

Featuring Control Power

CORPORATE LAW AND ECONOMICS REVISITED

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SUMMARY



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Summary

Introduction

Corporate governance is a hot issue in the public opinion, in the agenda of policymakers, and in the scientific debate. The importance of economic and legal analysis for its understanding is hardly questionable. Integration of both is nowadays perceived as indispensable for interpreting different patterns of corporate governance around the world. 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. Economists have acknowledged that 'law matters' for both the form and the efficiency of corporate governance. Lawyers, who have never doubt it, are inclined more and more to assess the merits of legal policies based on their economic effects. Unfortunately, mainstream Corporate Law and Economics still does not explain a number of factual circumstances, let alone their efficiency or inefficiency. Based on the view that managers and shareholders stand in a principal-agent relationship, the prevailing approach identifies in investor protection the key legal underpinning of separation of ownership and control, and the ultimate goal of corporate law. However, separation of ownership and control varies considerably, in kind and degree, both within and between jurisdictions that provide outside shareholders with good protection of their investment. This applies, for instance, to Sweden and the Netherlands, but also to the US and the UK.

By combining the existing empirical evidence with economic theory and comparative corporate law, this book takes a broader perspective on the economic and legal determinants of separation of ownership and control. It shows that investor protection is a necessary condition for separation of ownership and control, but it is not also sufficient. Corporate governance requires further legal support, namely the empowerment of corporate controllers with limited ownership and their inducement to part with control when confronted with a bid by a more efficient management. Featuring control powers in corporate governance is at least as important as protecting investors from their abuse. Corporate law does not only matter in the last respect; it matters in both.

This result is derived by interpreting corporate governance based on three categories of private benefits of control. This parallels the current focus of economic and legal analyses on extraction of private benefits, by managers and controlling shareholders, at the expenses of non-controlling shareholders. However, this book

argues that the prevailing account of private benefits of control is underspecified. It only includes the private benefits that corporate controllers can extract in their capacity as shareholder agent. Consequently, private benefits of control are either *distortionary* or *diversionary* in nature, depending on whether they account for management's failure to maximize shareholder value or for outright shareholder expropriation. Merging the key insights of the theory of entrepreneurship into the incomplete contracts theories of the firm, I posit that a third category of private benefits exists, which are *idiosyncratic* to the corporate controller – i.e., they depend on his/her identity in combination with the firm under control. *Ex ante*, idiosyncratic private benefits of control are harmless to non-controlling shareholders, inasmuch as they account for further value to be uncovered by the application of entrepreneurship to the corporate enterprise. In sole proprietorships, entrepreneurs appropriate this value as a reward of investment of firm-specific human capital under uncertainty, when the firm they own turns out to be successful. Separation of ownership and control makes *ex post* appropriation of private benefits of control a more complicated issue for both wealth-constrained entrepreneurs and suppliers of equity finance. On the one hand, controllers fear that outside shareholders will expropriate them of idiosyncratic private benefits by interfering with management and eventually forcing a change in control via a hostile takeover. On the other hand, non-controlling shareholders fear that controllers will fail to maximize profits, or even divert a part of them to their pockets, when they are in control of corporate assets that they own only partially. Both categories of players are reluctant to separate ownership from control because of that.

The introduction of a richer taxonomy of private benefits provides a comprehensive explanation of how these problems affect the efficiency of corporate governance. Private benefits have different implications for firm value. Diversionary private benefits are only extracted with a deadweight loss, which implies in turn a higher cost of capital, and they are therefore unambiguously 'bad.' Distortionary private benefits are the traditional dimension of agency costs involved by separation of ownership and control, which alignment of managerial incentives can only partially cope with. They may be 'ugly' for they cannot be eliminated, but separation of ownership and control still brings mutual benefits to entrepreneurs and outside investors in spite of them. Idiosyncratic private benefits are the prospective reward to entrepreneurship in corporate governance. Entrepreneurs are reluctant to go public to the extent that they cannot secure these benefits in the wake of a takeover – i.e., when corporate control is not tenured. However, control tenure apparently prevents takeover by a more efficient management, thereby increasing the potential for extraction of diversionary and distortionary private benefits. This conclusion is unwarranted when the only constraint to efficient takeovers is compensation of

idiosyncratic private benefits of control. Therefore, these benefits are ‘good’ inasmuch as they promote the investment of entrepreneurial talent *ex ante* and they create no further impediment to efficient takeovers than their being compensated *ex post*.

