduciary duties in the US provide an effective upper bound on the controlling shareholder's ability to siphon off assets from the company.[81] If we take into account that courts also police collusion, especially when it comes to looting, it is unlikely that sales of control blocks can be motivated by the acquirer's ability to extract higher diversionary PBC than the seller. Still, as we know, a majority shareholder is entitled by American law to freeze-out minority shareholders. Once again, fiduciary duties prevent him from going for this strategy on any unfavorable terms to minority shareholders.

When a controlling shareholder is in charge, the demanding requirements of *Weinberger* apply.[82] To start with, shareholders cannot be frozen out at any price

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76 Bainbridge, S.M. [2002a], *op. cit.*, 345-346.

77 Easterbrook, F.H. and Fischel, D.R. [1991], *op. cit.*, 132-134.

78 Allen, W.T. [2006], *U.S. Corporate Governance: The Treatment of Controlling Shareholders, with Special Focus on Dual Vote Structures*, briefing on Comparative Regulation, TRANSATLANTIC CORPORATE GOVERNANCE DIALOGUE, Meeting of 27 June 2006 ('Controlling Shareholders and Corporate Governance'), transcripts (slides) available at www.ecgi.org

79 The Chancery Court considered, in a summary judgment action, a stockholder challenge to the acquisition of Tele-Communication, Inc. (TCI) by AT&T Corp., in which TCI's controller demanded for his Class B (super-voting) shares a 10% premium to Class A shares. See In re Tele-Communications, Inc. Shareholders Litigation, 2005 WL 3642727 (Del.Ch. Dec. 21, 2005, revised Jan. 10, 2006).

80 See Edwards Angell Palmer & Dodge [2006], *Delaware Court of Chancery Applies Heightened Scrutiny to Arms-Length Merger where Directors Hold Majority of Class of High-Vote Shares Entitled to Premium: Does This Decision Portend Change In Accepted M&A Practice?*, available at www.eapdlaw.com.

81 See *supra*, Chapter Nine, section 9.2.

82 Weinberger v. OUP, Inc., 457 A.2d 701 (Del.Sup.1983), discussed *supra*, section 11.2.1.

lower than the market price. More importantly, there is no price that guarantees that the transaction is entirely fair, which is something that the controlling shareholder has almost no chance of proving so long as he profits from the transaction – a necessary condition from entering it into in the first place. The only possible way out of this bind is seeking a shift of the burden of proof through approval by a majority of the minority, which can be characterized as fair dealing so long as it is supported by the opinion of a special-purpose committee guaranteeing independent information.[83] Then, a freeze-out merger can go through only for a higher consideration than the market price. Proving unfairness of such consideration in the presence of independent approval is nearly as hard as proving the contrary in its absence – there is no such thing as an objective 'fair price' for the company's stock.

c) Post-Takeover Freeze-Out: The Short-Form Merger Solution

While the above arrangement protects minority shareholders from expropriation, it does not protect the acquirer of a control block from their free riding – the majority of the minority requirement still gives shareholders the opportunity to holdout. We know that this is a no less important issue for the efficiency of the takeover process.[84] However, the American system of fiduciary duties seems also to provide a way out of this problem. The post-*Siliconix* developments of Delaware case-law allow controlling shareholders to avoid review of freeze-out transactions under the entire fairness standard, if only they implement them by a particular tender offer for non-controlling shares and the requirement of fair dealing is fulfilled.[85]

The deal is the following. After gaining control of the company, and *anytime he finds it profitable*, the acquirer makes a tender offer for non-controlling stock combined with pre-arrangement of freeze-out of non-tendering shareholders at the *same* price. Normally, this transaction would be subject to the entire fairness standard.[86]

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83 Kahn v. Lynch Communication Systems, 638 A.2d 1110 (Del.Sup.1994).

84 See *supra*, Chapter Ten, section 10.3.2.

85 In re Siliconix, Inc. Shareholders Litigation, 2001 WL 716787 (Del.Ch.2001). See, for a detailed (but critical) discussion, Subramanian, G. [2005], *Fixing Freezeouts*, in YALE LAW JOURNAL, vol. 115, 2-70. For a more favorable assessment of these developments in Delaware case-law, see Bates, T.W., Lemmon, M.L. and Linck, J.S. [2006], *Shareholder Welfare and Bid Negotiation in Freeze-out Deals: Are Minority Shareholders Left out in the Cold?*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 81, 681-708.

86 The peculiarity of this freeze-out transaction is that the requirement of independent shareholder approval may be considered as implicitly met if a MOM have tendered their shares based on independent advice by a SC of outside directors. However, under *Kahn* (Kahn v. Lynch Communication Systems, 638 A.2d 1110 (Del.Sup.1994)), this could only be sufficient to shift the burden of proof while having no impact on the standard of review. It is exactly this point that has changed with *Siliconix*. Subramanian, G. [2007], *op. cit.*, 2-3.

But there is a way to escape this. Freeze-outs are no longer regarded as conflicted interest transactions when they are executed as a short-form merger, since the controlling shareholder (the parent company) has the statutory entitlement to perform it without both a conflicted shareholder vote and an equally conflicted board approval by the subsidiary.[87] A vote of neither body is required when the parent company owns at least 90% of the outstanding stock.[88] Therefore, the next step is making the bid conditional on acquisition of at least 90% of the company's shares.

At common law, judges are constrained by statutory entitlements, but they need not otherwise refrain from applying fiduciary duties. Although a freeze-out merger cannot involve a breach of fiduciary duties when it is executed in the short-form, a tender offer conditional on enabling a short-form merger potentially can.[89] Hereby the requirements of fair dealing and fair price are restored at the bid stage, albeit in a very special configuration.[90] The fair dealing requirement is simply met by tendering of the majority of minority shareholders, provided that they are adequately informed by a special-purpose committee and its opinion is not tainted by "retributive threats" by the controlling shareholder.[91] An additional requirement of fair dealing is that the bid be non-coercive, and here is the reason why the bid and the freeze-out price must coincide.[92] But what about fair price?

A non-coercive bid can only be successful to the extent that it offers shareholders a consideration somewhat higher than the current market price. Disgruntled shareholders would have a hard time in proving the unfairness of any such consideration, and would only get a lower one if they seek appraisal of their shares.[93] As a result, shareholders will accept the deal when the premium is attractive enough, and the controller would refrain from offering any when the stock price is already too high. It is also worth noting that the controller cannot profit from a post-takeover price any lower than the pre-takeover one, when he has just acquired a control

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87 Glassman v. Unocal Exploration Corp., 777 A.2d 242 (Del.Sup.2001).

88 DGCL § 253(a)

89 Empirical evidence about the wealth effects of post-*Siliconix* freeze-outs on shareholders is mixed. Two independent studies report opposite results. For the view that these transactions are detrimental to minority shareholders, see Subramanian, G. [2007], *op. cit.*; *contra*, see Bates, T.W., Lemmon, M.L. and Linck, J.S. [2006], *op. cit.*

90 This result obtains as a doctrinal combination of *Siliconix* (in the presence of fair dealing, the entire fairness standard of review does not apply to tender offer freeze-outs) and *Glassman* (short-form mergers are not subject to entire-fairness review). See Subramanian, G. [2005], *op. cit.*, 17-22, for a comprehensive explanation.

91 This has been summarized in the last opinion of Delaware Chancery Court on the matter. See In re Pure Resources Shareholders Litigation, 808 A.2d 421 (Del.Ch.2002). The court has also clarified that the MOM tender condition must be non-waivable.

92 In re Siliconix, Inc. Shareholders Litigation, 2001 WL 716787 (Del.Ch.2001).

93 Amihud *et al.* [2004], *Freezeout*, cit., 1341-1342.

block: in this case, it would be relatively easy for shareholders to demonstrate that the bid price was unfair, given the circumstances of the acquisition, in spite of any appearance of fair dealing.[94]

In conclusion, the current state of American law matches the optimal regulation of squeeze-out that I have advocated, also when it comes to the sale of control blocks: that is, squeeze-out conditional on the making of a tender offer for non-controlling shares, and for a no lower consideration than the highest between the pre-takeover and the post-takeover market price.[95] To be sure, a threshold of 90% is imposed for the freeze-out to go through any safely. According to our framework, this may be too a stringent requirement in that it allows for some value-increasing takeovers to be prevented by minority shareholders' holdout. This might be not much of a problem given the high rate of dispersion of non-controlling ownership in the US.[96] Nevertheless, it seems still advisable for statutory law to set the threshold of short-form mergers to a somewhat lower level.

11.3. The Discipline of Control Transactions in the UK

11.3.1. A Summary of the British Style

Takeover regulation in Britain is somewhat less intricate.[97] Rules are clearly set at the statutory level, by securities regulation, or by self-regulation having traditionally a binding character: there is almost no chance of doing business at the London Stock Exchange without complying with the Takeover Code.[98] Actually, this very

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[94] Such a deal would not easily go through in the first place. No SC would be able to support it without facing a considerable risk of liability. Even if the deal was consummated on these terms, most probably a disgruntled minority shareholder would be able to bring a class action suit against the original sale of control block on grounds of looting.

[95] See *supra*, Chapter Ten, section 10.3.2.

[96] See *supra*, Chapter Two, section 2.4.4.

[97] See, for a comprehensive overview, Farrar, J.H. and Hannigan, B (with contributions by Furey, N.E. and Wylie, P.) [1998], FARRAR'S COMPANY LAW, Butterworths, (hereinafter Farrar *et al.* [1998], *Company Law*), 588-617.

[98] The preamble of the first edition of the City Code on Take-overs and Mergers (1968) is illustrative of this point:

> "The Code has not, and does not seek to have, the force of law, but those who wish to take advantage of the facilities of the securities markets in the United Kingdom should conduct themselves in matters relating to take-overs according to the Code. Those who do not so

special kind of self-regulation is the most important source of discipline of control transactions in the UK. Nowadays, it has been given statutory authority in order to comply with the recently established takeover law at the EU level, but nothing else has changed in the form or substance of regulation.[99] The rules are contained in the *City Code on Takeover and Mergers*, and they are enforced by the homonymous *City Panel* under the ultimate threat of excluding infringers from the core of British finance: that is *The City*, "the one square mile district where [all of the] London's business community is located."[100]

Others have so nicely speculated on the virtues of such an enforcement mechanism that we can just focus on the rules as if they were dictated by the law, but enforced in a virtually perfect manner.[101] The only thing is that other sources of British law have also an impact on takeovers, whereas the judiciary has almost none.[102] While the former circumstance is often overlooked, the latter is now recognized as another prominent difference from the American regulation of corporate govern-

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conduct themselves cannot expect to enjoy those facilities and may find that they are withheld."

The City Code (which in 2006 has come to its 8th edition) was the result of the pressure exerted by institutional investors faced with the emergence of the new techniques of hostile acquisitions. These were perceived as disruptive of the relationship between investors and firm control (which had just turned from controlling shareholders to professional management). See Franks, J., Mayer, C. and Rossi, S. [2005a], *op. cit.* The City Code issued in 1968 was Britain's second try to deal with this problem as a matter of self-regulation, under the (credible) threat that legislation would have stepped in otherwise. The Bank of England's first attempt to issue a softer body of recommendations ('Notes on Amalgamation of British Business') had just failed a few years earlier: these recommendations remained a dead letter. The Code took the matter more seriously, by issuing a number of bright-line rules backed by general principles, and entrusting adjudication of disputes about the application of the rules (and, subsequently, their update) to a body of individuals: the City Panel on Take-overs and Mergers. Thanks to this enforcement mechanism, as a matter of fact, the Code is complied with in every control transaction involving a British listed firm as a target. See Armour, J. and Skeel, D.A. [2006], *Takeover Rules*, cit., 35-45.

99 For the first time since the establishment of the City Panel, the Code on Take-overs and Mergers has now statutory authority. This was necessitated by the coming into force of the European Takeover Directive. See The Takeovers Directive's Interim Implementation, Regulations 2006 – S.I. 2006/1183 (transitional provisions, in force since 20 May 2006); and Companies Act of 2006, §§ 942-965 (coming into force in 2008). The most important effect of this innovation is that the rules and the decisions issued by the City Panel are now also *legally* binding, so that the Panel has new powers to request court enforcement of its rulings. Still, a peculiarity of British takeover regulation is that breaches of the City Code provide no grounds for civil litigation, and complaints need to be always addressed to the City Panel in the first place.

100 Armour, J. and Skeel, D.A. [2006], *Takeover Rules*, cit., 4.

101 See, again, Armour, J. and Skeel, D.A. [2006], *Takeover Rules*, cit.

102 The other sources in question are company law, the Listing Rules, and the Combined Code on Corporate Governance. See *supra*, Chapter Seven, section 7.3.2.

ance.[103] In the takeover context, this suffers perhaps just a minor exception: the existing, but very limited role played by courts in upholding takeovers operated as schemes of arrangement.[104] We will come to that after discussing the most common way to operate a change in control in the UK: a takeover bid for all of outstanding shares.

11.3.2. Takeover Bids in the Acquisition of Free-Standing Firms

a) The Uneasy Life of Controlling Shareholders in the UK

The City Code requires that an 'any or all' bid for outstanding shares be made only for the acquisition of a listed firm, and basically in two circumstances: when somebody *wishes* to gain control of a company through a tender offer; and when somebody *does* acquires more than 30% of a company's stock.[105] Tricky as it may

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[103] See, e.g., Franks, J. and Mayer, C. [2002], *Corporate Governance in the UK – Contrasted with the US System*, in CESIFO FORUM No. 3/2002, 13-22. To be sure, in the takeover context, the standard juxtaposition is between Delaware courts and the London City Panel. See Kraakman *et al.* [2004], *The Anatomy*, cit., 172-173. But Armour, J. and Skeel, D.A. [2006], *Takeover Rules*, cit., 60-71, have suggested a subtler interpretation. Indeed, in the 60s and the early 70s, the UK common law on takeover defenses was remarkably similar to the opinions written by Delaware judges in the following decades. See Hogg v. Cramphorn [1967] Ch 254 (directors cannot take actions having the *primary* purpose of entrenching their control position); and Howard Smith Ltd v. Ampol Petroleum Ltd [1974] AC 821 (frustrating actions are not considered as breach of director's duty when they are *primarily* motivated by a legitimate business purpose). Since British courts were traditionally not inclined to second-guess the merits of business purpose (see *supra*, Chapter Nine, section 9.3.2.), the above combination resembles the proportionality test of Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del.Sup.1985) (see *supra*, Chapter Seven, section 7.3.1). Afterwards, the role of British judiciary was superseded by the institution of the City Panel, aggressively enforcing the principle and the rules of board neutrality. The real question is, therefore, why nothing like that happened in the US. According to Armour and Skeel, US federal legislation was the reason. As the authors conclude on this point (Id., at 71):

> "This, as we have explained, is a result of federal legislation which prevented institutional investors from developing sufficiently close links with one another to make collective action on this scale feasible in the US, together with federal regulation that displaced an earlier tradition of self regulation in the securities markets. There is an irony, therefore, in calls for federal legislation to remedy the perceived 'problem' of Delaware takeover law: in our view, it is federal legislation that is fundamentally responsible for the perceived problem."

[104] See *infra*, section 11.3.3.

[105] See, respectively, Rules 10 and 36 and Rule 9.1(a) of the City Code. Likewise, a shareholder who already owns between 30% and 50% of the stock has to make an 'any or all' bid if he "acquires an interest in any other shares which increases the percentage of shares carrying voting rights in which he is interested." Rule 9.1(b) of the City Code. The City Code used to provide for a *de minimis* exception to intensification of control, which did not trigger the mandatory bid so long as it was be-

appear, the bid is mandatory only in the last circumstance. In the first one, the bid is actually voluntary: regulation only constraints its structure and, possibly, its price.[106] The underlying principle is that shareholders shall be granted equal treatment in takeovers.[107] However, the same principle is implemented differently whether a free-standing or a shareholder-controlled firm is acquired. In the first case, regulation just prevents the tender offer from being restricted and any lower than the price paid in pre-bid purchases on the market;[108] partial offers are only allowed upon the Panel's authorization, and just when the bid is for less than 30%.[109] In the second case, regulation is much more demanding: not only must minority shareholders be granted a right of exit upon a change in control, but this right cannot be offered on any less favorable terms than those of the acquisition of the control block – which include a premium over the market price.[110]

Combined with the otherwise unfavorable regulation of the ongoing exercise of shareholder control, the mandatory bid is one prominent determinant of the rarity of controlling shareholders among firms listed in the UK. But notice that the opposite would hold in the absence of this combination – as it happens in the most part of continental Europe.[111] Compared to his colleagues on the continent, a British controlling shareholder would find it difficult not only to part with control at a premium, but also to exercise control on an ongoing basis due to the constraints set by the Listing Rules and the Combined Code on his ability to appoint the majority of board members.[112] It is for this reason that British entrepreneurs mostly face the choice of either parting with control when they go public or refrain from going public when the stock returns are insufficient to compensate for their control rents.[113] These rents can hardly be exploited, protected, or cashed in, in the capacity

low 1% on a yearly basis. This exception has been removed recently. See Kraakman *et al.* [2004], *The Anatomy*, cit., 179.

106 See Farrar *et al.* [1998], *Company Law*, cit., 594-596.

107 After the implementation of the EC Takeover Directive (see *infra*, section 11.4), this has now become Principle 1 of the City Code.

108 In the presence of pre-bid purchases, the City Code regulates both the *level* and the *nature* of consideration to be offered in voluntary bids. As far as the price is concerned, the offer cannot be on less favorable terms than those of purchases within the three-month period before the bid is announced. Rule 6.1 of the City Code. As far as the nature of consideration is concerned, the Code requires that cash be offered at leas as an option when pre-bid purchases for cash exceed 10% of any class of shares within the previous 12 months. Rule 11.1 of the City Code.

109 Rule 36 of the City Code.

110 Rule 9 of the City Code.

111 See, illustratively, Becht, M. and Mayer, C. [2001], *Introduction*, in F. Barca and M. Becht (eds.), THE CONTROL OF CORPORATE EUROPE, Oxford University Press, 1-45.

112 See *supra*, Chapter Seven, section 7.3.2.

113 This has been wonderfully illustrated by the British literature. See Brennan, M. and Franks, J. [1997], *Underpricing, Ownership and Control in Initial Public Offerings of Equity Securities in the UK*, in

as controlling shareholder of a British listed company. On the contrary, the injection of the mandatory bid in the otherwise unchanged regulation of corporate governance in continental Europe only affects the cashing in.

I will come to continental Europe the last sections of this Chapter. Now it is important to highlight how the regulatory disfavor towards controlling shareholders in Britain also affects the structure of takeovers of free-standing firms. Indeed, the success of a takeover bid depends on the ability of the acquirer to avoid being stuck in the inconvenient position of controlling shareholder – i.e., on his ability to either take the company private or to otherwise cash out minority shareholders. This determines, in turn, the ability of the incumbent management to resist an unwanted takeover.

The discipline of related-party transactions set forth by the Listing Rules prevents any shareholder accounting for more than 10% of voting rights from casting his vote at the general meeting, in the presence of a conflict of interest over a significant transaction.[114] Parent-subsidiary mergers and similar organic changes are always characterized as one such transaction.[115] The bottom line is that, in the UK, having even the vast majority of outstanding shares tendered in a takeover bid would be just a pyrrhic victory. The acquirer would not be able to merge the target company into his own, unless a super-majority of the non-tendering shareholders consent, and the presence of minority shareholders would make him subject to all the restrictions of decision rights faced by a controlling shareholder. Unsurprisingly, no takeover is operated in this way in Britain. Virtually all takeover bids voluntary made for the acquisition of a free-standing firm are conditional on at least 90% of outstanding shares being tendered.[116] The reaching of this threshold of stock ownership is what enables the bidder to compulsorily acquire minority shareholders.[117]

JOURNAL OF FINANCIAL ECONOMICS, vol. 45, 391-413; Mayer, C. [1999], *Firm Control*, Inaugural Lecture at the University of Oxford (February 18, 1999), available at www.finance.ox.ac.uk, as published in J. Schwalbach (ed.) [2001], CORPORATE GOVERNANCE: ESSAYS IN HONOR OF HORST ALBACH, Springer-Verlag.

114 Based on Listing Rules (LR) § 11.1.7, related parties and their associates cannot vote on the shareholder resolution approving the company's transaction with them. According to LR § 11.1.4 a substantial shareholder qualifies as related party. "Substantial shareholder" is defined in LR, Appendix 1, Relevant definitions, as "any person (excluding a bare trustee) who is entitled to exercise or to control the exercise of 10% or more of the votes able to be cast on all or substantially all matters at general meetings of the company."

115 LR §§ 11.1.3-11.1.5. See also LR § 11, Annex 1R – Transactions to which related party transaction rules do not apply.

116 Franks, J., Mayer, C. and Renneboog, L. [2001], *Who Disciplines Management in Poorly Performing Companies?*, in JOURNAL OF FINANCIAL INTERMEDIATION, vol. 10, 241. See also Farrar *et al.* [1998], *Company Law*, cit., 595-596 and 607.

117 Farrar *et al.* [1998], *Company Law*, cit., 607-609.

Given the regulation of controlling shareholders, minority's squeeze-out is a necessary condition for the success of a takeover in Britain more than anywhere else.

b) Structure of Voluntary Bids and Takeover Resistance

This feature of takeover bids explains a number of important things. To start with, the City Code's insistence on tender offers being 'any or all' is superfluous whenever control is at stake.[118] The bidder cannot make any lower offer than the price paid in the acquisition of a toehold;[119] he needs anyway to purchase 90% of the stock to perform a squeeze-out;[120] and the consideration of the latter must be equal to the bid price.[121] This means that partial offers would make no sense anyway, provided that two-tier bids are prohibited by statutory law.[122] Secondly, the hurdles faced by the bidder in reaching the critical 90% threshold enables the management to resist a hostile takeover, in spite of the board being prohibited by the City Code from taking frustrating actions, with respect to actual or imminent bids, in the absence of a specific authorization by the general meeting of shareholders.[123] This is both necessary and mostly sufficient to feature the board with bargaining power in the face of a takeover bid.

It is necessary, provided that the board is not otherwise entitled to implement defensive tactics. Post-bid resistance would have little chance to be upheld by shareholders, whereas pre-bid defenses – which are theoretically legal – are almost never established since they are expected to be voted down by institutional investors.[124] The high threshold for squeeze-out is most often sufficient for board resistance because of two reasons. First, board members in the UK account, on average, for more than 10% of share ownership;[125] this enables them to form coalitions powerful enough to block a takeover without taking any frustrating action: they simply would not tender.[126] Second, in every case in which board ownership is below average, management may still counter an unwanted bid by issuing an unfavorable recommendation to shareholder and/or taking other actions which do not

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[118] The reader should recall that the Panel may allow partial bids on condition that they cannot result in accumulation of a share block accounting for more than 30% of voting rights. See Rule 36 of the City Code.

[119] Rule 6 of the City Code.

[120] Companies Act (CA) 1985 § 428 (CA 2006 § 979).

[121] CA 1985 § 430C (CA 2006 § 986).