This interpretation of corporate governance has far-reaching implications on how corporate law ‘matters.’ This book shows that this depends on how corporate law affects *each* category of private benefits of control, and not just those accounting for shareholder expropriation. Three major areas of regulation of corporate governance are considered with this view. The first is *legal discipline of conflicted interest transactions*, setting constraints on the extraction of ‘bad’ private benefits of control. The second is *legal distribution of corporate powers*, determining how ‘good’ private benefits can be appropriated by corporate controllers. The third is *regulation of corporate control transactions*, affecting the way in which ‘ugly’ benefits are minimized by the market for corporate control. In order to check consistency of this approach with the empirical evidence, I formulate three predictions on how different laws can make separation of ownership and control differ from country to country, and on whether the outcomes are efficient.

Prediction 1: Law and Investor Protection

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

This prediction confirms the mainstream ‘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*. Once shareholders are protected from expropriation of their investment, provision of legal entitlements to firm control via distribution of powers between management and non-controlling owners determines how much separation of ownership and control can be afforded in corporate governance. Given the management’s concern with non-contractible rewards to entrepreneurship, distribution of corporate powers may make the ownership structure either more or less concentrated than it would be efficient.

This prediction is partly novel. Distribution of legal powers in the corporation, whose importance was recently highlighted in the literature, has not yet been connected with the incentive effects of private benefits of control on wealth-constrained entrepreneur’s dealing with uncertainty.

Prediction 3: Law and the Market for Corporate Control

Besides supporting control powers and constraining their abuse, law matters in that it promotes a market for corporate control based on non-hostile takeovers. Insufficient protection of non-controlling shareholders makes control stuck in overly concentrated ownership structures. However, when takeover regulation features excessive shareholder protection, insurgents may be prevented from inducing less efficient incumbents to part with control via side payments. Eventually, this leads to excessive consumption of *distortionary private benefits* under too dispersed or too concentrated ownership structures.

This prediction is novel. Both the consequences of private benefits of control on the takeover mechanism and the effects of shareholder protection on the acquirer's incentives are dealt with by the existing literature, but they have always been considered separately.

The predictions are both positive and normative in character. The positive account is tested through the analysis of corporate governance and its regulation in a five-country case study. Despite of the popularity of quantitative methods for assessing the impact of corporate laws on separation of ownership and control, the test is performed qualitatively and not quantitatively. The reason is that the state of our knowledge does not allow broad legal comparisons to be performed quantitatively. Comparative law is meaningful only to the extent that it is functional to the problem being addressed. The regulatory factors which have a potential bearing on each of the three predictions are simply too many to be evaluated for more than a restricted sample of countries. Conversely, the number of jurisdictions included in quantitative analysis should be sufficiently large for statistical inference to be reliable.

Selection of the countries of the case study is based on a falsification criterion. According to the mainstream view, investor protection is the only dimension in which corporate law matters for separation of ownership and control. Therefore, I pick five countries that, for different reasons, cast some doubts on the validity of this explanation. These countries are Italy, the US, the UK, Sweden, and the Netherlands. Legal analysis based on the above predictions turns out to match the different corporate governance patterns of these five countries. Thus, the underlying theory of private benefits of control has higher explanatory power than the standard 'law matters' approach to Corporate Law and Economics. At least in the restricted domain of the five countries under consideration, these predictions are sufficiently robust to draw normative conclusion on how corporate law should be in order for corporate governance to be efficient.

Structure

This book is divided in three parts. The first deals with existing knowledge about corporate governance and its regulation, 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 third part is where the three predictions on how corporate law affects separation of ownership and control are confronted with the five-country case study. Discussion of the effects of regulation on the prevailing patterns of separation of ownership and control shows the explanatory power of this framework and its implications for legal policy.

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 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 these features fail to account for at least one player and one problem of real-world corporate governance: the player is the entrepreneur in his/her 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.

Chapter Two deals with comparative corporate governance. 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 between 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 shows 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 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.

Do existing theories of corporate governance match the evidence? *Chapter Three* provides a negative answer to this question. The traditional principal-agent framework cannot explain why different patterns of corporate governance exist in different countries, and what corporate law has to do with this. 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, 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 are quite convincing regardless of how control is allocated between managers and shareholders, the upgrade of the agency framework based on delegation of control rights still does not explain why we observe much less convergence in corporate governance, corporate laws, and contestability of corporate control than the theory would predict.

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. 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 from shareholder wealth, but also in that it allows protection of control rents that outside shareholders are unable to price at the outset, and yet they may wish to appropriate at a later stage. In this narrow configuration, corpo-

rate law does not explain international diversity in prevailing ownership structures as opposed to regularity of entrenchment of corporate control.

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

Chapter Five introduces the interpretation of corporate governance based on a more comprehensive taxonomy 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 can only be diversionary or distortionary in that framework. The conclusion is different when the agency paradigm is departed from and consideration for a third category of private benefits – the idiosyncratic ones – is added. I explore the hypothesis that how corporate governance is implemented at both the firm and the country level depends on interaction between all these three kinds of private benefits, and not between just two of them. Adding consideration of control rents as a prospective reward to idiosyncratic investments allows for a more even welfare assessment of private benefits of control. I argue on this basis that, while diversionary private benefits undermine efficiency of corporate governance in the absence of adequate institutional constraints, idiosyncratic private benefits can provide an efficiency-based explanation of entrenchment of corporate control. In this framework, distortionary private benefits are ultimately policed by a market for corporate control where takeovers are friendly, and not hostile. This explanation is consistent with the empirical evidence.

Entrenchment is then not 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 is an efficient way to conduct and finance business. Implementation requires 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. Consistently 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 not sufficient. Corporate controllers should also be induced to part with control when profits are not being maximized – i.e., when distortionary

private benefits are extracted in excessive amount. This problem can be handled through side payments compensating for the incumbent's idiosyncratic rents while allowing insurgents to reap the remainder of the gains from an efficient takeover. The market for corporate control is thus interpreted as an application of the Coase Theorem. Corporate law should accordingly cope with its frictions depending on transaction costs. This chapter is concluded with the three predictions on how corporate law affects corporate governance through the impact on each category of private benefits of control.

Part III – Corporate Law and Economics Revisited

Sequence of predictions 1 and 2 is inverted for logical reasons. *Chapter Seven* discusses the second one (law and protection of idiosyncratic private benefits) through the analysis of distributions of corporate powers in the five jurisdictions of the case study. 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. 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 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 moderately dispersed ownership where controlling shareholders are the only option. Standard arguments in favor of empowerment of non-controlling shareholder are reversed in this framework. So are the traditional beliefs that Dutch law empowers shareholders too little, that American law empowers directors too much, and that the liberal attitude of Swedish law towards disproportional voting power is problematic. Opposite results hold for the celebrated, but often little understood, shareholder friendliness of British company law. Issues of board structure and stakeholder involvement in the appointment of board members turn out to be of secondary importance.

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 related-party transactions in functional terms. 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 (innocent being convicted) and false negatives (guilty being acquitted) in policing diversion of shareholder value. Efficiency of the three functional features of this regulation – disclosure, standards, and enforcement – is assessed upon this criterion.