[122] CA 1985 § 428 (CA 2006 § 974).

[123] Rule 21 of the City Code.

[124] See, e.g., Stapledon, G.P. [1996], INSTITUTIONAL SHAREHOLDERS AND CORPORATE GOVERNANCE, Oxford University Press.

[125] See *supra*, Chapter Two, section 2.4.4.

[126] See *supra*, Chapter Seven, section 7.3.2.

amount to frustration (like, e.g., seeking for a 'white knight').[127] The City Code does not prescribe absolute 'board passivity,' but just 'board neutrality.'[128] In fact, very few takeovers – if any – manage to go through in the UK when the board keeps on objecting as legitimately as strongly.

This just tells us *how* British managers can force bidders to come to terms with them. Notice that, so far, takeovers of free-standing firms work not so differently from the US. The major difference depends neither on the regulation of the bid (which is slightly more burdensome) nor on that of board resistance (which is only apparently disallowed in the UK), but, rather, on the threshold for minority's squeeze-out (which, by the way, is *preferably* – but not *necessarily* – performed at 90% also in the US).[129] What we still do not know is *why* British managers wish to resist a takeover bid – i.e., what they are allowed to bargain for. Indeed, here lies a fundamental difference between takeovers in the UK and in the US: under British company law, board members are prevented from renegotiating severance payments ("payments for loss of office") in the wake of takeovers, unless this is approved by the general meeting of shareholders.[130] Let us assume that this is sufficient to rule out renegotiation: 'acquirer-paid sweeteners' are basically unheard of in the British takeover practice.[131] Does this mean that, in Britain, managers have no better choice than entrenching themselves? This would be a too hasty conclusion and it is in fact contradicted by the empirical evidence. Both the US and the UK feature perhaps the highest levels of takeover activity in the world, although the former outperforms the latter even when results are corrected for the relative size of the economy; in none of the two countries deals *concluded* as hostile account for more than half a percentage point – although the score in the UK is somewhat higher than in the US.[132] These figures are illustrative of what is actually going on.

Hostile takeovers are extremely exceptional events everywhere.[133] They might be slightly more frequent in the UK, due to larger regulatory constraints on board resistance: but this result is both of negligible importance and otherwise open to

[127] Franks, J., Mayer, C. and Renneboog, L. [2001], *op. cit.*, 240-242.

[128] Kraakman *et al.* [2004], *The Anatomy*, cit., 164-168. See the new formulation of the General Principles 2-3 of the City Code (corresponding with the statement of general principles in the EC Takeover Directive – see *infra*, section 11.4).

[129] See *supra*, section 11.2.1 (takeover of free-standing firms).

[130] See Kraakman *et al.* [2004], *The Anatomy*, cit., 168; and, in more detail, Farrar *et al.* [1998], *Company Law*, cit., 613-614. §§ 312-316 of CA 1985 have been replaced § 215-222 of CA 2006.

[131] Compare with Bebchuk, L.A. and Fried, J.M. [2004], *op. cit.*, 87-94.

[132] Armour, J. and Skeel, D.A. [2006], *Takeover Rules*, cit., 13-17.

[133] See Becht, M., Bolton, P. and Röell, A. [2002], *Corporate Governance and Control*, ECGI Finance Working Paper No. 02/2002, available at www.ssrn.com and www.ecgi.org, as published in G. Constantinides, M. Harris, and R. Stulz (eds.) [2003], HANDBOOK OF ECONOMICS AND FINANCE, North-Holland.

question.[134] What matters is that the market of corporate control is very active in both countries, where it is normally operated through friendly deals.[135] Then the impact of regulation on this kind of deals, more than on hostile takeovers, is what ultimately determines the functioning of the market of corporate control and its size and performance in either place. In spite of their inability to renegotiate severance payments, still British managers have to cash in their control rents as a precondition of their parting with control. When the quality of management is not up to the expectations (i.e., managers are seriously underperforming), renegotiation is not actually an issue. One should recall from Chapter Six that the best strategy for a lazy or otherwise unskilled manager is just to take the present value of his prearranged compensation package and leave the steering wheel to any better manager, provided that he or the shareholders are able to pay the minimum price for the ticket.[136] The empirical evidence about changes in control in the UK apparently confirms this result: the worst performing firms indeed exhibit higher board turnover.[137] However, takeovers appear to be otherwise 'unfocused' in the UK: not only are they not targeted to poorly performing firms, but they also score comparatively worse than in the US in this particular respect.[138] It seems then that the British market for corporate control is both smaller in size and less performing compared to the US. This suggests that more value-increasing takeovers are foregone. Why?

c) Takeover Premia as Renegotiated Severance Payments

Value-decreasing acquisitions are no possible explanation of underperformance of the market for corporate control, since takeover regulation effectively prevents them from occurring in Britain. The principle of equal treatment of shareholders is so carefully implemented that no rider can profitably take over unless he is bound to increase shareholder value. The problem is that takeovers need to increase *significantly* the firm value to be any profitable for the acquirer.[139] This is only apparently due to the necessity to acquire 100% of the company's stock: we know that this would always be the best strategy for a truly value-increasing bidder, provided that he can so exclude shareholders from any part of the takeover gains.[140] The real rea-

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[134] See Schwert, G.W. [2000], *op. cit.*, for the conceptual and empirical issues relating to the definition of 'hostility' in takeovers.
[135] See, e.g., Weir, C. and Laing, D. [2003], *op. cit.*
[136] See *supra*, Chapter Six, section 6.3.3.
[137] Franks, J., Mayer, C. and Renneboog, L. [2001], *op. cit.*, 235-238
[138] Id., at 220-224.
[139] This is the major drawback of a strict implementation of the principle of shareholders' equal treatment. See Kraakman *et al.* [2004], *The Anatomy*, cit., 180-181.
[140] See *supra*, Chapter Ten, section 10.2.2.

son is that exclusion of non-controlling shareholders from the takeover gains can only be imperfectly performed because of company law's discipline of severance payments.

British manager are not allowed to negotiate their severance payments separately from the takeover premium, anytime they are performing sufficiently well to be credibly committed to renegotiate compensation of their control rents, but sufficiently bad for a takeover to be efficient.[141] Of course, this would not be a problem if takeovers were allowed to be hostile; but in fact, neither this happens in most of the situations – if ever – nor, after all, would it be desirable from a theoretical perspective. As a result, incumbent managers are able to holdout for their control rents in their capacity as (coalition of) shareholders, and possibly to induce other shareholders to do the same, until the takeover premium gets high enough. Since the takeover premium accrue in equal terms to all of the target's stockholders, and not just to its controllers, this explains how legal protection of minority shareholders in the UK leads to moderately value-increasing takeovers being foregone. Notice that this result does not obtain in the US, since both the power of incumbent managers to claim compensation of control rents, and their profits from doing so, do not depend on shareholding.[142] An appropriate regulation of side-payments in takeovers, more than their outright ban, proves therefore more efficient in that it allows more gains from trade to be captured, no matter of how they are divided. In a sense, this can be interpreted as one more salute to the work by Ronald Coase.

11.3.3. Takeovers as 'Scheme of Arrangement'

Since a takeover bid is not mandatory for the acquisition of a free-standing firm, a would-be acquirer may prefer to resort to a different technique. In the UK, the basic alternative to a tender offer is a takeover implemented by a scheme of arrangement. This option is completely neglected by the international literature, but is important and also relatively popular.[143] It is in fact a way to overcome some of the rigidities of takeover bids.

The procedure is mostly regulated by the Companies Act, although it grants no exception to the mandatory provisions of the City Code (most notably, it cannot be used to avoid the mandatory bid) and the disclosure requirements of the latter are

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[141] Compare with Chapter Six, section 6.3.3, above.

[142] See *supra*, section 11.2.1.

[143] I wish to thank Professor Julian Franks for having suggested me this line of inquiry in personal communication. See also Franks, J. and Harris, R.S. [1989], *Shareholder Wealth Effects of Corporate Take-overs: The UK Experience 1955-1985*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 23, 228-229.

anyway triggered by the takeover purpose, not differently from a tender offer.[144] That being said, takeovers implemented as schemes of arrangement do not significantly alter the picture of takeover regulation in the UK, especially as regards the cashing in of control rents: schemes of arrangement make this no easier, since they do not allow controllers to get anything that is not given to each class of shareholders on equal terms. To be sure, compared to a tender offer, schemes of arrangement may considerably empower non-controlling shareholders relative to both the management and the prospective acquirer. It is probably for this reason that they are much less popular than takeover bids, and they are mostly employed when shareholders are very dispersed or otherwise out of reach, or for tax reasons.[145]

The scheme of arrangement is a far-reaching procedure, which can be used to bind dissenting or otherwise apathetic shareholders to a number of decisions. Here we just consider its use to operate a takeover. "A typical scheme of arrangement effecting a transfer of control would involve the existing shareholders in the target company transferring their shares to the offeror in consideration of a cash payment or of an issue of shares in the offeror."[146] Abstracting from legal formalism, this scheme basically results in a takeover being directly implemented through a merger. The board must agree to this purpose, since its cooperation is required to call one or more shareholder meetings for the approval of the scheme. Overcoming the board's reluctance by a shareholder resolution is not an option, since – as we are about to see – the higher the insurgent's voting power, the lower the chances that a takeover can succeed as a scheme of arrangement. Therefore, the friendly character of the takeover holds even more strictly in this scenario.

A consenting board is far from sufficient for the deal to go through. The target management is not completely in control of the implementation of the scheme, for it requires that one or more shareholder meetings be convened by the competent court and that the latter sanctions the deal upon its valid approval by shareholders. Courts, however, will only check more the regularity of the procedure and that shareholders are adequately informed about the deal.[147] In this last respect, additional checks are independently performed by the Takeover Panel based on the provisions of the City Code.[148] Therefore, the last word about schemes of arrangement rests with shareholders, and they are indeed the pivot of the transaction.

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[144] Farrar *et al.* [1998], *Company Law*, cit., 683-685.

[145] See Herbert Smith [2004], *Takeovers Using Schemes of Arrangements*, April 2004, available at www.herbertsmith.com.

[146] Farrar *et al.* [1998], *Company Law*, cit., 683.

[147] Id., at 684.

[148] Herbert Smith [2004], *op. cit.*

The Companies Act – unaffected in this respect by the 2006 reform, save for the disappearing of the word "scheme" – provides that an "arrangement" between the company and its "members" must be approved by a majority in number representing 75% in value of the shareholders present and voting either in person or by proxy.[149] To this purpose, a vote must be held separately for each class of shareholders. Let us abstract, for simplicity, from the presence of multiple classes of shares – incidentally, a situation not so common among British listed firms. The crucial point is that the shares held by the would-be acquirer are considered as belonging to a *separate class*, so that they do not count for the approval of the scheme. Notice that the acquirer's voting power would be otherwise frozen by the Listing Rules, anytime he can be characterized as a 'substantial shareholder.'[150] As a result, the acquirer may only count on the board's ability to gather enough independent support for the proposal at the shareholder meeting.

Paradoxically, the higher the acquirer's ownership stake in the company, the higher the chance that he will fail: this would just make easier for one or more dissenting shareholders to account for 25% of the shares that can be voted. But the final outcome also depends on the number of shares that are actually voted. In summary, a scheme of arrangement has the advantage that dissenting shareholders may be more easily squeezed-out than by a takeover bid, due to the difference in thresholds of acceptance of the deal and in how they are calculated. The disadvantage is that the scheme is much riskier. Very notably, this strategy recently failed as an attempt to squeeze-out minority shareholders of a company already controlled by a *majority* shareholder (a scheme of arrangement is no option when controlling ownership is between 30% and 50%, because then any increase in the controller's stake triggers the mandatory bid).[151] In that case, the majority shareholder had finally to launch a takeover bid to take the company private.[152] It is for this reason that, before being 'trapped' into the position of majority shareholder, a prospective acquirer may prefer to go for a takeover bid from the very beginning.

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149 §§ 425-427 of CA 1985 have been restated by §§ 895-899 of CA 2006. The key provisions are contained in CA 1985 § 425 and CA 2006 § 899.

150 'Arrangements' are also subject to LR §11. See *supra*, section 11.3.2, for a general discussion of how this affects the ability of controlling shareholders to consummate parent-subsidiary restructurings.

151 Rule 9.1(b) of the City Code. Notice that, differently from voluntary bids, mandatory bids must be *unconditional* (more precisely, they cannot include any condition other than as to the need for 50% acceptance and the authorization by competition authorities – Rules 9.3 and 9.4 of the City Code). As a result, the mandatory bid by a controlling shareholder cannot be conditioned on 90% of voting shares being acquired – the threshold for operating a minority squeeze-out.

152 See, for illustration of events, *Dick's Tricks at Harvey Nicks*, 12 November 2002, available at www.webb-site.com.

Finally, it is worth noting that there is no reason to expect that, compared to a tender offer, a scheme of arrangement will result in a lower takeover premium. Company law requires that any interest of directors in the transaction be disclosed and approved by shareholders together with the deal.[153] This has an effect equivalent to the discipline of payments for loss of office in the wake of a takeover bid. Also in this scenario, then, managers are prevented from renegotiating separately any severance payment. What they only can do is – like in the face of a tender offer – using their bargaining power to claim compensation in the form of a takeover premium shared with the rest of shareholders. The latter would not object to this kind of directors' interest in the transaction, for it is perfectly aligned with theirs. I have already highlighted the adverse consequences of this result of British regulation on the probability of value-increasing takeovers.

11.3.4. Why the Mandatory Bid Does Little Harm in the UK (and What Else May Do More)

If the picture of British takeover regulation is just shadowed by the above remarks as far as the acquisition of free-standing firms is concerned, it becomes very dark in the case of takeover of shareholder-controlled listed companies. Here a different regulation applies: changes in control involving the transfer of a 30% stake or higher trigger a mandatory 'any or all' bid featured with equal opportunity to be granted to minority shareholders; and there is basically no way to get around this discipline.[154] This means that, unless control is allowed to change hands below that threshold, no scope is left by regulation for private negotiations over the control premium. The latter may only be paid as inducement to part with control to the extent that the same offer is extended to non-controlling shareholders.

This is consistent with the regulation of controlling management's severance payments illustrated above. However, the size of the control rents at stake is incomparable in the two scenarios. The bottom line is that, in the presence of a controlling shareholder, the obligation to share the control premium with non-controlling shareholders may simply make no takeover profitable enough to pay that price while leaving the acquirer better off, unless takeover gains are of extraordinarily large magnitude.[155]

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[153] CA 1985 § 426 (CA 2006 § 897).

[154] See the detailed discipline provided for by Rule 9 of the City Code. Exemptions from the mandatory bid may be granted only by the City Panel under a very limited set of circumstances. See City Code, Section F, Notes on dispensation from Rule 9.

[155] See *supra*, Chapter Ten, section 10.4.4.

Luckily, being controlling shareholders is much inconvenient under the British regulation of listed companies. In fact, controlling shareholders are very rare.[156] It is therefore not worthwhile discussing the mandatory bid any further, since the vast majority of takeover bids in the UK is voluntary.[157] But one point is worth making as a conclusive remark. British regulation does not allow significant control rents to be cashed in through a change in control, and this is one of the reasons why high control rents are simply not featured by corporate governance in the UK.[158] Apart from the inefficiencies that it generates in the takeover process, this regulatory disfavor towards private benefits of control also restricts the set of choices available for separating ownership and control.

As one British economist has authoritatively argued, the drawback of this solution may be the inability of the institutional system in the UK to support economic activities that financial markets cannot reward entirely.[159] Colin Mayer nicely attributes this to a British predilection for eunuchs ("responsibility without power") over harlots ("power without responsibility").[160] Being the present dissertation concerned with positive and normative analysis of law, more than with its cultural determinants, I just claim – perhaps more simplistically – that the current state of British regulation of corporate governance may result in too high a degree of ownership dispersion compared to what would be efficient.

11.4. The European Directive on Takeover Bids

11.4.1. The Failure of Harmonization

It took almost 15 years of negotiations between Member states, but finally a European takeover regulation was established in April 2004 by the Directive 2004/25/EC.[161] The history of the Thirteenth Directive on European company law

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[156] See *supra*, Chapter Two, section 2.4.

[157] Farrar *et al.* [1998], *Company Law*, cit., 595.

[158] I am not the first to make this point. Franks and Mayer have already suggested, nearly two decades ago, that the British takeover regulation may be unsuitable to firm-specific investments in a long-term horizon. See Franks, J. and Mayer, C. [1990], *Takeovers*, in ECONOMIC POLICY, April 1990, 214-215.

[159] Mayer, C. [1999], *op. cit.*, 16-18.

[160] Id., at 19.

[161] Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids (hereinafter Takeover Directive). See, illustratively, Enriques, L. and Gatti, M. [2006a],

is very well known.[162] Its enactment was preceded by the dismissal by the Parliament of a former proposal aimed at creating a 'level playing field' as far as the regulation of takeovers was concerned. This was the first failure of the harmonization attempt. Then the Directive could only be passed as a compromise between opposite positions of the Member states, by providing them with a number of options for its implementation.[163] As a result, the second failure of harmonization is just in the making. Member states have exercised the options available to implement the Directive without significant departures from their regulatory tradition; and those for whom tradition was hard to reconcile with the (few, indeed) inescapable provisions of the Directive have not yet implemented it, in spite of the implementation deadline lapsing in May 2006.[164] Curiously enough, this holds irrespective of the national attitude towards timely implementation of EU law: in our sample, neither Italy nor the Netherlands have yet implemented the Directive at the time this dissertation is being written.

From a theoretical perspective, the adoption and implementation of the Takeover Directive raises a number of interesting issues, regardless of its contents: the allocation of institutional competence for takeover legislation (centralization v. decentralization);[165] whether harmonization is preferable to regulatory competition;[166]

EC Reforms of Corporate Governance and Capital Markets Law: Do They Tackle Insiders' Opportunism?, Working Paper, available at www.ssrn.com, 13-19.

162 See, e.g., McCahery, J.A., Renneboog, L. (with P. Ritter and S. Haller) [2003], *The Economics of the Proposed European Takeover Directive*, CEPS Research Report in Finance and Banking No. 32, available at www.ceps.be, 46-51. For a more updated history of events, see Owen, G., Kirchmaier, T. and Grant, J. (eds.) [2005], CORPORATE GOVERNANCE IN THE US AND EUROPE, Macmillan, *Appendix IV: European Takeover Code*, 145-156.

163 The European Commission's proposal of a revised Takeover Directive (European Commission [2002], *Proposal for a Directive on Takeover Bids*, COM(2002)534, available at www.ec.europa.eu) was largely based on the first report by High Level Group of Company Law Experts, set up by the Commission after the European Parliament failed to pass the first proposal of a Takeover Directive in second reading. See High Level Group of Company Law Experts [2002a], *Issues Related to Takeover Bids*, Final Report, 10 January 2002, available at www.ec.europa.eu.int. However, the proposal faced the strong opposition of a number of Member states, most notably from Nordic Countries. As a result, the proposal was substantially amended by the European Parliament, and subsequently adopted in the amended configuration despite of the Commission's opposition. Most important modifications of the original proposal include optionality of the board neutrality and the breakthrough rules, a complicated two-tier mechanism of opt-in/opt-out, and the introduction of the principle of reciprocity. All of this will be briefly discussed in the next section.

164 For a survey of the state of implementation of the Takeover Directive, see European Commission [2007], *Report on the Implementation of the Directive on Takeover Bids*, SEC(2007)268, available at www.ec.europa.eu.

165 See, generally, Van den Bergh, R.J. [1998], *Subsidiarity as an Economic Demarcation Principle and the Emergence of European Private Law*, in MAASTRICHT JOURNAL OF EUROPEAN AND COMPARATIVE LAW, vol. 5, 129-152.

and whether these are truly crucial issues in corporate governance, or convergence and divergence of regulation occur on a rather different basis.[167] In the Ninth Chapter, I have just suggested that the latter might be the case. It was shown that – at least as far as the legal discipline of self-dealing is concerned – national regulations seem to address similar functional problems; although they bear the influence of comparative experience, ultimately they evolve along their own path.[168] European harmonization is most unpromising, and unlikely to succeed, in that field. But whether the European legislator could fare any better in takeover regulation is just a too complicated question to be answered here. While self-dealing is mostly confined to a national dimension, thereby suggesting that freedom of incorporation may be the right way to address institutional diversity, corporate acquisitions obviously are not quite so, and therefore the case for harmonization is, *prima facie*, stronger.

Issues of federalism and regulatory competition in corporate governance would deserve a separate inquiry anyway, but here we need to cope with a more severe problem concerning the European regulation of takeovers. Even assuming that an optimal model of regulation exists, the European Union has simply chosen the wrong one. The basic idea underlying the Takeover Directive, in both the original and the compromised version, is that of transplanting the British discipline of corporate control transactions in the other Member states.[169] This model, however, has not been completely understood: on the one hand, its suitability to dispersed ownership structures depends on the interaction with other legal rules that have nothing to do with the discipline of takeovers; on the other hand, the same model is unsuitable for creating an active market of corporate control in concentrated ownership structures.

To be sure, European regulators were aware of the second problem, and of its particular severity for most countries of continental Europe.[170] So they tried to get

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[166] Enriques, L. and Gatti, M. [2006b], *The Uneasy Case for Top-Down Corporate Law Harmonization in the European Union*, in UNIVERSITY OF PENNSYLVANIA JOURNAL OF INTERNATIONAL ECONOMIC LAW, vol. 27, 939-998.

[167] See, e.g., Mayer, C. [2005], *Corporate Governance Systems – How Much Convergence?*, in G. Owen, T. Kirchmaier and J. Grant (eds.), CORPORATE GOVERNANCE IN THE US AND EUROPE, Macmillan, 31-36.

[168] See *supra*, Chapter Nine, section 9.4.2.

[169] See, e.g, Hopt, K.J. [2006], *Modern Company and Capital Market Problems: Improving European Corporate Governance after Enron*, in J. Armour and J.A. McCahery (eds.), AFTER ENRON, IMPROVING CORPORATE LAW AND MODERNISING SECURITIES REGULATION IN EUROPE AND THE US, Hart Publishing, 479-484.

[170] See, for an economic discussion, Burkart, M. and Panunzi, F. [2003], *Mandatory Bids, Squeeze-out, Sell-out and the Dynamics of the Tender Offer Process*, ECGI Law Working Paper No. 10/2003, available at www.ssrn.com and www.ecgi.org, as published in G. Ferrarini, K.J. Hopt, J. Winter, and E. Wy-

around it, by introducing an element unknown as to British regulation as to any other legislation in the world: the breakthrough rule, which – at least in the intentions of the experts who invented it – was supposed to create dispersed ownership and control structures where there was none.[171]

Not only is the attempt to force dispersion of ownership theoretically unfounded – as we lastly discussed with reference to the UK;[172] but the breakthrough rule was certainly the wrong way to try.[173] Unsurprisingly, that attempt failed, and it contributed very much to the dismissal of the Commission's original proposal. We know that no breakthrough rule could have possibly succeeded in imposing full contestability of corporate control in the long run, but the very idea and its disruptive effects on existing patterns of corporate governance was nonetheless rejected by some Member states. What remains of the Takeover Directive is a patchwork of mandatory rules, possible waivers, and optional provisions, which still attempts to emulate as closely as possible the British model of takeover regulation.[174]

The overall result is mostly unfortunate. Options and permissible waivers only partly allow Member states to adapt that model to the prevailing features of corporate governance in their country. The bottom line is that they may choose to restrict or promote contestability nearly as much as they wish.[175] But we know that this is the wrong question for the efficiency of takeover regulation, and that the regulatory attitude towards contestability is ultimately just a source of distortions. When it comes to the crucial point – the ease of friendly takeovers – Member states enjoy much less freedom. The most prominent achievement of the Takeover Directive as to harmonization is about shareholder protection.[176] The establishment of an active market for corporate control is anyway sacrificed to that goal through the adoption across the board of a British-style mandatory bid rule. The adverse consequences of this choice are the more evident the more ownership structures depart, at the national level, from those prevailing in the UK.

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meersch (eds.) [2004], REFORMING COMPANY AND TAKEOVER LAW IN EUROPE, Oxford University Press.

[171] High Level Group of Company Law Experts [2002a], *Issues Related to Takeover Bids*, cit.

[172] See *supra*, section 11.3.4.

[173] See *supra*, Chapter Ten, section, 10.4.4.

[174] Enriques, L. and Gatti, M. [2006a], *op. cit.*, 18.

[175] Enriques, L. [2006a], *EC Company Law Directives and Regulations: How Trivial Are They?*, in UNIVERSITY OF PENNSYLVANIA JOURNAL OF INTERNATIONAL ECONOMIC LAW, vol. 27, 1-78.

[176] See, for a detailed illustration, Ventoruzzo, M. [2006], *Europe's Thirteenth Directive and U.S. Takeover Regulation: Regulatory Means and Political and Economic Ends*, in TEXAS INTERNATIONAL LAW JOURNAL, vol. 41, 171-221.

11.4.2. The Contents of the Directive

A brief illustration of the main provisions of the Takeover Directive is in order, before discussing their impact on the three remaining countries of our sample. As I mentioned, the mandatory core of the Directive is shareholder protection, interpreted as a principle of equal treatment of shareholders in the wake of a takeover, which may not suffer exceptions in the implementation at the national level.[177] The mandatory bid is the prominent application of this principle.

a) Mandatory Bid

Upon a change in control, minority shareholders must be offered equal opportunity of exit compared to the controlling shareholder.[178] To this purpose, an obligation to make an 'any or all' tender offer is triggered by the acquisition of a percentage of voting rights sufficient to determine a change in control; and the bid price is set equal to the highest consideration paid for the acquisition of the control block over a period between 6 and 12 months before the triggering event.[179] Specification of the percentage of voting rights that qualifies as triggering event (i.e., the threshold of the mandatory bid) is left to the Member states.[180] However, this is not the only degree of freedom that Member states enjoy in both the implementation and the application of the mandatory bid: some aspects of the mechanism established in the Directive may be waived on condition that the principle of equal treatment of shareholders is otherwise preserved.[181]

The mandatory bid must be put in context. To start with, the obligation is superseded in the acquisition of a free-standing firm. Here the tender offer will be voluntary, although – in principle – the discipline of the mandatory bid still prescribes that the offer be unrestricted.[182] This is the first requirement that can be waived at the national level. Partial bids are allowed by the general derogation clause of the Directive, on condition that they are neither discriminatory (acceptances must be satisfied pro-rata) nor otherwise coercive (two-tier bids are prohibited at any rate).[183]

Partial bids may be likewise permitted on the same conditions in the presence of a controlling shareholder, but they cannot allow for outright circumvention of the

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[177] See Takeover Directive, Recital 9 and art. 3.1(a) (General Principle 1).
[178] Hopt, K.J. [2006], *op. cit.*, 480-481.
[179] Art. 5.1 and 5.4 of the Takeover Directive.
[180] Art. 5.3 of the Takeover Directive.
[181] Art. 4.5 of the Takeover Directive.
[182] Art. 5.2 of the Takeover Directive.
[183] See Recital 9, art. 3.1(a), and art. 4.5 of the Takeover Directive.

obligation to share the control premium with minority shareholders. An explicit corollary of the binding principle of equal treatment in the Directive is that "if a person acquires control of the company, the other holders of securities must be protected."[184] Thus, partial bids may not allow for the control bock to be traded on different terms from non-controlling shares, but only for the latter to be entitled to limited participation in the control premium – provided that it is pro-rata.

Derogations are also allowed, but on a different basis, as far as the price of the mandatory bid – that must be unrestricted in any case – is concerned. The national Security Authority may set the bid price either higher or lower than that fixed by the Directive "in circumstances and in accordance with criteria that are clearly determined."[185] If we take both the case-by-case approach and the objectivity of criteria any seriously, this leaves Member states with limited margins of action. Most importantly, it should prevent national regulations from providing for a general discount on the sharing of the control premium, in order to ease the transfer of controlling blocks.[186]

b) Pre-bid and Post-bid defenses

Two other key provisions of the directive are instead just optional, namely the regulation of post-bid and pre-bid defenses that may be set up by the target company.[187] The first is the prohibition of the board from frustrating a takeover bid in the absence of authorization by the shareholder meeting.[188] The second is the infamous breakthrough rule.[189] The two provisions are intended to complement each other: the first is clearly modeled after the principle of board neutrality established by the British City Code; the second is aimed at replicating the conditions of corporate governance in the UK. The goal is to prevent both the board and controlling shareholders from hindering contestability.

In the face of a takeover bid, the incumbent needs to count on existing restrictions on either the transfer of shares or the exercise of voting rights; alternatively, the board must be authorized by the general meeting to take defensive measures. The breakthrough rule provides that restrictions on the transfer of securities be set aside upon the making of a tender offer, while restrictions on the exercise of voting rights have no effect in the shareholder meeting which decides upon defensive

[184] Art. 3.1(a) of the Takeover Directive.
[185] Art. 5.4, 2nd paragraph, of the Takeover Directive.
[186] For how these solutions were implemented at the national level before the adoption of the Takeover Directive, see Kraakman *et al.* [2004], *The Anatomy*, cit., 180-181.
[187] Art. 12.1 of the Takeover Directive.
[188] Art. 9 of the Takeover Directive.
[189] Art. 11 of the Takeover Directive.

measures.[190] The latter provision applies to all restrictions established either contractually or in the corporate charter, and it downgrades to one the power of multiple-voting shares.[191] Assuming that this is sufficient to short-circuit frustration of the bid, the restrictions in place could still prevent a successful bidder from taking over the company's control. Therefore, the breakthrough rule also provides that restrictions on both the transfer and the exercise of voting rights – including multiple votes – are either repealed *ope legis* or may be removed by the acquirer, on condition that he holds at least 75% of the voting shares following the bid and equitable compensation is offered to the beneficiaries of those restrictions.[192] Terms and procedure of this compensation are to be established by the Member states.[193]

Both the breakthrough and the board neutrality rules are subject to a complicated mechanism of opting-out, at the level of Member states, and opting-in, at the firm level.[194] That is, Member states may choose not to implement either provision as mandatory, but must allow companies subject to their jurisdiction to uphold each of them in the corporate charter.[195] It is established that opting-in at the company's level should be reversible, which is unsurprising – and probably useless – provided that either rule would implemented as a provision of the corporate charter. As a result, both the breakthrough and the board neutrality rule may hardly feature a credible commitment unless they are implemented as mandatory in national corporate laws.[196] While some Member states have already implemented the rule of board neutrality in this fashion, or seem otherwise willing to do so, virtually none of them has endorsed or wishes to endorse the breakthrough rule as a mandatory provision.[197] The breakthrough rule is going to fare no better at the company's level, even under the heroic assumption that companies may find it any interesting to apply it. Finally, the application of both rules, on either a mandatory or a voluntary basis, may be suspended in the absence of reciprocity by the bidder.[198] This is fur-

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[190] Art. 11.2 and 11.3 of the Takeover Directive.

[191] It should be noticed that wipe-out of restrictions on voting power suffers an important exception. One share–one vote shall not be restored with respect to "securities where the restrictions on voting rights are compensated for by specific pecuniary advantages." Art. 11.6 of the Takeover Directive. This basically implies that most kinds of limited-voting and non-voting stock can be easily set out of the scope of the rule – even assuming that it is not opted out.

[192] Art. 11.4 of the Takeover Directive. Also in this case the provision does not apply to restrictions compensated by specific pecuniary advantages.

[193] Art. 11.5 of the Takeover Directive.

[194] Art. 12.1 and 12.2 of the Takeover Directive.

[195] See Recital 21 of the Takeover Directive.

[196] See *supra*, Chapter Eight, section 8.1.3.

[197] European Commission [2007], *Report on the Implementation of the Directive on Takeover Bids*, cit., 6-8 and Annex 1.

[198] Art. 12.3 of the Takeover Directive.

ther option given to the Member states. However, reciprocity on these matters hardly makes any economic sense. This has been already demonstrated in the literature, and therefore the following discussion will simply abstract from any consideration of reciprocity in takeover regulation.[199]

c) Squeeze-out and Sell-out

There are a few other provisions in the Takeover Directive having an impact on our framework of analysis. One is disclosure of all existing arrangements concerning corporate control and its transfer.[200] This disclosure is in fact a precondition for the efficient functioning of the market for corporate control.[201] Even more important is the regulation of the squeeze-out and sell-out rights. The Directive provides that the two rights should be equally triggered by a 90% threshold of both ownership and voting rights reached after a takeover bid, no matter of whether it is voluntary or mandatory.[202] Member states may, however, raise that threshold through an appropriate drafting of their company laws, provided that it does not exceed 95%.[203] Consideration is determined to be fair inasmuch as it is equal to the bid price, even though the additional requirement that at least 90% of voting shares be effectively tendered at that price is established in case of a voluntary bid.[204] In implementing both rights, Member states have only limited discretion as to the threshold. As we are about to see, this part of the EU regulation just results in minor changes for the jurisdictions of our sample, but prevents them from choosing in the future a more efficient approach to the dynamics of control allocation.

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[199] See Becht, M. [2003], *Reciprocity in Takeovers*, ECGI Law Working Paper No. 14/2003, available at www.ssrn.com and www.ecgi.org, as published in G. Ferrarini, K.J. Hopt, J. Winter, and E. Wymeersch (eds.) [2004], REFORMING COMPANY AND TAKEOVER LAW IN EUROPE, Oxford University Press.

[200] Art. 10 of the Takeover Directive.

[201] Kraakman *et al.* [2004], *The Anatomy*, cit. 174-176.

[202] Art. 15 and art. 16 of the Takeover Directive.

[203] Art. 15.2 and art. 16.2 of the Takeover Directive.

[204] Art. 15.5 of the Takeover Directive.

11.5. Takeover Regulation in Continental Europe

11.5.1. Takeovers and Their Discipline in Sweden

a) *Pre-Empting the European Legislator*

The Swedish approach to the implementation of the Takeover Directive is open to interpretation. According to some commentators, the Swedish case supports the thesis of convergence of takeover regulation towards the British standard, regarded – at least in Europe – as the prevailing one.[205] Sweden introduced both the mandatory bid and the rule of board neutrality, originally on a voluntary basis, and, about one year before the Directive came into force, on the basis of mandatory self-regulation, which – as I illustrated in the Ninth Chapter – is no less binding than corporate and securities law for Swedish listed companies.[206] Like the UK, Sweden had subsequently to give statutory authority to these regulations in order to comply with the Directive, but nothing else was changed in either the contents or the basic enforcement mechanism.[207] Apparently, Sweden had little reason to switch spontaneously to such a restrictive regulation of takeovers and a very good one not to do it. While effective protection of minority shareholders has never been a problem in Swedish corporate governance, the mandatory bid was a serious challenge to the market for corporate control, given the absolute prevalence of controlling shareholders in the structure of corporate ownership.[208] Hence, convergence seems to be the only possible explanation: despite of the peculiarities in national corporate governance, Sweden had no choice but following the European trend, especially when it became clear that the Takeover Directive would have been eventually approved.

This interpretation is certainly correct, and it explains too why many other European countries started to reckon with the British model of takeover regulation much before that the European Directive compelled them to do so.[209] But this is

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[205] Ventoruzzo, M. [2006], *op. cit.*, 194-198.

[206] See Organization for Economic Cooperation and Development [2006], *Corporate Governance and Company Law Database*, The OECD's Directorate for Financial and Enterprise Affairs and The Stockholm Centre of Commercial Law, available at http://oecd.eddy.se – restricted access, on file with author (last accessed May 1, 2007).

[207] Roschier, Attorneys Ltd. – Sweden [2006], *Implementation of the Takeover Directive in Sweden*, 9 May 2006, available at www.lexuniversal.com.

[208] Skog, R. [1995], DOES SWEDEN NEED A MANDATORY BID RULE? A CRITICAL ANALYSIS, Juristförlaget.

[209] Grundmann, S. [2005], *The Market for Corporate Control: The Legal Framework, Alternatives, and policy Considerations*, in K.J. Hopt, E. Wymeersch, H. Kanda, and H. Baum, CORPORATE GOVERNANCE IN

only one part of the story. By introducing a British-style takeover regulation, national legislators have anticipated the European one: on the one hand, this gave them the opportunity to adapt the model to the features of their country's corporate governance; on the other hand, this strategy conferred upon them bargaining power in the negotiations about the EU legislation. If anything, Sweden was somewhat smarter in this respect. On the one hand, together with other Scandinavian countries, it contributed to the failure of the original attempt to impose the breakthrough rule as mandatory – which would have had disruptive effects on the Swedish system.[210] On the other hand, Sweden made sure that the introduction of the mandatory bid was the least troublesome for its market for corporate control.

b) *How to Neutralize the Mandatory Bid: Two-Stage Acquisitions*

It is still sometimes reported by the literature that Sweden has a threshold of 40% of the voting rights for the mandatory bid.[211] However, this information is outdated. In September 2003, the threshold was lowered to 30% by the Swedish *Näringslivets Börskommitté* (NBK), which was in charge of takeover regulation before the Takeover Act came into force in July 2006.[212] As I mentioned, the substantive contents of the present regulation are basically unchanged.[213] The higher threshold was more consistent with the Swedish ownership structure, and was intended to ease changes in control between controlling shareholders, but in the end convergence towards the prevailing European standard was probably considered as unavoidable for preserving the good reputation of the stock market. Anyway, when the threshold is passed, the acquirer has to make a tender offer for all outstanding

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CONTEXT: CORPORATIONS, STATES, AND MARKETS IN EUROPE, JAPAN, AND THE US, Oxford University Press, 421-446.

[210] See, e.g., McCahery, J.A., Renneboog, L. (with P. Ritter and S. Haller) [2003], *op. cit.*, 50-51.

[211] Ventoruzzo, M. [2006], *op. cit.*, 196.

[212] See the Rules Issued by the *Näringslivets Börskommitté*, NBK (The Swedish Industry and Commerce Stock Exchange Committee), 5th edition, 2004, available at www.naringslivetsborskommitte.se (hereinafter NBK Rules). The New Takeover Act – *Lag (2006:451) om offentliga uppköpserbjudanden på aktiemarknaden* [Act (2006:451) on Public Purchase Offers in the Stockmarket] – is not available in English.

[213] See Roschier, Attorneys Ltd. – Sweden [2006], *op. cit.*; and von Haartman, A. [2006], *The regulatory framework for takeover bids changes on 1 July 2006*, Memorandum Finansinspektionen, available at www.fi.se (hereinafter, von Haartman, A. [2006], *Memorandum Finansinspektionen*). I have checked the validity of information reported in the following discussion by personal communications with Swedish practitioners. I wish to thank, for their invaluable help, Peter D. Camesasca and Kristian Hugmark at Howrey LLP, Brussels, Ekaterina Pischalnikova at Cleary Gottlieb Steen & Hamilton LLP, New York, and Per Österlind at *Advokatfirman Vinge KB*, Malmö. I take full responsibility for any mistake.

stock at the highest price paid for each class of shares in the previous 6 months.[214] The question is how he can possibly avoid extending the payment of the control premium to minority shareholder under these conditions, especially when the burden of this obligation would induce him to refrain from taking over in the first place. The answer is, of course, that the control transaction must be structured in such a way as to avoid triggering the mandatory bid. But, in order to understand this, we need to step back to the takeover practice before the introduction of the mandatory bid.

Acquisitions in Sweden used to be operated in two stages.[215] The first stage was the transfer of the control block at a freely negotiated price. The second step was an unrestricted tender offer for non-controlling shares, conditional on the acquisition of 90% of the outstanding stock: this is in fact the threshold traditionally established by Swedish corporate law for the minority's squeeze-out.[216] It should be noticed that this result obtained in the absence of restrictive regulation of takeovers: at that time, the mandatory bid was just a non-binding recommendation. This free-market result indirectly confirms the optimality of the takeover mechanism that was illustrated in the previous Chapter with reference to controlling shareholder systems.[217] Swedish corporate governance features very little, if any, scope for diversionary PBC, so that there is essentially no risk that takeovers are value-decreasing – at least, as far as the target shareholders are concerned. In introducing a takeover regulation, the Swedish authorities had the difficult task of preserving this mechanism in spite of the constraints that were about to come from the EU law. So they did through the regulation of voluntary bids, which – as the reader may recall – are regarded by the Directive as a valid exception to the mandatory bid.

Acquisitions can still be operated in two stages in Sweden, and nowadays they may need to be operated in such a fashion in order to avoid the mandatory bid. As before, the acquirer will have to purchase a toehold from the controlling shareholder, but now this must necessarily account for less than 30% of the voting rights. The rest will have to be purchased together with non-controlling shares through a voluntary tender offer. When the threshold is surpassed by way of an 'any or all' voluntary bid, the mandatory bid does no longer apply.[218] However, the price of voluntary bids is also regulated. In the presence of pre-bid purchases, both

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[214] NBK Rules III.1 and III.5.

[215] Agnblad, J., Berglöf, E., Högfeldt, P. and Svancar, H. [2001], *Ownership and Control in Sweden: Strong Owners, Weak Minorities, and Social Control*, in F. Barca and M. Becht (eds.), THE CONTROL OF CORPORATE EUROPE, Oxford University Press, 246-248.

[216] Karnell, G. [1981], *The Law of Associations, with Special Regard to Company Law*, in S. Strömhold (ed.), AN INTRODUCTION TO SWEDISH LAW, vol. 2, Kluwer, 349-350.

[217] See *supra*, Chapter Ten, section 10.3.2.

[218] See NBK Rule III.1.

the voluntary and the mandatory bid must offer a consideration no lower than the highest price paid in the previous six months.[219] Thus the bidder has to wait half a year, if he wants to avoid the tender offer being overpriced. Apparently, this is not much of a change for the Swedish takeover tradition, whose "remarkable feature [...] is that the bidder often has a substantial long-term toehold in the target firm."[220] Intuitively, this only makes sense in a context where takeovers cannot but be friendly. Both stages of the control transaction need to be negotiated at the outset between the incumbent and the insurgent controllers. This appears to be also a prominent feature of the Swedish market for corporate control.

Other elements of takeover regulation support, or are otherwise no impediment to, the functioning of the above mechanism. Swedish self-regulation pre-empted the Takeover Directive also in introducing a rule of board neutrality,[221] which is now in the law.[222] This does not undermine the controlling shareholder's ability to fend off a hostile takeover – he would always count on sufficient voting rights to uphold defensive measures, should they ever be necessary -, and is otherwise irrelevant provided that managerial control is not featured by the general corporate law. The Swedish legislator instead protected both the typical ownership structure and the takeover market from potential (albeit temporary) disruption by opting out the breakthrough rule.[223] Swedish firms are quite unlikely to opt in although, in theory, they are permitted to do so – they would rather spontaneously restructure dual class security-voting arrangements, instead of stupidly exposing them to hostile takeovers.

As a result, dual class shares are bound to stay safe in Swedish corporate governance. As in the past, they are still allowed differential treatment in takeover bids.[224] Notice, however, that this would not be always sufficient to avoid the sharing of the control premium involved by the mandatory bid, provided that the controller normally neither holds none of the low-voting shares nor does he own all of the high-voting ones,[225] and that takeover bids cannot be restricted to just one class of shares.[226] Conversely, dual class shares may contribute to the cashing in of the control premium when the transaction is structured in two stages, although differential treatment in the tender offer stage is not strictly necessary to this purpose. It

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[219] NBK Rule II.10 (also applicable to mandatory bids per Rule III.5).
[220] Agnblad, J., Berglöf, E., Högfeldt, P. and Svancar, H. [2001], *op. cit.*, 247.
[221] NBK Rule II.16.
[222] von Haartman, A. [2006], *Memorandum Finansinspektionen*, cit.
[223] Id., at 1. See also European Commission [2007], *Report on the Implementation of the Directive on Takeover Bids*, cit., Annex 1.
[224] See NBK Rule II.9 (applicable to mandatory bids per Rule III.5).
[225] Agnblad, J., Berglöf, E., Högfeldt, P. and Svancar, H. [2001], *op. cit.*
[226] von Haartman, A. [2006], *Memorandum Finansinspektionen*, cit.

is reported that, before the introduction of takeover regulation, the vast majority of voluntary bids addressed to dual-class targets did not differentiate between classes of shares.[227]

c) *What Is Wrong with Swedish Corporate Governance?*

Little more can be said about takeover regulation in Sweden, save that perhaps the only weakness of Swedish corporate governance does not depend on it. The Swedish system seems to have coped pretty well with the constraints set by the Takeover Directive. It can be predicted that the smoothness of the takeover process will not be much affected by compliance with the EU regulations, even though they constrain the national legislator's ability to improve that smoothness in the future. The lower bound on the squeeze-out threshold is a prominent example in this regard, regardless of the 90% figure actually corresponding to the Swedish tradition. But this is a negligible problem compared to the side effects that distribution of legal powers, under Swedish corporate law, has on the efficient dynamics of control allocation.

The reader will recall that this distribution does not allow for managerial control of listed companies.[228] This means, in turn, that dispersion of ownership nurtured by a sequence of changes in control faces an unavoidable lower bound. It can be expected that, when this limit is reached, idiosyncratic control rents do no longer play a substantial role in corporate governance. However, the impossibility of transition to managerial control limits the incumbent's controller's ability to cash them in.[229] As a result, control is stuck in families for generations and generations, ownership and control are more concentrated than it would be desirable, and fewer and more 'unfocused' takeovers occur than it would be efficient.[230] Mismanagement of free cash and empire building – all instances of distortionary PBC – do not exactly arise from the takeover process, but from its failure to determine an efficient evolution of the ownership structure. Extraction of higher perquisites is just the only way to profit from control, when its rents cannot be otherwise cashed in. This interpretation is supported by the empirical evidence, showing that Swedish companies are mostly involved in highly mature businesses, and that both their finance and acquisitions are tainted more by traditional 'agency costs' than by expropriation of mi-

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[227] Agnblad, J., Berglöf, E., Högfeldt, P. and Svancar, H. [2001], *op. cit.*, 247.
[228] See *supra*, Chapter Seven, section 7.4.1.
[229] See *supra*, Chapter Six, section 6.7.3.
[230] Cronqvist, H. and Nilsson, M. [2003], *Agency Costs of Controlling Minority Shareholders*, in JOURNAL OF FINANCIAL AND QUANTITATIVE ANALYSIS, vol. 38, 695-719.

nority shareholders.[231] I subscribe to the view of Swedish financial economists that distortionary PBC, and not diversion of shareholder value, are the real problem of corporate governance in Sweden.[232] I only add to the conclusion that this is determined by the failure of corporate law to provide sufficient entitlements for managerial control, rather than by too a liberal attitude towards pyramids or dual class shares and the inefficiencies of the takeover process that they may, allegedly, result in.