Chapter Nine applies the functional framework to the analysis of the five jurisdictions. This demonstrates 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, qualitative framework than by the popular quantitative methodology of international comparisons. I show that Sweden features a limited degree of separation of ownership and control in spite of excellent investor protection due to a highly peculiar combination of legal and extralegal factors. Dutch corporate law – which otherwise supports dispersed ownership – is 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 have much less in common than is told by received wisdom. Italian corporate law actually features weak protection of minority shareholders, but, in the face of recent regulatory improvements, this cannot be the sole responsible of ownership concentration. In addition, Italy is not the only country where the balance between false positives and false negatives in policing diversionary private benefits can be improved further. I suggest that reforms of independent directorships would fare better 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 results 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 minimized by the market for corporate control, regulation should encourage value-increasing takeovers too. This chapter demonstrates

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 is more efficient when it provides for an optimal discipline of squeeze-out coupled with a ban on takeovers having looting purposes. This makes 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 just 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 two 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 results in somewhat lower frequency and worse performance of friendly takeovers. The drawbacks of the mandatory bid are much more severe in continental Europe, where ownership is significantly more concentrated than in Britain. Emulation of the British model by the EC Takeover Directive has 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 will 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 is carried out on this basis.

Conclusions

Doctoral dissertations in the Netherlands end with a highly formal public defense. As a part of this ceremony, the candidate issues eleven propositions 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 sum-

marize its major results. The last one is a handy expedient to introduce a few avenues for future research.

1. Corporate governance is not just a relationship between principals and agents.

Principal-agent models of corporate governance assume that shareholders delegate control rights to managers, so that they can withdraw from that delegation anytime the management is underperforming. However, comparative corporate governance shows that control rights are not delegated by the owners, but rather retained as entitlements by the corporate controllers. This suggests that the agency paradigm may be the wrong approach to Corporate Law and Economics. The principal-agent framework still captures two prominent features of corporate governance. 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 the institutions of corporate governance do not support incentive-compatibility 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.

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. 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 has generated 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. When ownership is separated from control, rewards to entrepreneurial talent are only appropriable in the non-contractible form of private benefits of control. Corporate law supports this result

by providing entitlements to firm control separated from the ownership of enterprise.

3. Private benefits of control and its entrenchment are not just bad for corporate governance.

The idea that private benefits of control may play a beneficial role conflicts with both the lawyers' view of shareholder democracy and the economists' reliance on principal-agent models. Albeit for different 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. The empirical evidence contradicts both fairness and efficiency of this ideal picture. 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. The only way to reconcile this evidence with efficiency (and maybe with fairness, if we could 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 also they must perform such a role. Idiosyncratic private benefits of control 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.

4. The market for corporate control can be efficiently operated by friendly takeovers.

Hostile takeovers would be disruptive of idiosyncratic private benefits, whose protection is efficient. This is the reason why hostile takeovers are disallowed, as in theory as in practice. Friendly takeover are just the only option when corporate control is entrenched, and they may do quite as well. The market for corporate control can still make sure that shareholder value is maximized, under the constraint that previous entrepreneurship is rewarded, when changes in control are operated on condition that the incumbent's private benefits are compensated. This compensation is a side payment, which usually takes the form of golden parachutes or control premia depending on whether the management or a controlling shareholder is in charge. Efficiency of the market for corporate control rests ultimately on Coasian bargaining. If this was frictionless, corporate law should do nothing else than defining entitlements to corporate control. The presence of transaction costs ex-

plains why allocation and regulation of these entitlements matter. 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. In fact, diversionary private benefits also interfere with the takeover mechanism, and may compromise its constrained efficiency.

5. Director's autonomy from the shareholder meeting is a legal precondition of managerial control.

Entrepreneurs concerned with idiosyncratic private benefits may only go public with an ownership structure that supports 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 supplying control rights only partly related to ownership or even not at all. In this perspective, 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 available in corporate law in order to support efficient choice of ownership structure. Managerial control of publicly held companies is only possible in those jurisdictions that empower the board of directors relative to the general meeting of shareholders. This needs not distort the choice of ownership structure in favor of dispersed ownership, so long as a controlling shareholder can still be in control of the board. A regulatory bias against controlling shareholders only supports managerial control at the price of such a distortion. Conversely, empowerment of shareholders as a class makes managerial control unfeasible and biases corporate governance towards ownership concentration.

6. A one share—one vote rule is not desirable for efficient separation of ownership and control.

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. 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. Any further dilution of controlling ownership would result in exposure to hostile takeover. The bottom line is that distribution of powers in corporate law not only affects the legal feasibility of managerial control, but also determines how far separation of ownership and control can go under shareholder control until transition to managerial control is economically viable. 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.