11.5.2. A New Takeover Regulation in the Netherlands

The Dutch case is a more difficult one to handle. There are many reasons for that. One is that the Netherlands did not have so far any mandatory bid rule in place, not to speak about obligations of board neutrality in the wake of a takeover;[233] at the time this dissertation is being written, it is still uncertain how the Takeover Directive will be implemented in both respects.[234] The second difficulty is that, differently from other countries in continental Europe, corporate governance in the Netherlands features both managerial and shareholder control,[235] which are obviously affected by takeover regulation in different fashions.[236] Thirdly, assessing the impact of takeover regulation in the Netherlands is made more difficult by the objective complications in the legal distribution of corporate powers; as we saw in the Seventh Chapter, these are the key legal underpinnings of the Dutch model of corporate governance.[237] Therefore, let us consider separately the issues of takeover resistance and of the mandatory bid with reference to companies that have, or have not, a controlling shareholder.

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[231] Holmén M. and Högfeldt P. [2004], *A Law and Finance Analysis of Initial Public Offerings*, in JOURNAL OF FINANCIAL INTERMEDIATION, vol. 13, 324-358.

[232] Holmén, M. and Högfeldt, P. [2005], *Pyramidal Discounts: Tunneling or Agency Costs?*, ECGI Finance Working Paper No. 73/2005, available at www.ssrn.com and www.ecgi.org.

[233] Meinema, M. [2003], *Mandatory and Non-Mandatory Rules in Dutch Corporate Law*, in ELECTRONIC JOURNAL OF COMPARATIVE LAW, vol. 6.4, 199-224, available at www.ejcl.org/64/art64-10.pdf

[234] In mid-2006, the Netherlands introduced some interim regulations mainly intended to implement those provisions of the Takeover Directive having direct effects, which could be invoked by private parties for holding the Dutch government liable. These regulations are known as Temporary Exemption Regulations for Public Offers, and mostly deal with the institution of the European Passport for takeover bid circulars approved by regulators of other Member states. Art. 10 of the Directive (information on ownership and control structure of listed companies) was also implemented by means of a separate decree. See Norton Rose [2006], *Implementation of the European Takeover Directive in the Netherlands*, July 2006, available at www.nortonrose.com

[235] See *supra*, Chapter Two, section 2.4.2.

[236] See *supra*, Chapter Ten, sections 10.4.3 and 10.4.4.

[237] See *supra*, Chapter Seven, section 7.3.3.

a) *When the Management Is in Charge*

Takeover resistance is the key issue under managerial control, since the latter could not be featured when managers have no way to shield themselves from a hostile takeover. The Dutch legislator seems to be somewhat aware about that, and apparently it has chosen to opt out both the board neutrality and the breakthrough rules. To be sure, the Dutch Government had originally decided to challenge some of the traditional takeover defenses, and 'flirted' with the breakthrough rule to some extent.[238] In the first bill of implementation of the Takeover Directive, not only was a hostile takeover bid no longer allowed as an exception to the duty of the *Administratiekantoor* to issue a proxy to holders of depository receipts, but also priority shares (carrying preferential nomination rights) and protective preference shares (allowing dilution of unwelcome bidders) were bound to be neutralized upon at least 75% of the share capital being tendered to the bidder.[239]

The Dutch Parliament, however, rejected that proposal.[240] As a result, it is now quite clear that no breakthrough rule will be introduced in the law of the Netherlands – if not, as the Directive prescribes, on a voluntary basis. A similar destiny is expected for the rule of board neutrality.[241] Neither the Government nor the Parliament have apparently ever questioned the principle, established by the judiciary since the time of the battle over control of Gucci, that the board may take frustrating actions in the interest of the company and of its *stakeholders*.[242] The articles of associations will have to be allowed to incorporate the provision of an additional shareholder authorization, which, however, will be no exception to the principles established by the case-law – and is therefore even more unlikely to be adopted by Dutch companies than anywhere else in Europe. What only seems that will remain of the legislative stance against takeover defenses is the obligation for the *Administratiekantoor* to issue a proxy to the holders of depository receipts also in the event of a takeover.[243] Nonetheless, the incumbent management is still left with a wide array of options as to takeover resistance.

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[238] De Brauw Blackstone Westbroek (hereinafter De Brauw) [2005], *Bill for Public Offers*, 30 December 2005, available at www.debrauw.com.

[239] See also Freshfields [2005], *New Public Takeover Regime in the Netherlands*, April 2005, available at www.freshfields.com.

[240] De Brauw [2006], *Bill for Public Offers – Status Report*, 17 July 2006, available at www.debrauw.com.

[241] See, on both issues, Freshfields [2006b], *Implementing the Takeover Directive in the EU*, July 2006, available at www.freshfields.com, 5-6; and European Commission [2007], *Report on the Implementation of the Directive on Takeover Bids*, cit., Annex 1.

[242] See *supra*, Chapter Seven, section 7.3.3.

[243] De Brauw [2006], *Status Report*, cit., 2.

The mandatory bid is not really a matter of concern as long as the target's ownership is dispersed: the acquirer will be always smart enough to avoid triggering it. In this situation, takeover bids will continue to be voluntary, and the price will be agreed upon between the acquirer and the incumbent management. The expertise of the Enterprise Chamber of the Amsterdam Court of Appeals, and the ease of activating a proceeding before it, can be expected to provide sufficient constraints against value-decreasing takeovers.[244] Two-tier bids are traditionally impossible under Dutch corporate law, due to restrictive regulation of the minority's squeeze-out.[245] This is going to change very little with the implementation of the Takeover Directive, which compels Member states to provide for post-bid squeeze-out while regulating the consideration in such a way as to exclude coercive bids.[246]

The approach of the Dutch legislator seems to be quite conservative in this respect. Apparently, both squeeze-out and sell-out rights, for a consideration equal to the bid price, will be triggered by the acquisition of 95% of more of the outstanding shares.[247] This will result in the introduction of a sell-out right, where there was none,[248] and in the squeeze-out right being modified just in the price regulation: the Enterprise Chamber will continue to be in charge of the proceeding, but a consideration equal to the bid price will have to be considered as fair under the conditions established by the Directive.[249] Needless to say, a lower threshold for the exercise of squeeze-out could ease the takeover process without undermining investor protection; unfortunately, 90% is the lowest figure allowed by the Takeover Directive.

However, one major problem with the takeover of free-standing firms in the Netherlands has nothing to do with the Directive. It is about regulation of severance payments. Before the last reform, corporate law provided that management compensation *could* be handled at the (supervisory) board level: although the default rule was different, many listed companies used to opt it out.[250] After 2004, all aspects of management remuneration – *including* severance payments – *must* be disci-

[244] See *supra*, Chapter Nine, section 9.3.3. It should be reminded that the Enterprise Chamber has exclusive jurisdiction on the Inquiry Procedure. Over the last few years, this procedure has become extremely popular in the takeover context. It can be activated on grounds of mismanagement pending a takeover bid. See Meinema, M. [2003], *op. cit.*, 161.

[245] Timmerman, L. and Doorman, A. [2002], *Rights of Minority Shareholders in the Netherlands*, in ELECTRONIC JOURNAL OF COMPARATIVE LAW, vol. 6.4, 181-211, available at www.ejcl.org/64/art64-12.html, 204-206.

[246] Art. 15 of the Takeover Directive.

[247] Freshfields [2005], *op. cit.*, 3; European Commission [2007], *Report on the Implementation of the Directive on Takeover Bids*, cit., Annex 4.

[248] Timmerman, L. and Doorman, A. [2002], *op. cit.*, 206-207.

[249] De Brauw [2005], *Bill*, cit., 6.

[250] Stibbe [2004], *Amendment of the Rules Relating to the Large Company Regime Has Been Adopted by the Upper Chamber of the Dutch Parliament*, 21 July 2004, www.stibbe.com (on file with author).

plined according to a policy endorsed by the shareholder meeting.[251] Apparently, with the aim of limiting the high costs of board members' dismissal, the Government even considered to set an upper bound to the management's golden parachutes, based on a compensation formula adopted by Sub-district Courts in labor cases (the "Dutch cantonal formula", so-called *Kantonrechtersformule*).[252] This has never become law, although some companies have actually chosen to establish their remuneration policy on that basis.[253] The upper bound on management's severance payments is set instead by the Corporate Governance Code, which – as we know from the Ninth Chapter – is both binding and complied with by the near totality of Dutch listed firms:[254] golden parachutes cannot exceed the amount of one-year salary, which can be raised up to two-year in case of long-term employment.[255] This provides incumbent management with limited, and possibly no ability to renegotiate severance payments in the event of a takeover, thereby forcing bidders to offer a higher takeover premium and to forego takeovers when this is too a high price to pay compared to the gains at stake. Not differently from the UK, Dutch managers hold significant ownership stakes in the companies they control.[256]

b) How Will Controlling Shareholders Tackle the Mandatory Bid?

In the presence of a controlling shareholder, neither takeover resistance (which would obtain anyway, especially in the absence of breakthrough rules) nor golden parachutes (which are unnecessary) affect the functioning of the market for corporate control on the basis of negotiated deals. However, the mandatory bid potentially does, and this is probably the reason why the Takeover Directive has not yet been implemented in the Netherlands. It seems nonetheless quite clear that the threshold triggering the obligation will be set at the level prevailing in Europe, namely 30% of voting rights.[257] In addition, according to the latest developments, the price of the mandatory bid will be determined based on the highest considera-

[251] De Brauw [2004], *Change of 'Structure Regime' – Statutory Basis for Corporate Governance Code*, 7 July 2004, available at www.debrauw.com.

[252] Corporate Governance Committee [2003], *The Dutch Corporate Governance Code*, available at www.commissiecorporategovernance.nl, 43 (Account of the Committee Work – Domestic Developments, section 9).

[253] See Ontslagrecht Advocaat [2007], *Vergoeding*, available at www.ontslagrechtadvocaathaarlem.nl.

[254] See *supra*, Chapter Nine, section 9.3.3.

[255] See Corporate Governance Code § II.2.7.

[256] de Jong, A., Kabir, R., Marra, T. and Röell, A. [2001], *Ownership and Control in the Netherlands*, in F. Barca and M. Becht (eds.), THE CONTROL OF CORPORATE EUROPE, Oxford University Press, 188-206.

[257] Freshfields [2006b], *op. cit.*, 5-6; European Commission [2007], *Report on the Implementation of the Directive on Takeover Bids*, cit., Annex 2.

tion paid by the bidder for stock acquisitions over the preceding 12 months. The Dutch Securities Authority (*Autoriteit Financiële Markten*) will have limited ability to waive either the mandatory bid or its price regulation under special circumstances.[258] Therefore, this discipline of control transactions is going to be very burdensome, and the best strategy for a takeover is trying to get around it.

Apparently, the legislation in the making will allow a few opportunities for circumventing the mandatory bid when a control block is transferred.[259] One possibility is that controlling ownership is lower than 30%. In this case, the acquirer will be allowed to purchase this block at a premium, without having to pay the same control premium to minority shareholders. He may then decide whether to make a voluntary bid for the rest of the company's shares. Currently, it is only established that passing the 30% threshold through a voluntary, 'any or all' tender offer does not trigger the mandatory bid, but it is unclear whether and how the price of such an offer would be regulated.[260] In case it would with reference to the previous purchases, the acquirer should wait one year to take the company private.

Most often, however, controlling shareholders account for more than 30% of share capital. Here comes the importance of a second derogation to the mandatory bid. The latter shall not apply to the *Administratiekantoor*, whatever the percentage of shares held in trust and its variation.[261] In principle, changes in control operated through this kind of foundation should not trigger the mandatory bid. In practice, this is not as simple, for apparently changes in beneficial ownership (i.e., transfers of depositary receipts) do count for the calculation of the critical threshold.[262] Given the uncertain state of legislation in the making, we cannot speculate upon this much further. But it seems that the mandatory bid could be circumvented by allowing changes in control of the trust foundation to be accompanied by limited transfer of either stock or beneficial ownership below the threshold, with the rest being possibly – but not necessarily – purchased through a voluntary bid. This arrangement has an important shortcoming: it allows control to be transferred separately from ownership. Therefore, it may result in inefficient control allocations.[263]

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[258] De Brauw [2006], *Status Report*, cit.

[259] See European Commission [2007], *Report on the Implementation of the Directive on Takeover Bids*, cit., Annex 3.

[260] Freshfields [2005], *op. cit.*, 1.

[261] De Brauw [2006], *Bill*, cit., 3. In addition, it should be mentioned that the mandatory bid will be also not applicable when the threshold is surpassed due to the issuance of protective preference shares (see *supra*, Chapter Seven, section 7.3.3). They can therefore continue to be operated as takeover defenses.

[262] Id., at 2.

[263] See *supra*, Chapter Ten, section 10.2.

Whether this outcome is any preferable to the mandatory bid preventing most part of efficient takeovers is open to question.

c) The Dutch 'Structured Regime' and the Takeover Process

Finally, it should be highlighted that one major impediment to the efficient functioning of the market for corporate control depends on the Dutch tradition, more than on the implementation of the Takeover Directive. Under both managerial and shareholder control, the structured regime undermines the acquirer's ability to replace the members of both the management and the supervisory board, in spite of his being in control of the majority – or even the totality – of voting rights.[264] Even under the new regulations, the shareholder meeting is not entitled to place binding nominations, but only to veto the supervisory board's ones; and the power of appointing new board members, upon dismissal of the old ones, resides only with the Enterprise Chamber.[265] As it was illustrated in the Seventh Chapter, this is no sufficient impediment to the controlling shareholder exercising ongoing control in the long run; but it is indeed an impediment to changes in control that require replacement of management in the very short run – for which control of the supervisory board is a necessary condition.[266]

The structured regime is often associated to the Dutch managers' entrenchment, but it is actually unnecessary to this purpose: managerial control may otherwise avail itself of both a favorable distribution of powers and takeover resistance, and it is in fact featured also where the structured regime does not apply. Then the only practical effect of the structured regime is that it undermines the ease of the takeover process, and the Dutch legislator may profit from the implementation of the Takeover Directive for having it finally repealed. At the very least, it should be established that the same regime is suspended in the wake of a takeover, so that the acquirer face no restraints in replacing the incumbent management. Currently, it is unclear whether the Dutch Parliament will go for this solution.

11.5.3. Implementing the Directive in Italy: Making a Virtue of Necessity?

The Italian case may be regarded as both an easy and an extremely difficult one. It may look easy, provided that corporate governance just features controlling shareholders and takeover regulation includes the key elements of the European

[264] Freshfields [2005], *op. cit.*, 2-3.
[265] See *supra*, Chapter Seven, section 7.3.3.
[266] See *supra*, Chapter Seven, section 7.6.3.

Directive since more than a decade.[267] However, it is extremely difficult, given that the patterns of separation of ownership and control appear to be strongly determined by the traditional weakness of the discipline of conflicted interest transactions and the absence of distributions of corporate powers supporting managerial control.[268] Both factors contribute to ownership concentration and stock market underdevelopment, but – even more importantly – they constrain the efficiency of the takeover process. As I mentioned, the solution of these two problems has to be regarded as a precondition for an efficient regulation of the market of corporate control.[269] I shall start by assuming that they can be tackled in the ways illustrated in the foregoing Chapters on distribution of powers and regulation of related-party transactions. Next, I shall consider the implications for takeover regulation when they are not.

a) *The 'Italian Model' of Takeover Regulation*

Italy has not yet implemented the Takeover Directive, and the government has postponed the term for its implementation until the end of September 2007.[270] Information about the coming legislation is fragmentary and mostly confidential.[271] But it is worth noting that regulation of takeovers is already very strict in Italy. A mandatory bid is triggered by a threshold of 30% of voting rights being surpassed, with limited exceptions.[272] Defensive measures can only be taken by the board in the presence of shareholder authorization with at least a 30% majority.[273] However, the bid price is not regulated as strictly as under the British City Code: it is not set

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[267] The first comprehensive body of takeover regulation was introduced in Italy in 1992 (Act No. 149/1992 – "Disciplina delle offerte pubbliche di vendita, sottoscrizione, acquisto e scambio di titoli"). The 1992 legislation provided – *inter alia* – for both a mandatory bid (to be imposed by the National Securities Authority – *Consob* – without a fixed threshold) and absolute board passivity pending a hostile bid. The current regulation is established by the Legislative Decree No. 58/1998 ("Testo unico delle disposizioni in materia di intermediazione finanziaria"), which has introduced a threshold of 30% of voting capital triggering the mandatory bid, substituted board neutrality for board passivity, and provided for a mini-breakthrough rule concerning voting pacts.

[268] See *supra*, Chapter Seven, section 7.4.1; and Chapter Nine, section 9.3.5.

[269] See *supra*, Chapter Ten, section 10.1.

[270] Act No. 77/2007 ("Delega legislativa per il recepimento delle direttive 2002/15/CE del Parlamento europeo e del Consiglio, dell'11 marzo 2002, 2004/25/CE del Parlamento europeo e del Consiglio, del 21 aprile 2004 e 2004/39/CE del Parlamento europeo e del Consiglio, del 21 aprile 2004, nonché per l'adozione delle disposizioni integrative e correttive del decreto legislativo 19 agosto 2005, n. 191, di attuazione della direttiva 2002/98/CE").

[271] For an informal, but publicly available, draft, see Sabbatini, R. [2006], *Opa italiana: il progetto del Tesoro per adeguarsi alla direttiva UE*, Il Sole 24 Ore, 16 June 2006, available at www.24oreborsaonline.ilsole24ore.com.

[272] Art. 106(1) Legislative Decree No. 58/1998.

[273] Art. 104 Legislative Decree No. 58/1998.

equal to the highest consideration paid for pre-bid acquisitions, but to the average between that consideration and the market price weighted-average over the past 12 months.[274] Alternatively, the acquirer may seek a discount on the sharing of the control premium by making a partial, non-discriminatory bid for at least 60% of outstanding stock. This option is only available in the absence of significant pre-bid purchases, and it is conditional on both approval by the shareholder meeting (without the votes held by controlling shareholders) and authorization by the Securities Authority (*Consob*).[275] Finally, regulation of takeover defenses is not as strict as it may appear. Most controlling shareholders in Italy hold more than 30% of the voting rights, and are otherwise entrenched when they do not.[276] In addition, some financial instruments recently introduced by corporate law can be used with anti-takeover purposes, and they may escape the rule of board neutrality when they are issued before that a bid is in the making.[277] However, since they cannot support ongoing managerial control, but only its defense, they have had so far little impact on the governance of listed firms.[278]

It is often overlooked that the existing takeover regulation in Italy features a very interesting compromise between shareholder protection and the promotion of an active market for corporate control.[279] On the one hand, the mandatory bid is made relatively uneasy to circumvent anytime control is exercised with more than 30% of the voting rights. Splitting the control block would not help, since pre-bid purchases also affect the price of voluntary bids, although, under certain conditions, mergers and other organic changes may allow a change in control to escape the mandatory bid.[280] On the other hand, regulation does not compel full sharing of the control premium with minority shareholders. A discount is allowed on either the price or the quantity of the bid, thereby easing the takeover process at least in those cases where the control premium is not too high relative to inefficiencies in management.[281] Apparently, this strategy has not been particularly successful. Although some more dynamism is observed in the ownership structure of listed companies, it

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[274] Art. 106(2) Legislative Decree No. 58/1998.
[275] Art. 107 Legislative Decree No. 58/1998.
[276] Bianchi, M., Bianco, M., Giacomelli, S., Pacces, A.M. and Trento, S. [2005], PROPRIETÀ E CONTROLLO DELLE IMPRESE IN ITALIA, Il Mulino.
[277] See *supra*, Chapter Seven, section 7.4.2.
[278] See, e.g., Enriques, L. [2006a], *op. cit.*, 52-53.
[279] This is a well-known topic for Italian commentators. See, e.g., Ventoruzzo, M. [2006], *op. cit.*, 199. However, the peculiarity of the Italian model of takeover regulation is also acknowledged in the comparative literature. See, most notably, Kraakman *et al.* [2004], *The Anatomy*, cit., 180-181.
[280] See art. 106(5) Legislative Decree No. 58/1998 and art. 49 Consob Reg. No. 11971/1999.
[281] See art 106(2) and art. 107 Legislative Decree No. 58/1998.

seems that, overall, changes in control either take place below the mandatory bid threshold or they do not occur at all.[282]

Perhaps two mistakes were made in drafting the Italian takeover regulation. The first, and the fundamental one, was expecting that contestability of corporate control would have obtained eventually thanks to these rules. To this purpose, not only was the rule of board neutrality laid down (in spite of its little usefulness in concentrated ownership structures), but Italy was one of the first countries to introduce a 'breakthrough' rule. Shareholder agreements as to both the voting and the transfer of shares have no effect in the wake of a tender offer, and may be definitively set aside when the bid is successful.[283] As it turns out, no more contestability has occurred so far – nor do I believe that it could ever have. More importantly, virtually no listed company is managed without the support of a controlling shareholder or a coalition of them – unfeasibility of managerial control just depends on a different set of rules. The second mistake was instead a venial sin. The traditional problem of Italian corporate governance is expropriation of minority shareholders, and a sufficiently strict takeover regulation was considered as necessary to avoid the worsening of this problem in spite of the adverse effects of the mandatory bid on the dynamics of control allocation. In this perspective, the rules established in 1998 could be regarded as quite a good compromise, until a more efficient discipline of diversionary PBC was available. However, after about ten years, a change in approach is in order: takeover regulation is not the right tool for policing shareholder expropriation, and should be freed from this concern in order to support an efficient market for corporate control.

b) *Activating the Market for Corporate Control*

Separating protection of minority shareholders from the regulation of takeovers is certainly not in the spirit of the EU Directive, although it should be from a normative perspective. Therefore, what can only be suggested to the Italian legislator is to make a virtue of necessity. Unfortunately, the Takeover Directive provides very little opportunity to do so. Italy will have to repeal its peculiar regulation of the bid price, and the *Consob* will have only limited discretion in allowing discounts on the highest price paid in pre-bid purchases.[284] The option of making a partial bid is instead compatible with the Takeover Directive, and it should stay. For the rest, the coming Italian legislation should make use of its discretion in determining the trig-

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[282] Bianchi, M. and Bianco, M. [2006], *Italian corporate governance in the last 15 years: from pyramids to coalitions?*, ECGI Finance Working Paper No. 144/2006, available at www.ssrn.com and www.ecgi.org.
[283] Art. 123(3) Legislative Decree No. 58/1998.
[284] Compare with art. 5.4 of the Takeover Directive.

gering event as to allow efficient changes in control to get around the mandatory bid. One possible solution is to set a higher threshold than that in force. However, this seems to be quite an unlikely scenario, given the convergence of the vast majority of European jurisdictions towards the 30% figure.[285]

The alternative could be to liberalize voluntary bids. Currently, unless the acquirer goes straightly for the partial bid option, voluntary bids do not allow price regulation to be easily escaped.[286] However, the Takeover Directive definitively allows for this possibility, at least when the voluntary bid is unrestricted. The Italian regulation might ease the transfer of controlling blocks by making the following strategy legal. Payment of the control premium is allowed inasmuch as it concerns less than 30% of the outstanding capital. The control premium need *not* be paid to minority shareholders when their shares are acquired by means of a subsequent tender offer. To this purposes, the price of both voluntary bids and of subsequent purchases should be left unregulated – or, at least, it should be regulated in such a way as to allow for two-stage acquisitions with a window no larger than six months. The reader will have recognized that this is the solution implemented in Sweden.[287]

There are two important requirements for the above mechanism to be an effective acquisition strategy. The first is that the acquirer of the control block should be entitled to both the exercise and the defense of corporate control with less than 30% of voting rights – at least until he is prevented from acquiring more. In part, this depends on the distribution of corporate powers; but let us abstract from this problem here. More importantly, the acquirer needs to be able to shield the company from another takeover (which may well be hostile) until he can make a tender offer for the rest of the shares. This might be not much of a problem if, at it seems to be the case, Italian law will opt out *both* the board neutrality and the break-

[285] European Commission [2007], *Report on the Implementation of the Directive on Takeover Bids*, cit., Annex 2.

[286] In the presence of significant pre-bid purchases (i.e., above 1% of the voting capital), partial bids are not allowed to excuse a mandatory bid. Art. 107(1)(a) Legislative Decree No. 58/1998. The price of unrestricted bids may be also constrained by prior purchases, depending on interpretation of art. 106(2). More importantly, further restrictions are established on the price of subsequent purchases, through additional mandatory bid obligations: when the controller's stake is increased by 3% or more within a one-year period; and when the same stake has reached 90% of the voting capital (which is not sufficient for squeezing-out minority shareholders in Italy). See art. 46 Consob Reg. No. 11971/1999 and art. 108 Legislative Decree No. 58/1998. Finally, increases of 1% or more in the ownership stake within a one-year period from consummation of a partial bid trigger again the mandatory bid (art. 107(3) Legislative Decree No. 58/1998).
For all of these reasons, the idea of liberalizing voluntary bids in Italy has been a long-standing matter of debate. See, e.g., Camera dei Deputati [2004], *Indagine conoscitiva sull'attuazione del testo unico delle disposizioni in materia di intermediazione finanziaria*, Allegato 2, Documento conclusivo approvato dalla Commisione, 7 April 2004, available at www.camera.it.

[287] See *supra*, section 11.5.1.

through rules and leave the choice on these arrangements to the individual company's charters.[288] Apart from the traditional 'breakthrough' of voting pacts (which unfortunately is likely to stay, but is also not essential to the case we are considering), companies that are subject to neither of these rules can be good targets for a friendly acquisition below the mandatory bid threshold, just because – maybe somewhat paradoxically – they would not be good ones for a hostile takeover after that acquisition. In a sense, this mechanism can be interpreted as a first step towards the emergence of managerial control, although this could only be established in the long run upon an appropriate regulation of both distribution of corporate powers and conflicted interest transactions.[289]

The second requirement is that the acquirer must find it profitable to make a tender offer for non-controlling shares. We know that a necessary condition for this is that the takeover is value-increasing, and let us keep this assumption for one more moment. The best of all worlds would be if the acquirer was just entitled to freely decide whether to make the bid or not, and on what terms, immediately after the acquisition of the control block (or of the largest part of it).[290] But we are just making a virtue of necessity – the implementation of the Takeover Directive. So let us assume that the acquirer would have to wait – like in Sweden – at least six months for overcoming all regulatory restrictions on the bid price.[291] This already places an important constraint on the acquirer's ability to profit from the tender offer: the market price may just rise too much meanwhile, if he is really going to improve the management.

Anyway, the odds of making a successful bid for non-controlling stock are more importantly affected by the rules governing the purchase of the shares that are not tendered. Here comes the importance of the regulation of squeeze-out: if the bidder has no good chances of taking the company private by a tender offer, he would definitely go for another strategy. The current Italian regulation of post-bid compulsory acquisition does not help: the triggering threshold is set as high as 98%, and the consideration is determined upon appraisal by an expert appointed by the court.[292] This is going to change little after the implementation of the Directive,

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[288] European Commission [2007], *Report on the Implementation of the Directive on Takeover Bids*, cit., Annex 1.

[289] See *supra*, Chapter Seven, section 7.6.1; and Chapter Nine, section 9.3.5.

[290] See *supra*, Chapter Ten, section 10.3.2. The American regulation is the one coming closer to this scenario. See *supra*, section 11.2.2.

[291] Just incidentally, it is worth reminding that no such requirement is explicitly established by the Takeover Directive. However, compare art. 5.2 with the general principle of equal treatment of shareholders, as enunciated in art. 3.1(a) of the Takeover Directive.

[292] Art. 111 Legislative Decree No. 58/1998. Notice the significant asymmetry with the controller's obligations to purchase non-controlling stock through a second tender offer – which *must* be 'any

unless the Italian legislator bravely decides to lower the squeeze-out threshold down to the level triggering the sell-out right – which has always been 90%.[293] That being said, supplementing the constraint of the bid price – set by the Directive – with the appraisal by an expert – the heritage of the Italian tradition – may be useful to disallow tender offers below the market price prior to the transfer of the control block. We know that such a bid would be detrimental to minority shareholders, and can only serve the purpose of subsidizing value-decreasing acquisitions.[294]

c) Looting and the Broader Set of Problems of Italian Corporate Governance

Once again, it is embarrassing to say for an Italian, but we cannot safely assume that takeovers are not value-decreasing in Italy. This does not just depend on the regulation of squeeze-outs (a value-decreasing acquirer would simply not go for the purchase of non-controlling shares), but on a number of legal and institutional shortcomings that determine the corporate controller's ability to effect non-pro-rata distributions. I have extensively reviewed these shortcomings in Chapter Nine. However, the core of the problem is more in how corporate control is exercised on an ongoing basis than in how it is transferred. This is one of the key arguments of the present inquiry. Surely, in the presence of diversionary PBC, the market for corporate control cannot be assumed to work any efficiently. However, this is not a good reason to address the question with the wrong answer.

The highest priority for Italian corporate law is to police diversionary PBC, but this should not necessarily come at the expenses of other equally important issues. As regards takeovers, one has just to make sure that acquisitions do not result in increase in non-pro-rata distributions.[295] On the one hand, the significant improvements in the Italian discipline of conflicted interest transactions provide indirect support of this result, at least as far as the ongoing management is concerned; this support was probably not available nine years ago.[296] On the other hand, this may be still not sufficient to rule out value-decreasing takeovers. Then policymakers

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or all'. These are triggered either by non-negligible post-bid purchases or, anyway, by the ownership of 90% or more of the voting capital. See *supra*, note 286.

[293] This does not seem to be the case. Apparently, the Italian legislator is just inclined to lower the threshold down to the maximum level allowed by the Takeover Directive (i.e., 95%). See European Commission [2007], *Report on the Implementation of the Directive on Takeover Bids*, cit., Annex 4. The same threshold will have to govern the sell-out right, which – as I mentioned – was traditionally implemented in Italy as a mandatory bid triggered by ownership of 90% or more of the voting capital.

[294] See *supra*, Chapter Ten, section 10.4.5.

[295] See *supra*, Chapter Ten, section 10.2.3.

[296] That is, when the Legislative Decree No. 58/1998 was enacted with the main purpose of strengthening the protection of minority shareholders. See *supra*, Chapter Nine, section 9.3.5.

should directly address looting instead of trying to prevent it by making takeovers so expensive to be as unprofitable for any looter as for the vast majority of efficient would-be acquirers. This may be an overly high price to pay for protecting minority shareholders.[297] Having it tempered by a less burdensome configuration of the mandatory bid is only an imperfect solution – which, incidentally, will be only limitedly available after the implementation of the Directive.

Indeed, the comparative picture suggests a better alternative: having control transactions scrutinized by the judiciary under the same 'no shareholder diversion' standard as in the ongoing exercise of corporate control.[298] This requires both an easy access to court proceedings by shareholders (or their representatives), and that courts have as sufficient expertise to dismiss nuisance litigation in a summary judgment as to 'smell out' most sophisticated instances of looting that must be stopped until they go to trial (or are settled for damage compensation). We have seen that the two countries of our sample that go for this solution – the US and the Netherlands – allow for both appropriate procedural rules and a specialized judiciary to police conflicts of interest also when it comes to control transactions.[299]

None of these tools is currently available under Italian corporate law (at least, not entirely), although this may change in the near future.[300] Italian legislation should take stock of the ongoing improvements in the policing of diversionary PBC, by allowing first for their consolidation, and subsequently for their extension to corporate control transactions. Also in this context, judicial oversight should be limited to the risk of value diversion, and allow for as little interference as possible with business judgment (i.e., the merits of a change in control). Then the approach to takeover regulation can be safely liberalized inasmuch as this is allowed by the European Directive. The next and final step towards a more efficient regulation of corporate governance would be a more even distribution of corporate powers, which allowed control to be exercised by the board of directors also in the absence of controlling shareholders.[301] As it was illustrated in the Seventh Chapter, this may require little more than a reform of the proxy voting system.[302]

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[297] See Kraakman *et al.* [2004], *The Anatomy*, cit., 186.

[298] See *supra*, Chapter Ten, section 10.4.5.

[299] See *supra*, sections 11.2 and 11.5.2. For more details on legal protection of non-controlling shareholders in the US and in the Netherlands, see *supra*, Chapter Nine, sections 9.2 and 9.3.3.

[300] See *supra*, Chapter Nine, section 9.3.5.

[301] See *supra*, Chapter Seven, sections 7.4.1 and 7.6.1.

[302] Reforming the discipline of proxy solicitation would be also necessary to strengthen investor protection along the path described in Chapter Nine. See *supra*, Chapter Nine, section 9.3.5.

Conclusions

Doctoral dissertations in the Netherlands end with a highly formal public defense. As a part of this ceremony, eleven propositions are issued by the candidate, of which only a few can be related to the subject-matter of the thesis being defended. As homage to the University and the Country that hosted this work, I am presenting its conclusions also in the form of ten plus one propositions. However, all of them are specifically related to the research that has been carried out. The first ten summarize its major results. The special meaning of the last one is better left as a surprise for the reader.

1. Corporate governance is not just a relationship between principals and agents.

Historically, the agency theory was a major turning point in the economic and legal analysis of corporate governance. Economic theory was hardly able to explain why corporate finance mattered besides different taxation of debt and equity.[1] Legal theory was ultimately unable to explain what was wrong with separation of ownership and control.[2] With the emphasis on asymmetric information between managers and financiers, principal-agent models identified in agency costs the explanation of both issues, and in their minimization the virtue of the corporate contract.[3] Corporate Law and Economics was born under this premise.[4] Managers were regarded as agents of shareholders, creditors, and other firm constituencies, but the open-

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[1] Modigliani, F. and Miller, M.H. [1958], *The Cost of Capital, Corporation Finance, and the Theory of Investment*, in AMERICAN ECONOMIC REVIEW, vol. 48, 261–297.

[2] Berle, A.A. Jr. and Means, G.C. [1932], THE MODERN CORPORATION AND PRIVATE PROPERTY, MacMillan.

[3] Jensen, M.C. and Meckling, W.H. [1976], *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 3, 305-360.

[4] Easterbrook, F.H. and Fischel, D.R. [1991], THE ECONOMIC STRUCTURE OF CORPORATE LAW, Harvard University Press.

ended structure of the equity contract made incentive alignment with shareholder interest the fundamental issue: shareholders needed to have sufficient powers to hold managers accountable. In spite of subsequent developments in economic theory, Corporate Law and Economics is still a prisoner of this view.

What I have attempted to demonstrate in this work is that the above view is seriously incomplete, and – at least in some respects – it turns out to be even wrong. On the one hand, it does not match the empirical evidence. Principal-agent models can explain different choices of ownership and capital structure at the firm level, but cannot tell why these choices exhibit structurally different patterns across countries. The absolute prevalence of controlling shareholders outside the US and the UK is a remarkable challenge to the agency framework. On the other hand, the agency theory is contradicted by positive corporate law. The theory would predict that, not differently from the law of commercial contracts, corporate law is basically a collection of default rules. However, even the law traditionally considered the closest to this paradigm – the law of Delaware – features mandatory rules: the judge-made law of fiduciary duties and a few key elements in the statutory distribution of powers provide exemplary illustrations of this point.

From a purely theoretical perspective, traditional principal-agent models are incomplete in that they do not allow institutions and the law to play a significant role. Incomplete does not necessarily mean wrong. The more recent elaboration on contractual incompleteness has tried to fix the inconsistencies of the agency framework while preserving the original insight. Apparently, managers may still be regarded as shareholder agents in this perspective. However, given the imperfections of the corporate contract, corporate law is necessary to protect dispersed shareholders from expropriation and to empower them *vis à vis* the management. When it fails to achieve this goal, controlling shareholders are the only option for incentive alignment.[5]

As I have shown, this view – the 'law matters' version of the agency framework – fares no better in spite of its popularity. On the legal side, ownership concentration prevails also in those jurisdictions that, besides protecting shareholders from expropriation, empower them the most. Sweden is a case in point. On the economic side, the underpinnings of this modified agency framework are also contradicted by the empirical evidence. Under contractual incompleteness, shareholders are supposed to delegate control rights to corporate controllers, and the law should guarantee that they could withdraw from that delegation anytime. Whatever the contents of the law are in this regard, there is virtually no place in the world where

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[5] Shleifer, A. and Vishny, R. [1997], *A Survey of Corporate Governance*, in JOURNAL OF FINANCE, vol. 52, 737-783.

shareholders can count on that. Both lawyers and economists tend to blame this as a major distortion in corporate governance, but the fact is that hostility in real-world takeovers is highly exceptional and may hardly exist at all.

The ultimate reason why the agency paradigm is unsuitable to corporate governance is that *control rights are not delegated by the owners, but rather retained as entitlements by the corporate controllers*. This is the *first conclusion* of the present inquiry, and it also explains why and to what extent the agency approach is flawed. That being said, the principal-agent framework still captures at least two prominent features of the phenomenon. One is that the corporate controller's incentives need to be aligned with the interest of shareholders, for they would not invest otherwise. The other is that incentive alignment can only be achieved as a second best. The crucial difference highlighted by the present study is that incentive-compatibility is not obtained by allocating powers to shareholders, but by constraining abuse of the same powers by corporate controllers. In this perspective, managers and controlling shareholders can no longer be considered as agents, as if they were sort of employees of investors. Surely, they do not consider themselves as being in such a position.

2. Entrepreneurship is a major omission in incomplete contracts theories of separation of ownership and control.

At least since Ronald Coase's famous article of 1937, the theory of the firm was separated from the theory of entrepreneurship. However, it is remarkable how Coase – building more on legal theory than on an economic one that did not exist yet – intended the firm relationships as closer to those established between a master and its servants than to those between agents and principals.[6] About thirty years later, the founding father of Corporate Law and Economics – Henry Manne – inaugurated the study of the market for corporate control by claiming that control of corporations should be treated like any other commodity. In spite of his contention that authority, not consensus, explained the nature of the firm, Coase is considered as the intellectual father of the nexus of contracts theory of the firm, which lately provided the basis for the agency approach to corporate governance. Manne is considered as the first author to have advocated the virtue of hostile takeovers; but his oft-cited paper contains no such advocacy and rather points to negotiations for mergers as a way to allocate control to the best available manager.[7] None of these authors explicitly discussed entrepreneurship. Yet both of them clearly had entre-

6 Coase, R.H. [1937], *The Nature of the Firm*, in ECONOMICA, vol. 4 (New Series), 392, note 1.

7 Manne, H.G. [1965], *Mergers and the Market for Corporate Control*, in JOURNAL OF POLITICAL ECONOMY, vol. 76, 110-120.

preneurs in mind when they respectively analyzed the exercise of authority in firm management and the discovery of profit opportunities in corporate takeovers.

Uncertainty is the ultimate reason why entrepreneurs exist: they may be especially skilled individuals or just visionaries, but the fact is that they look beyond what markets already give a price to.[8] Everyday, most entrepreneurs fail and only a few of them are successful: we owe economic progress to the latter, but they may never get their chance in the absence of the former. Uncertainty is also the reason why contracts are incomplete and firms need to exist as hierarchical organizations alternative to markets. Perhaps the most curious thing about the study of uncertainty is that it resulted in two theories of the same phenomenon that hardly speak to each other. *The second conclusion* of the present dissertation is that *a thorough understanding of corporate governance requires integration of the theory of the firm with the theory of entrepreneurship.*

Mainstream economics is with the theory of the firm, which took up the heritage of the neoclassical paradigm. That paradigm already featured the problem of rewards to inventiveness in price theory, but only managed to describe the firm as a 'black box'.[9] More recent economics of contractual incompleteness has integrated Marshall's notion of quasi-rents in the theory of the firm:[10] non-contractible rewards to inventiveness, more customarily described as firm-specific investments, are appropriated in the form of quasi-rents by the owner(s) of the enterprise.[11] This approach had the remarkable merit to explain why firms exist and grow, but not how they may be owned by non-controlling shareholders. Explaining separation of ownership and control in this framework required that asset-specificity be centered in shareholders' investments, not in the manager's. As a result, shareholders had ultimate authority over the firm's assets, and just delegated their daily management. Protection of managerial firm-specific investment was deemed unimportant in public companies, where entrepreneurial inventiveness was not considered an issue compared with the problem of managers' incentives alignment with the owner's interest.

The conflict with the parallel theory of entrepreneurship is striking. One prominent result of this theory is separation of entrepreneurs from the capitalists. Own-

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8 Shackle, G.L.S. [1970], EXPECTATION, ENTERPRISE AND PROFIT: THE THEORY OF THE FIRM, Allen and Unwin; Casson, M.C. [1982], THE ENTREPRENEUR: AN ECONOMIC THEORY, Martin Robertson.

9 Coase, R.H. [1991], *The Institutional Structure of Production*, in AMERICAN ECONOMIC REVIEW, vol. 82, 713-719.

10 Marshall, A. [1893], *On Rents*, in ECONOMIC JOURNAL, vol. 3, 74-90; Klein, B., Crawford, R.G. and Alchian, A.A. [1978], *Vertical Integration, Appropriable Rents and the Competitive Contracting Process*, in JOURNAL OF LAW AND ECONOMICS, vol. 21, 297–326.

11 Hart, O. [1995], FIRM, CONTRACTS, AND FINANCIAL STRUCTURE, Oxford University Press.

ership is never a condition for entrepreneurship.[12] The corporation is then considered as a way to ease the access of entrepreneurial talent to large-scale financing. This implies that returns on entrepreneurship need also to be separated from returns on shareholders' capital. Following the traditional controversy between Neo-Austrian and neoclassical economics, the theory of entrepreneurship does not specify how rewards to entrepreneurial talent are appropriated, and only contends that – in some way or another – they are. The very process of appropriation is what ultimately motivates entrepreneurship and economic progress, at least until the same process makes entrepreneurs obsolete.[13] Despite of Schumpeter's famous prophecy about the destiny of capitalism, we have not yet experienced such obsolescence. 'Creative destruction' of entrepreneurs seems to go on endlessly, and the only thing we know about this process is that it is inherently unpredictable.

I am not the first who has tried to integrate entrepreneurship in mainstream economics of corporate governance. Clearly, the only possible way to operationalize this intuition is through the notion of quasi-rents as a reward of managerial choices under uncertainty. Some have tried to overcome the hurdles of the property rights approach by hypothesizing a state-contingent allocation of control rights (carrying conditional entitlements to quasi-rents) between managers and shareholders.[14] Others have followed Oliver Williamson's intuition of 'forbearance' in enforcement of legal entitlements, and hypothesized sources of power alternative to ownership in a comprehensive stakeholder theory of the firm.[15] I find these explanations not entirely convincing, and therefore advocate a different one. Rewards to entrepreneurial talent are appropriated in the non-contractible form of private benefits of control, and corporate law supports this result by providing entitlements to firm control separated from ownership of the corporation.

3. Private benefits of control and its entrenchment are not just bad for corporate governance.

I had a difficult case in challenging the conventional wisdom that private benefits of control are a curse for corporate governance. The idea that private benefits may play a beneficial role conflicts with both the lawyers' view of shareholder democracy and the economists' reliance on principal-agent models. Albeit for differ-

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12 Kirzner, I.M. [1979], PERCEPTION, OPPORTUNITY, AND PROFIT, University of Chicago Press.

13 Schumpeter, J.A. [1943], CAPITALISM, SOCIALISM, AND DEMOCRACY, Unwin University Books.

14 Burkart, M., Gromb, D. and Panunzi, F. [1997], *Large Shareholders, Monitoring, and the Value of the Firm*, in QUARTERLY JOURNAL OF ECONOMICS, vol. 112, 693-728.

15 Rajan, R.G. and Zingales, L. [1998], *Power in a Theory of the Firm*, in QUARTERLY JOURNAL OF ECONOMICS, vol. 113, 386-432; Williamson, O.E. [1991], *Comparative Economic Organization: The Analysis of Discrete Structural Alternatives*, in ADMINISTRATIVE SCIENCE QUARTERLY, vol. 36, 269-296.

ent reasons, both views contend that shareholders as a whole should be ultimately in charge of corporate governance and that fighting extraction of private benefits of control should be a major goal of corporate law. Yet, both fairness and efficiency of this ideal picture are contradicted by the empirical evidence. Non-controlling shareholders are happy with their being powerless so long as they earn conspicuous returns on their investment. The vast majority of companies featuring generations of controlling shareholders or a self-perpetuating management are both profitable for investors and reward controllers with private benefits on top of that. It may seem cynical, but there is no such thing as a shareholder democracy in the real world. It may seem heretical, but shareholders do not stand to gain all of the firm's residual (alias, profits). The only way to reconcile this evidence with efficiency (and maybe with fairness, if we only managed to agree on a unique definition of that) is to allow *private benefits of control* to *perform also some beneficial role in corporate governance*. *The third conclusion* of this investigation is that not only they can, but most probably they must perform such a role.