7. An efficient discipline of related-party transactions is necessary, but not sufficient, for separation of ownership and control.

The ‘law matters’ approach to corporate governance contends that protection of non-controlling shareholders is both a necessary and a sufficient legal condition for separation of ownership and control. Contrariwise, this book argues that it is necessary, but not also sufficient. The importance of rewarding entrepreneurship under incompleteness of the corporate contract is the reason why it is not sufficient. Corporate law must also enable protection of managerial firm-specific 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-shareholders relationship are barely constrained by the corporate contract. 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. This spectacular flexibility depends on the very nature of the firm, but has an important drawback: the corporate contract cannot be a source of credible commitment for controllers. Therefore, the rules countering expropriation of non-controlling shareholders need to be mandatory in order to be out of the controller’s reach. However, mandatory constraints on the controller’s decision-making powers should not exceed the domain of conflicts of interest, which are most likely to result in diversion of shareholder value.

8. Shareholder protection by corporate law does not necessarily mean shareholder empowerment in corporate governance.

The exemplary domain of the corporate controller's conflicts of interest is related-party transactions. A problem with these transactions is that they may easily result in expropriation of outside shareholders, but may also have plenty of business purpose. 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 then involves a tension between discretion and accountability of corporate control. This is more precisely understood as a tradeoff between false positives and false negatives in the enforcement of shareholder protection against stealing. In whatever configuration, this tradeoff cannot be eliminated, but an efficient regulation of related-party transactions should provide for its optimization. This book shows 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 eighth 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.

9. Efficiency of takeover regulation requires an optimal discipline of minority squeeze-out.

A most serious problem with the operation of the market for corporate control is 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 is optimally operated by squeeze-out of minority shareholders, so long as regulation prevents them from being exploited by this mechanism. This result, which has been recently demonstrated for takeovers in dispersed ownership structures, equally holds in concentrated ownership structures with minor regulatory adjustments.

10. When control is entrenched and non-controlling shareholders are protected from expropriation, unequal treatment of shareholders is preferable to the mandatory bid.

The principle of equal treatment of shareholders is itself hardly questionable, but must be put in perspective. It certainly implies that shareholders participate in the division of corporate profits pro-rata, but not also that they should be granted equal opportunity to share in the control premium. 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. In their capacity as active entrepreneurs, not as passive shareholders, these players need to gain more than non-controlling shareholders do. Therefore, granting controlling and non-controlling shareholders exit on equal terms via the mandatory bid is economically unfounded. It has the advantage of preventing value-decreasing acquisitions from being imposed on non-controlling shareholders. To this purpose, however, it reduces the frequency of value-increasing takeovers by making compensation of the control premium overly expensive. Value-decreasing acquisitions are no longer a problem when takeovers are friendly and extraction of diversionary private benefits of control is efficiently constrained by the controller's fiduciary duties. In this situation, market bargaining for the control premium provides sufficient guarantee that takeovers are efficient. The last conclusion of this dissertation is that equal treatment of shareholders unnecessarily interferes with this mechanism.

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 bringing together economic and legal expertise may still sound as ironical to some extent. Hopefully this dissertation shows that this is not the case. That being said, this book raises a number of

issues that seem worth of future interdisciplinary research. One of them is the institutional or contractual nature of the public company. This parallels the fundamental question of how institutions are created, and evolve over time in the economy and the society. Solving this puzzle is a major challenge for both legal and economic institutionalism. A related question is the ownership structure of the corporate enterprise and the determinants of its evolution at different stages of economic development. Our knowledge of the matter is still very limited from both a theoretical and an empirical point of view. One final question is the mechanisms of production of corporate laws. This dissertation only takes a public interest approach, but production of legal rules is actually influenced by private constituencies, public bodies, and inter-jurisdictional competition. Applying this perspective to the alternative interpretation of corporate governance proposed in this book would be a very interesting line of inquiry for Corporate Law and Economics.