In principal-agent models, private benefits of control always come at the non-controlling shareholders' expenses. They depend either on stealing or on shirking by the corporate controller. These two categories of private benefits are respectively characterized as diversionary and distortionary as regards shareholder value.[16] If we take the latter as a criterion for welfare analysis, both these benefits cannot but have adverse effects on the efficiency of corporate governance. However, distortionary private benefits are an unavoidable consequence of separation of ownership and control. They might be ugly for this reason, but we have to live with them. Diversion and distortion of shareholder value are not the only way in which private benefits of control may be generated, although these are the only two sources allowed by the agency framework. If we depart from that framework and take a straightforward incomplete contracts perspective, we can assume that part of the firm value is neither observable nor verifiable. This part is therefore excluded from shareholder value (stock returns need to be at least observable, and become verifiable when they are impounded in market prices) and accounts for the value of entrepreneurship in the corporate enterprise. These are profits 'in the entrepreneur's head' and have no value whatsoever for outside shareholder, at least until they become observable by somebody else. I have defined this value as idiosyncratic private benefits of control. Consideration for entrepreneurship in the exercise of corporate control is the reason why they must be featured in corporate governance. Their idiosyncrasy to the

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16 Mayer, C. [1999], *Firm Control*, Inaugural Lecture at the University of Oxford (February 18, 1999), available at www.finance.ox.ac.uk, as published in J. Schwalbach (ed.) [2001], CORPORATE GOVERNANCE: ESSAYS IN HONOR OF HORST ALBACH, Springer-Verlag.

corporate controller is the reason why their extraction does not reduce shareholder wealth.

This still does not tell why these private benefits are good for corporate governance. In order to provide incentives to entrepreneurship in corporate governance, they need to be *appropriable* by the corporate controller.[17] I am not making the heroic assumption that managers or controlling shareholders are less greedy than investors in the stock market are. They may just be more patient. It could seem that idiosyncratic private benefits of control account for some incommensurable physic satisfaction, and to be sure, they are sometimes characterized in this fashion.[18] However, in the wake of a change in control, profits that are still to be realized come out of the entrepreneur's head: they become a tangible issue inasmuch somebody else is willing to pay for taking a chance on them. The quasi-rent nature of idiosyncratic private benefits becomes apparent in this circumstance. The market for corporate control makes them both valuable and appropriable. If we considered only the takeover stage, their appropriation would be just a matter of distribution. If we consider them as a prospective reward to the investment of entrepreneurial talent, efficiency requires that they be appropriated by the incumbent controller: the latter would not make any firm-specific investment under a different arrangement. Incumbents can only appropriate control rents when they cannot be ousted against their will; that is, when control is entrenched. Idiosyncratic private benefits explain how entrenchment of corporate control can be efficient in corporate governance; entrenchment is what allows idiosyncratic private benefits to play a motivational role for entrepreneurship.

Entrenchment of corporate control has two major implications for corporate governance. One is that separation of ownership and control can only take place to the extent that corporate law allocates entitlements to exercise of corporate control independently of ownership. The second implication of entrenchment is that hostile takeovers are disallowed, and the market for corporate control is just operated by friendly takeovers. These two implications are consistent with the empirical evidence about economics and regulation of corporate governance. However, both are challenged by economic theory and legal policy.

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[17] Zingales, L. [2000], *In Search of New Foundations*, in JOURNAL OF FINANCE, vol. 55, 1623-1654.

[18] Gilson, R.J. [2006], *Controlling Shareholders and Corporate Governance: Complicating the Taxonomy*, in HARVARD LAW REVIEW, vol. 119, 1641-1679.

4. The market for corporate control can be efficiently operated by friendly takeovers.

According to the standard view of corporate governance, when the corporate controller is entitled to shield himself from hostile takeover, shareholders lose twice: their shares are worth less because of excessive consumption of control perquisites; and they forego the opportunity of profitable tender offers by more efficient managers willing to take over. Apparently, both circumstances raise the agency costs of separation of ownership and control. As I hope to have demonstrated, this is not the only possible way to look at the market for corporate control. This view does not explain why the vast majority of non-controlling shareholders still invest in spite of control entrenchment, and therefore it is very likely to be misguided.

In an incomplete contracts perspective, corporate governance features more than just agency costs. The latter are included in the notion of private benefits of control; but this is broader, and allows also for protection of control rents – and entrenchment necessary to that purpose – to be efficient. To rephrase the fundamental insight of the agency theory, opportunity cost of the incumbent's consumption of distortionary private benefits will rise, all else being equal, as soon as a more efficient controller appears on the market. This problem is ideally dealt with by the market for corporate control, which should provide for dynamic minimization of distortionary private benefits over time. When nothing else than these benefits is at play, hostile takeovers would be the solution. But this is not what the empirical evidence tells us, and a number of complications are added by the introduction of a tripartite account of private benefits in order to interpret this evidence.

Hostile takeovers would be disruptive of idiosyncratic private benefits, whose protection is efficient. Therefore, hostile takeover must be disallowed. Friendly takeover are just the only option under entrenchment of corporate control, and they may do quite as well. However, idiosyncratic private benefits create a wedge between the interest non-controlling shareholders in maximizing their returns and the controllers' concern for reward of their firm-specific investments. The market for corporate control can still minimize distortionary private benefits under this constraint, when it allows for changes in control to be operated on condition that the incumbent's control rents are compensated. This would imply that control changes hands if and only if insurgents can *both* make the company more profitable *and* compensate incumbents of their previous efforts in bringing the firm to the current state of development. Unfortunately, diversionary private benefits also interfere with this mechanism, and may compromise its constrained efficiency. In the presence of such benefits, control may end up being allocated to the best 'thief' of minority shareholders, instead of to the best available manager of the firm.[19]

An appropriate set of constraints on extraction of diversionary private benefits of control is therefore a precondition for the efficient functioning of the market for corporate control, as it is for efficient separation of ownership and control. Given that corporate law *allocates* powers in such a way as to preserve the incumbent's idiosyncratic rents, it should also prevent control rents from being extracted in the form of diversion of shareholder value by *regulating* the abuse of the same powers. These are two necessary conditions for efficient corporate governance, but they are not sufficient. Corporate controllers should be proactively induced to part with control when a more efficient manager is available. The only way in which this can be reconciled with protection of idiosyncratic control rents *ex ante* is allowing the market for corporate control to be operated through side payments *ex post*. These payments are, alternatively, golden parachutes in managerial control structures and control premia in controlling shareholder structures. This may sound weird to lawyers, but – at least on condition that stealing is efficiently policed by the legal system – side payments should not be merely regarded as 'bribes:' they are actually necessary to capture gains from trade, which promote in turn the efficient allocation of corporate control. One prominent implication of uncertainty about the prospective value of corporate control – depending on my previous assumptions about entrepreneurship – is that the amount of these payments cannot be determined at the outset, but must be freely bargained for at the takeover stage.

The market for corporate control is thus understood as an application of the Coase Theorem. If takeover bargaining was frictionless, corporate law should do nothing else than defining entitlements to corporate control. The presence of transaction costs explains not only why allocation and regulation of these entitlements matter, but also why further discipline of control transactions is required to cope with the frictions in the takeover process. Besides the specific implications for takeover regulation, *the fourth conclusion* of this work is that a *market for corporate control based on a smooth sequence of friendly acquisitions can guarantee dynamic efficiency of control allocation*, so long as the incumbent's control rents are compensated at every stage and value diversion from minority shareholders is disallowed.

This result builds on the few models in contract theory that have treated entrenchment of corporate control under a narrower set of assumptions. Some of

[19] Bebchuk, L.A., Kraakman, R.H. and Triantis, G. [2000], *Stock Pyramids, Cross-Ownership, and Dual Class Equity: the Mechanisms and Agency Costs of Separating Control from Cash-flow Rights*, in R. Morck (ed.), CONCENTRATED CORPORATE OWNERSHIP, NBER Conference Volume, University of Chicago Press, 295-315.

them consider control rents as a non-contractible reward to managerial effort,[20] and at least one of them studies the dynamics of takeover process under the assumption of (non-diversionary) rent extraction at the going public stage.[21] Bundling issues of deferred compensation with the dynamics of the market of corporate control I manage to obtain results that differ from those achieved by the existing literature. The bottom line is that shareholder value maximization under entrenchment of corporate control is constrained-efficient. The constraint is given by the size of idiosyncratic control rents necessary to motivate the investment of entrepreneurial talent under uncertainty. An assumption consistent with the theory of entrepreneurship is that this size is decreasing over the firm's lifecycle. This may still involve that the constraint remains always sufficiently binding to rule out contestability. However, different sizes of idiosyncratic private benefits explain the choice of different ownership structure. In this perspective, both this choice and its evolution in a sequence of changes in control are endogenous to the business.

Corporate law may make these choices suboptimal depending on how it regulates, or fails to regulate, the three kinds of private benefits affecting exercise, abuse, and transfer of corporate control. This is how I have derived three fundamental functions of corporate law in an economic perspective: i) supporting control (protection of idiosyncratic private benefits); ii) protecting investors (constraining extraction of diversionary private benefits); and iii) promoting the market for corporate control (minimization of distortionary private benefits).

5. Director's autonomy from the shareholder meeting is a legal precondition of managerial control.

Elements of novelty in the economic framework that I am advocating for interpretation of corporate governance are such that a few contentions of received wisdom about Corporate Law and Economics are simply turned on their heads. One of them is that corporate law should empower non-controlling shareholders.[22] Having rejected the agency-based framework of delegation of control rights from shareholders to the management, I claim that corporate law should do exactly the opposite: empower corporate controllers. The rationale of this assertion has been already summarized with the above results of the inquiry into the economic theory.

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[20] See, e.g., Schnitzer, M. [1995], *'Breach of Trust' in Takeovers and the Optimal Corporate Charter*, in JOURNAL OF INDUSTRIAL ECONOMICS, vol. 43, 229-259.

[21] Bebchuk, L.A. and Zingales, L. [2000], *Ownership Structures and the Decision to Go Public: Private versus Social Optimality*, in R. Morck (ed.), CONCENTRATED CORPORATE OWNERSHIP, NBER Conference Volume, University of Chicago Press, 55-75 (also available as NBER Working Paper No. 5584).

[22] Bebchuk, L.A. [2005a], *The Case for Increasing Shareholder Power*, in HARVARD LAW REVIEW, vol. 118, 833-914.

Entrepreneurs concerned with idiosyncratic private benefits may only go public with an ownership structure that supports both ongoing exercise of corporate control and its protection from hostile takeover. Corporate law determines how much ownership entrepreneurs can sell to the investing public without risk of losing control, by providing control rights only partly related to ownership or even not at all.[23] In a sense, corporate law complements the system of ownership entitlements established under property law. How these entitlements are allocated between participants in the corporate enterprise depends on the legal distribution of corporate powers. The *fifth conclusion* of this dissertation is that *some distributions of powers are suitable to dispersed ownership structures, whereas others just suit controlling shareholdings*. Ideally, both kinds of distributions should be provided for by corporate law.

This conclusion is two-sided. On the positive account, distribution of powers may affect the workability of managerial control and shareholder control systems; on the normative side, too an inflexible distribution of powers may bias the selection of corporate governance patterns and induce suboptimal choices. Specifically, an entrepreneur may wish to go public with a certain ownership structure. When uncertainty of the business is high, and idiosyncratic control rents are likewise high, retaining a controlling shareholding can be the efficient outcome of stock placement with the investing public. Conversely, when idiosyncratic private benefits are of a limited size, selling virtually all of the company's stock to the investing public can be more efficient. The lack of legal entitlements to either managerial or shareholder control may induce respectively less and more separation of ownership and control than it would be efficient. In the first scenario, entrepreneurs are prevented from deconcentrating ownership by legal inability to keep control uncontested under managerial control; in the second, they may choose not to take a highly innovative business public, or to forego it altogether, because the legal system does not support controlling shareholders in listed companies. The study of corporate law in the five jurisdictions of the case study set up for the present dissertation not only supports the positive account, but also provides the basis for normative assessment.

The analysis of distribution of decision rights between the two major bodies of the corporate structure shows that managerial control of publicly held companies is only featured in those jurisdictions that empower the board of directors relative to the general meeting of shareholders. What matters is whether directors may avail themselves of sufficient powers to make sure that they are reappointed to office, that they can have favored resolutions passed by the general meeting, and – most importantly – that they are not ousted midterm against their will. The three jurisdic-

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[23] Cools, S. [2005], *The Real Difference in Corporate Law Between the United States and Continental Europe: Distribution of Powers*, in DELAWARE JOURNAL OF CORPORATE LAW, vol. 30, 697-766.

tions of the sample that feature managerial control (namely, the US, the UK, and the Netherlands) provide directors with a favorable distribution of power in all of the above-mentioned respects. The other two jurisdictions of the sample – Sweden and Italy – fail to support managerial control with one or more of the necessary entitlements. Weakness of the board of directors relative to the general meeting is one fundamental reason why corporate governance can only feature controlling shareholders in those countries. Contrary to what is often contended by at least one part of the legal and economic literature, issues of board structure and stakeholder involvement in the appointment in board members (which both vary considerably between the five jurisdictions) turn out to be of secondary importance.

Legal configuration of entitlements supporting managerial control varies across jurisdictions. British regulation of listed firms is very unfavorable to controlling shareholding, and this – besides privileged access to the proxy machinery – is how directors ultimately manage to be in control. Dutch corporate law allegedly empowers stakeholders, but this – at least in the absence of a controlling shareholder – just results in directors' autonomy from the general meeting thanks to the structured regime of the board, board control over voting of shares placed in a trust, so-called 'oligarchic' devices, and statutory/judicial support of takeover defenses. American law makes directors extremely powerful when ownership is dispersed, but does not deny controlling shareholders the opportunity to hold directors accountable whenever ownership is coalesced. A number of items of Delaware law and in the federal regulation of proxy voting unambiguously put the board on the driver seat; but board powers are easily superseded anytime a change in control is agreed upon. Dutch law does not have this last feature because of the hurdles of the structured regime; this determines a superfluous impediment to the takeover process. Apart from that, both American and Dutch corporate law as regards distribution of powers display more virtue than they are usually credited for, since they equally support managerial and shareholder control. The opposite result holds for British law, which supports managerial control as much as it opposes shareholder control by empowering those who never wish to be in charge: non-controlling shareholders.

Two basic policy guidelines for corporate jurisdictions that do not support managerial control can be derived from the analysis of those that do. The first is that corporate law should allow the board of directors to take all relevant decisions about firm management (including those as to whether or not to sell control of the company, but excluding those involving other conflicts of interest) without shareholders having more than to rubberstamp them, at least so long as they are dispersed and therefore unwilling to actively participate in firm control. Italian corporate law is not so far from achieving this result, and may just need a reform of the proxy voting system to that purpose. On the contrary, Swedish law seem to have a much longer way to go before it can allow for management to be in charge in the absence of a controlling shareholder.

The second policy implication is that legal reforms aimed at fostering managerial control should not create the opposite bias against shareholder control. Since ownership can be in principle either too dispersed or too concentrated because of corporate law's rigidities, neither bias is good. The weakness of the otherwise celebrated British regulation of listed companies, which fails to support controlling shareholdings, is as illustrative of this point as the fundamental strength of the heavily criticized American and Dutch models: neutrality as to the choice of managerial and shareholder control of publicly held companies.

6. A one share–one vote rule is not desirable for efficient separation of ownership and control.

In a sense, the dichotomy between managerial and shareholder control is an oversimplification of the choice between ownership structures. Dispersed ownership is also compatible with controlling shareholders. Then voting rights have to be separated from ownership stakes or, at least, the two must not stand in a relation of strict proportionality. From a purely positive standpoint, the principle of proportionality in security-voting structures – also known as 'one share–one vote' – sets a constraint on the ability of controlling shareholders to deconcentrate ownership. If they wish to remain controlling shareholders safely, they may not sell more than a half of the share capital to the investing public under this arrangement. Any further dilution of controlling ownership would bring about the risk of a hostile takeover.

Very few commentators analyze one share–one vote in this perspective, and this is probably because most think that the positive account is just a trivial issue compared with the normative one. Allowing more than one vote to be cast per share is often considered as unfortunate in both a legal perspective (where shareholder plutocracy could at most yield to shareholder democracy – i.e., one vote per person) and from an economic standpoint (where one share–one vote may be the ultimate source of empowerment of the principals relative to their agents). However, the matter has been always very controversial. Interpreting one share–one vote under the broader heading of legal distributions of corporate powers allows putting it in the right perspective.

The choice of ownership structure based on the size of idiosyncratic private benefits faces a discontinuity. Investors' willingness to pay for non-controlling stock is decreasing in the amount of anticipated control rents, and that is why controlling shareholdings are the only outcome financially consistent with positive control premia. However, when idiosyncratic private benefits are low enough, investors may purchase all of outstanding stock under the promise of a lower bound on their compensation. This is how golden parachutes substitute for control premia, and transition from shareholder control to managerial control is operated. Distribution of powers in corporate law not only affects the legal feasibility of this transition, but also determines how far separation of ownership and control can go under shareholder control until time for transition is ripe. It so does by allowing deviations from the one share–one vote arrangement. The *sixth conclusion* of the present inquiry is that *one share–one vote regulation in corporate law restricts the range of choices as to separation of ownership and control, and may force the adoption of suboptimal ownership structures*.

This conclusion is less striking than the previous one. It has been also authoritatively advocated – among others – by Sanford Grossman and Oliver Hart, who otherwise demonstrated, under certain assumptions, the optimality of one share–one vote for a contestable market for corporate control.[24] Faced with the popularity of disproportional security-voting structures in the real world, reputable academics do not dare to argue in favor of contestability across the board: as a matter of fact, more than of theory, the majority of them are uncomfortable with mandatory one share–one vote regulations. The framework of the present analysis, which disallows contestability on efficiency grounds, brings about clearer conclusions about one share–one vote rules, which parallel the discussion of the legal underpinnings of managerial control.

First, shortage of legal entitlements to corporate control undermines its separation from ownership: as a weak board of directors makes managerial control legally unviable, restrictions on disproportionality of security-voting structures may prevent wealth-constrained controlling shareholders from going public. This is particularly problematic in Italy where, in spite of the recent reforms aimed at increasing flexibility of the corporate structure, dual class shares are still made unattractive by the heritage of a restrictive regulation. On the one hand, multiple voting shares are prohibited – and, despite of appearances, limited-voting shares do not perform equally well in enhancing a controlling shareholder's voting power. On the other hand, limited-voting shares cannot account for more than 50% of share capital.

Second, the corporate structure allows for different techniques for separating voting rights from ownership, but normally regulation can only tackle some of them. Once again, non-neutrality in distribution of powers may have adverse consequences on efficiency. For instance, mandatory proportionally of security-voting structure can be circumvented by pyramidal group structures, which are more difficult to regulate. However, while pyramids are inherently suitable to midstream lev-

24 Grossman, S.J. and Hart, O. [1988], *One Share–One Vote and the Market for Corporate Control*, in JOURNAL OF FINANCIAL ECONOMICS, vol. 20, 175-202.

eraging of voting power, dual class shares are more easily prevented from harming existing shareholders by the discipline of share capital (like in Europe) or by an explicit ban on unilateral recapitalizations (like in the US). Once again, this is a problem in Italy, where listed companies with significantly dispersed ownership are often controlled through pyramidal group structures. This situation may even be worsened by the negative attitude of national policymakers towards somewhat less dangerous techniques of enhancement of shareholder control – like, e.g., voting pacts. Conversely, the frequency of pyramidal structures in Sweden may owe as little to regulatory restrictions on dual class shares as much to the unavailability of legal support for managerial control. The bottom line is that, before considering regulation of pyramidal structures in corporate governance, the biases in the legal distribution of corporate powers should be removed.

A third and related point is that contestability of corporate control cannot be imposed by regulation, for it can be always short-circuited at the firm level. As it turns out, control of the vast majority of companies is hardly made contestable when they go public, no matter how strict the regulation of one share–one vote is. The argument that, as a matter of principle, control of listed firms *should be* contestable is a recurring source of mistakes by policymakers. In the 1980s, the SEC was about to "kill shareholders with kindness" by attempting the prohibition of dual class stock among companies listed in American stock exchanges.[25] In the 2000s, the European legislator likewise attempted to 'breakthrough' disproportional security-voting structures. As academics argued in both circumstances, these regulatory initiatives, if successful, would have been most likely either to be circumvented by alternative (but not necessarily more desirable) arrangements or to induce less and less firms to go public.[26] Luckily, and perhaps unavoidably, both attempts ultimately failed. The lesson of the American experience is that regulation ended up with addressing only the right problem: midstream changes in security-voting structures. After having tried to promote, instead of prevent, these midstream changes with an economically unfounded breakthrough rule, hopefully the European legislation will also find its way to put the problem of one share–one vote in the right perspective.

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25 Hart, O. [1988], *SEC May Kill Shareholders with Kindness*, in THE WALL STREET JOURNAL, Jul. 14, 1988.

26 Bebchuk, L.A. and Hart, O. [2002], *A Threat to Dual-Class Shares*, in FINANCIAL TIMES, May 31, 2002.

7. An efficient discipline of related-party transactions is necessary, but not sufficient, for separation of ownership and control.

One recurring statement of the present dissertation is that separation of ownership and control requires both willing sellers and willing buyers of the company's stock. The argument that corporate controllers, and not minority shareholders, should be empowered by corporate law is grounded on protection of idiosyncratic control rents as an explanation of the first part of the statement. The second part is equally important. Once controllers have all the decision-making powers, non-controlling shareholders must be provided with a meaningful guarantee that those powers are not abused for expropriating them of their investment. According to the mainstream view, this is essentially the only relevant issue for Corporate Law and Economics. On the assumption that protection of control rents is unimportant for the efficiency of corporate governance, controllers have no reason to be empowered. Contrariwise, controllers are naturally empowered by a number of circumstances depending on delegation of decision rights by dispersed and rationally apathetic shareholders, and therefore corporate law should constrain the exercise of control powers or, even worse, reallocate them from controllers to non-controlling shareholders. This is how law is supposed to 'matter' in corporate governance.[27] I have shown that this view is misguided. The *seventh conclusion* of this work is that *legal protection of non-controlling shareholders is a necessary, but not sufficient condition for separation of ownership and control and its efficiency*.

The importance of managerial firm-specific investments under contractual incompleteness is the reason why it is not sufficient: corporate law must also *enable* the corporate contract to protect those investments independently of corporate ownership, and it can only do so by providing a sufficiently broad range of entitlements to control power. This is the reason why legal protection of non-controlling shareholders is necessary, too. Differently from other commercial contracts, decision rights in the controller-shareholder relationship are barely constrained by the corporate contract. Long-term supply or credit contracts may include few or many provisions; they are possibly renegotiated in the face of unforeseen contingencies, but cannot be unilaterally amended. Corporate charters are almost empty at their core; virtually none of their provisions is governed by unanimity, and control powers include the ability to have them amended when new circumstances materialize. The spectacular flexibility of the corporate contract parallels the substitution of authority for consensus, which is the ultimate reason why firms are established to

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27 La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R. [1998], *Law and Finance*, in JOURNAL OF POLITICAL ECONOMY, vol. 106, 1113-1155.

cope with relationships that markets cannot support.[28] The flip side of the coin is that the corporate contract cannot be a source of credible commitment for controllers. In order to induce non-controlling shareholders to invest in spite of that, credible commitments need to be established on the basis of institutions that are out of the controller's reach. Corporate law's rules qualify to the extent that they are *mandatory* – i.e., they cannot be opted out by the corporate charter. However, mandatory constraints on the controller's decision-making power should not exceed the domain of conflicts of interest that may result in shareholder expropriation.[29] Regulation of related-party transactions is the case in point.

The framework of the present analysis thus provide an explanation of why corporate law should be as enabling as possible as far as distribution of powers is concerned, while it should be mandatory when it comes to constraining direct or indirect tunneling of shareholder value to the controller's pockets. The mandatory/enabling balance of corporate laws is perhaps the favorite matter of debate for lawyers, while it is dismissed as an unimportant issue by economists. The former tend to view incompleteness of the corporate contract as either a case for gap-filling or a reason to overreach by regulation the unintended creation of control powers. The latter are definitely more comfortable with power in the governance of the firm, and consider law as just a device to correct for allocations of control rights unfavorable to the shareholders. Either view only captures one aspect of a twofold problem, and therefore neither is correct. Indeed, both power and law matter in corporate governance. Law needs to *support* control power *and* to *constrain* its abuse. Power needs to be *allocated* to corporate controllers in order for them to have authority over assets that they do not own, and to be *regulated* in order for shareholders not to be expropriated of assets that they do not control. Answering the question of what the mandatory/enabling balance should be in corporate law also explains why legal protection of outside shareholders is necessary, but not sufficient, for separation of ownership and control.[30]

This contention is supported by the empirical evidence at least as far as the case study of the present work is concerned. In all considered jurisdictions, the discipline of related-party transactions is essentially mandatory. A reliable enforcement of this discipline is a precondition for non-controlling ownership, but separation of

[28] Hansmann, H. [2006a], *Corporation and Contract*, in AMERICAN LAW AND ECONOMICS REVIEW, vol. 8, 1-19 (who, however, disagrees on both the presence and the need of a mandatory core in American corporate law).

[29] Rock, E.B. and Wachter, M.L. [2001], *Islands of Conscious Power: Law, Norms and the Self-Governing Corporation*, in UNIVERSITY OF PENNSYLVANIA LAW REVIEW, vol. 149, 1619–1700.

[30] I am paraphrasing the opposite contention: Romano, R. [1989], *Answering the Wrong Question: The Tenuous Case for Mandatory Corporate Laws*, in COLUMBIA LAW REVIEW, vol. 89, 1599-1617.

ownership and control also requires that suitable distributions of powers be enabled. The sophisticated system of fiduciary duties administered by Delaware courts cannot be opted out if not by a reincorporation decision that hardly any shareholder would rubberstamp. Combined with securities regulation at the federal level, this system is as strictly enforced as to disallow most instances of diversion of shareholder value, but also flexible enough to allow control power to be exerted in either dispersed or concentrated ownership structures. Perhaps unconventionally, I have shown that non-controlling shareholders are fairly well protected from expropriation under Dutch corporate law, too. While statutory law provides for distributions of powers also suitable to managerial control, good protection of non-controlling shareholders is obtained in the Netherlands through case-law elaboration by a specialized judiciary. The Dutch discipline of non-pro-rata distributions is remarkably similar to Delaware law and so are the venues for private enforcement, in spite of the significant differences in civil procedure.

I have also reconsidered the legal underpinnings of the excellent protection of minority shareholders in Sweden. The stability of a powerful system of social norms ultimately relies upon a set of enforceable anti-expropriation rules as a credible threat. Still, controlling shareholders are the only governance solution supported by the legal distribution of corporate powers. Italian corporate law shares the same problem, but on top of this, it features inadequate protection of minority shareholder because of an unfocused discipline of related-party transactions, formalistic adjudication by unspecialized judiciary, too little scope for private enforcement, and weak social norms. Italy may be the only country of the sample that apparently supports the standard 'law matters' argument; but, even there, the unchanged patterns of corporate governance in spite of recent improvements in shareholder protection suggest that something else is at play.

Britain is a strange case. On the one hand, shareholder protection from outright theft just relies on a few mandatory provisions in company law and in the regulation of listed companies. On the other hand, this protection is not enforced in courts, through the existing discipline of related-party transactions, but rather it depends on the power of non-controlling shareholders to veto these transactions and to oust directors who fail to bring them to their attention. These powers are hardly ever exercised. Still, they provide institutional investor with a sufficiently credible threat to police managerial disloyalty. The only drawback of this arrangement is that, as the rest of the discipline of listed companies in the UK, it may overly constrain discretion in corporate management. But this is another, and more complicated, story.

8. Shareholder protection by corporate law does not necessarily mean shareholder empowerment in corporate governance.

Ideally, one would wish that control powers are exercised with the broadest possible discretion and that controllers are only accountable to outside shareholder for mischief – that is, they are prevented from *stealing*. The case for making controllers also accountable for negligence – that is, *shirking* – is particularly weak in corporate governance.[31] The standard argument in Corporate Law and Economics is that judges are ill equipped for reviewing business judgment. Finding that this argument would equally apply to many professional judgments, which yet are subject to enforceable standards of diligence, I have shown that the rationale of the so-called business judgment rule (a functional principle of judicial abstention from second-guessing the quality of corporate management) is rather to prevent adjudication with a hindsight bias.[32]

Any business decision could be regarded as very clever when it turns out to be profitable and blamed for utmost negligence when it turns out badly. The fact is that diligence is inherently indeterminate *ex ante* when decisions – like those of entrepreneurs – are taken under uncertainty. Differently from the risks of a surgery, uncertainty of a business venture cannot be assigned a probability by definition.[33] This is the reason why legal liability of corporate controllers should only be established for disloyalty. Unfortunately, this is also the reason why policing disloyalty is only possible at the cost of some second-guessing. Related-party transactions may have plenty of business purpose, but they may also result in expropriation of outside shareholders. At the end of the day, nobody can scrutinize the diversionary potential of business decisions without interfering with its merits. Any regulation of related-party transactions involves a tension between discretion and accountability of corporate control.[34]

Another, perhaps more conventional, way to interpret this tension is the tradeoff between false positives (innocent being convicted) and false negatives (guilty being acquitted) in the enforcement of shareholder protection against stealing.[35] In whatever configuration, this tradeoff cannot be eliminated, but an efficient regula-

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[31] Roe, M.J. [2003c], POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE, Oxford University Press.

[32] See Eisenberg, M.A. [1989b], *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, in FORDHAM LAW REVIEW, vol. 62, 437-468; but see also Gevurtz, F.A. [1994], *The Business Judgment Rule: Meaningless Verbiage or Misguided Notion?*, in SOUTHERN CALIFORNIA LAW REVIEW, vol. 67, 287–337, for the view that the argument equally applies to malpractice in law and medicine.

[33] Knight, F.H. [1921], RISK, UNCERTAINTY, AND PROFIT, Houghton Mifflin.

[34] Bainbridge, S.M. [2002a], CORPORATION LAW AND ECONOMICS, Foundation Press.

[35] Enriques, L. [2000], *The Law on Company Directors' Self-Dealing: A Comparative Analysis*, in INTERNATIONAL AND COMPARATIVE CORPORATE LAW JOURNAL, vol. 2, 297-333.

tion of related-party transactions should provide for its optimization. I have shown that, as far as accountability is concerned, systems based on independent scrutiny of conflicted interest transactions may fare as well as those based on empowerment of non-controlling shareholders in decision-making. However, the former normally outperform the latter as far as discretion in the exercise of business judgment is concerned. The *eight conclusion* of this inquiry is that *shareholder protection from expropriation should not be confused with shareholder empowerment in corporate governance*. As it turns out, empowering non-controlling shareholders may add little to their protection from expropriation and just result in too conservative management strategies that ultimately undermine profitability of their investment.

The majority of jurisdictions in the sample go for a strategy of independent scrutiny of related-party transactions. This may be based on approval by disinterested directors *ex ante*, judicial review *ex post*, or a combination of both. The US feature the most sophisticated combination. Delaware courts do not trust disinterested director approval entirely, so long as it is not proven to be really independent of the corporate controller, and securities class actions before federal courts are often also an option for disgruntled shareholders (or, more precisely, for their lawyers). The bite of both securities and corporate litigation under US law raises as little concerns of false negatives (apart from large-scale, one-shot appropriations in the Enron-style, which no legal system could possibly prevent) as moderately serious ones concerning false positives. At least as far state law is concerned, the business judgment rule shields pretty well corporate controllers from unfounded litigation.

The problem of false positives is potentially more severe in the UK where, instead of having directors and/or a skilled judiciary to do the job, all substantial related-party transactions need to be ultimately approved by non-controlling shareholders, and only manage to go through with the support of institutional investors. Those investors naturally abstain from business judgment, but may nonetheless induce the management to forego profitable strategies when they involve too a high conflicts of interest.

Both the American and the British systems could be improved by separating professional monitoring of conflicted interest transactions from empowerment either of non-controlling shareholders or of their lawyers working on a contingent-fee basis. I have argued that independent directors could be a good solution, so long as they are neither nominated nor appointed by the corporate controller. Differently from other proposals in the same vein,[36] I contend that they should *exclusively* be in charge of approving transactions that involve significant risk of

[36] Bebchuk, L.A. [2003b], *The Case for Shareholder Access to the Ballot*, in THE BUSINESS LAWYER, vol. 59, 43-66.

shareholder expropriation. In addition, I am skeptical about both feasibility and desirability of a 'one-size-fits-all' approach to regulation of related-party transactions. Legal institutions are sticky: they tend to evolve along their own path, and very often, this provides a safeguard against too hasty legal transplants. This makes the case for both convergence and harmonization very weak. An institutional complementarities approach to independent directorship may thus fare better than much too coarse exercises in 'numerical comparative law' or clumsy implementation of 'me too reforms' at either the national or at the super-national level.

The US and the UK feature two different approaches to shareholder protection, which are often regarded as models for the rest of the world. Yet, at least one country of our sample seems to perform even better than Anglo-American law as far as shareholder protection is concerned. This is Sweden. To be sure, the optimal balance between discretion and accountability in Sweden is due to a rather unique combination of social norms and legal rules. However, it is also supported by consistent regulation. The introduction of independent directors by a *de facto* binding Code of Corporate Governance follows exactly the guidelines of no-interference with the exercise of corporate control and of exclusion of corporate controllers from the appointment process. The other countries of the sample perform much worse on this account. The Dutch Corporate Governance Code, whose compliance is now regulated by a legally enforceable 'comply-or-explain' principle, relies on *formal* independence of all of supervisory board members, the majority of which, however, must be necessarily part of the control chain – at least under the structured regime. Nevertheless, in the Netherlands, a sophisticated judiciary and aggressive tools for private enforcement compensate for the weakness of internal controls. None of the above features is so far available under Italian corporate law, for which strengthening the independence of internal controls, improving the quality of adjudication, and enhancing private enforcement have all equal status of top priorities.

9. Efficiency of takeover regulation requires an optimal discipline of minority squeeze-out.

The same conclusions regarding allocation and regulation of control powers apply to the market for corporate control, but with a complication. The operation of takeovers brings in a third player: the acquirer. When a takeover bid is made, the would-be acquirer is neither in control nor, in principle, a significant shareholder. However, in order to succeed, he has both to induce the incumbent to part with control and to purchase stock from non-controlling shareholders in such a way as to make takeover profitable for him. The first condition is necessitated by the assumption that protection of control rents matters in corporate governance, and therefore the market for corporate control is normally operated by friendly acquisitions. Still, when only friendly takeovers are considered, the second problem remains. Prospective acquirers need to have sufficient incentives to seek for potential targets, thereby initiating the takeover process, and these incentives are only available to the extent that they can make profits on the stock market through the acquisition of undervalued shares.

The ultimate problem of the market for corporate control is therefore the distribution of takeover gains between the acquirer and existing shareholders. This problem is normally understood as a tradeoff between efficient allocation of corporate control and protection of non-controlling shareholders. By making the incumbent also participate in the distribution of takeover gains, I show that the tradeoff is actually different: it is between *ex ante* efficiency of rent protection and *ex post* maximization of shareholder value. This tradeoff is solved dynamically, through a process of value-increasing acquisitions conditional on compensation of existing control rents. In order for this process to be as smooth as possible, most of the remaining gains should be allocated to prospective acquirers. Protection of non-controlling shareholders is unnecessary so long as looting is disallowed and there is potential competition among bidders. Under these conditions, minority shareholders are efficiently excluded from the takeover gains. The *ninth conclusion* of this dissertation is that *the market for corporate control can be optimally operated by squeeze-out of minority shareholders*, so long as regulation prevents them from being exploited by this mechanism.

Once the market for corporate control is interpreted as an application of Coasian bargaining, it might be not entirely clear why it should be regulated at all. The reason is that the Coase Theorem does not apply in its strongest formulation due to the presence of transaction costs. This has two prominent implications: controllers, acquirers, or both (if they collude) may go for value-decreasing takeovers when shareholders do not knowledgeably participate in the bargaining; shareholders participation in the bargaining may instead prevent value-increasing takeovers when they do not manage to coordinate on how to split the gains efficiently. Because of these two circumstances takeovers may generate two opposite problems, respectively known as pressure to tender and free riding, which are the ultimate reason for regulatory intervention. Mainstream economics tends to identify the solution in some optimal amount of pressure to tender that keeps free riding sufficiently low.

As a result, some value-decreasing takeovers are allowed and some value-increasing takeovers are foregone.[37]

However, more recent advances in economic analysis of takeover regulation have shown that, at least in dispersed ownership structures, the free riding problem can be solved without generating pressure to tender if successful bidders are allowed to squeeze-out non-tendering shareholders at the higher between the bid and the market price.[38] I have elaborated this result under the assumption of (potential) bidding competition. Thanks to the incumbent's involvement in bargaining, the efficient outcome obtains in spite of appropriation of a moderately positive takeover premium by shareholders. I have also extended the analysis of squeeze-outs to the sale of controlling blocks in concentrated ownership structures, where changes in control are normally analyzed by abstracting from problems of free riding and pressure to tender. I have demonstrated that allowing, but not forcing, the purchaser to make a tender offer for non-controlling shares maximizes the probability of value-increasing takeovers without generating pressure to tender, if squeeze-out can be operated at the higher between the bid and the market price *before* the announcement of takeover. When takeovers are friendly, efficiency of the above squeeze-out rules requires that looting be otherwise disallowed. In dispersed ownership structures, incumbents and insurgents must be also prevented from restricting bidding competition by colluding on severance payments. Besides efficiently regulating squeeze-outs, corporate law should also meet these requirements.

Takeover regulation is the only issue of the present dissertation where the five-country tournament has just one winner: this is the US. There is a special reason for that. Takeovers are a relatively recent phenomenon, and the two jurisdictions that first addressed it still provide the two fundamental models of legal discipline. That of the UK has lately become the European model, but unfortunately – at least according to the framework developed here – it performs comparatively worse than the American one. British regulation does allow for minority squeeze-out. However, on the one hand, it sets ownership of 90% of outstanding shares as the minimum threshold for its operation; this still gives minority shareholders the opportunity to holdout when they are large enough. On the other hand, the squeeze-out option is superseded by the mandatory bid when controlling blocks are transferred; this could be a serious impediment to the market for corporate control if control-

37 Burkart, M. and Panunzi, F. [2003], *Mandatory Bids, Squeeze-out, Sell-out and the Dynamics of the Tender Offer Process*, ECGI Law Working Paper No. 10/2003, available at www.ssrn.com and www.ecgi.org, as published in G. Ferrarini, K.J. Hopt, J. Winter, and E. Wymeersch (eds.) [2004], REFORMING COMPANY AND TAKEOVER LAW IN EUROPE, Oxford University Press.

38 Amihud, Y., Kahan, M. and Sundaram, R.K. [2004], *The Foundations of Freezeout Laws in Takeovers*, in JOURNAL OF FINANCE, vol. 59, 1325-1344.

ling shareholdings were not otherwise disfavored by British regulation of listed firms. American law does not feature any of these constraints. Both federal and state laws do not interfere with mandatory bid requirements, whereas Delaware courts have found their way to regulate squeeze-outs exactly as they should be. To be sure, a 90% threshold is also set by Delaware law for squeeze-outs following tender offers by an already controlling shareholder. This requirement is unnecessary; but it is also not particularly harmful, given the low concentration of non-controlling ownership in the US.

That being said, both models of takeover regulation are consistent with the law governing listed companies. Corporate law in both the US and the UK provides sufficient constraints on looting to make value-decreasing takeovers very unlikely. If anything, British law achieves this result at the price of making value-increasing deals more difficult to go through. In addition, the high squeeze-out threshold under British law is practically the only defense for incumbent management against hostile takeovers. This could not be changed unless US-style takeover defenses were introduced. The other European jurisdictions of the sample do not necessarily face these constraints. Some of them did not even have a takeover regulation a few years ago, let alone a discipline of takeover defenses. Also, they may not worry about efficiency of friendly takeovers, when the high standards of protection of minority shareholders are already sufficient to rule out looting. Nowadays, however, they may be face constraints from a different source: EC legislation. The Takeover Directive has not only imposed a mandatory bid rule, which interferes with the squeeze-out mechanism and normally short-circuits its virtues, but has also set at 90% the minimum threshold for post-takeover squeeze-outs. This solution may possibly make sense for those countries – like Italy – where the standards of protection of minority shareholders are traditionally low, although its rigidity limits the regulator's ability to compromise investor protection with the goal of promoting efficient changes in control. However, it is the more counterproductive for efficiency of the market for corporate control the more concentrated the ownership structures are. As it turns out, ownership concentration is a renowned feature of corporate governance in continental Europe.

10. When control is entrenched and non-controlling shareholders are protected from expropriation, unequal treatment of shareholders is preferable to the mandatory bid.

The general principle of equal treatment of shareholders is featured by virtually any corporate jurisdiction. It is hardly questionable in Law and Economics, and with good reason. A fundamental tenet of incentive-compatibility of corporate governance is that shareholders, whether they are controlling or not, must participate in the firm's residual pro-rata. This explains why an outright prohibition of non-pro-rata distributions (diversionary private benefits of control) makes sense in corporate law. Yet this reasoning only applies to verifiable profits, not also to that part of the firm value that owes its existence to unverifiable entrepreneurial talent. Appropriation of this value does not contradict the rationale of equal treatment of shareholders, although it may conflict with the application of the same principle to takeovers. The implications of entrepreneurship for the market for corporate control are that incumbents must cash in their idiosyncratic private benefits and insurgents must be able to appropriate the remainder of differences between current and prospective shareholder value. Otherwise, neither would incumbents part with control nor would insurgents bother of uncovering new profit opportunities in potential takeover targets. These players undoubtedly need to get more than non-controlling shareholders do in takeovers. However, they do in their capacity as active entrepreneurs, not as passive shareholders, regardless of how much stock they hold. The bottom line is that controlling and non-controlling shareholders play two structurally different roles in takeovers, and they should be likewise treated differently.

For reasons of fairness, the majority of lawyers would probably refuse to reconsider equal treatment of shareholders in that view. Legal economists' concern for efficiency leads to a more balanced position. They recognize that private benefits of control are necessary to operate the market for corporate control, but they are also worried that the quest for private benefits may result in value-decreasing takeovers.[39] The two positions tend to converge in advocating the case for mandatory bid regulation, at least in a configuration sufficiently flexible to allow acquirers (and possibly incumbents too) to appropriate some part of the takeover gains.[40] Also in this respect, takeover regulation is understood as a tradeoff between shareholder protection and efficient allocation of corporate control. This contention is based on confusion between different categories of private benefits of control. By disentangling three categories of these benefits, I have shown that the above tradeoff is unwarranted.

Specifically, when corporate control is entrenched, value-decreasing takeovers mostly depend on incremental extraction of diversionary private benefits (looting), which must be disallowed by regulation in order for the market for corporate con-

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39 Bebchuk, L.A. [1994], *Efficient and Inefficient Sales of Corporate Control*, in QUARTERLY JOURNAL OF ECONOMICS, vol. 109, 957-993.

40 Burkart, M. and Panunzi, F. [2006b], *Takeovers*, ECGI Finance Working Paper No. 118/2006, available at www.ssrn.com and www.ecgi.org; Kraakman, R.H., Davies, P., Hansmann, H., Hertig, G., Hopt, K.J., Kanda, H. and Rock, E.B. [2004], THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH, Oxford University Press, 157-191.

trol to work efficiently. Then takeover regulation should only worry of efficient allocation of corporate control, by letting incumbents cash in their idiosyncratic private benefits and insurgents appropriate sufficient gains in shareholder value to minimize distortionary private benefits. The *last and one of the most important conclusions* of this dissertation is that *equal treatment of shareholders unnecessarily interferes with the takeover mechanism*. Shareholder protection in takeovers may undermine the operation of the market for corporate control not just because there is too much or too little of it, but rather because it is implemented in the wrong fashion. This makes the case for mandatory bid regulation extremely weak, if not completely unfounded.

Comparison of the US and the UK – the two countries of the sample featuring the most active market for corporate control – is illustrative of this point. Takeover regulation in the US does not feature a mandatory bid, since it does not require equal treatment of controllers and non-controlling shareholders. Protection of the latter is implemented by strict enforcement of fiduciary duties more than by regulation of control premia, severance payments, or the structure of tender offers. Corporate law eases an efficient dynamics of control allocation by allowing relatively unrestricted negotiations upon these variables, whatever the ownership structure. Conversely, the discipline of takeovers in Britain is based on a mandatory bid as a consequence of a strict principle of equal treatment of shareholders. Negotiations upon control premia and managerial severance payments are therefore not allowed to ease the takeover process. On top of this, becoming controlling shareholders is not only more expensive because of the mandatory bid, but also unattractive due to the biases of the Listing Rules and the Combined Code of Corporate Governance, and this is what ultimately allows the management to resist unwanted acquisitions in spite of formal prohibition of takeover defenses. As a result, takeovers in the UK allow no more hostility than in the US, but the empirical evidence shows that they are much less targeted to managerial underperformance.[41]

Maybe surprisingly, activity of the market for corporate control is only slightly lower in Britain than in the US, when the different size of the economy is accounted for.[42] There is an explanation for that: controlling shareholdings are the most sensitive to the adverse effects of the mandatory bid, but the British regulation makes them very infrequent among listed companies. The problem of regulation of corporate governance in the UK is that it restricts extraction of private benefits across the board, no matter of the efficient properties that they may have,

41 Franks, J., Mayer, C. and Renneboog, L. [2001], *Who Disciplines Management in Poorly Performing Companies?* , in JOURNAL OF FINANCIAL INTERMEDIATION, vol. 10, 209-245.

42 Armour, J. and Skeel, D.A. [2006], *Who Writes the Rules for Hostile Takeovers, and Why? The Peculiar Divergence of US and UK Takeover Regulation*, ECGI Law Working Paper No. 73/2006, available at www.ssrn.com and www.ecgi.org.

and therefore it may be unsuitable to highly innovative business that requires higher ownership concentration and idiosyncratic private benefits in order to be carried out efficiently. The British case thus provides a good illustration of the consequences of common misunderstandings in the interpretation of Corporate Law and Economics that this work has tried to uncover. The only reason why this does not result in considerable underperformance of corporate governance is the peculiar consistency of the British model, based on a combination of legal rules and structure of corporate ownership that could be hardly replicated elsewhere.

The drawbacks of the mandatory bid are much more severe in continental Europe, where ownership structures are much more concentrated than in Britain, and therefore the inability to negotiate a control premium separately from minority shareholders may just make corporate control stuck in suboptimal allocations. I have shown that the attempt by the European Takeover Directive to level the playing field based on the British model of regulation of control transactions has been very unfortunate. On the one hand, that attempt has remarkably failed in the purpose of replicating the conditions of corporate governance in the UK through the adoption of breakthrough and board neutrality rules, which became eventually optional. On the other hand, the ability of European jurisdictions to support an efficient market for corporate control will depend on how the very core of harmonization – the mandatory bid – can be circumvented.

Within our sample, Sweden seems to have succeeded in keeping the traditional features of its rather liberal market for corporate control, in spite of the regulatory constraints at the EU level. Dutch law seems likewise on its way to achieve similar results with the forthcoming introduction of a takeover regulation, which did not exist in the past. Although the discipline of control transactions could be improved in both countries by taking stock of the more sophisticated American example, takeover regulation is a major problem for corporate governance in none of them. Swedish law simply does not feature possibilities for evolution towards managerial control, whereas the Dutch structured regime is a useless impediment to a smooth takeover process. Italian law has similar problems concerning the distribution of corporate powers, but the case is also complicated by the traditional weakness of shareholder protection from expropriation. In spite of that, it may be still advisable to find a way out of the hurdles of the mandatory bid, if the minimal conditions for preventing incremental value diversion were met by an adequate discipline of non-pro-rata distributions. There is at least a chance that this may happen soon.

11. Economists and lawyers have much to learn from each other: subjects for future research.

In the tradition of doctoral defenses in the Netherlands, the eleventh proposition is usually a joke. This is definitely not, although it may sound as ironical to some extent. One major result of the present dissertation is that the overall understanding of corporate governance is significantly improved by bringing legal and economic knowledge together: either account scores much worse on its own than in combination with the other. I believe that this result can be extended to a large number of social phenomena having an economic background and a legal discipline. This is the reason why I am committed to economic analysis of law since more than a decade, and this is probably going to continue for the rest of my professional life. That being said, the analysis of corporate governance carried out in this work suggests that a number of topics may be worth of further investigation with a similar approach. These suggestions are spread throughout the book, but they are too many to be comprehensively summarized here. To conclude, I shall just focus on a few promising avenues for future research in Corporate Law and Economics, which are most related to the results of the present inquiry.

The thesis that the corporate structure supports not just investor protection, but also the exercise of control powers, has one prominent implication that would be interesting to explore: the *nature of the public company*. The principal-agent approach to separation of ownership and control has made the long-standing debate on the nature of the corporation progressively outdated. For now a long time, supporters of the institutional nature of the corporate structure have had a difficult case against the prevailing nexus of contracts paradigm.[43] The intrinsic limitations of the agency approach in the interpretation of corporate governance may reopen the door to institutionalism in corporate law. I have shown that legal personality of the corporation may be more than just a fiction, inasmuch as it enables managers or controlling shareholders to be in control of assets that they do not own. However, I have not pushed the reasoning so far as to deny the contractual nature of the corporate enterprise. I doubt whether there are sufficient grounds for it to be denied. Undoubtedly, the publicly held corporation realizes a highly peculiar allocation of entitlements that complements the property rights system. But these entitlements are not necessarily created with the corporation: separation of ownership and control only obtains by means of a number of choices in the corporate contract. This parallels the fundamental question of how institutions are created and evolve over time

[43] But see, for a reappraisal of this debate, Blair, M.M. and Stout, L.A. [2006], *Specific Investment: Explaining Anomalies in Corporate Law*, in JOURNAL OF CORPORATION LAW, vol. 31, 719-744.

in the economy and the society.[44] Solving this puzzle is a major challenge for both legal and economic institutionalism. Corporate governance may be the right domain for a fruitful dialogue.

A related question is the *evolution of corporate enterprises' ownership structure*. Here I have made one fundamental assumption and one conjecture, which are both based on the theory of entrepreneurship. The assumption is that rewards to entrepreneurship are also featured in corporate governance, in the form of private benefits of control, and that they endogenously determine the ownership structure in the absence of legal shortcomings or needless constraints. The conjecture is that these private benefits of control are asymptotically decreasing with the shrinking of uncertainty during the firm's lifecycle, and that this may result in progressive dispersion of ownership structures based on a sequence of efficient changes in control – at least, in the absence of legal impediments. While some theoretical and empirical studies support the assumption,[45] no dynamic analysis of corporate governance I am aware of has so far investigated that conjecture. This dissertation's results about the efficiency of the takeover process, and its normative implications on takeover regulation, are ultimately based on that intuition. Theoretical models that have analyzed the takeover dynamics under entrenchment of corporate control allow private benefits of control to be, at best, neutral to social welfare.[46] Although I have questioned their results on this and other grounds, a formal integration of private benefits motivating the investment of entrepreneurial talent awaits future research in the economic theory of corporate governance. This may also allow reconsidering the empirical question of whether one or more optimal ownership structures exist at any geographical or industrial level. I suspect that the answer may vary depending on the stage of economic development. But then, the role of corporate laws in fostering economic growth through separation of ownership and control should also be reconsidered, possibly by extending the framework of the present investigation to developing and transition economies. Needless to say, the theoretical, the empirical, and the legal accounts should not be just three separated lines of inquiry.

Ownership structure is also worth exploring from a different angle. Empirically, we do not have yet sufficient knowledge to *determine with precision how listed firms are owned and controlled in different countries*. This research has shown that most reliable information comes from the studies at the national level. However, on the one

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44 North, D.C. [1990], INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE, Cambridge University Press.

45 Demsetz, H. [1983], *The Structure of Ownership and the Theory of the Firm*, in JOURNAL OF LAW AND ECONOMICS, vol. 26, 375-390; Demsetz H. and Lehn, K. [1985], *The Structure of Corporate Ownership: Causes and Consequences*, in JOURNAL OF POLITICAL ECONOMY, vol. 93, 1155-1177.

46 Bebchuk, L.A. and Zingales, L. [2000], *op. cit.*

hand, they often do not match in the international comparisons; on the other hand, they have always missing information on their own. I have only managed to draw a parsimonious distinction between controllers and non-controlling shareholders on this basis, limited to a relatively narrow sample of countries, and with reference to data that are now older than ten years. I believe that updating, improving, and making comparable our knowledge about ownership and control of listed companies around the world is one of the more urgent topics for research in corporate governance. This would ultimately allow us to distinguish between corporate controllers and between non-controlling shareholders based on their identity. I did not find the available evidence sufficiently reliable to endeavor such a distinction. However, it may have very promising implications for the study of certain categories of non-controlling owners and of controlling shareholders from both a legal and an economic viewpoint. The recent debate about the role and regulation of hedge funds in corporate governance and the long-standing one about the involvement of banks in corporate control are two prominent examples in this regard.[47]

One final question for future research is the *mechanisms of production of corporate laws in both a national and an international perspective*. Having to confront with the very core of mainstream interpretation of corporate governance, this dissertation only takes a public interest approach. A considerable part of Corporate Law and Economics is also concerned with the role of vested interest, and analyzes how production of legal rules is influenced and constrained by private constituencies, public bodies, and inter-jurisdictional competition. Throughout the present inquiry, I have repeatedly suggested that path-dependency of corporate laws, determined by national traditions and the role of interest groups therein, may have more virtue than it is usually credited for, especially when the opposite issues of convergence and harmonization are interpreted on the basis of the wrong paradigm. While I hope to have demonstrated this misinterpretation in the present work, I have not even suggested what the implications of the alternative paradigm that I am advocating could be for regulatory competition. I have the impression that, regardless of the commentators' beliefs on effectiveness and efficiency of regulatory competition, the issue of production of corporate laws is too often dealt with cynically.[48] Although I

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47 See, e.g., most recently, Kahn, M. and Rock, E.B. [2006], *Hedge Funds in Corporate Governance and Corporate Control*, ECGI Law Working Paper No. 76/2006, available at www.ssrn.com and www.ecgi.org: Santos, J.A.C. and Wilson, K.E. [2006], *Does Banks' Corporate Control Benefit Firms? Evidence from US Banks' Control over Firms' Voting Rights*, AFA 2007 Chicago Meetings Paper, available at www.ssrn.com.

48 For two authoritative examples see, on the lawyers' side, Enriques L. [2005a], *Scelte pubbliche e interessi particolari nella riforma delle società di capitali* (*Public Choices and Special Interests in the Italian Corporate Law Reform*), in MERCATO, CONCORRENZA, REGOLE, vol. 1/05, 145-192; on the economists' side, Hellwig, M. [2000], *On the Economics and Politics of Corporate Finance and Corporate Control*, in X. Vives

took stock of this cynicism in the attempt to bring theory closer to the evidence, I do not subscribe to this view. Ideally, I believe that research in Law and Economics is not just about understanding the world better, but mostly about how having the world improved by lawmakers.

I therefore wish to conclude this book by quoting from the famous conclusion of John Maynard Keynes' *General Theory*. Although neither the scope nor the results of this research are slightly comparable to the achievements of Keynes' work, his final admonition applies to any inquiry into social sciences: past, present, and future.

> "[T]he ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back. I am sure that the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas. Not, indeed, immediately, but after a certain interval; for in the field of economic and political philosophy there are not many who are influenced by new theories after they are twenty-five or thirty years of age, so that the ideas which civil servants and politicians and even agitators apply to current events are not likely to be the newest. But, soon or late, it is ideas, not vested interests, which are dangerous for good or evil."[49]

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(ed.), CORPORATE GOVERNANCE: THEORETICAL AND EMPIRICAL PERSPECTIVES, Cambridge University Press, 95-134.

[49] Keynes, J.M. [1936], THE GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY, Macmillan.

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Samenvatting (*)

Dit proefschrift tracht het bestaande kader van de economische analyse van het ondernemingsrecht te herzien. Hiertoe wordt een herwaardering voorgesteld van de economische benadering van de juridische grondslagen van corporate governance. De huidige benadering is gebaseerd op de populaire '*law matters*'-these, op grond waarvan het ondernemingsrecht scheiding van eigendom en zeggenschap zou bevorderen door de belangen van de minderheidsaandeelhouders te beschermen. Dit boek biedt een bredere blik op de economische en juridische factoren die corporate governance beïnvloeden. Het laat zien dat de bescherming van de belangen van (minderheids-)aandeelhouders een noodzakelijke maar onvoldoende juridische voorwaarde is voor een efficiënte scheiding tussen eigendom en zeggenschap. Speciale aandacht voor de zeggenschapsbevoegdheden die aan het bestuur of aan meerderheidsaandeelhouders zijn toegekend, is minstens even belangrijk als de bescherming van (minderheids-)aandeelhouders tegen misbruik door hen. Ondernemingsrecht is niet alleen van belang voor dat laatste; het is van belang voor beide.

Deze conclusie is verkregen door corporate governance te bezien aan de hand van drie categorieën van persoonlijke voordelen van zeggenschap. De heersende rechtseconomische benadering van corporate governance houdt slechts met twee categorieën rekening: persoonlijke voordelen van bestuurders die zich onvoldoende inzetten (gebruikelijke kosten van toezicht en controle – *agency costs*) en persoonlijke voordelen die voortvloeien uit 'stelen' (directe benadeling van de belangen van aandeelhouders). Deze beperkte karakterisering vloeit voort uit de 'principaal-agent'-theorie, in het licht waarvan corporate governance over het algemeen wordt geanalyseerd door economen. Wanneer het kader van de 'principaal-agent'-theorie wordt verlaten, kunnen de persoonlijke voordelen van zeggenschap in een ander licht worden bezien, namelijk als prikkel om ondernemerstalent te benutten in een sfeer van onzekerheid. In dit perspectief betekent onttrekking van persoonlijke voordelen van zeggenschap niet alleen maar een lagere winst voor de aandeelhouders, maar ook de toe-eigening van een beloning voor het transparant maken van een waarde die nog gerealiseerd moet worden: de waarde van het ondernemerschap.

De economische implicaties van deze nieuwe classificatie van persoonlijke voordelen van zeggenschap zijn verregaand. Persoonlijke voordelen afkomstig van stelen zijn zonder meer '*bad*' voor corporate governance, omdat deze onttrekkingen leiden tot hogere kapitaalkosten. Persoonlijke voordelen afkomstig van onvoldoen-

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de inzet hebben hetzelfde gevolg, maar ze zijn de prijs die betaald moet worden voor een overigens efficiënte scheiding van eigendom en zeggenschap. Aangezien ze niet geëlimineerd maar slechts geminimaliseerd kunnen worden, zijn ze alleen maar '*ugly*'. Scheiding tussen eigendom en zeggenschap verklaart ook waarom een derde categorie persoonlijke voordelen, die de winst voor de aandeelhouders niet *ex ante* vermindert en mogelijk zelfs *ex post* kan vergroten, '*good*' is voor corporate governance. Een manager zet zijn of haar ondernemerstalent alleen in bij aanwezigheid van niet-controlerende aandeelhouders als hij of zij een niet-contracteerbare beloning voor die investering krijgt in de vorm van persoonlijke voordelen van zeggenschap. Voor zover deze beloning bovenop de bestaande aandeelhouderswaarde komt, wordt deze vlak voor een overname efficiënt te gelde gemaakt. In die situatie zorgen indirecte betalingen in de vorm van controlepremies of *golden parachutes* ervoor dat de zittende managers beloond worden voor hun eerdere persoonlijke investeringen en dat ze bereid zijn plaats te maken voor een doelmatiger management. Dit beloningsmechanisme vereist het vasthouden van de zeggenschap over de vennootschap en verklaart waarom vijandige overnames zeer ongebruikelijk zijn.

De juridische gevolgen van deze nieuwe classificatie zijn niet minder opvallend. Dit proefschrift toont aan dat het ondernemingsrecht van invloed is op de inrichting van corporate governance voor elke categorie persoonlijke voordelen van zeggenschap en niet alleen voor de categorie die betrekking heeft op de aantasting van de belangen van aandeelhouders. Drie belangrijke onderwerpen binnen het ondernemingsrecht worden onder de loep genomen. Het eerste is dat van de transacties tussen verbonden partijen. Het recht moet het onttrekken van 'slechte' persoonlijke voordelen van zeggenschap inperken door te voorkomen dat bestuurders en meerderheidsaandeelhouders profiteren van hun tegenstrijdige belangen. Wanneer het recht dit doel niet bereikt, is de scheiding tussen eigendom en zeggenschap minder groot dan efficiënt is. Het tweede onderwerp heeft betrekking op de verdeling van bevoegdheden binnen de vennootschap. Die verdeling is bepalend voor de wijze waarop ondernemers die een beursgang nastreven, zich 'goede' persoonlijke voordelen kunnen toe-eigenen. Wanneer de mogelijkheden om zeggenschap over de vennootschap uit te oefenen en veilig te stellen, te veel beperkt worden door de bescherming van (minderheids-)aandeelhouders, komt de scheiding tussen eigendom en zeggenschap eveneens in gevaar. Het derde onderwerp betreft de regulering van overnametransacties. Deze regulering beïnvloedt de wijze waarop 'vervelende' voordelen van zeggenschap kunnen worden geminimaliseerd door de disciplinerende werking van de overnamemarkt. Het ondernemingsrecht zou een soepel verlopend overnameproces moeten bevorderen en moeten voorkomen dat het misbruikt wordt voor 'graaien'. Wanneer het recht minderheidsaandeelhouders teveel bescherming biedt, zullen er minder waardevermeerderende veranderingen in zeggenschap plaatsvinden. Wanneer het recht minderheidsaandeelhouders te weinig beschermt, zullen er waarschijnlijk meer waardeverminderende overnames plaatsvinden. Beide situaties ondermijnen de doelmatigheid.

Dit boek toetst de voorspellingen voor elk van de drie onderwerpen door in vijf landen onderzoek te doen naar de economische en juridische aspecten van corporate governance. Deze vijf landen zijn de Verenigde Staten, het Verenigd Koninkrijk, Zweden, Nederland en Italië. Het onderzoek laat zien dat wanneer het ondernemingsrecht wordt begrepen in het licht van de gevolgen ervan voor de drie categorieën persoonlijke voordelen van zeggenschap, het de verschillende patronen en performance van corporate governance in deze landen verklaart. Deze uitleg van het ondernemingsrecht is niet alleen nuttig om inzicht te krijgen in de scheiding tussen eigendom en zeggenschap, maar ook om aan te geven hoe de efficiëntie door middel van juridische interventie verbeterd kan worden.

Het boek bestaat uit drie delen. Deel I gaat over de bestaande kennis van corporate governance en de bijbehorende regelgeving en stelt datgene centraal wat zowel theoretische als empirische analyses tot dusver nog niet hebben kunnen verklaren. Hoofdstuk 1 laat zien dat de gebruikelijke economische analyse van het ondernemingsrecht verzuimt rekening te houden met de machtige bestuurders, de meerderheidsaandeelhouders en de machteloze minderheidsaandeelhouders die we in de echte wereld zien. Hoofdstuk 2 staaft dit standpunt door middel van empirisch onderzoek van corporate governance-patronen in Europa en de Verenigde Staten. Hoofdstuk 3 legt het onvermogen bloot van de heersende 'principaal-agent'-theorie om een aantal feiten op het gebied van corporate governance te verklaren, waarvan de opvallendste zijn de onaantastbaarheid van de zeggenschap over een vennootschap door het gebrek aan mogelijkheden voor vijandige biedingen en het grote verschil in de eigendom- en zeggenschapsmodellen in verschillende landen. Hoofdstuk 4 bespreekt de heersende benadering van corporate governance waarin het belang van het recht voor de inrichting van corporate governance centraal staat ('*law matters*'-these) en de kritiek hierop bezien vanuit de financiële economie en de traditionele economische analyse van het ondernemingsrecht.

Deel II komt met een alternatief analysekader gebaseerd op de drie categorieën persoonlijke voordelen van zeggenschap en laat zien hoe het ondernemingsrecht de doelmatigheid van corporate governance beïnvloedt door de onttrekking van persoonlijke voordelen te reguleren. Hoofdstuk 5 bespreekt het economische probleem van de toegang van de ondernemer tot aandelenfinanciering. Het laat zien dat blijvende zeggenschap over de vennootschap het enige evenwicht is dat scheiding tussen eigendom en zeggenschap combineert met forse, niet-contracteerbare persoonlijke arbeidsinvesteringen van een ondernemer. Hoofdstuk 6 laat zien dat dit evenwicht onder bepaalde voorwaarden efficiënt is. De voorwaarden zijn dat persoonlijke voordelen afkomstig van stelen niet zijn toegestaan, dat ondernemerschap dat persoonlijke voordelen oplevert veilig gesteld kan worden, ongeacht de eigendomsstructuur, en dat persoonlijke voordelen afkomstig uit onvoldoende inzet geminimaliseerd worden door bij overnames indirecte betalingen toe te laten. Elk van deze voorwaarden vereist ondersteuning door het ondernemingsrecht en zo zijn de drie voorspellingen tot stand gekomen over de wijze waarop ondernemingsrecht de scheiding tussen eigendom en zeggenschap beïnvloedt.

In Deel III worden deze voorspellingen getoetst aan het ondernemingsrecht in elk van de genoemde vijf landen geplaatst. Hoofdstuk 7 gaat over de juridische bevoegdheidsverdeling in een vennootschap. Het laat zien dat wanneer het bestuur geen bevoegdheden krijgt, dit in de weg staat aan zeggenschap van bestuurders (zoals in Zweden), dat beperkingen van de wanverhouding tussen eigendom en stemrechten niet effectief zijn tegen stelen en contraproductief zijn bij de scheiding tussen eigendom en zeggenschap (zoals in Italië) en dat het beter zou zijn dat de spreiding van beslissingsbevoegdheden geen invloed heeft op de eigendomsstructuur (zoals in Nederland en nog meer in de Verenigde Staten) dan om de concentratie van eigendom te ontmoedigen (zoals in het Verenigd Koninkrijk). In hoofdstuk 8 en 9 komt het juridisch gebied van het zich onrechtmatig toe-eigenen van geld aan de orde, bezien vanuit een functioneel rechtsvergelijkend standpunt en een beleidsstandpunt. Ze laten zien dat de efficiëntie van het recht in dit opzicht afhangt van de balans tussen type I- en type II-fouten bij het opleggen van het verbod op stelen, dat ondernemingsrecht zowel niet ver genoeg kan gaan (zoals in Italië) als te ver kan gaan (zoals in het Verenigd Koninkrijk) en dat onafhankelijkheid van bestuurders een veelbelovend middel kan zijn om aantasting van de belangen van aandeelhouders op efficiënte wijze tegen te gaan, maar dat er over het algemeen voor hen geen optimale regelgeving bestaat. Hoofdstuk 10 en 11 hebben betrekking op de disciplinerende werking van de overnamemarkt en de regulering daarvan. Wanneer zeggenschap over de vennootschap blijvend is verkregen, kunnen overnames alleen tot stand komen door de persoonlijke voordelen van de zittende partij te compenseren. Om de motivatieprikkels van de overnemende partij in stand te houden, moeten de niet-meerderheidsaandeelhouders uitgesloten worden van de rest van de overnamewinst. Aangetoond wordt dat de juiste regelgeving met betrekking tot '*squeeze-out*' van de aandeelhouders die hun aandelen houden kan garanderen dat overnames uitsluitend plaatsvinden als ze efficiënt zijn, dat het verplichte bod efficiënte overnames alleen maar onwaarschijnlijker maakt wanneer de belangen van aandeelhouders op andere wijze beschermd worden, dat het Amerikaanse overnamemodel beter voldoet dan het Britse en dat de Overnamerichtlijn van de EU de onderhandelde overdrachten van zeggenschap overmatig bemoeilijkt, tenzij dit op lidstaatniveau wordt omzeild.

De conclusies worden gepresenteerd in de vorm van elf stellingen over hoe corporate governance werkt, op welke wijze corporate governance wordt beïnvloed door belangrijke gebieden van het ondernemingsrecht en hoe ondernemingsrecht de doelmatigheid kan verbeteren. Tot slot volgt een korte onderzoeksagenda voor juridische en economische analyse.

Curriculum Vitæ

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Alessio holds a *cum laude* degree in economics at the LUISS University of Rome (1994) and the European Master in Law and Economics (Universities of Hamburg and Manchester, 1995), which was awarded with distinction and the first prize for the best thesis. In 2003, he was visiting scholar at UC Berkeley, Boalt Hall School of Law. Since 1994 he has been researching and published in many fields of Economic Analysis of Law: Torts, Contracts, Banking and Securities Regulation, and Corporate Law.

Alessio teaches Public Law and Economics, Advanced Topics in Competition and Regulation, Corporate Governance, and General Introduction to Law and Economics. His current research interests are Corporate Law and Finance, Comparative Law and Economics, and the Economics of Regulation.

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